ICAI VALUATION STANDARDS 2018

Seminar on Valuation Standards and Rules

at ICAI BKC

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INTRODUCTION TO REGISTERED VALUER

- Section 247 of the Companies Act, 2013 ('Act') provides:
  - Valuation of property, stocks, shares, debentures, securities, goodwill or other assets/liabilities/networth of a company under the Act
  - To be done by a Registered Valuer (RV)
  - Appointed by Audit Committee or in its absence the Board of Directors of that company

REGISTERED VALUER RULES

On 18 Oct 2017, MCA notified the Companies (Registered Valuers and Valuation) Rules, 2017

IBBI → **Registered Valuer Organization ('RVO')** → **Registered Valuer ('RV')**

IBBI: Authority to administer & perform the functions under these Rule

Registered Valuer Organization ('RVO'): Organisation to regulate and impart training to the Registered Valuers

Registered Valuer ('RV'):

- Individual, Firm, LLP or Company
- Member of a RVO
- Registered with IBBI

ICAI VALUATION STANDARDS ('ICAI VS')2018

- ICAI issued Valuation Standards to address the need for consistent, uniform and transparent valuation policies.
- Valuation Standards lay down a framework to ensure:
  - uniformity in approach; and
  - quality of valuation output
- Applicability for Chartered Accountants
  - On mandatory basis for valuation reports issued under the Companies Act, 2013 on or after 01 Jul 2018
  - On recommendatory basis for valuation under other statutes like Income tax, SEBI, FEMA

ICAI VS 2018

Framework for Preparation of valuation report in accordance with ICAI VS

ICAI VS 101	Definitions
ICAI VS 102	Valuation Bases
ICAI VS 103	Valuation Approaches and Methods
ICAI VS 201	Scope of Work, Analyses and Evaluation
ICAI VS 202	Reporting and Documentation
ICAI VS 301	Business Valuation
ICAI VS 302	Intangible Assets
ICAI VS 303	Financial Instruments

ICAI VS 102

VALUATION BASES

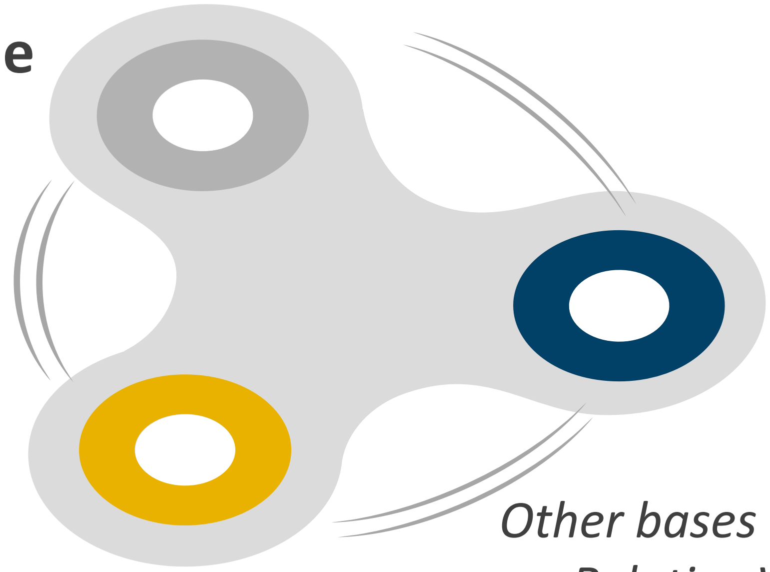
VALUATION BASES

- Indication of the type of value being used in an engagement
- Different valuation bases may lead to different conclusions of value.

Fair Value

Participant specific value

Liquidation Value



Other bases of value

- *Relative Value for mergers / demerger*
- *Agreement/ arrangement between the parties*
- *Prescribed by statute/ regulations (e.g. Income Tax Act, SEBI Regulations)*

1 FAIR VALUE

The Fair Value ('FV') is a price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the valuation date.

FV in case of a non-financial asset to be measured assuming highest and best use of such asset by market participants

Price	Price in the principal / most advantageous market
Valuation date	Specific date at which the valuer estimates the value
Orderly transaction	Not forced or distress sell
Market participants	Not entity specific

- willing buyers & sellers, not forced
- Independent
- Knowledgeable
- Able to enter into transaction

2 PARTICIPANT SPECIFIC VALUE

- Value estimated after considering specific advantages or disadvantages of
  - Owner; or
  - Identified Acquirer
- Consider factors which are specific to such parties and may not be applicable to market participants in general.
- For example:
  a) Synergies e.g. backward / forward integration for the acquirer
  b) Ability of an acquirer to utilise the tax losses of the seller in an accelerated manner
  c) Transfer of stake by a minority shareholder to a shareholder holding 49% stake - consider aspects such as control premium

3 LIQUIDATION VALUE

- Three Elements
  - value realised on sale of an asset
  - business termination
  - cost of disposal to be reduced
- Orderly transaction with a typical marketing period or forced transaction with a shortened marketing period

OTHER VALUATION BASES - RELATIVE VALUE

- In case of mergers and demergers, a relative valuation needs to be carried out
- Relative values are determined by
  - using similar valuation approaches / methods; and
  - applying similar weightages to values arrived under each approach / method
- Use of different approach / methods may be appropriate in certain cases
- Share exchange ratio for Merger – valuation of shares of Transferor Co and of Transferee Co
- Share entitlement ratio for Demerger – valuation of Demerged Undertaking and of Resulting Co

RELATIVE VALUE

SHARE EXCHANGE RATIO

Merger of Co A into Co B

Valuation Approach	Co A Value per share (INR)	Co A Weights	Co B Value per share (INR)	Co B Weights
Asset Approach	25.00	0%	120.00	0%
Income Approach	116.00	50%	285.00	50%
Market Approach	120.00	50%	305.00	50%
Relative value per share	**118.00**	**100%**	**295.00**	**100%**
Exchange ratio (rounded off)	**2.50**			

2 (two) equity shares of Co B of face value of INR 10 each fully paid up for every 5 (five) equity shares of Co A of face value of INR 100 each fully paid up

SHARE ENTITLEMENT RATIO

Demerger of 'Undertaking X' of Co A into Co B

Valuation Approach	Undertaking X of Co A Value per share (INR)	Undertaking X of Co A Weights	Co B Value per share (INR)	Co B Weights
Asset Approach	10.00	0%	120.00	0%
Income Approach	58.00	50%	285.00	50%
Market Approach	60.00	50%	305.00	50%
Relative value per share	**59.00**	**100%**	**295.00**	**100%**
Entitlement ratio (rounded off)	**5.00**			

1 (one) equity share of Co B of face value of INR 10 each fully paid up for every 5 (five) equity shares of Co A of face value of INR 100 each fully paid up

PREMISE OF VALUE

- Refers to the conditions and circumstances of how an asset is deployed
- Some common premises of value are :
  a) Highest and best use
  b) As-is-where-is basis
  c) Orderly liquidation
  d) Forced transaction
  e) Going concern value
- Single or multiple premises of value can be adopted depending upon the facts

PREMISE OF VALUE

- **Highest and best use ('HABU')** is the use of a non-financial asset by market participants that maximises the value of the asset and it is physically possible, legally permissible and financially feasible
- **As-is-where-is premise** will consider the existing use of the asset which may or may not be its highest and best use
- An **orderly liquidation** refers to the realisable value of an asset in the event of a liquidation after allowing appropriate marketing efforts and a reasonable period of time to market the asset on an as-is, where-is basis.
- **Forced transaction** is a transaction where a seller is under constraints to sell an asset without appropriate marketing period or effort to market such asset
- **Going concern value** is the value of a business enterprise that is expected to continue to operate in the future

Examples

Purpose	Bases	Premise
Acquisition of shares / business	- Fair Value - Participant Specific Value	- HABU (could be as-is-where-is premise and/or going concern value / orderly liquidation value, depending on specific circumstances of the asset) - Premise considering seller (‘as-is’)/ acquirer specific factors (Synergy/ integration costs)
Financial Reporting for PPA in case of business acquisition	Fair Value	HABU (could be as-is-where-is premise and/or going concern value / orderly liquidation value)
Bankruptcy	Liquidation Value	- Orderly liquidation - Forced liquidation
Merger / Demergers	Relative Value	Going concern
Determination of open offer price (‘Floor Price’)	SEBI Takeover Regulations	
Transfer of shares	Section 56(2)(x) and Section 50CA of IT Act	

ICAI VS 103

VALUATION APPROACHES AND METHODS

VALUATION APPROACHES

- Market Approach
- Income Approach
- Cost Approach

MARKET APPROACH

Uses prices and other relevant information generated by market transactions involving subject asset or identical / comparable assets ('market comparables')

Applicable in following instances:

- subject asset or market comparable(s) is traded in the active market
- there is a recent, orderly transaction in the subject asset
- there are recent orderly transactions in market comparables and information for the same is available and reliable

Use other valuation approaches instead of / in combination with Market approach:

- where the asset has fewer market comparables
- there are material differences between the subject asset and the market comparables, which require significant adjustments
- sufficient information on the comparable transaction(s) is not available

MARKET APPROACH

- **Market Price Method:**
  - Applicable in case of valuation of shares of listed company
  - Valuation derived from the quoted market prices of shares of the subject company
- **Comparable Companies Multiple (CCM) Method:**
  - Also known as 'Guideline Public Company Method'
  - Valuation determined by using multiples derived from prices of market comparables traded on active market (for eg. EV/Revenue Multiple, EV/EBIDTA Mutiple, % of AUM in case of AMCs)
  - Market comparables to be chosen carefully
  - Market multiples to be adjusted for material differences, if any

MARKET APPROACH

- **Comparable Transaction Multiple (CTM) Method:**
  - Also known as ‘Guideline Transaction Method’
  - Valuation determined using transaction multiples derived from prices paid in transactions of subject asset; or in publicly disclosed transactions of market comparables (‘comparable transactions’)
  - Comparables transactions to be chosen carefully
  - Transaction multiples to be adjusted for material differences, if any

INCOME APPROACH

Converts maintainable / future amounts (e.g., cash flows / income & expenses) to a single current amount (i.e. discounted or capitalised)

Applicable in following instances:

- subject asset does not have any market comparable or comparable transaction
- subject asset has fewer relevant market comparables; or
- Subject asset is an income producing asset for which the future cash flows are available and can reasonably be projected

Use other valuation approaches instead of / in combination with Income approach:

- subject asset has not yet started generating income or cash flows e.g. projects under development
- there is significant uncertainty on the amount and timing of income/future cash flows e.g. start-up companies
- client does not have access to information relating to the asset being valued

INCOME APPROACH

Business

- Discounted Cash Flow (DCF) Method

Intangible Assets

- Relief from Royalty (RFR) Method
- Multi-Period Excess Earnings Method (MEEM)
- With and Without Method (WWM)
- Greenfield Method
- Distributor Method

Financial Instruments

- DCF Method
- Option pricing models such as Black-Scholes-Merton formula or binomial (lattice) model

COST APPROACH

Reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)

Applicable in following instances

- an asset can be quickly recreated with substantially the same utility as the subject asset
- in case where liquidation value is to be determined
- income approach and/or market approach cannot be used

Use other valuation approaches instead of / in combination with Income approach:

- subject asset was recently created
- subject asset has not yet started generating income / cash flows
- an asset can be created but there are regulatory / legal restrictions and involves significant time for recreation

COST APPROACH

- **Replacement Cost Method:**
  - Also known as 'Depreciated Replacement Cost Method'
  - Cost that would be incurred by a market participant to recreate an asset with substantially the same utility (comparable utility) as that of the subject asset
  - Adjustment for obsolescence – physical, functional (technological) and economic (external)
- **Reproduction Cost Method:**
  - Cost that would be incurred by a market participant to recreate a replica of the subject asset
  - Adjustment for obsolescence
- Generally used in case of valuation of :
  - property, plant and equipment
  - certain intangible assets

SELECTION OF VALUATION APPROACHES

- Key factors for selection of valuation approach and method are:
  a) valuation bases and premises
  b) nature of asset to be valued
  c) availability of adequate inputs or information and its reliability
  d) strengths and weakness of each valuation approach and method
  e) valuation approach/method considered by market participants
- No single approach/method may be best suited for valuation in every situation
- Valuer may adopt one distinct valuation approach/method or multiple valuation approaches/methods as may be appropriate
- If multiple valuation approaches/methods are used, results to be evaluated considering the range of values indicated by those results

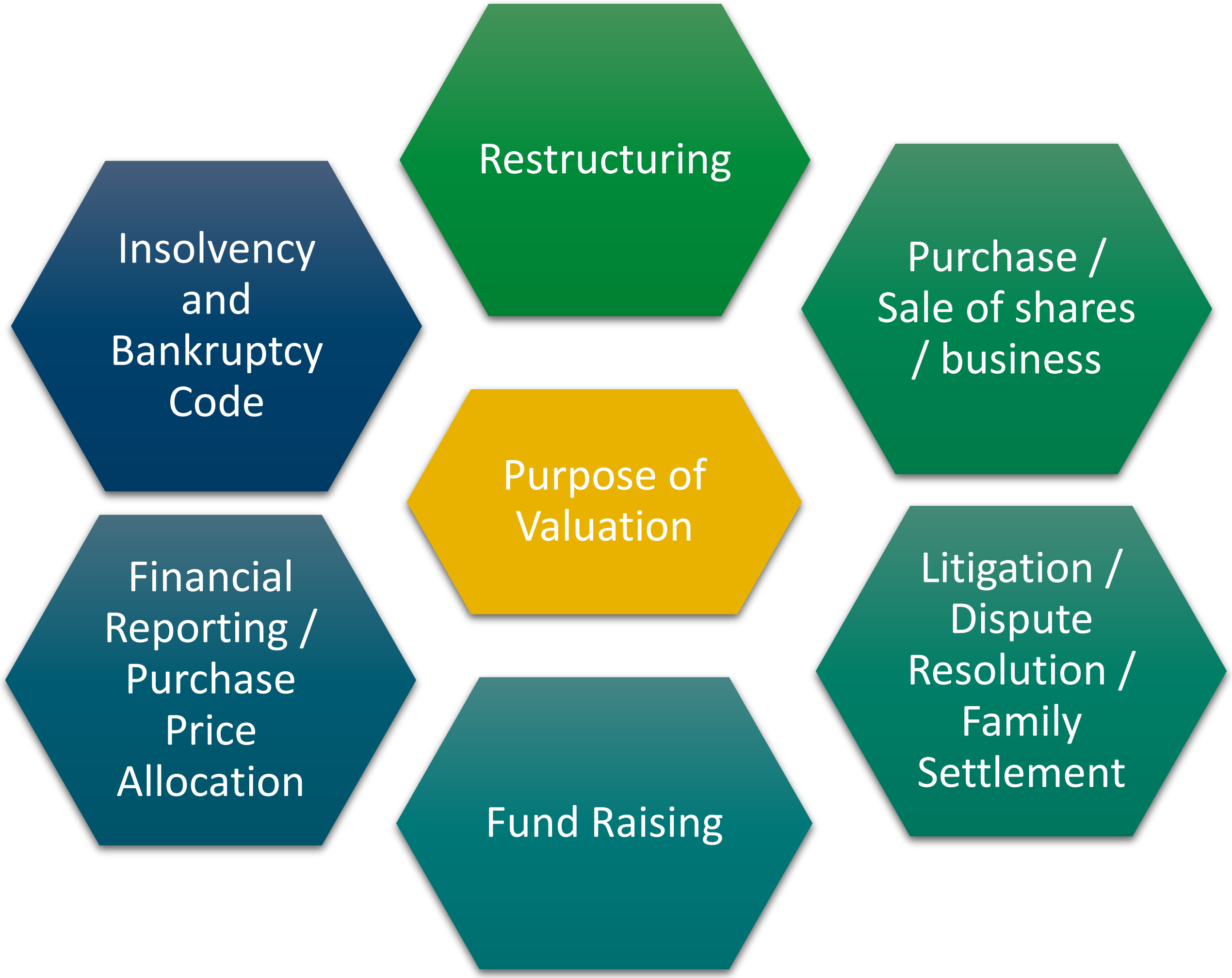
EXAMPLES

Nature of asset	Approach
Knowledge based companies	Income / Market
Manufacturing companies	Income / Market / Cost
Brand driven companies	Income / Market
Investment holding companies	Cost (considering fair value of the underlying investments)
Company going for liquidation	Cost (Liquidation value)

ICAI VS 301

BUSINESS VALUATION

NEED FOR VALUATION



BENCHMARKS

Enterprise Value	•Equity Shareholders + Debt + Minority Interest + Preference Shareholders - Amount of non-operating cash and cash equivalents
Business Value	•All shareholders i.e. Equity Shareholders + Preference Shareholders
Equity Value	•Equity Shareholders value

VALUATION PROCESS

1 → 2 → 3 → 4

1. Information
- Obtaining information
- Business Understanding

2. Analysis
- Data Analysis and review
- Discussion with the Management

3. Valuation Methodologies
- Selection of method
- Conducting sensitivity analysis

4. Recommendation
- Assigning Weights
- Recommendation
- Reporting

COMMON ADJUSTMENTS

- Investments
- Non-operating surplus assets
- Surplus cash
- Contingent liabilities / assets
- Tax concessions

ICAI VS 302

INTANGIBLE ASSETS

NEED FOR VALUATION

- Purchase price allocation
- Impairment testing
- Transfer pricing
- Taxation
- Transaction
- Financing
- Litigation
- Bankruptcy / restructuring
- Insurance
- Issuance of sweat equity shares

WHAT IS INTANGIBLE ASSET

- Identifiable – separable or arises from contractual or legal rights
- Non-monetary asset without physical substance
- Grants economic rights and / or benefits to its owner
- Represents legal rights developed or acquired by an owner
- Transferable
- Not Goodwill

Goodwill is the residual amount after ascribing values to identified intangible assets, other assets and liabilities

CATEGORIES OF INTANGIBLE ASSET

Customer-based	Marketing-based	Contract-based	Technology-based	Artistic-based
• Customer Contracts • Customer Relationships • Customer Lists • Order Backlog	• Trademark – brand, logo, service mark • Internet domain names	• Lease Agreements • Non-compete Agreements • Licensing Agreements • Royalty Agreements • Employment Contracts	• Patents / Know-how • Trade Secrets • Copyrights • Processes • Software • Designs • Formulae	• Books • Films • Plays • Music

VALUATION APPROACHES

Market Approach	Income Approach	Cost Approach
• Price / Valuation Multiples / Capitalisation Rates • Guideline Pricing Method	• Relief from Royalty (RFR) Method • Multi-Period Excess Earnings Method (MEEM) • With and Without Method (WWM) • Greenfield Method • Distributor Method	• Replacement Cost Method • Reproduction Cost Method

INCOME APPROACH

- **RFR Method**
  - Value determined based on the present value of royalty payments saved by owning the subject asset instead of taking it on lease over its remaining useful life
- **MEEM**
  - Generally used for valuing intangible asset that is leading or the most significant intangible asset out of group of intangible assets being valued
  - Value determined based on present value of *incremental* after-tax cash flows ('excess earnings') attributable to the subject asset over its remaining useful life
  - Incremental after-tax cash flows are arrived at by reducing contributory asset charges ('CAC') from the after-tax cash flows of the combined group of assets.

INCOME APPROACH

- **WWM**
  - Value determined based on present value of the difference between projected cash flows over the remaining useful life of the asset under the following two scenarios:
    - business with all assets in place including the subject intangible asset to be valued; and
    - business with all assets in place except the subject intangible asset to be valued
- **Greenfield Method**
  - Value determined as if subject asset is the only asset with all other tangible or intangible assets being created, leased or acquired
- **Distributor Method**
  - This is a variation of MEEM and is adopted for valuation of customer-based intangible assets

ECONOMIC USEFUL LIFE

- Intangible assets could have a finite or indefinite life
  - Life established by legal (eg. law, contract), functional, economic or technological factors
- Legal and economic factors to be considered together as well as individually

DISCOUNT RATES

- Return expected by a market participant from a particular investment
  - Reflects time value of money
  - Reflects risk inherent in subject asset as well as risk inherent in achieving the future cash flows
- Factors to be considered
  - Intangible assets are relatively riskier than tangible assets / business
  - Intangible assets with longer life are considered to have higher risk
  - Intangible assets with ascertainable cash flows have relatively lower risk
- Generally, asset specific risk premium is applied over and above the discount rate of the business

TAX AMORTISATION BENEFIT

- Certain intangible assets qualify for tax amortisation, thereby reducing the tax liability
- Under Income Approach, the present value of tax savings on account of tax amortisation, known as Tax Amortisation Benefit (‘TAB’), can be added to the value of such intangible asset, if appropriate
- Tax deductibility of amortisation of intangible asset is dependent upon the tax legislations of individual countries
- Discount rate to determine present value of TAB
  - WACC; or
  - discount rate used for valuation of the subject intangible asset

SELECTION OF METHODS

Type of Asset	Valuation Method
Trademarks, Service Marks, Brands	RFR Method / MEEM
Non-compete Agreement	WWM
Customer relationship and contracts	MEEM
Assembled workforce	Replacement Cost Method
Technology	RFR Method / MEEM

thank you!