SURESH & CO.,

Chartered Accountants

Spotted & Reported- Business Valuation

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Indian Valuation Standards notified by the Institute of Chartered accountants of India

Background

- Valuation discipline is gaining importance now and is considered as one of the most critical areas in finance areas such as buy/ sell, solvency, merger and acquisition, etc. It also plays an important role in the insolvency resolution regime where liquidation value has to be ascertained by resolution professional through the registered valuers. Looking at the importance, the ICAI has constituted Valuation Standards Board in the year 2017-18, the Valuation Standards Board has been constituted to focus on the release of Indian Valuation Standards, providing interpretations, guidance and technical materials from time to time and implementation of the Standards.

- The Valuation Standards have been issued to set up concepts, principles and procedures which are generally accepted, having regard to legal framework and practices prevalent in India.

- With a vision to promote best practices in this niche area of practice, the Standards lay down a framework for the Chartered Accountants to ensure uniformity in approach and quality of valuation output.

- On 10 June 2018, the Institute of Chartered Accountants of India (ICAI) issued the preface to the Indian Valuation Standards (Ind VS), the Framework for the preparation of valuation report in accordance with the Ind VS and also the following eight Ind VS applicable for all valuation engagements under the 2013 Act:
  1. Preface to the Indian Valuation Standards
  2. Framework for the Preparation of Valuation Report in accordance with the standards
  3. Indian Valuation Standard 101 – Definitions
  4. Indian Valuation Standard 102 - Valuation Bases
  5. Indian Valuation Standard 103 - Valuation Approaches and Methods
  6. Indian Valuation Standard 201 - Scope of Work, Analyses and Evaluation
  7. Indian Valuation Standard 202 - Reporting and Documentation
  8. Indian Valuation Standard 301 - Business Valuation
  9. Indian Valuation Standard 302 - Intangible Assets
  10. Indian Valuation Standard 303 - Financial Instruments

This Article is regarding the Indian Valuation Standard – 301

BUSINESS VALUATION

Applicability

Indian Valuation Standard 301 Business Valuation, issued by ICAI on 10th June 2018 shall be applied for the valuation reports issued on or after 1st July, 2018.

- These Indian Valuation Standards will be applicable for all valuation engagements on mandatory basis under the Companies Act 2013 as per section 247 read with rule 18 of the Companies (Registered Valuers and Valuation) Rules, 2017. In respect of Valuation engagements under other statutes like Income Tax, SEBI, FEMA etc, it will be on recommendatory basis for the members of the Institute.

- In formulating the Valuation Standards, ICAI considered best valuation practices followed globally as well as in India, uniqueness of Indian conditions, current practices in India along with their advantages and disadvantages and various purposes for which valuations might be required over and above the requirements of Companies Act, 2013.

- Provisions under the Companies Act, 2013 which requires Valuation Report from a Registered Valuer

Section	Particulars
62(1)(c)	Valuation report for further issue of shares
192(2)	Valuation of assets involved in arrangement of non-cash transactions involving directors
230(2)(c)(v)	Valuation of shares, property and assets of the company under a scheme of corporate debt restructuring
230(3)	Valuation report along with Notice of creditors/shareholders meeting – under scheme of compromise/Arrangement.
232(2)(d)	The report of the expert with regard to valuation, if any, would be circulated for meeting of creditors/Members
232(3)(h)	The Valuation report to be made by the tribunal for exit opportunity to the shareholders of transferor company – under the scheme of compromise/arrangement in case the transferor company is listed company and the transferee-company is an unlisted company.
236(2)	Valuation of equity shares held by the minority shareholders.
260(2)(c)	Preparing valuation report in respect of shares and assets to arrive at the reserve price for company administrator
281(1)	Valuing assets for submission of report by liquidator

Objective

Valuations of businesses is performed for a wide variety of purposes including the following:

- Valuation of financial transactions such as acquisitions, mergers, leveraged buyouts, initial public offerings, employee stock ownership plans and other share-based plans, partner and shareholder buy-ins or buy-outs, stock redemptions, etc.
  (Village financial services pvt ltd was recently acquired by Capital first ltd at a valuation of ₹113 crore. Nirlep appliances was acquired by Bajaj electricals at a valuation of ₹47 crore)

- Valuation for dispute resolution and/or litigation/pending litigation relating to matters such as marital dissolution, bankruptcy, contractual disputes, owner disputes, dissenting shareholder and minority ownership oppression cases, employment disputes, etc;

- Valuation for compliance-oriented engagements, for example:
  - financial reporting.
    (Valuations play a crucial role in determining the fair value of the shares, assets, liabilities, in order to determine the goodwill or gain on bargain purchase at the time of business combinations, acquisitions, etc.)
  - tax matters such as corporate reorganizations, purchase price allocations etc
    (Purchase price allocation includes a process of identifying the intangible assets, assessing and selecting the appropriate valuation approach, developing the valuation model, assessing the reasonableness of the results and managing the purchase price allocation process.)
- Valuation under Insolvency and Bankruptcy Code.
- Valuation for other purposes like the valuation for planning, internal use by the owners etc.;

Scope

- All applicable requirements of this standard should be followed during valuation of a business.
- This standard shall not apply where any requirement of this Standard is inconsistent with:

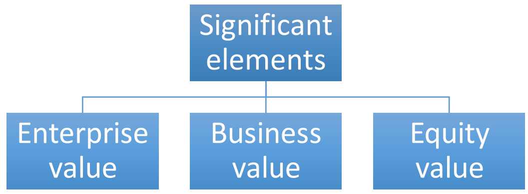
(a) the requirements prescribed under; or

(b)valuation procedures specified by any law, regulations, rules or directions of any government or regulatory authority, or Court order.

In such cases, the valuer shall follow the requirements prescribed by any law, regulations, rules or directions of any government or regulatory authority, or Court order.

Significant elements

- When valuing a business or business ownership interest, a valuer may express either an exact number or a range of values. There could be different benchmarks at which the estimate of value of an entity could be expressed by the Valuer as given below



❖ Enterprise Value: Enterprise Value is the value attributable to the equity shareholders plus the value of debt and debt like items, minority interest, preference share less the amount non-operating cash and cash equivalents.
This value is determined in case of merger, dissolution, etc.

Enterprise Value = Market value of common stock + Market value of preferred equity + Market value of debt + minority interest - cash and investments.

Note: In the above formula investments must be deducted only when it is categorised under non-operating asset

- <u>Business Value:</u> Business value is the value of the business attributable to all its Shareholders.
  There are numerous ways a company can be valued. Some of these methods include:
  - Market Capitalization
  - Times Revenue method
  - Earnings Multiplier
  - Discounted Cash Flow Method
  - Book Value
  - Liquidation Value

  Business Value = (Enterprise Value-
  Market value of Debt)

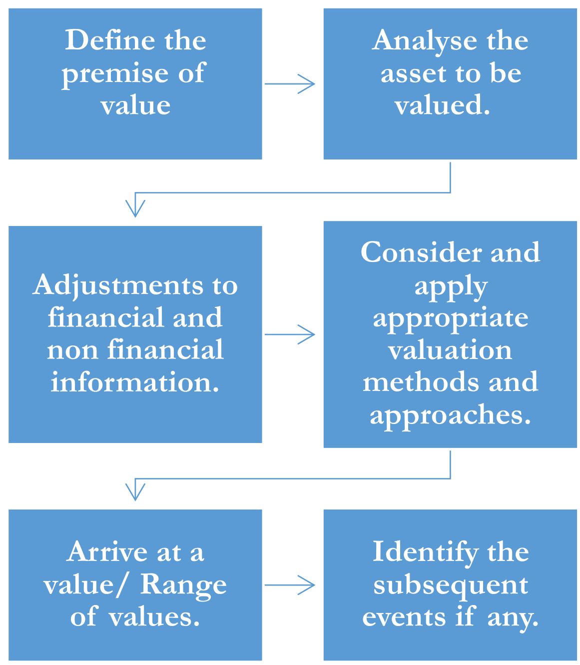
- <u>Equity Value:</u> Equity Value is the value of the business attributable to equity shareholders. Equity value uses the same calculation as enterprise value, but adds in the value of stock options, convertible securities, and other potential assets or liabilities for the company.
  This method is commonly used to find out the value of equity shares during the sale/purchase of such shares

Comparison of IVS with Ind AS 103 and Ind AS 113

- The principles in Ind AS 113 provide general guidance in measuring fair values in the context of acquisition accounting.
- Ind AS 103 provides guidance on the valuation and accounting of business combinations and requires fair value measurement of the following;
  - Consideration transferred, including deferred consideration and contingent consideration.
  - The gain or loss on the effective settlement of non-contractual pre existing relationship

    (The acquirer and acquiree may have a relationship that existed before they contemplate the business combination, referred to here as a 'pre-existing relationship'. A pre-existing relationship between the acquirer and acquiree may be contractual (for example, vendor and customer or licensor and licensee) or non-contractual (for example, plaintiff and defendant).
  - Assets acquired and liabilities assumed,
  - 'Ordinary' non-controlling interest that the acquirer chooses to measure at fair value; and
  - The non-controlling equity interest in the acquiree before obtaining control in a business combination achieved in stages.
- IVS on business valuation covers many more situations than just business combinations and therefore, has a wider scope.

Valuation Methodology



Explanation for the methods are provided below

Notes on Valuation Methodology

Premise of value	➢ Premise of the value refers to the conditions and circumstances how an asset is deployed. ➢ Determining the business value depends upon the situation in which the business is valued, i.e., the events likely to happen to the business as contemplated at the valuation date. *(The situation of the business plays a major role in deriving the value of the business.* *The value would change as on the valuation date as under-* ▪ *Business is valued differently at different stages such as growth stage, matured stage and decline stage.* ▪ *If the business is expected to grow, the business value would be comparatively higher.* ▪ *If the business is expected to decline, the business value would be comparatively lower.* ▪ *If the business is expected to be shut down, the business value would be equal to the resale value of the net operating assets.* *Hence the business value depends on scenario as on the valuation date.)*
Analysis of asset to be valued	➢ The analysis of the asset to be valued shall assist the valuer in considering, evaluating, and applying the various valuation approaches and methods to the valuation engagement. ➢ In analyzing the asset to be valued, the valuer shall gather, analyze and adjust the relevant information necessary to perform a valuation, appropriate to the nature or type of the engagement. Such information shall include: (a) non-financial information; (b) ownership details; (c) financial information; and (d) general information. ➢ In addition to above valuations involve an ongoing process of gathering, updating, and analyzing information. ➢ The conditions, rights and obligations of ownership right are usually mentioned in the legal document such as articles of association, bye-laws, shareholders agreement, partnership agreements, etc. of the asset to be valued. These documents may consider certain restrictions or give certain benefits for ownership rights for certain groups of stakeholders. A valuer shall consider and incorporate the same in the valuation of the ownership interest of the business.
Adjustment to information from financial statements.	➢ Adjustments to financial information are modifications to the reported financial information which is relevant and significant to the valuation process. Adjustments may be appropriate for the following reasons; (a)To present financial data of the underlying and comparable companies on a consistent basis. (b)To adjust revenues and expenses to levels that are reasonably representative of continuing operations. (c) To adjust for non-operating/non-recurring assets and liabilities, and any revenues and expenses related to the non-operating items. *(A company may receive income or incur an expense as the result of an event that is abnormal, unrelated to the company's ordinary day-to-day operations, or unlikely to reoccur in the foreseeable future. These items are often referred to as one-time, extraordinary, or unusual gains/losses, and are often a result of events such as lawsuits, discontinued business operations, natural disasters, restructuring charges, one-time repairs/renovations, insurance payouts, abnormal expenses, gains/losses on the sale of assets.* *Keeping these items on an income statement distorts a company's true earning capacity and reduces value. Appraisers review financial statements and interview management of the subject company to identify these types of items before adjusting for them. Non-recurring expenses are added back to the company's earnings while non-recurring gains/revenues are removed.)* ➢ Adjustments to the financial information are made for the sole purpose of assisting the valuer in reaching a value.

Valuation approaches and methods.	Generally, the following three main valuation approaches are adopted to perform the business valuation; ➢ Market approach- Market approach is a valuation approach that uses prices and other relevant information generated by market transactions involving identical or comparable (i.e., similar) assets, liabilities or a group of assets and liabilities, such as a business. The following are the common methodologies for the market approach: (a) Market Price Method; (b) Comparable Companies Multiple Method; and (c) Comparable Transaction Multiple Method. ➢ Income approach-Income approach is the valuation approach that converts maintainable or future amounts (e.g., cash flows or income and expenses) to a single current (i.e. discounted or capitalized) amount. The fair value measurement is determined on the basis of the value indicated by current market expectations about those future amounts. *The most commonly used income approach is Discounted Cash Flow method* ➢ Cost approach- Cost approach is a valuation approach that reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost).
Identification of subsequent events.	➢ If the subsequent event relates to the facts and circumstances that existed on the date of valuation then certain adjustments need to be recognized, and if the event does not relate to the facts and circumstance as on the valuation date, those events need not be recognized.

Treatment of non operating assets and inter company investments

- Apart from operating assets, entities hold non-operating assets. Such assets should be valued based on their realizable values net of costs and outgoes and added to the value arrived under the various approaches to derive the value for ownership interest.
- Inter-company adjustments or substantial cross holdings between companies in the business valuations should be considered at fair value.

Consideration of capital structure of business

- A business is usually financed by a combination of investments such as equity interests, debt (including redeemable preference shares) and quasi equity instruments. Certain engagements may require the valuer to allocate the enterprise value of the business into;
  (a) Value allocable to equity
  (b) Value allocable to debt.
- In deriving the above allocation, the valuer should give due consideration to the capital structure of the business including the terms of instruments used to finance the business. The value allocable to equity interests is usually the residuary value after reducing the debt from enterprise value.

Our comments

- The preface to IVS mentions that these valuation standards are mandatory, and it is the responsibility of the valuer to comply with these standards. It is not clear whether these standards are mandatory for only those valuers that are registered with ICAI's Registered Valuers Organization.

- The scope of IVS is much wider as compared to Ind AS 103. The methods of market approach for measurement of fair value mentioned in Ind AS 113 appear to be similar to those referred in Ind VS 301. Additionally, the term asset has been defined to include business or business ownership interest in the IVS framework. This term has not been defined in Ind AS 103.

Conclusion

- The recent developments in the valuation spectrum by the Government and Regulatory Bodies show that it is envisioned to regulate the valuation process as a professional practice. The IVS, the Valuation Rules, both are intended for setting up benchmarks for ensuring uniformity in the valuation practices adopted by various professionals in India.

- The Valuation Standards also focusses on the reporting where a Valuer should document the methods & procedures adopted for valuation, relevant evidences obtained, its observations based on those evidences and management representations.

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