



VALUATION RULES AND STANDARDS

J. B. NAGAR CPE STUDY CIRCLE

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23 DECEMBER 2018



EVOLUTION OF VALUATION REGULATIONS

Since 1992

SEBI Act was introduced wherein Cos. were free to price their issues in consultation with the Merchant Bankers.

1990-1992

Pricing for valuation introduced as per Comptroller of Capital Issue guidelines.

1957-1989

Wealth Tax Rules, 1957 prescribed valuation of unquoted shares.

2010

FEMA - DCF for valuations in case of issue / transfer of shares of Indian company which was subsequently changed to internationally accepted valuation methodology.

2017

The MCA notified Companies (Registered Valuers and Valuation) Rules, 2017 ('Rules') w.e.f. 18 Oct 2017.





REGISTERED VALUER RULES

UNDER THE COMPANIES ACT, 2013



INTRODUCTION TO REGISTERED VALUER RULES

- 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
- For conducting the valuation exercise as envisaged under section 247, the Ministry of Corporate Affairs has notified Companies (Registered Valuers and Valuation) Rules, 2017 ('Rules') w.e.f. 18 Oct 2017
- Transitional Provision: A valuer may continue to render valuation services under the Act without a certificate of registration up to 31 Jan 2019

REGISTERED VALUER RULES

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



Authority to administer & perform the functions under these Rules

Organisation to regulate and impart training to the Registered Valuers

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

LIST OF RVOs

Name of RVO	Asset Class
ICAI Registered Valuers Organisation	Securities or Financial Assets
Association of Certified Valuers and Analysts	
Institution of Estate Managers and Appraisers	Land and Building, Plant and Machinery, Securities or Financial Assets
IOV Registered Valuers Foundation	
ICSI Registered Valuers Organisation	
The Indian Institution of Valuers	
ICMAI Registered Valuers Organisation	
PVAI Valuation Professional Organisation	Land and Building, Plant and Machinery
CVSRTA Registered Valuers Association	
CEV Integral Appraisers Foundation	

(as of 11 Dec 2018)

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TO BE A REGISTERED VALUER

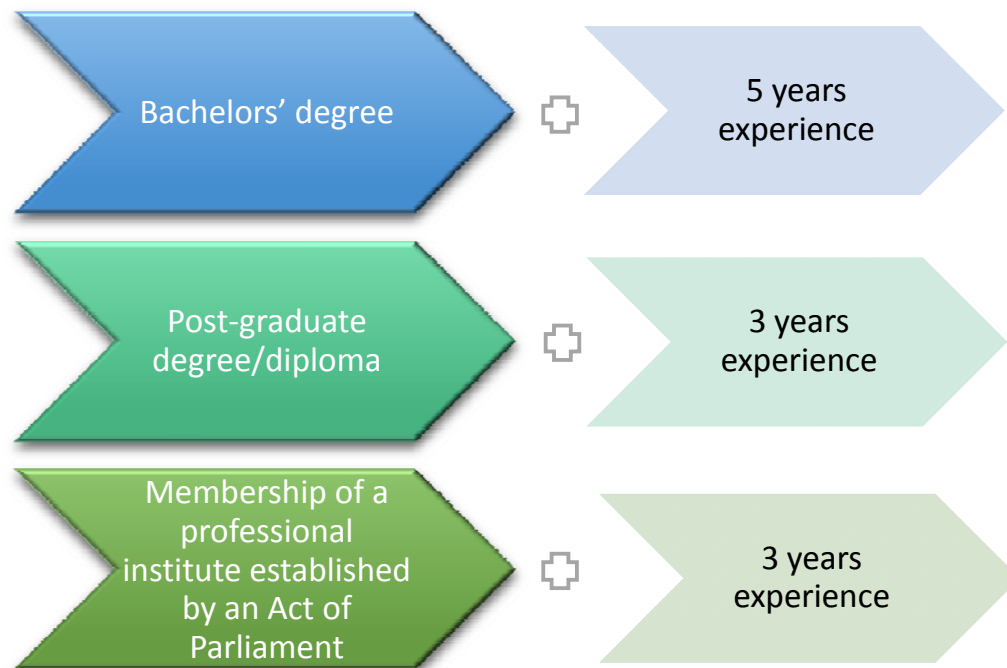
1 Obtain Educational Qualifications and Experience

2 Pass Valuation Examination

3 Satisfy other specified Eligibility Criteria

EDUCATIONAL QUALIFICATIONS AND EXPERIENCE

To be a RV, an individual must have the following educational qualifications and experience:

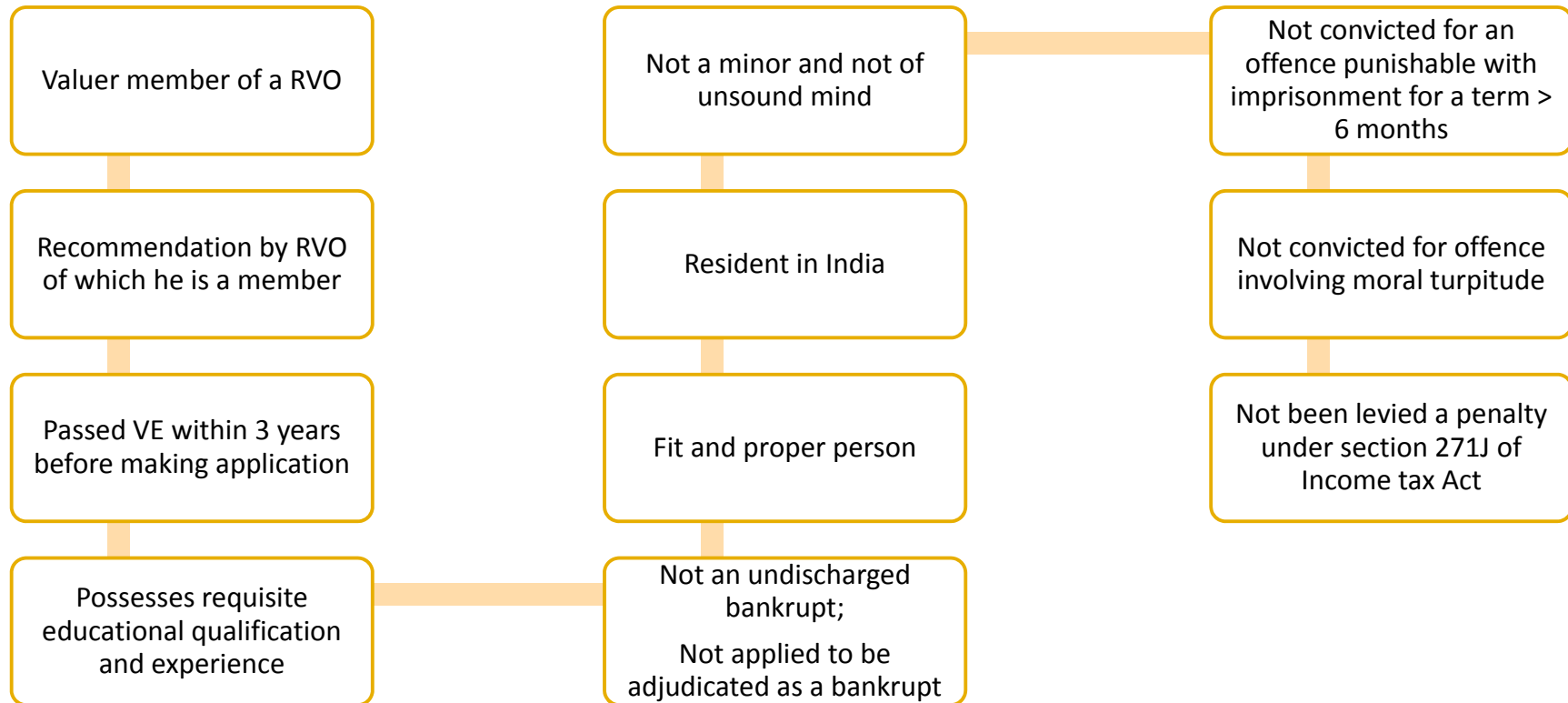


In addition, one should also have completed educational course conducted by RVO

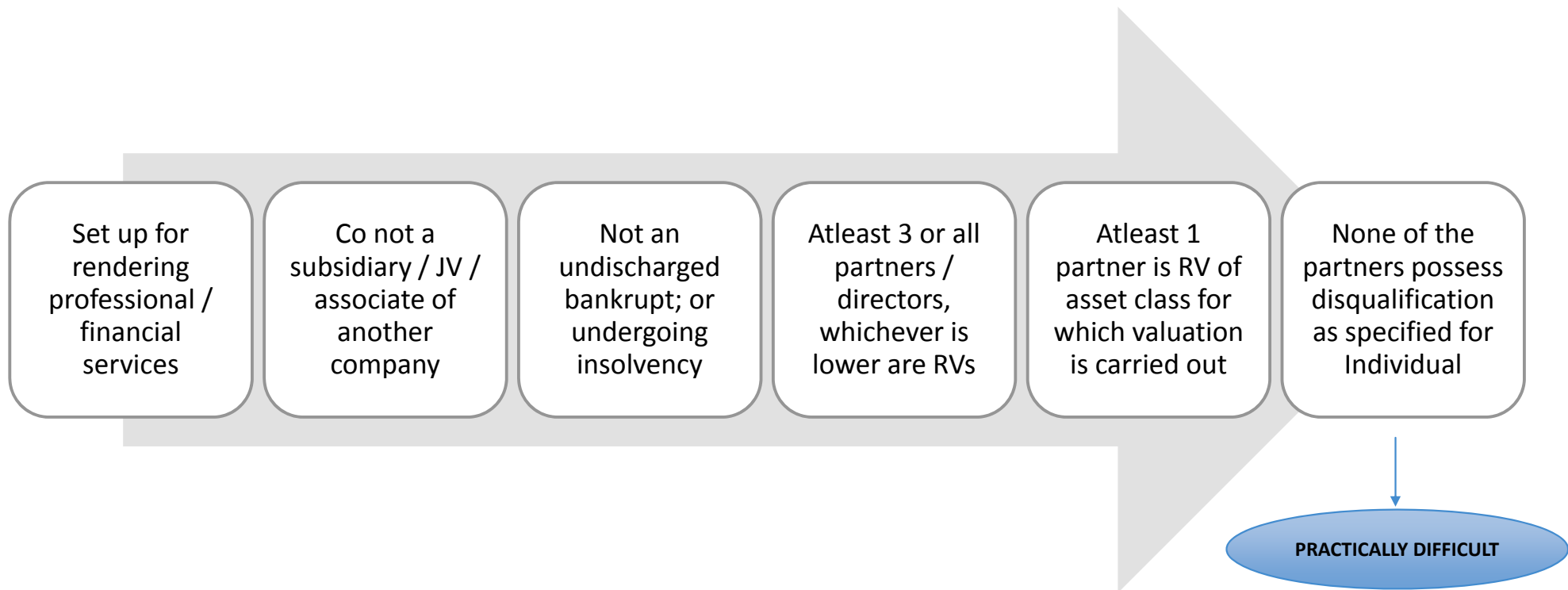
VALUATION EXAMINATION ('VE')

- An individual possessing the requisite educational qualifications and experience shall be eligible to appear for VE
- IBBI or its designated agency shall conduct VE for various asset classes
- Syllabus, format and frequency of VE, including qualifying marks, shall be published on IBBI's website at least 3 months before the examination
- On passing VE, individual shall receive acknowledgment of passing the examination
- No restriction on number of times that an individual can appear for VE

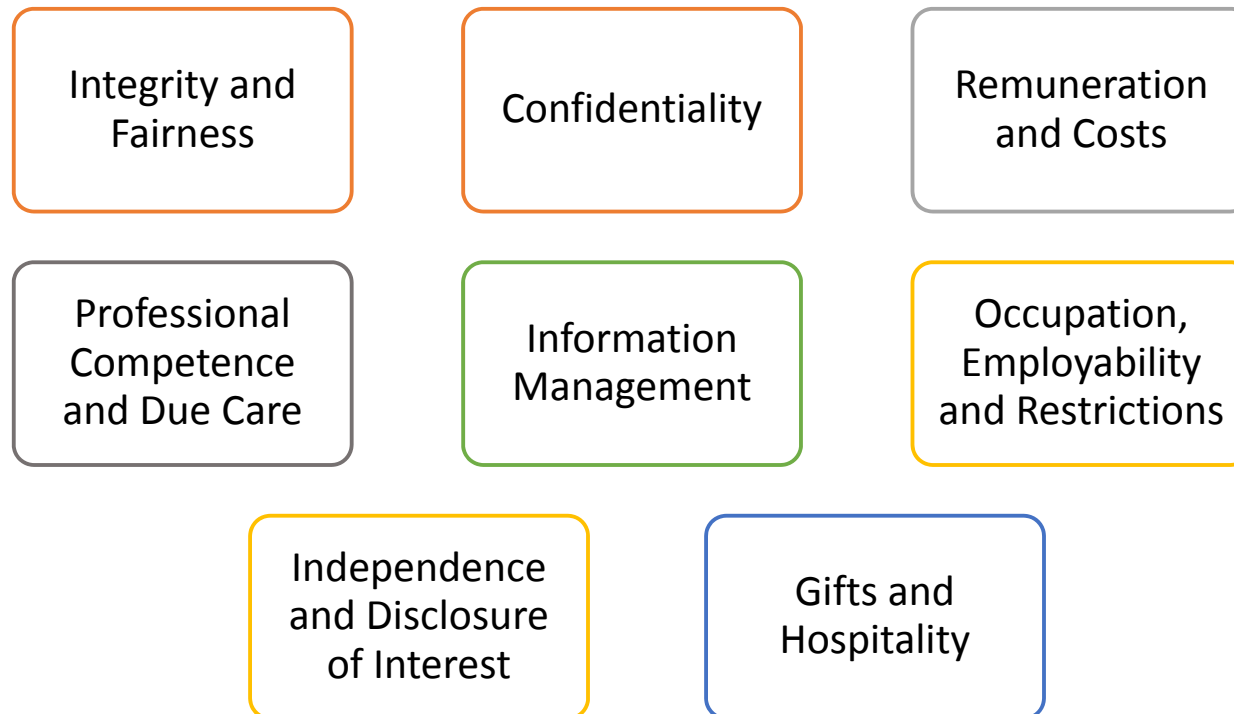
OTHER ELIGIBILITY CRITERIA - INDIVIDUALS



OTHER ELIGIBILITY CRITERIA – FIRMS/COMPANIES/LLP



MODEL CODE OF CONDUCT



CONDUCT OF VALUATION

- RV shall, while conducting valuation, comply with valuation standards notified or modified by Central Government
- Until valuation standards are notified by CG, a valuer shall make valuations as per:
 - Internationally accepted valuation standards;
 - Valuation standards adopted by any RVO



ICAI VALUATION STANDARDS 2018

ISSUED BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA



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 RVO has adopted the valuation standards issued by ICAI

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

• Valuation Report and Documentation

ICAI VS 301

• Business Valuation

ICAI VS 302

• Intangible Assets

ICAI VS 303

• Financial Instruments

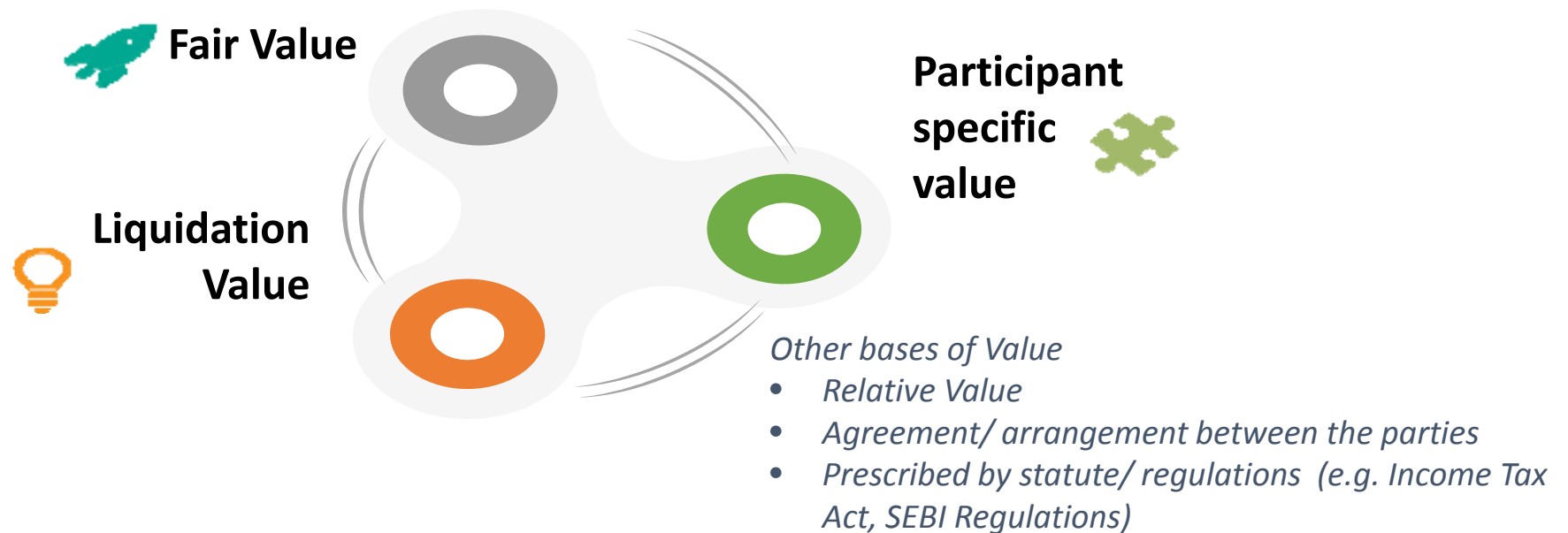


ICAI VS 102 – VALUATION BASES



VALUATION BASES

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

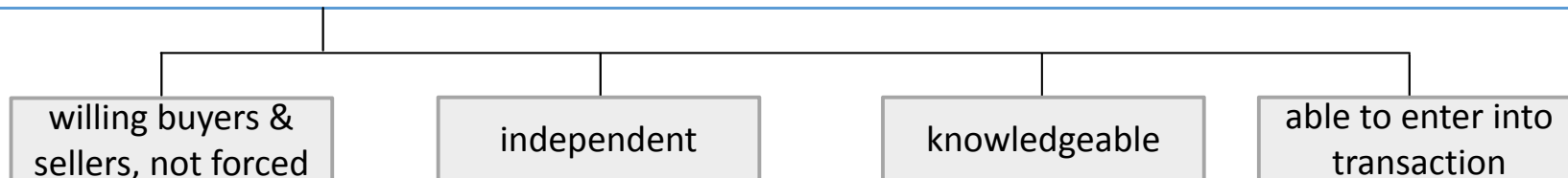


VALUATION BASES - FAIR VALUE

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



VALUATION BASES – 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 minority discount and control premium

VALUATION BASES – LIQUIDATION VALUE

- Three Elements
 - value realizable 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

PREMISE OF VALUE

- Refers to the conditions and circumstances of how an asset is deployed
- Some common premises of value are as follows:
 - a) Highest and best use
 - b) As is where is value
 - 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
- **As-is-where-is basis** 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	<ul style="list-style-type: none"> - Fair Value - Participant Specific Value 	<ul style="list-style-type: none"> - HABU (could be as-is-where-is basis) - As-is-where-is basis after considering seller / acquirer specific factors
Financial Reporting for PPA in case of business acquisition	Fair Value	HABU (could be as-is-where-is basis)
Family Settlement	Participant Specific Value	As-is-where-is basis after considering factors agreed in the arrangement
Bankruptcy	Liquidation Value	<ul style="list-style-type: none"> - Orderly liquidation - Forced liquidation
Merger / Demergers	Relative Value	As-is-where-is basis
Determination of open offer price	SEBI Takeover Regulations	Market Price as per formula laid down in the Regulations
Transfer of shares	Section 56(2)(x) and Section 50CA of IT Act	Formula as laid down in Rule 11UA of IT Rules



ICAI VS 103 – VALUATION APPROACHES AND METHODS



VALUATION APPROACHES



MARKET APPROACH

Uses prices and other relevant information generated by market transactions involving identical or 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/EBITDA Multiple, % 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 the information relating to the asset being valued

INCOME APPROACH

Business Valuation

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

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
Company going for liquidation	Cost



ICAI VS 201 – SCOPE OF WORK, ANALYSES AND EVALUATION



SCOPE OF WORK / TERMS OF ENGAGEMENT

- Agree on terms of engagement before commencement of the engagement
- Engagement Letter to include:
 - Details of the client and other users, if any
 - Details of the valuer
 - Purpose of the valuation
 - Identification of the subject matter of valuation
 - Valuation date
 - Basis and premise of valuation
 - Responsibilities of the client and the *valuer*
 - Confidentiality obligations of the client and the *valuer*
 - Scope/Limitations
 - Fees
 - Details of third party expert, if any, and their scope of work, scope limitations, and responsibilities

ANALYSIS AND EVALUATION

- Valuer shall obtain and evaluate the following information:
 - Non-financial information
 - Nature, background, history of the business
 - Economic environment
 - Industry, future outlook, etc.
 - Ownership details
 - Type of ownership
 - Shareholders / Joint Venture agreement
 - Licensing / Franchisee agreements, Contracts in case of intangible assets, etc.
 - Financial information
 - Historical financial statements, projections, etc.



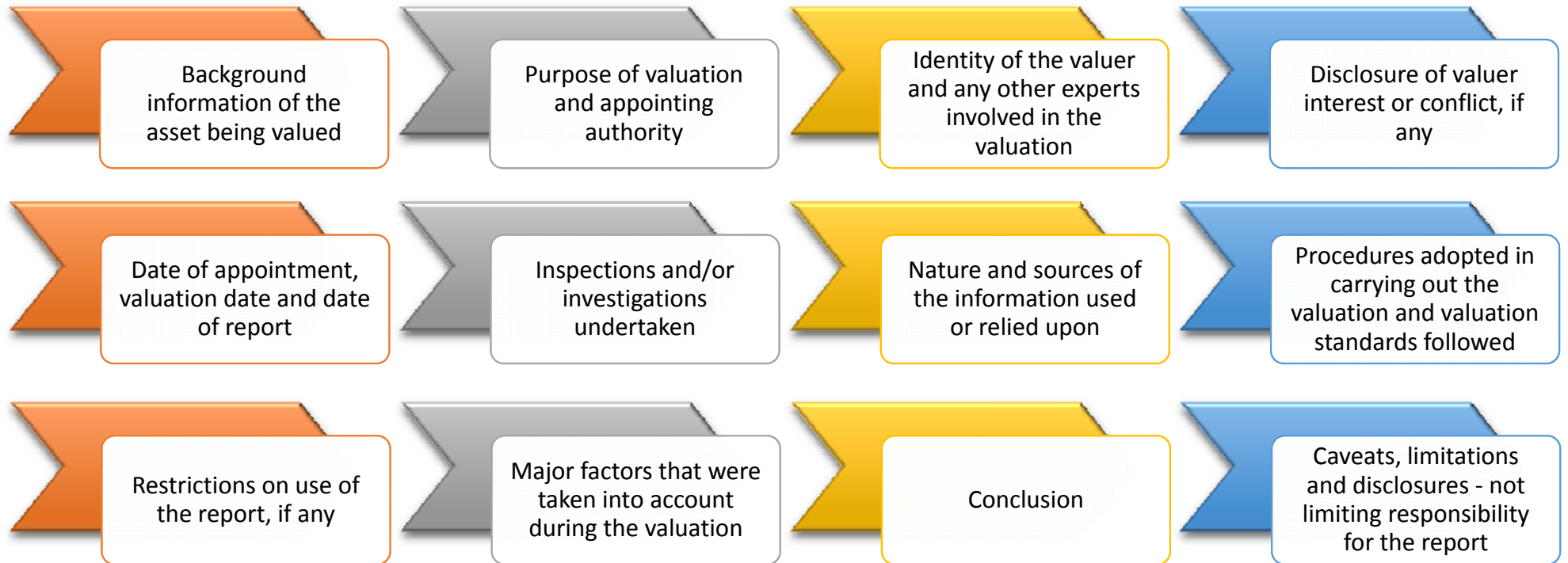
ICAI VS 202 – VALUATION REPORT AND DOCUMENTATION



VALUATION REPORT AND DOCUMENTATION

- Form and Content of Valuation Report depends on:
 - Nature of Engagement; and
 - Purpose of Valuation
- Reliance of the work of other experts:
 - Where a *valuer* uses the work of an expert during the process of valuation, he shall disclose the identity of such expert and the reliance placed on the valuation report of such expert.
 - A *valuer* may decide to include the valuation report issued by such expert as an annexure to his valuation report.
- Valuer to obtain written representations from the management/client regarding information obtained for performing the valuation assignment.

CONTENTS OF REPORT



DOCUMENTATION

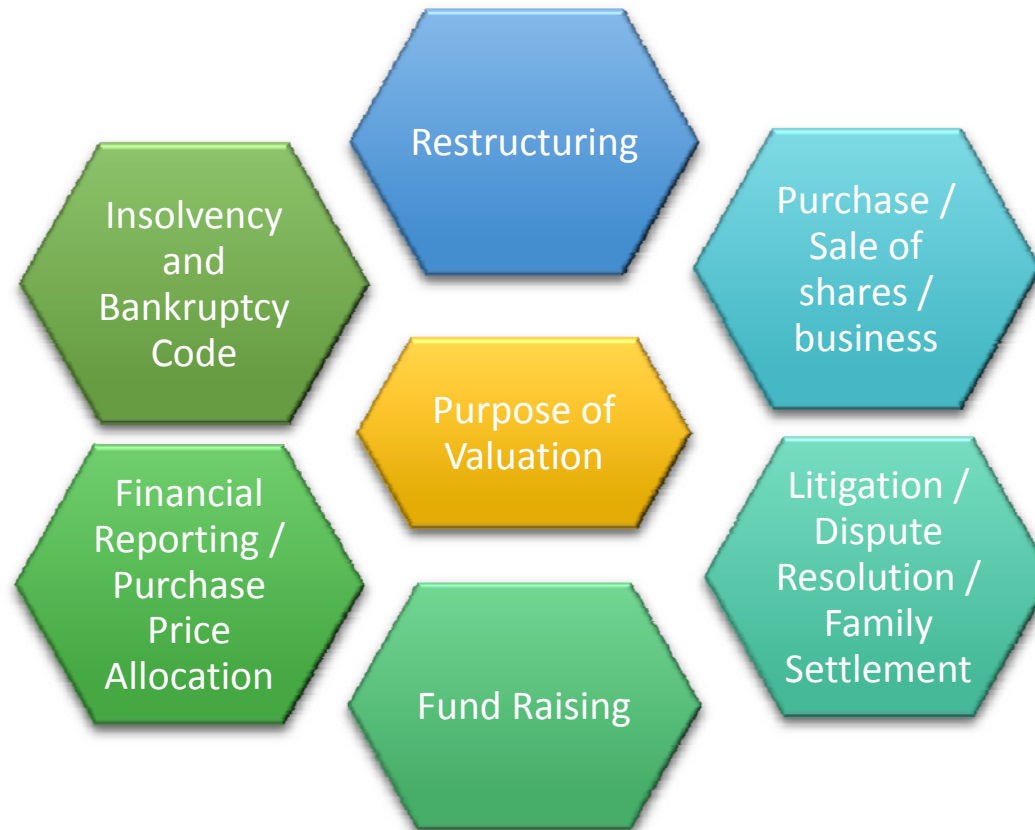
- Following documents/information/analyses to be documented:
 - engagement letter
 - data obtained during the course of valuation
 - valuation workings
 - copies of relevant circulars, extracts of legal provisions
 - bases, approaches and methods used
 - assumptions, a change in which, may materially affect the value
 - copy of the signed valuation report issued
 - management/client representation letter



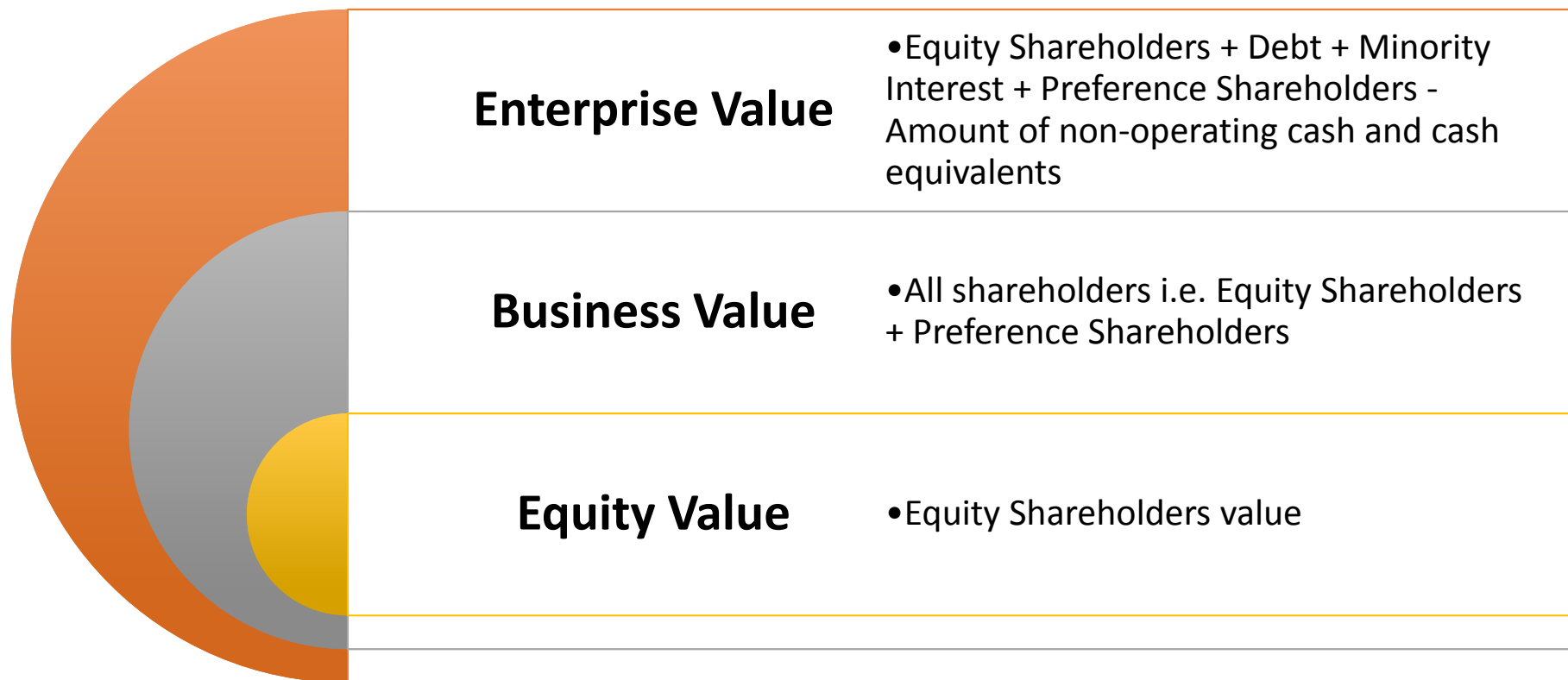
ICAI VS 301 – BUSINESS VALUATION



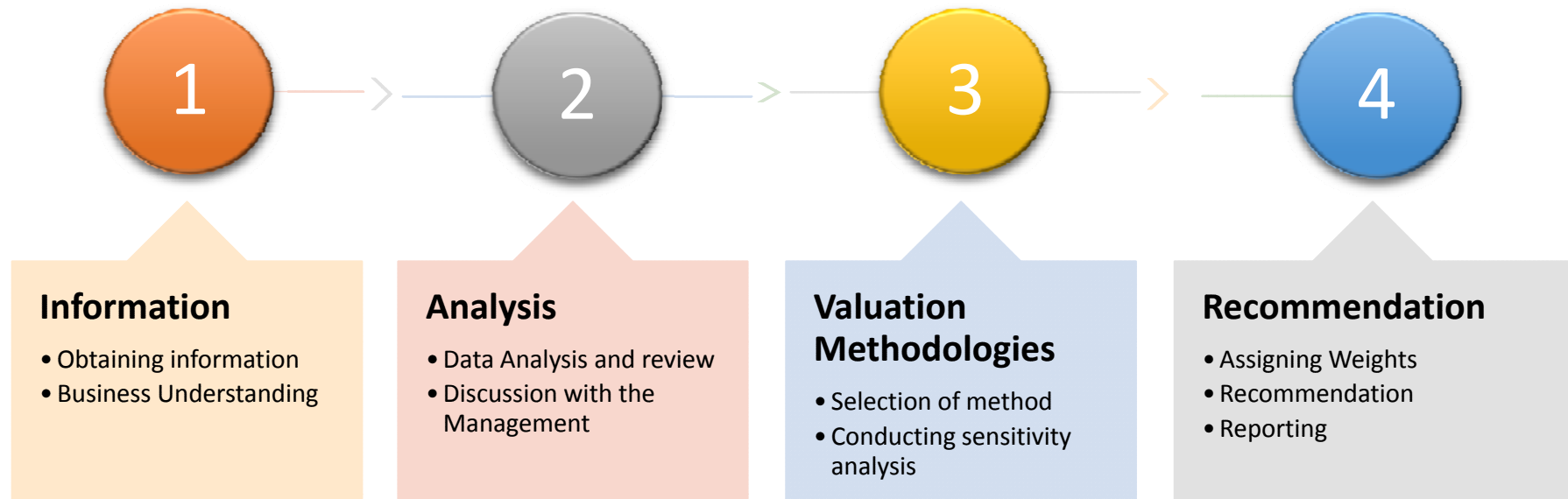
NEED FOR VALUATION



BENCHMARKS



VALUATION PROCESS



COMMON ADJUSTMENTS

- Market value of investments
- Non-operating surplus assets
- Surplus cash
- Contingent liabilities / assets
- Tax concessions





ICAI VS 302 – INTANGIBLE ASSETS



WHAT IS AN 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

NEED FOR VALUATION

Purchase price
allocation

Impairment testing

Transfer pricing

Taxation

Transaction

Financing

Litigation

Bankruptcy /
Restructuring

Insurance

Issuance of sweat
equity shares

CATEGORIES OF INTANGIBLE ASSET

Customer-based

- Customer Contracts
- Customer Relationships
- Customer Lists
- Order Backlog

Marketing-based

- Trademark – brand, logo, service mark
- Internet domain names

Contract-based

- Lease Agreements
- Non-compete Agreements
- Licensing Agreements
- Royalty Agreements
- Employment Contracts

Technology-based

- Patents / Know-how
- Trade Secrets
- Copyrights
- Processes
- Software
- Designs
- Formulae

Artistic-based

- Books
- Films
- Plays
- Music

VALUATION APPROACHES

Market Approach

- Price / Valuation Multiples / Capitalisation Rates
- Guideline Pricing Method

Income Approach

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

Cost Approach

- 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

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

SELECTION OF METHODS

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

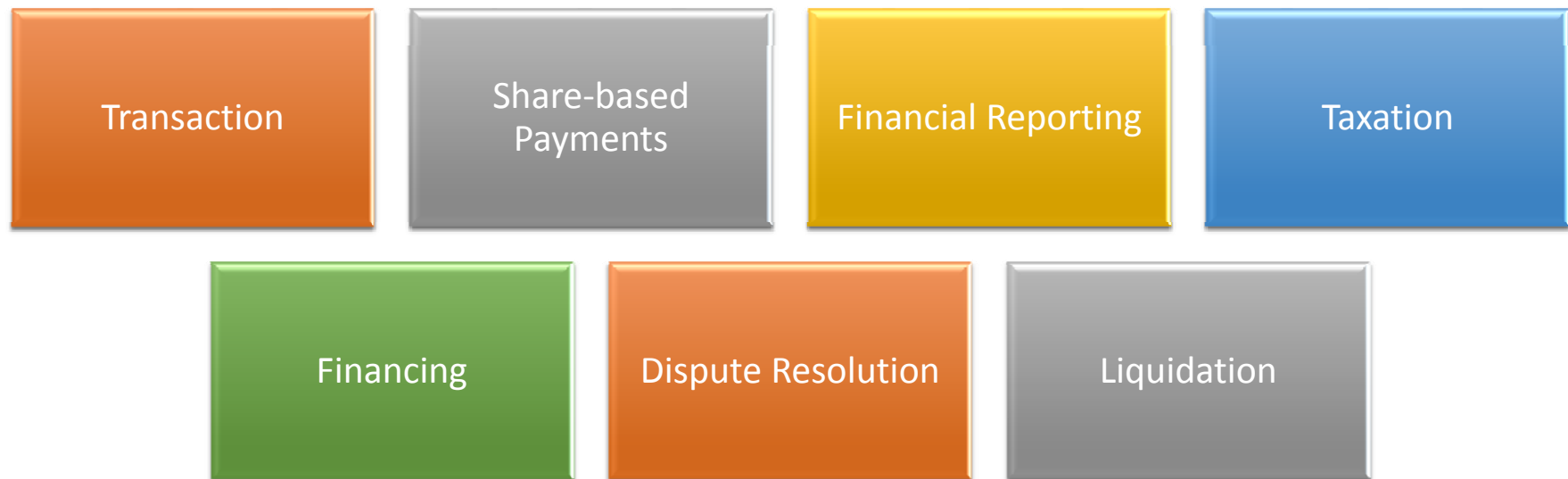


ICAI VS 303 – FINANCIAL INSTRUMENTS



FINANCIAL INSTRUMENTS

- **Financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability/equity of another entity
 - Examples: Equity shares, debt instruments, compound instruments, derivatives, etc.



VALUATION APPROACHES

Market Approach

- Traded price of the financial instrument in the active market
- Traded price of an identical / comparable financial instrument in the active market
- Comparable pricing or private transaction pricing (in absence of active market benchmark price)

Income Approach

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

Cost Approach is rarely used



thank you!