Purpose of Valuation

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Topics

- **Valuation of plant and machinery for following purposes**
- - Mergers and Acquisitions (including purchase price allocation)
- - Financial statements
- - Impairment
- - Auction
- - Insurance
- - Leasing
- - Disposal
- - Capital raising
- - Corporatization and privatization
- - Stamp duty
- - Any other purpose
- - Valuation Standards as per the provisions of the Companies Act, 2013
- - Indian Accounting Standards (Ind AS 16, Ind AS 36, Ind AS 105, Ind AS 113, Ind AS 116) as applicable to valuation
- - Valuer as an expert witness in Court
- - Valuers' functions and responsibilities, error of judgement and professional negligence

Mergers & Acquisition

- ***Mergers*** is the combination of two companies to form one.
- ***Acquisitions*** is one company taken over by the other.

- M&A is that two separate companies together create more synergy than being existing separately.
- Objective of wealth maximization,
- Companies keep evaluating different opportunities through the route of merger or acquisition

- In M&A transaction,
  - valuation is the price that one party will pay for the other.
  - The value that one side will give up to make the transaction work.
  - Valuations can be made via appraisals or the price of the firm's stock if it is a public company.
  - At the end of the day valuation is often a negotiated number.
- Valuation is often a combination of cash flow and the time value of money.
- A business's worth is in part a function of the profits and cash flow it can generate.
- How much is the buyer willing to pay and at what rate of interest should they discount the other firm's future cash flows

Purchase Price Allocation

- ***Net identifiable assets***
  - The total value of assets of an acquired company less the total value of its liabilities.
  - Note that the identifiable assets with a certain value at a given point in time and whose benefits can be recognized and reasonably quantified.
  - Assets represent the book value of assets on the balance sheet of an acquired company.
  - Identifiable assets include both tangible and intangible assets.
- ***Write-up***
  - Adjusting increase to the book value of an asset made if the asset's carrying value is less than its fair market value.
  - The write-up amount is determined when an independent business valuation specialist.
- ***Goodwill***
  - The amount paid in excess of the actual amount paid for the purchase of target company assets and liabilities over their total value.
  - Goodwill is calculated as a difference between the purchase price and the total value of assets and liabilities of an acquired company.
- *Consulting fee in acquisition is an expense of the acquirer.*

Financial Statements

- *Financial statements provides the results of operations, financial position, and cash flows of an organization.*
- *This information is used to make decisions regarding the allocation of resources*
- Profit / Loss Statements
  - Can it generate a profit?
  - Where are expenses coming from?
  - What is the way company is moving
- Balance Sheet
  - Assets & Liabilities.
  - Wealth of the company.
- Cash Flow
  - How is cash coming in & going out.

- *These information then generate many ratio's.*
- *Ratios are the right mechanism to compare the firm with it's peers.*

Use of Financial Statements in Valuation

- MARKET VALUE is the price at which a seller and buyer actually transact.
- ADJUSTED BOOK VALUE the amount that a contract or other document dictates.
- FAIR VALUE is the pro rata share of an ongoing business.
  - Also used for estate duty or transfer tax.

Terms

- *Book value* is the net worth of the business -- assets minus liabilities -- as shown on the company's balance sheet.
- *Liquidation value* is the net amount remaining after a business is brought to an end, its assets are sold individually, and its creditors are paid.
- *Company cash flow* or *earnings* is the value of the company based on projections of what its earnings or cash flow is likely to be -- using past trends to predict the future.
- *Income statement* is the principal source for information in valuing a business.
  - Estimates of future earnings, are derived from income statements.
  - DCF is then used.
  - Valuators then capitalize these earnings.

Impairment

- Impairment is a permanent reduction in the value of a company's asset, normally a fixed asset.
- If it's found that the book value of the asset exceeds the cash flow or benefit of the asset, the difference between the two is written off
- The value of the asset declines on the company's balance sheet.
- The impairment of a fixed asset can be described as an abrupt decrease in fair value due to physical damage, changes in existing laws creating a permanent decrease, increased competition, poor management, obsolescence of technology, etc.
- In case of a fixed-asset impairment, the company needs to decrease its book value in the balance sheet and recognize a loss in the income statement.

- **Advantages of Impairment**
  - Different ways to assess a company's management and its decision-making track record.
  - Managers who write off or write down assets because of impairment might not have made good investment decisions or lacked the vision before making that kind of investment.
  - Many business failures are heralded by a fall in the impairment value of assets.
- **Disadvantages of Impairment**
  - Difficult to know the measurement value
  - Measuring impairment include finding out the current market value, current cost, NRV, or the sum of future net cash flows from the income- producing unit.
  - Detailed guidance on treatment for impairing assets is not there.
- **Impairment vs. Amortization**
  - Impairment is a sudden and irreversible decrease in the value of an asset,
  - Amortization is systematic decrease in the book value of an intangible asset, based on the planned amortization plan.

Auction

- Limited companies going in for disposal of capital good
- Its scrap or residual commodities are auctioned only after soliciting valuer written opinion.
- It is probable that all the public limited companies also fall in line with it.
- Valuation for auction, is the value that it may fetch, if the activity takes place fairly.

Insurance

- **The Importance of Insurance Valuations**
- If current valuations are several years out of date
- If there is a significant reliance on foreign machinery
- Where assets and machinery are old
- Where a business has undertaken significant restructuring, investment or downsizing

The value of the asset is more in tune of the present conditions.

Valuation gives an independent third party view.

Valuation Methods

- *Reinstatement*
  - This is the cost to repair, reconstruct or renew assets to a condition equal to but not better than when new
- *Indemnity*
  - This is the sum assured for items equivalent to the cost of replacing the items with identical or substantially similar equipment in a condition comparable to the existing asset
- *Market Value*
  - This is the recoverable value where assets are surplus or no longer used

Leasing

- Valuation for leasing is to arrive the justifiable lease amount.
- This is mainly for secondary and later lease.
- One cannot lease the asset more than the fair value.
  - Rental can be any value, not related to asset value.
- This also determines the residual value

Disposal

- To arrive the disposal value considering the condition of sale & technical aspects.
- To make sure that there is no malpractice.
  - Undervalue for disposal purpose.
- Done by large organizations to be fair and transparent.
- PSU – are doing it in India.

Capital Raising

- Capital raising is voluntary contributions of money or other resources, by requesting donations.
- Typically refers to efforts to gather money for non-profit organizations,
- Raising money is a complicated multi-stage process.
- A valuation is one of the most important steps to raise capital.
  - Aim too high and investors will look the other way. Aim too low and you will leave money on the table.
- One strange fact about the fundraising process is that the more you raise, the higher the valuation tends to be.

Corporatization and Privatization

- The act of reorganizing PSU with the corporate structure found in publicly traded companies.
- Privatization describes the process by which a piece of property or business goes from being government owned to being privately owned.
- Note that privatization also describes the transition of a company from being publicly traded to becoming privately held. This is referred to as corporate privatization
- The valuation then describes the right price of shares that it must issue to public.
    - This is the sum of all assets, good will, brand, technology etc.

Stamp Duty

- How much taxes are needed to be paid to transfer the ownership.
- What part of the total company falls in which class.
- Each class has a different transfer duty / tax.
- Undervaluation is also considered a tax crime, and punishable with relevant laws.

Valuation Standards as per the provisions of the Companies Act, 2013

- 18-Oct-2017 – MCA notified Sec 247 of Companies Act 2013.
- It included – establishment of Valuation Standards.
- 10-Jun-2018 – Indian Valuation Standards made by ICAI.

Ind VS 101, *Definitions*

Ind VS 102, *Valuation Bases*

Ind VS 103, *Valuation Approaches and Methods*

Ind VS 201, *Scope of Work, Analyses and Evaluation*

Ind VS 202, *Reporting and Documentation*

Ind VS 301, *Business Valuation*

Ind VS 302, *Intangible Assets*

Ind VS 303, *Financial Instruments.*

These are for Financial Assets.
For others, International Valuation Standards will be used.

Ind VS 101- Definitions

- The Ind VS 101 provides definitions and principles.
- Unless a Valuer is required to use a definition prescribed by any law, regulations, rules or directions of any government or regulatory authority.
- Some of the definitions from Ind AS 113 – Fair Value Measurement have been retained here as well, with some modifications in certain cases. The ones which have been are - “Active market”, “Fair Value”, “Cost Approach”, “Income Approach”, “Highest and Best Use”, “Market Approach”, “Market Participants”, “Observable inputs”, “Orderly transactions”, “Unobservable inputs”.
- In addition to the aforesaid, there have been some new additions as well.

Ind VS 102- Valuation Bases

- ***Fair value*** means the 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.
- ***Participant specific value*** is the estimated value of an asset or liability after considering the advantages and disadvantages that may arises to the owner, identified participant or identified acquirer.
- ***Liquidation value:*** Liquidation value is the amount that will be realized on sale of an asset or a group of assets when an actual/hypothetical termination of the business is contemplated/assumed.
- ***Premise of value***
  - Highest and best use
  - Going concern value
  - As is where is value
  - Orderly liquidation
  - Forced transaction.

Ind VS 103- Valuation Approaches and Methods

- Market approach,
- Income approach and
- Cost approach.

The approach will be decided by the valuer, depending upon

- Nature of asset to be valued;
- Availability of adequate inputs or information and its reliability;
- Strengths and weakness of each valuation approach and method; and
- Valuation approach/method considered by market participants

However, if there is any law that governs the method to be used, that will be used.

Ind VS 201- Scope of Work, Analyses and Evaluation

- Terms and conditions of an engagement must be clear to avoid any misunderstanding between a Valuer and a client.
- Valuer should make analyses and evaluations through discussions, surveys, inspections and various calculations, etc. and the extent of such analyses and evaluation depends on the terms and purpose of the engagement.
- A guidance on to what extent a Valuer should place reliance on the work of an expert and the responsibilities of the Valuer while using work of other experts.
- The type of information required to reach to a valuation conclusion such as:
  - non-financial information;
  - ownership details;
  - financial information; and
  - general information

Ind VS 202- Valuation Report and Documentation

- Valuer shall at a minimum include the following in the valuation report:
  - Background information of the asset being valued;
  - Purpose of the valuation and appointing authority;
  - The identity of the Valuer and any other experts involved in the valuation
  - Disclosure of the Valuer’s interest or conflict, if any;
  - Date of appointment, valuation date and date of the valuation report;
  - Inspections and/or investigations undertaken;
  - Nature and sources of the information used or relied upon;
  - Procedures adopted in carrying out valuation and valuation standards followed;
  - valuation methodology used;
  - restrictions on use of the valuation report, if any;
  - major factors that were taken into account during the valuation;
  - conclusion
  - caveats, limitation and disclaimers.

Indian Accounting Standards (Ind AS 16)

- The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment.
- The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:
  - it is probable that future economic benefits associated with the item will flow to the entity
  - the cost of the item can be measured reliably.
- An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost.
  - its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
  - any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended.
  - the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

- Measurement after recognition
  - An entity shall choose either the cost model or
    - After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.
  - The revaluation model
    - After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses
  - As its accounting policy and shall apply that policy to an entire class of property, plant and equipment.
  - The carrying amount of an item of property, plant and equipment shall be derecognised:
    - On disposal;
    - When no future economic benefits are expected from its use.

- DISCLOSURE
- The financial statements shall disclose, for each class of property, plant and equipment:
  - the measurement bases used for determining the gross carrying amount;
  - the depreciation methods used;
  - the useful lives or the depreciation rates used;
  - the gross carrying amount and the accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period; and
- Reconciliation of the carrying amount at the beginning and end of the period showing:
  - additions;
  - assets classified as held for sale or included in a disposal group classified as held for sale
  - acquisitions through business combinations;
  - increases or decreases resulting from revaluations
  - impairment losses recognised in profit or loss
  - Impairment losses reversed in profit or loss
  - Depreciation;
  - The net exchange differences arising on the translation.
  - Other charges

Indian Accounting Standard (Ind AS) 36

- **Impairment of ASSETS**
- An asset is impaired when its carrying amount exceeds its recoverable amount.
- Assessment at the end of each reporting period whether there is an asset may be impaired.
- External sources of information
  - Indications that the asset's value has declined during the period significantly more than would be expected as a result of the passage of time or normal use.
  - Significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, as per technology.
  - market interest rates or other market rates of return on investments have increased
  - The carrying amount of the net assets of the entity is more than its market capitalisation.
- Internal sources of information
  - Evidence is available of obsolescence or physical damage of an asset.
  - significant changes with an adverse effect have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used.
  - Evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

Indian Accounting Standard (Ind AS) 105

- The objective of this Standard is to specify the accounting for assets held for sale, and the presentation and disclosure of discontinued operations.
- It will classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.
- It shall measure a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

Indian Accounting Standard (Ind AS) 113

- This standard :: defines fair value; sets a framework for measuring fair value; and requires disclosures about fair value measurements.
- Fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- A fair value measurement is for a particular asset or liability.
  - When measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.
  - Such characteristics include, for example, the following: (a) the condition and location of the asset; and (b) restrictions, if any, on the sale or use of the asset

Valuer as an Expert witness in Court

- The expert must have scientific, technical, or other specialized knowledge which will help the judge to understand the fact of evidence or to determine a fact in the issue
- The expert's testimony must be based on sufficient facts or data
- The testimony must be a product of reliable principles and methods
- The expert must have reliably applied the principles and methods to the facts of the case.

Here the report of valuation is not on trial, but Valuer is an EXPERT.

He will be asked questions about his process, his opinion.

He has to be careful, about the way questions are asked. He may ask for clarifications.

Error of Judgement and Professional Negligence

- Error of judgement is
  - Good and Fair intentions.
  - But mistake has happened, without intentions.
- Professional Negligence
  - Done valuation, that is out of the scope of work.
  - Done valuation that is not what you have been approved of.
  - Report is very poor and sketchy – does not list the regular details.
  - Not doing physical verification of the asset.
  - Not checking the ownership documents
  - Not doing market search for similar assets.
  - Having a conflict of interest.
  - Sighing the report on behalf of other party.
  - Giving a valuation that is far different that the “fair vale”
  - Leaking data to other parties.