

**Response to the International Valuation Standards Board ‘s Exposure Draft
entitled
“Proposed New International Valuation Standards”**

**Italian Permanent Committee on
Business Valuation Guidelines**

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We appreciate helpful discussions with and comments from **Simone Maurizio,**
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Introduction

The International Valuation Standard Board (IVSB), the standard-setter body of the International Valuation Standard Council (IVSC), has published an Exposure Draft of the Proposed New International Valuation Standards (IVS). Both the structure and contents of the proposed new IVS reflect a profound revision of the valuation standards currently in force, which were issued before the recent reform of the IVSC, thanks also to the recommendations of the Critical Review Group.

The IVSC is not a professional body and, as such, has no regulatory power. This is why the new standards are not intended mainly for valuers but for users of valuations, that is investors, lenders, auditors, among others.

The Italian Permanent Committee on Business Valuation Guidelines (hereinafter IPC) is pleased to have the opportunity to express its views on the Exposure Draft issued by the IVSC. This letter has been developed by the members of the Committee and its content cannot be construed in any way as being representative of the official position of the institutions to which such individual members belong.

The IPC is promoted by Bocconi University. It consists of members of academia and representatives of the professions and other stakeholders (valuers, auditors, investors, accounting standard setters, financial markets) and its purpose is similar to that of the IVSC, that is to advance quality improvement in business and asset/liability valuations through the dissemination of guidelines and valuation standards. The IPC does not have any expert (from academia or otherwise) in the field of property valuation. The IPC is not a professional body and, like the IVSC, has no regulatory power. However, given the absence in Italy of a standard setter for valuation and a professional body specialising in corporate valuations, the IPC addresses both valuers and users, as its mission as a technical body is to advance the quality of the valuation of companies, financial instruments and/or real assets, regardless of who performs it (professionals, equity analysts, investment bankers, among others) and why (financial reporting, acquisitions, fairness opinions, stock market listings and new share issues, in-kind contributions, among others).

Given these shared objectives, the IPC, with its genuine interest in raising the standards of valuation quality, is a natural interlocutor of the IVSC.

The outcome of a valuation process is an informed opinion, a value judgment which is reached after considering all the relevant pieces of information. If the process is governed by clear and effective valuation standards, then the values assigned to a business or an asset by two different professionals operating on the basis of a common body of knowledge, and following those standards, should not vary substantially from each other. Reduced scatter in results engenders also greater user confidence in the outcome of the valuation process.

Overview

The IPC regards as extremely useful the development of a widely-shared set of international valuation standards intended to improve valuation quality and transparency, and consequently the confidence of those who make decisions (users) on the basis of the outcome of a valuation process. The quality of valuation standards has to be judged in relation to their ability to prevent the (inevitable) subjectivity of the valuation process from being used as an excuse for arbitrariness or for an (inexplicable) scatter in results. Valuation is not a black box or the mere application of (more or less proprietary) valuation formulae or methods but a rigorous and consistent process, conducted on the basis of clear valuation standards shared and accepted as good practices. The objective of the valuation standards is to reduce measurement errors and unwarranted discretionality in valuation. In principle, given that

$$\textit{Valuation result} = \textit{True value} + \textit{measurement error} + \textit{valuer bias} \quad [1]$$

the objective of valuation standards should be to minimise both measurement error and valuer bias.

The key problem is that there is a trade-off between measurement error and valuer bias. For instance, valuer bias can be reduced by setting the estimated value of an asset or a business as equal to the market price for that asset (thus removing the valuer's discretionality and increasing the reliability of the estimate) but, since price can deviate substantially from the true value of an asset, this approach is subject to a high risk of measurement error.

The IPC's letter of comment is inspired by the above objective. The considerations developed in the following notes are designed to bring to light those choices implicit in the ED which - according to the IPC - might limit to a significant extent the practical effectiveness of valuation standards.

The IPC's general comment to the ED is presented in the following 9 points.

1) The standards are perhaps too general and do not seem to define a sufficient set of recognised norms.

If the valuation standards set by the IVSB are mainly intended for users, they should include guidance to allow them to understand the possible extent of both measurement error and valuer bias. For instance, the user needs to be aware that, in estimating the investment value of a business, the assessment of any synergy entails greater measurement error and valuer bias compared with the valuation of the business "as is". Also, the user needs to be aware that certain valuation models (e.g. the criteria to estimate the value of an option) applied to assets not quoted in active markets are not very reliable as even the smallest of change in inputs may determine substantial variations in the *valuation result*.

The IPC feels that the ED does not address these issues and that the choice to deal with high level principles (for both assets and businesses without distinction, without providing any guidance for the valuation and input selection criteria) in the 100 series of IVS risks missing the true objective for which the standards are defined. In fact, in the valuation field implementation matters tremendously.

The IPC shares the view that valuation standards should not be concerned with the details of valuation techniques and, more generally, with the manner of implementation of valuation techniques ("the standards are not a training manual" and should only indicate "what to do" not "how to do"). The IPC also shares the view that valuation techniques evolve over time and the standards should not contain method lists or valuation formulae. That said, the IPC considers also

necessary to set out precisely the “what to do” in the form of standards generally accepted by valuers and easily recognisable by users. The IPC feels that, since valuation is an empirical discipline, the standards should provide clear indications on how to judge the quality of the valuation. This is not the case when two or more professionals, operating on the basis of a common body of knowledge and following the same valuation standards, reach widely differing results.

In principle, to be internally consistent and effective in its implementation, a set of valuation standards should unfold along three levels of detail:

- a) The first level – typical of a conceptual framework – would set out the key concepts underpinning the entire valuation standard system;
- b) The second level would lay down the actual standards, each of which providing for a specific subject in light of the conceptual framework (thus in keeping with the other standards) in the form of recognised norms;
- c) The third level would provide illustrative examples of application of the standards and manners of application.

While on one hand it is appropriate to have technical papers and other educational material serve the purposes of the third level – because valuation techniques evolve over time – on the other it is equally appropriate for standards to be more than a mere description of key concepts (first level) and to take on a greater degree of detail (defining *recognised norms*). In other words it is necessary to draw a clearer line between standards and valuation techniques.

The IPC feels that in many parts the ED addresses topics at too general a level, which is typical of a conceptual framework, with the result that matters that should be dealt by the standards would be covered by the technical papers (to be issued in the future) while users would be left without useful recognised norms.

This has two consequences:

- a) There is a risk that the standards may be ineffective in their goals to reduce the scatter in the results obtained by two professionals operating on the basis of a common body of knowledge and, consequently, to increase users’ confidence in valuations (for instance, with respect to the direct market comparison approach the standards do not provide any guidance for the identification of the comparable factors of a business or an asset undergoing valuation or for any adjustment to multiples, and this while the application of multiples derived from “false” comparables and/or the use of “adjusted” variables for the application of multiples is undoubtedly one of the most critical and unruly areas in valuation practice);
- b) The area covered by the standards is limited and incomplete and leaves room for valuers’ arbitrariness (e.g. the problem of premiums and discounts in valuation: is this a subject to be dealt with in relation to valuation techniques? Would it not be worthy of consideration at the standard level? Moreover, is it appropriate for standards to consider only valuations for financial reporting purposes and not many other different types of corporate valuations such as share withdrawal, merger, spin-off, in-kind contribution valuations?)

2) Absence among the standards of intrinsic value and the greater weight given (in general) to relative valuation criteria.

There are two possible alternative approaches to reducing measurement errors and valuers’ discretionality:

- a) The adoption of a valuation hierarchy that prefers without exception the price of the business or asset undergoing valuation over any other estimate, as recommended by IVS 102 section 7 in the ED as follows “...where directly observable prices for identical or similar

assets are available at or close to the valuation date, the direct market comparison approach is generally preferred (...)" ;

- b) The reduction, in connection with the estimation of intrinsic (or fundamental) value, of fundamental inputs that are not objectively observable or verifiable. Generally, this approach is founded on the limited use of long-term forecasts, inputs characterised by highly volatile or subjective estimates, valuation methods too sensitive to discretionary inputs. The IPC recommends the adoption of this approach.

The approach under a) suggests that the more it is founded on prices objectively observable in active markets the more a valuation is reliable. This solution indicates that price should always be preferred to estimated value, regardless of the fundamental efficiency of the market where that price is formed and the purpose of the valuation. This approach reduces discretionality in the valuation process (lower valuer bias in the equation [1]) but makes the estimate less relevant from an economic point of view (greater measurement error). This because prices may differ (and normally they do) from fundamental values and financial and goods markets may produce speculative bubbles. This approach has two main consequences which, in the IPC's opinion, should be avoided:

- a) It fails to recognise intrinsic (or fundamental) value as an important type of value;
- b) It creates a valuation method hierarchy where relative valuation criteria (multiples) are given greater importance (or weight) than absolute valuation criteria (income-based).

On the other hand, the second approach seems to suggest that the main objective of a valuation should be the estimate of intrinsic value (which is the standard to which all other types of value are anchored and is the type of value that comes closest to true value) and that, to reduce discretionality in the process, such speculative inputs as unpredictable results and unreasonably volatile or clearly inefficient fundamental prices should be avoided. A valuation is only as good as the inputs underlying it. This approach leads to a limitation in the use of prices when these deviate from fundamentals, which is a highly frequent occurrence also for assets traded in active markets. Intrinsic value needs to be supported by facts, observable conditions, short-term forecasts where visibility is reasonable. Market prices instead may capture also strongly speculative elements. Suffice it to think of the internet bubble in 2000, when loss-making companies were traded at prices that bore no relationship to fundamentals. Market sentiment often alternates euphoria to panic. That is why it is important to draw a sharp distinction between the concepts of price and value (from a fundamental standpoint, price is what you pay and value is what you get) without, however, failing to reconcile price and value by analysing the reasons for their difference. The adoption of this approach means also setting the standards that have to govern the valuation process in terms of completeness of the information obtained and input selection (income stream, growth and risks), to separate what is known from mere speculation.

Between the two approaches, the IPC prefers the latter, where the main objective of every valuation is intrinsic (or fundamental) value and the quality of the valuation process is a function of the inputs utilised. In fact, the IPC thinks that this is the best way to minimise "*measurement error + valuer bias*". On the other hand, the former – which makes the valuation process objective by anchoring it as much as possible to market prices – risks losing to measurement error the benefits obtained on the valuer bias front.

The adoption of the second approach means:

- a) in principle, attributing greater importance to absolute valuation criteria (income-based) than to relative ones, based on the assumption that markets are not efficient in terms of fundamentals (prices and costs may be equal, but they do not have to be equal, to value);

- b) that a different hierarchy of methods is used only in special cases, in relation to special valuation purposes or requirements. For accounting purposes, for instance, it is obvious that fair value (= exit value) has to be determined on the basis of a hierarchy (levels 1, 2 and 3) capable of ensuring that the estimate is the same as the price quoted, or reasonably expected to be quoted, in an active market for a specific asset, liability or business (regardless of the efficiency in terms of fundamentals of that market that expresses that price). In fact, fair value is a type of value different from fundamental value. When instead value in use has to be determined, it is necessary to refer to a fundamental (and entity specific) value.

Thus, two of the main limits that the IPC found in the Exposure Draft are as follows:

- a) the absence of intrinsic value in the standards. In the Anglo-Saxon culture certain commentators regard intrinsic value as a special kind of investment value. However, in Continental Europe's tradition, intrinsic value is a type of value totally different from investment value for two reasons:
 - i. investment value reflects the view of a specific operator while intrinsic value reflects the view of a generic market participant;
 - ii. investment value may express potential value while intrinsic value is predicated on current or short-term earning power.
- b) the greater weight (generally) attributed to relative valuation criteria (direct market comparison approach) compared with absolute valuation criteria (income approach). The IPC thinks that this choice, together with an insufficient level of detail in the standards (see previous section) – which do not provide any guidance for the identification and selection of comparable assets and businesses – is very dangerous as it lends itself to distorted uses.

The IPC attributes these limits to the IVSB's implicit choice of wanting to reduce valuer bias in valuations by limiting room for the valuer's subjectivity, albeit without considering the risk of a widening gap between estimated value (= price) and true value at the expense of the economic relevance of the estimation process.

3) Business and business interest valuation should be treated at the standard level as a special case of the more general valuation of individual assets

The IVSB considers that all general valuation principles (IVS 100) apply to the valuation of both individual assets, on one side, and businesses and business interests, on the other, and that, accordingly, the peculiarities associated with the valuation of businesses and business interests should be treated in the general principles outlined at the level of specific assets (IVS 300).

The IPC does not share this view because the valuation of businesses and business interests differs from the valuation of any other finite-life asset due to a number of important aspects:

- a) a valuation must adopt an indefinite time horizon and this gives rise to the so-called truncation problem, that is the need to estimate at the end of a specific future period (of variable length) the terminal value through a perpetuity calculated on the basis of inputs that, on one side, have significant effects on the final result and, on the other, are hard to estimate. The indefinite time horizon approach gives rise to a number of specific issues that need to be addressed at the level of general principles. For instance, the emphasis placed by fundamental analysis on the completeness of information and the demonstrability, accuracy and reliability of the valuation inputs are aspects of a general nature that need to be adequately provided for and that go beyond the simple identification of valuation approaches. For instance, in valuing a business, the income approach may be adopted on the basis of: (i) medium-to-long term profits obtained on the basis of simple extrapolations, a process which may be formally correct but which cannot be verified in substance;

(ii) or the company's proven short-term earning power. The traditional prudential attitude of Continental Europe's culture in the area of company valuation is the reason for the scepticism toward long-term forecasts, whose sustainability cannot be verified objectively. Moreover, given the same time-horizon estimate (short or long) and income metric of reference (current income or potential future income), particularly important is the choice of the growth rate (if any) used in estimating terminal value (which will magnify any distortive effects determined by the use of potential income streams over very long time horizons). In addition, the use of cash flows instead of income streams may give rise to significant distortions in value estimation, without the necessary adjustments.

b) the valuation of a business interest requires the identification of an appropriate unit of valuation. At the general principle level it is necessary to define whether the value of a business interest can and should be obtained on the basis of a valuation $P \times Q$ (where P is the price/value of a single share and Q is the quantity of shares that make up the business interest) or on the basis of a valuation that would consider, for instance:

a) that the value of a non-controlling interest in a closely-held company is a function of the company's earning power as is where is, which may be also very different from that determined by the highest and best use of the company's assets;

b) that the value of a controlling interest in a structurally loss-making company has to reflect the peculiar illiquidity that characterises the investment, etc.

c) The valuation of a business interest may be based on an asset-side approach or an equity-side approach. However, given a high level of debt, the percentage difference within the range of possible valuation results obtained on the basis of the former is multiplied by the latter, thus making the choice of the valuation approach to be adopted far more complex. In fact, assuming that the asset-side values of business A fall within a range variance (= maximum value/ minimum value - 1) of 25% - for instance, due to a maximum value of CU 100 obtained on the basis of the direct market comparison approach and a minimum value of CU 80 obtained on the basis of the income approach, whence $100/80 - 1 = 25\%$ -, in the presence of net borrowings equal to CU 50 the (maximum/minimum - 1) equity-side value range goes up to 67% (= $(100-50)/(80-30) - 1 = 67\%$).

4) Guidance should be provided for the selection of the information inputs

The IPC agrees that valuation is based on a process and that valuation standards should not contain lists of valuation models or formulae. Models and formulae are largely known also to valuation users and, in any case, they evolve over time. Less well known, however, are the criteria to be utilised in the identification and selection of valuation inputs.

The IPC feels that valuation standards should lay down general principles, to prevent any paradoxical situation whereby – on certain issues – reference would be made to other authoritative literature. An example is appendix A of IAS 36 (“Using present value techniques to measure value in use”), which indicates the main traditional and expected approaches to be used in the income approach and the elements to be considered in choosing the discount rate.

Obviously, there are important questions related to the information inputs concerning growth rates in terminal value, forecast horizons, risks.

It would be necessary to add a section in the general part devoted specifically to the selection of pertinent inputs for purposes of liability estimation.

5) The applications should include many types of valuation that are as important as those for financial reporting purposes.

The IPC feels that the 200 series of IVS is skewed toward valuations for financial reporting purposes. Generally speaking such valuations aim to minimise valuer bias. The accounting standard setter is aware that accounting estimates may also deviate substantially from the true value of the asset or the business, but this choice is dictated by a need for valuation objectiveness. In this respect, it can be said that fair value under accounting standards is a conventional value for all the assets held by the company to carry out its operations (and not to be sold).

The IPC feels that all equity-related transactions are a special area of application of the standards and methods of valuation of businesses and assets. These transactions (which fall in general under one of the following macro-categories: in-kind contributions /divestments, mergers, spin-offs, capital increases, shareholder withdrawals, IPOs, transfers under common control and related-party transactions) are carried out by different types of professional operator, with varying skills and functions (which fall in general under one of the following macro-categories: valuers, corporate lawyers, accountants, auditors), who play a “watchdog role” on behalf of non-controlling shareholders and stakeholders. Valuations carried out for these purposes must reduce as much as possible both valuer bias and measurement error. The type of value adopted in these cases is generally intrinsic value (i.e. the type of value closer to the true value of the asset or the business).

Consequently, valuations performed to protect public confidence (“public watchdog”) are different from valuations for financial reporting purposes and should be treated under specific standards. All user categories have to be able to understand:

- the peculiarities of the specific transaction;
- the limits and the constraints that might characterise the valuations in relation to the specific context/purpose.

This can happen only if the valuations are conducted in keeping with certain conceptual and operational rules capable of ensuring integrity and fairness.

Obviously in this area valuation choices are conditioned as there are legal constraints and national regulations. However, there are general principles that should inform all valuations performed for public confidence purposes which should be adopted by the international standards.

Another area where the standards should provide general principles is damage estimation.

6) *The treatment of taxes in valuations should be addressed.*

Taxation is a factor capable of affecting to a significant extent the outcome of a valuation. Professional practice is lacking guidance for the treatment of taxation in connection with certain critical aspects:

- a) in determining discount rates. As an example, the problems relate to the usability of the Modigliani-Miller model (with corporate income taxes), the Miller model (with personal income taxes, too) and the estimation of the beta levered and unlevered on the basis of Hamada’s formula with or without taxes;
- b) the manner of appreciation of the tax shield on debt (directly, through the adjusted present value and the valuation of the individual tax shields or, indirectly, through the calculation of the weighted average cost of capital);
- c) the manner of use of the valuation approaches (in applying the cost approach is it necessary to consider costs net of the tax benefit and then to add the Tax Amortization Benefit (TAB)? When does the market approach consider the TAB and when does it not?

7) *Mixed valuation criteria should be addressed, as these are used extensively in the valuation of businesses and business interests.*

The IPC feels that the identification of the three valuation approaches – market, income, cost – within the general principles is appropriate for the valuation of individual assets. In the case of

business and business interest valuation, there is an increasing use of mixed criteria (typically the Residual Income Model). The benefit of these models is the reduction of the weight of terminal value in income-based valuations. The IPC recommends the inclusion within the 100 series of IVS (general principles) of a standard specifically devoted to the identification of the criteria and approaches that can be adopted to value businesses and business interests and contemplating the use of mixed valuation models. The popularity in Europe of the mixed income- and asset-based company valuation method dates back to 1961, when a commission of the Union Européenne des Experts Comptables Economiques et Financiers (consisting of Otto Bredt from Germany, Jacob Viel from Switzerland, Karl Hax from Germany and Maurice Renard from France) showed for the first time a preference for it.

8) *Issues related to the treatment of uncertainty in valuations should be addressed*

One of the most important aspects in any valuation is the treatment of uncertainty. Usually this can be addressed by acting on different elements:

- a) choice of valuation approach;
- b) forecast time horizon;
- c) income streams to be discounted to PV;
- d) adoption of different scenarios;
- e) discount rate;
- f) future income growth rate;
- g) target financial structure.

The presence of all these elements on which valuers can act on to address the uncertainty issue makes it hard for users to understand how valuation captures the risk profiles that are pertinent in the estimation of the individual asset or the business as a whole. For instance, the valuation of an income stream based on a higher discount rate and a lower income growth rate in perpetuity (apparently using a more prudent approach than the income-based method) may turn out to be far more aggressive than another valuation only because it uses explicit forecasts over a longer time horizon with a very fast income growth rate. Furthermore, a valuation based on the direct market comparison approach may be unsuited to express the value of a business when comparable companies are larger than the company to be valued (different demand risk) or the latter has too short a history or is characterised by different degrees of operating and financial leverage.

The IPC invites the Board to consider the possibility to add in the series 100 of IVS a standard specifically designed to provide high level principles for the treatment of uncertainty in asset or business valuations and the manners of disclosure of the solutions adopted to incorporate risks in the valuation process.

9) *Guidance should be provided for the reconciliation of the different types of value.*

The IPC feels that one of the most important aspects of the valuation process is transparency of the choices made by the expert in relation to the specific type of value that he or she is trying to estimate. Transparency is necessary to reconcile values that are different from one another as they refer to different types of value.

If, for instance, the expert estimates the intrinsic value of the equity of a listed company to be equal to CU 100 while the company's market capitalisation is CU 80, then the expert should account for the difference between the two. Furthermore, if the expert sets the investment value of a majority equity stake (60%) in the same company for a specific strategic buyer at CU 70, then the expert

should explain the reason for the difference with respect to the pro-rata intrinsic value (= 60% x 100 = 60) and the pro-rata market capitalisation (= 60% x 80 = 48).

Our comments on specific questions in the exposure draft

GENERAL QUESTIONS:

Comment to Q1: Do you find the new structure of the Standards to be logical and easy to follow ? If not, what alternative would you propose ?

The IPC thinks that the standards are structured in a way that might make it hard for them to fulfil their purposes, for the following reasons:

- a) Standard IVS 101 should be expanded and should become the conceptual framework of the standards and should not be itself a standard;
- b) The other standards of the 100 series – which should set out high level principles – should include two additional standards specifically devoted to:
 - a. The valuation of businesses and business interests which, for the reasons indicated in section 3 of the overview, requires its own high level principles;
 - b. The purposes of the valuation, which are not only conducive to the determination of different types of relevant value but are founded also on different high level principles, as illustrated in section 5 of the overview;
 - c. The treatment of uncertainty in valuations for the reasons outlines in section 8 of the overview;
- c) The standards of the 200 series deal mainly with valuations for financial reporting purposes (IFRSs) while they should address also other applications (shareholder withdrawals, mergers, spin-offs, common control transactions, related-party transactions, valuations for tax purposes, etc.). Furthermore, IVS 201.01-201.04 are simple references for IFRSs but do not provide any additional information of interest for users;
- d) The standards of the 300 series do not add any value to the high level principles. Mostly they refer to the 100 series of IVS. The various valuation considerations for the different classes of assets are merely descriptive and list the issues without setting out any norm as to what to do.

In our opinion the standards should be supported by “bases for conclusions” so as to allow users to have a better understanding of the rationale underlying the standard setter’s choices. This because international valuation standards should be conducive to a progressive harmonisation of different “valuation” cultures. In our view the current standards are excessively terse; they need logical underpinnings and any reference to foster the necessary consensus and to understand the rationale of the choices made.

Lastly, also this new version of the standards suffers from the original approach, in that it is skewed toward the valuation of real property more than businesses and business interests.

Comment to Q2: Do you consider that the combination of background information and specific directions to be helpful ? Would you prefer all background information and explanatory information on asset classes to be removed from the standards so that only the specific directions applicable to each application or asset type remained ?

The IVS of the 300 series may be a bit too descriptive and do not seem to provide clear rules to be followed in valuing specific assets. If all the background and explanatory information were removed, it would be clear that the 300 series of IVS should be expanded.

Comment to Q3: Which delivery method for the new edition of the standards are you or your organization likely to use ?

A hard copy of the standards would be necessary only if our suggestion were followed and a “basis for conclusion” section were added in each standard, with an explanation of the rationale for the choices adopted. In this case the document would be bulkier and its consultation in hard copy would be more convenient.

IVS 101 – GENERAL CONCEPTS AND PRINCIPLES

Comment to Q4: Do you consider that this objective has been met ? Do you consider that there are any additional valuation concepts and principles that should be considered and discussed in this standard ?

This standard should include the following concepts:

- a) unit of valuation;
- b) distinction between businesses and assets.

The definition of value as the “estimate of the likely price to be paid for goods and services” is different from our definition of the concept of value.

Comment to Q5: Are you in agreement with this approach or would you prefer the word “valuation” either not to be used at all or always used with qualifying words to indicate the intended meaning, for example “valuation process” or “valuation result” ?

The standard clarifies that valuation is based on a process. In our opinion, it is not necessary to distinguish in the text between valuation process and valuation result.

IVSC 102 – VALUATION APPROACHES

Comment to Q 6: Do you agree that these three approaches encompass all methods used in the assets or liabilities that you value ? If not, please describe what approaches you feel have been omitted

In general the three approaches – market-income-cost or MIC – are the main methods to value individual assets and liabilities.

In valuing businesses and business interests use is made very often of mixed approaches, such as the residual income model. The standard does not consider these “mixed” approaches.

The three approaches should be described more thoroughly. Generally speaking, it might be a good idea to identify the approach to which the different possible valuation techniques refer. If, for instance, to distinguish between the market approach and the income approach reference were made to the nature of the main inputs used in the valuation process, the classification of the valuation techniques might be different from that proposed by the IVSB. For example, in IVS 301.2 (valuation of intangible assets) the relief-from-royalty method is classified under the income

approach, even though the main input used with the valuation technique (royalty rate) is typically observable in the market. Actually, many authors think of relief-from-royalty as part of the market approach.

Comment to Q7: Do you agree with this hierarchy and do you consider it helpful? If not explain if you would prefer to see no reference to a hierarchy or would prefer an alternative hierarchy.

We do not agree with the creation of a hierarchy of valuation approaches. We think that the hierarchy of approaches will change in relation to the purpose of the valuation and the type of value to be determined. If the valuation is intended to estimate intrinsic value, the proposed hierarchy would not be of great help.

Comment to Q8: Do you find this change of terminology to be helpful? If not please explain what alternative you would prefer and why.

We feel that the term direct comparison market approach might engender confusion, as it seems to define a valuation technique more than a valuation approach.

IVSC 103 – BASES OF VALUE

Comment to Q9: Do you agree with the proposed change to the definition? If not indicate what alternative you prefer and why

In valuation practice in Italy, the term “assumption” is used. We recommend the use of “fundamental assumptions”.

Comment to Q10: Do you agree with this proposed change? If not, please explain why and what you believe the distinction is between investment value to a prospective purchaser and special value to a prospective buyer who can realise that special value to be?

In our opinion the new definition of investment value is misleading. The adoption of the new definition implies the choice of not including intrinsic value among value standards (which would become a special case of investment value). For the reasons explained in the overview, investment value and intrinsic value are totally different. The IPC would consider favourably the adoption of intrinsic value as a specific type of value in addition to the others already identified by the IVSB.

Comment to Q11: Do you support the continued use of the term “Investment Value” or would you prefer an alternative? If so, what would that alternative be?

Investment value is used extensively in professional practice and we think it is appropriate to continue to use it.

Comment to Q12: Do you agree with the approach taken in IVS? If not, explain why not and give examples where you believe the highest and best use may be different from the market value.

Highest and best use may be different from market value, when the unit of valuation is not the same as the unit of exchange in the market. Accepting the IVS approach means agreeing, for instance, that the controlling interest in a company should be valued on the basis of the market price of the single share. This choice implies the decision, not expressly indicated in the standards, to not deal with the issue of control premium. To this end, reference is made to the “Request for Comments

Regarding the Assessment and Measurement of Control Premiums in Valuations for Financial Reporting” of the Valuation Financial Reporting Working Group no. 3 of The Appraisal Foundation. (Discussion question 1 view A e view B). The IPC does not agree with the decision to not deal with premiums and discounts at the general level in the standards.

Comment to Q13: Do you consider this proposed change in the definition to be helpful ? If not, please indicate how you believe it could be improved.

We think that it is correct to stress that the definition of fair value in IFRSs can only be “conventional”.

Thus, it is correct to emphasise the difference between the definition of fair value in general use and the definition of fair value in IFRSs.

However, it should be specified that the two definitions:

- a) should tend to converge, considering that a discrepancy between the two would weaken the effectiveness of the use of IFRSs;
- b) should be illustrated in IFRSs, to avoid confusion and to provide the users of financial statement prepared in accordance with IFRSs with useful information (already required by many regulators).

IVS 104 – SCOPE OF WORK

Comment to Q 14: Do you:

- a) *agree with the inclusion of a standard for scope of work in IVS ?*
- b) *that the minimum contents identified in the draft are proportionate and represent a realistic minimum standard ?*

If you disagree, please explain why.

We agree with the Board on the need for a specific standard relating to Scope of Work, with a summary of the reasons for a valuation process.

As to the content of the standard, we submit a number of recommendations:

- i) Contents should include at a minimum an item describing the **context in which the valuation process is conducted**, such as:
 - a merger or an acquisition
 - an *IPO*
 - an investment or divestment transaction by a private equity firm
 - valuation for financial reporting purposes
 - a turnaround, with a creditor agreement or a debt-to-equity conversion.

In describing the valuation context, the expert should specify whether he or she has been retained to prepare a fairness opinion or an official valuation and, consequently, outline the relevant responsibilities. For instance, in the case of a fairness opinion the expert acts in an advisory capacity, providing a service that will allow others (typically the principal) to make an independent decision while in an official valuation the expert’s opinion is binding or has a strong influence on third parties for their decision.

ii) Concerning **item a)** “Identification of the valuer and confirmation of competence” emphasis should be placed also on the valuer’s independence and autonomy from the principal, within the scope of the engagement. Any potential conflict of interest should be disclosed immediately.

iii) Concerning **item c)** of the standard, “Purpose of the valuation”, it is necessary to distinguish the purpose of the valuation from the “basis or bases of value” which should constitute, as indicated in e), an autonomous aspect. Purpose of the valuation should mean the objective of the valuation, such as:

- a value self-diagnosis for merely informative purposes (typically commissioned by the company’s top management to measure the value created at a certain date)
- bias in portfolio investments (typically in asset management)
- decision-making in relation to equity-related transactions
- what-if analyses designed to review the various scenarios contemplated in business plans.

iv) Concerning **item f)**, Valuation date, it might be worthwhile to indicate also the validity period of the valuation.

IVS 105 – VALUATION REPORTING

Comment to Q 15: Do you agree with the changes that have been made ? If not, please explain what provisions of the current IVS 3 you believe should be carried forward into the new standard

In principle, even though guidance provided to prepare a valuation report was reduced, we feel that the effort to condense and simplify the current IVS 3 is welcome because it contributes to the understanding of the Standard in question and to the overall consistency compared with previous and successive Standards (especially IVS 104). However, the IPC thinks that associating this simplification to a sharper and clearer indication of the principles that should guide the preparation of a valuation report is of the essence. These should include the principles of thoroughness, clarity and transparency in disclosing the sources of information, the assumptions underlying calculations and the reasoning that led to the valuation conclusions.

In particular, a comparison between item 5 of IVS 105 and the corresponding item 5.0 of IVS3, currently in force, shows that it would be appropriate to act in the following areas:

i) **Item h)** “*Nature and source of the information relied upon*”, providing more details of the information relied on by the valuation process, specifying:

- the information obtained by the principal and the checks performed by the valuer or other third party (and whether these are required under the terms of the engagement)
- the external sources utilised
- the reliability and completeness of the sources used.

The expert should indicate in the final report whether the information has been verified.

ii) **Item i)** “*Assumptions and any special assumptions*”, combining the condensed (and simplistic) statement that assumptions should be outlined, with more specific and detailed indications concerning:

- the identification, formulation and description of the main assumptions,
- the reasons for their introduction,
- their weight on the final results.

Such an effort to achieve clarity and transparency should be considered a fundamental condition to allow users to develop an informed opinion on the degree of subjectivity incorporated in the calculations and, consequently, in the conclusions. Suffice it to think of the distortions that the estimates of the discount rate, the synergies or the determination of terminal value produce on final results. Recognisability and measurability (to the extent possible) of the assumptions are paramount for the clarity of the final report.

iii) **Item I** “Valuation approach and reasoning”, providing greater details on:

- the description of the valuation methods utilised
- the reasons underlying the choice of methods
- the weight attributed to each method
- the result or valuation range determined by the application of the individual methods and the criteria adopted to arrive at a final amount from the range of values (and the reasons that caused any discrepancies in the amounts obtained with the various methods)
- more generally, the line of reasoning followed to reach the valuation conclusions.

Concerning this last aspect, we feel that it might be appropriate to refer to and use a comment in the current IVS3 which has been stricken off the proposed new version, IVS105. In fact, item 6.0 (Discussion) of the current version stresses effectively the importance of an adequate reference framework (market evidence, procedures utilised, valuation methodology, reasoning that led to the final result) as a condition to ensure a clear and unequivocal understanding of the conclusions. Such reference seems consistent with the need for clarity and transparency of every valuation report, to allow the final user an in-depth understanding, on the basis of objective criteria, of the conclusions of the valuation process.

Still within this context, and especially with reference to company valuation, we stress the importance of a full and in-depth description of the value drivers and the forces of competition in an industry, the company’s business model and related resources and core competencies. In its attempt to connect the factors underlying value creation, fundamental analysis is a necessary condition to provide a broader and fuller frame of reference against which the outcome of the valuation process should be interpreted.

As a last general comment, we recommend that consideration be given to the foregoing proposed changes to IVS 104 Scope of Work also for IVS 105, as covered by this question.

APPLICATIONS STANDARDS

Comment to Q16: Which view do you support? If you consider that future IVS should contain application standards do you consider that the degree of details of those in the draft is appropriate and help the better understanding of the valuation requirements?

The IPC considers appropriate the decision to introduce the 200 series of IVS related to valuations for specific purposes. However, the IPC thinks that:

- a) given their current structure, the standards in the 200 series are nearly exclusively for financial reporting purposes, neglecting both their role to

protect public confidence and valuation for damage calculation purposes (see item 5 of the overview)

- b) the standards in the 200 series devoted to valuations for financial reporting purposes do not add anything useful to valuation that is not already available in IFRSs; on the other hand, there might be room, in connection with IFRSs, to provide standards useful for the development of commonly accepted good practices.

Comment to Q17: Which of these views do you support ?

The introduction of fair value in addition to the cost principle by IFRSs entailed the need to develop further the culture of economic valuations in preparing financial statements.

However, it is clear that – even within the context of the general criteria which typically inform valuation activities - valuations for financial reporting purposes refer to specific rules that define special types of value.

The types of value applicable in connection with accounting standards can be more easily verified and are less arbitrary than is normally the case when intrinsic value is estimated, thereby expressing conventional values.

However, these conventional values cannot undermine economic relevance and, accordingly, there must be a possibility to reconcile the types of value determined for financial reporting purposes and intrinsic value.

Broadly speaking, in an ideal world, when dealing with valuation issues, the accounting standard setter should call on the valuation standard setter for technical support and the latter should be given the role of technical interpreter of the manners of application of the standards set by the former. Instead, the ED only repeats what is already in IFRSs without providing more analytical underpinnings (in terms of standards and norms).

Thus, view (b) is more convincing [“involvement” of IVS in issues related to valuation for financial reporting purposes] also for the reasons described above and in the overview, which are different from those indicated in the question.

ASSET STANDARDS

Comment to Q18: Do you have any other comments on the general structure of the Asset Standards?

The IPC thinks that asset standards do not provide sufficient guidance to value specific assets. Asset standards are mostly a duplication of the series 100 of IVS.

Furthermore, the IPC does not think that the valuation of businesses and business interests should be dealt with at the asset standards level.

Comment to Q18 [Q18 is repeated here in the original; it should be Q19]: Do you consider that a class of “personal property” can be identified that is not already covered by the proposed new asset standards ? If so, do you consider that it has distinct characteristics that need to be considered in valuations that would benefit from a new IVS asset standard being developed ?

The IPC has no competence in this area.

Comment to Q19: Do you agree that a standard on valuing non financial liabilities is required and what topics should it cover ?

The IPC thinks that a standard on non-financial liabilities should cover the valuation of contingent liabilities. Contingent liabilities are hard to estimate and their valuation is highly volatile, in relation to their probability of occurrence and underlying value. The intrinsically unstable nature of their value makes the estimation of an appropriate value for contingent liabilities very hard. For instance, what is the market value of the earn-out payable by the buyer in a business combination?

Typically, an earn-out is a negotiated clause between a buyer and a seller with different expectations of future developments. According to the IPC, these different expectations prevent in fact the inclusion of the views of market participants in the process to value contingent liabilities.

The standard should provide also guidelines to value the three main types of contingency (which can be identified on the basis of the different degrees of uncertainty):

- amount payable certain, probability uncertain
- amount payable uncertain, probability certain
- amount payable uncertain, probability uncertain

and indicate

- when to use:
 - (a) single scenario models;
 - (b) multiple scenario models
- and how to incorporate risk in the valuation process.

Comment to Q20: Please identify any additional types of asset or liability that you believe should be considered for future inclusion in IVS, together with an indication of the benefits that you consider a new standard would bring.

Standard IVS 304.01 (Valuations of Financial Instruments) is generic. It might be appropriate to develop valuation standards for more specific types of financial instrument.

Specifically, guidelines should be set out for the valuation of hybrid financial instruments as the valuation of such instruments would be conducive to the solution of complex problems related to the identification of the debt and equity components and to the valuation of the embedded option.

Moreover, assuming that the issue has not been addressed by the valuation standard for “non financial liabilities”(IVS305.01), it might be appropriate to prepare a valuation standard for contingent liabilities or to include such standard in the abovementioned project (see comment to Q20).