29 April 2011

International Valuations Standards Council
Moorgate
London
DC2R 6PP
United Kingdom
Email: ivsc@ivsc.org

Dear Sirs,

Comments on exposure draft technical information paper 1: The Discounted Cashflow Method with Property and Business Valuations

Thank you for the opportunity for the Institute of Chartered Accountants in Australia (the Institute) to provide comments on your technical information paper 1 exposure draft.

The Institute is the professional body representing chartered accountants in Australia. Our reach extends to more than 66,000 of today’s and tomorrow’s business users, with some 54,000 chartered accountants and 12,000 Australian best accounting graduates, who are currently involved in our world class graduate program.

Our members are involved in diverse roles across industry, academia, government and public practice throughout Australia and in over 109 countries around the world. The Institute is a founding member of the Global Accounting Alliance, (GAA).

In general we are supportive of increased guidance for valuation practitioners in relation to technical aspects of valuations. In our view, this guidance should be supplemented with cross references to relevant guidance in specific contexts such as international accounting standards, US accounting standards or taxation office details. However, the generic approach proposed by the IVSC is a helpful step forward.

Detailed comments on the exposure draft set out in the Appendix to this letter. These were prepared by the Institute’s Business Valuations Special Interest Group (BVSIG). The special interest group is one of those affected by the issues in the exposure draft.

In July 2005 the Institute established the Business Valuations Special Interest group, for the benefit of the Institute, members and stakeholders, including regulations in the community. BVSIG currently has approximately 1000 members, working in the field of business valuations. The aims of the BVSIG include promotion of improved standards in the area of business valuation, as well as improving the profile, continuity and education of business practitioners in Australia. The BVSIG is represented in most states and nationally.

Should you have any questions in relation to the matter discussed in the attached document please contact Richard Stewart, Chair BVSIG on +61 2 8266 8839.

Yours sincerely,

Lee White
Executive General Manager - Members
Institute of Chartered Accountants in Australia
Discounted flow valuations

Increasingly, discounted cash flow (DCF) methods underpin valuation conclusions in the Australian business valuation market.

The Australian business valuation market includes the preparation of valuations for regulatory purposes, including accounting standard valuations, tax valuations, dispute related valuations and the provision of independent expert reports in relation to public company transactions. DCF methods are used across each of these valuation contexts.

DCF methods are also common in the valuation of other assets and liabilities besides businesses including intangible assets and restoration provisions.

We see the guidance introduced in this exposure draft as helpful, and accordingly provide comments below to clarify aspects particularly those related to business valuations.

We have provided our comments in response to your questions, and then follow with specific comments on various paragraphs of the document.
1. Responses to specific questions

1. Do you agree that the DCF method, if possibly applied, can be used as a method to arrive at market value?

The definition of fair market value that we would consider appropriate, is that it is the price at which the asset would change hands between a willing buyer and a willing seller, neither being under any compulsion to act and both having reasonable knowledge of relevant facts.

We agree that the DCF method, if properly applied, can be used as a method to arrive at fair market value (and market value).

However, we consider that it is appropriate in almost all circumstances to cross-check a valuation calculated using the DCF method with alternative methods of valuation including cost and market estimates.

DCF valuations should be cross-checked because of the number of estimates on which the approach, by necessity, relies. If only a small number of these estimates are biased or incorrectly estimated, it can lead to the exponential differences in the ultimately calculated value. Cross-checking limits the potential for errors of this nature to persist in the final valuation conclusion.

2. Do you agree that the underlying DCF method described in this paper applies equally to the valuation of real property and businesses? If not, please explain the differences that you believe exist.

We agree that the underlying DCF method applies equally to the valuation of real property and businesses.

We note, however, that the drivers of value are significantly different between the two aspects.

The discussion of real property also appears to be disproportionately heavily addressed in the exposure draft.

3. Do you agree, or do you consider that other matters should be taken into account, in determining the appropriate discount rate?

We assume that this paragraph relates to paragraph 11, rather than paragraph 10.

We agree with the statement that the discount rate should reflect the market’s view on the risk associated with the cash flows.

However, for business valuations, the description of the discount rate as “being determined by market participants’ views on risk, discount rates or returns as implied by recent transactions involving similar assets” could only be considered to describe market practice at a very high level of abstraction. Specifically, a weighted average cost of capital, estimated using the capital asset model (CAPM) assumptions, is most typically applied.

As is well known, this model only incorporates the systemic risk contribution of the business in the discount rate, but relies on the discounting of an appropriately probability-weighted and unbiased set of cash flow forecasts.

Accordingly, the way paragraph 11 is worded may lead valuers to include an allowance for the specific risk in circumstances where in fact none is required. The wording would benefit from some clarification.
Appendix – Discounted flow valuations

In practice, other factors that are most commonly taken into account in the calculation of business valuation discount rates include:

- the incorporation of size premiums in the valuation of smaller or less diverse business enterprises, and
- specific allowances to adjust for cash flows not being consistent with a market participant’s view (that is unbiased and appropriately probability weighted) for the outlook of the business.

4. Do you agree that the most commonly adopted terminal valuation calculation at the end of the explicit forecast period, is the “constant growth model” cross-checked for sensibility to an implied capitalisation rate, or exits multiple? If not, please identify what other method you most commonly use.

We agree that the most commonly adopted terminal valuation calculation at the end of the explicit forecast period is, in fact, the constant growth model. In practice, this constant growth model is cross-checked against implied capitalisation or exit-multiples.

However, it is appropriate to therefore imply that it is the only method that is correct, for example, growth and fading growth methods can be appropriate in the case of certain assets.

In general, the most significant issue that we identify in relation to the use of terminal values is that the cash flow period to which the constant growth is applied does not necessarily reflect a sustainable long-term position. In addition, the terminal calculation can often include implied returns on capital that are difficult to sustain over a long term period.

In addition, where there is a particular license (or other intellectual property) which expires after a longer period than the explicit forecast period, then it is inappropriate to use the constant growth model, in perpetuity. Unfortunately, this error can occur in practice.

5. Do you agree that providing a discount is used that it consistent with the financial assumptions made and calculated in cash flows, that the choice of using explicit or implicit financial assumptions in the cash flows, should not affect the valuation result?

In general, we agree that it is appropriate to use a discount rate that is consistent with the assumptions made and calculated in the cash flows. For example, if real cash flows have been used, it will be a process to adopt real discount rates.

We consider that it would be inappropriate to use undisclosed or implicit financial assumptions in the cash flows.

A particular issue that frequently emerges is making simplified assumptions to deal with tax (e.g. grossing up discount rates to discount pre-tax cash flows) and capex (e.g. using depreciation as a proxy) can result in significant valuation errors.

In our view, the non-disclosure of the assumptions and the sensitivity of outcomes to those valuations would make the valuation less reliable. This is because it creates a limited ability to re-perform the valuation itself and to assess the reasonableness or otherwise of individual assumptions.
6. Do you agree that a more detailed discussion in terms of valuation input for into a discounted cash flow model are inappropriate? If not, how much additional information do you think should be included in best practice guidance?

In relation to a more detailed discussion or example on valuations to a discounted cash flow model, more guidance could be helpful.

However, the danger in taking this approach would be that there are already a number of reputable valuation texts which could provide alternative solutions of this information.

An alternative approach would be to provide examples of valuation texts which provide more detailed explanations of these techniques, rather than recreating them in the cash flow valuation guidance.

Moreover, it should be clear that complying with the guidance should only be part of the rigour that is necessary to prepare a DCF method valuation appropriately. For example, the valuer should have the appropriate experience and qualifications in addition to following the guidance.
2. **Relationship with other guidance**

The exposure draft is drafted to identify best practice, in isolation of alternative guidance that exists in relation to the use of DCF.

For example, under the financial accounting standards in relation to the conduct of impairment tests, the methodology for performing discounted cash flow valuation is prescribed by the standards themselves.

Accordingly, valuations conducted in accordance with the technical information paper, may in fact not be compliant with these standards.

This could be addressed through the exposure draft referring to instances of specific guidance such as accounting standards or perhaps a broad reference to having regard to local laws and regulations. Where the purpose of the valuation is for the purposes of complying with the accounting standards then clearly the accounting standard DCF guidance should prevail.
3. Detailed comments on the exposure draft, by paragraph

Paragraph 4 – whilst we agree with the issue raised in paragraph 4, we do not believe that this view would be held by all practitioners.

Paragraph 5 – whilst we have no issues with the descriptions and the definitions adopted, we consider that these could be expanded to include, inter alia, terminal values and forecast period.

Paragraph 8 – Terminal value for an asset of defined life could be positive, reflecting the residual value of the net assets employed, or negative representing dismantling or rehabilitation costs.

Paragraph 9 – in relation to the cash flows estimated under a market value assumption, these would need to reflect the cash in-flows and out-flows that would be reasonably expected by market participants.

Paragraph 11 – as noted above, we have concerns in relation to the drafting of this paragraph.

Paragraph 16e – we agree that an appropriate discount rate needs to be applied to the cash flows. One of the key issues in relation to this excludes the pre-or-post tax nature of the cash flows. We believe it would be worth expanding on this in relation to real property investment. In this market, we see the potential for unjustifiably divergent approaches to taxation adopted between business and real property valuers. Perhaps this should be rectified by bifurcating the guidance under the two categories in this area.

Paragraph 16i – Amortisation is not a cash flow

Paragraph 16j – should refer to not only surplus assets but surplus liabilities (ie those that are not trading liabilities of the business).

Paragraph 16k – the discount rate description is not typical of the one which business valuers use to approach the task. Typically the discount rate is computed looking at the beta factors in relation to comparable business factors and adjusting for differential size and capital structure, rather than the factors described in section k. The drafting of this section could be made less generic in this regard.

Paragraph 22 – there are 4 typographic errors in this paragraph. In addition, we note that the process of adapting cash flows and discount rates from post tax to pre tax and nominal to real is complex. Simple application of the fisher equation is unlikely to result in the results of the valuation if the cash flows fluctuate or the tax shield from interest and tax depreciation is material to the valuation.

Paragraph 24 – we are strongly in favour of the disclosure that is set under in paragraph 24.

Paragraph 25 – As noted in our responses set out in section 1 above, we are strongly of the view that another valuation method should be used as well as DCF.

The rationale behind this view is that DCF analyses have a number of points of estimation. Due to the mechanics of the DCF calculation, small differences or errors in relation to one or several of the valuation inputs can multiply to result in an unreasonable outcome.

The use of cross-checks prevents valuers from appearing to give unreasonable outcomes where DCF methods are the primary valuation methodology used.

There are also limitations of DCF in certain circumstances. In particular, a DCF analysis is a “static” valuation model that does not take into account the flexibility of management to respond to changes in financial and market conditions. Accordingly, in addition to sensitivity analyses, the use of simulations, decision tree or scenario analysis in addition to the static DCF may be appropriate.