IVSC October 16, 2018

Attn.: Technical Director
aaronsohn@ivsc.org

File Reference: *IVS 2017 Proposed Revisions*

Dear Technical Director,

We are pleased to respond to the IVSC's request for comments on the Exposure Draft: *IVS 2017 Proposed Revisions*. Duff & Phelps is the premier global valuation and corporate finance advisor with expertise in valuations for financial reporting and tax, complex valuation, dispute and legal management consulting, M&A, restructuring, and compliance and regulatory consulting. Our valuation advice is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques.

We support the IVSC's efforts to develop robust and widely accepted global valuation standards. We are happy to provide you and the IVSC staff with further clarifications to our comments.

Sincerely,

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IVSC

October 16, 2018

Comments on Exposure Draft –

IVS 2017 Proposed Revisions

(July 17, 2018)

IVS Glossary Comments

IVS Glossary

Answers to specific questions

Question 1: **Do you believe that IVS should define the terms Price, Cost, and Value? If so, please discuss why you think the additional definitions are necessary.**

Response: Considering that the goal of IVS is to be a global standard, one that harmonizes existing valuation standards and one that fills the gap where there are none, we believe that these concepts should be included in the IVS Glossary.

However, we do not fully agree with the direction taken on some of the definitions themselves. Here are a few observations:

- **Proposed definition of *Price***: There appears to be an exit perspective taken in the definition of Price (first sentence). Why so? While this perspective is consistent with the one used in fair value for financial reporting (IFRS 13 / FASB's Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurement*), fair value is not an IVS basis of value itself. We think that the definition should be more neutral as to whether it captures an exit – or an entry – perspective. For example, consider modifying the first sentence of the proposed definition along the following lines:

  > *The word "price" refers to the amount paid or received to exchange (or transact) ~~sell~~ an asset or ~~paid to transfer~~ a liability.*

  > Or,

  > *The word "price" refers to the amount at which ~~received to sell~~ an asset is transacted or ~~paid to transfer~~ a liability is transferred or settled.*

  Since IVS is intended to be applied to a variety of valuation purposes, we believe that a "neutrality" in the definition should be maintained.

- **Proposed definition of *Valuation*:** we think that the definition should reference arriving at an *opinion of value*, rather than just an estimate of value. An opinion of value entails (and implies) a more rigorous process.

  Additionally, we believe that a **Valuation Review** should also be defined. Currently, IVS 2017 only defines a **Valuation Reviewer**, as follows:

  > *A "valuation reviewer" is a professional valuer engaged to review the work of another valuer. As part of a valuation review, that professional may perform certain valuation procedures and/or provide an opinion of value.*

Last, but not least, we believe that these definitions should be consistent with the approach taken by some of the more widely accepted valuation standards by individual VPOs, to avoid or mitigate any inconsistencies or potential market confusion.

- **Proposed definition of *Value*:** While we agree that value is an opinion, we disagree that this opinion should be characterized as *an opinion of the valuer*. This approach confuses 1) the *valuation opinion*, resulting from the valuation process undertaken by the valuer, with 2) the concept of *value*, which is an economic concept that is typically described and examined in the context of *price* vs. *cost* vs. *value*.

  We recommend that **value** be defined as an opinion, but without making a reference to the valuer. *Value is an opinion* that reflects the stipulations of a given basis of value (e.g., market value, investment value). The Board can then separately describe a **valuation opinion** (or a conclusion of value) as that of the valuer, arrived at in a valuation analysis with a specified basis of value objective.

  Finally, we disagree that value is a fact when price and value are equivalent. This also confuses the concepts. *Value is an economic concept*. In addition, *value is always an opinion*, not a fact, even if it may coincidentally equal price in some cases. Furthermore, we do not see the merit of highlighting the special situations in which value may equal price, especially in a glossary. (By the same token, one could make additional commentary on, for example, cost: that **cost** can also be a **price** when considered in a transactional context - the cost incurred by a buyer for an asset is the price paid - but these kinds of reflections would be misplaced in a glossary.)

  Overall, we believe that the definitions should be self-contained and succinct, and consistent with the general understanding and description of these concepts in other widely-accepted standards, even if the glossary is only meant to be applicable to IVS 2017. Only then can IVS be progressing towards its purpose of unifying and harmonizing standards, rather than contributing to diversity.

Question 2: Do you believe IVS should define *Calculation* and *Calculation Engagement*? Please explain why.

Response: We believe that *Calculation* and *Calculation Engagement* should be defined, as these types of engagements are encountered in practice. A valuer who otherwise complies with (or wishes to comply with) IVS should understand how a calculation engagement fits into IVS.

Additionally, the valuation and/or performance standards of member organizations in the IVSC have defined calculation (or limited) engagement. Echoing the same concerns and suggestions shared in the response to **Question 1**, we believe that such IVS definitions should be as consistent as possible with existing definitions in widely accepted valuation standards.

For additional reference in developing an IVS definition for these terms, also consider the definitions of a **calculation engagement** in AICPA's *VS Section*

100, and, compare the definitions of a **calculation engagement** and a **complete valuation analysis** in the *Mandatory Performance Framework for the Certified in Entity and Intangible Valuations™ Credential*.

Question 3: Should a calculation be IVS compliant, and if so, what difference in the scope of work and disclosures outlined in IVS should be required by the valuer?

Response: We do not believe that a **calculation** should be IVS-compliant for several reasons. First, because a calculation is not a "value" – i.e., it is not an economic concept, or an opinion rendered with respect to specified basis of value. Second (also related to the first point), this type of engagement involves constraints on the information available to the valuer and/or the procedures performed by the valuer. This limits the ability of the valuer to apply professional judgment in establishing a scope of work in full consideration of the facts and circumstances, relevant data & assumptions, and applicable valuation approaches.

In fact, the idea that a calculation can be deemed to be IVS-compliant seems to run counter to the requirements of par. 20.3 of IVS 102 - *Investigations and Compliance*, which states:

> *"20.3 Limits may be agreed on the extent of the valuer's investigations. Any such limits must be noted in the scope of work. However, IVS 105 Valuation Approaches and Methods, para 10.7 requires valuers to perform sufficient analysis to evaluate all inputs and assumptions and their appropriateness for the valuation purpose. If limitations on investigations are so substantial that the valuer cannot sufficiently evaluate the inputs and assumptions, the valuation engagement must not state that it has been performed in compliance with IVS."*

IVS 102 Comments

IVS 102 – Investigations and Compliance

Answers to specific questions

Question 4: Should IVS provide examples of "substantial" limitations? If so, please provide examples of such limitations.

Response: In general, we think that the guidance in par. 20.3 is sufficient on the topic of limitations on work.

Also, we think that the evaluation of the extent of limitations should be best left to the professional judgment of the valuer. It should be noted that in addition to the IVS 102 guidance, the valuer would be subject to the Code of Ethics and the Professional Standards of his/her valuation membership organization, which impose additional obligations on the valuer to act with integrity, objectivity, competence, and transparency. This further informs the valuer's assessment of any limitations, including substantial limitations on the engagement.

As to the proposed changes to par. 20.7 of IVS 102, we think it would be useful to work in not only a reference to "sufficient *evaluation* of the inputs and assumptions", but also to whether the valuer can in fact *obtain* relevant data, which in turn may limit the ability to apply otherwise relevant valuation approaches. In other words, the Board should consider expanding the proposed edits a bit further.

IVS 105 Comments

IVS 105 - Valuation Approaches and Methods

Answers to specific questions

Question 5: Do you agree with the suggested changes to IVS 105 section on Discount Rates? If not, please provide details of the additional information you think should be included or excluded from this section.

Response: In general, we consider the suggested changes to the Discount Rates section to IVS 105 appropriate, and an improvement relative to the existing standard. However, we do have some concerns in specific sections of the proposed changes to IVS 105.

The newly-added **paragraph 50.6-e)** regarding the nature of cash flows appears to imply that there are only two types of cash flows: expected vs. most likely cash flows. However, when valuing certain types of securities (e.g. investment in a debt instrument), a valuation professional may use contractual or promised cash flows and then adjust the discount rate to take into consideration the risk that the contractual cash flows may not be realized in the timing and amount promised originally. A good description of the distinction between the types of projected cash flows vs. the appropriate accompanying discount rate can be found in ASC 820 and IFRS 13 *Fair Value Measurement*:

- ASC 820-10-55-4 through 20
- IFRS 13, paragraphs B12 through B30

In **paragraph 50.32,** we suggest that certain words are modified. Specifically:

- When listing the capital asset pricing model (CAPM) in paragraph 50.32-a) without any qualifiers, it may be strictly interpreted by some constituents as representing the textbook form of CAPM, where no adjustments are allowed except for market risk (i.e., beta multiplied by an equity risk premium). Meanwhile, valuation professionals in many jurisdictions will adjust the traditional (textbook) CAPM for additional risk factors. Therefore, to avoid any confusion, we suggest one of two options:

    1) List a separate method called "Modified CAPM" or

    2) Add a qualifier to the existing bullet (see suggested text in underline): "a capital asset pricing model (CAPM) <u>or variation on the model (i.e., a Modified CAPM)"</u>

- When listing a build-up method in paragraph 50.32-b), we suggest that the text in parenthesis “(generally used in the absence of market inputs)” to be deleted for two reasons:

  1) It is inaccurate, since the build-up method does rely on market-based inputs (e.g. historically observed returns over the risk-free rate);

  2) It includes a qualifier of when it should be used, whereas the other listed methods do not (e.g. when would it be appropriate to use observed yields?).

Paragraph 50.33 will likely cause confusion and it probably should not be added to IVS 2017 in its current form. In particular, the examples given as corroborative of a discount rate (i.e., the internal rate of return – or IRR – and the weighted average return on assets – or WARA) are misleading. For instance, in the context of a business combination, in a valuation for financial reporting purposes, a discount rate such as the weighted average cost of capital (WACC) is used to corroborate the IRR of the transaction, not the other way around. A transaction IRR does not automatically equate to the estimated WACC; however, to assess the reasonableness of a transaction’s deal projections and associated IRR, one should compute independently an industry WACC, using market participant assumptions, as possible corroborating (or not) evidence. Likewise, the WARA may employ the WACC, cost of equity, or cost of debt as the basis (or inputs) to estimate the required rate of return on individual assets. However, the WARA is not a rate that the valuation professional would use to corroborate the appropriateness of his/her estimated WACC, cost of equity, or cost of debt.

In **paragraph 50.34,** we suggest that in addition to factors already listed that a valuer should consider when developing a discount rate, a new factor is added to consider the currency denomination of the projected cash flows. This is one of the most common mistakes that we observe in practice – a mismatch between the currency used for the projected cash flows and the currency used for inputs selected when computing the discount rate. Therefore, including a factor to reminder to the valuer to consider the currency in which the projections are denominated may be worthwhile.

IVS 200 Comments

IVS 200 – Business and Business Interests

Overall comment

The IVSC proposal is very high-level, and as such, misses many of the necessary nuances. For example, the AICPA Working Draft, *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies* (the “AICPA PE/VC Draft Guide”), has several paragraphs/pages identifying weaknesses in OPM and necessary adjustments. It would be remiss to not have some level of discussion of these issues, or direct specific cross references to the AICPA PE/VC Draft Guide (see Ch. 8 and the related FAQs therein), otherwise the amendments to IVS 200 could be more detrimental than helpful. Additionally, further nuances may come into play depending on the basis of value used in the analysis and purpose of the valuation. While we understand the desire to keep the standards at the principles level, an oversimplification could give a user of IVS false comfort in grasping the issues, given the complexity of the subject.

Answers to specific questions

Question 6: Do you agree that the methods are more relevant to business valuation and the placement in IVS 200 is appropriate? If no, please explain why.

Response: Overall, we think that the placement of this guidance in IVS 200 is appropriate. However, perhaps these methods can be couched as allocation methods, once the equity value has been determined using other methods.

The application of the back solve method may also deserve a more complete discussion in conjunction with the other methods addressed, and particularly highlighting the pitfalls in using it.

Question 7: Are there additional methods that should be included in the proposed revisions, for example the Hybrid Method? If yes, please discuss the additional methods to consider.

Response: Yes. The Hybrid Method should be included to ensure consistency with the AICPA PE/VC Draft Guide. In addition, the Hybrid Method it is already addressed in a few paragraphs, so why not make it a standalone method?

Question 8: Are there additional topics within Early Stage Company Valuation that you feel should be included in IVS or explored further by the Boards? Please provide an outline for any topics suggested.

Response: We do not believe that the IVSC should be delving into the early stage space. The high-level and principles-based nature of the IVS standards, and the abbreviated nature of the guidance, cannot do justice to the critical nuances involved. Additionally, further issues may arise from the basis of value used, such that even considering IVS in its entirety may not be sufficient to guide the user in addressing the complexity encountered in practice.

Additional observations

Par. 130.1: Could “some other form of ownership interest” be interpreted to mean a crypto currency or ICO?

Par.130.6: This paragraph should address if and why OPM, which estimates outcomes using a lognormal distribution, would be appropriate when the outcomes it is trying to estimate are not logarithmically normally distributed.

Par. 130.14, par. 130.17 (a), par. 130.20, par. 130.22(a), and possibly elsewhere: References to "equity value of the *asset"*, where "asset" is intended to refer to a business enterprise, are confusing. Furthermore, such references to the "asset" make it difficult to distinguish when the discussion is about the business enterprise vs. a security.

Par.130.15: Reference here is made to the Hybrid Method – it should be discussed as a fourth method in the proposed revisions.

Par.130.19: This guidance should be supplemented with further discussion, and a caution. Generally, OPM tends to overstate or understate value because it does not anticipate future terms from future rounds of fundraising, future dilution, and the fact that preferences are not always enforced exactly as outlined legally.

Par.130.24: See comment to par. 130.15. In many instances, the Hybrid Method, which is a combination of methods, may be more powerful.

IVS 410 Comments

IVS 410 – Development Property

Answers to Specific Questions

Question 9: Do you feel that the inclusion of the "As Is" and "As Proposed" value for the Development Property will reduce the risks in relation to the valuation of development property? If no, what additional information would you like to see included?

Response: In our experience, lenders generally benefit from having the following data points: 1) an *"as completed*" (*"as proposed"*") value, which refers to the project's value when ready for sale as vacant; 2) an *"as is"* value, which describes what a market participant would expect to realize upon a sale of the property, which is a function of the anticipated price for the project when completed, the remaining development costs, and a developer's profit commensurate with those costs; and occasionally, and/or as appropriate, 3) an "*as stabilized*" value, which assumes a stabilized level of occupancy, once the project is completed. An "as is" value, as described above, is conceptually consistent with market value when market participant assumptions are used.

We think that the Board should state the valuer *should* provide an "as completed" and an "as is" value, rather than mandate it in all cases. Providing a robust discussion of the key assumptions underlying the "as completed" value, including the risks, sensitivities, and limitations involved, may be an alternative way to address the Board's concerns and inform the user of the valuation of the inherent risks of development property.

We also observe that disclosing or reporting the values derived using different assumptions does not reduce the risk in the *valuation process* per se (as

Question 9 infers), but rather, informs the user of the general assumptions and inputs upon which the valuation is based.

Additionally, one of the reasons for the Board's proposal to require an "as is" value in addition to an "as completed" value references future price increases built into the valuation. However, it should be noted that the "as is" value uses the anticipated price or value of the project when completed as an input in the analysis.

Finally, we recommend that the Board define the terms "as is" and "as proposed" (or "as completed") within IVS 410 so that the standard is clearer for users of IVS generally.

Question 10: Should the *valuer* be compelled to state the method of valuation they have used in their calculation of market value and report the assumed (or calculated) Developers Profit when reporting market value? If no, please explain why not?

Response: We observe that in addition to the question above, the Board has added par. 120.2 in its entirety as a proposed amendment, so our response covers this as well.

While we think that using two methods (typically a cost approach and an income approach) in estimating the market value of development property may be best practice, the Board should not *mandate* the use of multiple (or "a minimum of two appropriate and recognized") methods. While inputs to apply both a cost and an income approach are typically available, the IVS are principles-based and should not prescribe the type(s) and number of approaches and methods used. The valuer, using professional judgment, should select the appropriate valuation approach(es) and method(s) based on the facts and circumstances. Here too, disclosing why certain approaches and methods were used but other approaches and methods were not, may also be very informative to users.

Further, we think that it is beneficial to disclose the key assumptions (significant inputs) in the valuation, and the rationale for using these. A Developers Profit is such a significant assumption. (It should be noted, however, that the Developers Profit may vary depending on the purpose of the valuation - this would impact, for example, whether the assumption is market-based or investor-specific.)

Additional observations

Par. 90.1 – A sentence regarding the relationship between the residual method value indication and market value has been struck out. (*"The residual value, derived from the residual method, may or may not equate to the market value of the development property in its current condition."*) Rather than striking out the sentence, we think that the standard should explain that the value indication from the residual method is a function the basis of value in the analysis and the assumptions employed, including the source and relevance of the inputs used.