EACVA’s Commentary to IVS 2017 Proposed Revisions Exposure Draft

Dear Mr. Zyla,

Thank you very much for giving us the opportunity to comment the IVS 2017 Proposed Revisions Exposure Draft (ED). We welcome the improvement process of IVS 2017 and believe that the ED is a good basis for doing this. Because of our professional background, we concentrate our answers to the questions to only three of the treated five chapters, namely IVS Glossary, IVS 105 – Valuation Approaches and Methods and IVS 200 – Business and Business Interests.

**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.

**Anticipating the arguments given below, we would prefer not to define the mentioned terms. We explain the reasons for our recommendation as follows:**

First, we see a contradiction between para 10.2 and the proposed definitions for cost, price, valuation and value. Para 10 states that the glossary does not attempt to define basic valuation, accounting or finance terms, whereas the following paragraphs exactly try to do so. **There has to be a decision what the IVSC wants to do: to delete para 10.2 or to delete the definitions.**

Second, if the IVSC decides to define the terms, the definitions have various shortcomings.
Cost

The proposed definition of "cost" is not fully compatible with the mentioned applicability to IVS 2017. The definition says

"The word 'cost' refers to the amount required to acquire or create the asset as of a particular date."

This proposal is in contradiction to

i. IVS 104 – Bases of Value para 80.1 that requires: "Liquidation Value should take into account the costs of getting the assets into saleable condition as well as those of the disposal activity."

ii. IVS 104 para 210.1 which knows "seller's costs of sale".

iii. IVS 105 – Valuation Approaches and Methods paras 50.22 (c) and 50.28 that contain "disposal cost".

iv. IVS 300 – Plant and Equipment para 20.5 (a) which knows "costs of decommissioning and removal".

This inconsistency disappears if one changes the proposed definition to:

"The word 'cost' refers to the amount required to acquire, create, sell or dispose of the asset as of a particular date."

But that does not help to eliminate a more important consistency problem with the term "weighted average cost of capital (WACC)" in IVS 105 para 50.30 or IVS 400 – Real Property Interest para 60.5 (a).

The WACC does not contain amounts to acquire, create, sell or dispose an asset, but contains cost of capital rates. Even if one tries to explain that amounts of money are in the background of those rates and are part of their definition, that explanation fails for equity cost of capital.\(^1\) Equity cost of capital are expected risk-adjusted rates of return of investment alternatives to the valuation object.\(^2\)

In addition, IVS 400 – Real Property Interest para 70.4 mentions "the time cost of money" which is not consistent to the proposed definition.

To sum up: It is difficult to define "cost" with respect to all IVS 2017 in which the term is used. Because of the mentioned consistency problems, especially those with equity cost of capital and WACC, we prefer not to define the term "cost".

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\(^1\) In our view, it is not by chance that IVS 105 para 70.11 (b)7 explains "finance costs (eg, interest on debt financing)" only with respect to debt, not to equity.

\(^2\) Also compare IVS 105 para 70.12: "However, financing costs, if included, may already reflect participants' required return on capital deployed, (...)".
Price

The proposed definition of "price" is:

"The word 'price' refers to the amount received to sell an asset or paid to transfer a liability. Because of the financial capabilities, motivations or special interests of a given buyer or seller, the price paid may be different from the value which might be ascribed to the asset by others."

There is no problem with the first sentence, but we wonder about the second one. The reason is that a difference between price and value is explained with respect to "financial capabilities, motivations or special interests of a given buyer or seller".

According to basic economic theory and neglecting other than financial aspects, a good or a service is sold, if its price exceeds the individual value for the seller and a good or a service is bought, if the individual value for the buyer exceeds price. Of course, we are aware that other aspects than financial ones may be the reason for an observed price in reality. But does it help to explain those reasons by "financial capabilities, motivations or special interests", especially when it is considered that "motivations" or "special interests" are not very concrete? Could not there be other explanations? Is the explanation list complete?

To sum up: We would prefer to delete the second sentence of the definition of "price".

Valuation and Value

We have no comments with respect to the definition of "valuation", but with respect to "value".

The proposed definition of "value" is:

"The word 'value' refers to an opinion of the valuer of the estimated amount consistent with one of the Bases of Value set out in IVS 104, or in instances in which value and price are equivalent, the word 'value' refers to a fact."

We do not have a problem with the second part of the sentence, starting with "or (...)". But we think that the definition of value as "an opinion of the valuer of the estimated amount consistent with one of the Bases of Value set out in IVS 104" is not very concrete.

IVS 104 para 10.1 states:

"Bases of value (...) describe the fundamental premises on which the reported values will be based. It is critical that the basis (or bases) of value be appropriate to the terms and purpose of the valuation assignment, as a basis of value may influence or dictate a valuer’s selection of methods, inputs and assumptions, and the ultimate opinion of value."
Paras 10.3 and 10.4 add:

"10.3. While there are many different bases of value used in valuations, most have certain common elements: an assumed transaction, an assumed date of the transaction and the assumed parties to the transaction."

"10.4. Depending on the basis of value, the assumed transaction could take a number of forms:
(a) a hypothetical transaction,
(b) an actual transaction,
(c) a purchase (or entry) transaction,
(d) a sale (or exit) transaction, and/or
(e) a transaction in a particular or hypothetical market with specified characteristics."

IVS 104 para 20.1 says:

"20.1. In addition to the IVS-defined bases of value listed below, the IVS have also provided a non-exhaustive list of other non-IVS-defined bases of value prescribed by individual jurisdictional law or those recognised and adopted by international agreement:
(a) IVS-defined bases of value:
  1. Market Value (section 30),
  2. Market Rent (section 40),
  3. Equitable Value (section 50),
  4. Investment Value/Worth (section 60),
  5. Synergistic Value (section 70), and
(b) Other bases of value (non-exhaustive list):
  1. Fair Value (International Financial Reporting Standards) (section 90),
  2. Fair Market Value (Organisation for Economic Co-operation and Development) (section 100),
  3. Fair Market Value (United States Internal Revenue Service) (section 110), and
  4. Fair Value (Legal/Statutory) (section 120):
     a. the Model Business Corporation Act, and
     b. Canadian case law (Manning v Harris Steel Group Inc)."

Taking those paragraphs as a starting point, we do not know what the value definition as being "an opinion of the valuer of the estimated amount consistent with one of the Bases of Value set out in IVS 104" really means.

i. Is market rent a value? Economists distinguish status measures from flow measures, i.e., value or wealth as a measure at a certain point of time from income or rent as a measure for a certain period of time. IVS 104 para 20.1 mixes both by naming rent a value. Does it make sense to contradict basic economic theory? – In addition only: Could market rent (for leasing) be a cost? Would cost be the same as value?

ii. According to basic investment theory synergies may be part of investment value. Does it make sense to separate investment value from synergistic value?
iii. IVS 104 para 30.2 (a) states an unprovable characteristic of market value with the sentence: "It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer." A best price for seller and buyer? We cannot imagine that it is best for both, when financial interests motivate the transaction. This means for a buyer individual value > price, for a seller individual value < price. Only by chance do we get an equal sign (=) instead of an unequal sign (≥ and ≤).

iv. It may be right that most bases of value assume a transaction at an assumed date with assumed parties. But very prominent exceptions can be seen in the cases of a squeeze-out or freeze-out, heritage taxation or resumption which are events against the will of a party. Another prominent exception is financial reporting, if the "value in use" is searched for, e.g., in IAS 36.

v. IVS 104 para 30.4 states another unprovable fact: "The Market Value of an asset will reflect its highest and best use." The background of this sentence seems to be IFRS, i.e., a regulation of financial reporting. It is not shown that this characteristic is of any relevance or truth for business valuation. There we would expect that "value in use" is much more important. Value in use can easily be combined with investment value and synergistic value. Value in use is also known in financial reporting. Why is it not mentioned here, whereas a definition part of fair value according to IFRS is mentioned here? What explains the asymmetry?

vi. Does it make sense to mention "Fair Market Value of U.S. IRS" and Canadian case law, but not to mention comparable (or other) values of other countries? We are aware that the list is called "non-exhaustive". But what criteria drive the selection?

To sum up:

*With respect to basic economic theory and evident usage in practice we would prefer to define "value" as

(a) a non-observable financial dimension of utility that is attributed to a good or service by an actual or potential market participant by way of estimation

or as

(b) a certain kind of price estimation in some regulations (e.g. taxation, financial reporting) or commonly adopted rules.*
Question 2: Do you believe IVS should define Calculation and Calculation Engagement? Please explain why.

In practice "calculations/calculation engagements" do not play a prominent role. However, although small in their nature, such engagements occur relatively frequently. In Germany main reasons for "calculation engagements" are either tax-related or for pure (deal-)pricing purposes.

Hence, it would be helpful to clarify the difference(s) between a "valuation"/"valuation engagement" and a "calculation"/"calculation engagement". In particular it would be important to understand differences in terms of accountability of the result of a "valuation" vs. the result of a "calculation".

Irrespective of the general interest to clearly draw a line between "valuation" and "calculation" we see a challenge to find a definition that is able to factor in requirements from different jurisdictions as well as from different regulatory environments.

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

No, a "calculation" should not be compliant with IVS.

If a definition of "calculation"/"calculation engagement" can be developed that can be reliably applied in various jurisdictions and regulatory environments, the responsibility of the appraiser and the (very) limited level of comfort (if any) of the result must be clearly reported. Any likelihood of misunderstandings (e.g. mixing up an "indicative valuation" and a "calculation") must be avoided. Limitations need to be observable. These requirements can be described in the IVS, but it does not mean that meeting the definition of a "calculation" means IVS-compliance.

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

See answer to question 3.
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.

In general, we agree with the suggested changes and propose only slight changes of the wording.

i. Para 50.37 and 50.38 both mention "the risk of achieving the forecast cash flow", which we propose to substitute by "the risk of the forecast cash flow”. In our opinion, risk is a characteristic of future cash flow and not a characteristic of the valuer who estimates future cash flow.

ii. Para 50.32 mentions an internal rate of return (IRR) and a weighted average return on assets (WARA) as examples for a corroborative analysis for assessing a discount rate. The IRR could be a historical or a required measure. We are not sure what is meant. Required IRRs would not find our support, since the discount rate should reflect market conditions. The same should apply to WARA.

iii. Para 10.10 (c) requires: "If expected cash flow incorporates an expected inflation rate, the discount rate has to include the same inflation rate." We propose to substitute this sentence by "If expected cash flow is in nominal terms, the discount rate has to be in nominal terms." The reason is: Future cash flows of a business are influenced by firm-specific inflation rates for cost, revenues and the resulting profits and dividends. Discount rates are influenced by capital market policies of supranational and national organisations. It is only by chance that inflation rates for profits or dividends are the same as those for cost of debt and cost of equity.

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.

We agree that the Current Value Method (CVM), Option Pricing Method (OPM) and Probability-Weighted Expected Return Method (PWERM) are more relevant to business valuation and that the placement is appropriate.

Nonetheless, we detect that the new proposals seem to be driven by U.S. background which might lead to some sentences that do not necessarily make sense for other countries. Let us explain:

i. IVS 200 para 130.1 states: "While equity or a particular class of equity can occasionally be valued directly, more often the enterprise value of the business is determined and then that value is allocated between the various classes of debt and equity." The second half of the sentence states a fact, that may be doubted for German speaking countries. In Germany, e.g., the enterprise value can often be seen as part of a transaction process, but that is not the case in the
very many valuations for compensation of minority shareholders according to Aktiengesetz (Stock Corporation Act) or Umwandlungsgesetz (Transformation Act). Here the equity approach dominates. The same applies to Austria and Switzerland.

ii. Let us remark additionally that the first part of the cited sentence leaves open whether it also states a fact, or not. If "can occasionally" has to be read as "can only occasionally", then the second interpretation would not be true.

iii. Does para 130.3 make a differentiation between "economic rights" and "control rights" or shall apply both terms for the same? Please give a reason for the differentiation or make the different terms for the same explicit.

iv. In para 130.8, the CVM is not sufficiently explained by (only) "assuming an immediate sale of the enterprise", since the conditions of the sale are open to discussion. Is it a forced sale because of a liquidity problem or is it a hypothetical sale in a situation without force? Does the answer depend on the concrete situation? We are aware that para 130.10 tries to give an answer, but in our opinion an imminent liquidity event would or could have other valuation implications than the fact that "no material progress has been made on the company’s business plan". Therefore, it would be very helpful to be more concrete about the assumptions of the sale and their implications for valuation.

v. In the description of the OPM, para 130.17 (h) allows to combine the results of the option pricing model of Black-Scholes with applying premiums and discounts. Is there any theoretical basis? What criterion can be used to decide whether "it may be appropriate", or not?

vi. The same question applies to the combination of present values and premiums and discounts mentioned in para 130.22 when using the PWERM.

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.

We have no recommendations with respect to this question.

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.

We have no recommendations with respect to this question.
Again, thank you for giving us the opportunity to comment the IVS 2017 Proposed Revisions Exposure Draft (ED) and for taking our views and recommendations into consideration.

Kind regards

EACVA e.V.

Andreas Creutzmann  
Chairman of EACVA

Dr. Klaus Rabel  
Vice Chairman of EACVA