CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

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Submission by email: aaronsohn@ivsc.org

Dear Sirs

IVSC Agenda Consultation 2017

We are happy to provide commentary on the IVSC Agenda. These comments have been provided by our Business Valuations Committee and represent the views of those members. Our commentary to each of the points raised is set out in the Appendix to this letter.

If you have any questions, please contact me through the CA ANZ Business Valuations Committee Secretariat Jan Jackson on jan.jackson@charteredaccountantsanz.com

Yours sincerely

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Appendix

IVS Gap Analysis

Question 1: *Do you agree with the current categorization and timings of the topics contained in the gap analysis and if not why?*

In general we are in agreement with the categorization by timeframe, with the following suggestion:

- Public service assets are more time critical than price vs value. Price vs value is largely dealt with by references in existing IVS to alternative bases of value (e.g. investment value)

The categorization of the asset types as standards as opposed to guidance notes merits significant consideration by the board. We prefer principle based standards at a high level, such as those contained in existing IVS and supporting guidance notes by category.

Our concern is that standards might be interpreted as mandatory despite the elemental facts and circumstances of a particular case. A guidance note framework lends itself to an "if not followed, please explain" approach, which is more flexible for circumstances unforeseen when drafting the standards.

Question 2: *Are there any other topics which you believe should be included or deleted from the IVS gap analysis and if so why? (Please state the relevant specialism, categorization and timing for any proposed additional topics).*

Valuation of property intensive businesses:

- Where possible property should be valued separately and a pro-forma lease charge calculated to estimate combined business value.
- Guidance would also be helpful as to whether the property or the business should include the value for letting up periods and/or lease incentives when the property is owner occupied.
- There is widely variant practice in both these areas.
- In addition, guidance would be helpful of what is meant by a valuation range. There appears to be limited agreement on the meaning of a range, (e.g. is a range akin to a confidence interval between which a certain percentage of transactions would be expected to take place or some other thing). In addition, observed ranges are dimensionally similar for assets of much greater valuation uncertainty and significantly less liquidity, which does not seem intuitive.

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Chapter 1 – Non-Financial Liabilities

Question 1.1: *Is the valuation of non-financial liabilities a critical area that should be addressed by the IVSC? Please explain why.*

There appears to widely variant practice in the following areas:

- Valuation of mining rehabilitation/restoration liabilities for business valuation and accounting standards.
- Deferred revenue/deferred service obligations in service and software businesses.
- Valuation of warranty obligations including particularly of third party margins in estimating repair costs, and the derivation of incidence estimates for such provisions
- Valuation of contingent amounts (litigation/earnouts).

Question 1.2: *Should IVS provide a separate definition of liabilities? If yes, do you agree with the definitions provided by the FASB and IASB, please explain why?*

Wherever possible, the definitions in IVS should align with those previously proffered by IASB/FASB to minimize confusion for users of valuation reports.

Question 1.3: *What non-financial liabilities do you observe in practice? For each liability, what valuation methods do you most commonly see used? Which of the non-financial liabilities you listed have the greatest diversity of valuation in practice?*

Majority of categories are dealt with in question 1.1. Valuation is almost universally variations of DCF, with probability estimates where payments are uncertain. The divergence of practice is largely around inputs to the DCF in terms of appropriate sources of probability estimates, discount rates, and inclusion of third party service margins.

Question 1.4: *Do you agree with the decision to exclude financial liabilities from this ITC? If yes, do you think IVSC should add financial liabilities as a possible project(s) in the future?*

Yes, but they could be incorporated as part of financial instruments, as they tend not to be widely problematic.

Question 1.5: *Do you think IVSC should add financial instruments, pension liabilities, and insurance liabilities as a possible project(s) in the future?*

Financial instruments – yes. Pension liabilities and insurance liabilities are already dealt with by existing actuarial guidance and so accordingly no.

Question 1.6: *Of the potential Standard Alternatives outlined above (A, B, C), which do you prefer and why?*

We strongly support option A, as consistent with general IVS philosophy.

Question 1.7: *Are there methodologies and best practices utilised by the insurance industry that the Boards should consider for inclusion in future standards? If so, please discuss.*

There are a range of actuarial standards that have useful insight. However, we do not suggest replicating these standards. A more pragmatic approach would be to incorporate relevant material by reference rather than duplication.

Chapter 2 – Discount Rates

Question 2.1: *Are additional standards related to the derivation of discount rates a critical area that should be addressed by the IVSC? Please explain why.*

Yes. Further assistance is required as there is wide divergence of practice in terms of the following. This could be either standards or guidance:

- Use of alternative approaches (e.g. bonds plus approach) for PPP projects
- Inclusion of alpha factors dealing with cash flow estimation risk rather than systematic factors
- The inclusion of risk in both cash flow weighting and discount rates
- Divergent approaches to dealing with small size
- The use of normalisation approaches of different types to deal with current low interest rate environment which has not generated multiple expansion.
- Different practices around estimation of beta, gearing, risk free rate tenor, and bond premium.

Question 2.2: *Given the extensive use of the CAPM for derivation of discount rates used in business enterprise and asset valuations, do you agree with the Boards proposal to issue new standards to target diversity in practice related to discount rate derivation? Please explain why.*

Yes. As per question 2.1.

Question 2.3: *Which inputs have you observed to have diversity in practice that would benefit from additional guidance in IVS and why?*

As per question 2.1

Question 2.4: *What other methods of deriving discount rates for business enterprise valuation do you commonly observe in practice? For each method, do you commonly observe diversity in practice in its application?*

In practice, CAPM is the most frequently quoted approach but usually alpha is included which is more akin an APT approach.

We observe the bonds plus approach in government backed infrastructure reflecting the underlying risk of the primary customer.

We also observe a market yield being used as a discount rate in some property valuations, without due references to cash flow risks (and opportunities) that are built into market yields. There is also very limited reference to why yields might differ from CAPM (or other discount rate alternatives).

Question 2.5: *Of the potential Standard Alternatives outlined above (A, B, C), which do you prefer and why?*

Alternative B, because there is divergence across asset types.

Chapter 3 – Early Stage Company Valuation

Question 3.1: *Are additional standards for the valuation of early-stage companies a critical area that should be addressed by the IVSC? Please explain why.*

Additional guidance would be helpful given the large failure rate for early stage companies, which mean that with hindsight most valuations will look inflated. In addition, there is wide variation in valuation practice and the VC market as to the appropriate methods to use.

Furthermore, the market for early stage companies is relatively illiquid, and is often subject to significant information asymmetry and widely differing views between buyers and sellers. This means that transacted values can vary widely, as well as being highly sensitive to new information.

Use of guidance or standards can provide protection for valuation professionals from hindsight bias on the part of users of valuation reports and to provide a point of potential convergence for widely variant practice.

Question 3.2: *In which areas of the valuation of early-stage companies do you see the greatest diversity in practice? Are there additional areas of concern not noted above in this ITC? If so, please discuss.*

There are several areas of divergence:

- Different valuation techniques (eg Venture capital method, scenario method, scorecard/building block techniques, real options)
- Widely spread use of rules of thumb, without allowing for particulars of the case.
- Disparate probabilities of success being applied
- Significant behavioural finance issues including representativeness heuristic, familiarity, and overweighting of limited reliability diligence compared to base rates
- Use of the Black-Scholes option valuation technique in the option price back-solve method, when the distribution of outcomes does not look like those assumed in the Black-Scholes model. This generally overstates the difference between ordinary equity and the security with the option.
- Use of pre- and post- money comparables without appropriate adjustment to enterprise value
- Exclusion of follow on options in quoting comparable transactions (eg security issued at $1.00 including a follow-on option at the same price). The value of ordinary equity issued should be discounted for the follow on option, but often is not.

Question 3.3: *Of the potential Standard Alternatives outlined above (A, B, C), which do you prefer and why?*

Alternative B at a minimum, with likely progression to Alternative C. There are too many divergences for users of valuation reports to be comfortable with the current state of affairs.

Chapter 4 – Biological Assets

Question 4.1: *Should IVS provide a standard of Biological Assets? If yes, do you agree with the title of this standard and the distinction provided by the FASB and IASB between Biological Assets and Agricultural Produce, please explain why?*

Yes. We consider that the standard should include both categories, both in the title and in substance.

Question 4.2: *Do you observe a significant variation in valuation practice for Biological Assets? For each type of Biological Asset, what methods do you most commonly see used? Which type of the Biological Asset you listed have the greatest diversity in practice?*

For Biological assets, there is significant variation in valuation practice concerning:

- Estimation of harvest volumes
- Adjustment for climatic variation and water availability
- Allowance for contributory assets (particularly land and water)
- Allowance for tax net or gross of applicable rural allowances
- Sporadic use or availability of transaction evidence
- Estimation of crop pricing and exchange rates

Question 4.3: *Do you observe a significant variation in valuation practice for Agricultural produce? For each type of Agricultural Produce, what methods do you most commonly see used? Which type of the Agricultural Produce you listed have the greatest diversity in practice?*

For agricultural produce, there is relatively little variation in practice. Selling prices at the date of valuation less costs of getting to the point of sale is the predominant technique we observe. There are instances of costs of getting to market not being allowed for.

Question 4.4*: Is the valuation of Biological Assets critical area that should be addressed by the IVSC? Please explain why.*

In some markets it is an important consideration, but in terms of market integrity it would have a lower urgency than, say, financial instruments.

Question 4.5: *Does the separation of value between the agricultural produce and its bearer plants cause issues within your market? Please explain why.*

Not in our experience, it is typically dealt with in a fashion consistent with finished goods emerging from WIP inventory.

Question 4.6: *Do you feel that there is conceptual Issue in allocating components of Fair Value? Please explain why together with your recommendations for resolving these issues.*

There is a conceptual issue about the inclusion or exclusion of contributory assets like land and water rights, and the inclusion of efficiencies with integrated operations. In our view, the contributory assets should be separately valued from the biological asset and efficiencies of integrated operations should be treated in a fashion similar to buyer specific synergies.

In most property valuations, these items are not considered separately and reflect the value of a property. This is at odds with other business valuation practice.

Question 4.7: *Do you think that potential alternative uses should be considered when valuing land as part of a Biological Asset valuation? Please explain why.*

Yes. In our view, the land should be valued at highest and best use and a contributory asset charge levied on the value of the biological asset reflecting the opportunity cost of the land use in generating the biological asset.

Question 4.8: *Do you think that there are four basic sampling and measurement techniques for the valuation of Biological Assets? If not, please explain what sampling techniques have seen used in practice.*

These reflect the basic types of sampling approaches. However, given the emergence of technology solutions like drones, satellite/aerial photography, and image analysis it is possible to generate population analysis as quickly and cheaply as samples in some cases.

Question 4.9: *Do you think that there are four basic sampling and measurement techniques for the valuation of Biological Assets? Do you think that the inclusion of information on generally accepted sampling and measurement techniques would substantially reduce diversity of valuation practice and if so, how?*

For first part of question, refer 4.8. The inclusion of sampling and or measurement techniques should be considered in generating the valuation range for the subject asset. For some valuation applications, lower accuracy suffices, and should be able to be dealt with by disclosure.

It may also be helpful to provide examples of the degree of variation that may exist given the various sampling techniques rather than relying on the pre-existing knowledge of valuers or surveyors.

Chapter 5 – Extractive Industries

Question 5.1: *Should IVSC produce combined standards and guidance for Extractive Industries or produce separate pronouncements for mining and for oil and gas? If you believe the latter, please indicate the reasons why you consider separate guidance is appropriate.*

We consider that for most issues, combined standards will work adequately. There is however, substantial differences in terminology for broadly equivalent concepts across the two sub-sectors, so appendices or sections dealing with the two types of mineral asset will be useful.

Question 5.2: *Should the standards focus just on the valuation of reserves and resources or should it extend to other assets employed in the industry and to entire businesses in the sector? Please provide reasons for your answer.*

The relevance of this question differs across the maturity of the development. In our view, the standards should deal with all three to reflect the issues that exist at each stage of mine or field development.

Question 5.3: *Which classification code or codes are most commonly used in your industry / sector? Which code do you normally use or rely on? Are you aware of differences across your / industry sector on the classification codes used? If so please indicate whether these differences cause problems in undertaking or understanding valuations.*

For mining assets in Australia, generally VALMIN and JORC are the guides to current practice. There is also guidance issued by the local Property Institute (http://anzvps.api.org.au/documents/ANZVPS-06-14.pdf). These are largely consistent with international practice.

The classification code for reserves and resources is different for oil and gas and in this country it is SPE:PRMS, which is generally consistent with international guidance.

There is limited guidance in the application of appropriate risk weightings for different categories of reserve and resource.

Question 5.4: *When valuing with a discounted cashflow do you use internal production forecasts developed by the entity's own geological and engineering specialists, external forecasts, or a combination of both and you adjust the production forecasts for risk by reserve category?*

Generally the base is internal production forecasts, adjusted for risk by resource category. In some cases, further diligence is provided by consulting geologists and engineers, and analysis against around key cost and capital drivers, but seldom is an entirely separate forecast developed.

Question 5.5: *Please indicate what methods you use or are familiar with that fall under the Cost Approach and that are used in valuing assets in the Extractive Industries. Please indicate in your experience how the cost of an equivalent asset is determined and please indicate the three most common adjustments that are made in your experience to reflect physical, functional or economic obsolescence, and what metrics are used to determine these adjustments?*

The assets that are most commonly valued using variants of the cost method include mining information, plant and equipment (particularly when fixed, or difficult to move), and the void for open pits. The void value is usually only used for Australian Tax purposes.

Physical obsolescence is typically measured with regard to the evolution of the mine plan, functional obsolescence is measures with respect to either modern equivalent capacity measures or differential costs. Economic obsolescence is measured with respect to the value of the mine itself, or scrap is surplus sale values.

Question 5.6: *Please identify any intangible assets that are normally separately identified and valued; in transactions between entities in the Extractive Industries and ii. When accounting for the acquisition of a business in the Extractive Industries.*

Generally mining information and occasionally IP, if particular, proprietary, technology is used to develop a resource.

Question 5.7: *In your experience what, if any, value is attributed to components of goodwill, eg an assembled skilled workforce, in corporate transactions in the Extractive Industries. Please briefly indicate any valuation techniques used to establish the value of goodwill in such circumstances.*

Occasionally workforce is recognized as goodwill, but in most cases, the value of goodwill is solely related to tax balances generated due to the difference between book and tax base. However, the practice of many miners is to include all residual value in the value of reserves and resources, to recognize the wasting nature of the resource itself, and require amortization accordingly.

Question 5.8: *Please provide any examples of which you are aware of significant differences between the value of otherwise similar resources arising solely from different Governmental policies. Please indicate how "country risk" factors are reflected in the way in which you price or value extractive assets.*

The main issues relate to tax, resource reversion, rehabilitation standards and royalty policy, but also allowance for country risk is common. Taxes, reversion, rehabilitation and royalties usually feature in cash flow estimates but country risk is usually incorporated in discount rate estimates.

Chapter 6 – Inventory

Question 6.1: *Should IVS provide separate standards for valuing inventory? Please explain why.*

This would be helpful as this is often the subject of contention for both financial reporting and tax valuations.

Question 6.2: *What methods for the valuation of inventory do you most commonly see used in practice?*

We typically see application of principles consistent with the SFAS 141. Occasionally valuations are done at selling price without regard to costs of disposal for tax purposes.

Question 6.3: *Do you agree with the decision to focus on the application of the Comparative Sales Method? If not, please discuss the other methods that should be included in the performance framework.*

We consider that the performance framework should follow the form of the SFAS 141 formulation with worked examples for clarity.