August 15, 2017

JICPA Comments on the IVSC Invitation to Comment,

IVS Agenda Consultation 2017

The Japanese Institute of Certified Public Accountants ("we", "our", and "JICPA") is pleased to provide you with our comments on the IVSC Invitation to comment, *IVS Agenda Consultation 2017* (ITC). Our comments below focus on the questions from the ITC we would like to respond to.

IVS Gap Analysis

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

(Comment)

・We basically agree but we would like to make the following comments.

＜"Discounts and Premiums" categorized under Medium Term＞

In IVS 105 Valuation Approaches and Methods, there is a statement that Control Premiums may be quantified using any reasonable method. Accordingly, it is desirable that a specific method of quantification is indicated.

On the other hand, the method of quantifying Control Premiums through the comparison of bid prices for acquiring controlling interests in publicly-traded securities to the observed price before such a transaction is announced involves statistical and practical research and takes considerable time. Moreover, we should consider the research carefully as levels of Premium could fluctuate significantly depending on the stock prices, which would make it difficult to set clear benchmarks. In this respect, we agree that this issue should be addressed in the Guidance Notes.

＜"Early Stage/Development Stage Valuation"＞

This is an issue which is also being taken up by JICPA as a research theme and which JICPA expects should be categorized as Critical. A detailed comment is given below in Chapter 3.

＜"Infrastructure"＞

Upon the request of Tokyo Stock Exchange, Inc., JICPA has released a Research Report on the evaluation of "renewable energy power generation facilities" out of "Infrastructure," and continues to place emphasis on "Infrastructure" as a research theme.

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, categorisation and timing for any proposed additional topics).

(Comment)

＜Valuation purpose＞

While not included in the list of topics for gap analysis, it is important to identify and clarify several types of valuation purposes. It is also necessary to clarify the consideration points for the valuer depending on each valuation purpose.

In the Research Report published by JICPA, valuation purposes are classified into the following categories, and for categories (1) through (5) JICPA has articulated an outline of each process, the relevant procedures and the corresponding consideration points:

> (1) Valuation for transaction purposes, such as M&As; (2) Fair and neutral, court-appointed valuation for judicial purposes; (3) Property appraisal pursuant to the insolvency law; (4) Valuation for accounting purposes such as Purchase Price Allocation; (5) Valuation for reference purposes such as for use in investment decisions of investors; and (6) Valuation for taxation purposes such as for inheritance and gift taxes.

For example, the final paragraph of 30.17 of IVS105 contains a prohibition on the application of blockage discounts in fair value assessments for financial reporting purposes. It should be clarified such diversity arising from varying valuation purposes.

＜Valuation of financial institutions＞

We believe that valuation of financial institutions including banks, insurance companies and securities companies should be taken up, as such valuations pose issues unique to financial institutions.

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.

(Comment)

・We believe that additional standards related to discount rates is necessary.

As the discount rate could have a far-reaching impact on DCF valuation, concrete and practical standards regarding the calculation method for the discount rate can help us to avoid using of arbitrary discount rates.

> 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.

(Comment)

・As valuation practices based on CAPM have been firmly established and there are no doubt regarding its use, we agree setting discount rates-related standards based thereon.

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

(Comment)

- Equity risk premiums, which are often used based on historical data, represented inputs that significantly impact the derivation of discount rates using CAPM. However, since the results are volatile/ sensitive to track-records of historical data, it could lead to differences in opinion of the valuers.

  Additionally, as pointed out by the Board, size premiums vary significant depending on the cited source. Thus, we believe that guidance is necessary.

- It is preferable that guidance is provided for the type of supplemental premiums including size premiums and the definition of the premiums. However, from the standpoint of diversity, the supplemental premiums should be provided for guidance purposes only.

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?

(Comment)

- Deriving discount rates using CAPM is not fitted to DCF method of business enterprises with no sales track record and whose future cash flows are uncertain. Alternatively, we sometimes use the IRR, which is assumed by venture capital, as the discount rate in such valuations (see AICPA "Accounting and Valuation Guide," Appendix B Venture Capital Rates of Return).

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

(Comment)

- As the CAPM would not be applicable to the valuation for an early-stage company, Alternative A would not be preferable; moreover, it is possible that there is no prospect of forming a framework and prescriptive guidance in accordance with Alternative C; Alternative B would be the most preferable, for the time being.

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.

(Comment)

- We believe that standards are required for the valuation of an early-stage company. In the valuation of an early-stage company, (1) it may become necessary, from an accounting standpoint, to value the equity interests of the venture investors, and (2) in many cases, stock options are issued by the early-stage company, in which case it would be necessary to estimate the valuation of such stock options. We therefore believe that corresponding standards are necessary.

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.

（Comment）

・Issues not covered in this ITC include the treatment of using the DCF method in valuation of an early-stage company. The IPEV Valuation Guidelines state, "DCF technique may be useful as a cross-check." However, it adds that the DCF technique may be inappropriate without reasonable support. We believe that this issue needs further clarification.

・As the ITC points out, early-stage companies are usually uncertain in projecting future revenue and profitability. Consequently, if the DCF method is applied, the underlying assumptions of future revenue and profitability projections applied should be considered.

Considering the significant uncertainties around future revenue and profitability projections, we presumed that venture capital inclined to use the high rate of return rather than the CAPM as discount rates. We, therefore, believe that issues with respect to the discount rates for an early-stage company also need to be considered (Please refer to AICPA "Accounting and Valuation Guide," Appendix B Venture Capital Rate of Return).

・Further elaboration around the deliberation status between IVSC and IPEV is more appreciated.

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

（Comment）

・As aforementioned in our reply to Question 3.2, we believe the clarification is necessary for issues unique to early-stage company valuations and to present a basic standpoints on the method. Therefore, we find Alternative C to be preferable.

Chapter 6 – Inventory

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

(Comment)

・In practice, there are numerous situations that call for fair value assessments including Purchase Price Allocation in business combinations. Therefore, IVS should provide separate standards for the valuation of inventory. In such cases, it will be necessary to address the diversity in handling according to the valuation purposes, for example, if the valuation is to be conducted for transactions, judicial or accounting purposes, and to clarify the consideration points required for valuers (See comment to Question 2).

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

(Comment)

・The Replacement Cost Method and the Comparative Sales Method have been applied depending on the valuation purpose, such as transaction purposes including M&As, and also depending on the nature of the inventory.