IVSC Invitation to Comment – dated 15 May 2017

The International Institute of Business Valuers

The International Institute of Business Valuers ("iiBV") is an independent entity with a membership largely comprised of various valuation professional organizations in North America, Europe and Asia. The iiBV provides training to valuation professionals in various countries; it is committed to the development of high standards of the global business valuation practice.

The iiBV welcomes the opportunity to make representations to the IVSC in respect of the above Invitation to Comment.

In this response we refer to the various page numbers and Chapter numbers in the above document for ease of reference.

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Bid Premiums misinterpreted as Control Premiums

Although stated not to be within the scope of this document, we consider that there is a critical need for greater clarification on the misinterpretation of the bid premiums in the public markets as control premiums. We have been informed that the issue of the final paper in respect of financial reporting in the USA *"The Market Participant Acquisition Premium"* ("MPAP") by The Appraisal Foundation ("TAF") is likely in the next four to five months, following two periods of exposure.

We are also aware that much of the appraisal profession in North America appears to have embraced this change, following seminal work undertaken by Eric Nath and others more than 20 years ago. We anticipate that the rest of the world will follow this lead in due course. The IVSC can help very considerably in this regard.

We have not identified in the academic literature relating to takeovers in the public markets any use of the control premium as an explanation for the observable bid premiums on takeovers. There appears to be a significant disconnect between the academic analysis of the market evidence and the way that it has been considered until recently in the business valuation profession. The academic literature does not even consider the question of a control premium, presumably due to the absence of economic logic and intellectual rigour implicit within it.

We assume that all parties would wish to have the greatest consistency between the IVSC and TAF on matters which are as fundamental as this to the interpretation of market data.

IVS 2017 supported some of the MPAP conclusions. However, in our view IVS 2017 gave less than a full endorsement to this concept. We are aware that this was addressed in the *IVS 2017 Bases of Conclusions* paper as this also appeared to be the view of various respondents.

We therefore consider that there is significant merit in the IVSC adopting an approach which is far closer to the TAF in this area.

In like manner we consider that the inversion of the bid premium data in order to derive a discount for lack of control to be unsound.

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We agree with the proposed structure of Discussion Papers, Exposure Drafts and Second Consultations. However we assume that the end product will not always be a Valuation Standard; in certain areas we consider that finalised discussion papers and guidance notes may be a better means of disseminating best practice. The titles of these documents are of less of an importance than the contents. However we recognise the need for some consistency in description.

We agree with the general approach that the Valuation Standards should be principles-based, rather than rules-based. We recognise that there may also be material outside the Standards in the form of technical guidance.

We are of the view that contributions to the various projects from individuals knowledgeable in each subject area would be beneficial. It is our view that the starting point should be the existing valuation best practices which should then be challenged and developed.

We refer later in our responses to a range of other bodies which are engaged in the development of valuation best practice in specific areas. In our opinion there is much to be gained by the IVSC using this resource of knowledge and practice, in order to distil valuation principles of general application.

We are very pleased that IVS 2017 was delivered in January 2017 in accordance with the stated timetable. We consider that the continuing discipline of certainty of timing will continue to serve the IVSC well. Whereas the working groups will doubtless seek consensus, time constraints may not always allow this.

It is our opinion that the IVSC should continue to work closely both with regulators, and also other standard setting bodies such as The Appraisal Foundation.

The Appraisal Foundation ("TAF")

In view of firstly, the size of the USA market and secondly, the thought leadership of the business valuation professions in North America, we consider that there needs to be close correlation of the work of both the IVSC and TAF.

There is inevitably a major benefit in the development of a set of broadly consistent set of principles between all business valuation professionals, regardless of the countries in which they operate.

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We recognise that there will be certain materials which do not fit naturally into a set of published valuation standards, but which are of importance in terms of informing the valuation communities of best practice. We are uncertain that a distinction between *Discussion Papers* and *Guidance Notes* will be relevant in practice.

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

We concur with the Gap analysis, with the following exceptions:

Critical

- Biologic Assets – would this be part of the BV board as well as the TA board?
- Discount rates – consider issuing a discussion paper and/or guidance note (versus standard) based on the considerable material that is already available on the topic. The aim should be to identify principles, rather than rules.
- Early Stage/Development Stage Valuation – again consider discussion paper/guidance note versus a standard. Consider beginning with the reference sources already developed or under development in the area, e.g., valuation of privately-held-company equity securities issued as compensation by the AICPA as referred to in this Invitation to Comment and the International Private Equity Valuation Guidelines 2015.
- Extractive Industries – considerable work has already been developed on disclosure and measurement standards – see NI 43-101 issued by the Toronto Stock Exchange and Ontario Security Commission for http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20150304_43-101_tsx-venture.pdf
    - Canadian Institute of Mining, Metallurgy and Petroleum ("CIM") Best Practices/Definitions/Guides are already well developed
    - Timeframe would not be critical
    - Consider coordinating work with CIM
- Inventory – consider a Discussion Paper or Guidance note versus Standard
- Non-Financial Liabilities - consider a Discussion Paper or Guidance note versus Standard
- Price versus Value – do not view this as Critical. Agree that is would be Discussion Paper or Guidance Note.
- Complex Capital Structures – do not view this as critical as it is already addressed in existing guidance

Medium Term

- Alternative Financing Arrangements – topic requires a clearer definition
- Recovery and Resolution – topic requires a clearer definition
- Privatisation – this topic could be immensely broad and requires narrowing and clearer definition in our view
- Trade related property - topic requires a clearer definition: we assume that this relates to real estate such as hotels, care homes and similar in which the value of the business as conducted by a reasonably competent operator is represented within the real estate valuation;
- Valuation of Markets Susceptible to Change: Certainty and Uncertainty – topic requires a clearer definition and consider a Discussion Paper or Guidance note versus Standard

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).

Generally - Consistency with IFRS and local GAAPs

We are of the opinion that there are various subjects in the gap analysis which are within the scope of those standard setters responsible for measurement for financial reporting purposes.

In view of the existence of IFRS and Generally Accepted Accounting Practice and Principles in different countries, it is our opinion that the starting point for the gap analysis should be to determine whether or not such measurement issues are already covered within the above accounting rules. There are various matters in the gap analysis which relate closely to accounting standards dealing with revenue recognition, accounting for inventories, lease classification, etc. In addition the valuation of inventories for business combinations may often produce a result which is immaterially greater than inventories as valued in the normal course of business operations for financial reporting purposes.

The pricing in the public markets is determined by a great many sources of information, including the way that assets and liabilities are measured in financial statements and interim financial reports. As much of business valuation using the markets approach is based upon metrics derived from this financial data, it is our view that there is a need for consistency in measurement concepts where appropriate.

Specifically

- Customer relationship valuation
- Contingent liability valuation (we recognise that litigation contingencies are included in non-financial liabilities)
- Use and testing of prospective financial information in valuation analysis

In general a significant amount of work has been developed or already exists within many topic areas and the IVSC should build from the work it considers to be best practices. We have referred to certain of these sources in this response. This will enable the valuation professional to better distinguish between reference sources that are credible and those that lack credibility.

Chapter One 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.*

Yes, the valuation of non-financial liabilities should be addressed by the IVSC given the increased importance of valuation related information on financial statements. The guidance by the IVSC would be to establish “best practice” approaches that provide reasonably consistent and verifiable valuation conclusions particularly where diversity in practice exists.

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?*

The IVS definition of a liability should align with definitions provided by FASB and IASB. The role of the business valuation professional should be to provide a fair value measurement information that aligns with the accounting definition.

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?*

Deferred revenue and contingent consideration are non-financial liabilities that are frequently encountered by valuation professionals. There are established methods to value deferred revenue. In the case of Valuing Contingent Consideration *The Appraisal Foundation* has already published a First Exposure Draft on the topic that the IVSC should consider before deciding to launch a project on this topic area.

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?*

The valuation of "non-exotic" financial liabilities should be part of the core skill of a business valuation professional and there is no reason why the IVSC should not include the valuation of financial liabilities as part of a possible future project. Well established reference materials exist for the topic area, e.g., *The Handbook of Fixed Income Securities*. In addition, diversity in practice concerning financial liabilities does exist and guidance from the IVSC as to the valuation principles may reduce the diversity in practice in valuations performed for financial reporting purposes.

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

The IVSC should consider adding financial instruments, pension liabilities and insurance liabilities as possible future projects if it establishes that significant diversity in practice in valuations for financial reporting purposes exists and that guidance by the IVSC will reduce the diversity in practice. We recognise that these are specialised areas requiring the inputs of actuarial and other skills. We also recognise that the IVSC wishes to cover complex financial instruments within its range.

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

Alternative B would be preferred as this approach would lead to less diversity in valuation practice.

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.*

We have no comment on this question.

Chapter 2 Discount Rates

We agree with the view of the Board that there exist already well established texts that provide guidance on the derivation of discount rates. The Board has recognised that it wishes to follow a principles based approach to valuation standards. In this context, it is unlikely that the IVSC would wish to replicate the depth of analysis and timeliness that already exists in respect of different computational models.

It is our view that Alternative A where the IVSC would set out a minimum threshold of investigation, analysis and documentation should be followed.

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.*

No the IVSC should not prescribe a standard that derives a discount rate. Significant guidance exists in the profession already on the development of discount rates. The IVSC may wish though to develop a standard that sets out the required work and investigation that a business valuation professional must follow in reaching a discount rate conclusion, i.e., Alternative A or B.

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.*

Alternatives A and B should be able to address diversity in practice in the use of the CAPM approach for deriving discount rates. If significant diversity in practice continues post implementation of a standard similar to Alternative A, the IVSC may wish to develop targeted improvements. Although used by business valuation professionals, we recognize that CAPM was not designed for this purpose and that there are some who challenge its use. In view of this challenge, we consider that there could be a benefit in the exploration of some of the more obvious intellectual difficulties. These include the inability of the majority of owners of smaller businesses to diversify some risk away, due to the concentration of wealth in one investment. In addition it is recognised that the beta of an individual stock incorporates both the systemic risk of the relevant sector but also the unsystemic risk applying to the company in question. Ways in which these challenges to the use of CAPM for the valuation of private companies could be addressed would be helpful.

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

We consider that many inputs continue to evolve: there are different methods for identifying the question of country risk, without there being one settled method; the use of historic small stock premium data is being questioned by some; a real challenge arises in the subjectivity of the company specific risk premium, which can be very large. At the iiBV our teaching approach is to review all of the many methods which exist, due to the evolutionary nature of these areas. We are aware that some commentators consider that company specific risk should not be included, but that adjustments should be made to the cash flows.

However, in our view it is not individual inputs which are necessarily problematic. The challenge comes with the business valuation professional who selects at either end of the range for each of the inputs, thereby aggregating a discount rate which is unduly high or low. This is, at least in part, an ethical issue.

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?*

CAPM is the method most commonly observed in practice. The other method commonly encountered is the build-up method. We recognize that false precision should not be the aim if the discount rate includes a very significant and subjective company specific risk premium.

At the iiBV we are concerned to aid understanding for our learners. This includes a focus on the relationships between discount rates and single period multiples.

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

Alternative A is the preferred alternative.

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.*

Alternative A would be favoured. As pointed out in the Invitation to Comment document, quality work is underway and has already been developed in the area of early-stage company valuation as reviewed in the anticipated AICPA Exposure Draft. The IVSC should focus its resources on reviewing this work effort and others. It may then highlight for practitioners either through a Discussion Paper or Guidance Paper the extent of work expected by valuation practitioners. Alternatively, where gaps are identified IVSC may target projects to address specific needs or where diversity in practice is considered large. In certain developing international jurisdictions information sources may not yet exist and the IVSC may wish to establish acceptable alternative practices that valuation professionals can use in those situations.

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.*

We understand that market participants seldom use advanced computational techniques such as PWERM or other financial modelling. There is therefore the prospect of significant divergence between valuation professionals and the realities of the market in this area. We have no other comments on this question.

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

We prefer Alternative A because it acknowledges that valuation principles are consistent no matter the age of maturity of the business. It is our view that valuation questions and issues should be considered within a consistent framework of cost, market or income approaches. In addition, there are existing reference sources available that are used by valuation professionals. In addition work is currently being undertaken to develop additional peer reviewed guidance in this area. The IVSC should avoid contributing to additional standards unless there exists clearly identified gaps in practice and then should begin with guidance documents, not standards to address any issues.

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 recognise the wish of accounting standards setters and various regulators for valuation standards in this area. However, the iiBV draws the attention of the IVSC to the significant work already done in this topic area by groups like CRIRSCO (formed in 1994) and their underlying members: JORC (Australasia), Brazil (CBRR), Canada (CIM), Chile (National Committee), Europe (PERC), Kazakhstan (KAZRC), Mongolia (MPIGM), Russia (NAEN), South Africa (SAMREC) and the USA (SME). The combined value of mining companies listed on the stock exchanges of these countries accounts for more than 80% of the list capital of the mining industry.

In the case of Canada a summary of the extensive framework already in place to address this industry can be found at http://www.osc.gov.on.ca/documents/en/Securities-Category4/rule_20150304_43-101_tsx-venture.pdf

Page 18 of the above presentation addresses the Education, Ethics and Experience requirements and standards of Qualified Persons of those responsible for estimating and signing off on mineral reserves.

The role of the IVSC within this already well established framework of guidance would need to be carefully considered to ensure that it enhances and does not diminish investor confidence in the area.

We therefore consider that the IVSC should not provide standards and guidance for Extractive Industries. This work already exists and is regulated through existing bodies and regulatory organizations. We do not consider that this business sector should be subject to special attention by the IVSC ahead of other areas such as healthcare, technology, etc.

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.*

No the IVSC should not focus on the valuation of reserves and resources. If the assets pertain to personal property the guidance of the IVSC's Tangible Assets Board may relevant.

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.*

We have no comments on this question.

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 [do] you adjust the production forecasts for risk by reserve category?*

This information should already be addressed by existing developed standards in the area that are created by CRIRSCO members. In Canada National Instrument 43-101 provides significant guidance on this information.

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?*

We have no further comments.

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

Business Valuation Resources publication ***Benchmarking Identifiable Intangibles and Their Useful Lives in Business Combinations 2nd Edition**,* identifies for the Mining, Quarrying and Oil and Gas Extraction industry (79 observations) various metrics in respect of customer relationships, noncompete agreements, trade names and trade marks, etc. the following identifiable intangible assets: (i) customer relationships (19.4% of median intangible value as a percentage of sold business value), (ii) noncompete agreements (1.9%%) (iii) trade names (3.4%), (iv) Trade Marks and Trade Names (1.5%), (v) favourable contracts (67.8%), (vi) IPR&D (1.6%), and (vii) software (0.4%).

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.*

According to the above BVR reference goodwill in the Mining, Quarrying and Oil and Gas Extraction industry the median business value for goodwill is 29.7% as a percentage of sold business value.

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.*

We have no comments.

Chapter 6 - Inventory

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

IVSC should await or contribute to the ***Business Combinations Task Force*** who are, among other matters, developing valuation best practices in the area of valuing inventory. The IVSC should not focus on developing a separate standard for inventory (thereby potentially increasing the diversity in practice) but rather should consider the work currently underway and assist with narrowing the diversity in practice in fair valuing inventory by potentially developing or referencing best practice guidance. Such best practice guide may review what guidance has already been developed and consider what additional guidance would be necessary or useful to value inventory. The example of The Appraisal Foundation's ***Best Practices for Valuation in***

Financial Reporting: Intangible Asset Working Group – Contributory Assets would be a useful approach for the IVSC to consider for inventory valuation guidance if it is considered necessary.

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

In the case of finished goods, in our experience, fair values are estimated by determining the net realizable value or estimated selling price of the inventory and deducting the sum of: (i) costs of disposal, and (ii) reasonable profit allowance for the selling effort.

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.*

The IVSC should consider and contribute to the work being developed by the ***Business Combinations Task Force*** and the area of inventory fair valuation. The IVSC should avoid developing valuation methods that are independent of other work going on in the area and should attempt where possible to converge valuation approaches unless there are specific reasons why the existing best practices will not work. Once best practices are established the IVSC may work on the practical application of the inventory valuation approaches through guidance notes and/or discussion documents with a view to reducing the diversity in practice worldwide.