Organismo Italiano di Valutazione

2 August 2017

Mark Zyla
Chair
International Valuation Standards Council
1 King Street
London
United Kingdom
EC4V 8AU

IVSC Invitation to Comment – IVSC Agenda Consultation 2017

Dear Mr Zyla,

OIV is pleased to send its comment in reply to the IVSC Invitation to Comment (henceforth ITC). OIV has greatly appreciated the IVSC's effort to identify the areas on which to focus its future projects.

OIV is the Italian valuation standard setter and its members include the following associations and entities: Italian Stock Exchange (Borsa Italiana), Italian Association of Auditors (Assirevi), Italian Association of CPA (CNDCEC), Italian Association of Financial Analysts (AIAF), Italian Association of CFO (ANDAF), Bocconi University.

As a national standard setter, OIV is particularly interested in ensuring that the International Valuation Standards address all the areas where substantial differences continue to exist in practice. However, OIV wishes to point out from the start that the IVS should refrain from providing prescriptive guidance. OIV feels that the quality of valuations depends on the quality of the valuation process and that, as such, in tackling new themes, the IVS should only develop the relevant performance frameworks (defining extent of investigation, analysis and documentation).

OIV thinks that it should only comment on matters of interest in business valuation (BV), regarding:

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

Fondazione senza scopo di lucro con riconoscimento della personalità giuridica n. 1242/11
Codice Fiscale 97602630150

1) Gap analysis;
2) Non-Financial liabilities;
3) Discount Rates;
4) Early stage/Development stage valuations;

1) 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?

OIV is highly appreciative of the gap analysis performed by the IVSC's Boards and agrees with the table shown on page 18 of the document, except for two topics:

a) **Discounts and Premiums**. According to the IVSC this is a medium-term issue while OIV regards it as critical (to be addressed in the next two years) as premiums and discounts can have a major impact on the final results of a valuation and are a grey area, while transparency and consistency in valuation practices should be encouraged. On page 7 the ITC indicates that "*IVSC intends to make targeted improvements to certain areas of IVS 2017, including: 1. Control Premium and Discount for Lack of Control (IVS 200 para 90) [….] The Boards determined that such updates do not warrant inclusion in this ITC as the scope of such projects is limited*." OIV is of the opinion that it might be appropriate to work on these improvements within the scope of a broader project dealing with Premiums and Discounts in general terms.
   It is worthy of note that the issue of premiums and discounts is particularly important for four reasons:
   (i) In many cases there is no adequate market information and premiums and discounts are derived from transactions carried out in markets that differ substantially from those of reference of the valuation (for example, the application of liquidity discounts in Europe based on research carried out in the U.S. market is very frequent);
   (ii) Also in cases where they are available, premium and discount measures often date too far back in time with respect to the valuation date and are calculated in very different ways from one another;
   (iii) Premiums and discounts is one of the areas where double counting errors occur more frequently;
   (iv) Premiums and discounts are often a shortcut to avoid more in-depth and detailed analyses.

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

Fondazione senza scopo di lucro con riconoscimento della personalità giuridica n. 1242/11
Codice Fiscale 97602630150

b) **<u>Price vs. value</u>**. IVSC regards this issue as critical, but one that should be addressed in a Discussion Paper. OIV's position is that this issue should <u>not</u> be addressed in a Discussion Paper but directly through improvements of IVS 2017.
The IVS 2017 use price and value interchangeably (in the sense that "value" is used synonym of "estimated price") and the IVS's Glossary has no entries for either price or value.
Expressing the value of a business (or an asset) does not necessarily mean expressing its value in exchange (i.e. its price). In many cases a valuation refers to value in use, or fundamental or intrinsic value, which is independent of the market conditions in which the asset or business can be bought or sold. This is the case of investment value (IVS), of value in use (IFRS) but also of the value that experts are called upon to estimate in connection with minority oppression or related-party transactions in nearly all jurisdictions worldwide. In certain fields (equity investment) and in certain jurisdictions, emphasis is placed also on intrinsic value [1], which reflects the value of the business and the asset in itself (regardless of its current owner).
The distinction between price and value takes on special significance because:
(i) The value in use of an asset or a business can differ to a significant extent from its value in exchange. The value in use of an asset or a business is based on its fundamentals: cash flows, growth and risk. The price of an asset or a business is much more affected by demand and supply, transaction costs, market liquidity, etc., as has long been demonstrated by behavioural finance[2];
(ii) If prices deviate significantly from values, it becomes critical to distinguish within the IVS the process that results in the estimation of the value of an asset from the process that results in the estimation of its price. Valuing

[1] Also intrinsic value expresses value in use. "*Intrinsic value and investment value may seem like similar concepts, but they differ in that intrinsic value represents a judgment of value based on the perceived characteristics adhering to an investment itself, while investment value is more reliant on characteristic adhering to a particular purchaser or owner*" Jay E. Fishman, Shannon P. Pratt and William J. Morrison, *Standards of Value. Theory ad Applications*, second eds., page 27

[2] In the Concluding Remarks of the Bank of Italy's Annual Report for 2017, the governor of the Italian central bank stated that the carrying amount of the non-performing on the books of Italian banks amounts to €20 billion and this amount is in line with the amount recoverable with a direct and active management of NPLs by the banks. If the banks were to sell these NPLs in the market they would probably lose an additional €10 billion. This is a clear indication that for certain assets under certain market conditions the difference between value in use and value in exchange could be substantial.

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

cannot be confused for pricing because they differ not only in terms of relevant information but also in terms of valuation methods and elements supporting the choices made and the reliability of the valuation;

(iii) Price estimates can be calibrated on the basis of market transaction evidence while value estimates cannot be calibrated, thus the estimation process is more discretionary;

(iv) When value is compared to price ("The price is what you pay, the value is what you get"), use should be made of information independent of prices: if prices differ from values then no reference can be made to prices to calculate values.

Every value – whether in use or in exchange – must be based on adequate information support and justified by "facts" (i.e. hard evidence). This is why it is necessary to be very cautious in utilising prices when value in use is estimated as it is necessary to be equally cautious in utilising fundamentals when prices are estimated. Before proceeding with a valuation, the valuer (or the appraiser) should have very clear in mind whether he has been retained to estimate the value (in use) or the price (i.e. value in exchange) of a business or an asset. Value processing and price processing follow different rationales.

Question 2: Are there any other topics which you believe should be included or deleted from the IVS gap analysis and if so why?

OIV does not think that there are other topics to be included or deleted.

<u>2) Non-Financial Liabilities</u>

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

OIV takes the view that the valuation of non-financial liabilities lacks adequate guidelines for valuers and there are significant differences in practice. Accordingly, OIV thinks that this area should be addressed by the IVSC.

Question 1.2. Should IVS provide a separate definition of liabilities? If yes, do you agree with the definition provided by the FASB and IASB?

The PIV – Italian Valuation Standards define non-financial liabilities as liabilities without corresponding assets. OIV thinks that this is the best definition of non-financial liabilities, because it makes it possible to grasp immediately the key feature of this type of liability (the payoff of the liability is unhedgeable).

The PIV include also insurance liabilities among liabilities without corresponding assets.

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?

OIV is of the opinion that the IVS should not address the detailed valuation of each type of non-financial liability. Rather they should set the key elements that characterise the estimation of these types of liability.

PIV III.9.2. states: "*If a liability does not have an observable transfer price, and if no corresponding assets are in place, the value of the liability will be equal to the cash flow of the payoff. In these cases, the most suitable valuation method is, typically, the discounted certainty equivalent with explicit risk loading*"

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?

OIV agrees. OIV's position is that from the valuer's standpoint there is no clear-cut distinction between financial liabilities and equity and there are many overlapping areas. Moreover, in case of companies in crisis, agency costs can transfer value from liabilities to equity and vice versa, in relation to governance mechanisms. Accordingly, a project designed to clarify which elements should be considered in valuing liabilities would really be appropriate.

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

OIV thinks that insurance liabilities should be included among non-financial liabilities. OIV feels that it would be a very good idea to cover hybrid instruments in a future project.

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

OIV's view is that alternative A is preferable. In this context, OIV feels that, in the case of non-financial liabilities, preference should always be given to the methods that consider risk in the numerator of the calculation formula.

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

Question 1.7. Are there methodologies and best practices utilised by the insurance industry that the boards should consider for inclusion in future standards?

OIV thinks that the valuation of a non-life liability in the insurance sector follows exactly the same rationales as the valuation of a liability for the restoration of a decommissioned industrial or mining site.

3. 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?

OIV is of the opinion that there is no need to devote additional standards to the derivation of discount rates. The main reason is that the discount rate cannot be considered separately from the risk associated with the cash flows used in valuation. As correctly noted in IVS 105 "*in developing a discount rate a valuer should consider the risk associated with the projections made in the cash flows used* (paragraph 50.31 sub-paragraph (a)" and "*typically, the projected cash flow will reflect one of the following: (a) contractual or promised cash flow; (b) the single most likely set of cash flow; (c) the probability-weighted expected cash flow, or (d) multiple scenarios of possible future cash flow*s" (paragraph 50.16).

Furthermore, it should be noted that the valuer's propensity to embody risk in the cash flows or in the discount rate depends also on the different jurisdictions. In relation to business valuations, for example, there are countries or geographical areas where typically the valuer does not adjust the projected cash flows approved by the company's board of directors and addresses the risk implied in those projections through the discount rate (and more specifically through a Company Specific Risk Premium – CSRP). On the other hand, there are countries or geographical areas where it is much more frequent the case of the valuer that adjusts projected cash flows whenever he thinks that such projections do not reflect average expected cash flows.

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?

OIV thinks that there is no need for the Boards to issue new standards to target diversity in practice related to discount rate derivation. The main reason is that it is difficult to consider all possible market and context situations in which the valuer may be called upon to operate. Suffice to think of negative risk-free rates or the government bonds issued by the different countries in the Eurozone that incorporate different country risk premiums.

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

OIV is of the opinion that diversity changes depending on the different financial market conditions. For example, more recently diversity concerned mostly the choice of the risk-free rate while in the past diversity involved mainly the equity risk premium (ERP).

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?

The CAPM's success is due to its simplicity. It is common knowledge that the CAPM has many limitations, from a theoretical standpoint, while other models (e.g. the Fama-French) are more robust in scientific terms but more complex to use. Because of its simplicity, however, the CAPM lends itself to use by valuers who are not familiar with its theoretical foundation and, as such, make mistakes in utilising the model or make adjustments to it that are not consistent with its theoretical underpinning.

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

OIV feels that the IVSC should not issue new standards. However, if the IVSC chose to issue new standards the preferred alternative would be B (Performance Framework for Multiple Methods).

<u>4. Early stage company valuation</u>

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

OIV thinks that the valuation of early-stage companies is a critical area of valuation and that additional standards addressing this topic should be issued. However, OIV feels that the lack of existing guidance, the diversity of the methodologies used, the absence of shared calibration methodologies suggest that the different possible alternative standards should be analysed in a discussion paper.

Question 3.2. In which areas of valuation of early-stage companies do you see the greatest diversity in practice? Are these additional areas of concern not noted above in this ITC?

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

The ITC illustrates very well all the main criticalities regarding the valuation of early-stage companies.

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

Lack of a clear consensus on best practices suggests the adoption of alternative B – Discussion Paper.

* * * *

According to OIV, the IVS should not be too prescriptive in technical terms while they should be more demanding with respect to the performance framework. A valuer's decision depends mostly on specific facts and circumstances that require the extensive use of professional judgment. The quality of the choices depends on the extent of the investigation, analysis and documentation. Two valuers with the same body of knowledge, who adopt the same technical standards and observe the same code of ethics, retained to value the same asset on the same date, can reach very different results in relation to the depth of the analysis performed and the quality of the valuation process. In OIV's experience, the main source of diversity in valuations concerns the quality of the valuation process. It is necessary to oppose the progressive tendency to adopt simplified and standardised approaches to meet client demands (increasingly shorter timings and lower prices), to the detriment of the actual ability of valuation to capture all value drivers that only an in-depth and specific investigation can guarantee. Regulators worldwide are requiring greater analytical depth to protect final users in valuation. This legitimate demand for greater professionalism (and lower standardisation) can be met by raising the bar of the minimum contents that the valuation process must comply with, through suitable performance frameworks.

Yours Faithfully

Prof. Mauro Bini

Chairman of Management Board of OIV

Mauro Bini

Organismo Italiano di Valutazione
Via Sarfatti 25 - 20136 Milano - Italia
Tel. 02 5836.2703
info@fondazioneoiv.it
www.fondazioneoiv.it

Fondazione senza scopo di lucro con riconoscimento della personalità giuridica n. 1242/11
Codice Fiscale 97602630150