INTERNATIONAL VALUATION STANDARDS COUNCIL

IVS 200: BUSINESS AND BUSINESS INTERESTS

EXPOSURE DRAFT

Publication date: 2 June 2016

Comments on this Exposure Draft are invited before 31 August 2016. All replies may be put on public record unless confidentiality is requested by the respondent. Comments may be sent as email attachments to:

commentletters@ivsc.org
Or by post to IVSC, 1 King Street, LONDON EC2V 8AU, UK

Please address publication and copyright matters to:

International Valuation Standards Council
1 King Street
LONDON
EC2V 8AU
United Kingdom
Email: ivsc@ivsc.org
www.ivsc.org

Introduction to Exposure Draft

Why is the International Valuation Standards Board (IVSB) issuing IVS 200 Business and Business Interests?

In October 2015 the IVSC published its *Purpose and Strategy Document* which stated that the priority of the IVSC is to expand the quality and depth of International Valuations Standards (IVS) and ensure they are fit for purpose and provide much needed clarity and market efficiency. Further to discussions with the Standards Board and other stakeholders, IVS 200 *Business and Business Interests* was identified as a priority chapter within IVS 2017.

What are the Main Provisions?

The main provisions of this chapter are:

(a) an overview of business and business interests and the circumstances in which they are valued,

(b) a framework for the selection and application of approaches and methodologies for the valuation of business and business interests, and

(c) a discussion of special topics related to the valuation of business and business interests including ownership rights, business information, economic and industry considerations, operating and non-operating assets, and capital structure considerations.

How do the Proposed Provisions Compare with IVS 2013?

This chapter includes elements from IVS 2013 that were included in IVS 200 *Business and Business Interests*. Some of the concepts from IVS 2013 have been clarified and/or expanded upon in this Exposure Draft, but the majority of the content has remained the same. Sections have been added related to selection and application of approaches and methodologies.

Questions for Respondents

The Board invites individuals and organisations to comment on all matters in this proposed update, particularly on the issues and questions below. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

(a) In IVS 2013, all substantive portions of IVS 200 *Business and Business Interests* were labelled as "commentary" (except for scope and effective date). This label seems to have created some confusion amongst stakeholders as to whether the standard was mandatory. The Board's position is that all aspects of IVS 2017 should be mandatory and this Exposure Draft has removed the "commentary" label for clarity. Do you agree with the removal of the commentary label?

(b) The Board believes that the standard presented in this Exposure Draft can be applied in the valuation of business and business interests regardless of the purpose of the valuation (acquisitions, mergers and sales of businesses, taxation, litigation, insolvency proceedings and financial reporting). Do you agree? If not, for what purpose(s) do you believe this standard cannot be applied? Why?

(c) Are there any further topics or special considerations that you feel the Board should add or remove from IVS 200 Business and Business Interests? If so, what are they and what is your rationale?

IVS 200 Businesses and Business Interests

10. Requirements

10.1. The principles contained in the General Standards apply to valuations of businesses and business interests. This standard contains additional requirements that apply to valuations of businesses and business interests.

20. Overview

20.1. The definition of what constitutes a business may differ depending on the purpose of a valuation. However, generally a business conducts a commercial, industrial, service, or investment activity. Businesses can take many forms, such as corporations, partnerships, joint ventures, and sole proprietorships. The value of a business may differ from the value of the individual assets or liabilities that make up that business. When a business' value is greater than the sum of the individual assets or liabilities that make up that business, the excess value is often referred to as going concern value or goodwill.

20.2. When valuing individual assets or liabilities owned by a business, valuers should follow the applicable standard for that type of asset or liability (IVS 210 for intangible assets, IVS 230 for real property, etc.)

20.3. It is important to establish whether the valuation is of the entire entity, shares or a shareholding in the entity, or a specific business activity of the entity. It is especially critical to clearly define the business or business interest being valued, as even when a valuation is performed on an entire entity, there may be different levels at which that value could be expressed. For example:

(a) Enterprise value: the total value of the equity in a business plus the value of its debt or debt-related liabilities, minus any cash or cash equivalents available to meet those liabilities.

(b) Equity value: the value of a business to all of its equity shareholders.

20.4. Valuations of businesses are required for different purposes including acquisitions, mergers and sales of businesses, taxation, litigation, insolvency proceedings and financial reporting. Business valuations may also be needed as an input or step in other valuations such as the valuation of stock options, particular class(es) of stock, or debt.

30. Bases of Value

30.1. In accordance with IVS 104 *Bases of Value*, a valuer must select the appropriate basis(es) of value when valuing a business or business interest.

30.2. Often, business valuations are performed using bases of value defined by entities/organizations other than the IVSC (some examples of which are mentioned in IVS 104 *Bases of Value*) and it is the valuer's responsibility to understand and follow the regulation, case law, and other interpretive guidance related to those bases of value as of the valuation date.

40. Valuation Approaches and Methods

40.1. The three principal valuation approaches described in IVS 105 *Valuation Approaches and Methods* can all be applied to the valuation of businesses and business interests.

40.2. When selecting an approach and method, in addition to the requirements of this chapter, a valuer must follow the requirements of IVS 105 *Valuation Approaches and Methods*, including para 10.3.

50. **Market Approach**

50.1. The market approach is frequently applied in the valuation of businesses and business interests as these assets often meet the criteria in IVS 105 *Valuation Approaches and Methods*, para 20.2 or 20.3. When valuing businesses and business interests under the Market Approach, valuers should follow the requirements of IVS 105 *Valuation Approaches and Methods*, sections 20 and 30.

50.2. The three most common sources of data used to value businesses and business interests using the market approach are:

(a) public stock markets in which ownership interests of similar businesses are traded,

(b) the acquisition market in which entire businesses are bought and sold, and

(c) prior transactions in shares or offers for the ownership of the subject business.

50.3. There needs to be a reasonable basis for comparison with and reliance upon similar businesses in the market approach. These similar businesses should be in the same industry as the subject business or in an industry that responds to the same economic variables. Factors to be considered in whether a reasonable basis for comparison exists include the following:

(a) similarity to the subject business in terms of qualitative and quantitative business characteristics,

(b) amount and verifiability of data on the similar business, and

(c) whether the price of the similar business represents an arm's length transaction.

50.4. When applying a market multiple, adjustments such as those in para 50.8 may be appropriate.

50.5. Valuers should follow the requirements of IVS 105 *Valuation Approaches and Methods*, paras 30.7 and 30.8 when selecting and adjusting comparable transactions.

50.6. Valuers should follow the requirements of IVS 105 *Valuation Approaches and Methods*, paras 30.13 and 30.14 when selecting and adjusting comparable public company information.

60. **Income Approach**

60.1. The income approach is frequently applied in the valuation of businesses and business interests as these assets often meet the criteria in IVS 105 *Valuation Approaches and Methods*, paras 40.2 or 40.3.

60.2. When the income approach is applied, valuers should follow the requirements of IVS 105 *Valuation Approaches and Methods*, sections 40, 50, and 60.

60.3. Income and cash flow related to a business or business interest can be measured in a variety of ways and may be on a pre-tax or post-tax basis, although the use of post-tax income is more common. The capitalisation or discount rate applied must be consistent with the type of income or cash flow used.

60.4. The type of income or cash flow used should be consistent with the type of interest being valued. For example:

(a) Enterprise value is typically derived using cash flows before debt servicing costs and an appropriate discount rate.

(b) Equity value may be derived using cash flows to equity, that is, after debt servicing costs and an appropriate discount rate.

60.5. The *income approach* requires the estimation of a capitalisation rate when capitalising income or cash flow and a discount rate when discounting cash flow. In estimating the appropriate rate, factors such as the level of interest rates, rates of return expected by market participants for similar investments and the risk inherent in the anticipated benefit stream are considered. See IVS 105 *Valuation Approaches and Methods*, paras 60.9–60.11.

60.6. In methods that employ discounting, expected growth may be explicitly considered in the forecasted income or cash flow. In capitalisation methods, expected growth is normally reflected in the capitalisation rate. If a forecasted cash flow is expressed in nominal terms, a discount rate that takes into account the expectation of future price changes due to inflation or deflation should be used. If a forecasted cash flow is expressed in real terms, a discount rate that takes no account of expected price changes due to inflation or deflation should be used.

60.7. Under the income approach, the historical financial statements of a business entity are often used as guide to estimate the future income or cash flow of the business. Determining the historical trends over time through ratio analysis may help provide the necessary information to assess the risks inherent in the business operations in the context of the industry and the prospects for future performance.

60.8. Adjustments may be appropriate to reflect differences between the actual historic cash flows and those that would be experienced by a buyer of the business interest on the *valuation date*. Examples include:

(a) to adjust revenues and expenses to levels that are reasonably representative of expected continuing operations,

(b) to present financial data of the subject business and comparison businesses on a consistent basis,

(c) to adjust non-arm's length transactions to commercial rates,

(d) to adjust the cost of labour or of items leased or otherwise contracted from related parties to reflect market prices or rates,

(e) to reflect the impact of non-recurring events from historic revenue and expense items. Examples of non-recurring events include losses caused by strikes, new plant start-up and weather phenomena. However, the forecast cash flows should reflect any non-recurring revenues or expenses that can be reasonably anticipated and past occurrences may be indicative of similar events in the future,

(f) to adjust the reported depreciation and tax basis to an estimate that compares to depreciation used in similar businesses,

(g) to adjust the inventory accounting to compare to similar businesses, whose accounts may be kept on a different basis from the subject business, or to more accurately reflect economic reality.

60.9. Inventory adjustments may be different when considering the income statement and when considering the balance sheet. For example, a first-in-first-out method of costing inventory may most accurately represent the value of the inventory when constructing a market value balance sheet. When examining the income statement, a last-in-first-out method of costing inventory may more accurately represent the income level in times of inflation or deflation.

60.10. When using an *income approach* it may also be necessary to make adjustments to the valuation to reflect matters that are not captured in either the cash flow forecasts or the discount rate adopted. Examples may include adjustments for the marketability of the interest being valued or whether the interest being valued is a controlling or non-controlling interest in the business.

60.11. Small and medium-sized businesses are often transferred as an asset sale rather than by transfer of the equity interest. In such cases it is common for items such as debtors, creditors and working capital to be excluded and for the value of the assets to be determined by applying an appropriate valuation multiple to the earnings before interest, tax and depreciation. Care should be taken to ensure that the multiple used is based on analysis of other similar asset sales.

70. **Cost Approach**

70.1. The cost approach cannot normally be applied in the valuation of businesses and business interests as these assets seldom meet the criteria in IVS 105 *Valuation Approaches and Methods*, paras 70.2 or 70.3. However, the cost approach is sometimes applied in the valuation of businesses, particularly in the following circumstances:

(a) The business is an early stage or start-up business where profits and/or cash flow cannot be reliably determined and comparisons to other businesses under the market approach is impractical or unreliable.

(b) The business is an investment or holding business, in which case the summation method as described in IVS 105 *Valuation Approaches and Methods*, paras 80.8 and 80.9.

(c) The business does not represent a going concern and/or the value of its assets in a liquidation may exceed the business' value as a going concern.

70.2. In the circumstances where a business or business interest is valued using a cost approach, valuers should follow the requirements of IVS 105 *Valuation Approaches and Methods*, sections 70 and 80.

80. **Special Considerations for Businesses and Business Interests**

80.1. The following sections address a non-exhaustive list of topics relevant to the valuation of businesses and business interests:

(a) Ownership Rights (section 80)

(b) Business Information (section 90)

(c) Economic and Industry Considerations (section 100)

(d) Operating and Non-Operating Assets (section 110)

(e) Capital Structure Considerations (section 120)

90. **Ownership Rights**

90.1. The rights, privileges or conditions that attach to the ownership interest, whether held in proprietorship, corporate or partnership form, require consideration in the valuation process. Ownership rights are usually defined within a jurisdiction by legal documents such as articles of association, clauses in the memorandum of the business, articles of incorporation, bylaws, partnership agreements and shareholder agreements (collectively "corporate documents"). In some situations, it may also be necessary to distinguish between legal and beneficial ownership.

90.2. Corporate documents may contain restrictions on the transfer of the interest or other provisions relevant to value. For example, corporate documents may stipulate that the interest should be valued as a pro rata fraction of the entire issued share capital regardless of whether it is a controlling or minority interest. In each case, the rights of the interest being valued and the rights attaching to any other class of interest needs to be considered at the outset.

90.3. Care should be taken to distinguish between rights and obligations inherent to the interest and those that may be applicable only to a particular shareholder (ie those contained in an agreement between current shareholders which may not apply to a potential buyer of the ownership interest).

90.4. All of the rights and preferences associated with a subject business or business interest should be considered in a valuation, including:

(a) If there are multiple classes of stock, the valuation should consider the rights of the each different class, including:

1. liquidation preferences,
2. voting rights,
3. redemption provisions, and
4. put rights.

(b) A controlling interest in a business may have a higher value than a non-controlling interest. Control premiums or discounts for lack of control may be appropriate depending on the valuation method(s) applied. See IVS 105 *Valuation Approaches and Methods*, para 30.18.(b).

100. **Business Information**

100.1. The valuation of a business entity or interest frequently requires reliance upon information received from management, representatives of the management or other experts. As required by IVS 105 *Valuation Approaches and Methods*, para 10.7, a valuer must perform analysis on information received from management, representatives of management, or other experts to evaluate whether it is appropriate to rely on that information for the valuation purpose. For example, prospective financial information provided by management may reflect owner-specific synergies that may not be appropriate when using a basis of value that requires a market participant perspective.

100.2. Although the value on a given date reflects the anticipated benefits of future ownership, the history of a business is useful in that it may give guidance as to the expectations for the future. Valuers should therefore consider the business' historical financial statements as part of a valuation engagement. To the extent the business' future performance is expected to deviate significantly from historical experience, a valuer must understand why historical performance is not representative of the future expectations of the business.

110. **Economic and Industry Considerations**

110.1. Awareness of relevant economic developments and specific industry trends is essential for all valuations. Matters such as political outlook, government policy, exchange rates, inflation, interest rates and market activity may affect assets in different locations and/or sectors of the economy quite differently. These factors can be particularly important in the valuation of businesses and business interests, as businesses may have complex structures involving multiple locations and types of operations. For example, a business may be impacted by economic and industry factors specific related to:

(a) the registered location of the business' headquarters,

(b) the nature of the business' operations and where each aspect of the business is conducted (ie manufacturing may be done in a different location to where research and development is conducted),

(c) where the business sells its goods and/or services, and

(d) where the business' suppliers are located.

120. **Operating and Non-Operating Assets**

120.1. The valuation of an ownership interest in a business is only relevant in the context of the financial position of the business at a point in time. It is important to understand the nature of assets and liabilities of the business and to determine which items are required for use in the income-producing process and which ones are redundant or "excess" to the business at the *valuation date*.

120.2. Most valuation methods do not capture the value of assets that are not required for the operation of the business. For example, a business valued using a multiple of EBITDA would only capture the value the assets utilized in generating that level of EBITDA. If the business had non-operating assets such as an idle manufacturing plant, the value of that non-operating plant would not be captured in the value. When the objective of a valuation assignment is to determine the total value of a business, the value of such non-operating assets should be separately determined and added to the operating value of the business.

120.3. Businesses may have unrecorded assets and/or liabilities that are not reflected on the balance sheet. Such assets could include intangible assets, machinery and equipment that is fully depreciated, and legal liabilities/lawsuits.

120.4. When considering non-operating assets and liabilities, a valuer should ensure that the income and expenses associated with non-operating assets are excluded from the cash flow measurements and projections used in the valuation. For example, if a business has a significant liability associated with an underfunded pension and that liability is valued separately, the cash flows used in the valuation of the business should exclude any "catch-up" payments related to that liability.

130. **Capital Structure Considerations**

130.1. Businesses are often financed through a combination of debt and equity. However, in many cases, valuers may be asked to value only equity or a particular class of equity in a business. 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 debt and any types of equity.

130.2. When the value of debt is equal to its carrying value/book value, allocations of value may be straightforward. For example, in such cases it may be appropriate to deduct the book value of debt from enterprise value to calculate equity value (sometimes referred to as a "waterfall" method of value allocation). However, valuers should not necessarily assume that the value of debt and its book value are equal.

130.3. In circumstances where the value of debt may differ from its book value, valuers should use a method that appropriately allocates value to debt and any equity securities such as a probability-weighted expected return method or an option-pricing model.

IVS 200 Business and Business Interests: Basis for Conclusions

The basis for conclusions do not form part of IVS 2017 and will not be included in the finalised document, but have been drafted to provide the reader with the rationale behind certain changes made within this Exposure Draft. The Board feels that the inclusion of this section is a necessary part of the consultative process and is in line with the recommendation contained within the IVS Purpose and Strategy Document requirement that "standards need sufficient consultation" and that the IVSC should be "operating in an open and transparent way".

In October 2015 IVSC published their *Purpose and Strategy Document* which stated that the priority of the IVSC is to expand the quality and depth of IVS and ensure they are fit for purpose and provide much needed clarity and market efficiency. Further to discussions with the Standards Board and other stakeholders, IVS 200 *Business and Business Interests* was identified as a priority chapter within IVS 2017.

Discussions with stakeholders indicated that there was a significant amount of confusion related to what content in IVS 200 *Business and Business Interests* represented mandatory standards versus what content represented non-mandatory commentary. The Board notes that in IVS 200 *Business and Business Interests* (like many other IVS 2013 standards), all substantive portions of the standard were labelled as "commentary" with the exception of the scope and effective date sections. This Exposure Draft has eliminated the "commentary" label to make it clear that the contents are mandatory for compliance with IVS.

The Board believes that one of the primary purposes of standards is to reduce diversity in practice. The IVSC performed outreach to stakeholders and identified several areas of diversity in practice related to the valuation of business and business interests. As a result of that outreach, this Exposure Draft includes new requirements related to:

- an overview of business and business interests and the circumstances in which they are valued,
- the selection of valuation approaches and methodologies,
- how debt and capital structure should be considered in certain valuations, and
- treatment of non-operating assets.