

# **BUSINESS VALUATION**

## **- Nuts and Bolts**

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# **AGENDA**

- **Business valuation introduction**
- **Valuation-Art or Science?**
- **Business Valuation – how to define ?**
- **Valuation standards**
- **Business Valuation Process**
- **Valuation Purpose**
- **Standard of Value**
- **Valuation Case Laws**
- **Valuation Myths**

# **BUSINESS VALUATION Introduction**

**“Some men know the price of everything and the value of nothing - Oscar Wilde**

**“ It’s better to be roughly right than to be precisely wrong”**  
- **J.M. Keynes**

**“It’s stupid the way people extrapolate the past and not slightly stupid, but massively stupid” -Charlie Munger**

# **BUSINESS VALUATION Introduction**

**Appraisers have a value in mind before they start the process and try to  
back into it**

**Aswath Damaodaran, Jan 14,2009**

*There is a vast difference between understanding something well enough to buy  
it as opposed to understanding it well enough to sell it.*

***Zig Ziglar, Secrets of Closing the Sale, 1984***

***The numbers are never a whole story, only a starting point.***

*We must always remember that market research, no matter how well done, is  
based on the past. We are always susceptible to discovering a truth whose time  
has gone.*

***Mark A. Johnson, The Random Walk and Beyond, 1988***

## **BUSINESS VALUATION: Arts or Science**

- **BV is promoted as more Art than Science.**
- **The art is professional judgement and science is statistics.**
- **Art is nebulous and synonyms with subjective judgement.**
- **Valuation conclusions are susceptible to challenge when based mainly on professional judgement.**
- **Professional judgement should be the method applied to evaluate relevance & reliability of data, applied methodology and the inference derived thereon.**
- **Professional judgement is not a substitute for properly applied statistical methods analysis and logical reasoning.**

## **BUSINESS VALUATION: Arts or Science**

- **A judicious man uses statistics, not to get knowledge, but to save himself from having ignorance foisted upon him.**

**[ Thomas Carlyle ]**

- **A relevant and reliable valuation conclusion is the product of the analysis of historical financial data, economic, industry and comparative data.**
- **The requisite financial analysis can not be performed absent applied statistical method.**
- **The analysis is most important – how you took the data, analysed it, and wed it to your conclusion. I want transparency; I want to see your thinking – because that’s what appellant courts want to see from me -**

**[ Judge David Laro ]**

# **BUSINESS VALUATION - how to define ?**

## **Business Valuation**

**‘An act or process of determining the value of a business, business ownership interest, security or intangible assets’**

**{The International Glossary of Business Valuation Terms}**

## **Alternative Definition**

**‘Business Valuation is a logical, defensible process of arriving at the opinion as to the worth of a business given the information available, assumption & limiting conditions as on the valuation date’**

## **Business Valuation standards**

- BVS are basically codes of practice that are used in business valuation
- The standards are very similar in terms of content and terminology, including a dependence on the eight factors to consider in business valuation which are listed and discussed in **IRS Revenue Ruling 59-60**



## **Business Valuation standards Need**

- To promote 'best practices' and fairness in valuation services
- To promote credibility, relevancy & transparency of valuation information.
- To enhance quality, consistency, comparability and uniformity of valuation practice
- To enhance reliance on the valuation amongst stakeholder
- To improve corporate governance
- To improve public confidence in valuation
- To improve market efficiency
- Enhance market knowledge and understanding

# Valuation standards

**AICPA Standards for valuation services 1 issued**

**Uniform Standards of Professional Practice (USPAP) issued by the Appraisal Foundation .**

**Standards published by the Institute of Business Appraisers (IBA)**

**American Society of Appraisers (ASA) issued business valuation standards**

# Valuation standards

**National Association of Certified  
Valuation Analysts (NACVA)**

**Internal Revenue Service (IRS)**

**Canadian Institute of chartered  
Business valuers standard**

**Canadian uniform standards of  
professional appraisal practice**

# Valuation standards

**International valuation standard**

**European valuation standard (Blue Book)**

**Royal Institute of charter surveyors valuation standard (Red book)**

**IFRS 13 Fair Value standard**

# BUSINESS VALUATION PROCESS

**Define Valuation  
Assignment**

**Information Collection**

**Site visits & Entrance  
conference**

**Environmental Scan**  
Global Economy  
Domestic Economy  
Industry overview

**Company overview &  
historical financial analysis**

- Subject interest to be valued
- Ownership characteristics
- Valuation date
- Purpose
- Standard of value
- Premise of value
- Deliverables
- Limitations
- Special instructions.

# BUSINESS VALUATION PROCESS



**Company strategy & risk analysis**



**Selection of approaches & methods**



**Prospective analysis**



**Discounts & Premiums**



**Value calculation & sanity check**



**Value Conclusion**

- **Income approach**
- **Market approach.**
- **Asset based approach**



# PURPOSE OF VALUATION

Purpose of valuation	Examples
<b>Valuation for transactions</b>	<b>Business purchase , Business sale, M&amp;A (Mergers &amp; Acquisition), Reverse merger, Recapitalization, Restructuring, LBO (Leverage Buy Out), MBO (Management Buy Out), MBI (Management Buy In), BSA (Buy Sell Agreement), IPO, ESOPs, Buy back of shares, Project financing and others</b>
<b>Valuation for court cases</b>	<b>Bankruptcy, Contractual disputes, Ownership disputes, Dissenting and Oppressive shareholder cases, Divorces cases, Intellectual property disputes and other</b>
<b>Valuation for compliances</b>	<b>Fair value accounting, Tax Issues, <b>DCF valuation under FEMA</b></b>
<b>Valuation for planning</b>	<b>Estate planning, Personal financial planning, M&amp;A planning, strategic planning</b>

# STANDARD OF VALUE

- **a definition of type of value being sought**

The identification of the type of value being utilised in a specific engagement

The International Glossary of Business Valuation Terms

## Types of Standards of Value

- **Fair Market Value (FMV)**
- **Investment Value**
- **Intrinsic Value**
- **Fair Value**
- **Market Value**



# STANDARD OF VALUE

## *Selecting Standard of Value*

- **Subject matter of Valuation**
- **Purpose of Valuation**
- **Statute**
- **Contracts**
- **Case Laws**
- **Circumstances**
- **Professional judgement & Experience**

## Fair Market Value (FMV)

### As defined by Statement on Standards for Valuation Services

Issued by the AICPA

- the price, expressed in terms of **cash equivalents**
- at which property would **change hands**
- between a **hypothetical willing and able buyer** and a **hypothetical willing and able seller**
- Acting **at arms length** in an **open and unrestricted market**,
- when **neither is under compulsion** to buy or sell and
- when both have **reasonable knowledge** of the relevant facts.

# Fair Market Value (FMV)

As defined by Revenue Ruling 59-60,

- the price at which the property would **change hands**
- between a **willing buyer and a willing seller**
- when the former is **not under any compulsion to buy** and the latter is **not under any compulsion to sell**,
- both parties having **reasonable knowledge** of the relevant facts.

## Fair Market Value (FMV)

**Cash or Cash equivalent:** Price without any financing support or special concession and contemplates prevalent economic & market condition on the valuation date.

**Hypothetical:** does not contemplate real but refer Potential

**Willingness:** motivated and assets would be exposed to the market for a reasonable period

**Arm's length:** third Party

## Fair Market Value (FMV)

**Open & unrestricted market:** excludes specific buyer

One transaction involving a willing buyer & seller can not establish a market price

**'Able':** pushes value downward

**No Compulsion:** Forced conditional transactions excluded

**Reasonable Knowledge of facts:** Average knowledge & not specific knowledge

# Fair Market Value (FMV)

## What Hypothetical Sale Transaction

<b>Contemplate</b>	<b>Does not contemplate</b>
<p><b>Price is cash or cash equivalents at the prevailing economic condition</b></p> <p><b>Willingness and ability to buy sell exist</b></p> <p><b>No compulsion to accept the deal</b></p> <p><b>Potential buyers of similar assets exist</b></p> <p><b>Reasonable time and knowledge exist</b></p> <p><b>No separate price for not to compete</b></p>	<p><b>Plan to sell to a particular buyer and adopting a planned strategy</b></p> <p><b>Buyer have specific knowledge</b></p> <p><b>Engagement of experienced and well connected negotiator get a favorable deal</b></p> <p><b>Other benefits attached with the deal like making available finance or key persons</b></p>

# INVESTMENT VALUE

**Value to a particular investor based on individual investment requirements & expectations**

**The International Glossary of Business Valuation Terms**

- **Investment value may be more than FMV or less than FMV**

## FMV VS. INVESTMENT VALUE

FMV	Investment Value
<b>Consensus opinion of market participants</b>	<b>Opinion of a specific investor</b>
<b>Sale is always contemplated</b>	<b>Sale is not necessary</b>
<b>Hypothetical investor</b>	<b>Specific investor</b>
<b>Impersonal</b>	<b>Personal</b>
<b>DLOC &amp; DLOM may apply</b>	<b>Control premium &amp; synergy premium apply</b>



# Factors creating difference between FMV and Investment Value

- **Estimation of cash flows**
- **Risk**
- **Tax**
- **Product synergy & cannibalisation**
- **Other strategic advantages**

# VALUATION CASE LAWS

## **Before 1983 – Delaware Block method (DBM)**

**A mechanical combination of three approaches – net asset, market and earning**

- **Step I: determine the value under three approaches.**
- **Step II: assign a percentage weight to the values derived in step I considering nature of the business.**
- **Step III: calculate the weighted average of the three valuations -this is the fair value or appraised value of the business.**

# VALUATION CASE LAWS

*After 1983 – Weinberger*

**Judicial birth of DCF & demise of DBM**

**‘more liberal approach must include proof of value by any technique or methods that are generally considered acceptable to financial community’**

**Did not prohibit DBM but allowed other methods**

## **Valuation case laws India**

### **1.Mahadev Jalan , Wealth Tax, 1972 (SC)**

**Break-up value for going concern is nor correct. Court laid down principles of valuation**

### **2.Kusumben Mahadevia, Gift Tax 1979(SC)**

**Reinforced principles laid down in the Mahadev Jalan**

## **Valuation case laws India**

**3. Bharat Hari Singhania , wealth tax, 1994 (SC)**

**Court recognised practical difficulties in application of principles of Mahadev Jalan**

**4. HLL, Companies Act 1994(SC)**

**All or combination  
of methods can be applied for fair value**

## **Valuation case laws India**

### **5.Miheer Mafat Lal , Companies Act, 1996 (SC)**

**Fair exchange ratio based on manageable profit method, net worth or break up method and market value accepted**

### **6.Mrs Renuka Datla, Companies Act 2003(SC)**

**DCF is acceptable**

**Combination of methods accepted**

**Intrinsic value cannot include control premium**

## **Valuation Myths**

- **Valuation is objective**
- **Valuation is a science**
- **Valuation gives precise number**
- **A single valuation serves more than one purpose**
- **A complex financial model gives better valuation**
- **Growth in earning increases value**
- **Valuation is worthless as it involves lot of assumptions**
- **All valuation approaches and methods apply in all situations**
- **There is single definition of value**

# Thank You

Send feedback & suggestions at

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