Preliminary Analysis of Valuation Report

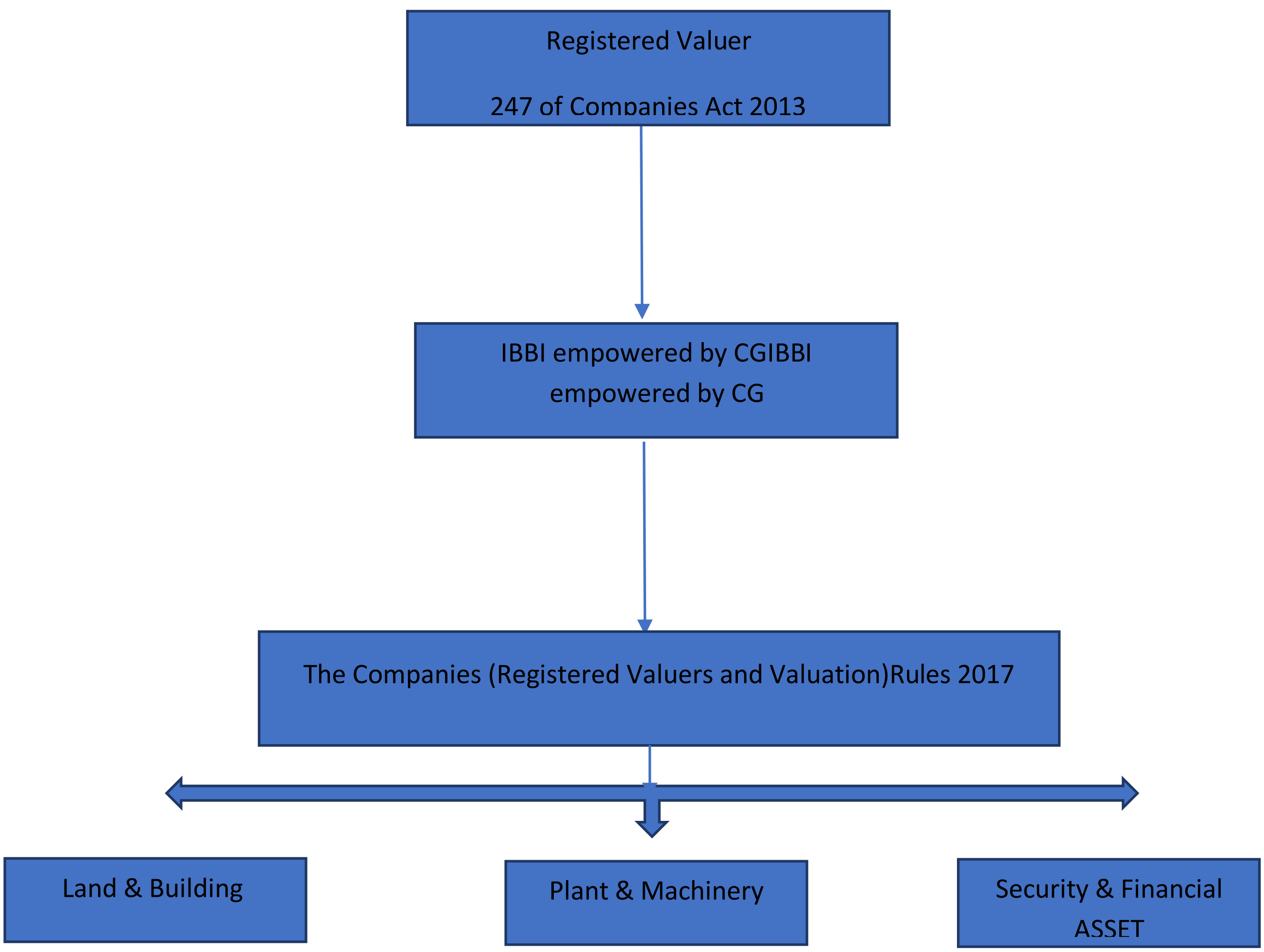
An Introduction

As per Section 247 of The Companies Act, where a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill or any other assets or net worth of a company or its liabilities under the provision of this Act, it shall be valued by a person having such qualifications and experience as prescribed in The Companies (Registered Valuer and Valuation) Rules 2017, and the registered valuer will be appointed by the audit committee or in its absence by the Board of Directors of that company.

As per Section 458, Central Government has delegated its power and function Insolvency and Bankruptcy Board of India (IBBI) , to regulate the Registered Valuer profession.

In simple words we can say that, where there is requirement of valuation in any provision of Companies Act, A report will be required from registered valuer. The profession of Registered Valuer will be regulated by IBBI.

This can be understood with the help of this flow chart.



Valuation Report

For a valuer, it is very important that he issues his report which should according to the valuation standards as prescribed by the Central Government. Central Government has not notified any valuation standard till date, so a valuer is required to adopt Internationally Valuation Standard or Standard issued by RVO. Only ICAI till date has issued its valuation standard.

As per sub section (3) of Section 247 The Companies Act 2013 "If a valuer contravenes the provisions of this section or the rules made thereunder, the valuer shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to one lakh rupees:

Provided that if the valuer has contravened such provisions with the intention to defraud the company or its members, he shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to five lakh rupees and

Subsection (4) of Section 247 of The Companies Act 2013 " Where a valuer has been convicted under sub-section (3), he shall be liable to—

(i) refund the remuneration received by him to the company; and

(ii) pay for damages to the company or to any other person for loss arising out of incorrect or misleading statements of particulars made in his report."

It is very important for a valuer to draft his/her/it's valuation report in such way that the report can justify the valuation so that he can avoid penal provisions. The report should cover all the vital points which are not just important to justify the valuation but also the standardized report help user to understand how the value is determined.

A valuer should while drafting report should always remember following points while drafting report:

Scope of Work-

A report must address the scope of work. A report should clearly state the following points:

(a) the class or classes of instrument to be valued,

(b) whether the valuation is to be of individual instruments or a portfolio, and

(c) the unit of account.

Purpose -

A report should clearly state the purpose of Valuation. For example, if the purpose of valuation is further issue of share or it is for issue of shares for consideration other than cash etc. The purpose of valuation limits the use of report by the subject company in any other purpose as mentioned in the report. A report without purpose should not be issued.

Timelines –

A report must have various times line, for example Date on which assignment was accepted, Date on which measurement has done and Date on which report is signed.

Timelines not only help the user to establish the measurement date but it also ensures the valuer that his/her/it's report will not be misused by any-one.

Titles -

A good report must have Titles. Titles not only help the user to understand the report correctly and directly refer to the material or important points in the report. Title also divides the report in parts which gives a systematic and simple look to the report.

Investigations and Compliance –

A valuer must do investigation and to support these investigations,sufficient evidence should be collected by the valuer. A good report must be descriptive and should briefly cover the Due Diligence which has been done by valuer while determining fair value. Documents from credible and reliable thirdparty must be assembled. To comply with these requirements, the followingare to be considered:

(a) All market data used or considered as an input into the valuation processmust be understood and, as necessary, validated.

(b) Any model used to estimate the value of a financial instrument shall beselected to appropriately capture the contractual terms and economics ofthe financial instrument.

(c) Where observable prices of, or market inputs from, similar financialinstruments are available, those imputed inputs from comparable price(s)and/or observable inputs should be adjusted to reflect the contractualand economic terms of the financial instrument being valued.

(d) Where possible, multiple valuation approaches are preferred. Ifdifferences in value occur between the valuation approaches, the valuermust explain and document the differences in value.

Disclosing Vital Information (Key Inputs) –

The requirement to disclose this information in the valuation report will differ for different categories of financial instruments. Sufficient information should be provided to allow users to understand the nature of each class of instrument valued and the primary factors influencing the values. Information that adds little to a users'understanding as to the nature of the asset or liability, or that obscures theprimary factors influencing value, must be avoided. The data is gathered from the management of subject company or from external sources and determining the levelof disclosure that is appropriate, following points must be considered-

a) Materiality: The value of an instrument or class of instruments in relationto the total value of the holding entity’s assets and liabilities or theportfolio that is valued.

(b) Uncertainty: The value of the instrument may be subject to significantuncertainty on the valuation date due to the nature of the instrument, themodel or inputs used or to market abnormalities. Disclosure of the causeand nature of any material uncertainty should be made.

(c) Complexity: The greater the complexity of the instrument, the greaterthe appropriate level of detail to ensure that the assumptions and inputsaffecting value are identified and explained.

(d) Comparability: The instruments that are of particular interest to usersmay differ with the passage of time. The usefulness of the valuationreport, or any other reference to the valuation, is enhanced if it reflects

the information demands of users as market conditions change,although, to be meaningful, the information presented should allowcomparison with previous periods.

(e) Underlying instruments: If the cash flows of a financial instrument aregenerated from or secured by identifiable underlying assets or liabilities,the relevant factors that influence the underlying value must be providedin order to help users understand how the underlying value impacts theestimated value of the financial instrument.

Premise used in Valuation-

A Valuer in valuation report must mention the premise used while determining the fair value of an asset. There are two premise while doing valuation of an asset- (i) Going Concern and (ii) Liquidation

The premise help user to understand the situation. A distressed sale will most of the time be conservative and is not derived by income approach where as in case of going concern a valuer prefer income approach apart from the two other approaches.

Valuation Approaches and Methods Applied –

The three valuation approaches described in IVS 105 Valuation Approachesand Methods may be applied to the valuation of financial instruments.According to IVS 105, three commonly used approaches are- (i)Themarket approach, (ii) The income approach or (iii) The costapproach.

A good valuer report should briefly explain the valuation approaches and the reason for selecting one or all approach or where any weighted is given. The reason or logic should be properly explained.

When using a particular valuation method or model, it is important to ensurethat it is calibrated with observable market information, where available, ona regular basis to ensure that the model reflects current market conditions.

As market conditions change, it may become necessary to change to amore suitable model(s) or to modify the existing model and recalibrate and/or make additional adjustments to the valuation inputs. Those adjustmentsshould be made to ensure consistency with the required valuation basis,which in turn is determined by the purpose for which the valuation isrequired.

Caveats, Limitation and Disclosures–

A valuer must disclose the estimates, assumptions or any limitation. The valuer must disclose if he has considered a work from an expert or other valuer.

This not only provides a support to valuer on how he determined value of an asset but also helps a user to understand the basis of estimates and the assumption valuer has taken while determining the value.

Conclusion-

A good valuation report must give a conclusion remark at the end of report, so that a user can quickly go through the gist of the report.