

IVS: Basis for Conclusions

**Reflecting changes introduced to IVS
(effective 31 January 2020)**



Basis for Conclusions

IVS 2017 Technical Revisions

**IVS 2017 Additional Technical
Revisions**

&

IVS 220 Non-Financial Liabilities



International Valuation Standards Council

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- Changes from previous editions of International Valuations Standards are shown in red or ~~crossed-out~~.
- New glossary terms are *italicised in red*.

General Consultation Overview

As part of ongoing efforts to improve its standard-setting process and consistent with the goals in the IVSC *Purpose and Strategy Document*, the IVSC believes that it should be “operating in an open and transparent way.” The IVSC believes that this document outlining the basis for many changes made in IVS (effective 31 January 2020) is a critical part of a transparent standard-setting process, consistent with the practices of other standard-setters around the world.

The IVS 2017 *Proposed Revisions*, IVS 2017 *Additional Technical Revisions* and *Non-Financial Liabilities Basis for Conclusions* do not form part of IVS but have been drafted to provide the reader with the rationale behind certain technical revisions made within IVS (effective 31 January 2020). This document provides bases for conclusions for certain technical revisions made from IVS as a result of the responses received as part of the IVS 2017 *Proposed Revisions*, IVS 2017 *Additional Technical Revisions* and IVS 220 *Non-Financial Liabilities Exposure Draft* consultation process. The IVSC believes that this *Basis for Conclusions* document provides important insights into the standard-setting process and historical context for these standards, which may be considered in the interpretation of these standards and in future standard-setting activities.

As part of the consultation process, the IVSC Boards (collectively Standards Review, Business Valuation, Financial Instruments and Tangible Asset Boards) received over thirty comment letters for the IVS 2017 *Proposed Revisions*, sixteen comment letters for the IVS 2017 *Additional Technical Revisions Exposure Draft* and twelve comment letters for IVS 220 *Non-Financial Liabilities Exposure Drafts*. Many of the consultation responses were written by organisations representing hundreds or thousands of stakeholders and many of the comment letters were written by committees of individuals. The IVS 2017 *Proposed Revisions*, IVS 2017 *Additional Technical Revisions* and IVS 220 *Non-Financial Liabilities* chapter contained within this document and within the IVS (effective 31 January 2020) were made as a result of these comment letters. This *Basis for Conclusions* document is not intended to address the reasons behind every minor change made to IVS (effective 31 January 2020). Rather, the following sections focus on more significant changes and the reasoning behind those changes and/or feedback that led to them.

The Boards note that there was wide diversity in views related to the appropriate depth and level of IVS 2017 *Proposed Technical Revisions*. The majority of respondents agreed with the level of detail and depth in the IVS 2017 *Proposed Revisions*. However, some respondents believed that more detail would be helpful and that the standards should address additional topics not currently covered in the proposed revisions. Other stakeholders believed the IVS 2017 *Proposed Revisions* were too detailed for standards. The Boards discussed all stakeholder views in depth. Ultimately, the Boards felt that the level of detail in the proposed revisions were appropriate and met the immediate needs of the IVSC and its stakeholders. However, the Boards noted that additional topics could be addressed in future standard-setting and will continue to issue *Invitation to Comment* (ITC) for stakeholders to highlight the need for additional standards.

The IVS 2017 *Additional Technical Revisions* partly emanated from harmonisation discussions with CUSPAP and USPAP. The Boards noted that there was also a wide diversity of views related not only to the appropriate depth and level of proposed additional technical revisions, but also in relation to the inclusion of

glossary definitions for “Assignment” and “Confidentiality”, as well as the inclusion of the new sections on “Allocation of Value” and “Valuation Modelling”. The Boards further noted that much of the diversity of views were across specialisms (Business Valuation, Financial Instruments and Tangible Assets) and as such engaged in further market outreach with key IVS stakeholders, member organisations and the IVSC Advisory Forum Working Group to fully examine and explore the issues raised as part of the consultation process.

As a consequence of this outreach the Board decided to delay inclusion of the definitions of “Assignment” and “Confidentiality” and section 220 on “Allocation of Value” until further investigations could be made to ensure these proposed revisions to the General Standard could work across all specialisms.

In addition, the Boards made some further minor text revisions to the section on “Valuation Modelling” to ensure this section not only applied to all specialisms but also to enable more detailed asset specific standards on valuation modelling and data handling to be incorporated within the IVS Asset Standards in the next edition of IVS.

In respect of IVS 220 *Non-Financial Liabilities* there were 12 consultation responses received from IVS stakeholders and members and based on stakeholder feedback, the Business Valuation Board determined that for purposes of IVS 220, non-financial liabilities should be defined as those liabilities requiring a non-cash performance obligation to provide goods or services. The Business Valuation Board have therefore excluded contingent consideration from the scope of IVS 220, even in those instances in which contingent consideration liabilities include a non-cash performance obligation.

The IVS 2017 *Proposed Revisions, Additional Technical Revisions* and new chapter on *Non-Financial Liabilities* contained within this *Basis of Conclusions* will be effective from 31 January 2020, though early adoption is encouraged. Further to Board and additional discussions with IVSC Trustees it was agreed that future IVSC standards should be referred to as IVS with reference to the effective date for each new version. For example, IVS (effective 31 January 2020).

IVS 2017 Glossary: Basis for Conclusions

IVS 2017 Proposed Revisions Exposure Draft (Consultation period 16 July 2018 to 19 October 2018)

Based on Stakeholder feedback, the Boards recommended the following change to the Glossary in order to highlight that the definitions contained within the glossary are only applicable to IVS:

- 10.2 This glossary **is only applicable** to IVS 2017, **and** does not attempt to define basic valuation, accounting or finance terms, as valuers are assumed to have an understanding of such terms (see definition of “valuer”).”

In relation to the question on whether “IVS should define the terms Price, Cost, and Value,” most respondents indicated they would support the inclusion of the terms Price, Cost, and Value. Almost all respondents who were in favour of including such terms also provided suggested revisions to the proposed definitions in the *Technical Revisions Exposure Draft*. While there were some common themes to the suggested revisions, the Boards felt that the significant divergence in suggested revisions indicated that the inclusion of Price, and Cost at this time was not possible, particularly as there was significant crossover in these terms. In some instances for example “price” could also be a “cost” or “value”. Additionally, those respondents which did not support the inclusion of the terms provided thoughtful perspectives that require additional considerations by the Boards if they choose to revisit at a future date. Further to comments received and Board discussions it was decided that *IVS 2017 Technical Revisions* should only include the following definitions for “Valuation” and “Value”.

20.14. Valuation

A “*valuation*” refers to the act or process of determining an estimate of *value* of an asset or liability by applying IVS.

20.16 Value (n)

The word “*value*” refers to the judgement of the *valuer* of the estimated amount consistent with one of the bases of value set out in *IVS 104 Bases of Value*.

The respondents were equally split on whether IVS should define “Calculation” and “Calculation Engagement”. Additionally, in nearly all cases, respondents believed a “Calculation” should not be compliant with IVS or only be compliant if significant disclosures and qualifications were made by the valuer. Most IVSC Board members agreed with this view and given the significant diversity in responses, the Boards determined that IVS should not define “Calculation” and “Calculation Engagement” at this time. However, the Boards plan to perform further research and stakeholder outreach regarding the broader market considerations related to “*Calculation*” and “*Calculation Engagement*”, and are engaged in further discussions regarding Automated Valuation Models (AVMs) and valuation modelling.

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation from 28 March 2019 until 29 June 2019)

Further to the publication of *A Bridge from USPAP to IVS* in January 2018, representatives of the Canadian Standard Setters (CUSPAP) and the American Standard Setters (USPAP) met with representatives of the IVSC in August 2018 to discuss harmonisation of valuation standards and further alignment with IVS. As part of this process it was felt that the first initial step to harmonisation was the inclusion of some common definitions within the IVS 2017 glossary. A further harmonisation meeting with the IVS and CUSPAP and USPAP was held in May 2019.

During the harmonisation meeting it was felt that the inclusions of the USAP definitions for “Assignment”, “Client”, “Confidential Information”, “Intended Use”, “Intended User” and “Purpose” would not only be beneficial for the harmonisation of valuation standards but would also provide extra technical clarification to the use and interpretation of IVS.

The Boards discussed the context of additional definitions within IVS 2017, and whether such definitions represent universal terms to be utilised across all specialisms and jurisdictions, or whether these terms are specific to IVS. The Boards agreed that not only did these additional definitions work across all specialisms, but also felt that the inclusion of these terms would help drive harmonisation across disciplines and jurisdictions.

As part of the consultation the IVSC asked stakeholders whether “IVS should seek to harmonise valuation standards with other standards such as CUSPAP and USPAP?” The majority of respondents were supportive of this concept and felt that “*public trust in the valuation profession is enhanced by having valuation standards that do not contain conflicting standards*”.

However, in respect of the question as to whether “IVS should define the term Assignment” (shown in italics) below, there were several conflicting responses, with some respondents feeling that the definition of assignment referred more to the service itself than the agreement to provide the service.

Assignment: *A valuation service that is provided by an appraiser as a consequence of an agreement with a client.*

Based on stakeholder feedback, the Board further reviewed the definition and felt that the inclusion of this definition could cause issues in business valuation and financial instruments where assignment could be defined differently. Further to discussions the Boards decide to delay the inclusion of this definition in order to discuss potential issues further.

In respect of replacing the existing IVS definition of client with the USPAP definition of client (shown in italics below) there were a variety of responses varying from those supportive of this change, against this change and non-committal.

Client: *the party or parties (ie, individual, group, or entity) who engage, by employment or contract, an appraiser by employment or contract in a specific assignment, whether directly or through an agent.*

Further to the consultation the Board discussed this change in depth and felt that the current definition of client contained within IVS 2017 (shown in italics overleaf) had greater depth as it included direct reference to “*third parties*” and “*internal clients*”. Furthermore, the Board felt that replacing an established definition which was already included within IVS 2017 could cause market confusion. The Boards therefore decided not to make any change in this instance and to keep the existing definition of client contained within IVS.

202. Client

The word “*client*” refers to the person, persons, or entity for whom the *valuation* is performed. This may include external *clients* (ie, when a *valuer* is engaged by a third-party *client*) as well as internal *clients* (ie, *valuations* performed for an employer).

The Boards also discussed the responses in relation to the *question* “Do you believe that IVS should define the term *Confidential Information*? If so, please discuss why you think the additional definition is necessary?” The respondents were equally split on whether IVS should include this definition and a number of respondents suggested that this definition (shown in italics below) should be expanded to include the fact that confidential information is “*not available in the public domain*” and “*information that the client and appraiser have agreed is confidential*”.

Confidential Information:

Confidential Information: information that is either:

- *identified by the client as confidential when providing it to an appraiser and that is not available from any other source; or*
- *classified as confidential or private by applicable law or regulation.*

Furthermore, a number of respondents felt that this definition was not required as it was a commonly understood term. Further to discussions the Boards felt that the defined term “*confidential information*” directly connected to the more complex issue of “*confidentiality*” and further research was necessary on the issue of “*confidentiality*” before incorporating this definition into IVS.

The Boards also reviewed the inclusion of the definitions of the definitions of “*intended use*”, “*intended user*” and “*purpose*” shown in red italics below. The majority of respondents were supportive of the inclusion of these definitions and the Boards felt that the inclusion of these definitions added depth and clarity to IVS and have therefore incorporated these definitions within the IVS Glossary.

203. Intended Use

The use(s) of a *valuer’s* reported *valuation* or *valuation review results*, as identified by the *valuer* based on communication with the client.

204. Intended User

The *client* and any other party as identified, by name or type, as users of the *valuation* or *valuation review report* by the *valuer*, based on communication with the *client*.

209. Purpose

The word “*purpose*” refers to the reason(s) a *valuation* is performed. Common *purposes* include (but are not limited to) financial reporting, tax reporting, litigation support, transaction support, and to support secured lending decisions.

IVS 2017 Framework: Basis for Conclusions

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation period 28 March 2019 to 29 June 2019)

As part of the feedback received from the IVS 2017 *Proposed Technical Revisions Exposure Draft* consultation process, a number of respondents asked for clarification on section 50.1. Some respondents commented that in developing markets it may not always be possible for “*valuations to be prepared by an individual or firm having the appropriate technical skills, experience and knowledge of the subject of the valuation, the market(s) in which it trades and the purpose of the valuation*”. Furthermore, respondents commented that by making this requirement mandatory it may act as a barrier to entry for markets where the valuation profession was still being developed. The Boards discussed these comments and felt that in order not to exclude any markets from adopting IVS this requirement should be changed from “*must*” to “*should*”.

As part of the consultation the IVS 2017 *Additional Technical Revisions Exposure Draft* consultation stakeholders were asked whether IVS change should Section 50.1 on “*Competence*” from “*must*” to “*should*” as shown below and if not to provide their reasons.

50. Competence

50.1. *Valuations* should ~~*must*~~ be prepared by an individual or firm having the appropriate technical skills, experience and knowledge of the subject of the *valuation*, the market(s) in which it trades and the *purpose of the valuation*.

The majority of respondents were against this change, with comments ranging from “*this can greatly compromise valuation quality*” to “*no, we strongly disagree with this. It waters down the integrity of our profession*” as “*IVS are formal standards, not aspirations, and clearly cannot be satisfied if valuations are undertaken by those with insufficient technical skills, experience and knowledge*”.

Further to discussions the Boards agreed with the comments received from the consultation process and decided to make no change to section 50.1 and keep the wording as shown below.

50. Competence

50.1. *Valuations must* be prepared by an individual or firm having the appropriate technical skills, experience and knowledge of the subject of the *valuation*, the market(s) in which it trades and the *purpose of the valuation*.

General Standards

IVS 102 *Investigations and Compliance*: Basis for Conclusions

IVS 2017 Proposed Revisions Exposure Draft (Consultation period 16 July 2018 to 19 October 2018)

IVS 2017 is principles based in nature and an overarching principle of the standard is that the client must understand what is to be provided and any limitations on the valuation's use before the valuation is finalised and reported.

As part of the feedback received from the *Invitation to Comment (ITC)*, a number of respondents asked for clarification on limitations and related compliance with IVS. The Boards discussed in depth what valuations are compliant with IVS. The Boards felt that it was necessary to further highlight that in certain instances the limitations placed on the valuer may be so significant that the valuation could not claim compliance with IVS. An example of such a situation that the Boards discussed was many calculation engagements.

As noted in the IVS 2017 *Glossary Basis for Conclusions*, the Boards are engaged in discussions on AVMs and chose to defer additional clarification on this topic until further market engagement and research can be performed.

Further to the consultation, and consistent with where the majority of respondents were supportive of the change suggested, the following revision was made to IVS 102 *Investigations and Compliance* to provide additional clarification:

- 20.7. If, during the course of an assignment, it becomes clear that the investigations included in the scope of work will not result in a credible *valuation*, or information to be provided by third parties is either unavailable or inadequate, **or limitations on investigations are so substantial that the valuer cannot sufficiently evaluate the inputs and assumptions**, the valuation assignment will not comply with IVS.

In response to the questions posed as part of the consultation process, on whether IVS should "*provide examples of 'substantial' limitations*", a significant majority of respondents indicated that IVS should not provide examples of substantial limitations. The rationale provided by respondents was that it is difficult to account for all the possibilities that may arise as substantial limitations, as well as the inherent judgement involved in determining whether a limitation is substantial. The Boards agreed with the majority feedback from respondents and made no adjustments to the proposed language in the exposure draft.

IVS 102 Investigations and Compliance: Basis for Conclusions

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation period 28 March 2019 to 29 June 2019)

As part of the feedback received from the IVS 2017 *Proposed Technical Revisions Exposure Draft* consultation process, several respondents asked for clarification on section 20.4 as they felt that the use of the word “*significant*” within this sentence was too subjective. The Boards discussed this comment further and agreed that the word “*significant*” was too open to interpretation. Furthermore, the Boards felt that the use of the word “*may*” was too open to interpretation and therefore have changed this to; “*Inputs provided to the valuer (eg, by management/owners), should be considered and...*”.

The Boards consulted over whether the IVS should change IVS section 20.4 to state “*Inputs*” (shown in italics below) and, if not, to provide their reasons.

- 20.4. When a valuation assignment involves reliance on information supplied by a party other than the *valuer*, consideration *should* be given as to whether the information is credible or that the information *may* otherwise be relied upon without adversely affecting the credibility of the valuation opinion. Significant inputs provided to the *valuer* (eg, by management/owners) *may* require consideration, investigation and/or corroboration. In cases where credibility or reliability of information supplied cannot be supported, such information *should* not be used.

The Board noted that, whilst though the majority of tangible valuation assets respondents supported this change, the majority of business valuation and financial instruments valuation respondents were against this change. Comments ranged from “*we strongly agree with these proposed changes*” to “*we do not support the deletion of the word ‘significant’ from section 20.4. In our view, inputs and information should be assessed for materiality to determine the impacts they would have in a valuation assignment. Excluding the word ‘significant’ from this section could cause greater confusion as users may interpret that information and inputs all have equal importance when they may not.*”

Further to the consultation the Boards carried out additional outreach and discussion with the IVSC Advisory Forum Working Group, IVSC members and other stakeholders. As a result of this outreach the Boards concluded that the change from significant inputs being investigated to all inputs being investigated was too onerous and impractical, particularly in the field of business valuation and financial instrument where multiple inputs would be used, many of which come from established indices, which would not be possible to investigate. However, the Boards felt that the overall requirement for inputs should be changed from “*may be considered*” to “*should be considered*” in order to meet current market practices. As a result of these deliberations the Boards have revised Section 20.4 as shown below.

- 20.4. When a valuation assignment involves reliance on information supplied by a party other than the *valuer*, consideration *should* be given as to whether the information is credible or that the information *may* otherwise be relied upon without adversely affecting the credibility of the valuation opinion. *Significant* inputs provided to the *valuer* (eg, by management/owners) ~~*may require consideration should be considered, investigated and/or corroborated. - investigation and/or corroboration.*~~ In cases where credibility or reliability of information supplied cannot be supported, consideration *should* be given as to whether or how such information is used.

IVS 103 Reporting: Basis for Conclusions

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation period 28 March 2019 to 29 June 2019)

As part of the feedback received from the IVS 2017 Proposed Technical Revisions Exposure Draft consultation process and from the CUSPAP, IVSC and USPAP harmonisation meeting, several respondents felt that a report, in addition to the other requirements, must also convey “*the intended use*” of the report.

The Boards discussed this comment in detail and felt that in order to restrict the valuers liability in relation to the issuance of a valuation report the report should also state the intended use, Furthermore the Boards felt that the inclusion of both “*Intended Use*” and “*Intended User*” as additional defined words within the glossary would provide further clarification on this matter.

The Boards consulted over whether IVS 103 should state that a report that is the result of an assignment involving the valuation of an asset or assets, in addition to the other requirements shown below should also convey the intended use.

- 30.1. Where the report is the result of an assignment involving the *valuation* of an asset or assets, the report *must* convey the following, at a minimum:
- (a) the scope of the work performed, including the elements noted in para 20.3 of IVS 101 *Scope of Work*, to the extent that each is applicable to the assignment,
 - (b) *the intended use*,
 - (c) the approach or approaches adopted,
 - (d) the method or methods applied,
 - (e) the key inputs used,
 - (f) the assumptions made,
 - (g) the conclusion(s) of *value* and principal reasons for any conclusions reached, and
 - (h) the date of the report (which *may* differ from the valuation date).

The majority of respondents were supportive of this change and comments ranged from “*Yes. Intended use is a key driver in scope of work determination, and reporting intended use thus puts the valuation in the proper context*” to “*Yes, a report must specify its intended use. This is both a common practice and a common requirement in other valuation and performance standards.*”

Further to discussions the Boards agreed that this was a necessary change and have added “*intended use*” as a mandatory reporting requirement.

IVS 104 *Bases of Value*: Basis for Conclusions

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation period 28 March 2019 to 29 June 2019)

Further to the feedback received from the IVS 2017 *Proposed Technical Revisions Exposure Draft* and additional discussions with stakeholders and other stakeholders the Boards engaged in discussions on Allocation of Value.

The Boards noted that many of the issues in relation to the valuation of a portfolio or business entity lay not in the overall Bases of Value reported, for example Fair Value or Market Value, but in how the overall valuation figure was allocated among the individual assets, particularly when in a business valuation, where there is an element of assemblage value, or within a tangible asset valuation, where there is an element of portfolio premium or discount.

Furthermore, for financial statements or for taxation purposes there is often a requirement to separate the purchase price of the building from the land, so the annual depreciation expense can be determined for the buildings. These bases of value also require allocations in a number of other situations including the acquisition of a basket of assets, or, the allocation of a gain/loss to individual assets.

The Boards noted that in many markets there was an inconsistency in the way values were allocated and felt that standards were required on allocation of value to provide greater consistency and transparency within markets and to reduce risk.

The Boards drafted the following overarching section on allocation of value to be included within IVS 104 *Basis of Value* with the aim of adding further sections on this topic within each of the asset standards at a later date.

220. Allocation of Value

- 220.1 Allocation of value, also known as apportionment of value, is the separate reporting of value of an asset on an overall, individual or component basis.
- 220.2 When allocating a value, the valuer must follow any legal or regulatory requirements and set out a clear and accurate description of the purpose and intended use of the assignment (see IVS101 *Scope of Work*, para 40.1, IVS 102 *Investigations and Compliance*, para 40.1 and IVS 103 *Reporting*, para 10.2)
- 220.3 If the total value for the sum of the components reported differs from the aggregate of the allocated value of its individual components, the valuer must state the reason(s) for the difference.
- 220.4 If the value of the asset includes an element of assemblage value or portfolio premium/discount the valuer must report the overall value separately from the value of the individual assets or components.

As part of the consultation process the Boards asked the following questions;

Question 8: Should IVS 2017 use the term 'allocation of value' or 'apportionment of value' or both?

Question 9: Should it be mandatory for the valuer to state the reason for the sum of the assets/components being greater or less than the whole as stated in para 220.3? If not, please provide your reasoning.

Question 10: Section 220.4 states that *“If the value of the asset includes an element of assemblage value or portfolio premium/discount the valuer must report the overall value separately from the value of the individual assets or components.”* Are there any instances where you feel that this is not the case, if so, please provide examples?

Question 11: Section 220 has been drafted to apply to all specialisms. Should additional Information be included within the Assets Standards for Business Valuation, Financial Instruments or Tangible Assets? If yes, please provide examples of the initial information to be included.

In respect of Question 8 there was a diversity of opinions from respondents and it was apparent that different markets and different specialisms tended to favour one of these terms and in some markets both terms were used.

In relation to Question 9 there was also a wide diversity of opinion, with some respondents commenting that, *“This rule can only apply if the valuer has determined component values. We generally agree with the rule. By complying, the valuer is providing additional valuable rationale which will benefit the user of the report”* whereas others felt that *“this section appears confusing as currently drafted”*.

Regarding Question 10 there was an even wider diversity of opinion among respondents, with some respondents commenting that *“the valuer must report the overall value separately from the value of the individual assets or components”* whereas other respondents commenting that *“the issue of portfolio premium/discount; assemblage value; sum-of-the parts vs aggregate value; assignment of value to the components of a group - as the topic might be described in many ways - is a complex issue that does not lend itself to a simple amendment and must be addressed in separate standard setting”*.

Finally, in relation to Question 11 there was also a wide diversity of opinion, with the majority of Tangible Assets respondents feeling no further information is needed within the Assets Standards for Tangible Assets, whereas the majority of Business Valuation and Financial Instruments respondents felt further additional standards were required.

Further to the consultation, the Boards carried out additional outreach and discussion with the IVSC Advisory Forum Working Group, IVSC members and other stakeholders. As a result of this outreach the Boards concluded that this was a complex issue and further market research and outreach was required. Furthermore, the Boards felt that it would be necessary to publish any section on *“allocation of value”* simultaneously within the General Standards and the Asset Standards.

IVS 105 Valuation Approaches and Methods: Basis for Conclusions

IVS 2017 Proposed Revisions Exposure Draft (Consultation period 16 July 2018 to 19 October 2018)

Stakeholder feedback on the proposed changes to IVS 105 *Valuation Approaches and Methods* was positive, with many agreeing with the language proposed in the *Exposure Draft* without edit. However, other respondents did provide specific comments and suggested edits for consideration by the Boards. Finally, a small number of respondents did not agree with the inclusion of the additional language as they believed the proposed additions were overly detailed. Ultimately the Boards believed that inclusion of the additional language on discount rates was warranted given the positive stakeholder feedback and made targeted updates to the proposed language from the *Exposure Draft* in response to respondent suggestions and additional Board discussions.

Furthermore, the Business Valuation Board (BVB) noted that the additional language may be difficult for stakeholders to interpret without additional discussions outside of the revised standard. As such, the BVB has sought to provide such detail and guidance within this Basis for Conclusions.

The Boards propose several minor revisions to IVS 105 *Valuation Approaches and Methods*. In particular, the Boards felt the additional text in para 10.5 regarding Option Pricing Models, etc, related more to business valuation and thus have been addressed in IVS 200 *Businesses and Business Interests* rather than the general section that applies to all asset classes.

With regard to paras 10.9 and 10.10, further to the comments contained in Section 102 *Investigations and Compliance Basis for Conclusions*, the Boards felt additional information on valuation limitations was required in order to provide further clarification and to provide additional detail to the changes made in IVS 102 *Investigations and Compliance*, para 20.7.

Further to comments received from the consultation process the Board have made the following changes to provide additional clarification:

- 10.5. While this standard includes discussion of certain methods within the Cost, Market and Income approaches, it does not provide a comprehensive list of all possible methods that *may* be appropriate. ~~Some of the many methods not addressed in this standard include option pricing methods (OPMs), simulation/Monte Carlo methods and probability weighted expected return methods (PWERM).~~ It is the *valuer's* responsibility to choose the appropriate method(s) for each *valuation* engagement. Compliance with IVS *may* require the *valuer* to use a method not defined or mentioned in the IVS.
- 10.9. ~~In certain circumstances, the *valuer* and the *client* may agree on the valuation approaches, methods and procedures the *valuer* will use or the extent of procedures the *valuer* will perform. Depending on the limitations placed on the *valuer* and procedures performed, such circumstances may result in a *valuation* that is not IVS compliant.~~
- 10.10. ~~A *valuation* may be limited or restricted where the *valuer* is not able to employ the valuation approaches, methods and procedures that a reasonable and informed third party would perform, and it is reasonable to expect that the effect of the limitation or restriction on the estimate of *value* could be *material*.~~

In respect to para 50.5 the Boards felt that with the additional language within the Discount Rate discussion, further clarification on “*expected*” versus “*most likely value*” of cash flows was needed. Respondents from the consultation process broadly agreed with these changes and therefore the Boards have revised this paragraph as follows;

- 50.5. When selecting the appropriate type of cash flow for the nature of *asset* or assignment, *valuers must* consider the factors below. In addition, the discount rate and other inputs *must* be consistent with the type of cash flow chosen:
- (a) Cash flow to whole *asset* or partial interest: Typically cash flow to the whole *asset* is used. However, occasionally other levels of income *may* be used as well, such as cash flow to equity (after payment of interest and principle on debt) or dividends (only the cash flow distributed to equity owners). Cash flow to the whole *asset* is most commonly used because an *asset should* theoretically have a single *value* that is independent of how it is financed or whether income is paid as dividends or reinvested.
 - (b) The cash flow can be pre-tax or post-tax: ~~if a post tax basis is used,~~ The tax rate applied *should* be consistent with the basis of value and in many instances would be a *participant* tax rate rather than an owner-specific one.
 - (c) Nominal versus real: Real cash flow does not consider inflation whereas nominal cash flows include expectations regarding inflation. If expected cash flow incorporates an expected inflation rate, the discount rate has to include ~~the same inflation rate~~ an adjustment for inflation as well.
 - (d) Currency: The choice of currency used *may* have an impact on assumptions related to inflation and risk. This is particularly true in emerging markets or in currencies with high inflation rates. ~~The currency in which the forecast is prepared and related risks are separate and distinct from risks associated with the country(ies) in which the asset resides or operates.~~
 - (e) ~~The type of cash flow contained in the forecast: For example, a cash flow forecast may represent expected cash flows, ie, probability-weighted scenarios), most likely cash flows, contractual cash flows, etc.~~

Based on stakeholder feedback it was felt that further standards were needed to address the significant diversity in practice in the derivation of discount rates. In particular, it was felt that further detail regarding consideration of projected cash flows and the relationship to the discount rate was needed. Given its inclusion in the *General Standards*, the proposed revisions to the Discount Rate section applies to all disciplines.

The Boards performed significant market engagement and considered various options on how to address the diversity in practice, including the creation of an additional chapter and substantial additions to the standards. However, to continue to provide principle-based standards, the Boards determined that the additions to the existing IVS 2017 section were sufficient and appropriate.

As outlined in the ITC, “*The assessment of an appropriate discount rate is a significant and highly subjective assumption often required to be made by valuers. The Boards and Stakeholders have noted significant diversity in practice and the absence of sufficient documentation supporting the rationale for discount rate assumptions. IVS 105 Valuation Approaches and Methods, para 50.29 through para 50.31, outlines various methods valuers may use and certain items a valuer*

should consider; however, stakeholder feedback has noted a relative lack of specificity within the current Standards. Such factors suggest that additional standards related to discount rate derivation would be helpful toward improving consistency and quality in the marketplace.”

Based on the findings from the ITC, the Boards determined that additional standards were required on the derivation of discount rates. In particular, feedback from the ITC noted persistent failure of valuers to provide their rationale or perform requisite diligence on the projected cash flow forecast as well as the unsubstantiated adjustments (eg, alpha- or company-specific risk premiums) to the discount rate. The proposed changes seek to address the diversity in practice in these areas.

The Board performed significant market engagement and considered various options on how to address the diversity in practice, including the creation of an additional chapter and substantial additions to the standards. However, to continue to provide principle-based standards, the Board determined that the following additions to the existing IVS 2017 section were sufficient and appropriate. The Boards have also recommended the following changes to IVS 105 paras 50.30-50.33 on Discount Rates in response to market feedback over inconsistency in market practices:

50.30. The discount rate *must* be consistent with the type of cash flow.

50.31. *Valuers may* use any reasonable method for developing **an appropriate discount rate**. While there are many methods for developing **a discount rate** or determining the reasonableness of a discount rate, a non-exhaustive list of common methods includes:

- (a) **a the** capital asset pricing model (CAPM),
- (b) **a the weighted average cost of capital (WACC),**
- (c) **the** observed or inferred rates/yields,
- (d) **a the** build-up method. **(generally used only in the absence of market inputs).**

50.32. *Valuers should* consider corroborative analyses when assessing the appropriateness of a discount rate. A non-exhaustive list of common analyses *should* include:

- (a) an internal rate of return (IRR),
- (b) **a weighted average return on assets (WARA),**
- (c) **value** indications from other approaches, such as market approach, or comparing implied multiples from the income approach with guideline company market multiples or transaction multiples.

50.33. In developing a discount rate, a *valuer should* consider:

- (a) ~~the risk associated with the projections made in the cash flow used,~~
- (a) the type of *asset* being valued. For example, discount rates used in *valuing* debt **could** be different to those used when *valuing* real property or a business,
- (b) the rates implicit in comparable transactions in the market,
- (c) the geographic location of the asset and/or the location of the markets in which it would trade,

- (d) the life/term and/or maturity of the asset and the consistency of inputs. For example, ~~the risk free rate considered would differ for an asset with three year life versus a 30 year life~~ the maturity of the risk-free rate applied will depend on the circumstances, but a common approach is to match the maturity of the risk-free instrument to the time horizon of the cash flows being considered.
- (e) the bases of value being applied.
- ~~(f) the type of cash flow being used (see para 50.5), and~~
- (f) the currency denomination of the projected cash flows.

In relation to the proposed additions to paras 50.34-50.37 stakeholders were broadly supportive of the changes suggested and further to feedback received and discussions the Board have revised these paragraphs as follows;

50.34. In developing a discount rate, the *valuer must*:

- (a) document the method used for developing the discount rate and support its use,
- (b) provide evidence for the derivation of the discount rate, including the identification of the significant inputs and support for their derivation or source.

50.35. *Valuers must* consider the *purpose* for which the forecast was prepared and whether the forecast assumptions are consistent with the basis of value being applied. If the forecast assumptions are not consistent with the basis of value, it could be necessary to adjust the forecast or discount rate (see para 50.38).

50.36. *Valuers must* consider the risk of achieving the forecast cash flow of the *asset* when developing the discount rate. Specifically, the *valuer must* evaluate whether the risk underlying the forecast cash flow assumptions are captured in the discount rate.

50.37. While there are many ways to assess the risk of achieving the forecast cash flow, a non-exhaustive list of common procedures includes:

- (a) Identify the key components of the forecast cash flow and compare the forecast cash flow key components to:
 - Historical operating and financial performance of the *asset*,
 - Historical and expected performance of comparable *assets*,
 - Historical and expected performance for the industry, and
 - Expected near-term and long-term growth rates of the country or region in which the *asset* primarily operates,
- (b) Confirm whether the forecast cash flow represents expected cash flows (ie, probability-*weighted* scenarios), as opposed to most likely cash flows (ie, most probable scenario), of the *asset*, or some other type of cash flow,
- (c) If utilising expected cash flows, consider the relative dispersion of potential outcomes used to derive the expected cash flows (eg, higher dispersion *may* indicate a need for an adjustment to the discount rate),
- (d) (d) Compare prior forecasts of the asset to actual results to assess the accuracy and reliability of managements' estimates,
- (e) (e) Consider qualitative factors, and

(f) (f) Consider the value indications such as those resulting from the Market Approach.

The Boards note that there are many different practices to assess the risk of achieving the forecast cash flow. As noted by para 50.37 the provided examples are not meant to be exhaustive, as facts and circumstances may dictate the use of other methodologies. Additionally, the Boards also note that para 50.37 is not a performance framework to assess the risk of achieving the forecast cash flows. As such, it may not be necessary for the valuer to perform every analysis listed. Similarly, the performance of each example does not ensure that the valuer has sufficiently assessed the risk of achieving the forecast cash flow as the specific facts and circumstances may necessitate an additional analysis as being most instructive to development of the discount rate.

Additionally, the Boards discussed consideration of qualitative factors. The Boards believe that the valuer should perform certain quantitative processes as described in paragraph 50.38, but also undertake a qualitative process to relate the quantitative considerations to the unique facts and circumstances of the subject company. The Boards discussed how if the subject company's forecasted cash flow diverge from the guideline public companies' projections and or industry/economy expectations, it does not necessarily mean that the forecast is inappropriate for use in the valuation. The valuer should understand the rationale for the differences and exercise professional judgement to assess whether this is appropriate based on the body of evidence obtained.

The Boards acknowledge the inherent difficulty in deriving an appropriate discount rate, especially under instances with increased uncertainty and large variability in potential cash flow. With regard to the revisions to IVS 105 on discount rates, the Boards are not attempting to implement a purely mechanical process, but rather ensure that a sufficient level of intellectual rigour has been employed when assessing the risks of the forecast and the derivation of any adjustments to the discount rate model through the use of alpha or company-specific risk premium (CRSP). Para 50.38 (a) and (b) outline the requirements for adjusting the forecast cash flows and the discount rate, respectively. As outlined in para 50.36, the Boards believe that the derivation of the adjustment to cash flows or to the discount rate should begin by understanding the differences between the subject company forecast cash flows, and historical performance of the subject company and industry expectations. The determination of industry expectations for growth and profitability may be derived from consideration of multiple sources, including: macro-economic trends, geographic growth considerations, industry growth rates as estimated by industry research reports, published equity analyst estimates of the subject company (if publicly traded) and the comparable companies, among other sources.

If the valuer determines the subject cash flows are not consistent with market participant expectations, and that the difference is not already captured in other elements of the discount rate, para 50.38 (a) outlines the various procedures to support the rationale for adjusting the forecast cash flows. The Boards acknowledge that there are multiple considerations to be made when adjusting the cash flows. For example, should the valuer default to industry revenue growth expectations? The answer will likely depend on similarity of the subject company and industry, as the more dissimilar the more possibility that expected cash flows of the subject company will diverge from the industry. For overall profitability and expected changes in profitability in the forecast period, the considerations are more complex. When faced with a forecast profitability or growth rate of the subject company that is not consistent with the industry, the valuer should first consider if the divergence has existed historically between the subject company and industry date (eg, profitability of the comparable companies). If the difference has not previously existed, the valuer should attempt to identify the source of the expected divergence and its merit. Alternatively, if the divergence has existed historically, the valuer should observe the level of divergence (eg, typically the subject company's profit has been at or near the maximum of the comparable companies), and if such outperformance is expected to persist in the future, then track to ensure that any contraction or expansion in

industry margins is also captured in the subject company forecast.

Cash flow forecasts used for valuation purposes may deviate from expected cash flows for a variety of reasons including acquisition synergies, the subject company's stage in the business life cycle, company restructurings and initiatives, inherent management bias (eg, stretch budget), etc. In many instances such reasons will make it difficult to adjust the forecast. In these situations, an adjustment to the discount rate will be necessary. In such cases, the best practice in the view of the Boards is for the valuer to adjust the discount rate to account for such risks. In other words, if the valuer does not utilise market participant cash flows, unadjusted use of the WACC is not appropriate as it theoretically will not match the risk in the forecast. The Boards noted a best practice is to determine the amount of alpha- or company-specific adjustment that is implied in the cash flows as compared to industry expectations. To do so, first the valuer would determine how much the cash flows would need to be adjusted to be consistent with industry expectations and determine the estimated value without any adjustments to the discount rate. Next, the valuer can revert to the provided forecast and solve for the amount of alpha or CSRP that is needed to equate the value to that derived with the industry consistent forecast. However, in many instances it is expected that the company will generate incremental return, such is the case with forecast synergies from an acquisition. In such instances, the incremental discount rate adjustments will likely be lower than that implied by adjusting the forecast down to industry expectations. While the Boards did not believe this quantitative reconciliation is necessary in all circumstances, they also did not believe that adding a CSRP or an alpha of x% to a discount rate based on professional judgement or a list of qualitative factors that are not calibrated in some way to the magnitude of the CSRP was consistent with IVS.

Further to feedback received and discussions the Boards have revised para 50.38 as follows;

- 50.38. If the *valuer* determines that certain risks included in the forecast cash flow for the *asset* have not been captured in the discount rate, the *valuer must*
- 1) adjust the forecast, or 2) adjust the discount rate to account for those risks not already captured:
 - (a) When adjusting the cash flow forecast, the *valuer should* provide the rationale for why the adjustments were necessary, undertake quantitative procedures to support the adjustments, and document the nature and amount of the adjustments, and
 - (b) When adjusting the discount rate, the *valuer should* document why it was not appropriate or possible to adjust the cash flow forecast, provide the rationale for why such risks are not otherwise captured in the discount rate, undertake quantitative and qualitative procedures to support the adjustments, and document the nature and amount of the adjustment. The use of quantitative procedures does not necessarily entail quantitative derivation of the adjustment to the discount rate. A *valuer* need not conduct an exhaustive quantitative process but *should* take into account all the information that is reasonably available.

The Boards reviewed para 50.39 and discussed that, in certain situations, market participants' view regarding the unit of account may have a significant impact on the appropriate risk profile of a specific asset or business. For example, the Boards discussed the divergent views market participants may take with regard to an early stage technology investment. The Boards discussed three different perspectives on the unit of account; 1) the technology project, 2) the technology project which constitutes the primary or only viable asset of an early stage company, and 3) the technology project as owned by a large conglomerate with numerous projects with similar risk profiles. If evaluating in isolation on a standalone basis (scenario 1), such projects typically have binary outcomes, many unknowns regarding achieving technical and market success, and thus high risk profiles.

Additionally, as part of an early stage company (scenario 2), the risk profile may be further increased due to risk factors attributable to other aspects of the business such as the company's funding requirements. Finally, the viewpoint of the project risk by a large diversified enterprise that may have hundreds of such projects, would be substantially different. As many of these risks are considered to be unsystematic in nature, a larger enterprise may consider the potential diversification effect of owning a portfolio of assets, and thus may evaluate the project value from this perspective.

The Boards also discussed how the selection of size premiums often requires similar considerations on the unit account market participants would assume. Market participants can reasonably take differing views on the appropriate size premium with regard to acquisitions (target size or acquirer size) as well as impairment analyses (CGU/reporting unit size or enterprise size). However, the Boards note that valuers should ensure that all other related assumptions are consistent with the unit of account that has been chosen. For example, it would generally not be correct to assume the diversification and umbrella benefits of a reporting unit/CGU being part of a larger enterprise (eg, use of the enterprise size premium), if the forecast did not also include the related overhead costs associated with administering the enterprise.

Further to feedback received and discussions the Boards have revised para 50.39 as follows;

50.39. In developing a discount rate, it may be appropriate to consider the impact the asset's unit of account has on unsystematic risks and the derivation of the overall discount rate. For example, the valuer should consider whether market participants would assess the discount rate for the asset on a standalone basis, or whether market participants would assess the asset in the context of a broader portfolio and therefore consider the potential diversification of unsystematic risks.

The Boards also discussed the impact of intercompany structures and the impact on an asset's risk profile. Many multinational corporations employ various transfer pricing structures that limit the risk for certain entities by giving them a fixed return on either sales or costs, while increasing the risk for other entities that act as a residual earner. When valuing entities and assets with such structures, the Boards noted that many valuers fail to consider the impact on the risk profile and appropriate discount rate. For entities with reduced risk, use of a CAPM without further consideration is typically not appropriate. The CAPM relies on the betas of comparable companies that are entrepreneurial, and thus bear the full risk of variability in both revenue and costs and the resulting operating leverage, whereas the limited risk entities are provided a fixed return and are only subject to the variability of either the change in revenue or costs. Further to the feedback received and discussions the Board have revised para 50.40 as follows;

50.40. A valuer should consider the impact of intercompany arrangements and transfer pricing on the discount rate. For example, it is not uncommon for intercompany arrangements to specify fixed or guaranteed returns for some businesses or entities within a larger enterprise, which would lower the risk of the entity forecasted cash flows and reduce the appropriate discount rate. However, other businesses or entities within the enterprise are deemed to be residual earners in which both excess return and risk are allocated, thereby increasing the risk of the entity forecasted cash flows and the appropriate discount rate.

IVS 105 Valuation Approaches and Methods: Basis for Conclusions

IVS 2017 Additional Technical Revisions Exposure Draft (Consultation period 28 March 2019 to 29 June 2019)

Further to the feedback received from the IVS 2017 *Proposed Technical Revisions Exposure Draft* and additional discussions with stakeholders the Boards engaged in discussions on Valuation Modelling.

The Boards had originally begun to look at this topic due to market feedback on technological disruption caused by the increasing use of Automated Valuation Models (AVMs) in many markets, particularly by banks and valuers for the valuation of residential properties for secured lending purposes. The Boards felt that many of these AVMs were used by valuers who may take the valuations at face value without fully understanding the workings or limitations of the model that they are using. Moreover, certain valuers could mistakenly believe that calculations (such as those derived from AVMs) are compliant with IVS.

Further to discussions amongst the Boards it was decided that the issue was greater than just the use of AVMs, as most valuations were conducted using some form of model as a tool for analysis, which can be applied in automated, semi-automated or manual format. Furthermore, the Boards felt that when a valuation model is used *“the valuer must take responsibility for the output of valuation model and keep appropriate records to support the selection of the model”*.

The Boards agreed that in the first instance IVS 2017 should include a section comprising an overarching valuation standard on valuation modelling requirements within IVS 104 *Valuation Approaches and Methods*. In due course the Boards are planning to include standards on data management within the General Standards and more specialism specific valuation modelling standards within the Asset Standards, such as a section on the use of AVMs within IVS 400 *Real Property Interests* or the use of valuation models for business valuation or the valuation of financial instruments.

As a result of these deliberations the following proposed section 90 was included with the IVS 2017 *Additional Technical Revisions Exposure Draft*.

- 90.1. A valuation model refers collectively to the quantitative methods, systems, techniques and qualitative judgements used to estimate and document *value*.
- 90.2. When using or creating a valuation model the *valuer must*:
 - a) Keep appropriate records to support the selection or creation of the model,
 - b) Understand and ensure the output of the valuation model, the significant assumptions and limiting conditions are consistent with the basis and scope of the *valuation*, and
 - c) Consider the key risks associated with the assumptions made in the valuation model.
- 90.3. Regardless of the nature of the valuation model, to be IVS compliant, the *valuer* must ensure that the *valuation* complies with all other requirements contained within IVS.

As part of the consultation process the Board asked the following questions;

Question 8: Should IVS 2017 use the term “*allocation of value*” or “*apportionment of value*” or both?

Question 12: Do you think that IVS should include a section within the *General Standards* on Modelling for Valuation purposes? If not, please provide your reasoning.

Question 13: Do you believe that IVS should define the term valuation model? If so, please suggest a definition and discuss why you think the additional definition is necessary.

Question 14: Do you believe that IVS should define the term valuation calculation? If so, please suggest a definition and discuss why you think the additional definition is necessary.

Question 15: Section 90.2 states that “*When using a valuation model the valuer must take responsibility for the output of valuation model....*” Are there any instances where you feel that this is not the case, if so, please provide examples?

Question 16: Section 90.2 also states that “*When using a valuation model the valuer must.... keep appropriate records to support the selection of the model.*” How long are you required to keep valuation records in the market(s) in which you operate? Please provide details of any relevant valuation record keeping legislation within the market(s) in which you operate.

Question 17: Do you agree with Section 80.3 that “*when using a valuation model the valuer must take responsibility for the output of valuation model and keep appropriate records to support the selection of the model?*” If not, please provide instances when this is not the case.

Question 18: Do you feel that additional valuation standards on valuation modelling are required within the *Asset Standards* (ie, IVS 200 *Business and Business Interests*, IVS 400 *Real Property Interests*, IVS 500 *Financial Instruments*)? If so, please provide an indication of the proposed content and where within the IVS *Asset Standards* you think this additional content should be contained.

In respect of Question 12 the majority of respondents *strongly supported the inclusion of a section on Modelling for Valuation Purposes within IVS General Standards.*

In relation to Question 13 the majority of respondents felt that a valuation model was sufficiently defined within Section 90.1, although a number of other respondents felt that the inclusion of a definition within the IVS glossary would be helpful.

Regarding Question 14 the majority of respondents did not feel that IVS should define the term “*calculation*” separately, as in they felt that, although calculations may form part of a valuation they were outside the context of IVS and their inclusion could cause confusion.

In respect of Question 15 the majority of respondents felt that there were no instances that the valuer, when using a valuation model, must not take responsibility for the output of a valuation model. Some respondents commented further that “*it is a fundamental principle of the IVS that a valuer takes responsibility for the value reported*”.

In relation to Question 16 most respondents agreed that “*when using a valuation*

model the valuer must keep appropriate records to support the selection of the Model". However, it was noted that this requirement related to all valuations and a number of respondents suggested that IVS should include a record keeping rule for all valuations. Furthermore, it was noted that each market had its own requirements in relation to record keeping, some of which are contained in legislation.

Regarding Question 17 most respondents agreed with the proposed section 80.3, which stated that *"when using a valuation model the valuer must take responsibility for the output of a valuation model and keep appropriate records to support the selection of the model"*.

Finally, in relation to Question 18 most respondents agreed that *"additional valuation standards on valuation modelling are required within the Asset Standards (ie, IVS 200 Business and Business Interests, IVS 400 Real Property Interests, IVS 500 Financial Instruments)"*.

Further to the consultation the Boards carried out additional outreach and discussion with the IVSC Advisory Forum Working Group, IVSC members and other stakeholders. As a result of this outreach the Board slightly amended the text to eliminate any ambiguities and ensure the revised text is fit for purpose for all specialisms. As a result of these deliberations the following text shown below has been incorporated into IVS;

90 Valuation Model

- 90.1. A valuation model refers collectively to the quantitative methods, systems, techniques and qualitative judgements used to estimate and document *value*.
- 90.2. When using or creating a valuation model, the *valuer* must:
 - (a) Keep appropriate records to support the selection or creation of the model,
 - (b) Understand and ensure the output of the valuation model, the significant assumptions and limiting conditions are consistent with the basis and scope of the *valuation*, and
 - (d) Consider the key risks associated with the assumptions made in the valuation model.
- 90.3. Regardless of the nature of the valuation model, to be IVS compliant, the *valuer* must ensure that the *valuation* complies with all other requirements contained within IVS.

IVS 200 Businesses and Business Interests: Basis for Conclusions

IVS 2017 Proposed Revisions Exposure Draft (Consultation period 16 July 2018 to 19 October 2018)

As part of the ITC process the Boards and stakeholders noted significant diversity in practice for the valuation of early-stage companies resulting in a lack of transparency and market confusion. Both the Boards and stakeholder feedback initially indicated that there are certain issues that arise in the valuation of early stage companies that are unique, and therefore may not be covered in current IVS. Further to discussion amongst the Boards it was felt that many of the issues were shared with other valuations undertaken with limited information or high uncertainty, and therefore there was no need for an additional new chapter on the topic, with the exception of complex capital structures which required additional standards. The Boards also noted consistent feedback from stakeholders with regard to a lack of standards related to complex capital structure considerations and that complex capital structures had itself been identified as a separate topic for consideration within IVSC's Gap Analysis. Instead of preparing a separate chapter to provide additional standards on complex capital structure methods and considerations, the Boards decided to expand upon the existing Capital Structure Considerations section within IVS 200 *Businesses and Business Interests*.

Additionally, the AICPA released in 2018 its first working draft entitled *Valuation of Portfolio Company Investments of Venture Capital and Private Equity Funds and Other Investment Companies*. The Boards are actively monitoring and communicating with the AICPA PE/VC Task Force, and where applicable and appropriate, plan to ensure consistency between IVS and the AICPA handbook.

The Boards also discussed inclusion of these changes within IVS 105 *Valuation Approaches and Methods*. However, further to discussions it was felt that the techniques and methods were more applicable to business valuation than to other asset classes. As such, it was considered more appropriate to include the changes in IVS 200 *Businesses and Business Interests*.

Stakeholder feedback on the proposed changes to IVS 200 *Businesses and Business Interests* was positive, with many agreeing with the language proposed in the *Exposure Draft* without edit. Other respondents did provide specific comments and suggested edits for consideration by the Boards. Finally, a small number of respondents did not agree with the inclusion of the additional language as they believed the proposed additions were overly detailed. Ultimately the Boards believed that inclusion of the additional language on capital structure considerations was warranted given the positive stakeholder feedback and made targeted updates to the proposed language from the *Exposure Draft* in response to respondent suggestions and additional Board discussions.

Further to the feedback received and discussions the Board have made the following changes to IVS 200 in order to provide additional clarification:

130.1 Businesses are often financed through a combination of debt and equity. However, in many cases, valuers **could may** be asked to value only equity, or a particular class of equity or **some other form of ownership interest 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 the various classes of 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.~~

130.2 While there are many ownership interests in an asset which a valuer could be asked to value, a non-exhaustive list of such interests includes:

- (a) bonds,
- (b) convertible debt,
- (c) partnership interest,
- (d) minority interest,
- (e) common equity,
- (f) preferred equity,
- (g) options,
- (h) warrants.

~~130.2 130.3. In circumstances where the value of debt may differ from its book value, valuers should either value the debt directly or 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.~~

When a *valuer* is asked to *value* only equity, or determine how the business value as a whole is distributed among the various debt and equity classes, a *valuer must* determine and consider the different rights and preferences associated with each class of debt and equity. Rights and preferences can broadly be categorised as economic rights or control rights.

A non-exhaustive list of such rights and preferences *may* include:

- (a) dividend or preferred dividend rights,
- (b) liquidation preferences,
- (c) voting rights,
- (d) redemption rights,
- (e) conversion rights,
- (f) participation rights,
- (g) anti-dilution rights
- (h) registration rights, and
- (i) put and/or call rights.

130.4 For simple capital structures that include only common stock and simple debt structures (such as bonds, loans and overdrafts), it may be possible to estimate the value of all of the common stock within the enterprise by directly estimating the value of debt, subtracting that value from the enterprise value, then allocating the residual equity value pro rata to all of the common stock. This method is not appropriate for all companies with simple capital structures, for example it may not be appropriate for distressed or highly leveraged companies.

130.5 For complex capital structures, being those that include a form of equity other than just common stock, valuers may use any reasonable method to determine the value of equity or a particular class of equity. In such cases, typically the enterprise value of the business is determined and

then that value is allocated between the various classes of debt and equity. Three methods that valuers could utilise in such instances are discussed in this section, including:

- (a) current value method (CVM);
- (b) option pricing method (OPM); and
- (c) probability-weighted expected return method (PWERM).

- 130.6 While the CVM is not forward looking, both the OPM and PWERM estimate values assuming various future outcomes. The PWERM relies on discrete assumptions for future events and the OPM estimates the future distribution of outcomes using a lognormal distribution around the current value.
- 130.7 A valuer should consider any potential differences between a “pre-money” and “post-money” valuation, particularly for early stage companies with complex capital structures. For example, an infusion of cash (ie, “post- money valuation”) for such companies may impact the overall risk profile of the enterprise as well as the relative value allocation between share classes.
- 130.8 A valuer should consider recent transactions in the subject equity or a particular class of equity, and ensure the assumptions used in the subject valuation are updated as necessary to reflect changes in the investment structure and changes in market conditions.

Current Value Method (CVM)

- 130.9 The current value method (CVM) allocates the enterprise value to the various debt and equity securities assuming an immediate sale of the enterprise. Under the CVM, the obligations to debt holders, or debt equivalent securities, is first deducted from the enterprise value to calculate residual equity value (valuers should consider if the enterprise value includes or excludes cash, and the resulting use of gross or net debt for allocation purposes). Next, value is allocated to the various series of preferred stock based on the series’ liquidation preferences or conversion values, whichever would be greater. Finally, any residual value is allocated to any common equity, options, and warrants.
- 130.10 A limitation of the CVM is that it is not forward looking and fails to consider the option-like payoffs of many share classes.
- 130.11 The CVM should only be used when 1) a liquidity event of the enterprise is imminent, 2) when an enterprise is at such an early stage of its development that no significant common equity value above the liquidation preference on any preferred equity has been created, 3) no material progress has been made on the company’s business plan, or 4) no reasonable basis exists for estimating the amount and timing of any such value above the liquidation preference that might be created in the future.
- 130.12 Valuers should not assume that the value of debt, or debt-like securities, and its book value are equal without rationale for the determination.

Option Pricing Method (OPM)

- 130.13 The OPM values the different share classes by treating each share class as an option on the cash flows from the enterprise. The OPM is often applied to capital structures in which the payout to different share classes changes at different levels of total equity value, for instance,

where there are convertible preferred shares, management incentive units, options, or other classes of shares that have certain liquidation preferences. The OPM may be performed on the enterprise value, thereby including any debt in the OPM, or on an equity basis after separate consideration of the debt.

- 130.14 The OPM considers the various terms of the stockholder agreements that would affect the distributions to each class of equity upon a liquidity event, including the level of seniority among the securities, dividend policy, conversion ratios, and cash allocations.
- 130.15 The starting point for the OPM is the value of total equity for the asset. The OPM is then applied to allocate the total equity value among equity securities.
- 130.16 The OPM (or a related hybrid method) is suited to circumstances where specific future liquidity events are difficult to forecast or the company is in an early stage of development.
- 130.17 The OPM most frequently relies on the Black–Scholes option pricing model to determine the value associated with distributions above certain value thresholds.
- 130.18. When applying the OPM, a non-exhaustive list of the steps *valuers should* perform includes:
- (a) Determine the total equity value of the *asset*,
 - (b) Identify the liquidation preferences, preferred dividend accruals, conversion prices, and other features attached to the relevant securities that influences the cash distribution,
 - (c) Determine the different total equity value points (breakpoints) in which the liquidation preferences and conversion prices become effective,
 - (d) Determine the inputs to the Black–Scholes model:
 - 1) determine a reasonable time horizon for the OPM,
 - 2) select a risk-free rate corresponding to the time horizon,
 - 3) determine the appropriate volatility factor for the equity of the *asset*, and,
 - 4) determine the expected dividend yield.
 - (e) Calculate a *value* for the various call options and determine the *value* allocated to each interval between the breakpoints,
 - (f) Determine the relative allocation to each class of shares in each interval between the calculated breakpoints,
 - (g) Allocate the *value* between the breakpoints (calculated as the call options) among the share classes based on the allocation determined in step (f) and the *value* determined in step (e),
 - (h) Consider additional adjustments to the share classes as necessary, consistent with the basis of value. For example, it *may* be appropriate to apply discounts or premiums.
- 130.19. When determining the appropriate volatility assumption *valuers should* consider:
- 1) the development stage of the *asset* and the relative impact to the

volatility when compared to that observed by the comparable companies, and,

2) the relative financial leverage of the asset.

130.20. In addition to the method as discussed above, the OPM can be used to back solve for the *value* of total equity value when there is a known price for an individual security. The inputs to a back solve analysis are the same as above. *Valuers* will then solve for the price of the known security by changing the *value* of total equity. The back solve method will also provide a *value* for all other equity securities.

Probability-Weighted Expected Return Method (PWERM)

130.21. Under a PWERM, the *value* of the various equity securities are estimated based upon an analysis of future *values* for the *asset*, assuming various future outcomes. Share value is based upon the probability-weighted present value of expected future investment returns, considering each of the possible future outcomes available to the *asset*, as well as the rights and preferences of the share classes.

130.22. Typically, the PWERM is used when the company is close to exit and does not plan on raising additional capital.

130.23. When applying the PWERM, a non-exhaustive list of the steps *valuers should* perform includes:

- (a) Determine the possible future outcomes available to the *asset*,
- (b) Estimate the future value of the *asset* under each outcome,
- (c) Allocate the estimated future value of the *asset* to each class of debt and equity under each possible outcome,
- (d) Discount the expected value allocated to each class of debt and equity to present value using a risk-adjusted discount rate,
- (e) *Weight* each possible outcome by its respective probability to estimate the expected future probability-weighted cash flows to each class of debt and equity,
- (f) Consider additional adjustments to the share classes as necessary, consistent with the basis of value. For example, it *may* be appropriate to apply discounts or premiums.

130.24. *Valuers should* reconcile the probability-weighted present values of the future exit values to the overall *asset* value to make sure that the overall *valuation* of the enterprise is reasonable.

130.25. *Valuers* can combine elements of the OPM with the PWERM to create a hybrid methodology by using the OPM to estimate the allocation of *value* within one or more of the probability-weighted scenarios.

IVS 220 Non-Financial Liabilities: Basis for Conclusions

IVS 220 Non-Financial Liabilities: Exposure Draft (Consultation period 4 January 2019 to 1 April 2019)

The Boards conducted a robust process on the valuation of non-financial liabilities, which culminated with the issuance of IVS 220 *Non-Financial Liabilities*. Central to this process was the issuance of the IVS 220 *Exposure Draft*, which was in consultation between 4 January 2019 and 1 April 2019. The Boards have carefully considered all the comments received during the consultation process in order to finalise IVS 220 *Non-Financial Liabilities*.

The determination of the IVS 220 scope was critical to the overall project and resulting standard. Based on stakeholder feedback, the Boards determined that for purposes of IVS 220, non-financial liabilities should be defined as those liabilities requiring a non-cash performance obligation to provide goods or services.

The Boards have excluded contingent consideration from the scope of IVS 220, even in those instances in which contingent consideration liabilities include a non-cash performance obligation. The Business Valuation Board felt that the unique attributes and valuation techniques of contingent consideration warrant a separate project and related standard. As such, the Business Valuation Board will work with the Financial Instruments Board to proceed with a project on contingent consideration.

The Boards believe that the valuation of non-financial liabilities should continue to be an ongoing project for consideration. In particular, the Boards believe that targeted additions may prove helpful. Such topics in which IVS 220 may revisit at a future date include:

- Discount rates
- Risk margins
- Discussion on methodologies and considerations related to specific non-financial liabilities.

Further to feedback received from stakeholders, the Boards have issued the new chapter IVS 220 *Non-Financial Liabilities* within IVS.

IVS 220 Non-Financial Liabilities

10. Overview

- 10.1 The principles contained in the General Standards apply to *valuations* of non-financial liabilities and *valuations* with a non-financial liability component. This standard contains additional requirements that apply to *valuations* of non-financial liabilities.
- 10.2 With regard to the determination of discount rates and risk margins, in circumstances in which IVS 105 *Valuation Approaches and Methods* (see paras 50.29-50.31) conflicts with IVS 220 *Non-Financial Liabilities*, *valuers must* apply the principles in sections 90 and 100 of this Standard in *valuations* of non-financial liabilities.

20. Introduction

- 20.1 For *purposes* of IVS 220 *Non-Financial Liabilities*, non-financial liabilities are defined as those liabilities requiring a non-cash performance obligation to provide goods or services.
- 20.2 A non-exhaustive list of liabilities that *may* in part or in full require a non-cash fulfilment and be subject to IVS 220 *Non-Financial Liabilities* includes: deferred revenue or contract liabilities, warranties, environmental liabilities, *asset* retirement obligations, certain contingent consideration obligations, loyalty programmes, power purchase agreements, certain litigation reserves and contingencies, and certain indemnifications and guarantees.
- 20.3 Although certain contingent consideration liabilities *may* require a non-cash performance obligation, such liabilities are not included in the scope of *IVS 220 Non-Financial Liabilities*.
- 20.4 The party assuming a non-financial liability typically requires a profit margin on the fulfilment effort to compensate for the effort incurred and risk borne for the delivery of goods or services.
- 20.5 For financial liabilities, cash fulfilment is typically the only performance obligation and no additional compensation is needed for the fulfilment effort. Given that cash fulfilment is the only performance obligation for financial liabilities, asset-liability symmetry most often enables valuers to assess the subject liability using an asset framework.
- 20.6 Asset-liability symmetry typically does not exist for non-financial liabilities due to the performance obligation to provide goods and services to satisfy the liability and additional compensation for such effort. As such, non-financial liabilities will most often be valued using a liability framework.
- 20.7 In instances in which a corresponding asset is recognised by the counterparty, the *valuer must* assess if the *values* would reflect asset-liability symmetry under circumstances consistent with the basis of value. Certain bases of value issued by entities/organisations other than the IVSC require the specific consideration and reconciliation to a corresponding asset under certain circumstances. The *valuer must* understand and follow the regulation, case law, and other interpretive guidance related to those bases of value as of the valuation date (see IVS 200 *Businesses and Business Interests*, para 30.2). Instances in which the *valuer* should reconcile to a corresponding asset value will be rare, reasons include:

- (a) Non-financial liabilities often do not have a recorded corresponding *asset* recognised by the counterparty (eg, environmental liability), or can only be transferred in conjunction with another *asset* (eg, an automobile and related warranty are only transferred together).
 - (b) The corresponding *asset* of a non-financial liability *may* be held by numerous parties for which it is impractical to identify and reconcile the *asset values*.
 - (c) The market for the non-financial *asset* and liability is often highly illiquid, thus resulting in asymmetric information, high bid ask spreads, and *asset-liability asymmetry*.
- 20.8 *Participants* that most often transact in the subject non-financial liability *may* not be the comparable companies and competitors of the entity holding the subject non-financial liability. Examples include insurance companies, third party warranty issuers, and more. *The valuer should* consider if a market, or *participants*, exist outside the immediate industry in which the entity holding the subject non-financial liability operates.
- 20.9 Non-financial liability *valuations* are performed for a variety of *purposes*. It is the *valuer's* responsibility to understand the *purpose* of a *valuation* and whether the non-financial liabilities *should* be valued, whether separately or grouped with other *assets*. A non-exhaustive list of examples of circumstances that commonly include a non-financial liability *valuation* component is provided below:
- (a) For financial reporting *purposes*, *valuations* of non-financial liabilities are often required in connection with accounting for business combinations, *asset* acquisitions and sales, and impairment analysis.
 - (b) For tax reporting *purposes*, non-financial liability valuations are often needed for transfer pricing analyses, estate and gift tax planning and reporting, and ad valorem taxation analyses.
 - (c) Non-financial liabilities *may* be the subject of litigation, requiring *valuation* analysis in certain circumstances.
 - (d) *Valuers* are sometimes asked to *value* non-financial liabilities as part of general consulting, collateral lending and transactional support engagements.
- 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 non-financial liabilities.
- 30.2 Often, non-financial liability valuations are performed using bases of value defined by entities/organisations other than the IVSC (some examples of which are mentioned in IVS 104 *Bases of Value*) and the *valuer must* understand and follow the regulation, case law, and other interpretive guidance related to those bases of value as of the valuation date (see IVS 200 *Businesses and Business Interests*, para 30.2).
- 40. Valuation Approaches and Methods**
- 40.1 Elements of the three valuation approaches described in IVS 105 *Valuation Approaches* (market, income and cost approach) can all be applied to the *valuation* of non-financial liabilities. The methods described below *may* exhibit elements of more than one approach. If it is necessary for the *valuer* to classify a method under one of the three approaches,

the *valuer should* use judgement in making the determination and not necessarily rely on the classification below.

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

50. Market Approach

- 50.1 Under the market approach, the *value* of a non-financial liability is determined by reference to market activity (for example, transactions involving identical or similar non-financial liabilities).
- 50.2 Transactions involving non-financial liabilities frequently also include other *assets*, such as a business combinations that include tangible and intangible *assets*.
- 50.3 Transactions involving standalone non-financial liabilities are infrequent as compared with transactions for businesses and *assets*.
- 50.4 While standalone transactions of non-financial liabilities are infrequent, *valuers should* consider relevant market-based indications of *value*. Although such market-based indications *may* not provide sufficient information with which to apply the market approach, the use of market-based inputs *should* be maximised in the application of other approaches.
- 50.5 A non-exhaustive list of such market indications of *value* includes:
- (a) Pricing from third parties to provide identical or similar products as the subject non-financial liability (eg, deferred revenue),
 - (b) Pricing for warranty policies issued by third parties for identical or similar obligations,
 - (c) The prescribed monetary conversion amount as published by *participants* for certain loyalty reward obligations,
 - (d) The traded price for contingent *value* rights (CVRs) with similarities to the subject non-financial liability (eg, contingent consideration),
 - (e) Observed rates of return for investment funds that invest in non-financial liabilities (eg, litigation finance).
- 50.6 *Valuers must* comply with paras 20.2 and 20.3 of IVS 105 *Valuation Approaches and Methods* when determining whether to apply the market approach to the *valuation* of non-financial liabilities.
- 50.7 The diverse nature of many non-financial liabilities and the fact that non-financial liabilities seldom transact separately from other *assets* means that it is rarely possible to find market evidence of transactions involving similar non-financial liabilities.
- 50.8 Where evidence of market prices is available, *valuers should* consider adjustments to these to reflect differences between the subject non-financial liability and those involved in the transactions. These adjustments are necessary to reflect the differentiating characteristics of the subject non-financial liability and those involved in the transactions. Such adjustments *may* only be determinable at a qualitative, rather than quantitative, level. However, the need for *significant* qualitative adjustments could indicate that another approach would be more appropriate for the *valuation*.

- 50.9 In certain instances a valuer may rely on market prices or evidence for an asset corresponding to the subject non-financial liability. In such instances, the valuer should consider an entity's ability to transfer the subject non-financial liability, whether the asset and related price of the asset reflect those same restrictions, and whether adjustments to reflect the restrictions should be included. The valuer should take care to determine if the transfer restrictions are characteristics of the subject non-financial liability (for example, an illiquid market) or restrictions that are characteristics of the entity (for example, financial distress).
- 50.10 The comparable transaction method, also known as the guideline transactions method, is generally the only market approach method that can be applied to value non-financial liabilities.
- 50.11 In rare circumstances, a security sufficiently similar to a subject non-financial liability could be publicly traded, allowing the use of the guideline public company method. One example of such securities is contingent value rights that are tied to the performance of a particular product or technology.

Market Approach Methods

- 50.12 A method to value non-financial liabilities under the Market Approach is often referred to as the Top-Down Method.

Top-Down Method

- 50.13 Under the Top-Down Method, valuing non-financial liabilities is based on the premise that reliable market-based indications of pricing are available for the performance obligation.
- 50.14 A *participant* fulfilling the obligation to deliver the product or services associated with the non-financial liability could theoretically price the liability by deducting costs already incurred toward the fulfilment obligation, plus a mark-up on those costs, from the market price of services.
- 50.15 When market information is used to determine the *value* of the subject non-financial liability, discounting is typically not necessary because the effects of discounting are incorporated into observed market prices.
- 50.16 The key steps in applying a Top-Down Method are to:
- (a) Determine the market price of the non-cash fulfilment.
 - (b) Determine the costs already incurred and *assets* utilised by the transferor. The nature of such costs will differ depending on the subject non-financial liability. For example, for deferred revenue the costs will primarily consist of sales and marketing costs that have already been incurred in generating the non-financial liability.
 - (c) Determine a reasonable profit margin on the costs already incurred.
 - (d) Subtract costs incurred and profit from the market price.

60. Income Approach

- 60.1 Under the income approach, the *value* of a non-financial liability is often determined by reference to the present value of the costs to fulfil the obligation plus a profit margin that would be required to assume the liability.
- 60.2 *Valuers must* comply with paras 40.2 and 40.3 of IVS 105 *Valuation Approaches and Methods* when determining whether to apply the income approach to the *valuation* of non-financial liabilities.

Income Approach Methods

- 60.3 The primary method to value non-financial liabilities under the Income Approach is often referred to as the Bottom-Up Method.

Bottom-Up Method

- 60.4 Under the Bottom-Up Method, the non-financial liability is measured as the costs (which *may* or *may not* include certain overhead items) required to fulfil the performance obligation, plus a reasonable mark-up on those costs, discounted to present value.
- 60.5 The key steps in applying a Bottom-Up Method are to:
- (a) Determine the costs required to fulfil the performance obligation. Such costs will include the direct costs to fulfil the performance obligation, but *may* also include indirect costs such as charges for the use of contributory assets. Fulfilment costs represent those costs that are related to fulfilling the performance obligation that generates the non-financial liability. Costs incurred as part of the selling activities before the acquisition date *should* be excluded from the fulfilment effort.
 1. Contributory asset charges *should* be included in the fulfilment costs when such assets would be required to fulfil the obligation and the related cost is not otherwise captured in the income statement.
 2. In limited instances, in addition to direct and indirect costs, it *may* be appropriate to include opportunity costs. For example, in the licensing of symbolic intellectual property, the direct and indirect costs of fulfilment *may* be nominal. However, if the obligation reduces the ability to monetise the underlying asset (in an exclusive licensing arrangement for example), then the *valuer should* consider how *participants* would account for the potential opportunity costs associated with the non-financial liability.
 - (b) Determine a reasonable mark-up on the fulfilment effort. In most cases it *may* be appropriate to include an assumed profit margin on certain costs which can be expressed as a target profit, either a lump sum or a percentage return on cost or *value*. An initial starting point *may* be to utilise the operating profit of the entity holding the subject non-financial liability. However, this methodology assumes the profit margin would be proportional to the costs incurred. In many circumstances there is rationale to assume profit margins which are not proportional to costs. In such cases the risks assumed, *value* added, or intangibles contributed to the fulfilment effort are not the same as those contributed pre-measurement date. When costs are derived from actual, quoted or estimated prices by third party suppliers or contractors, these costs will already include a third party's desired level of profit.
 - (c) Determine timing of fulfilment and discount to present value. The discount rate *should* account for the time value of money and non-performance risk. Typically it is preferable to reflect the impact of uncertainty such as changes in anticipated fulfilment costs and fulfilment margin through the cash flows, rather than in the discount rate.
 - (d) When fulfilment costs are derived through a percent of revenue, *valuers should* consider whether the fulfilment costs already implicitly include the impact of discounting. For example, prepayment for services *may* result in a discount as one would expect to pay less for the same service as compared with paying throughout the contract term. As a result,

the derived costs *may* also contain an implicit discount and further discounting *may* not be necessary.

70. Cost Approach

- 70.1 The cost approach has limited application for non-financial liabilities as participants typically expect a return on the fulfilment effort.
- 70.2 Valuers must comply with paras 60.2 and 60.3 of IVS 105 Valuation Approaches and Methods when determining whether to apply the cost approach to the valuation of non-financial liabilities.

80. Special Considerations for Non-Financial Liabilities

- 80.1 The following sections address a non-exhaustive list of topics relevant to the *valuation* of non-financial liabilities.
- (a) Discount Rates for Non-Financial Liabilities (section 90)
 - (b) Estimating Cash Flows and Risk Margins (section 100)
 - (c) Restrictions on Transfer (section 110)
 - (d) Taxes (section 120)

90. Discount Rates for Non-Financial Liabilities

- 90.1 A fundamental basis for the income approach is that investors expect to receive a return on their investments and that such a return *should* reflect the perceived level of risk in the investment.
- 90.2 The discount rate *should* account for the time *value* of money and non-performance risk. Non-performance risk is typically a function of counterparty risk (ie, credit risk of the entity obligated to fulfil the liability) (see para 60.5c of this Standard).
- 90.3 Certain bases of value issued by entities/organisations other than the IVSC *may* require the discount rate to specifically account for liability specific risks. The *valuer must* understand and follow the regulation, case law, and other interpretive guidance related to those bases of value as of the valuation date (see IVS 200 *Businesses and Business Interests*, para 30.2).
- 90.4 *Valuers should* consider the term of the subject non-financial liability when determining the appropriate inputs for the time value of money and non-performance risk.
- 90.5 In certain circumstances, the *valuer may* explicitly adjust the cash flows for non-performance risk.
- 90.6 What a *participant* would have to pay to borrow the funds necessary to satisfy the obligation *may* provide insights to help quantify the non-performance risk.
- 90.7 Given the long-term nature of certain non-financial liabilities, the *valuer must* consider if inflation has been incorporated into the estimated cash flows, and *must* ensure that the discount rate and cash flow estimates are prepared on a consistent basis.

100. Estimating Cash Flows and Risk Margins

- 100.1 The principles contained in IVS 105 *Valuation Approaches and Methods* *may* not apply to *valuations* of non-financial liabilities and *valuations* with a non-financial liability component (see IVS 105 *Valuation Approaches and*

Methods, paras 50.12-50.19). *Valuers must* apply the principles in sections 90 and 100 of this Standard in *valuations* of non-financial liabilities.

- 100.2 Non-financial liability cash flow forecasts often involve the explicit modelling of multiple scenarios of possible future cash flow to derive a probability-weighted expected cash flow forecast. This method is often referred to as the Scenario-Based Method (SBM). The SBM also includes certain simulation techniques such as the Monte Carlo simulation. The SBM is commonly used when future payments are not contractually defined but rather vary depending upon future events. When the non-financial liability cash flows are a function of systematic risk factors, the valuer should consider the appropriateness of the SBM, and may need to utilise other methods such as option pricing models (OPMs).
- 100.3 Considerations in estimating cash flows include developing and incorporating explicit assumptions, to the extent possible. A non-exhaustive list of such assumptions *may* include:
- (a) The costs that a third party would incur in performing the tasks necessary to fulfil the obligation,
 - (b) Other amounts that a third party would include in determining the price of the transfer, including, for example, inflation, overhead, equipment charges, profit margin, and advances in technology,
 - (c) The extent to which the amount of a third party's costs or the timing of its costs would vary under different future scenarios and the relative probabilities of those scenarios, and,
 - (d) The price that a third party would demand and could expect to receive for bearing the uncertainties and unforeseeable circumstances inherent in the obligation.
- 100.4 While expected cash flows (ie, the probability-weighted average of possible future cash flows) incorporate the variable expected outcomes of the *asset's* cash flows, they do not account for the compensation that *participants* demand for bearing the uncertainty of the cash flows. For non-financial liabilities, forecast risk *may* include uncertainty such as changes in anticipated fulfilment costs and fulfilment margin. The compensation for bearing such risk *should* be incorporated into the expected payoff through a cash flow risk margin or the discount rate.
- 100.5 Given the inverse relationship between the discount rate and *value*, the discount rate *should* be decreased to reflect the impact of forecast risk (ie, the compensation for bearing risk due to uncertainty about the amount and timing of cash flows).
- 100.6 While possible to account for forecast risk by reducing the discount rate, given its limited practical application, the *valuer must* explain the rationale for reducing the discount rate rather than incorporating a risk margin, or specifically note the regulation, case law, or other interpretive guidance that requires the accounting for forecast risk of non-financial liabilities through the discount rate rather than a risk margin (see IVS 200 *Businesses and Business Interests*, para 30.2).
- 100.7 In developing a risk margin, a *valuer must*:
- (a) document the method used for developing the risk margin, including support for its use, and,
 - (b) provide evidence for the derivation of the risk margin, including the

identification of the significant inputs and support for their derivation or source.

100.8 In developing a cash flow risk margin, a valuer must consider:

- (a) the life/term and/or maturity of the *asset* and the consistency of inputs,
- (b) the geographic location of the *asset* and/or the location of the markets in which it would trade,
- (c) the currency denomination of the projected cash flows, and
- (d) the type of cash flow contained in the forecast, for example, a cash flow forecast *may* represent expected cash flows (ie, probability-weighted scenarios), most likely cash flows, contractual cash flows, etc

100.9 In developing a cash flow risk margin, a *valuer should* consider:

- (a) the less certainty there is in the anticipated fulfilment costs and fulfilment margin, the higher the risk margin *should* be,
- (b) given the finite term of most non-financial liabilities, as opposed to indefinite for many business and *asset* valuations, to the extent that emerging experience reduces uncertainty, risk margins *should* decrease, and vice versa,
- (c) the expected distribution of outcomes, and the potential for certain non-financial liabilities to have high 'tail risk' or severity. Non-financial liabilities with wide distributions and high severity *should* have higher risk margins,
- (d) the respective rights and preferences of the non-financial liability, and/or related *asset*, in the event of a liquidation and its relative position within the liquidation waterfall.

100.10 The cash flow risk margin *should* be the compensation that would be required for a party to be indifferent between fulfilling a liability that has a range of possible outcomes, and one that will generate fixed cash outflows.

100.11 A *valuer* need not conduct an exhaustive quantitative process, but *should* take into account all the information that is reasonably available.

110. Restrictions on Transfer

110.1 Non-financial liabilities often have restrictions on the ability to transfer. Such restrictions can be either contractual in nature, or a function of an illiquid market for the subject non-financial liability.

110.2 When relying on market evidence, a valuer should consider an entity's ability to transfer such non-financial liabilities and whether adjustments to reflect the restrictions should be included. The valuer may need to determine if the transfer restrictions are characteristics of the non-financial liability or restrictions that are characteristics of an entity, as certain basis of value may specify one or the other be considered (see IVS 220 *Non-Financial Liabilities*, para 50.9).

110.3 When relying on an income approach in which the non-financial liability value is estimated through a fulfilment approach, the valuer should determine if an investor would require an additional risk margin to account for the limitations on transfer.

120. Taxes

- 120.1 Valuers should use pre-tax cash flows and a pre-tax discount rate for the valuation of non-financial liabilities.
- 120.2 In certain circumstances, it may be appropriate to perform the analysis with after tax cash flows and discount rates. In such instances, the valuer must explain the rationale for use of after tax inputs, or specifically note the regulation, case law, or other interpretive guidance that requires the use of after tax inputs (see IVS 200 *Businesses and Business Interests*, para 30.2).
- 120.3 If after tax inputs are used, it may be appropriate to include the tax benefit created by the projected cash outflow associated with the non-financial liability.

IVS 410 Development Property: Basis for Conclusions

IVS 2017 Proposed Revisions Exposure Draft (Consultation period 16 July 2018 to 19 October 2018)

Development valuations is one of the biggest risk areas for financial stability within the banking sector, particularly as many market valuations include the special assumption that the development has been completed, even though at the time of valuation the development may comprise undeveloped land. The Boards received feedback from stakeholders that, although the valuation process used is often correct when the development valuation gets used for secured lending purposes, lenders do not always fully understand the risk implications contained within the report. This is partly because a development valuation may build in future price increases within the valuation process. Further to discussion the Boards felt that a solution to this issue would be to mandate an additional value within the report such as the “As Is Value” so the report would not be misleading in relation to the risks and the assumptions made. Furthermore, when carrying out a development valuation for secured lending purposes the valuer must carry out a minimum of two appropriate valuation methods and must be able to justify the selection of the one reported.

The Boards *discussed para 20.5 and felt that the inclusion of the phrase* “of the current value” in reference to the *“the costs of the project or the value on completion”* was unnecessary and could cause confusion. The Boards have therefore revised this paragraph as follows;

- 20.5 This sensitivity also applies to the impact of *significant* changes in either the costs of the project or the *value* on completion. ~~of the current value.~~ If the *valuation* is required for a *purpose* where *significant* changes in *value* over the duration of a construction project *may* be of concern to the user (eg, where the *valuation* is for loan security or to establish a project’s viability), the *valuer* *must* highlight the potentially disproportionate effect of possible changes in either the construction costs or end value on the profitability of the project and the *value* of the partially completed property. A sensitivity analysis *may* be useful for this *purpose* provided it is accompanied by a suitable explanation.

Further to the feedback received from the consultation process the Boards made some additional changes. In respect of para 90.1 the Boards felt that the additional sentence stating that *“the residual value, derived from the residual method, may or may not equate to the market value of the development property in its current condition”* should be deleted, as it did not add anything to the standard nor provide additional clarification.

- 90.1. The residual method is so called because it indicates the residual amount after deducting all known or anticipated costs required to complete the development from the anticipated value of the project when completed after consideration of the risks associated with completion of the project. This is known as the residual value. ~~The residual value, derived from the residual method, may or may not equate to the market value of the development property in its current condition.~~

Further to comments received in relation to the calculation of the discount rate the Boards felt that a direct reference to IVS 105 *Valuation Approaches and Methods*, paras 50.30-50.39 on the discount rate at the end of para 90.35 would provide additional clarity.

- 90.35 In order to arrive at an indication of the *value* of the development property on the valuation date, the residual method requires the application of a discount rate to all future cash flows in order to arrive at a net present value. This discount rate *may* be derived using a variety of methods (see IVS 105 *Valuation Approaches and Methods*, ~~paras 50.29-50.34~~ 50.30-50.39).

The Boards also discussed the mandatory requirement within para 120.2 to “*apply a minimum of two appropriate and recognised methods to valuing Development Property for each valuation project*”. The Boards felt that in some instances you may have direct comparable market evidence of recent transactions for similar development and in these instances, it would be wrong to artificially apply a second method of valuation. The Boards therefore have revised para 120.2 (shown below) to state that “*valuers should apply a minimum of two appropriate and recognised approaches*”.

Furthermore, the Board felt that a reference to IVS 105 *Valuation Approaches and Methods* para 10.4 should be included to ensure that valuers note that development property is an area where there is often “*insufficient factual or observable inputs for a single method to produce a reliable conclusion*”. Further to these discussions the Boards revised para 120.2 as follows;

120.2 To demonstrate an appreciation of the risks involved in valuing development property for secured lending or other purposes, the valuer should apply a minimum of two appropriate and recognised methods to valuing development property for each valuation project, as this is an area where there is often “insufficient factual or observable inputs for a single method to produce a reliable conclusion” (see IVS 105 *Valuation Approaches and Methods*, para 10.4).

Further to the feedback received the Boards felt that the phrases “As Is” and “As Proposed” contained within paragraph 120.3 could be open to misinterpretation and therefore the Boards have revised this paragraph to state ““As Is” (existing stage of development) and an “As Proposed” (completed development) value for the Development Property” in order to provide additional clarification. Finally, the Boards felt that it was worth including a direct reference IVS 103 *Reporting*, para 30.1-30.2 and the mandatory requirement to “record the process undertaken and a rationale for the reported value”. Further to these discussions and the feedback received, the Boards revised paragraph 120.3 as follows;

120.3 The valuer must be able to justify the selection of the valuation approach(es) reported, and should provide an “As Is” (existing stage of development) and an “As Proposed” (completed development) value for the development property and record the process undertaken and a rationale for the reported value” (see IVS 103 *Reporting*, paras 30.1-30.2).

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