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Approaches to business valuation

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For long, valuation has been debated in India as an art or science and substantial part of the litigation in Mergers and Acquisitions (M&A) takes place on the issue of valuation as it involves an element of subjectivity that often gets challenged.

More so, as in India, there are not much regulatory standards for business valuation specifically for unlisted and private companies, so in many cases the valuation lacks the uniformity and generally accepted global valuation practices. Even limited judicial guidance is available over the subject in India.

Further, absence of any stringent course of action and non-regulation under any statute is also leading to loose ends.

Institute of Chartered Accountants of India (ICAI) has developed and recommended Business Valuation Practice Standards (BVPS) aiming to establish uniform principles,

practices and procedures for valuers performing valuation services in India.

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Justifying the value of businesses has grown more complex and challenging as it has been accepted that valuation is not an exact science and depends upon a number of factors like purpose, stage of business, past financials, industry scenario, management and promoters strengths etc.

Business Valuation is the process of determining the "Economic Worth" of a company based on its Business Model under certain assumptions and limiting condition and subject to data available on the valuation date.

It is an important concept in corporate finance and **business** management. Supposing a **business** is for sale, how does one know what is the real value that **business** is worth? More basically, how does a **business** owner know the net value of his business, or how is valuing a **business** for sale accomplished?

Relevance of Act and Laws

The Finance Act, 2012 introduced Section 56(2)(viib), which provides that where a closely held company receives from a resident person any consideration for the issue of shares that exceeds the FMV of such shares, the same shall be chargeable to tax in the hands of the share-issuing company as 'income from other sources'. An exemption is currently provided for shares issued to venture capital companies / funds.

The FMV of the shares have to be determined based on Rules 11U and 11UA of the Income Tax Rules, 1962 with Rule 11U prescribing the various definitions (such as balance sheet, valuation date, etc.) Rule 11UA prescribing the method for computation of FMV. Rule 11UA provides flexibility to use either of the following methods for computation of FMV:

- Book value of the shares as on the issue date/ latest audited balance sheet date, subject to adjustments as provided in the applicable Rule; or
- Valuation as undertaken by a Merchant Banker or Fellow Chartered Accountant of Institute of Chartered Accountants of India (ICAI) as per the Discounted Free Cash Flow method.

It is also pertinent to note that in July 2014, the Reserve Bank of India has done away with the prescription of DCF methodology for valuation under FEMA, providing freedom and flexibility to investors for determining the FMV as per any internationally accepted valuation methodology.

FEMA Regulations

These Regulations deal with Foreign Direct Investment (FDI) into India and the transfer of shares from or to a person resident outside India. These Regulations provide for numerous valuation requirements in case of transfer of shares between resident and non-resident, fresh issue of shares to non-resident investor, share swap, conversion of preference shares/ debentures.

It requires a certificate from a Chartered Accountant on the value of such securities according to the guidelines issued by Securities & Exchange Board of India or as per any internationally accepted pricing methodology on arm's length basis for listed companies and unlisted companies, respectively.

Generally acceptable methodologies of valuation

A number of **business** valuation models can be constructed that utilize various methods under the broad **business** valuation approaches. Most treatises and court decisions encourage the valuer to consider more than one method, which must be reconciled with each other to arrive at a value conclusion. Understanding of the internal resources and intellectual capital of the **business** being valued is as important as the economic, industrial and social environment.

The choice of the appropriate valuation approach (or approaches) to be used in a given valuation project is based on the judgment of the valuer. The valuer's choice of methods is determined by the characteristics of the **business** to be valued, the purpose and use of the valuation and its report, the pattern of historical performance and earnings of the subject company, the company's competitive market position, experience and quality of management, the availability of reliable information requisite to the various valuation methods, the marketability of equity ownership interest to be valued, and others. These factors are summarized below:

- History and nature of the business
- Industry and general economic outlook
- Book value and financial condition
- Earning capacity
- Dividend-paying capacity
- Prior sales and size of the block of stock; and



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- Comparisons to similar publicly traded guideline companies.

There are broadly three approaches of valuation:

- Asset Approach
- Income Approach
- Market Approach

Asset Approach

In this cost based approach, the primary emphasis is placed upon the fair market value of the assets and liabilities of a business. As a result, this approach uses various methods that consider the value of individual assets and liabilities including intangible assets. The most well-known method in this approach relies upon reported balance sheet assets and liabilities generally termed as book value. It should be recognized, however as per book value concept assets are reported in accordance with various accounting conventions that may or may not accurately reflect fair market value.

Thus, NAV is not perceived as a true indicator of the fair [business](#) value. However, it is used to evaluate the entry barrier that exists in a [business](#) and is considered viable for companies having reached the mature or declining growth cycle and also for property and investment companies having strong asset base.

Income Approach

Income based method of valuations is based on the premise that the current value of any [business](#) is a function of the future value that an investor can expect to receive from purchasing all or part of the business. In other words, the value of the [business](#) must be related to the profits it will earn and the cash it will generate in the future.

Market Approach

Market Approach refers to the notion of arriving at the value of a company by comparing it to the market value of similar publicly listed companies. The comparison is based on certain financial ratios or multiples, such as the price to book value, price to earnings, EV/EBITDA, etc., of the equity in question to those of its peers. This type of approach, which is popular as a strategic tool in the financial industry, is mainly statistical, based on historical data, and current market sentiments. This is also known as relative valuation method.

About the author:


Neeraj Bhagat is a member of the Institute of Chartered Accountants of [India](#) (ICAI) since 1997. He is also an Associate member of Association of International Accountants, United Kingdom. He is founder of Neeraj Bhagat & Co, an Indian Chartered Accountancy firm serving various MNC'S from across the globe. Neeraj Bhagat & Co. has its offices at New Delhi, Gurgaon and Mumbai.

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