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# ANNAMALAI UNIVERSITY

## DIRECTORATE OF DISTANCE EDUCATION

# M.Sc. PLANT AND MACHINERY VALUATION

First Year

## PRINCIPLES OF VALUATION

LESSONS: 1 - 20

## M.Sc. PLANT AND MACHINERY VALUATION

## First Year

# PRINCIPLES OF VALUATION




**Lesson Writer**

**Vr.P.K.Ranganathan**
Consultant and Valuer (Plant and Machinery)
3 C Grand Residency,
VGP Selva nagar, Velacherry
Chennai - 42

# M.Sc. PLANT AND MACHINERY VALUATION

## First Year

## PRINCIPLES OF VALUATION

### SYLLABUS

**Introduction:** Cost, price and value; types of value; value elements – ingredients; characteristics – highest and best use – value in use – value in exchange ; definitions ; International Valuation Standards

**Plant & Machinery:** Definitions, Features & aspects influencing value. Need for Plant & Machinery Valuation, Obsolescence & Statutory limitations and constraints

**Income approach to value:** Recognition of income, Expenses related to production, Fixed & Variable costs, Gross income & net income

**Market approach to value:** Market – Industrial equipment market – market value, Comparison of sale instances – factors, methods and weightages, Sources of information

**Cost approach to value:** Acquisition cost – invoice / taxes & duties / abatements / treatment of incidental costs, Depreciation – various methods of depreciation and their uses, Encumbrances – provision & methods.

Age – effective age – economic life and remaining life, Depreciated replacement cost

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# M.Sc. PLANT AND MACHINERY VALUATION

## First Year

## PRINCIPLES OF VALUATION

### CONTENTS

# VALUATION

## 1.1 INTRODUCTION

Valuation is an independent exercise carried out by an approved individual or organisation, to meet the requirement of an interested person or organisation, to assess and or help determine the worth of tangible assets. Valuation may be required for a variety of purposes and circumstances. In this lesson we look at need for valuation and eligibility criteria for valuers.

## 1.2 OBJECTIVES

- Valuers should have the competency to undertake the assignment. Eligibility criteria have been developed for valuers. This lesson is intended to familiarise the student with different categories of valuers and eligibility criteria.
- Valuation of property (assets) has developed during past decades from an art or business occupation into a profession. The word "property" is now given not only to physical things but also to the legal rights of ownership of tangible or intangible entities. Valuation encompasses three classes of operations, namely:
  a. estimation of the cost of producing or replacing physical property,
  b. forecasting of the monetary earning power of certain classes of property,
  c. valuation or determination of the worth of property.
- Valuation requires specialized knowledge and abilities, in addition to general qualification(s). Today a competent valuer needs to be familiar with not only the type of assets valued, but also related issues like, relevant laws, statutes, approvals, constraints & restrictions – governing the rights of use & enjoyment of the assets.

Valuers have been recognised as professionals and qualifications are being prescribed for practitioners.

## 1.3. CONTENTS

1.3.1 Income Tax Dept. has Specified Various Categories of Valuers Under Wealth Tax Act Section 34 Ab.

1.3.2 A Valuer of Life Interest, Reversions and Interest in Expectancy

1.3.3 Indian Banks Association – Guidelines for Valuers for Secured Lending

## 1.3.1 INCOME TAX DEPT. HAS SPECIFIED VARIOUS CATEGORIES OF VALUERS UNDER WEALTH TAX ACT SECTION 34 AB.

### Qualifications of Registered Valuers

8A. (1) For the purposes of sub-section (2) of section 34AB, the qualifications for registration as valuers of different classes of asset shall be as specified in sub-rules (2) to (11).

A valuer of immovable property (other than agricultural lands, plantations, forests, mines and quarries) shall have the following qualifications, namely:

(A) he must be a graduate in civil engineering, architecture or town planning of a recognised university; orbe a post-graduate in valuation of real estate from a recognised university; or possess a qualification recognised by the Central Government for recruitment to superior services or posts under the Central Government in the field of civil engineering, architecture or town planning; and](A) he must be a person formerly employed in a post under Government as a gazetted officer; or in a post under any other employer carrying a remuneration of not less than Rs.2,000 per month, and, in either case, must have retired or resigned from such employment after having rendered service for not less than ten years as a valuer, architect or town planner, or in the field of construction of buildings, designing of structures, or development of land; or as a professor, reader or lecturer in a university, college or any other institution preparing students for a degree in civil engineering, architecture or town planning, or for any qualification] referred to in clause (i), and must have retired or resigned from such employment after having taught for not less than ten years any of the subjects of valuation, quantity surveying, building construction, architecture, or town planning;

or

(B) He must have been in practice as a consulting engineer, valuer of real estate, surveyor or architect for a period of not less than ten years and must have acquired experience in any of the following four fields

1. valuation of buildings and urban lands; quantity surveying in building construction;
2. architectural or structural designing of buildings or town planning;
3. construction of buildings or
4. development of land;

and his gross receipts from such practice should not be less than fifty thousand rupees in any three of the five preceding years.

Provided that in the case of a person possessing a post-graduate degree in valuation of real estate from a recognised university, the provisions of this sub-rule shall have effect as if, for the words ten years, the words two years had been substituted; for the words fifty thousand rupees in any three of five preceding years, the words fifty thousand rupees in any one of the two preceding years had been substituted.

#### 1.3.1.1 A Valuer of Agricultural Lands

Other than plantations referred to in sub-rule (4) shall have the following qualifications, namely:

1. He must be a graduate in agricultural science of a recognised university and must have worked as a farm valuer for a period of not less than five years; or

2. A post under Government as a Collector, Deputy Collector, Settlement Officer, Land Valuation Officer, Superintendent of Land Records, Agricultural Officer, Registrar under the Registration Act, 1908 (16 of 1908), or
3. Any other officer of equivalent rank performing similar functions and must have retired or resigned from such employment after having rendered service in any one or more of the posts aforesaid for an aggregate period of not less than five years.

**1.3.1.2 A Valuer of Coffee Plantation, Tea Plantation, Rubber Plantation**

As the case may be, cardamom plantation shall have the following qualifications, namely:

1. he must have, for a period of not less than five years, owned, or acted as manager of a coffee, tea, rubber or, as the case may be, cardamom plantation having an area under plantation of not less than four hectares in the case of a cardamom plantation or forty hectares in the case of any other plantation; or
2. a post under Government as a Collector, Deputy Collector, Settlement Officer, Land Valuation Officer, Superintendent of Land Records, Agricultural Officer, Registrar under the Registration Act, 1908 (16 of 1908), or any other officer of equivalent rank performing similar functions and must have retired or resigned from such employment after having rendered service in any one or more of the posts aforesaid for an aggregate period of not less than five years, out of which not less than three years must have been in areas, wherein coffee, tea, rubber or, as the case may be, cardamom is extensively grown.

**1.3.1.3 A Valuer of Forest**

Must be a person formerly employed in a post under Government and must have retired or resigned from such employment after having rendered service for not less than five years in a gazetted post requiring specialised knowledge in forestry.

**1.3.1.4 A Valuer of Mines and Quarries**

Shall have the following qualifications, namely:

1. He must be a graduate in mining of a recognised university, or must possess a qualification recognised by the Central Government for recruitment to superior services or posts under the Central Government in the field of mining; and
2. He must be a person formerly employed in a post under Government as a gazetted officer or in a post under any other employer carrying a remuneration of not less than Rs. 2,000 per month, and, in either case, must have retired or resigned from such employment after having rendered service as a mining engineer for not less than ten years.

**1.3.1.5 A Valuer of Stocks, Shares, Debentures, Securities, Shares in Partnership Firms and of Business Assets, Including Goodwill.**

But excluding those referred to in sub-rules (2) to (6) and (8) to (11), shall have the following qualifications, namely:

- He must be a member of the Institute of Chartered Accountants of India or the Institute of Cost and Works Accountants of India 62[or the Institute of Company Secretaries of India]; and

1. He must have been in practice as a chartered accountant or a cost and works accountant or a company secretary for a period of not less than ten years and his gross receipts from such practice should not be less than fifty thousand rupees in any three of the five preceding years, or
2. He must be a person formerly employed in a post under Government as a gazetted officer,

or

3. in a post under any other employer carrying a remuneration of not less than Rs. 2,000 per month,
4. And, in either case, must have retired or resigned from such employment after having rendered service for a period of not less ten years in the field of audit and accounts or taxation work, or as a Company Secretary or a Deputy Company Secretary or an Assistant Company Secretary in a post carrying a remuneration of not less than Rs.2,000 per month and must have retired or resigned from such employment after having rendered service for a period of not less than ten years.

**1.3.1.6 A Valuer of Machinery and Plant**

Shall have the following qualifications, namely:

1. He must be a graduate in mechanical or electrical engineering of a recognised university; or
2. Possess post-graduate degree in valuation of machinery and plant from a recognised university; or
3. possess a qualification recognised by the Central Government for recruitment to superior services or posts under the Central Government in the field of mechanical or electrical engineering; and he must be a person formerly employed in a post under Government as a gazetted officer; or in a post under any other employer carrying a remuneration of not less than Rs.2,000 per month, in either case, must have retired or resigned from such employment after having rendered service as a mechanical or electrical engineer or valuer of machinery and plant for a period of not less than ten years, or

4. As a professor, reader or lecturer in a university, college or institution preparing students for a degree in mechanical or electrical engineering or for any qualification referred to in clause (i), and must have retired or resigned from such employment after having taught for a period of not less than ten years; or
5. He must have been in practice as a consulting engineer or valuer of machinery and plant for a period of not less than ten years and must have acquired experience in the valuation of machinery and plant and his gross receipts from such practice should not be less than fifty thousand rupees in any three of the five preceding years :

Provided that in the case of a person, possessing a post-graduate degree in valuation of machinery and plant from a recognised university, the provisions of this sub-rule shall have effect as if, for the words ten years, the words two years had been substituted; for the words fifty thousand rupees in any three of five preceding years, the words fifty thousand rupees in any one of the two preceding years had been substituted.

**1.3.1.7 A Valuer of Jewellery**

Must have been, for a period of not less than five years, a sole proprietor or partner in a partnership firm carrying on jewellery business which has on an average an annual turnover of not less than rupees 15 lakhs or profit (including fees for valuation of not less than rupees fifty thousand)] in the last three accounting years immediately preceding the year in which the application for registration as a valuer is made by him.

**1.3.1.8 A Valuer of Works of Art**

Shall have the following qualifications, namely:

He must have specialised by virtue of his academic and professional pursuits in the particular line of art, for the works of which he seeks to be registered as a valuer, and he must have served in any one or more of the following capacities, namely:

Director General or Superintending Archaeologist of the Archaeological Survey of India;

Director of National Museum, New Delhi, Salar Jung Museum, Hyderabad, Prince of Wales Museum, Bombay, Indian Museum, Calcutta, Asutosh Museum, Calcutta, Madras Museum, Madras or Bharat Kala Bhavan, Varanasi;principal of a Government School of Art; member of the Art Purchase Committee of any of the museums referred to in sub-clause (b), or of the Lalit Kala Akademi.

**1.3.2 A VALUER OF LIFE INTEREST, REVERSIONS AND INTEREST IN EXPECTANCY**

*Shall have the following qualifications, namely:*

He must be a graduate of a recognised university; and

(a) He must have been in practice as an actuary under the Insurance Act, 1938 (4 of 1938), for a period of not less than ten years; or he must have rendered continuous service for a period of not less than ten years as an actuary under Government or in the Life Insurance Corporation of India established under the Life Insurance Corporation Act, 1956; or he must have practiced as an actuary or served as such under Government or in the Life Insurance Corporation of India referred to in sub-clause (b) for an aggregate period of not less than 78 [ten] years.

No person shall qualify for registration as a valuer, other than as a valuer of works of art, if he is employed under Government or any other employer.

Notwithstanding anything contained in sub-rules (1) to (12), no person shall qualify for registration as a valuer if, he has been dismissed or removed from Government service; or he has been convicted of an offence connected with any proceeding under the Income-tax Act, 1961 (43 of 1961), or the Wealth-tax Act, 1957 (27 of 1957), or the Gift-tax Act, 1958 (18 of 1958), or a penalty has been imposed on him under clause (iii) of sub-section (1) of section 271 or clause (i) of section 273 of the Income-tax Act, 1961, or under clause (iii) of sub-section (1) of section 18 of the Wealth-tax Act, 1957, or under clause (iii) of sub-section (1) of section 17 of the Gift-tax Act,1958; or he is an un discharged insolvent; or he has been convicted of any offence and sentenced to a term of imprisonment; or he has been found guilty of misconduct in his professional capacity,

In a case where he is a member of any association or institution established in India having as its object the control, supervision, regulation or encouragement of the profession of engineering, architecture, accountancy, or company secretaries or such other profession as the Board may specify in this behalf by notification in the Official Gazette, by such association or institution; or(ii) in any other case, by the Chief Commissioner or the Director General in accordance with the procedure laid down in rule 8F and rules 8H to 8K, which in the opinion of the Chief Commissioner or the Director General, renders him unfit to be registered as a valuer.

Notwithstanding anything contained in sub-rules (2), (6), (7), (8) and (11) as amended by the Wealth-tax (Second Amendment) Rules, 1988, the provisions of the said sub-rules, as they stood immediately before such amendment, shall continue to apply in the case of a person whose name is included in the Register of Valuers immediately before the 1st day of June, 1988, and who makes an application for continuation of his registration as a valuer under sub-section (1) of section 34AE, subject to the modification that in addition to the requirement that such person should have, for a period of not less than five years, rendered service in any capacity or taught any subject or practiced any profession, such person should also have an experience of not less than five years as a valuer registered under section 34AB.

The requirement laid down in any of the foregoing sub-rules that the applicant should have, for a period of not less than ten years or five years, as the case may be rendered service in any capacity, or taught any subject, or practised any profession, orgained experience in any other capacity or field, as specified therein, shall be deemed to have been fulfilled if the period for which the applicant has rendered such service, taught such subject, practiced such profession or otherwise gained experience in such other capacity or field, taken either singly or collectively, is not less than ten years or five years, as the case may be, in the foregoing sub-rules.

### 1.3.3 INDIAN BANKS ASSOCIATION – GUIDELINES FOR VALUERS FOR SECURED LENDING

Indian Banks Association has prescribed certain qualifications for Valuers for purposes of secured lending. The Reserve Bank of India in their letter No: DNBS(PD)CC.No.802/CRC/26.03.001/2014-15 dated 8th August 2014 to the Indian Banks' Association (IBA) expressed a need for improving the valuation process followed by banks to tone up the credit administration. Towards this, IBA was requested to standardize the process for empanelment of valuers by the banks.

#### 1.3.3.1 IBA Latest (Dec 2015) Guidelines as follows

In the following chapters the procedure for empanelment of valuers by the banks are dealt in detail outlining the following issues.

1. Purpose of Valuation and Appointment of Valuers
2. Criteria for Empanelment of Valuers
    a. Educational Qualifications and Previous Work Experience
    b. Minimum Age Requirement
    c. Membership of Professional Bodies
    d. Categories of Valuers
    e. Registration with Government
    f. References
    g. Other Conditions
3. Empanelment Procedure
4. Duration of Empanelment
5. Removal of Valuers from Bank's Panel
6. Re-Empanelment
7. Compliance of Standards and Procedures
8. Independence and Objectivity
9. Obligations of Banks and HFIs
10. Continuing Education

**1. Purpose of Valuation and Appointment of Valuers**

The purpose of valuation to be undertaken by Banks and Financial Institutions (FIs) is to ascertain the value of the property for-

- The purpose of as certaining the value of the property offered as security.
- The purpose of periodically as certaining the value of the property that has been mortgaged, whether it is increasing or decreasing over the mortgage period
- For the purpose of realizing the value of non-performing assets (NPAs)and
- For the purpose of resumption of properties in cases of default.

**2. Criteria for Empanelment of Valuers**

In order to ascertain the value of properties for any of the above purposes, banks and FIs shall appoint external independent valuers for undertaking valuations. The empanelled valuers shall carry out valuation of different types of assets as under:

- Land and Building
- Plant & Machinery
- Stocks and Trade
- Agricultural Land

**A. Educational Qualifications and Previous Work Experience**

It is necessary that valuer possess proper educational qualifications which make him competent to carry out the task of valuation of securities. In addition, relevant work experiences also important. In this back drop the Working Group, after discussion, recommended that Persons possessing the following Educational Qualifications and Work Experience shall be eligible for empanelment as valuers:

**1. Valuation of Land& Building /Real Estate**

There is no Act to regulate profession of valuation of real estate in our country.

From 01.01.2020only academically qualified valuers possessing following qualifications in valuation of Land & Building/Real Estate shall be empanelled.

- PostGraduatedegreeinvaluationofrealestatefromarecogniseduniversityi.e.the universitiesestablishedunderStateorCentralActswith2years'experiencein valuation f real estate.
- Examination in valuation of real estate conducted by any institution which is recognised by the Govt. of India for recruitment to superior services or postswith2years'experience in valuation of real estate.
- However, Banks are free to consider Valuers having the Post Graduate degree in Valuation (Masters Degreein Valuation) for empanelment with effect from 01.04.2018 depending upon the availability of Valuers with such Qualifications.

The educational qualifications for empanelment as valuers of Land & Building/real estate from01.01.2016 till 31.12.2019 shall be as under:

| S.No. | Educational Qualification | Work Experience | Remarks |
|---|---|---|---|
| 1 | Bachelor's degree in Civil Engineering/ Architecture/ Town Planning or equivalent. | 5 years' work experience in the field of valuation of real estate after completion of the degree or equivalent | **For applicants below the age of 60**: The applicants with these qualifications who have not attained the age of 60 years as on 01.01.2016 will also have to pass an examination for a duration of one semester in the subjects which are vital for valuation of real estate and not covered in course curriculum of civil engineering, architecture and town planning from recognized universities / the institution conducting the examination in valuation of real estate which are recognized by the Govt. of India for recruitment to superior services or posts on or before 31.12.2019. **For applicants attained the age of 60 and above** The applicants with these qualifications who have attained the age of 60 years and above as on 01.01.2016 will also have to undergo two week training in the subjects which are vital for valuation of real estate and not covered in course curriculum of civil engineering, architecture and town planning from recognized universities/ the institution conducting the examination in valuation of real estate which are recognized by the Govt. of India for recruitment to superior services or posts on or before 31.12.2019. **Note:** The applicants empanelled on the basis of criteria laid down under sr.no.1 (a&b) above shall be eligible for empanelment even after 1.1.2020 |
| 2 | Diploma in Civil Engineering / Architecture. | 8 years' work experience in the field of valuation of real estate after completion of the diploma | They must complete six months course in valuation of real estate prescribed underSr.no.1 above. **Note:** The applicants empanelled on the basis of criteria laid down undersr.no.2 shall be eligible for empanelment even after 1.1.2020 |

| S.No. | Educational Qualification | Work Experience | Remarks |
|---|---|---|---|
| 3 | Pass in examination in valuation of real estate recognized by the Govt. of India for recruitment to superior services or posts conducted by any institution | 2 years' work experience in the field of valuation of real estate after completing the examination | - |
| 4 | Master's degree in Valuation of real estate awarded by a recognized University in India | 2 years' work experience in the field of valuation of real estate after completing the examination | |
| 5 | Chartered /Professional membership of the Royal Institution of Chartered Surveyors RICS) or American Society of Appraisers (ASA) or Appraisal Institute (AI),USA obtained by passing an examination equivalent to examinations mentioned under sr.no.(3) & (4)above. | | Since the process of procurement of membership with these organizations include straining as an integral component, no further experience requirement is being prescribed. |

The Diploma Holders in Civil Engineering / Architecture are eligible for empanelment to undertake valuations with value up to 1croreonly.

I. Valuation of Plant and Machinery

Educationalqualificationsandexperienceforempanelmentasvaluersofplant&machinery:

There is no Act to regulate profession of valuation of plant &machinery in our country.From1.1.2020onlyacademicallyqualifiedvaluerspossessingfollowingqualificationsinvaluation of plant & machinery shall be empanelled.

- Post Graduate degree in valuation of plant & machinery from a recognised university i.e. the universities established under State or Central Acts with 2 years' experience in valuation of plant & machinery.
- Examination in valuation of plant & machinery conducted by any institution which is recognised by the Govt. Of India for recruitment to superior services or posts with 2 years' experience in valuation of plant & machinery.
- However, Banks are free to consider Valuers having the Post Graduate degree in Valuation (Masters Degree in Valuation) for empanelment with effect from 01.04.2018 depending upon the availability of Valuers with such Qualifications.

The educational qualifications for empanelment as valuers of plant &machinery from 1.1.16to 31.12.2019 shall be as under:

| S.No | Educational Qualification | Work Experience | Remarks |
|---|---|---|---|
| 1 | Bachelor's degree in mechanical, electrical, chemical, production, computer Engineering etc. | 5 years work experience in the field of valuation of Plant & machinery after completion of the degree or equivalent | **For applicants below the age of 60**<br>(a)Graduate in mechanical, electrical, production, industrial, computer, mining, chemical, textile, electronics etc. engineering, from a recognized university with 5 years' experience in valuation of plant &machinery. The applicants with these qualifications who have not attained the age of 60 years as on 1.1.2016 will have to pass an examination for a duration of one semester in the subjects which are vital for valuation of plant &machinery and not covered in course curriculum of above examinations from recognized universities or the institution |

| S.No | Educational Qualification | Work Experience | Remarks |
| --- | --- | --- | --- |
| | | | conducting the examination in valuation of plant &machinery which are recognized by the Govt. of India for recruitment to superior services or posts on or before 31.12.2019.<br>**(b)For applicants attained the age of 60 and above**<br>Graduate in mechanical, electrical, production, industrial, computer, mining, chemical, textile, electronics etc. engineering, from a recognized university with 5 years' experience in valuation of plant &machinery. The applicants with these qualifications who have attained the age of 60 years as on1.1.2016 will have to undergo two week training (topics to be covered in such a programme is enclosed) in the subjects which are vital for valuation of plant &machinery and not covered in course curriculum of above examinations from recognized universities or the institution conducting the examination in valuation of plant &machinery which are recognized by the Govt. of India for recruitment to superior services or posts on or before 31.12.2019.<br>**Note:** The applicants empanelled on the basis of criteria laid down under 1(a) and (b) shall be eligible for empanelment even after 1.1.2020 |
| 2 | Diploma in mechanical, electrical, production, chemical etc Engineering. | 8 years work experience in the field of valuation of Plant and machinery after completion of the diploma | They must complete six months course in valuation of plant and machinery prescribed under Sr.no.1 above.<br>The applicants empanelled on the basis of criteria laid down under sr.no.2 shall be eligible for empanelment evenafter1.1.2020 |

| S.No | Educational Qualification | Work Experience | Remarks |
|---|---|---|---|
| 3 | Master's degree in Valuation of plant & machinery awarded by are cognized University in India | 2 years work experience in the field of valuation of Plant & machinery after completing the examination | |

II. Valuers of Agricultural land

EducationalqualificationsandexperienceforEmpanelmentasValuersofAgricultural Land:

There is no Act to regulate profession of valuation of agricultural land. There are no courses available in our country to qualify as a valuer of agricultural land. Valuer of agricultural land ought to have knowledge of following principles of valuation

- Cost, price, value and worth
- Various types of value
- Value elements – ingredients–characteristics
- Annuities–capitalization–rateofcapitalization–redemptionofcapital
- Three approaches to value viz. Income, Market and cost
- Laws applicable to agricultural land

Till the courses are available the empanelment may be carried out as per criteria laid down under the Wealth Tax Rule 8A (3) and same is reproduced below:

**Rule 8A (3)** A Valuer of agricultural lands (Other than plantations referred to in sub-rule

Shall have the following qualifications, namely:-

- Hemustbeagraduateinagriculturalscienceofarecogniseduniversityandmusthave worked as a farm valuer for a period of not less than five years; and
- He must be a person formerly employed in a post under Government as Collector, Deputy Collector, Settlement Officer, Land Valuation Officer, Superintendent of Land Records, Agricultural Officer, Registrar under the Registration Act,1908 (16of1908), or any other officer of equivalent rank per forming similar function sand must have retired or resigned from such employment after having rendered service in anyone or more of the posts a fore said for an aggregate period of not less than five years.

III. Valuers of agricultural Land (Plantations) under Wealth tax rule 8A(4) Educational qualifications and experience for empanelment

A valuer of coffee plantation, tea plantation, rubber plantation or, as the case may be, cardamom plantation shall have the following qualifications, namely:

- He must have, for a period of not less than , owned, or acted as manager of a coffee, tea, rubber or, as the case may be, card a mom plantation having an area under plantation of not less than four hectares in in the case of any other plantation; or
- He must be a person formerly employed in a post under Government as a Collector, Deputy Collector, Settlement Officer, Land Valuation Officer, Superintendent of Land Records, Agricultural Officer, Registrar under the Registration Act, 1908 (16of1908), or any other officer of equivalent rank performing.

Similar functions and must have retired or resigned from such employment after having rendered service in any one or more of the posts aforesaid for an aggregate period of not less than five years, out of which not less than three years must have been in areas, where in coffee, tea, rubber or, as the case may be, cardamom is extensively grown.

IV. Valuers of Stock (inventory), Shares

V. In the case of the seas sets criteria laid down under the Wealth Tax Rule 8A (7) to be adopted.

**Rule 8A (7)** a Valuer of stocks, shares, debentures, securities, shares in partnership firm sand of business assets, including good will but excluding those referred to in sub-rules(2)to (6) and (8) to(11), shall have the following qualifications, namely,

- He must be a member of the Institute of Chartered Accountants of India or the Institute of Cost and Works Accountants of India or the Institute of Company Secretary of India; and
- He must have been a practice as chartered accountant or a cost and works accountants or accompany secretary for a period of not less than ten years and his gross receipts from such practice should not be less than fifty thousand rupees in any three of the five preceding years.

Evidence of previous experience needs to be provided to the Banks/FIs. In case of companies/partnership firms undertaking valuations, the qualification and experience shall apply to the lead valuers of the company/all partners of the partnership firm.

**B. Minimum Age Requirement**

Age is an important criteria while empanelling valuers. The minimum age for empanelment with banks and financial institutions shall be 25 years and there is no maximum age limit for a valuer to remain on the panel.

**C. Membership of Professional Bodies**

It is important that a valuer actively participates in professional activities in various professional bodies. It shall be necessary that every valuer empanelled by Banks/FIs in India be a member in good standing of any one of the under mentioned associations namely:

**Institution of Valuers (IOV)**

- Institution of Surveyors (Valuation Branch) (IOS)
- Institution of Government Approved Valuers (IGAV)
- Practicing Valuers Association of India (PVAI)
- The Indian Institution of Valuers (IIV)
- Institute of Estate Managers and Appraisers
- Centre for Valuation Studies, Research and Training (CVSRT)
- Royal Institution of Chartered Surveyors, India Chapter (RICS)
- American Society of Appraisers(ASA),USA
- Appraisal Institute (AI), USA

**D. Categories of Valuers**

The objective of categorization of valuers is to ensure that whilst lesser value assignments are handled by relatively junior valuers, the senior valuers can handle higher order valuations.

The empanelment of valuers therefore shall be in the following categories:

| S.No. | Category of Valuers | Work Experience in Undertaking Valuation | Value of property for assignment of Valuation Work |
|---|---|---|---|
| 1. | A | More than 10years | No limit |
| 2. | B | More than 5 years and less than 10 years | Up to 50 crores |
| 3. | C | Up to 5years | Up to **5 crore** |

Valuers need to furnish proof of experience. Anyone of the following may be accepted as proof of experience:

1. Letter of empanelment by any Bank / FI
2. Letter of empanelment by any Court of India
3. Registration Certificate under Wealth Tax Act, 1957
4. Letter of appointment as valuation consultant by Government of India/ any State Government / any Municipality/ any Municipal Corporation
5. Letter of appointment as valuer employee by Government of India/ any State Government /any Municipality/any Municipal Corporation
6. Letter of appointment as a valuer employee by any Limited Company engaged in the business of valuation

7. Letter of appointment as a valuation consultant by any Limited Company.
8. Letter of appointment as a valuer employee by any partnership/proprietorship/private limited Company engaged in the business of valuation for the last five years

The Experience of the Valuer shall be calculated from the date of his first empanelment with any Bank /Financial Institution / High Court or registration under Wealth Tax Act, 1957

**E. Registration with Government**

Registration with the central/state governments is desirable but not compulsory. However, it may be noted that for under taking valuations under the SARFAESI Act, valuation has to be obtained from Registered Valuer under the Wealth Tax Act (Sections 34AA to 34AE). While assigning/outsourcing valuation work to valuers, it is necessary that bank stake the provisions of the SARFAESI Act in to account and comply accordingly.

**F. References**

Carrying out a reference check is extremely important in order to verify the competence of a valuer. Valuers need to submit atleast 3 reference letters and banks need to verify the quality of services provided by the valuer in the previous instances before empanelling the valuers on their panel. The referees shall be either (i) bank managers where previously the valuer had done valuations or (ii) companies for whom the valuer had previously done valuations. The reference letter shall be on the letter head of the bank/Financial Company/any other company where valuations have been done and shall be duly signed by a senior level manager / officer.

**G. Other Conditions**

In addition to the above, the other conditions to be fulfilled by the valuers for empanelment areas under:

1. The valuer is a citizen of India
2. The valuer has not been removed/dismissed from valuation related service (previous employment) earlier
3. The valuer has not been convicted of any offence and sentenced to a term of imprisonment
4. The valuer has not been found guilty of misconduct in professional capacity
5. The valuer is not an undischarged insolvent
6. The valuer has not been convicted of an offence connected with any proceeding under the Income Tax Act 1961, Wealth Tax Act 1957 or Gift Tax Act 1958.
7. The valuer possesses PAN Card number/Service Tax number as applicable (Service Tax No. is a must for Category “A” Valuer).

Insurance Regulatory Authority (IRDA) has prescribed the qualifications for purposes of Insurance claims & settlements.

**Licensing Procedure**

Application for, and matters relating to, grant of license to individual Surveyors and Loss Assessors

Every person who is a Student Member of the Institute and intending to act as a Surveyor and Loss Assessor in respect of general insurance business shall apply to the Authority for grant of License in FORM–IRDAI-1-AF as given in Schedule II to these Regulations.

Eligibility Criteria

- Qualifications:
  a. Academic / technical/ professional/Insurance Qualifications given in Schedule I Annexure–1 of these Regulations.
  b. Other qualifications as may be specified by the Authority from time to time.
  c. Shall be a "Member" of the Institute.
- Training:
  a. Practical training for a period of not less than twelve months as specified in Regulation 17(1)
  b. Such other training which the Authority may specify from time to time.
- Explanation:

Any person who has undergone the requisite training for obtaining a license to act as a Surveyor and Loss Assessor, as stated above may have to undergo such other training as may be specified by the Authority.

- Examination:

Passing of relevant paper(s) of Surveyor and Loss Assessor Examination conducted by the Insurance Institute of India, Mumbai or any other Institute recognized by the Authority.

- Explanation:

Any person who has, as on the date of notification of these Regulations, successfully completed the examination for obtaining a license to act as Surveyor and Loss Assessor, is exempt from taking examination once again stated under 3(2)(c) above.

Some provisions are expected to be included in the Companies Act prescribing competency requirements for Valuation under the Companies Act.

Hence Value & therefore Valuation is dependent on purpose for which valuation is sought. This requires specialised knowledge for appraisal & preparation of valuation report, so as to meet the needs of the purpose and need of the client.

The objective of this course to set out authoritative principles and a code of professional ethics, broad enough to cover all classes of property as well as the complexities of the various appraisal procedures. Principles & code of ethics are designed to provide guidance to Valuers and to provide a structure for regulating conduct of Valuer professionals.

We have relied heavily on Standards & recommendations of International Valuations Standards Council & American Society of Appraisers as required for definitions & explanations.

We need to have a pre-agreed set of definitions that we need to use in the practice of the Valuation Profession. There has to be clarity on what is meant by a certain expression in the context of Valuation. We therefore begin with definitions. We are reproducing set of definitions as specified in International Valuations Standard (IVS), to be in conformity.

Institution of Valuers India, is a professional body representing Valuers in India. It has more than 25,000 valuers as members. It has its head-quarters in New Delhi. All Valuers Institutions, Associations or Bodies are expected to have a code of conduct for their Members. They are expected to offer continual education & awareness programs to keep their members updated about the latest developments related to the Valuation Profession. It is hoped that India will also have a Recognised Charter for Valuation Professionals in course of time, through an Act of Parliament.

### 1.4 REVISION POINTS

1. Income Tax Dept. has specified various categories of valuers under Wealth Tax Act Section 34AB.
2. IBA latest (Dec 2015) guidelines as follows

### 1.5 INTEXT QUESTIONS

1. What is valuation?
2. Name 5 categories of valuers under the Income Tax, Gift Tax &Wealth Tax Act& IBA guidelines.
3. Name some eligibility criteria for taking up valuation profession

### 1.6 SUMMARY

Valuation profession offers services to a variety of sectors. Depending on the purpose for which valuation is sought, expertise, qualification requirements, methodology and information required change. We have discussed eligibility criteria for valuers – under the Income Tax, Gift Tax & Welath Tax act, for Banks requirements for secured lending, for Insurance purposes etc.

### 1.7 TERMINAL EXERCISE

1. What is the eligibility of valuer for plant & Machinery?
2. What are the memberships of professional bodies?

### 1.8 SUPPLEMENTARY MATERIALS

1. http://www.incometaxindia.gov.in/Rules/Wealth-

### 1.9 ASSIGNMENTS

1. Discuss the eligibility criteria for purposes of Banks & Insurance – similarity & divergences.

### 1.10 REFERENCE BOOKS


1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.


### 1.11 LEARNING ACTIVITIES

Group decision during PCP days

1. Licensing Procedure
2. Qualification of Valuer
3. IBA latest (Dec 2015) guidelines

### 1.12 KEY WORDS

Qualification of valuer, licensing procedure, Guideline for valuer.

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LESSON - 2

# DEFINITIONS

**(BASED ON INTERNATIONAL VALUATION STANDARDS)**

## 2.1 INTRODUCTION

Communication is all about conveying messages with clarity. Any written communication should be clear, and un-ambiguous. Valuation reports are essentially techno-economic reports. Words & phrases have to be understood & interpreted in the context of valuation. It is therefore necessary to state what is meant by each word or phrase in the context of Valuation. In this lesson we learn definitions as approved by International Valuation Council and adopted by most countries.

## 2.2 OBJECTIVES

- To understand terminology used in Valuation practice & their meaning.
- The definitions below are of words or phrases used in IVS General Standards or Valuation practice, that have a specific or limited meaning in the context of Valuation of Assets. Definitions are given in alphabetical order.

## 2.3 CONTENTS

### 2.3.1 DEFINITIONS

- **Basis of value** – a statement of the fundamental measurement assumptions of a valuation.
- **Cost approach** – provides an indication of value using the economic principle that a buyer will pay no more for an asset than the cost to obtain an asset of equal utility, whether by purchase or by construction.
- **Fair value** – the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.
- **Goodwill** – any future economic benefit arising from a business, an interest in a business or from the use of a group of assets which is not separable.
- **Income approach** – provides an indication of value by converting future cash flows to a single current capital value.
- **Intangible asset** – a non-monetary asset that manifests itself by its economic properties. It does not have physical substance but grants rights and economic benefits to its owner.
- **Investment property** – property that is land or a building, or part of a building, or both, held by the owner to earn rentals or for capital appreciation, or both, rather than for:
  1. use in the production or supply of goods or services or for administrative purposes, or
  2. sale in the ordinary course of business.

- **Investment value** – the value of an asset to the owner or a prospective owner for individual investment or operational objectives.
- **Market approach** – provides an indication of value by comparing the subject asset with identical or similar assets for which price information is available.
- **Market rent** – the estimated amount for which a property would be leased on the valuation date between a willing lessor and a willing lessee on appropriate lease terms in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
- **Market value** – the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.
- **Real estate** – land and all things that are a natural part of the land, eg trees, minerals and things that have been attached to the land, eg buildings and site improvements and all permanent building attachments, eg mechanical and electrical plant providing services to a building, that are both below and above the ground.
- **Real property** – all rights, interests and benefits related to the ownership of real estate.
- **Special assumption** – an assumption that either assumes facts that differ from the actual facts existing at the valuation date or that would not be made by a typical market participant in a transaction on the valuation date.
- **Special buyer/purchaser** – a particular buyer for whom a particular asset has special value because of advantages arising from its ownership that would not be available to other buyers in a market.
- **Special value** – an amount that reflects particular attributes of an asset that are only of value to a special purchaser.
- **Synergistic value** – an additional element of value created by the combination of two or more assets or interests where the combined value is more than the sum of the separate values.
- **Trade related property** – any type of real property designed for a specific type of business where the property value reflects the trading potential for that business.
- **Valuation date** – the date on which the opinion of value applies. The valuation date shall also include the time at which it applies if the value of the type of asset can change materially in the course of a single day.
- **Valuation Review** – The act or process of considering and reporting on a valuation undertaken by another party, which may or may not require the reviewer to provide their own valuation opinion.

Definitions as stated above shall be used in the Valuation Profession & Practice. Where the context is not contrary or explicitly stated, meaning of various words & phrases shall be deemed to convey as specified.

**2.4 REVISION POINTS**

1. Real Estate
2. Market Value
3. Market approach

**2.5 INTEXT QUESTIONS**

1. What is the difference between Fair Value & market Value?
2. What is the difference between real estate & real property – in valuation?
3. What is the difference between special value & synergistic value?

**2.6 SUMMARY**

Definitions are very important tools for precise communication. In this chapter we have studied the specific meanings in Valuation practice for various related phrases.

**2.7 TERMINAL EXERCISE**

1. What is real value?
2. What is market value?
3. What is Goodwill?

**2.8 SUPPLEMENTARY MATERIALS**

1. www.gva.co.uk/valuation/our-guide-to-valuation-terminology

**2.9 ASSIGNMENTS**

1. Discuss each term or phrase – meaning with examples

**2.10 REFERENCE BOOKS**

1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc. Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.

**2.11 LEARNING ACTIVITIES**

Group decision during PCP days

1. Real estate
2. Real property

**2.12 KEY WORDS**

Good will, Market value, Fair value

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LESSON - 3

# VALUATION PRACTICE

## 3.1 INTRODUCTION

Methodology chosen should be appropriate for the purpose intended. Property appraisals are used throughout the economic, governmental, legal, and social activities of such a society. This lesson discusses and prepares the prospective Valuer to the world of Valuation.

## 3.2 OBJECTIVES

- To familiarise the student with need for valuation and principles involved in the process. We try to understand what are assets and classification of assets.

## 3.3 CONTENTS



## 3.3.1 VALUATION / APPRAISAL PRACTICE

The term Valuation / appraisal practice, applies to any of the following operations, singly and/ or in combination, these operations being executed within a framework of general principles of technical procedure and personal conduct:

1. Develop a credible opinion of the value of property on the basis of research and analysis according to current professional methodology
2. Forecasting of the earning power of property
3. Estimation of the value of property
4. Value of Production of a new property
5. Value of Replacement of an existing property by purchase or production of an equivalent property
6. Value of Reproduction of an existing property by purchase or production of an identical property
7. Determining non-monetary benefits or characteristics that contribute to value
8. Rendering of judgments as to age, remaining life, condition, quality, or authenticity of physical property, amenities; an estimate of the amount of a natural resource, population increase, nature of market, rate of absorption, etc.

### 3.3.2 VALUATION AND JUDGMENT

The following principles need to be adopted while executing a valuation assignment.

#### 3.3.2.1. Due Diligence

We need to exercise judgment when applying the principles of Valuation to specific cases. Judgment must be objective & reasonable - neither overstated nor understated. Valuer shall keep in mind purpose of valuation, the basis of value and any other assumptions as stated in the valuation.

#### 3.3.2.2. Factual

Valuation should be made with factual data as far as possible. Any assumptions should be clearly stated. Transparency and objectivity of the Valuer and the valuation should be apparent in the report.

#### 3.3.2.3. Code of Ethics

Valuer should adhere to Code of Ethic of the profession. Where the purpose of the valuation requires the valuer to have a specific status or disclosures confirming the valuer's status to be made, the requirements as set out in the appropriate standard should be strictly followed.

Matters relating to the conduct and ethical behaviour are to be evolved & regulated by Valuation Professional Organisations or other bodies that have a role in regulating or licensing individual valuers.

#### 3.3.2.4. Qualification

Because valuation requires the exercise of skill and judgement, it is a fundamental expectation that valuations are prepared by an individual or firm having the appropriate technical skills, experience and knowledge of the subject of the valuation, the market in which it trades and the purpose of the valuation.

#### 3.3.2.5. External Assistance

For complex or large multi-asset valuations, it is acceptable for the valuer to seek assistance from specialists in certain aspects of the overall assignment, providing this is disclosed in the report.

### 3.3.3 VALUATION OF PROPERTY / ASSET

An asset is an economic resource. Anything tangible or intangible that can be owned or controlled -to produce value and that is held to have positive economic value is considered an asset. Simply stated, assets represent value of ownership that can be converted into cash.

Hence for an asset to have value there must be a possibility for the asset to be converted to cash.

Assets can be tangible or intangible:

### 3.3.4 INTANGIBLE ASSETS

Intangible assets usually do not have physical substance but have value. They include patents, copyrights, franchises, goodwill, trademarks, trade names, etc.

These assets can add value to tangible assets. Sometimes intangible assets have value only when offered together with tangible assets. It is also possible for intangible assets to have value even unaccompanied by tangible assets.

In valuation practice, it is necessary to distinguish between tangible & intangible assets and the nature of the intangible asset.

Example 1: Let us take a case of a car (automobile) previously owned by a celebrity. The car may be valued at a much higher price than its original value. However, the value is inextricably conjoined with the physical asset and cannot be offered separately.

The car has a tangible asset value- like any other similar car not owned by a celebrity. Intangible asset value amounts to the balance of its market value.

Example 2: Let us now take the case of a manufacturer of a branded product like say a Mixer grinder. The factory producing the product has tangible assets whose assets can be valued in isolation of the brand value. The factory can be sold separately without the brand rights. The brand value is in a position to offer a value addition by virtue of its perception & trust in the market.

The owner of the brand can get the product manufactured without any factory, by outsourcing the manufacture. The brand will continue to command a market value, independent of the factory producing the product. In this case the value of tangible asset is not linked to value of the intangible asset.

### 3.3.5 TANGIBLE ASSETS

Tangible assets have a physical form. Hence they have physical dimensions, can be identified and have value. Land, buildings, plant & machinery, office equipment, plantations & agriculture based resources, commodities like gold, silver, iron, oils etc., inventory like tools, tackles, spares & consumables are all tangible assets. An asset that can be physically seen felt or measured is a tangible asset.

Value of the asset may increase or decrease with passage of time. Asset may be a wasting asset – market value decreases with age. Or the asset may be an appreciating asset – market value increases with age or passage of time.

Example 1: Wine or whiskey stored in casks for aging: The value of this asset increases with passage of time. In our every-day use old rice has more value than new rice.

Example 2: A new Car or any other unsold inventory: Any inventory or asset ready for sale that is not sold in specified time – decreases in value. A new car unsold but manufactured the previous year has to be sold at a discount.

Example 3: Items like food products & medicine have relatively short shelf life. Once its shelf life expires, they not only lose value, but may even need special disposal methods or therefore cost to dispose of (negative value).

Hence in Valuation practice one has to know the factors influencing value in each aspect of the asset that is being valued.

Tangible assets are classified into Fixed Assets & Current Assets.

### 3.3.6 FIXED ASSETS

Fixed assets are those that have a reasonably long life in years and return on their income is likely to last for many years. Hence value of a fixed asset is based not only on its present income but also on its future income.

Income from the asset may increase or decrease with passage of time. Asset may be a wasting asset – market value decreases with age & use. Or the asset may be an appreciating asset – market value increases with age or passage of time.

Example 1: Diesel Generator: Market Value of a diesel generator (fixed asset) is expected to decrease over time- based on its use & age.

Example 2. Building: market value of a building generally decreases over time – the rate may be slow but there is a decrease in value as the building ages.

But then how does the value of a residential flat increase over time?

Example 3: Land is an appreciating asset. In India land prices generally have consistently risen over the years disproportionately to inflation. Hence land value increases over time.

The Undivided share of land in the case of Flat or the value of the land in the case of full building contributes the increase in value. In this case the value of land & building is inextricably linked. One cannot be offered in exclusion of the other.

So the answer to the question in example 2 – it is value of land that contributes to the increase in value while the value of the building itself decreases with age.

### 3.3.7 CURRENT ASSETS

Current assets are those assets that are generally held for a limited period of time. Usually current assets are freely convertible between cash & product. In an industry, for purposes of valuation, raw materials, in-process inventory, finished goods, spares & consumables are all part of current assets.

Usually in-house or market data is readily available for purposes of valuation of these assets. However due diligence may be needed for determining the quantity & quality of current assets.

If current assets suffer from deficiencies like beyond shelf life, rejects or defectives then an assessment by a qualified Valuation professional may be called for.

### 3.4 REVISION POINTS

1. Valuation of Property / Asset
2. Current Assets
3. Fixed assets

### 3.5 INTEXT QUESTIONS

1. Name a few purposes for which valuation may be needed
2. What the basic principles to be observed during valuation?
3. What are tangible & -intangible assets – give a few examples
4. What is the difference between fixed asset & current asset

### 3.6 SUMMARY

We have discussed the need for valuation of an asset – when a valuation may be needed. Then we looked at what are the principles to observe while taking up a valuation assignment.

We then discussed what an asset is and how they are classified as tangible / intangible.

Tangible assets are further classified as fixed assets & current assets

### 3.7 TERMINAL EXERCISE

1. What is tangible asset?
2. What is fixed asset?

### 3.8 SUPPLEMENTARY MATERIALS

1. http://www.appraisalinstitute.org/

### 3.9 ASSIGNMENTS

Discuss the nature of each asset & expertise needed to assess in:

1. Class room
2. Educational Institution
3. A factory

### 3.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

### 3.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Intangible Assets
2. Tangible Assets

### 3.12 KEY WORDS

Intangible Assets, Tangible Assets

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# PRICE, COST AND VALUE

## 4.1 INTRODUCTION

Valuation practice has to arrive at a conclusion on value. For this purpose, it is necessary to look at various data. Price cost & value are interchangeably used in common parlance. However, in valuation practice they carry different & specific meaning. We discuss the meaning of price cost & value in this lesson.

## 4.2 OBJECTIVES

- To clearly differentiate the difference between price, cost & value in valuation practice. This is a fundamental requirement that requires to clearly understood & implemented in all valuation methodology & reports.

## 4.3 CONTENTS

### 4.3.1 PRICE, COST AND VALUE

In Valuation practice, it is necessary to understand the difference between price, cost & value. In every day experience these terms are used interchangeably. However, they have very specific meaning in valuation practice. Let us look at some examples, to understand the issues.

Example 1: A Flat is purchased at a fixed price say Rs.50 lakhs. Thereafter certain other amenities are paid for separately (Rs.6 lakhs) based on individual buyer requirements. Thereafter an amount is incurred towards registration of the sale deed (Rs.4 lakhs).

So what is price of the flat?

Example 2: A particular machinery – Milling machine is purchased for Rs.20, 00,000 + excise duty @ 10% = Rs.2,00,000 VAT @ 5% = Rs.1,10,000. An amount of Rs.15, 000 is incurred towards lorry hire charges and a further Rs.20,000 for unloading & positioning of the machine. An amount of Rs.30,000 is incurred towards required foundation work. Rs.40,000 is incurred towards providing electrical connection to the machine.

So what is the price of the machine?

Price of the flat or machinery for the seller is what he gets as cash in his account. Price for buyer is what he pays for acquiring the asset. So it has become necessary to differentiate between cost & price.

1. Price is the amount asked, offered or paid for an asset. Because of the financial capabilities, motivations or special interests of a given buyer or seller, the price paid may be different from the value which might be ascribed to the asset by others.
2. Cost is the amount required to acquire or create the asset and put the same to beneficial use. When that asset has been acquired or created, its cost is a fact. Price is related to cost because the price paid for an asset,is included in the cost to the buyer.

Example 3: Now let us assume our buyer wants to sell the asset the very next day. Let us assume the asset does not suffer from any deficiencies or any other issue. Let us assume there is a ready buyer for the asset.

In the case of Example 1 - the Flat - definitely the registration costs has to be borne again by the new prospective buyer. Preferences of amenities of the new buyer may be different from the earlier buyer. He may or may not see value in those amenities. He may want some other amenities.

What is the price the new buyer is likely to offer??

In the case of Example 2 – Milling machine – the new buyer has to again transport the machine to his factory, unload & install the same. Will he or will he not get the benefit of Excise duty & VAT rebate?? What about other costs incurred by the first buyer?

That brings us to the question of value.

3. Value is not a fact but an opinion of either:

   (a) the most probable price to be paid for an asset in an exchange, or

   (b) the economic benefits of owning an asset.

A value in exchange is a hypothetical price and the hypothesis on which the value is estimated is determined by the purpose of the valuation. A value to the owner is an estimate of the benefits that would accrue to a particular party from ownership.

It is an interesting exercise to get an opinion on value.

Class discussion: In Example 3 – resale of a flat – what is the most likely value that a prospective buyer may offer?

Class discussion: In Example 3 – resale of milling machine - what is the most likely value that a prospective buyer may offer?

During our discussion we shall be making many assumptions. What are the assumptions that need to be made?

How valid are assumptions?

The word “valuation” can be used to refer to the estimated value (the valuation conclusion) or to refer to the preparation of the estimated value (the act of valuing). Where there is potential for confusion or a need to make a clear distinction between the alternative meanings, additional words are used.

**4.4 REVISION POINTS**

1. Price
2. Cost
3. Value

**4.5 INTEXT QUESTIONS**

1. What is price?
2. What is cost?
3. What is value?

**4.6 SUMMARY**

Price cost & value are the basic & fundamental concepts in valuation. A clear unambiguous understanding of these terms is essential for successful practice. In this lesson we have looked at these with examples.

**4.7 TERMINAL EXERCISE**

1. What is resale of milling machine?
2. What is resale of a flat?

**4.8 SUPPLEMENTARY MATERIALS**

1. www. humancond.org/analysis/economics/price_vs_worth_vs_value

**4.9 ASSIGNMENTS**

Discuss what is price cost & value

1. For the motor car or (motor cycle) that you recently purchased.
2. For a machine tool – say a centre lathe that has been invoiced as new for say: Rs.5,00,000/-.

**4.10 REFERENCE BOOKS**

1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc.Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.

**4.11 LEARNING ACTIVITIES**

Group Discussion during PCP on

1. Resale of milling machine
2. Resale of a flat

**4.12 KEY WORDS**

1. Price
2. Cost
3. Value

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# THE MARKET

## 5.1 INTRODUCTION

Valuation is about the science of determining value. For a product or service to have value, there has to be a potential buyer. In this lesson we try to understand the relationship between value, purpose & market. We learn how "market" for purposes of valuation is to be understood.

## 5.2 OBJECTIVES

- To familiarise the student with term "Market".

Valuation requires that for value to exist, there has to be a potential buyer. A product or service for which there is no buyer has no value. The environment that provides an information exchange resulting in an exchange of goods/services for cash is called market.

## 5.3 CONTENTS

### 5.3.1 A MARKET

A market is the environment in which goods and services trade between buyers and sellers through a price mechanism. The concept of a market implies that goods or services may be traded among buyers and sellers without undue restriction on their activities. Each party will respond to supply- demand relationships and other price-setting factors as well as to their own understanding of the relative utility of the goods or services and individual needs and desires.

In order to estimate the most probable price that would be paid for an asset, it is of fundamental importance to understand the extent of the market in which that asset would trade. This is because the price that can be obtained will depend upon the number of buyers and sellers in the particular market on the valuation date.

To have an effect on price, buyers and sellers must have access to that market. A market can be defined by various criteria. These include:

(a) the goods or services that are traded, eg the market for motor vehicles is distinct from the market for gold,

(b) scale or distribution restraints, eg a manufacturer of goods may not have the distribution or marketing infrastructure to sell to end users and the end users may not require the goods in the volume at which they are produced by the manufacturer,

(c) geography, eg the market for similar goods or services may be local, regional, national or international.

However, although at any point in time a market may be self-contained and be little influenced by activity in other markets, over a period of time markets will influence each other.

For example, on any given date the price of an asset in one state may be higher than could be obtained for an identical asset in another. If any possible distorting effects caused by government trading restrictions or fiscal policies are ignored, suppliers would, over time, increase the supply of the asset to the state where it could obtain the higher price and reduce the supply to the state where the price was lower, thus bringing about a convergence of prices.

Unless otherwise clear from the context, references to the market mean the market in which the asset or liability being valued is normally exchanged on the valuation date and to which most participants in that market, including the current owner, normally have access.

Markets rarely operate perfectly with constant equilibrium between supply and demand and an even level of activity, due to various imperfections. Common market imperfections include disruptions of supply, sudden increases or decreases in demand or asymmetry of knowledge between market participants. Because market participants react to these imperfections, at a given time a market is likely to be adjusting to any change that has caused disequilibrium.

A valuation that has the objective of estimating the most probable price in the market has to reflect the conditions in the relevant market on the valuation date, not an adjusted or smoothed price based on a supposed restoration of equilibrium.

**5.3.1.1 Example 1**

Office space meant for leasing: A promoter develops commercial space with a view of offering lease rentals as the revenue model.

It is possible that office / commercial space market is currently at over-supply or under supply situation. The locational advantage the asset might have undergone change for the better or worse.

The purpose of creating the asset was earning revenue by lease rental method. Valuation of the asset should reflect the market realities when assessing this asset.

**5.3.1.2 Example 2**

An entrepreneur sets up an engineering unit to manufacture engineering components. To meet his production needs he carefully selects machinery required. Machinery procured are all standard well known popular machines.

The purpose of creating this set of assets was to produce certain components. However, machinery chosen are capable of producing a variety of components. These kind of used machinery may find a ready market for other applications.

Value of this machinery will have to reflect these assessments.

**5.3.1.3 Example 3**

A plant was set up manufacture a certain type of chemical. The plant has been operational for a certain period. Because of global developments & changes in technology, the process adopted by this plant is no more viable. Presently it is not economical to manufacture the product in this plant. The plant is well maintained and all equipment are operational.

### 5.4 REVISION POINTS

1. Market
2. Lease

### 5.5 INTEXT QUESTIONS

1. Why is existence of "market" essential for Valuation?
2. What is the role of quantity of potential buyers – in valuation?
3. How does the nature & purpose of asset creation influence market?

### 5.6 SUMMARY

We studied what is market and why it is necessary to have a market for value to exist.

We discussed how nature & purpose for which an asset was crated influence market & therefore value

### 5.7 TERMINAL EXERCISE

1. What is Market?
2. What is a potential buyer?

### 5.8 SUPPLEMENTARY MATERIALS

1. www.investopedia.com/terms/m/market.asp

### 5.9 ASSIGNMENTS

Discuss the relationship between value & market for:

1. a Current model car – say: Maruti Swift Desire
2. An old model car: say: Maruti Esteem
3. An obsolete model car: Say Premier Padmini (Fiat)

### 5.10 REFERENCE BOOKS


1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.


### 5.11 LEARNING ACTIVITIES

Group discussion during the PCP days

1. What is the value of this plant?

### 5.12 KEY WORDS

Market

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LESSON - 6

# MARKET ACTIVITY& PARTICIPANTS

## 6.1 INTRODUCTION

In this lesson we understand how a market behaves, under various circumstances. A good understanding of market behaviour is necessary in valuation practice. In this lesson we study some aspects of market behaviour.

## 6.2 OBJECTIVES

- To familiarise the student with market behaviour & factors influencing it.

## 6.3 CONTENTS

6.3.1 Market Activity & Participants

6.3.3 Oligopoly

6.3.2 Monopoly

6.3.4 Perfect Competition

6.3.5 Market Participants

## 6.3.1 MARKET ACTIVITY & PARTICIPANTS

The degree of activity in any market will fluctuate. Although it may be possible to identify a normal level of activity over an extended period, in most markets there will be periods when activity is significantly higher or lower than this norm. Activity levels can only be expressed in relative terms; eg the market is more or less active than it was on a previous date. There is no clearly defined line between a market that is active or inactive.

When demand is high in relation to supply, prices would be expected to rise which tends to attract more sellers to enter the market and therefore increased activity. The converse is the case when demand is low and prices are falling. However, different levels of activity may be a response to price movements rather than the cause of them.

### 6.3.1.1 Example 1

Government policy: Government can create a monopoly over an industry that it wants to control, such as defence related or railways.

### 6.3.1.2 Example 2

Exclusive rights: Patents: Among Pharma industries this is very common. A successful drug is protected by patents, thus providing an entry barrier

### 6.3.1.3 Example 3

Minerals & Mining rights: A country may be uniquely endowed with certain minerals. Exploitation of mineral wealth is thus restricted.

### 6.3.1.4 Example 4

Agro based industries: Proximity to area of harvest may be crucial for some industries. Tea factories, Sugar Factories are common examples.

### 6.3.2 MONOPOLY

A monopoly is a market structure in which there is only one or very few producers/sellers for a product. Entry barriers can be high costs or other impediments - economic, social or political.

### 6.3.3 OLIGOPOLY

In an oligopoly, there are only a few firms that make up an industry. This select group of firms has control over the price and, like a monopoly; an oligopoly has high barriers to entry. The products that the oligopolistic firms produce are often nearly identical and, therefore, the companies, which are competing for market share, are interdependent as a result of market forces.

#### 6.3.3.1 Example

Many fast moving consumer goods like cosmetics & consumer goods: These high value addition goods are manufactured by a select few companies. For example, in tooth paste category Colgate Palmolive may have 55% market share, Hindustan Lever may have 22 % market share and Dabur may have 13 % market share. These 3 brands contribute more than 80 % of the total market. So, if one company starts selling tooth-paste at a lower price, it will get a greater market share, thereby forcing the other Company to lower its prices as well.

### 6.3.4 PERFECT COMPETITION

This is the other extreme of Monopoly. In Perfect competition there is multitude of buyers and sellers, most products are similar in nature and substitutes for each other. In Perfect competition there are very few barriers for entry of new companies. Prices are determined by supply and demand.

Producers in a perfectly competitive market are subject to the prices determined by the market and do not have any leverage. If one firm decides to increase its selling price of a good, the consumers can shift to another competitor for a better price.

Transactions can and do take place in markets that are currently less active than normal and, just as importantly, prospective buyers are likely to have in mind a price at which they would be prepared to enter the market.

Price information from an inactive market may still be evidence of market value. A period of falling prices is likely to see both decreased levels of activity and an increase in sales that can be termed “forced”.

However, there are sellers in falling markets that are not acting under duress and to dismiss the evidence of prices realised by such sellers would be to ignore the realities of the market.

### 6.3.5 MARKET PARTICIPANTS

Market participants are to the whole body of individuals, companies or other entities that are involved in actual transactions or who are contemplating entering into a transaction for a particular type of asset.

There are 4 main types of factors influencing consumer behaviour: cultural factors, social factors, personal factors and psychological factors.

### 6.3.5.1 Cultural Factors

Cultural factors are coming from the different components related to culture or cultural environment from which the consumer belongs. Culture is crucial when it comes to understanding the needs and behaviours of an individual.

**Social classes**: A factor which influences culture or class perceptions is social class. Social classes are defined as groups more or less homogenous and ranked against each other according to a form of social hierarchy. We can usually find similar values, lifestyles, interests and behaviours in individuals belonging to the same social class.

For example, three general categories among social classes are: lower class, middle class and upper class based on economic conditions. Different classes can be based on communities, regions / countries of origin, also.

People from different social classes tend to have different perceptions, desires and consumption patterns.

Hence in any given sample, buyers may not all - always buy the same kind of equipment, do not choose the same kind of location, do not employ the same methods.

Consumer buying behaviour may change according to social class. A consumer from the lower class will be more focused on price. While a shopper from the upper class will be more attracted to elements such as quality, innovation, features, or even the "social benefit" that he can obtain from the product.

Throughout his existence, an individual will be influenced by his family, his friends, his cultural environment or society that will "teach" him values, preferences as well as common behaviours to their own culture. These play a role in the perception, habits, behaviour or expectations of consumers.

### 6.3.5.2 Social Factors

Social factors influence consumer behaviour. The influence level may vary depending on individuals and groups. But is generally observed common consumption trends among the members of a same group.

Within a reference group that influence the consumer buying behaviour, several roles have been identified:

#### The Initiator

The person who suggests buying a product or service

#### The Influencer

The person whose point of view or advice will influence the buying decision. It may be a person outside the group (singer, athlete, actor, etc..) but on which group members rely on.

#### The Decision-Maker

The person who will choose which product to buy. In general, it's the consumer but in some cases it may be another person. For example, the "leader" of a soccer supporters' group (membership group) that will define, for the whole group, which supporter's scarf to buy and wear during the next game.

**The buyer:** the person who will buy the product. Generally, this will be the final consumer.

### 6.3.5.3 Personal Factors

Decisions and buying behaviour are influenced by the characteristics of each consumer.

#### Age and Way of Life

A consumer does not buy the same products or services at 20 or 70 years. His lifestyle, values, environment, activities, hobbies and consumer habits evolve throughout his life.

The factors influencing the buying decision process may also change. For example, the "social value" of a brand generally play a more important role in the decision for a consumer at 25 than at 65 years.

The family life cycle of the individual will also have an influence on his values, lifestyles and buying behaviour depending on whether he's single, in a relationship, in a relationship with kids, etc.. As well as the region of the country and the kind of city where he lives (large city, small town, countryside, etc..).

#### Purchasing Power and Revenue

The purchasing power of an individual will have, of course, a decisive influence on his behaviour and purchasing decisions based on his income and his capital.

#### Life Style

The lifestyle of an individual includes all of its activities, interests, values and opinions.

### 6.3.5.4 Psychological Factors

Psychological factors can be divided into 4 categories: motivation, perception, learning as well as beliefs and attitudes.

#### Motivation

Motivation drives consumers to develop a purchasing behaviour. It is the expression of a need is which became pressing enough to lead the consumer to want to satisfy it.

To increase sales and encourage consumers to purchase, seller should try to create, make conscious or reinforce a need or visibility of the asset in consumer's mind.

#### Perception

Perception is the process through which an individual selects, organizes and interprets the information he receives in order to do something that makes sense.

The perception of a situation at a given time may decide if and how the person will act.

Depending to his experiences, beliefs and personal characteristics, an individual will have a different perception from another. Stigma, beliefs can influence buyer behaviour.

The perception mechanism of an individual is organized around three processes:

**Selective Attention**

The individual focuses only on a few details or stimulus to which he is subjected. The type of information or stimuli to which an individual is more sensitive depends on the person.

**Selective Distortion**

Usually two persons will not interpret the same information or data of a stimulus in the same way. Each individual will have a different perception based on his experience, state of mind, beliefs and attitudes. Selective distortion leads people to interpret situations in order to make them consistent with their beliefs and values.

**Selective Retention**

People retain only a fraction of information and stimuli they are exposed to. Selective retention is about what the individual stores and retains from a given situation.

For example, consumers may remember the benefits of a brand or product they like and will “forget” the advantages of a competitor.

While we need to understand market behaviour it is necessary to weigh these factors carefully while interpreting them for purposes of valuation.

In undertaking a market-based valuation, any constraint of the particular seller / buyer should be ignored. It is to be assumed that both the willing seller and the willing buyer are hypothetical individuals or entities – in a typical market participant.

### 6.4 REVISION POINTS

1. Psychological factors
2. Personal Factors
3. Cultural factors

### 6.5 INTEXT QUESTIONS

1. What are the factors influencing market activity?
2. What is monopoly?
3. What is perfect competition?
4. What are the factors influencing buyer behaviour?
5. Write short notes on Cultural factors / social factors / personal factors & psychological factors.

## 6.6 SUMMARY

In valuation practice, one needs to be in touch with the market. He / she must keep updated about happenings in the market place & trends. We need to know the type of market – monopoly / oligopoly / perfect competition – in which the asset to be valued operates.

Similarly, we need to understand buyer behaviour & factors influencing them to identify potential buyers & value perception. Value perception is influenced by Cultural factors / social factors / personal factors & psychological factors.

Constraints in free market activity can be imposed by Government regulations or change in law. Valuer needs to be updated on the changes that influence quality / quantity of the market & therefore value.

## 6.7 TERMINAL EXERCISE

1. What are the types of factors influencing consumer behaviour?

## 6.8 SUPPLEMENTARY MATERIALS

1. www.lbma.org.uk/market-overview

## 6.9 ASSIGNMENTS

1. Discuss the influence of Vaasthu – in the value of a building
2. Discuss the value of a fully refurbished / reconditioned car - involved in a fatal accident.
3. Discuss the value influences on a failed enterprise coming up for auction.

## 6.10 REFERENCE BOOKS

1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc.Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.

## 6.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Influence of Vaasthu – in the value of a building

## 6.12 KEY WORDS

Selective Distortion, Psychological factors, Personal Factors, Cultural factors

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LESSON - 7

# ENTITY SPECIFIC FACTORS OF AN ASSET

## 7.1 INTRODUCTION

Valuation practice calls for an understanding of market and potential buyer. In some cases, an asset offers additional value to a particular buyer. This additional value is not necessarily available to all buyers. This feature is known as Entity specific factor. In this lesson we learn about Entity specific factors.

## 7.2 OBJECTIVES

- To understand how market value can be influenced by particular buyers who have "interest" in the asset.

## 7.3 CONTENTS



## 7.3.1 ENTITY SPECIFIC FACTORS

These are features that add value to an asset for specified users only. These features are useful/beneficial under certain conditions or specific period of time or in some cases for the first (few) owner only.

The factors that are specific to a particular buyer or seller and not available to market participants generally are excluded from the inputs used in a market-based valuation. Examples of entity specific factors that may not be available to market participants are:

(a) Additional value derived from the creation of a portfolio of similar assets,

(b) Unique synergies between the asset and other assets owned by the entity,

(c) Legal rights or restrictions,

(d) Tax benefits or tax burdens,

(e) An ability to exploit an asset that is unique to that entity.

### 7.3.1.1 Example 1

State Governments offer incentives to set up industries in specified locations. Govt. sets up the infrastructure and offers developed area at concessions rates. Rebates on VAT may be offered for first few years of operation. All these factors influence choice of location. However, they may not necessarily influence value of the asset.

### 7.3.1.2 Example 2

A company expands its production facility by adding additional machinery in an existing location. It is very likely that because of increased availability, cost economies and other contributing factors – revenue from operations increases at a higher proportion to incremental investment. However, increase in value of the assets is based on or influenced by increase in revenue.

**7.3.1.3 Example 3**

A company discovers a new product or acquires a patent that allows its existing manufacturing facility to produce a higher value added product. The same machinery may now produce products with higher value and therefore revenue.

However, the asset value may remain unaffected by the increase in revenue.

If the objective of the valuation is to determine the value to a specific owner, entity specific factors are reflected in the valuation of the asset. Situations in which the value to a specific owner may be required include the following examples:

(a) Supporting investment decisions,

(b) Reviewing the performance of an asset.

**7.3.1.4 Example 4**

A buyer is proposing to buy an operational plant producing a certain product. Buyer already is in the same business and is looking expand operations. Valuation is sought by the buyer.

In this case, the buyer sees value in acquiring an operational plant. For him, lead time to production – like acquiring land, getting appropriate licences, construction, installation of plant & machinery, trial commissioning, recruitment / training of man-power etc., are significantly reduced. Cash to product cycle is quick.

Therefore, this specific buyer, sees value in acquiring the specific plant, that is not perceived as value by other buyers.

**7.3.2 AGGREGATION**

The value of an individual asset is often dependent upon its association with other related assets. Examples include:

(a) Offsetting assets and liabilities in a portfolio of financial instruments,

(b) A portfolio of properties that complement each other by providing a prospective buyer with either a critical mass or a presence in strategic locations,

(c) A group of machines in a production line, or the software required to operate a machine or machines,

(d) Recipes and patents that support a brand,

(e) Interdependent land, buildings, plant and other equipment employed in a business enterprise.

**7.3.2.1 Example 1**

In a commercial or IT office building, infrastructure plant & machinery like, standby diesel generators, lifts, central air-conditioning systems etc., are part of the office system and add value to the building. Lease rentals are higher for buildings with better infrastructure.

In this case, plant & machinery compliment the building and adds value. Hence this asset has to assessed based on aggregation.

Where a valuation is required of assets that are held in conjunction with other complementary or related assets, it is important to clearly define whether it is the group or portfolio of assets that is tobe valued or each of the assets individually. If the latter, it is also important to establish whether each asset is assumed to be valued:

(a) As an individual item but assuming that the other assets are available to a buyer, or

(b) As an individual item but assuming that the other assets are not available to a buyer.

#### 7.3.2.2 Example 2

A cinema theatre is to be valued. A theatre has land for building, food-court, and parking. There are special types of building areas, usable only as theatre. There is considerable investment in screen, projection equipment, audio equipment & so on. Furniture & furnishings are designed & suited for maximum customer appeal.

While valuing a cinema theatre it is necessary to consider all these aspects. Each of these assets except land may not have any significant value in isolation. They have value, only when considered as a whole asset.

In valuation practice it is necessary to recognise these factors and explicitly state them in the process of valuation.

### 7.4 REVISION POINTS

1. Entity specific factors
2. Aggregation

### 7.5 INTEXT QUESTIONS

1. What do you understand by entity specific factors?
2. How does an entity specific factor influence value?
3. What do you understand by aggregation?

### 7.6 SUMMARY

Entity specific factors are features that are useful/beneficial for select persons, under certain conditions or specific period of time or in some cases for the first (few) owner only.

The factors that are specific to a particular buyer or seller and not available to market participants generally are excluded from the inputs used in a market-based valuation. If the objective of the valuation is to determine the value to a specific owner, entity specific factors are reflected in the valuation of the asset. In certain cases, assets have value only when they are valued in combination as a whole. This is called aggregation. In valuation practice one has to differentiate between – entity specific factors – whether applicable or not and aggregation whether to be applied or not.

### 7.7 TERMINAL EXERCISE

1. Explain about aggregation
2. What is entity specific factor

### 7.8 SUPPLEMENTARY MATERIALS

1. www.iasplus.com/en/meeting-notes/iasb/2012/may/investment-entities

### 7.9 ASSIGNMENTS

1. Name an entity specific factor. Discuss its influence on value
2. Name an asset that offers value as an aggregated asset: Discuss the effect of asset value with & without aggregation.

### 7.10 REFERENCE BOOKS


1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.


### 7.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Aggregation
2. Specific factors

### 7.12 KEY WORDS

Entity specific factors, Aggregation

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LESSON - 8

# BASIS OF VALUE

## 8.1 INTRODUCTION

Basis of value is the foundation on which valuation exercise rests. Hence a clear understanding this aspect is essential to valuation practice. Data base needed, investigations to be done, interpretation and methodology for arriving at value conclusion all critically depend on Basis for valuation. In this lesson we learn about basis of valuation.

## 8.2 OBJECTIVES

- Basis of valuation is the starting point of valuation exercise. This sets the why, what & how of valuation. We need to understand this.

## 8.3 CONTENTS

8.3.1 A Basis of Value

8.3.2 Purpose of Valuation& basis

### 8.3.1 A BASIS OF VALUE

It is a statement of the fundamental measurement assumptions or purpose of a valuation.

It describes the fundamental assumptions, on which the reported value will be based, eg the nature of the hypothetical transaction, the relationship and motivation of the parties and the extent to which the asset is exposed to the market. The appropriate basis will vary depending on the purpose of the valuation. A basis of value should be clearly distinguished from:

(a) The approach or method used to provide an indication of value,

(b) The type of asset being valued,

(c) The actual or assumed state of an asset at the point of valuation,

(d) Any additional assumptions or special assumptions that modify the fundamental assumptions in specific circumstances.

A basis of valuation can fall into one of three principal categories:

(a) The first is to indicate the most probable price that would be achieved in a hypothetical exchange in a free and open market. Market value as defined in these standards falls into this category.

(b) The second is to indicate the benefits that a person or an entity enjoys from ownership of an asset. The value is specific to that person or entity, and may have no relevance to market participants in general. Investment value and special value as defined in these standards fall into this category.

(c) The third is to indicate the price that would be reasonably agreed between two specific parties for the exchange of an asset. Although the parties may be unconnected and negotiating at arm’s length, the asset is not necessarily exposed in the market and the price agreed may be one that reflects the specific advantages or disadvantages of ownership to the parties involved rather than the market at large. Fair value falls into this category.

Valuations may require the use of different bases of value that are defined by statute, regulation, private contract or other document.

### 8.3.2 PURPOSE OF VALUATION& BASIS

#### 8.3.2.1 Example 1

A bank proposes to extend term loan & other financial facilities to a Company. The company & its promoters offer as security assets that are expected to be created as part of the venture and as well as certain other assets.

What is the Value of assets to the Bank?

Bank is interested in the value of assets, to assure itself:

a. the appropriateness of the value – whether commensurate with the amount expended or not and

b. in case of default what is the amount recoverable by sale of assets in the market?

So this has to form the basis of valuation for this exercise. All assumptions &methodology chosen should be compatible with this purpose.

#### 8.3.2.2 Example 2

Valuation is required for purpose of insuring an asset. What is the purpose of insurance? Insurance is done to protect the owner from unforeseen circumstances that may destroy the asset and its value.

What are the foreseeable circumstances that may not be in ones ‘control that can cause loss of value?

In case of loss what is the desired extent of compensation expected?

These factors need to form the basis of valuation in the case of Valuation for this purpose.

#### 8.3.2.3 Example 3

Valuation is required for purposes of acquiring an asset. A prospective buyer approaches a Valuer for expert advice on market value of the asset.

In this the buyer wishes to acquire the asset for beneficial use. How does the buyer propose to utilise the assets acquired?

Method chosen & assumptions made should be compatible with the purpose of beneficial utilisation of the asset in the hands of the buyer – for the purpose the buyer intended.

### 8.4 REVISION POINTS

1. Value

### 8.5 INTEXT QUESTIONS

1. What is meant by basis of value or purpose of valuation?
2. Why should value vary with purpose?
3. Give example of purpose & basis of valuation

### 8.6 SUMMARY

Basis for valuation depends on the purpose for which valuation is needed. Hence Basis & purpose go together. Methods chosen should be consistent with purpose.

### 8.7 TERMINAL EXERCISE

1. What is the basis of valuation

### 8.8 SUPPLEMENTARY MATERIALS

1. www.investopedia.com/terms/b/basis-value.asp

### 8.9 ASSIGNMENTS

1. Discuss basis for valuation in the case of simple work shop machinery to be purchased as new – for purposes of secured lending (bank).
2. Discuss basis for valuation in the case of a wind-mill to be sold as used – for purposes of sale (present owner).

### 8.10 REFERENCE BOOKS


1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc.Pub; 2nd edition 1970.
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### 8.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Purpose of valuation

### 8.12 KEY WORDS

Valuation

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LESSON - 9

# MARKET VALUE (IVS DEFINITION)

### 9.1 INTRODUCTION

Market value is the single most important requirement in Valuation practice. It forms the foundation of valuation. Market value definition therefore assumes great importance. In this chapter we study what is market value, its characteristics requirements.

### 9.2 OBJECTIVES

- To familiarise the student with standard definition of Market Value

### 9.3. CONTENTS

### 9.3.1 DEFINITION

Market value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.

The definition of market value shall be applied in accordance with the following conceptual framework:

a. **"the estimated amount"** refers to a price expressed in terms of money payable for the asset in an arm's length market transaction. Market value is the most probable price reasonably obtainable in the market on the valuation date in keeping with the market value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing, sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of special value;

b. (b)**"an asset should exchange"** refers to the fact that the value of an asset is an estimated amount rather than a predetermined amount or actual sale price. It is the price in a transaction that meets all the elements of the market value definition at the valuation date;

c. **"on the valuation date"** requires that the value is time-specific as of a given date. Because markets and market conditions may change, the estimated value may be incorrect or inappropriate at another time. The valuation amount will reflect the market state and circumstances as at the valuation date, not those at any other date;

d. **"between a willing buyer"** refers to one who is motivated, but not compelled to buy. This buyer is neither over eager nor determined to buy at any price. This buyer is also one who purchases in accordance with the realities of the current market and with current market expectations, rather than in relation to an imaginary or hypothetical market that cannot be demonstrated or anticipated to exist. The assumed buyer would not pay a higher price than the market requires. The present owner is included among those who constitute “the market”;

e. **“and a willing seller”** is neither an over eager nor a forced seller prepared to sell at any price, nor one prepared to hold out for a price not considered reasonable in the current market. The willing seller is motivated to sell the asset at market terms for the best price attainable in the open market after proper marketing, whatever that price may be. The factual circumstances of the actual owner are not a part of this consideration because the willing seller is a hypothetical owner;

f. **“in an arm’s length transaction”** is one between parties who do not have a particular or special relationship, eg parent and subsidiary companies or landlord and tenant, that may make the price level uncharacteristic of the market or inflated because of an element of special value. The market value transaction is presumed to be between unrelated parties, each acting independently;

g. **“after proper marketing”** means that the asset would be exposed to the market in the most appropriate manner to effect its disposal at the best price reasonably obtainable in accordance with the market value definition. The method of sale is deemed to be that most appropriate to obtain the best price in the market to which the seller has access. The length of exposure time is not a fixed period but will vary according to the type of asset and market conditions. The only criterion is that there must have been sufficient time to allow the asset to be brought to the attention of an adequate number of market participants. The exposure period occurs prior to the valuation date;

h. **“where the parties had each acted knowledgeably, prudently”** presumes that both the willing buyer and the willing seller are reasonably informed about the nature and characteristics of the asset, its actual and potential uses and the state of the market as of the valuation date. Each is further presumed to use that knowledge prudently to seek the price that is most favourable for their respective positions in the transaction. Prudence is assessed by referring to the state of the market at the valuation date, not with benefit of hindsight at some later date. For example, it is not necessarily imprudent for a seller to sell assets in a market with falling prices at a price that is lower than previous market levels. In such cases, as is true for other exchanges in markets with changing prices, the prudent buyer or seller will act in accordance with the best market information available at the time;

i. **“and without compulsion”** establishes that each party is motivated to undertake the transaction, but neither is forced or unduly coerced to complete it.

1. The concept of market value presumes a price negotiated in an open and competitive market where the participants are acting freely. The market for an asset could be an international market or a local market. The market could consist of numerous buyers and sellers, or could be one characterized by a limited number of market participants. The market in which the asset is exposed for sale is the one in which the asset being exchanged is normally exchanged
2. The market value of an asset will reflect its highest and best use. The highest and best use is the use of an asset that maximizes its potential and that is possible, legally permissible and financially feasible. The highest and best use may be for continuation of an asset's existing use or for some alternative use. This is determined by the use that a market participant would have in mind for the asset when formulating the price that it would be willing to bid.
3. The highest and best use of an asset valued on a stand-alone basis may be different from its highest and best use as part of a group, when its contribution to the overall value of the group must be considered.
4. The determination of the highest and best use involves consideration of the following:

(a) to establish whether a use is possible, regard will be had to what would be considered reasonable by market participants.

Explanation: In the case of plant & machinery it is necessary to diligently establish whether the plant & equipment is capable of performing to its rated capacity, efficiency & productivity.

In case of any deficiency the same has to reported.

(b) to reflect the requirement to be legally permissible, any legal restrictions on the use of the asset, need to be taken into account,

Explanation: In the case of plant & machinery it is necessary to verify compliance to regulations like Factories Act., Indian Electricity Act., Indian Boilers & Pressure Vessels Act, Petroleum & Explosives Safety Organisation rules & regulations, Environment Protection Act., Pollution control regulations & rules and other such relevant Acts & rules.

(c) the requirement that the use be financially feasible takes into account whether an alternative use that is physically possible and legally permissible will generate sufficient return to a typical market participant, after taking into account the costs of conversion to that use, over and above the return on the existing use.

Explanation: The purpose of plant & machinery is to participate in the process of production or services – that is to help generate revenue & profit. Hence viability considerations of utilisation of plant & machinery – are necessarily included as part of assessment.

5. Market value is the estimated exchange price of an asset without regard to the seller's costs of sale or the buyer's costs of purchase and without adjustment for any taxes payable by either party as a direct result of the transaction.

Market is a very harsh place. It is driven play of supply & demand. Value of an asset can be different from acquisition cost or replacement value, depending on the circumstances.

Example 1: Electronic goods like computers, TV are classic examples. Market value for used equipment is disproportionate to acquisition cost & replacement value.

Example 2: In the Healthcare sector, price of medical equipment. When a new model diagnostic equipment is introduced the earlier model value is considerably eroded. In many cases the earlier model sale is stopped by the manufacturer. For example, value of a 64 slice CT Scan gets eroded when 128 slice CT scan is introduced.

It is debatable as to how much additional useful data is available for the Medical profession by the additional feature and the need for this additional information in many cases.

However, value of 62 slice CT scan takes a beating when new 124 slice CT scan machine is introduced.

### 9.4 REVISION POINTS

1. Market value
2. Buyer
3. Seller

### 9.5 INTEXT QUESTIONS

1. What is meant by Market value for secured lending purpose?
2. Explain the meaning of willing seller, willing buyer and acting without compulsion
3. What is meant by highest & best use as applicable to Plant & Machinery?
4. What the role of historical production record on value of Plant & machinery?

### 9.6 SUMMARY

In this chapter we look at what is market value and factors that determine Market, market participants, value in exchange, highest & best use criteria and how they influence value.

### 9.7 TERMINAL EXERCISE

1. What is market value?
2. What is meaning of value in exchange?

### 9.8 SUPPLEMENTARY MATERIALS

1. https://www.ivsc.org/files/file/view/id/646

### 9.9 ASSIGNMENTS

1. Take the case of one 40 KW air compressor in good condition available in a closed factory. How do we apply market value determinants in this case?

### 9.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

### 9.11 LEARNING ACTIVITIES

Group discussion on during PCP days

1. Market value
2. Buyer
3. Seller

### 9.12 KEY WORDS

Market value, Buyer, Seller

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LESSON -10

# INVESTMENT VALUE

## 10.1 INTRODUCTION

In this chapter we learn what investment value as applied in valuation practice is. This definition is slightly different from what is generally understood in public domain.

## 10.2 OBJECTIVES

- To familiarise the student with Investment Value as applied to Valuation practice

## 10.3 CONTENTS

### 10.3.1 INVESTMENT VALUE

It is the value of an asset to the owner or a prospective owner for individual investment or operational objectives. The benefit accruing is based on future events and is not available to the owner or a prospective owner in the near term (say one or 2 years).

This is an entity-specific basis of value. Although the value of an asset to the owner may be the same as the amount that could be realised from its sale to another party, this basis of value reflects the benefits received by an entity from holding the asset and, therefore, does not necessarily involve a hypothetical exchange.

Investment value reflects the circumstances and financial objectives of the entity for which the valuation is being produced. It is often used for measuring investment performance.

Differences between the investment value of an asset and its market value provide the motivation for buyers or sellers to enter the market place.

**Example 1**

A piece of un-used vacant land, adjacent to his existing running factory, is proposed to be acquired by a buyer. The buyer does not propose to conduct any activity on the land after acquisition.

In this case the only purpose of the buyer is to ensure availability of space for expansion in the future. He hopes that his business will expand, require additional land and it is convenient to have land in proximity.

Valuation for this purpose shall include methodology to estimate the value addition of this piece of land by virtue of its proximity to existing factory.

**Example 2**

An investor acquires a stake in a company manufacturing a product. Amount of investment is known. The investor desires valuation of the asset.

In this case, the investor is looking for returns & growth potential from his investment. Valuation methodology in this case should include:

a. current earnings capability of the company
b. Constraints & opportunities in operation – techno economic
c. Potential future earnings
d. Growth / expansion prospects of this line of business
e. risks in the line of business / industry

Investment value is the value addition available to a specific buyer that is not necessarily available to all buyers. Hence it is necessary to look at future potential while arriving at value. In this respect it is different from present market value – that is simply a value in exchange – in general. It is something more than market value.

So scenario building, risks & opportunities, production & sales forecasts of the specific buyer, are part of estimating investment value of the asset for the specific buyer.

Under certain circumstances even a denial of opportunity to a competitor can be the source of investment value.

### 10.4 REVISION POINTS

1. Investment value
2. appreciation value

### 10.5 INTEXT QUESTIONS

1. What is investment value?
2. How is investment value different from potential long term appreciation value?

### 10.6 SUMMARY

Investment value is more than market value, since the asset offers certain benefits to the specific buyer that is not necessarily available to all potential buyers. Valuation methodology for determining investment value should include: current earnings capability of the company, Constraints & opportunities in operation – techno economic, potential future earnings, Growth / expansion prospects of this line of business, risks in the line of business / industry.

### 10.7 TERMINAL EXERCISE

1. What is the meaning of investment value?
2. What is appreciation value?

### 10.8 SUPPLEMENTARY MATERIALS

1. www.valuadder.com/glossary/investment-business-value.html

#### 10.9 ASSIGNMENTS

1. Take the case of acquisition of a sick vendor unit by its OE buyer. This is very common in automobile industry.
2. What is the investment value?
3. An MNC wants to enter India. It acquires a existing company in India. The Indian company is not well presently and its brand is not well established.

#### 10.10 REFERENCE BOOKS


1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.


#### 10.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Investment value

#### 10.12 KEY WORDS

Investment value

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LESSON - 11

# FAIR VALUE, SPECIAL VALUE & SYNERGISTIC VALUE

### 11.1 INTRODUCTION

Definitions are very important in valuation practice. We need to differentiate between various factors that influence value. Methodology for determining value needs to be tuned to reflect the influence of these factors. In this chapter we learn about Fair Value, Special Value & Synergistic Value

### 11.2 OBJECTIVES

- To familiarise the student with concepts of Fair Value, Special Value & Synergistic Value

### 11.3 CONTENTS

11.3.1 Fair Value

11.3.2 Special Value

11.3.3 Synergistic Value

### 11.3.1 FAIR VALUE

It is the estimated price for the transfer of an asset or liability between identified knowledgeable and willing parties that reflects the respective interests of those parties.

The definition of fair value for purposes of Financial accounting under IFRS is different from Fair Value for purposes of Valuation (IVS). Fair Value for financial accounting is more consistent with Market Value. In this chapter we shall see that Fair Value and market Value can be different, although related to each other.

For purposes other than use in financial statements, fair value can be distinguished from market value. Fair value requires the assessment of the price that is fair between two identified parties taking into account the respective advantages or disadvantages that each will gain from the transaction. It is commonly applied in judicial contexts and for transfer of assets between interested parties. In contrast, market value requires any advantages that would not be available to market participants generally to be disregarded.

Fair value is a broader concept than market value. Although in many cases the price that is fair between two parties will equate to that obtainable in the market, there will be cases where the, assessment of fair value will involve taking into account matters that have to be disregarded in the assessment of market value, such as any element of special value or investment value, arising because of the combination of the interests.

Examples of the use of fair value include:

a. determination of a price that is fair for a shareholding in a non-quoted business or partnership, for determining exit value under normal circumstances

b. determination of a price that would be fair between a lessor and a lessee for either the permanent transfer of the leased asset or the cancellation of the lease liability.

c. The value of assets for purposes of determining equity value when a new partner or promoter enters an existing company.

It is to be noted in all the cases – market is not free and arms-length definition may not be 100% valid.

#### 11.3.1.1 Example1

A company provides an executive with a company owned car. After a few years the company wishes to sell the car to one of its executives. The sale price is fixed based on book value (written down value) of the car in the asset register.

This value is seen as fair value by both the company & its executive, who is the buyer. Depreciation is calculated based on Income tax & Companies Act rule s. Depreciation is an accepted & approved method to charge acquisition cost to P&L account over a period of time. It is a method to charge cost. It may or may not have any relevance to market value. The only link to market value is the acquisition cost.

Market value for the car may be based on model, make, age, kms run, condition etc. These are not considerations in book keeping methodology.

Hence Fair value based on financial accounting and market value can be different.

#### 11.3.1.2 Example 2

A partnership firm is proposed to be converted to a Private Limited Company. Assets of the Company have to be transferred from Partnership to the Company. Hence valuation of assets needs to be undertaken.

There is no real "sale" in the transaction. However, transfer of assets does take place. In this case valuation needs to recognise special relationships that exist between the parties to transaction.

The value as decided must be "fair" to both sides. It may not recognise constraints or features of the market that may discount or offer a premium for the assets, because of "circumstances" like time of transaction – market upturn / downturn etc.

### 11.3.2 SPECIAL VALUE

Special value is an amount that reflects particular attributes of an asset that are only of value to aspecial purchaser.

A special purchaser is a particular buyer for whom a particular asset has special value because of advantages arising from its ownership that would not be available to other buyers in the market.

Special value can arise where an asset has attributes that make it more attractive to a particular buyer than to any other buyers in a market. These attributes can include the physical, geographic, economic or legal characteristics of an asset.

Market value requires the disregard of any element of special value because at any given date it is only assumed that there is a willing buyer, not a particular willing buyer.

When special value is identified, it should be reported and clearly distinguished from market value.

#### 11.3.2.1 Example 1

A Company is operating from its owned premises. The Company is doing well and wishes to expand and is looking for suitable property (buyer). An adjacent plot with ready buildings is coming up for sale.

For this buyer, the adjacent property has special value.

#### 11.3.2.2 Example 2

A company is an established company A (buyer) in a particular segment of market – say cosmetics. Another well-established company B (seller) is looking to divest.

For Company A, the buyer, Company B offered for sale has special value. Acquisition of Company B offers many advantages.

a. Ready production facility

b. Reduced competition from rival product

c. Opportunity to occupy more shelf space for own product & improve visibility.

### 11.3.3 SYNERGISTIC VALUE

Synergistic value is an additional element of value created by the combination of two or more assets or interests where the combined value is more than the sum of the separate values. If the synergies are only available to one specific buyer, then it is an example of special value.

So synergistic value is additional value offered by the combination of assets to all potential buyers.

## 11.4 REVISION POINTS

1. Fair value
2. Special Value
3. Synergistic Value

## 11.5 INTEXT QUESTIONS

1. How is fair value different from Market value? Explain with an example
2. What is special value?
3. What is synergistic value

### 11.6 SUMMARY

Fair value is a broader concept than market value. Fair value ignores any volatility or special circumstances that have a temporary impact on the value of an asset. It is based on a normative value that assumes an interest between seller & potential buyer - to be fair or not exploit each other.

We see what special value is. Special value is that value that is available to a specific buyer and not all potential buyers. Synergistic value is relationship between a set of assets that offer additional value when grouped and where the additional value is not available when offered in isolation.

### 11.7 TERMINAL EXERCISE

1. What is fair value?
2. Explain about synergistic value

### 11.8 SUPPLEMENTARY MATERIALS

1. https://www.ivsc.org/files/file/view/id/646

### 11.9 ASSIGNMENTS

1. Discuss an example of interested party transaction and its impact on value of the asset.
2. Example 1: Sale of a motorcycle – transaction between friends.
3. Example 2. Friendly & amicable termination of a partnership or division of property.

### 11.10 REFERENCE BOOKS


1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.


### 11.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Fair value
2. Special Value
3. Synergistic Value

### 11.12 KEY WORDS

Fair value, Special Value, Synergistic Value

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LESSON -12

# FORCED SALE VALUE

## 12.1 INTRODUCTION

The term “forced sale” is often used in circumstances where a seller is under compulsion to sell and, as a consequence, a proper marketing period is not possible. The price that could be obtained in these circumstances will depend upon the nature of the pressure on the seller and the reasons why proper marketing cannot be undertaken. It may also reflect the consequences for the seller of failing to sell within the period available.

## 12.2 OBJECTIVES

- To understand the basis for valuation in the case of Forced Sale Value and constraints in estimating forced sale value assumptions.

## 12.3 CONTENTS

### 12.3.1 FORCED SALE VALUE

It is a very commonly used term in 7 practices. There is considerable difference between definitions as per Standards and present use of this term in the Banking & valuation practice in India. Valuers need to understand these issues and be guided accordingly. As India moves towards harmonizing with International Standards on Accounting & Financial Transactions, these definitions will get increasingly accepted.

Forced Sale, distress sale, fire-side sale, garage sale are all terms loosely used to represent transactions that take place in a casual or hurried manner, in an imperfect market, without much diligence or effort. Out of these Forced Sale is defined under IVS.

Forced Sale: (IVS): The term “forced sale” is often used in circumstances where a seller is under compulsion to sell and, as a consequence, a proper marketing period is not possible.

The price that could be obtained in these circumstances will depend upon the nature of the pressure on the seller and the reasons why proper marketing cannot be undertaken. It may also reflect the consequences for the seller of failing to sell within the period available.

Unless the nature of and the reason for the constraints on the seller are known, the price obtainable in a forced sale cannot be realistically estimated (IVS).

The price that a seller will accept in a forced sale will reflect its particular circumstances rather than those of the hypothetical willing seller in the market value definition.

The price obtainable in a forced sale has only a coincidental relationship to market value or any of the other bases defined in this standard.

A “forced sale” is a description of the situation under which the exchange takes place, not a distinct basis of value(IVS).

If an indication of the price obtainable under forced sale circumstances is required, it will be necessary to clearly identify the reasons for the constraint on the seller including the consequences of failing to sell in the specified period by setting out appropriate assumptions. If these circumstances do not exist at the valuation date, these must be clearly identified as special assumptions.

Sales in an inactive or falling market are not automatically "forced sales" simply because a seller might hope for a better price if conditions improved. Unless the seller is compelled to sell by a deadline that prevents proper marketing, the seller will be a willing seller within the definition of market value.

So for "Forced sale": The following pre-conditions are compulsory:

1. There must be a compulsion to sell – there must be loss on delay to the owner – by virtue of nature of asset (for example perishables or declining market value)
2. It is not feasible or possible to undertake proper marketing exercise-publicity and/or other such activity to attract buyers

In India the term "Forced Sales" is very freely used. In secured lending practice, banks often ask for "Forced Sale" value.

However, Courts have time & again held that banks cannot be arbitrary or make haste while disposing assets. There has to be due diligence and proper marketing activity. With the advent of E-Auctions, market information dissemination has become more transparent. So normally Banks cannot claim to meet condition 2.

To quote:

Australia Property Institute& PINZ "Technical Information paper3 – 1July2015:

Addressing the Concept of 'Forced Sale'

Objective: The objective of this TIP is to address circumstances whereby API and PINZ members are requested to take into account an actual or anticipated constraint which is inconsistent with 'market value'. The terms 'forced sale value', 'fire sale value' and/or 'distressed sale value' are considered inappropriate and not supported by this Institute. However, advice prepared by a Certified Practicing Valuer (Australia) / Registered Valuer (New Zealand) estimating a likely realizable price, based on an agreed set of circumstances may be provided, subject to agreeing and detailing all assumptions and any necessary qualifications.

Unquote:

Hence Value of assets to be determined for secured lending purposes, is Auction Sale value. The conditions under which auction sale takes place, influences value.

**12.3.1.1 Example 1**

Forced sale: A Vegetable oil refinery company closes operations for certain reasons. The company manufactures refined vegetable oils from oil seeds / raw oil. All current assets like – raw materials, in-process inventory, finished goods & consumables – oil seeds / raw oil / solvents / refined oil / by-products like tannin, fats etc. - need to be disposed of based on their shelf life.

Any prolonged storage is likely to result in significant loss of value. Hence quick decisions need to be taken based on limited available data & market information.

In this case Forced Sale value estimate has to made in quick time, with limited information as available.

**12.3.1.2 Example 2**

A company manufactures sugar. Due to unseasonal or excessive rain, the Sugar go-down gets flooded and stocks become wet. It is very difficult to estimate the extent of moisture ingress of the entire stock in detail. Prolonged storage is likely to result in significant loss of value.

In this case Forced Sale value becomes applicable, since estimates & decisions have to be taken within limited time & data availability.

**12.3.1.3 Example 3**

A commercial building venture becomes a non-performing asset and is put up for sale. A few months have already elapsed from the time of shut-down to the time taken to sell the asset in the open market.

Value of this asset is to be determined. There is no component or part of this asset that is likely to lose significant value with a lapse of a few weeks of time. However, if the time lapse is in years, then there could be loss of value.

Valuation of this asset cannot be on "Forced Sale" basis. There is no compelling reason to dispose of the asset "in a hurry". There is no justification for not undertaking a due diligence study.

Under these circumstances, "Auction Sale Value" with conditions as existing "As is Where is" is correct basis for valuation. Methodology & assumptions need to be made on this basis.

Hence in Valuation practice, Forced Sale Value and Auction Sale value are different.

For purposes of secured lending, Valuation of Fixed Assets – Auction Sale Value on "As is Where is" basis is likely to be more appropriate than "Forced Sale Value".

**12.4 REVISION POINTS**

1. Forced sale value

**12.5 INTEXT QUESTIONS**

1. What is forced sale – What conditions are necessary for forced sale?
2. Why is it very difficult to determine value –under forced sale?
3. What is the difference between Market value and value of an asset with constraints (special value)?

**12.6 SUMMARY**

Forced sale value is a very common term. In the light of Standard definitions adopted by IVSC, ASA, API, PINZ it is not appropriate to a valuation under forced sale basis in due course. Constraints in sale are to be clearly spelt out and values realizable under these conditions are to be to be estimated.

**12.7 TERMINAL EXERCISE**

1. What is fire sale value?

**12.8 SUPPLEMENTARY MATERIALS**

1. http://www.aicanada.ca/article/forced-sale-valuation

**12.9 ASSIGNMENTS**

1. A Flat – re-possessed by Bank is put up for sale by Bank. Discuss the influence value – constraints, market value & realizable value.
2. A diesel generator in working condition (with AMC) is re-possessed by bank and offered for sale. Discuss the influence value – constraints, market value & realizable value.

**12.10 REFERENCE BOOKS**

1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc.Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.

**12.11 LEARNING ACTIVITIES**

Group discussion on PCP days

1. Forced sale value

**12.12 KEY WORDS**

Forced sale value

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LESSON - 13

# ASSUMPTIONS

## 13.1 INTRODUCTION

In any estimation process assumptions are a very necessary feature. It is necessary to state the assumptions clearly & prominently so that a person who studies the valuation report understands them. Assumptions should be relevant & appropriate for the valuation exercise being undertaken.

## 13.2 OBJECTIVES

- Understanding the role of assumptions in Valuation practice.

In addition to stating the basis of value, it is often necessary to make an assumption or multiple assumptions to clarify either the state of the asset in the hypothetical exchange or the circumstances under which the asset is assumed to be exchanged. Such assumptions can have a significant impact on value.

Some common examples of assumptions for purposes of valuation:

a. a business is transferred on whole asset – enterprise basis (tangible & intangible)

b. only tangible assets are transferred (all assets in the unit)

c. only specified list of assets as per schedule are offered,

d. transfer of a part of ownership without any sale of asset

e. Property is owner-occupied or vacant in the hypothetical transfer.

f. Production process is being conducted in owned premises or rented(leased) premises

Special assumptions are based on certain prospective events / dates.

## 13.3. CONTENTS

### 13.3.1 SPECIAL ASSUMPTIONS

It is often used to illustrate the effect of possible changes on the value of an asset. They are designated as “special” so as to highlight to a valuation user that the valuation conclusion is contingent upon a change in the current circumstances or that it reflects a view that would not be taken by market participants generally on the valuation date.

Assumptions and special assumptions must be reasonable and relevant having regard to the purpose for which the valuation is required.

#### 13.3.1.1 Example 1

A running factory manufacturing say Mixer grinder is offered for sale. The Company manufacturing the product is offering only the tangible assets for sale. However, the Company is also willing to offer the entire asset – including brand & drawings for sale.

Valuation methodology to be adopted in each case is different.

### 13.3.1.2 Class Discussion: Case 1

In this case the production facility alone is for sale. Brand rights, drawings etc. are not part of sale. So valuations of tangible assets alone are to be valued. The production facility for the buyer becomes a stand-alone facility.

What is the methodology to be adopted?

What are the assumptions?

### 13.3.1.3 Class Discussion: Case 2

The Company production facility is offered complete with brand, drawing rights.

What is the methodology to be adopted?

What are the assumptions?

### 13.4 REVISION POINTS

1. Role of assumptions in Valuation practice
2. Special assumptions

### 13.5 INTEXT QUESTIONS

1. What are the assumptions used in valuations

### 13.6 SUMMARY

In any estimation process assumptions are a very necessary feature. It is necessary to state the assumptions clearly & prominently so that a person who studies the valuation report understands them. Assumptions should be relevant & appropriate for the valuation exercise being undertaken

### 13.7 TERMINAL EXERCISE

1. Give common examples of assumptions for purposes of valuation

### 13.8 SUPPLEMENTARY MATERIALS

1. https://www.saa.gov.uk/valuationassump.html

### 13.9 ASSIGNMENTS

1. Give the examples of assumptions used in tangible assets are transferred

### 13.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

### 13.11 LEARNING ACTIVITIES

1. Group discussion made on Role of assumptions in Valuation practice

### 13.12 KEY WORDS

1. Special assumptions

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LESSON - 14

# VALUATION APPROACHES

## 14.1 INTRODUCTION

Estimating the value of an asset requires a methodology or approach. There are 3 basic approaches to estimating value. Cost approach, income approach and market approach. We discuss these approaches their features and constraints.

## 14.2 OBJECTIVES

- To explain 3 basic approaches adopted for estimating the value of an asset for a purpose. One or more valuation approaches may be used in order to arrive at the valuation defined by the appropriate basis of value. Three approaches are described and defined here. They all are based on the economic principles of price equilibrium, anticipation of benefits or substitution. Using more than one valuation approach or method is especially recommended where there are insufficient factual or observable inputs for a single method to produce a reliable conclusion.

  1. Cost Approach
  2. Income Approach
  3. Market Approach

These approaches are now discussed.

In Valuation practice, we often come across situations where there are constraints in availability of information. In many cases the employer himself is not very clear or willing to disclose the purpose of valuation. In such cases it may be necessary to ask the right questions to understand the requirement.

## 14.3. CONTENTS



## 14.3.1 COST APPROACH

Cost approach uses historical information. Its main advantage is that it uses hard data – easily verifiable. However, past history, as we all know is not a very reliable indicator of present or future value. So, in cases where market has shown distinct trends positive or negative – cost approach may not reflect market value.

### The Cost Approach

This approach assumes that acquisition cost or historical cost is a reliable indicator of the asset's present market value. Adequate compensation is provided for changes in value based on Price index for nearest equivalent genre of machinery to arrive at replacement value. Allowances are made to account for losses in value due to physical depreciation, functional obsolescence, and economic obsolescence and other factors. Value after these allowances is the estimated present market value.

The basic advantage of this method is the reliability of data used in the estimates. Acquisition cost can be taken based on invoice copies and reasonable expenses incurred that add value to the asset as installed. Reserve Bank of India regularly publishes WPI indices for a wide variety of commodities, products and plant & machinery. The latest series is based on year 2004 (100). Indices are published every month and on yearly basis. (refer website: http://www.eaindustry.nic.in).

Valuer needs expertise to study the Plant & Machinery, understand the value drivers in the asset and choose the right Index (or Indices). Where multiple number of assets are involved it may be necessary to classify the assets into different classes – machine tools, furnaces, cranes, electrical machinery etc.

Index values on date of acquisition & date of valuation (month or year) estimated replacement cost can be calculated. If there are no major technology changes or market developments that influence value in the intervening time this method gives fairly reliable results. The reliability decreases as the time elapsed between acquisition and date of valuation increases.

It is difficult to specify age upto which cost approach can be reasonably employed. In general, for most plant & machinery where there have been no significant technological or techno-economic factors influencing value, it is fair to use this method for assets less than 5 years old.

One needs to be careful while using this method for longer periods since in most cases it is normal to see technological improvements or alternative methodology for same function.

After arriving at replacement value, one has to estimate allowances that need to be deducted for various factors like – functional deficiency or wear & tear, technological & industry practice changes that may render certain features obsolete, present condition of the asset etc. Here it is absolutely essential for the Valuer to apply due diligence. As far as possible factors & justification for allowances should be stated in the valuation report.

The asset-based approach should not be the sole appraisal approach used in assignments where the assets have been subject to modernisation and or refurbishment. These exercises can significantly alter the character of the asset and it is not fair to arrive at replacement value based on indices.

It is usual practice in any industry that whenever a major overhaul takes place a lot of technological refit also takes place. The old asset and the new asset are no more comparable on one to one basis. This is especially true of all chemical process plants. In general cost approach is not advisable for chemical process plants more than 10 years and should be avoided.

**Explanation: Cost approach can be used where**

P & M or equipment is under installation / commissioning and going concern assumption is valid. P & M or Equipment are relatively new and it is not fair to apply performance appraisal. It is difficult to get market data for equivalent machines – special types of machines, unique machines or process etc. Other circumstances justifying the use of cost approach

**14.3.2 INCOME APPROACH**

In this approach the net revenue or income generated by the asset is used to determine its value. While estimating revenue its present earnings ability or future earnings ability can be assessed and used as the basis.

As we studied earlier - Value of an asset is based on its enjoyment rights (income generation), residual life & residual value. So we need to estimate residual life & residual value. We have already assessed income.

By using Income approach, we can estimate Market Value by mimicking the expectation of buyers in the market.

**Income Approach to Valuation (ASA)**

The income approach is a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods through which derived / anticipated benefits are converted into value.

Value can be arrived at either income capitalization or discounted future benefits (DCF) methods. Are acceptable in capitalization of benefits methods, a representative benefit level is divided or multiplied by an appropriate capitalization factor to convert the benefit to value. In discounted future benefits methods, benefits are estimated for each of several future periods. These benefits are converted to value by applying an appropriate discountrate and using present value procedures.

**Derived Benefits**

It is necessary to arrive at net cash flow in monetary terms after considering all such income & expenses that are normally attributable to a going concern and other such contingent liabilities as anticipated.

**Anticipated benefits**

Anticipated benefits should be estimated by considering such items as the nature, capital structure and historical performance of the related business entity, the expected future outlook for the business entity and relevant industries, and relevant economic factors.

**Conversion of Anticipated Benefits**

Anticipated benefits are converted to value by using procedures that consider the expected growth and timing of the benefits, the risk profile of the benefits stream and the time value of money.

The conversion of anticipated benefits to value normally requires the determination of a capitalization factor or discount rate. In that determination, the valuer should consider such factors as the level of interest rates, the rates of return expected by investor son alternative investments and the specific risk characteristics of the anticipated benefits.

In discounted future benefits methods, expected growth is considered in estimating the future stream of benefits. In capitalization of benefits methods, expected growth is in corporate in the capitalization factor.

The capitalization factors or discount rates should be consistent with the types of anticipated benefits used. For example, pre-tax factors or discount rates should used with pre-tax benefits, common equity factors or discount rates should be used with common equity benefits and net cash flow factors or discount rates should be used with net cash flow benefits.

**Market Approach**

In this method we estimate the value of the asset based on quoted market price for a similar asset. We need to identify a similar asset that is comparable to the asset being valued. We need to obtain the price of an equivalent or nearly equivalent asset from the market. This information is used to estimate the price of the asset that needs to be valued.

For standard products (assets) freely traded in the market, and where used or pre-owned assets are freely sold – market approach is the most suitable.

**Market Approach to Valuation (ASA)**

**The Market Approach**

The market approach is a general way of determining a value indication of an asset by using one or more methods that compare the subject to similar assets that have been sold.

**Reasonable Basis for Comparison**

The asset used for comparison must serve as a reasonable basis for comparison to the subject. Factors to be considered in judging whether a reasonable basis for comparison exists include:

A sufficient similarity of qualitative and quantitative investment characteristics

The amount and verifiability of data known about the similar investment

Whether or not the price of the similar investment was observed in an arm's-length transaction or in a forced or distressed sale

**Selection of Valuation Ratios**

Comparisons are normally made through the use of valuation ratios. The computation and use of such ratios should provide meaningful insight about the value of the subject, considering all relevant factors. Accordingly, care should be exercised with respect to issues such as:

The selection of the underlying data used to compute the valuation ratios

The selection of the time periods and/or the averaging methods used for the underlying data

The computation of the valuation ratios

The timing of the price data used in the valuation ratios (in relationship to the effective date of the appraisal)

How the valuation ratios were selected and applied to the subject's underlying data

In general, comparisons should be made by using comparable definitions of the components of the valuation ratios. However, where appropriate, valuation ratios based on components that are reasonably representative of ongoing results may be used.

**Rules of Thumb**

Rules of thumb may provide insight in to the value of P & M or assets. However, value indications derived from the use of rules of thumb should not be given substantial weight unless they are supported by other valuation methods and it can be established that knowledgeable buyers and sellers place substantial reliance on them.

Hence we see that:

Market approach comes closest to determining market value.

Income approach is the second best since it mimics buyer behaviour and

Cost approach is based on historical data and suffers from assumptions.

In general cost approach is the last option and is to be used only in case the other 2 approaches are not feasible. IVS recommends that Valuer should discuss his choice of approach and state why he has chosen the selected approach.

In actual practice, it is common to see a combination of approaches and it is also possible to arrive at value based on more than one approach and reconcile the value based on assumptions.

The letter of assignment in many cases is vague and does not spell out any special need of the employer. The Valuer becomes aware of the intent only later.

As practicing valuer, it is necessary to find out the real need for the valuation report. The valuation report should specify the purpose & assumptions made.

Choice of approach also depends on circumstances of the case. It is a necessary requirement that choice of approach is made after due diligence, is rational and appropriate to the purpose.

Each approach is discussed separately.

**Example 1**

A company in good standing avails of term loan or Rs.100 crores to implement a project. During the process of implementation, the bank monitors the progress. After the project has achieved commissioning Bank calls for valuation. In this case what is the correct approach?

In this case assuming Company (borrower) has purchased all equipment as new, it is fair to assume they are under manufacturer’s warranty. Sufficient time has not lapsed to allow for encumbrance factors. The enterprise is operating as per schedule and assets are put to commercial production.

In this case Cost approach based on acquisition cost may be right approach.

**Example 2**

In the above case let us say that the project is way behind schedule (say 1 year behind) and there is a cost overrun. A bank is calling for valuation of assets after delayed commissioning. What should be approach?

In this case we need to make more assumptions based on data gathered. Is cost approach still valid?

That will depend on the circumstances of the case.

**Example 3**

Let us take a coal fired 100 MW power plant commissioned 3 years earlier. It is producing power with a PLF of 70%. Bank has called for valuation of this plant.

What is the approach to be adopted?

In this case the plant is still reasonable new, but is operation has stabilised (assumption). We can use cost approach and arrive at market value.

Can we use market approach? How have the prices of power plants behaved in the last 3 years?

Power plants have a single output – electricity. Power generated can be sold in the market or can be internally consumed if it is captive. However, its production output value can be determined without any difficulty. A power plant is designed as a 24x7 continuous output plant.

Is it fair to say that value of a Power Plant is determined by the cash flow & income generated by the plant? If yes then, income approach is a better option.

**Example 4**

A Diesel Generator of capacity 250 KVA of reputed make is to disposed of by Bank.

Bank requests for valuation. What is the approach?

In this case DG sets are standard products with a ready used equipment market. It is possible to ascertain prices from classifieds or web based information or from agents operating in used machinery. Hence, market approach can be adopted to do the valuation.

**14.4 REVISION POINTS**

1. Rules of thumb
2. Market Approach to Valuation (ASA)

**14.5 INTEXT QUESTIONS**

1. What are the 3 main approaches to Valuation?
2. What is cost approach? Name some advantages & disadvantages of cost approach.
3. What is market approach? Name some advantages & disadvantages of cost approach
4. A 20 year old refurbished 4 color printing press (Heidelburg) for disposal

### 14.6 SUMMARY

Valuation practice uses 3 basic approaches – cost approach, income approach & market approach. Each approach requires assumptions and offers advantages and constraints. IVS recommends that Valuer should discuss his choice of approach and state why he has chosen the selected approach.

### 14.7 TERMINAL EXERCISE

1. What is marketing value approach?
2. Explain about Conversion of anticipated benefits.

### 14.8 SUPPLEMENTARY MATERIALS

1. http://www.eaindustry.nic.in

### 14.9 ASSIGNMENTS

Discuss the best method of valuation of:

1. A newly built process plant being transferred to parent company on commissioning
2. An industrial shed in a private industrial estate – available for lease
3. A 10 year old Vertical machining center (Makino) for disposal
4. A 20 year old refurbished 4 color printing press (Heidelburg) for disposal

### 14.10 REFERENCE BOOKS


1. D.N. Banerjee, Parks " Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc. Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.
5. D.N. Banerjee, Parks Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,


### 14.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Marketing value approach
2. Conversion of anticipated benefits.

### 14.12 KEY WORDS

Rules of thumb, Market Approach to Valuation, Conversion of anticipated benefits

LESSON -15

# VALUATION REPORT

## 15.1 INTRODUCTION

A valuation exercise is complete only when the estimated value has been arrived at and set out in a document that offers the client clarity and serves the purpose for which the report was called for. In this chapter we study the requirements of a good valuation exercise &report.

## 15.2 OBJECTIVES

- To familiarise the student on the contents of a valuation report and how to prepare a good valuation report.

## 15.3 CONTENTS

15.3.1 Basis of Valuation Report

15.3.2 Description / Identification of the asset to be Valued

15.3.3 Selection and Weighting of Methods

15.3.4 Methods of Application - Approaches

15.3.5 Additional Important Factors in Arriving at Value

15.3.6 The Application of Discounts and Premiums

### 15.3.1 BASIS OF VALUATION REPORT

The conclusion of value reached by the valuer shall be based upon the applicable standard of value, the purpose and intended use of the valuation, and all relevant information available as of the valuation date in carrying out the type of engagement for the assignment.

The conclusion of value reached by the valuer will be based on value indications resulting from one or more methods performed under one or more appraisal approaches.

### 15.3.2 DESCRIPTION / IDENTIFICATION OF THE ASSET TO BE VALUED

A valuation report should describe the asset value sufficiently to identify it uniquely. It should be possible for the intended user to locate the asset.

In some cases, clarification may be needed to distinguish between an asset and an interest in or right of use of that asset.

Explanation: In the case of plant & machinery, description of the asset should be made in such a manner as to enable identification of the asset.

Conversely only such classes of plant & machinery that are possible to be clearly & unambiguously identified shall be valued.

For this purpose, it may be necessary to aggregate certain types of assets. Eg: LT cables, piping, steel structural supports & platforms, ducts etc.

If the valuation is of an asset that is utilised in conjunction with other assets, it will be necessary to clarify whether those assets are included in the valuation assignment.

### 15.3.3 SELECTION AND WEIGHTING OF METHODS

The selection of and reliance on appropriate methods and procedures depends on the judgment of the valuer and not on any prescribed formula. One or more approaches may not be relevant to a particular situation, and more than one method under an approach may be relevant.

### 15.3.4 METHODS OF APPLICATION - APPROACHES

Each of these principal valuation approaches includes different detailed methods of application. Various methods that are commonly used for different asset classes are discussed.

The valuer must use informed judgment when determining the relative weight to be accorded to indications of value reached on the basis of various methods, or whether an indication of value from a single method should be conclusive. The valuer's judgment may be presented either in general terms or in terms of mathematical weighting of the indicated values reflected in the conclusion. In any case, the valuer should provide the rationale for the selection or weighting of the method or methods relied on in reaching the conclusion.

In assessing the relative importance of indications of value determined under each method, or whether an indication of value from a single method should dominate, the valuer should consider factors such as:

The applicable standard of value

The purpose and intended use of the valuation

Status of the asset – going concern / shut down well stored / leased / impaired.

The quality and reliability of data underlying the indication of value

Such other factors those, in the opinion of the valuer, are appropriate for consideration

### 15.3.5. ADDITIONAL IMPORTANT FACTORS IN ARRIVING AT VALUE

Valuer should separately consider each of the following factors while reaching a final conclusion of value:

1. Marketability or lack thereof, considering the nature of the asset
2. The effect of relevant contractual and/or other legal restrictions
3. The condition of the market(s) in which the appraised interest might trade
4. The ability of an owner of the appraised interest to control the operation, sale, or liquidation of the relevant business
5. Such other factors that, in the opinion of the valuer, are appropriate for consideration

#### 15.3.5.1 The Concepts of Discounts and Premiums

A discount has no meaning until the conceptual basis underlying the base value to which it is applied is defined. A premium has no meaning until the conceptual basis underlying the base value to which it is applied is defined.

A discount or premium for purposes of valuation is different from commercial discount or commissions as applicable to an asset.

In valuation practice a discount is an encumbrance or factor that negatively influences value. Premium is a feature of the asset that positively influences value. These negative or positive influences may be temporary or based on certain events or condition.

A discount or premium quantifies an adjustment to account for differences in characteristics affecting the value of the subject interest relative to the base value to which it is compared.

### 15.3.6. THE APPLICATION OF DISCOUNTS AND PREMIUMS

The purpose, applicable standard of value, or other circumstances of an appraisal may indicate the need to account for differences between the base value and the value of the subject interest.

Where discount or premium is applied valuer is expected to state the reasoning for applying the discount or premium. The base value to which the discount or premium is applied must be specified and defined.

#### 15.3.6.1 Valuation Inputs

Valuation inputs refer to the data and other information that are used in any of the valuation approaches described in this standard. These inputs may be actual or assumed.

Examples of actual inputs include:

1. Prices achieved for identical or similar assets,
2. Actual cash flows generated by the asset,
3. The actual cost of identical or similar assets.

Examples of assumed inputs include:

1. Estimated or projected cash flows,
2. The estimated cost of a hypothetical asset,
3. Market participants' perceived attitude to risk.

Greater reliance will normally be placed on actual inputs; however, where these are less relevant, for e.g. where the evidence of actual transactions is dated, historic cash flows are not indicative of future cash flows or the actual cost information is historic, assumed inputs will be more relevant.

A valuation will normally be more certain where multiple inputs are available. Where only limited inputs are available particular caution is required in investigating and verifying the data.

Where the input involves evidence of a transaction, care should be taken to verify whether the terms of that transaction were in accord with those of the required basis of value.

The nature and source of the valuation inputs should reflect the basis of value, which in turn depends on the valuation purpose. For example, various approaches and methods may be used to indicate market value providing they use market derived data. The market approach will by definition use market derived inputs. To indicate market value the income approach should be applied using inputs and assumptions that would be adopted by market participants. To indicate market value using the cost approach, the cost of an asset of equal utility and the appropriate depreciation should be determined by analysis of market-based costs and depreciation. The data available and the circumstances relating to the market for the asset being valued will determine which valuation method or methods are most relevant and appropriate. If based on appropriately analysed market derived data each approach or method used should provide an indication of market value.

Valuation approaches and methods are generally common to many types of valuation. However, valuation of different types of assets involves different sources of data that must reflect the market in which the assets are to be valued. For example, the underlying investment of real estate owned by a company will be valued in the context of the relevant real estate market in which the real estate trades, whereas the shares of the company itself will be valued in the context of the market in which the shares trade.

### 15.4 REVISION POINTS

1. Valuation Inputs
2. Concepts of discounts and premiums
3. Weighting of methods

### 15.5 INTEXT QUESTIONS

1. What are the basic contents of a good valuation report?
2. What do you understand by discounts & premiums to basic value?

### 15.6 SUMMARY

A good valuation exercise & report shall document the following:

Basis & purpose of value

Intended use of the valuation report

Description of the asset

Approach &Methodology adopted and reasoning for adopting the same

Discussion on additional factors influencing value as considered

Discounts or encumbrances considered and their impact on value

Premiums considered and their impact on value

Any other factor(s) considered as relevant for the purpose as intended in the opinion of the valuer

### 15.7 TERMINAL EXERCISE

1. What is the Concepts of discounts and premiums?
2. What is the Basis of Valuation Report?

### 15.8 SUPPLEMENTARY MATERIALS

1. http://www.valuadder.com/product/sample-business-valuation-report.pdf

### 15.9 ASSIGNMENTS

1. Discuss the appropriate valuation methodology & contents of a Valuation Exercise
2. IT Software Technology park – 3 years old
3. Engineering Industry – with all standard machine tools – 5 years old

### 15.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

### 15.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Valuation Report
2. Concepts of discounts and premiums

### 15.12 KEY WORDS

Valuation Inputs

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LESSON -16

# SCOPE OF VALUATION WORK &REPORTS

**(GENERAL PRINCIPLES IVS)**

## 16.1 INTRODUCTION

In this chapter we discuss the contents of a good valuation exercise. The requirements for making an offer & acceptance for valuation exercise.

## 16.2 OBJECTIVES

- To familiarise the student on how to preparations & prerequisites for starting a valuation exercise.

  Valuation or valuation report is a document based on which the intended user takes certain informed decisions. Hence it is very important that the user is properly appraised or informed in a way that helps in the process of decision making.

  There are many different types and levels of valuation advice that may be provided. General Principles are designed to apply to a wide spectrum of valuation assignments including a valuation review where the reviewer may not be required to provide their own opinion of value.

  All valuation advice and the work undertaken in its preparation must be appropriate for the intended purpose.

  It is also important that the intended recipient of the valuation advice understands what is to be provided and any limitations on its use before it is finalised and reported.

## 16.3 CONTENTS

### 16.3.1 REQUIREMENTS OF ACCEPTANCE OF VALUATION ASSIGNMENT: TO BE CONFIRMED IN WRITING

a. Identification of the user

b. Any other user who is also likely to use the valuation report

c. Purpose of valuation

d. Identification of the asset to be valued

e. Identification and status of the valuer

f. Whether the valuer has any material connection or involvement with the subject of the valuation assignment or the party commissioning the assignment;

g. That the valuer is competent to undertake the valuation assignment.

**a. Identification of User**

It is necessary to establish & state clearly as to who is the intended user of the valuation report. It is very common in valuation practice for an individual or firm to approach the valuer for purposes of valuation. However, the individual or firm may not be the user.

It is necessary & required that Valuer ascertains who is the intended user, informs the individual or firm that the user will be specified and identified as the user in the report.

**b. Any other user who is also likely to use the Valuation Report**

In case multiple users are expected to use the report the same shall be ascertained. Any restriction on those who may rely upon the valuation assignment shall be agreed and recorded.

**c. Purpose of the Valuation**

The purpose for which the valuation assignment is being prepared shall be clearly stated, eg the valuation is required for loan security, for insurance, for sale of asset, for purchase of asset, to support transfer of asset between interested parties, to assess capital gains, or any other. The purpose of a valuation will determine the basis of value.

It is important that valuation advice is not used out of context or for purposes for which it is not intended.

**d. Identification of the Asset to be Valued**

Scope of work shall clearly establish the description quantity, location of the assets to be valued.

This is very important. In many cases the individual or firm may vaguely describe the asset while negotiating the contract. Only after acceptance, the valuer realises that the quantity, type and locations are more than what was generally understood at the beginning. Since a valuation report is meant for a specified user for a specified purpose – the valuation exercise must necessarily meet the requirement.

**Example**

A borrower approaches a valuer for valuation of assets for secured lending. Name of bank is specified. After taking up the exercise the valuer realises that the firm has multiple units and has hypothecated many other assets as primary / collateral security to the bank.

Or

In some cases, clarification may be needed to distinguish between an asset and an interest in or right of use of that asset.

Only such classes of plant & machinery that are possible to be clearly & unambiguously identified shall be valued. For this purpose, it may be necessary to aggregate certain types of assets. E.g. LT cables, piping, steel structural supports & platforms, ducts etc.

If the valuation is of an asset that is utilised in conjunction with other assets, it will be necessary to clarify whether those assets are included in the valuation assignment.

**e. Basis of Value**

The valuation basis must be appropriate for the purpose. The source of the definition of any basis of value used shall be cited or the basis explained.

Unless otherwise stated & agreed all valuation shall be expressed on local currency.

**f. Valuation Date**

The valuation date may be different from the date on which the valuation report is to be issued or the date on which investigations are to be undertaken or completed. Where appropriate these dates should be clearly distinguished.

**g. Extent of Investigation**

Any limitations or restrictions on the inspection, inquiry and analysis for the purpose of the valuation assignment shall be set out in the scope of work.

If relevant information is not available because the conditions of the assignment restrict the investigation, if the assignment is accepted, then these restrictions and any necessary assumptions or special assumptions shall be recorded in the scope of work.

**h. Nature and Source of the Information to be relied upon**

The nature and source of any relevant information that is to be relied upon and the extent of any verification to be undertaken during the valuation process shall be agreed and recorded.

**i. Assumptions and Special Assumptions**

All assumptions and any special assumptions that are to be made in the conduct and reporting of the valuation assignment shall be recorded.

Assumptions are matters that are reasonable to accept as fact in the context of the valuation assignment without specific investigation or verification. They are matters that, once stated, are to be accepted in understanding the valuation or other advice provided.A special assumption is an assumption that either assumes facts that differ from the actual facts existing at the valuation date or that would not be made by a typical market participant in a transaction on the valuation date.

**j. Restrictions on Use, Distribution or Publication**

Where it is necessary or desirable to restrict the use of the valuation advice or those relying upon it, this shall be recorded. If matters are identified that are likely to cause the valuation advice to be qualified, this shall also be recorded.

**k. Confirmation that the Valuation will be undertaken in Accordance with the IVS**

While confirmation of conformity with IVS is required, there may be occasions where the purpose of the valuation assignment requires a departure from IVS. Any such departure shall be identified together with justification for that departure. A departure would not be justified if it results in a valuation that is misleading.

**l. Description of Report**

Confirmation of the format of the report to be provided shall be agreed and recorded.

### 16.4 REVISION POINTS

1. Valuation report
2. Identification of user
3. Purpose of user

### 16.5 INTEXT QUESTIONS

1. What are important requirements that are to be decided & agreed between the valuer & the employer before taking up valuation work?

### 16.6 SUMMARY

In this chapter we have studied the requirements or basis of contract for taking up valuation work. These are:

a. Identification of the user

b. Any other user who is also likely to use the valuation report

c. Purpose of valuation

d. Identification of the asset to be valued

e. Identification and status of the valuer

f. whether the valuer has any material connection or involvement with the subject of the valuation assignment or the party commissioning the assignment;

g. that the valuer is competent to undertake the valuation assignment.

### 16.7 TERMINAL EXERCISE

1. What are the assumptions are made in valuations

### 16.8 SUPPLEMENTARY MATERIALS

1. www.charteredaccountants.com.au

### 16.9 ASSIGNMENTS

1. Discuss possible scenarios when there is no clarity one of the requirements – by sequence.

### 16.10 REFERENCE BOOKS


1. D.N. Banerjee, Parks "Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc. Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.1


### 16.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Purpose of valuation
2. Assumptions and special assumptions

### 16.12 KEY WORDS

IVS

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LESSON -17

# METHODOLOGY - STUDY, VISITS AND INVESTIGATIONS (IVS)

## 17.1 INTRODUCTION

Valuation practice requires physical verification of the asset and collecting & analysing relevant market data. In this chapter we look at the information & data requirements for preparation of a good valuation report.

## 17.2 OBJECTIVES

- To help the student understand the nature & scope of study of the asset to be valued and the market in which the asset operates.

After all required information as discussed earlier is collected, Valuer is expected to make a personal site visit to physically verify the asset and study first hand its characteristics. Valuer is expected to familiarise himself with the market in which the asset operates.

Investigations made during the course of a valuation assignment must be adequate having regard to the purpose for which the valuation is required and the basis of value to be reported.

Sufficient evidence shall be assembled by means such as inspection, inquiry, computation and analysis to ensure that the valuation is properly supported. When determining the extent of evidence necessary, professional judgement is required to ensure the information to be obtained is adequate having regard to the purpose of the valuation.

As a matter of practical expediency, it is normal for limits to be agreed on the extent of the valuer's investigations. Any such limits shall be recorded in the scope of work.

When a valuation assignment involves reliance on information supplied by a party other than the valuer, consideration shall be given as to the credibility and reliability of that information and whether it may be relied upon without adversely affecting the credibility of the valuation opinion.

In cases where the valuer has doubts as to the credibility or reliability of information, such information shall either not be used or the valuer's concerns made known to the commissioning party.

In considering the credibility and reliability of information provided account shall be taken of matters such as:

a. purpose of the valuation,

b. materiality of the information to the valuation conclusion,

c. expertise of the source in relation to the subject matter,

d. expertise of the valuer in relation to the subject matter,

e. whether the source is independent of either the subject or the recipient of the valuation,

f. extent to which the information is in the public domain and

g. limits on the duty to investigate included in the scope of work

## 17.3 CONTENTS

### 17.3.1 VALUATION APPROACHES

Consideration shall be given as to the relevant and appropriate valuation approaches. The most appropriate valuation approach or method will depend upon consideration of the following:

1. The adopted basis of value, determined by the purpose of the valuation,
2. The availability of valuation inputs and data,
3. The approaches or methods used by participants in the relevant market.

More than one valuation approach or method may be used to arrive at an indication of value, especially where there are insufficient factual or observable inputs for a single method to produce a reliable conclusion. Where more than one approach and method is used, the resulting indications of value should be analysed and reconciled to reach a valuation conclusion.

## 17.4 REVISION POINTS

1. Valuation approach

## 17.5 INTEXT QUESTIONS

1. What are the different methodology aspects to be adopted for valuation of an asset?

## 17.6 SUMMARY

1. In this chapter we discuss how to go about conducting site visit and the nature of information to be collected

## 17.7 TERMINAL EXERCISE

1. What is Study, visits and Investigations (IVS)?

## 17.8 SUPPLEMENTARY MATERIALS

1. www.prres.net/papers/nasir_education_on_plant_and_machinery.pdf

## 17.9 ASSIGNMENTS

Discuss the aspects / features to be verified & studied while assessing:

1. Machine tool
2. An engineering factory
3. A commercial complex

## 17.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

## 17.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Valuation Approaches

## 17.12 KEY WORDS

Assets, Valuation approach

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# VALUATION RECORD& REPORT

## 18.1 INTRODUCTION

It is necessary to keep a record of the work done during valuation process. Case diary is acceptable evidence in a court in case it becomes necessary.

Valuation report is document that is fair representation of the conclusion of the valuation exercise. In addition to the value conclusion, it must clearly set all relevant information, assumptions and agreements considered in the process of valuation.

## 18.2 OBJECTIVES

- In this chapter we look the presentation of a report – its contents & the need to keep records.

## 18.3 CONTENTS

18.3.1 Valuation Records

18.3.2 Valuation Report

18.3.3 Report Contents

### 18.3.1 VALUATION RECORDS

A record shall be kept of the work done during the valuation process for a reasonable period having regard to any relevant legal or regulatory requirements.

Subject to any such requirements this record shall include the key inputs, all calculations, investigations and analyses relevant to the final conclusion, and a copy of any draft or final report provided to the client.

All photographs and evidences in support of the conclusions arrived at shall be preserved for a reasonable time.

### 18.3.2 VALUATION REPORT

The final step in the valuation process is communicating the results of the assignment to the commissioning party and any other intended users. It is essential that the report communicates the information necessary for proper understanding of the valuation or valuation review. A report shall not be ambiguous or misleading and shall provide the intended reader with a clear understanding of the valuation or other advice provided.

To provide comparability, relevance and credibility, the report shall set out a clear and accurate description of the scope of the assignment, its purpose and intended use and disclosure of any assumptions, special assumptions, material uncertainty or limiting conditions that directly affect the valuation.

### 18.3.3 REPORT CONTENTS

The purpose of the valuation, the complexity of the asset being valued and the users' requirements will determine the level of detail appropriate to the valuation report.

In general Valuation report should state

a. Identification and status of the valuer
b. Identification of the client and any other intended users
c. Purpose of the valuation

d. Identification of the asset or liability to be valued
e. Basis of value
f. Valuation date
g. Extent of investigation
h. Nature and source of the information relied upon
i. Assumptions and special assumptions
j. Restrictions on use, distribution or publication
k. Confirmation that the assignment has been undertaken in accordance with the IVS
l. Valuation approach and reasoning
m. Amount of the valuation or valuations
n. Date of the valuation report

**18.4 REVISION POINTS**

1. Valuation report
2. Valuation record

**18.5 INTEXT QUESTIONS**

1. What are valuation records and what is its importance?
2. Name some of the basic contents of a valuation report?

**18.6 SUMMARY**

Valuation report is document that is fair representation of the conclusion of the valuation exercise. In addition to the value conclusion, it must clearly set all relevant information, assumptions and agreements considered in the process of valuation.

**18.7 TERMINAL EXERCISE**

1. What is the importance of valuation report

**18.8 SUPPLEMENTARY MATERIALS**

1. https://www.sa.gov.au/__.../SE1023-Supplementary-Valuation-Report-User-Guide

**18.9 ASSIGNMENTS**

1. Write about the details of valuation report and its important

**18.10 REFERENCE BOOKS**


1. D.N. Banerjee, Parks "Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc. Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.


**18.11 LEARNING ACTIVITIES**

Group discussion during PCP days

1. Valuation report
2. Valuation record

**8.12 KEY WORDS**

Valuation report, Valuation record

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LESSON -19

# PLANT & MACHINERY: DEFINITIONS

## 19.1 INTRODUCTION

So far we looked at various aspects of valuation that are general and exclusive to Plant & Machinery. We now look at what is Plant & Machinery, its features & characteristics. This chapter is an introduction to Plant & Machinery.

## 19.2 OBJECTIVES

- To familiarise students with the definition, features & characteristics of Plant & Machinery.

Most of us have general idea as to what is plant & machinery. However, there are situations when doubt arise as to whether certain specific equipment or class of assets constitute Plant & Machinery. In these circumstances, clear definitions and interpretation of the definitions help us to determine the nature of the asset.

IVS defines P&M as Plant and equipment collectively constitute a class of tangible assets that are: held by an entity for use in the production or supply of goods or services, for rental by others or for administrative purposes and expected to be used over a period of time. Note emphasis.

## 19.3 CONTENTS

### 19.3.1 EXPLANATION - MACHINERY

Machinery means an apparatus used for a specific process in connection with the operation of an entity. Machinery can be uniquely identified as a piece of equipment which can operate in a stand-alone fashion and has specific measurable input(s) and output(s).

Example: lathe, milling machine, transformer, DG set etc.

#### 19.3.1.1 What is Plant?

Plant means assets that are inextricably combined with others and that may include specialised structures, machinery and equipment.

#### 19.3.1.2 Explanation

A plant typically has many equipment and, inputs are sequentially processed in batch or continuous mode until a final product is produced. There may be stage inputs & outputs also in certain cases.

A typical feature of a plant is all or none criteria: That is, for the manufacturing process to be productive, all the equipment have to work in unison. Any breakdown in any one equipment or component results in stoppage of production. There is usually no measurable, storable, usable in-process inventory. So all such equipment taken together are called plant.

Examples of plant: Steam boiler, Chemical process plants like resin plant, refinery, solvent extraction, distillery etc.

**19.3.1.3 What is Equipment?**

Equipment means any asset that are used to assist the operation of an enterprise or entity.

It is necessary to group items in such a manner as to represent a value added system. Industry & banks are investing in distinct assets that are capable of production and have a residual value if & when sold. So assets need to be grouped in such a manner as to be identifiable, acquirable & saleable.

Value of an item of plant and equipment will differ depending on whether it is valued in combination with other assets within an operational unit or whether it is valued as an individual "item".

P & M Valuer needs to list assets in this way. Assessment & value basis for each of these classes can be different. Thus there is a need to classify assets into Plant, Machinery & equipment or utilities.

Factors influencing "value" of individual P&M to determine the methodology to be adopted for valuation for each class & within each class, type of P&M.

**Machinery: P & M needs to assess**

a. What is the nature of machinery? production / utility / service / peripheral or auxiliary
b. What is the technology relevance of this machinery?
c. What are other applications for this type of machinery?
d. What is the condition of the machinery – present state versus as purchased?
e. What is the residual market value for this type of machinery?

**Let us take a few examples to illustrate**

Example: Let us say an engg. unit has multiple machinery comprising Power Presses, injection molding machines, dies & tools, 2 nos SPM s (special purpose machines), EOT crane, fork-lift, DG set, air compressors, steam boiler, fabricated MS chimney, electrical control panels, cables, light fittings, quality checking instruments, water line & compressed air line piping. Let us say it has installed ERP software at a cost of Rs.4 Million.

We need to look at each type of machine to decide on the methodology for valuation.

Power Presses & injection molding machines, for example usually are age proof & have good residual value.

Dies & tools are product specific and value is scrap if model is discontinued.

EOT crane has a value in "going concern" basis, and becomes scrap if it is to be removed / relocated.

DG sets & Air compressors have wide applications in all types in industries & hence have a ready resale market.

Boiler resale value depends on type – package / FBC and capacity - pressure& TPH.

Chimney has value in a going concern but is scrap if it is dismantled.

Control panel value gets reduced to components if it has to be relocated.

All piping & cables reduce to scrap if to requires to be relocated.

Insulation has a high installed value but zero value if dismantled.

### 19.4 REVISION POINTS

1. Machinery
2. Equipment
3. Plant

### 19.5 INTEXT QUESTIONS

1. What is plant? How is it different from machinery?
2. Why is it necessary to classify Plant & machinery into different groups?
3. Name some classifications of Machinery

### 19.6 SUMMARY

In this chapter we studied what constitutes Plant & Machinery. We have studied the features of P & M. We looked different types or classes of P&M, and how their features influence market value.

### 19.7 TERMINAL EXERCISE

1. What is equipment
2. What is machinery

### 19.8 SUPPLEMENTARY MATERIALS

1. https://www.insolvencydirect.bis.gov.uk/technicalmanual/Ch25-36/.../part_4.htm

### 19.9 ASSIGNMENTS

1. Discuss nature of P &M in an Engineering factory.

### 19.10 REFERENCE BOOKS

1. William Britton, Keith Davis and Tony Johnson, Modern Methods of Valuation of Land, Houses and Buildings, Estates Gazette Ltd, 8th Revised edition, April 1989.
2. Ashok Nain, Valuation Principles and Procedures, Dew Drops Education Private Limited, Kolkata, 2010.
3. KiritBudhbhatti, Valuation of Plant & Machinery - Theory & Practice, KiritBudhbhatti Pub, 2nd edition, 2002.

### 19.11 LEARNING ACTIVITIES

Group discussion during PCP days

1. Plant
2. Machinery

### 19.12 KEY WORDS

Plant, Machinery

# VALUATION PROFESSION: ETHICS & OBLIGATIONS

## 20.1INTRODUCTION

Every profession cast responsibility on the professional to conform to certain established norms & propriety for collective good.

These are Ethics & Obligations. In this chapter we study the Ethics & obligations of a valuer in valuation practice.

## 20.2 OBJECTIVES

- To make the student aware of ethics & obligations of a Valuer in valuation practice. Valuers have a duty and responsibility, in each& every case to ensure that:
  a. an appropriate methodology is developed to address the purpose of valuation and
  b. to describe the approach & assumptions in arriving at Value or Estimated Cost.

A valuation report is not about “somehow” arriving at an estimated value.

There are several reasons & purposes for which a valuation report may be required. There may be legal implications, or valuation report may be used by client or his creditor / debtor for taking attendant decisions. Each purpose has a legitimate place as the end point of the valuation assignment. It is the valuer's obligation & duty to ascertain the purpose of the Valuation assignment that he/she is undertaking.

**For example, if the Valuer is performing a Valuation**

1. For Secured lending, the standard / type of value to be arrived at its Market Value (value in exchange).
2. For Secured Lending, Auction sale value under shut down conditions – when going concern assumption is not valid. This value may be related to market value but different from market value.
3. For purposes of calculating capital gains, the valuation method to be adopted is as prescribed under Income Tax law.
4. For insurance purpose – estimation of replacement cost of an asset is to be arrived at.
5. Value of a property meant for lease only and business model based on lease revenue. Valuation would not be properly discharged by reporting value based on depreciated new value based on cost approach / replacement cost.

Ultimately, the selection of the appropriate standard / type of value or estimated cost is the valuer's sole responsibility. It is his/her obligation fully to explain and describe what is meant by the particular value or cost estimate which he/she has developed, in order to eliminate misunderstanding and to prevent unwitting or deliberate misapplication.

**Examples**

Importance of Purpose declaration:

1. A client approaches Valuer for getting a valuation of an asset. He claims that it is for purposes of helping to sell the asset in the market. Valuer prepares the report and specifies estimated market value only. Let us say, this report is submitted to a Creditor (Bank) for purposes of secured lending. Bank takes decision based on this report.

Valuation assumptions for purposes of sale of asset are different from valuation for purposes of secured lending. What value is appropriate for being of assistance to “sell the asset” may not be appropriate value for “secured lending” by bank.

If the report does not specify the purpose & assumptions based on which the valuation report was made, the Valuer has failed in his duty & obligation to the Profession.

**20.3 CONTENTS**

20.3.1 Obligations of a Valuer (ASA)

20.3.2. Valuer’s Obligation to Avoid Giving a False Conclusion and Opinions

20.3.3. Valuer’s Obligation to Attain Competency and to Practice Ethically

20.3.4. Valuers Obligation to conform to requirements of Profession as a Member of Society of Valuers like Institution of Valuers

20.3.5. Valuers’ Responsibility to Third Parties

20.3.6. Valuer’s Obligation to His / Her Client

20.3.7. Confidential Character of a valuation Engagement

20.3.8 Valuer’s Obligation to Give Competent Service

20.3.9. Valuer’s Obligation to Giving Testimony

20.3.10. Valuer’s Obligation to Document Valuation Testimony

20.3.11 Valuer’s Obligation Relative to Serving More than One Client in the Same Matter

20.3.12. Agreements and Contracts for valuation Services

20.3.13. Protection of Professional Reputation of Other valuers

20.3.14. Valuer’s Obligation to Society of Professionals

**20.3.1 OBLIGATIONS OF A VALUER (ASA)**

Valuer’s Obligation to Develop a Value Conclusion and Opinions of a required Degree of Accuracy for the valuation Assignment

It is the valuer's obligation to develop the appropriate and applicable credible conclusion and opinions with as high a degree of accuracy as the particular objectives of the valuation assignment necessitate.

**20.3.2. VALUER'S OBLIGATION TO AVOID GIVING A FALSE CONCLUSION AND OPINIONS**

The valuer has every obligation to avoid providing a false / inappropriate value conclusion:

The valuation & value reported may be false / inappropriate for one of two reasons:

a. they could be a grossly inaccurate estimate (over / under valued)
b. Even though numerically accurate, the choice of method is inappropriate for the type of assignment.

**Comment**

There are instances that may arise where the valuer performs research about an asset and others perform different research and reach a different conclusion about the value.

It is important to note that as long as the valuer has followed generally accepted valuation standards and procedures, and documents his/her work accordingly, he/she will be considered to be in compliance, if all else is equal.

**20.3.3. VALUER'S OBLIGATION TO ATTAIN COMPETENCY AND TO PRACTICE ETHICALLY**

In order to meet his/her obligations, the valuer must be competent in his/her field. This competency is attained by education, training, study, practice, and experience. The Valuer is expected to constantly be updated about the changes occurring in his domain of interest with respect to market realities, laws & regulations, reporting standards and client requirements.

He/she must also recognize, understand, and abide by those ethical principles

**20.3.4. VALUERS OBLIGATION TO CONFORM TO REQUIREMENTS OF PROFESSION AS A MEMBER OF SOCIETY OF VALUERS LIKE INSTITUTION OF VALUERS**

The members of the Society are engaged in a professional activity. A profession is based on an organized body of specific knowledge, not possessed by laypersons. It is of such a character that it requires education and training and considerable expenditure of time and effort to acquire it and to become adept in its application. Anvaluer's client relies on the valuer's professional knowledge, judgment and abilities to whatever extent may be necessary to accomplish the assignment.

**20.3.5. VALUERS' RESPONSIBILITY TO THIRD PARTIES**

The valuation report must clearly state all intended users, including any third parties, who shall be able to rely on the findings and conclusions in the valuation report.

### 20.3.6. VALUER'S OBLIGATION TO HIS / HER CLIENT

The valuer's primary obligation to his/her client is to reach complete, accurate, and credible conclusions and numerical results regardless of the client's wishes or instructions in this regard.

The relationship between client and valuer is not one of principal and agent.

However, the valuer's obligation to his/her client goes somewhat beyond this primary obligation. These secondary obligations are set forth in the following sections.

### 20.3.7. CONFIDENTIAL CHARACTER OF A VALUATION ENGAGEMENT

The fact that a valuer has been employed to make a valuation is a confidential matter. In some instances, the very fact of employment may be information that a client, whether private or a public agency, prefers for valid reasons to keep confidential.

Knowledge by outsiders of the fact of employment of a valuer may jeopardize a client's proposed enterprise or transaction.

**Comment:** Members of the Society, in following appropriate professional standards, are obligated to keep confidential all matters relating to the valuation assignment for a set period of time, unless ordered by a court of competent and appropriate jurisdiction or made available for peer review.

### 20.3.8 VALUER'S OBLIGATION TO GIVE COMPETENT SERVICE

It is not proper for a valuer to accept an assignment to make a valuation of asset of a type he is not qualified to appraise or in a field outside his Society membership classification, unless

a. he/she fully acquaints the client with the limitations of his/her qualifications or
b. he/she associates himself/herself with another valuer or valuers who possess the required qualifications.

**Comment:** An important part of providing competent service to a client is to fulfil the obligations associated with an assignment on a timely basis.

### 20.3.9. VALUER'S OBLIGATION TO GIVING TESTIMONY

When a valuer is engaged by one of the parties in a controversy, it is the valuer's obligation to present the data, analysis, and value without bias, regardless of the effect of such unbiased presentation on his/her client's case.

**Comment:** Frequently, a valuer may be called upon to provide rebuttal services in a litigation assignment. It is perfectly acceptable for the valuer to rebut the work product of another valuer, as long as it is done in a manner that is objective, honest, and supported.

It is not acceptable to comment about the valuer, only the valuation work / methodology / assumptions may be commented upon.

**20.3.10. VALUER'S OBLIGATION TO DOCUMENT VALUATION TESTIMONY**

When a valuer accepts an assignment to perform a valuation assignment, or to testify as to value of asset before a court of law, regulatory authority or such other judicial/ quasi-judicial forum, the valuer shall document and substantiate all conclusions reached regardless of whether a written or oral report is provided as part of the assignment.

**Comment:** Testimony is frequently required as part of a litigation or regulatory hearing. This is considered to be an oral report that may or may not be preceded by a written report. In certain legal proceeding, the valuer may be asked by the client's legal counsel to not write a report.

The adversarial system provides an adequate mechanism to allow for cross-examination of the valuer. Therefore, in those situations, the rules of the jurisdiction will determine whether or not the valuer must provide a written report. However, whether or not a written report is provided, the valuer must document his/her files with all of the necessary support to back up the conclusions reached. Although a report may not have to be prepared for these types of assignments, the valuer is required to follow all other standards regarding the development of his/her opinions and conclusions.

**20.3.11 VALUER'S OBLIGATION RELATIVE TO SERVING MORE THAN ONE CLIENT IN THE SAME MATTER**

When two or more potential clients seek a valuer's services with respect to the same asset or with respect to the same legal action, the valuer may not properly serve more than one, except with the consent of all parties.

**Comment:** The valuer should be careful not to allow services to be rendered that place the valuer in a situation where that service will assist one client at the expense of another client.

**20.3.12. AGREEMENTS AND CONTRACTS FOR VALUATION SERVICES**

It is good practice to have a written contract between the valuer and client, covering objectives and scope of work, time of delivery of report, and amount of fees.

In certain circumstances, it may be desirable to include in the valuation service contract a statement covering the objective character of valuation findings and a statement that the valuer cannot act as an advocate or negotiator.

**20.3.13. PROTECTION OF PROFESSIONAL REPUTATION OF OTHER VALUERS**

It is unethical for a valuer to injure, or attempt to injure, by false or malicious statements or by innuendo the professional reputation or prospects of any valuer.

**20.3.14. VALUER'S OBLIGATION TO SOCIETY OF PROFESSIONALS**

A member of the Society, having knowledge of an act by another member, which, in his/her opinion, is in violation of the ethical principles incorporated in the Principles of valuation Practice and Code of Ethics of the Society, has the obligation to report the matter in accordance with the procedure specified in the Constitution, Bylaws and Administrative Rules.

**20.4 REVISION POINTS**

1. Obligations of a Valuer

**20.5 INTEXT QUESTIONS**

1. Define obligations of a valuer.
2. Name at least 5 obligations of a Valuer.
3. What is the valuer's obligation to society of Professionals?

**20.6 SUMMARY**

In this chapter we look at the code of ethics & obligations cast upon each valuer. We have discussed the obligation of the valuer to: give a value conclusion, specify purpose, state the intended user, accept assignments only when competent as required for the purpose, avoid misrepresentation, keep records, avoid conflict of interest, protect the reputation of the Valuation Society of which the valuer is a member, report known violations by another member and give evidence as necessary, required & competent on valuation related matters in a court or statutory body.

**20.7 TERMINAL EXERCISE**

1. What is the ethics of the valuer?

**20.8 SUPPLEMENTARY MATERIALS**

1. www. taqeem.gov.sa/en/about/Pages/ethic.aspx

**20.9 ASSIGNMENTS**

1. Discuss the impact of enforcement of code of ethics on valuers, taking one aspect at a time.

**20.10 REFERENCE BOOKS**

1. D.N. Banerjee, Parks "Valuation, Eastern Law House, Calcutta, 5th Edition, 1998,
2. Henry A. Babcork, Appraisal Principles and Procedures, Richard D. Irwin Inc. Pub; 2nd edition 1970.
3. American Society Appraisers, P.O. Box 17265, Washington D.C. 20041, U.S.A, http://www.appraisers.org.
4. Roshan H. Namavati, Theory and Practice of Valuation, Jain Book Depot, 4th Edition, 2010.

**20.11 LEARNING ACTIVITIES**

Group discussion during PCP days.

1. Ethics of valuer.
2. Obligations of a Valuer.

**20.12 KEY WORDS**

Ethics of valuer, Obligations of a Valuer.

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