APESB

Accounting Professional & Ethical Standards Board

APES GN 20 Quality and Extent of Evidence for Valuation Services

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1. Scope and application

1.1 Accounting Professional & Ethical Standards Board Limited (APESB) issues APES GN 20 *Quality and Extent of Evidence for Valuation Services* (the Guidance Note).

1.2 APES GN 20 provides guidance to assist Members on the application of paragraph 4.5 of APES 225 Valuation Services in determining the quality and extent of evidence that, depending on the particular circumstances, may be sufficient and appropriate evidence considering the type of Valuation Service.

1.3 This Guidance Note does not prescribe or create any requirements that Members shall follow.

1.4 This Guidance Note shall be interpreted in accordance with APESB "*Due process and working procedures for the development and review of APESB pronouncements*".

2. Definitions

For the purpose of this Guidance Note, all definitions are consistent with APES 225 *Valuation Services*.

3. Quality and extent of evidence for Valuation Services

3.1 When performing a Valuation Service, the Member is required by paragraph 4.5 of APES 225 to gather sufficient and appropriate evidence by such means as inspection, inquiry, computation and analysis to provide reasonable grounds that the Valuation Report and the conclusions therein are properly supported. And in determining the extent and quality of evidence, the Member is required to exercise professional judgement, considering the nature of the Valuation, the type of Valuation Service, and the use to which the Valuation Report will be put.

Nature of the Valuation

3.2 Under paragraph 2 of APES 225, a Valuation is the act or process of determining an estimate of value of a business, business ownership interest, security, or intangible asset by applying Valuation Approaches, Valuation Methods, and Valuation Procedures.

3.3 The set of evidence that would be sufficient and appropriate will differ depending on whether the asset being valued is a business, business ownership interest, security, or intangible asset. And the difference might be minor or great. For example, it is likely that the evidence the Member would gather to value a business ownership interest would include all of the evidence that the Member would gather to value the business but would also include evidence relating to the effect on value of the degree of control and marketability associated with the business ownership interest. Hence the Valuation of the business ownership interest would require a relatively minor amount of additional evidence compared to the Valuation of a business. On the other hand, the set of evidence that would be required to value a patent portfolio or a debt security, for example, would be significantly different from that required to value a business.

3.4 Similarly, for any particular asset, the set of evidence that would be sufficient and appropriate might differ depending on what Valuation Approaches and Valuation Methods the Member chooses to use. For example, if the Member chooses to value a business using the discounted cash flow method, then the Member will gather evidence relating (amongst other things) to forecasted cash flows and discount rates. But if instead the Member chooses to value the business using the capitalised earnings method, then the Member will instead gather evidence relating (amongst other things) to normalised earnings and capitalisation multiples.

Type of Valuation Service

3.5 In a Valuation Engagement, the Member is free to employ the Valuation Approaches, Valuation Methods, and Valuation Procedures that a reasonable and informed third party would perform taking into consideration all the specific facts and circumstances of the Engagement or Assignment available to the Member at that time.

3.6 However, in a Limited Scope Valuation Engagement, the Member is not free to employ the Valuation Approaches, Valuation Methods, and Valuation Procedures that a reasonable and informed third party would perform taking into consideration all the specific facts and circumstances of the Engagement or Assignment available to the Member at that time, and it is reasonable to expect that the effect of the limitation or restriction on the estimate of value is material. The limitation might affect the extent and quality of evidence the Member determines is necessary. In practice, the effect will often be to reduce the extent and quality of evidence (see Example 2 of Appendix 1 of APES 225), although it could be to increase both (see Example 4 of Appendix 1 of this Guidance Note).

3.7 In a Calculation Engagement, the Member and the Client or Employer agree on the Valuation Approaches, Valuation Methods and Valuation Procedures the Member will employ. The effect of that agreement will often be to affect significantly the extent and quality of evidence the Member determines is necessary, usually by reducing both. Indeed, it is possible that the agreement could be such that the Member does not need to gather any evidence at all and is merely engaged to perform a calculation based on agreed inputs (see Example 8 of Appendix 1 of APES 225).

Use to which the Valuation Report will be put

3.8 The intended purpose of the Valuation Report can sometimes affect the set of evidence that would be sufficient and appropriate for the Valuation. For example, if the Member is engaged to determine the fair value of an intangible asset for the purpose of accounting under accounting standards then the Member will need to consider any pronouncements in those accounting standards that affect the evidence the Member needs to gather. Another example would be where the Member is engaged to value an equity security under a shareholders' agreement and that agreement specifies certain matters the Member must take into account in performing the Valuation.

Conformity with International Pronouncements

The International Ethics Standard Board for Accountants (IESBA) has not issued a pronouncement equivalent to APES GN 20.

Appendix: Illustrative Examples

This Appendix contains some examples to assist Members determine the scope and extent of work for a Valuation Service.

Members are cautioned that the determination of the scope of work for a Valuation Service in accordance with APES 225 is a matter to be judged based on the particular facts and circumstances. The examples contained in this Appendix are provided for illustrative purposes only and are not intended to be, and cannot be, all inclusive. The examples are not a substitute for reading the full text of APES 225 and APES GN 20 and applying the pronouncements to the particular circumstances. In all of the examples presented below it is assumed that there are no unmentioned facts which would be relevant to the determination of the scope and extent of work for a Valuation Service.

Example 1: Valuation of a minority interest in equity for capital gains tax without access to the company

Facts: A Member in Public Practice is engaged by a Client who holds a minority interest in the issued share capital of a company to perform a Valuation as at today's date of that minority interest for the purpose of capital gains tax and to provide a written report to the Client. There is no restriction or limitation placed on the Member in choosing the appropriate procedures or approach to use. Neither the Client nor the Member has access to the management and the books and records of the company. The Member has access to the annual reports, minutes of general meetings, and other documents provided by the company to the Client as a shareholder.

Analysis: If the Member did have access to the company (i.e. to its management and to its books and records) then, depending on the circumstances, the Member might consider:

- holding discussions with management about the nature and history of, and outlook for, the company's business;
- obtaining and reviewing any management accounts and reports and asking for details of any assumptions underlying them and the basis of their preparation;
- obtaining and reviewing any strategic or business plans;
- obtaining and reviewing any forecasts or budgets and asking for details of any assumptions underlying them;
- obtaining details of any revenues, expenses, assets, or liabilities that the Member considers relevant;
- obtaining details of any borrowings;
- obtaining and reviewing any crucial contracts;
- obtaining information on any revenues and expenses reported in the financial statements that management considers to be non-recurring, abnormal, or on non-commercial terms; and
- asking for any other information that the Member considers, in the circumstances, to be relevant to the Valuation.

However, in this example this information is not available to the Member because the Member does not have access to the company. The fact that the extent and quality of the information available to the Member is less than would be the case if the Member did have access does not mean that the Engagement is a Limited Scope Valuation Engagement. That is because the Member remains free to employ the Valuation Approaches, Valuation Methods and Valuation Procedures that a reasonable and informed third party would perform taking into consideration all the *specific facts and circumstances* of the Engagement available to the Member at the time – and those specific facts and circumstances include the fact that the Member does not have access to the company.

Conclusion: This is a Valuation Service. The Member has been engaged to perform a Valuation, without any restriction or limitation placed on the Member by the Client, and to provide a Valuation Report, which constitutes a Valuation Engagement.

Example 2: Relationship between Valuation Conclusions in a Limited Scope Valuation Engagement and in a Valuation Engagement

Facts: A Member in Public Practice is approached by a Client who wishes to obtain a Valuation of a portfolio of patents for financial reporting and tax purposes. The Member's report will be provided to the Client's auditors and to the Australian Taxation Office. The Member is not a tax agent or an auditor. The Client wishes to minimise the cost of the Valuation and to that end is willing for the Member to limit the amount of work that the Member would otherwise do and for the Engagement to be a Limited Scope Valuation Engagement instead of a Valuation Engagement. The Member explains to the Client that if the Member were instead to perform a Valuation Engagement then the Valuation Conclusion, which will be in the form of a range of values, might be different. The Client says that it is willing to proceed with a Limited Scope Valuation Engagement because it understands that the range of values that the Member would determine in a Limited Scope Valuation Engagement is simply wider than that which the Member would determine in a Valuation Engagement.

Analysis: The Client understands that the Valuation Conclusion might be different under a Limited Scope Valuation Engagement than under a Valuation Engagement. However, the Client appears to assume that the range of values that would result from a Valuation Engagement would fall within the range of values that would result from a Limited Scope Valuation Engagement. Whether this would be the case will depend on the facts and often it will not be possible to predict without performing the additional work involved in a Valuation Engagement. Hence, while it is possible that the range of values under a Valuation Engagement would fall within the range under a Limited Scope Valuation Engagement, it is also possible that it would not or that there would only be a partial overlap.

Conclusion: In light of the Client's apparent misunderstanding, and assuming that the nature of the limitations on scope are such that it is not possible to predict whether the range of values that would result from a Limited Scope Valuation Engagement would fall within the range that would result from a Valuation Engagement, either fully, partially, or at all, the Member should inform the Client of that fact before an Engagement is entered into so that the Client is able to make an informed choice.

Example 3: Choosing between different types of Valuation Engagements

Facts: The facts are the same as for Example 2 except that (a) the Client understands that in the circumstances it is not possible to predict whether the range of values that would result from a Valuation Engagement would fall within the range that would result from a Limited Scope Valuation Engagement, either fully, partially, or at all; and (b) the Client asks the Member whether it should commission a Limited Scope Valuation Engagement or a Valuation Engagement.

Analysis: It is the Client's responsibility, not the Member's, to determine which type of Engagement should be commissioned. Many matters may be relevant to that determination and the Member may be able to assist the Client in understanding some of them. For example, the Member could assist the Client to understand how the two types of Engagement might involve different costs as well as different burdens on the Client from requests for information or access to management. The Member could also assist the Client to understand that because the Valuation Conclusion in a Limited Scope Valuation Engagement might be different from the Valuation Conclusion in a Valuation Engagement, commissioning a Limited Scope Valuation Engagement carries an additional degree of risk. Whether that risk is acceptable to the Client will depend on the circumstances, including the Client's tolerance for risk and how much weight the Client places on the perceived benefits such as lower cost and burdens. In the circumstances of this example, the determination may also depend on the attitude of the Client's auditors and of the Australian Taxation Office to a Limited Scope Valuation Engagement as well as on any relevant law or regulations.

Conclusion: The Member should inform the Client that it is the Client's responsibility, not the Member's, to determine which type of Engagement (i.e. Valuation Engagement or Limited Scope Valuation Engagement) should be commissioned in the circumstances. The Member could also inform the Client that the Member may assist the Client to understand some of the matters that may be relevant to that determination.

Example 4: Extent of evidence

Facts: A Member in Public Practice is engaged by a Client to perform a Valuation of a business, and provide a Valuation Report, for the purpose of the Client's negotiations with a third party for the sale of the business. The Valuation Report will not be provided to that third party. The Client instructs the Member to use the discounted cash flow method of Valuation. But for that instruction, the Member would have used the capitalised earnings method of Valuation. The Member will need more information to perform the Valuation using the discounted cash flow method than the Member would have needed to perform the Valuation using the capitalised earnings method. The additional information will include, amongst other things, long-term cash flow forecasts for the business.

Analysis: The Member is not free to use the Valuation Method that the Member believes a reasonable and informed third party would use taking into consideration all the specific facts and circumstances of the Engagement.

Conclusion: The Engagement is a Limited Scope Valuation Engagement, notwithstanding that the Member will do more work than would be required for a Valuation Engagement. It is a Limited Scope Valuation Engagement, due to the restriction placed on the Member on the Valuation Method to be used.