IVSC PERSPECTIVES PAPER

Getting the Process Right: Exploring Valuation Risk under IVS

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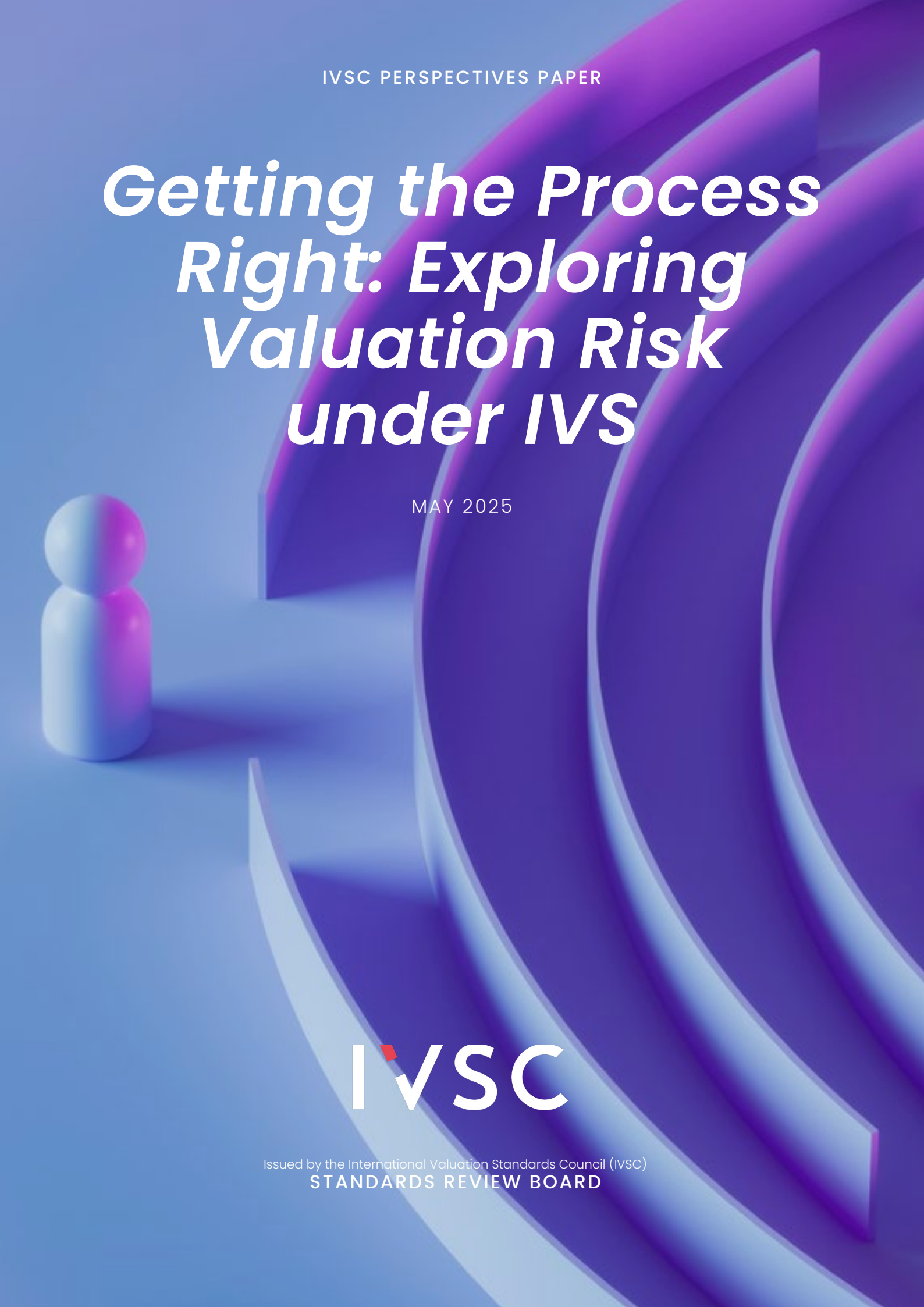

IVSC

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The IVSC issues Perspectives Papers from time to time, which focus on pertinent valuation topics and emerging issues. Perspectives Papers serve a number of purposes: they initiate and foster debate on valuation topics as they relate to the International Valuation Standards (IVS); they provide contextual information on a topic from the perspective of the standard setter; and they support the valuation community in their application of IVS through guidance and case studies.

Perspectives Papers are complementary to the IVS and do not replace or supersede the standards. Valuers have a responsibility to read and follow the standards when carrying out valuations.

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IVSC Perspectives Paper

Getting the Process Right: Exploring Valuation Risk under IVS

Introduction

When developing IVS (effective 31 January 2025), the IVSC Technical Boards agreed to consider refining the definition of *valuation risk* and assess the need for further requirements related to the understanding and management of this risk.

In addition, the IVSC received feedback during its 2024 Agenda Consultation indicating that respondents believed that *valuation risk* was a topic of importance to the valuation community. The responses, however, showed a wide range of interpretations of what constitutes *valuation risk* and how this relates to the valuation process as well as the resultant value.

Over the past year the IVSC Technical Boards have been exploring the topic of *valuation risk* and set up an IVSC SRB Valuation Risk working group ("working group") to further explore this concept and to draft a series of perspectives papers on this issue.

Valuation risk is inherent in the valuation process and may impact the relevance of the resulting outcome, the *value*. The IVSC Technical Boards believe that this risk needs to be understood and appropriately addressed by the *valuer*. During discussions on *valuation risk*, however, the IVSC Technical Boards noted differences, and potential confusion, in the risks between valuation process and value uncertainty (the outcome of a valuation process).

Valuation process risk is central in this initial paper. Value uncertainty is a different concept which is outcome related. The second perspective paper will focus on value uncertainty.

The IVSC Technical Boards are seeking input from stakeholders on whether the content within IVS on *valuation risk* is appropriate and as such have included consultation questions within this perspective paper.

IVS (Effective 31 January 2025)

The IVS (effective 31 January 2025) included the following definitions within the IVS Glossary related to the topic of *valuation risk*:

> (***bold italics are defined terms within the IVS Glossary***) :
>
> *Valuation: The act or process to determine a **value** as of a **valuation date** that is prepared in full compliance with IVS.*
>
> *Value: The **valuer's** quantitative conclusion on the results of a **valuation** (process) that is fully compliant with the requirements of IVS as of a **valuation date**.*
>
> *Valuation Risk: The possibility that the **value** is not appropriate for its **intended use**.*
>
> *Price: The monetary or other consideration asked, offered or paid for an asset or to transfer a liability. Price and value may be different.*

As described in IVS Framework in IVS 100 section 20, Valuation Process Quality Control includes the following requirements related to *valuation risk*:

> *20.08 The valuer should conclude that the level of **valuation risk**, subject to controls in place, is appropriate given the **intended use, intended user**, the characteristics of the **asset** or **liability** being valued and the complexity of the **valuation**.*

In IVS 106 Documentation and Reporting, documentation requirements are described in relation to *valuation risk*:

> *20.04 In all cases, documentation should describe the **valuation** or **valuation review** and how the **valuer** managed **valuation risk**. The **valuer must** keep a copy of any report issued on the **value** and a record of the valuation work performed for a period in accordance with legal, regulatory, authoritative, or contractual requirements relative to the **intended use**.*

Valuation Risk Examples

Valuation risk refers to the potential for errors within the valuation process, leading to the possibility that a *value* that is not appropriate for its *intended use*. This involves the possibility of inaccuracies, biases, or inconsistencies in the methodologies, assumptions, and data used during the valuation process.

Examples of potential errors in the valuation process include but are not limited to:

a. **Certain calculation errors occur in the estimation**; examples are: (i) the wrong determination of free cash flow, (ii) incorrectly discounting future (free) cash flows to the *valuation date*, or (iii) an incorrect determination of the concept of residual value.

b. **Inconsistencies in the estimation; typical examples here are**: (i) high growth of revenues through more sales volumes, while keeping the same amount of invested capital to produce these outputs, (ii) using pre-tax cash flows, while discounting with an after-tax discount rate, or (iii) including a high long-term growth rate, while not sufficiently maintaining the asset or invested capital;

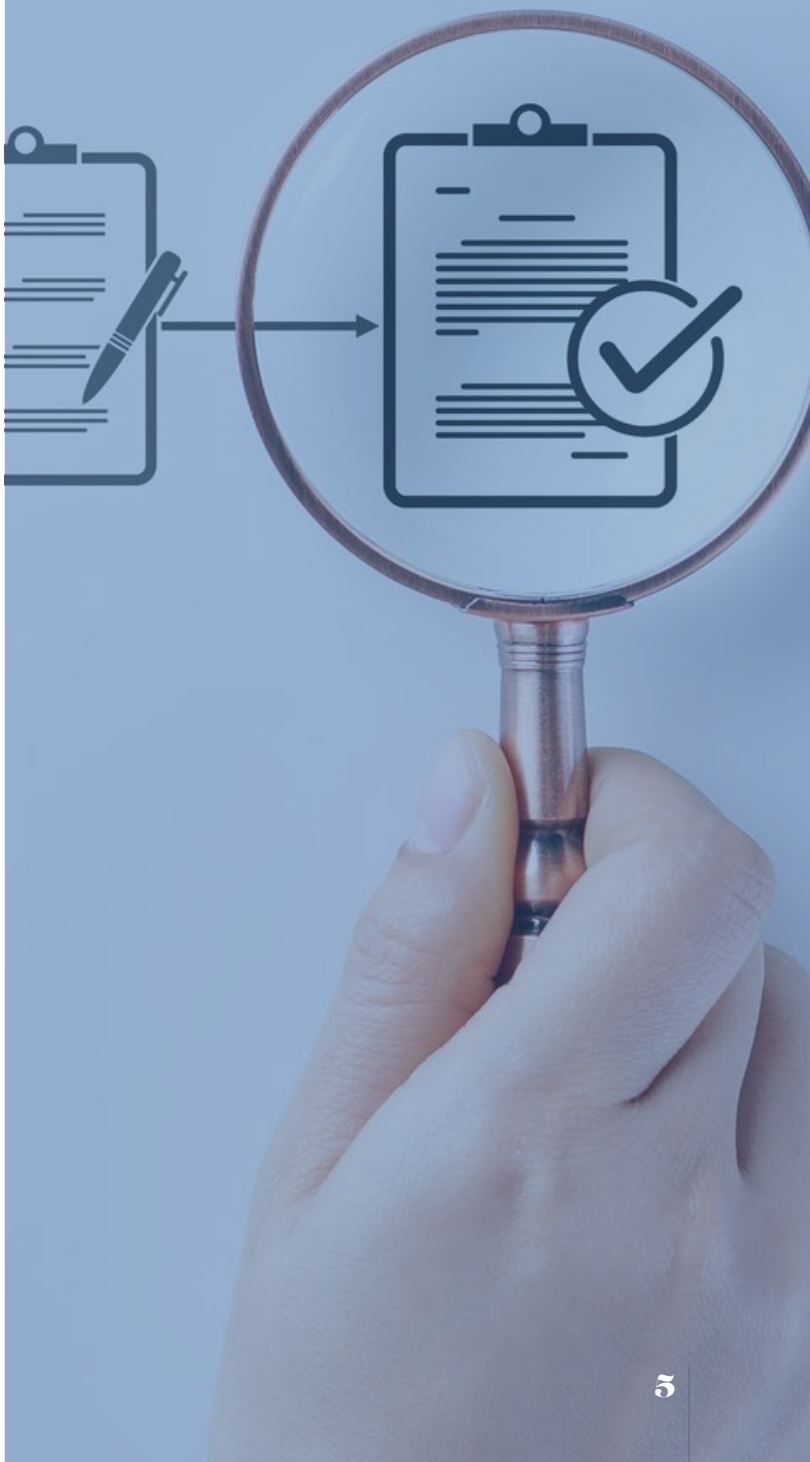
c. **Lack of sufficient substantiation of the relevant assumptions**; examples are: (i) high growth expectations in a mature market without indicating the underlying reasons for this expected increase of market share, (ii) an increase

in profit margin without touching upon price versus costs of good sold or the fixed character of certain operational expenditures, or (iii) limited further elaboration on the ability to create *value* over a longer time horizon, while operating on competitive markets.

d. **Errors in Professional Judgement**; Challenges may occur when valuing unique, complex, or less frequently traded assets or liabilities, which may require additional procedures and judgements to be made by the *valuer* during the valuation process. Unintentional or intentional errors (bias) can occur when exercising *professional judgment*. For example, the valuer might select an over-simplified valuation *model* that does not address the complexities of the subject asset or liability, resulting in a *value* that is not appropriate for its intended use.

Please note that these examples become more open for interpretation while going down the list. Little or no discussion is probably warranted for calculation errors, while assessing whether substantiations regarding key value drivers are sufficient is more open for debate. Key here is transparency; as long as the relevant substantiations are well described, the relevant *input* for a good debate is provided. In the end, estimations even amongst a group of experts may and will differ. This is inherent to *valuations*, being estimations of a theoretical price.

Valuation risk refers to the possibility that the value is not appropriate for its intended use.



Quality control can be defined as the process of ensuring the accuracy, consistency, and reliability of the valuation results.

The valuation (process) produces a value estimate

As defined in IVS (effective 31 January 2025), *value* is a quantitative conclusion, at a given *valuation date*, resulting from a valuation process. A *value* is based on the *valuer's* interpretation of the *intended use* of the *value* and of the specifications contained in the scope of work along with the *valuer's* choice of procedures and *professional judgement* made throughout the entire valuation process. By performing an IVS compliant valuation, the *valuer* should have followed valuation processes that minimise valuation risk.

Challenges in Performing an IVS Compliant Valuation

IVSC Technical Boards and the working group identified the significant challenges that might occur during a *valuation* and identified how they impact *valuation risk*. In developing the analysis enumerated above, the working groups found the following:

a. Competency and Ethics

. An overarching challenge is whether a *valuer* is competent and ethical while performing a *valuation*. For example, if a *valuer* did not have the appropriate training and experience to perform the *valuation* of an asset or *liability*, an inappropriate *valuation* might be performed. *Valuer* ethical, competence and professional requirements are part of the IVSC Professional Standards.

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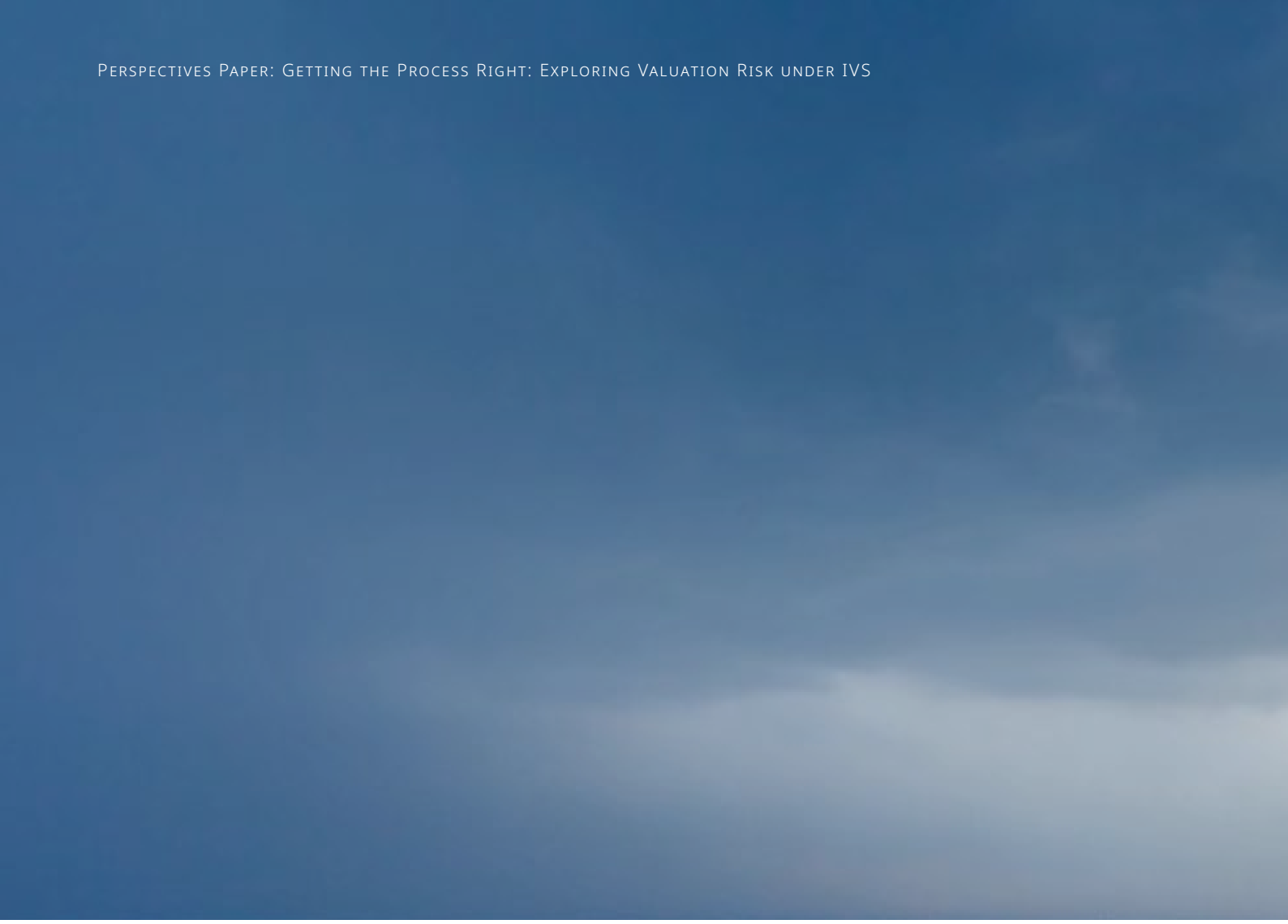
b. Valuation Execution

. Some challenges relate to errors in executing a *valuation*. For example,



the *valuer* could select an appropriate *valuation model,* but the *valuation model* might include unidentified coding errors that materially impact the appropriateness of the *value* for the specified *intended use*. As described in IVS, a *valuer must* implement consistent processes, including quality controls, that that allow the *valuer* to conclude that the level of *valuation risk* is appropriate given the *intended use*, *intended user,* and the characteristics of the asset or liability being valued.

. The existence of appropriate quality control processes for valuation execution is important and also plays a key role in identifying and managing *valuation risk*. Quality control can be defined as the process of ensuring the accuracy, consistency, and reliability of the valuation results or assessments of a company, *asset* or *liability*. In this context, quality control involves reviewing all aspects of the *valuation* including the *intended use* and *intended users*, scope of work, *basis(es) of value, valuation approach(es)* and *methodology(ies)*, *data and inputs, valuation methodology* and *assumptions*, and final documentation and report to ensure that the *valuation* is free from errors and fully reflects the *value*.

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c. Professional Judgment

. Other challenges are related to *professional judgement* made by a *valuer*. For example, the *valuer* might

Read the full Perspectives Paper online:

https://ivsc.org/valuation_risk