

ISCA - KNAV

Common Pitfalls in Valuation Review For Audits

Programme Outline



The following areas will be covered in today's webinar:

- The need for valuation review and its importance for audit conclusion
- The recurring audit inspection findings relating to fair value measurement
- The process of valuation review and the required expertise
- The common pitfalls and challenges in performing the valuation review
- The possible ways to address the relevant pitfalls and challenges

Presenters, Panelists and Moderator

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"Other notable tax firms' in India" recognition by ITR

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"Fastest Growing Firms in the Top 400 firms sub-group" by
INSIDE Public Accounting (United States)

Our Presenters and Panelists



Jason Pang
Associate Partner
Valuation Services
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- Jason Pang is the Associate Partner at KNAV Singapore. He has over 18 years of professional experience in the areas of valuation advisory, audit and assurance and other professional services.
- Jason is a Chartered Valuer and Appraiser (CVA) with IVAS and a registered Public Accountant with ACRA. In addition to the accreditation of ASEAN Chartered Professional Accountant (ASEAN CPA), he is a Chartered Accountant (CA) of Singapore and a Certified Internal Auditor (CIA) with IIA.
- In relation to the valuation advisory service, he has helped numerous clients in completing various type of valuation engagements successfully for the purpose of mergers and acquisitions, fund raising, stock options, intangible assets valuation, purchase price allocation, fair value measurement of financial instruments for financial reporting, valuation for litigation support and others.
- His client's portfolio includes SMEs, MNCs and listed companies from different industries including technology, retail, construction, manufacturing, trading, telecommunications, fund management, shipping, petrochemical, real estate, investment holding, food and beverage, charities, etc.



Snehal Pawar
Senior Manager
Valuation Services
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- Snehal Pawar is a Senior Manager, Valuations at KNAV. Snehal has over 10 years of experience in financial reporting valuation and alternative assets.
- She is a Chartered Accountant (CA) with Institute of Chartered Accountant of India (ICAI) and has successfully completed Level 1 – Accredited Business Valuer (US).
- Leads the Valuation Review Services for clients across US, Canada, UK, Singapore and India.
- She has extensive experience in performing valuation of intangible assets, purchase price allocations, impairment analysis, employee stock options and complex assets under US GAAP and IFRS.
- Focus lies in periodic valuations for mark-to-market analysis under International Private Equity and Venture Capital (IPEV) Guidelines for liquid and illiquid assets including common equity, preferred equity, debt, options, and warrants held by private equity funds.
- Prior to KNAV, Snehal has worked with Duff & Phelps (aka Kroll) and BDO.

Our Panelist and Moderator



Anand Shah
Associate Partner
Valuation Services
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- Anand Shah is an Associate Partner, Valuation Services at KNAV and leads the India valuation practice. He is based out of the Mumbai office. Anand has over 10 years of experience in valuation and financial reporting services.
- Performs valuation analyses for Global and Indian multinational companies for financial reporting purposes under USGAAP/ IndAS/ IFRS following International valuation standards.
- Performs valuations of business and intangible assets for regulatory requirements of FEMA/ RBI, Income Tax, IRS, CRA and HMRC.
- Prior to KNAV, Anand was a part of a start incubator, providing mentorship to start up companies and assisting them to set up operations and fund raising. Prior experience include accounting and financial due diligence and audit engagements under USGAAP/ IFRS and Indian GAAP.
- Anand is a Chartered Accountant from the Institute of Chartered Accountants of India, a Registered Valuer per Indian Companies Act, 2013 and has cleared both parts of the Accredited Business Valuer examination conducted by the American Institute of Certified Public Accountants.



Dominique Tan
Country Leader
Singapore
dominique.tan@knavcpa.com

- Dominique Tan heads the KNAV practice in Singapore.
- He has over 19 years of experience that includes audit and assurance, internal audit, financial due diligence, consulting and forensic accounting.
- Dominique commenced his career with PwC Singapore and PwC Norway and was involved in financial audits and due diligence projects. An entrepreneur at heart, Dominique founded Nebis group of companies, which he merged into Mazars LLP, where he led audit engagements in MNCs and public listed companies in Singapore. While at Mazars LLP, Dominique also headed the Business Risk Consulting division.
- Dominique is a Practicing Member of the Institute of Singapore Chartered Accountant (“ISCA”), an ASEAN CPA and an ISCA Financial Forensic Professional. He is also an adjunct professor at Nanyang Technological University.

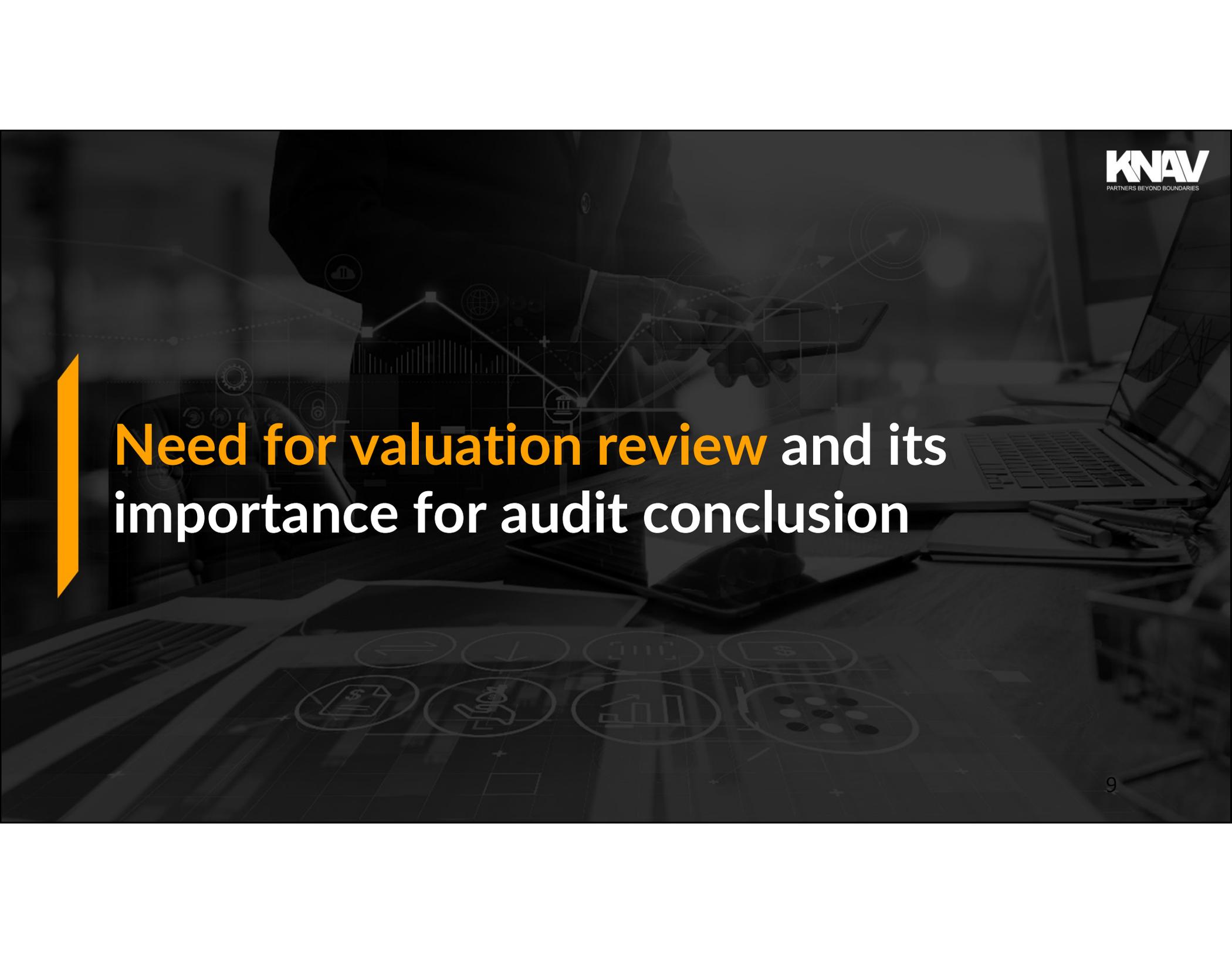


Introduction - Valuation

Valuation

- What is the subject of valuation?
- Why is valuation required?
- When is the date of valuation?
- How is the valuation performed?





Need for valuation review and its importance for audit conclusion

SSQM 1 – Singapore Standard on Quality Management 1

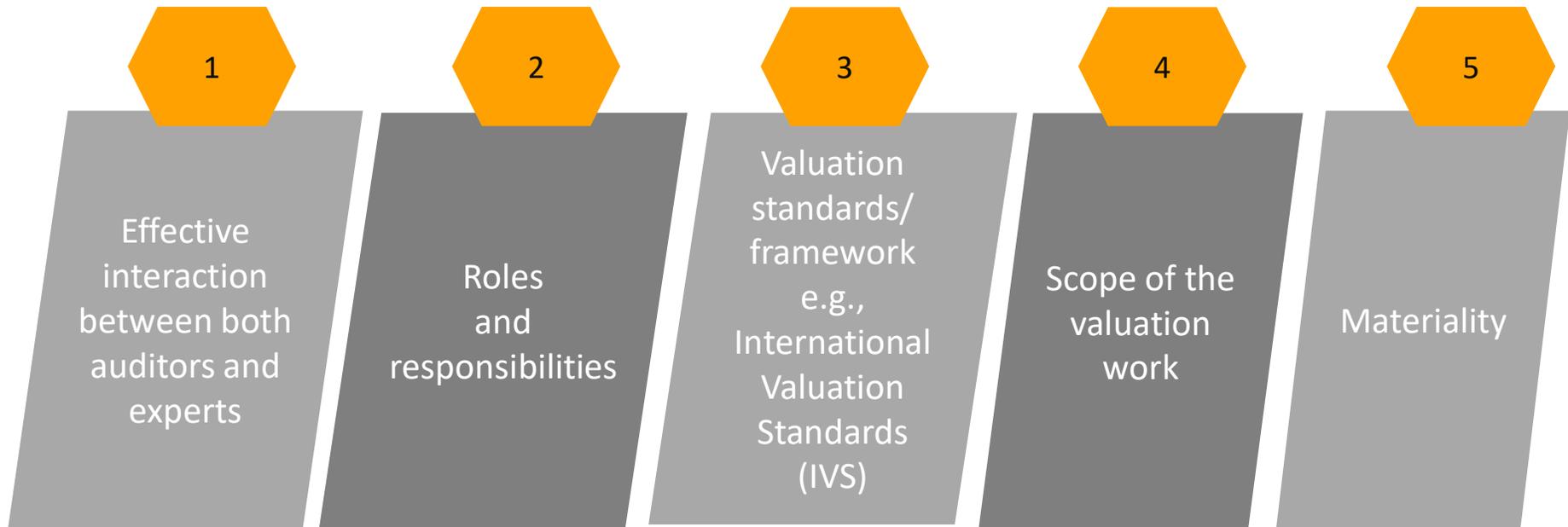
➤ Requirement of **SSQM 1 - Engagement Performance**

- Using the work of management's expert
 - Valuer engaged by audit client

- Using the work of an auditor's expert
 - Valuer as part of audit team - either internal or external party
 - Determining the need for an auditor's expert
 - Competence, capabilities and objectivity of the expert
 - Agreement with the auditor's expert
 - Evaluating the adequacy of the auditor's expert work



Support from valuation experts



Audit evidence for audit conclusion

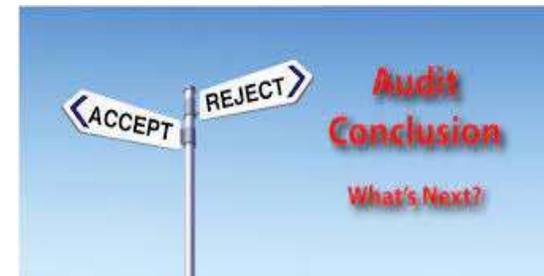
➤ Sufficient and appropriate evidence for audit conclusion

▪ *SSA 230 Audit Documentation*

- Documentation of audit procedures performed, and audit evidence obtained

▪ *SSA 500 Audit Evidence*

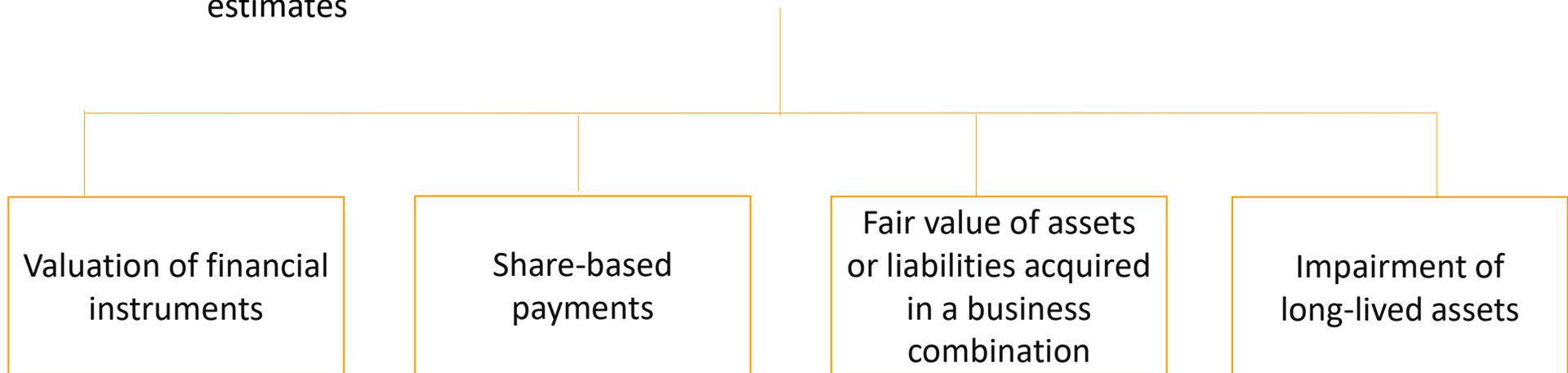
- Relevance and reliability of audit evidence in providing support for audit conclusion
- Information provided by management's expert as audit evidence
- Competence, capabilities and objectivity of the expert



Audit evidence for audit conclusion

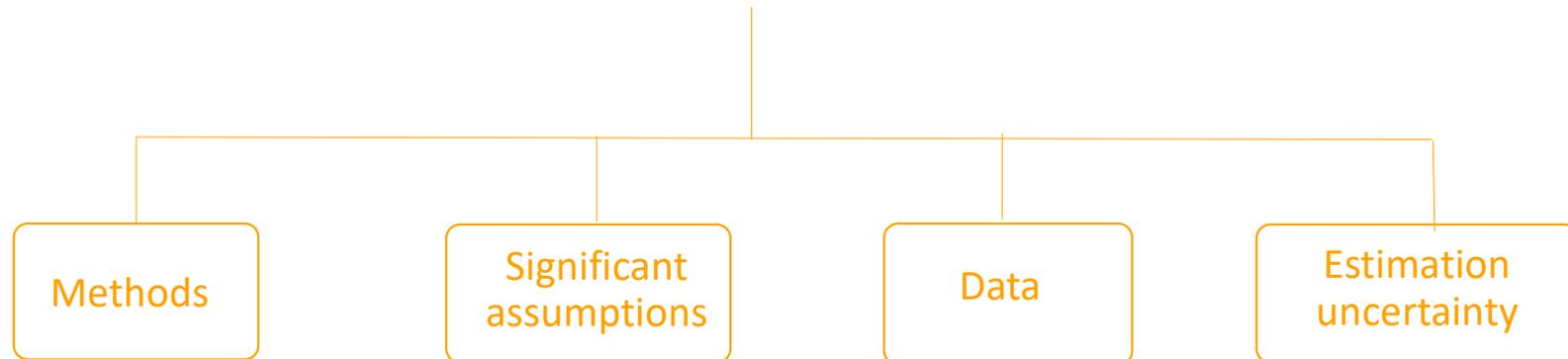
- *SSA 540 Auditing Accounting Estimates and Related Disclosures*

- Identifying and assessing the risk of material misstatement relating to accounting estimates



Accounting estimates – valuation

- Testing how management made the accounting estimates:



- Indicators of possible management bias



Misstatements relating to valuation

➤ Adjustments and misstatements

- Key findings in **Audit Adjustments Matter 2nd Edition** published by ACRA in January 2022
 - Impairment **(9%)**
 - Fair value measurements **(5%)**
 - Business combination, equity accounting and consolidation **(4%)**
- Lack of expertise or experience



Financial reporting aspects - valuation

- Financial reporting areas which require valuation inputs
 - Increased use of fair value in financial reporting (*IFRS 3 Fair value measurement*)
 - Others – IFRS 2, IFRS 3, IFRS 9, IAS 36, IAS 38, etc.

Fair value
measurement of
unquoted equity
instruments

Impairment of
intangible assets

Business
combinations

Share-based
payments

Areas of focus - valuation

- Areas of Review Focus in **ACRA Financial Reporting Practice Guidance No. 2 of 2020**
 - Adequacy of impairment charge and assumptions made in the impairment assessment
 - Which cash generating unit(s) (“CGUs”) are performing poorly?
 - How is goodwill allocated to CGUs?
 - How have cash flow forecasts been adjusted to reflect the current environment?
 - Others – assumptions by management, discount rate, etc.



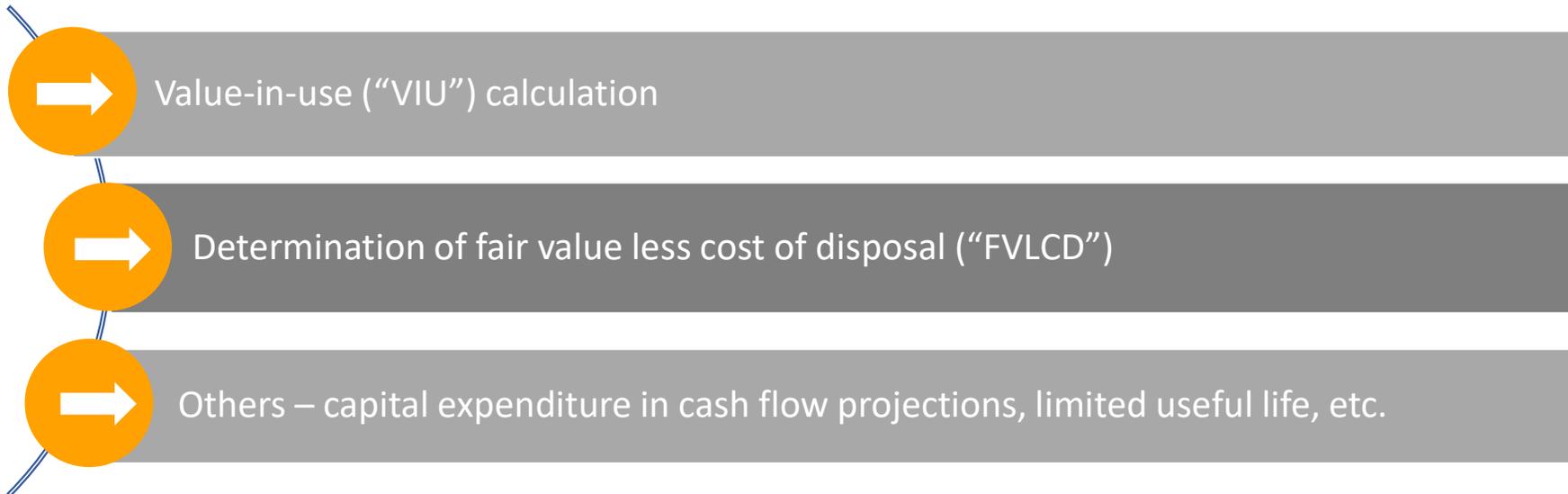
Areas of focus - valuation

- Areas of Review Focus in **ACRA Financial Reporting Practice Guidance No. 2 of 2020 (cont'd)**
 - Valuation of **investment properties** and **financial instruments**
 - Is any external professional valuer engaged?
 - Valuation multiples approach or income approach?
 - Has any asset's value declined significantly?



Areas of focus - valuation

- Areas of Review Focus in **ACRA Financial Reporting Practice Guidance No. 1 of 2021**
 - Impairment assessment of non-financial assets



Areas of focus – latest update 4 Nov 2022

- Areas of Review Focus in **ACRA Financial Reporting Practice Guidance No. 1 of 2022**

1

Impairment risks for CGUs

2

Discount rates/inflation for VIU and FVLCD

$$D_n = \frac{1}{(1 + r)^n}$$

Where D_n = discount factor
 r = discount rate
 n = number of years ahead

Areas of focus - valuation

- Case Study in **ACRA Financial Reporting Surveillance Program 3rd Report 2020**
 - Case study K4 – Unlisted preferred shares with conversion option
 - Extracts from the report - “Directors should engage a professional valuer when there is no adequate in-house valuation expertise, and the item is material.”



Recurring audit inspection findings relating to fair value measurement

Accounting estimates including fair value measurement

- **Audit engagement inspection findings - ACRA's Practice Monitoring Programme ("PMP") from 2020 to 2022**



Impairment assessment for investment in subsidiaries, associates and joint ventures



Goodwill and other intangible assets arising from business combinations and its impairment assessment

- Highest frequency of inspection finding which is consistent with the IFIAR Annual Inspection Findings Survey results

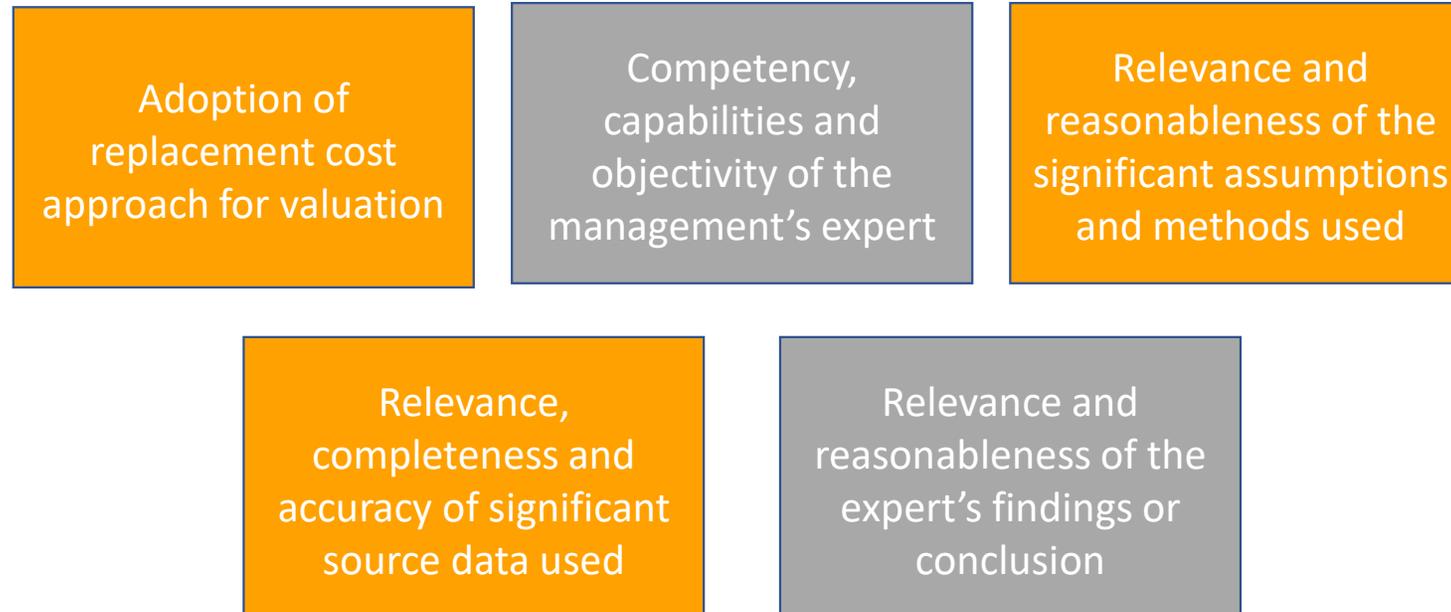
Common deficiencies

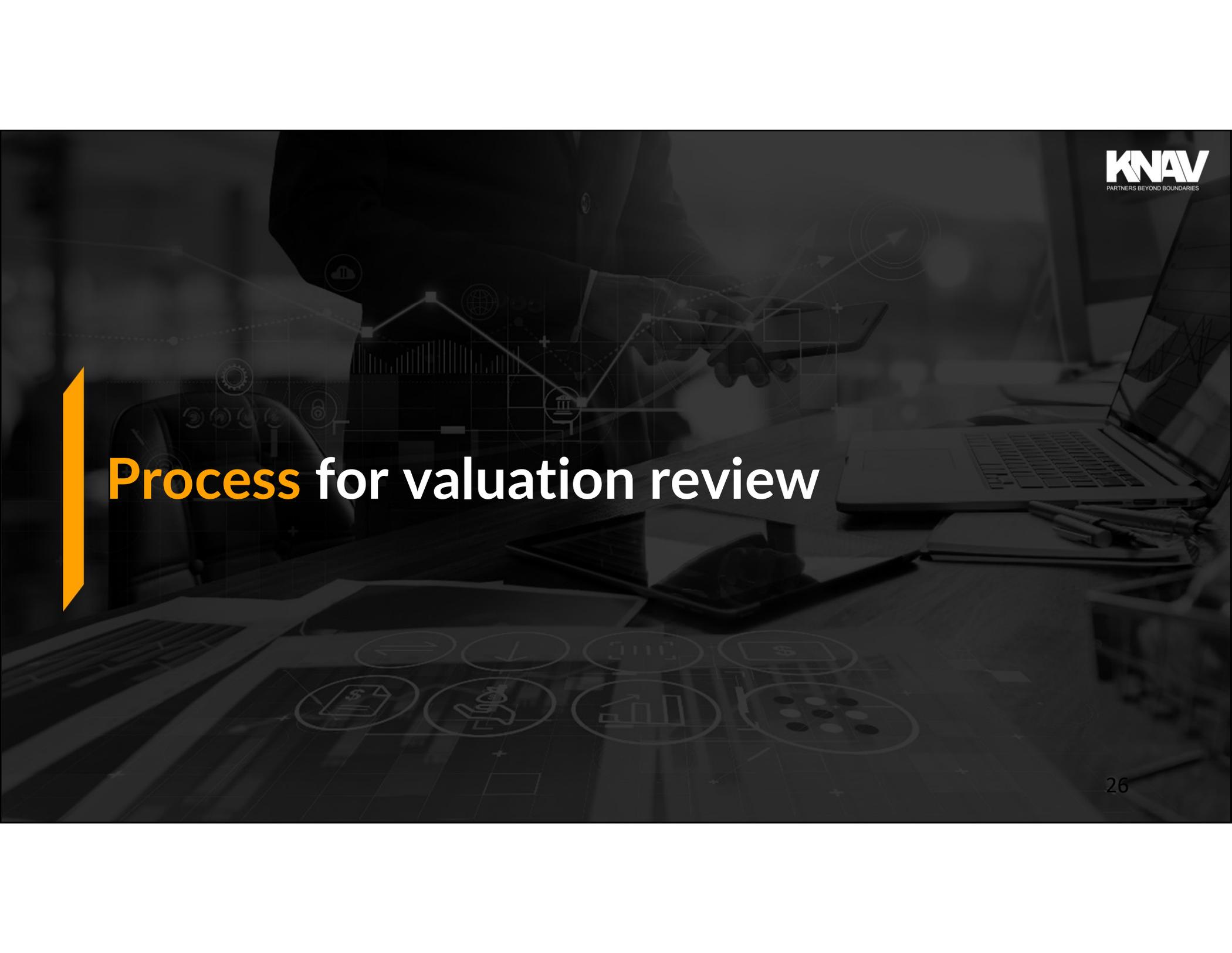
- Appropriateness of valuation methodologies used
- Consideration of management bias
- Professional skepticism in challenging the underlying assumptions used
 - Should not be merely assessing qualitatively with no quantitative assessment
 - Should not disregard contradictory evidence
- Assessment of the reasonableness, relevance and reliability of inputs and assumptions used



Case study from ACRA's PMP Report

➤ Use of experts or specialists

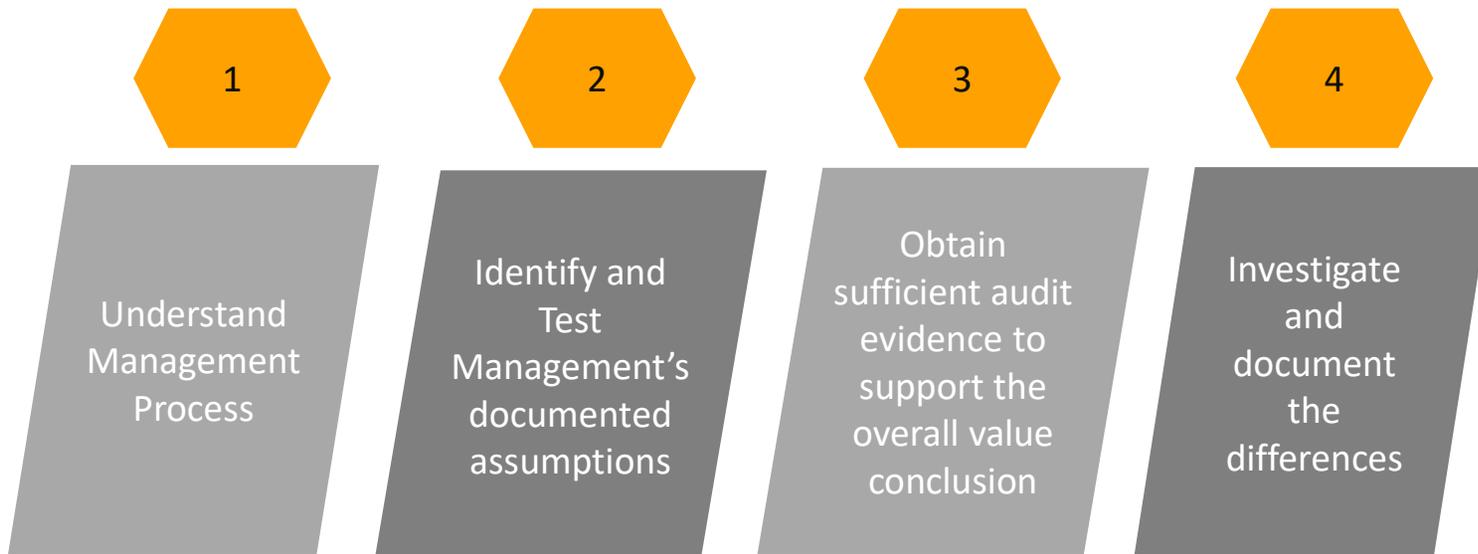




Process for valuation review

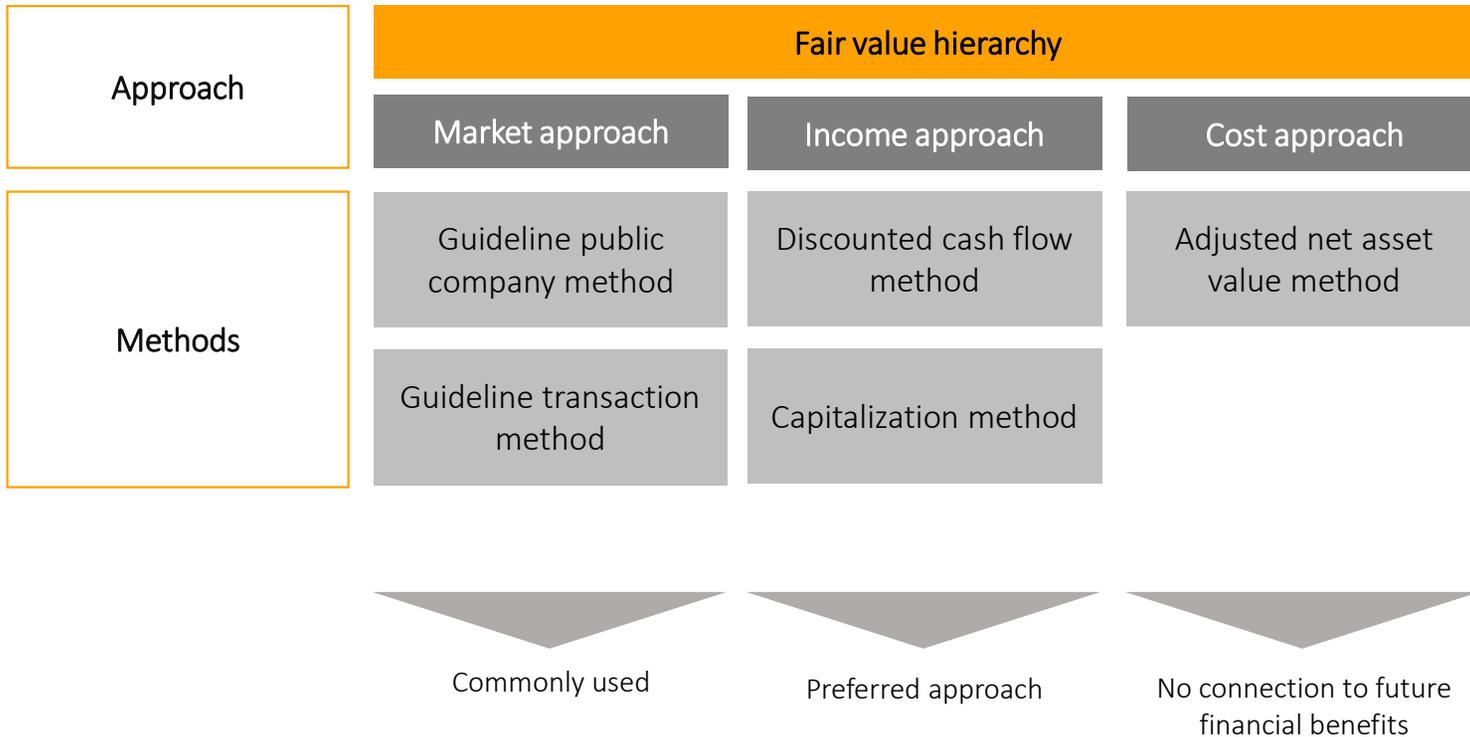
Process for valuation review

The process of valuation review should be such that they should enable the auditor to:



Common Pitfalls during valuation review

Common Valuation Methods



As we move from Level 1 to Level 3 assets – the complexity of valuation methods increase.

The specific valuation techniques used in a valuation engagement depend on the facts and circumstances specific to each case, including the nature and characteristics of the business enterprise being valued, and the purpose of the business appraisal. The appraiser's choice of methods is determined by the characteristics of the business to be appraised, the availability of reliable information requisite to the various methods, the function and use of the appraisal, applicable statutory law, case law, and administrative rulings.

Example GPCM

Amounts in USD thousands

Name of Company	Ticker	Trailing multiples		Forward multiples (FY +1)		Forward multiples (FY +12)	
		EV/ Revenue	EV / EBITDA	EV/ Revenue	EV / EBITDA	EV/Revenue	EV / EBITDA
Average							
Median							
High							
Low							
<u>Interquartile Range</u>							
75th Percentile							
50th Percentile							
25th Percentile							
Standard deviation							
Coefficient of variation							
Selected multiple - 50th Percentile							
Revenue/EBITDA							
Enterprise value ("EV")							
Plus: Cash and cash equivalents							
Market value of invested capital ("MVIC")							
Weights							
Weighted MVIC							
Minus: Interest bearing debt							
Equity value (Minority, marketable basis)							
Less: DLOM							
Equity value (Minority, non-marketable basis)							

Selection of Comps

Selection of multiple range

Operating metric

Adjustments

Example – DCF Method

Income Approach: Discounted Cash Flow Method
Valuation as of 31 March, 2022

	Fiscal year ended 31, March					
	Projected 12 months ended	Projected Terminal				
Revenues						
% Growth						
EBITDA						
As % of Revenues						
Less: Depreciation & Amortization						
Operating EBIT						
Less: Estimated Income Taxes						
As % of Operating EBIT						
Invested Capital Net Income						
As % of Revenues						
Add: Depreciation & Amortization						
Less: Capital Expenditure						
Less: Incremental DFNWC						
FREE CASH FLOW TO THE FIRM						
Present Value Factor (mid-period convention)						
Present Value						

PFI

Check for the reasonableness of the Prospective Financial Information (PFI).
Compare with previous year or quarter MIS approved by the Board and document reasons for material changes, if any.

Example – DCF Method

Terminal Value Computation

Stable Cash Flow (Terminal Year)
Discount Rate (Terminal Year)
Terminal Year Growth Rate
Undiscounted Terminal Value
Discount Factor

Discounted Terminal Value

Discount Rate (Projected Year)
Present Value of Cash Flows (Projected Period)
Discounted Terminal Value

Business Enterprise Value

Adjusted Business Enterprise Value

Less: Debt

Less: Long-term debt (Related party loan)
Add: Cash and cash equivalents as at Valuation Date
Add: PV of unutilised tax benefits arising after FY27
Less: Non-operational liabilities
Add: Factory Sheld Held for Sale

Estimated Equity Value

Less: Cost of Disposal @10%

Estimated Equity Value (Rounded)

Terminal value

Estimate the exit multiple and/or growth rate in perpetuity of the business at the end of the forecast period.

Discount Rate

Estimate the company's weighted average cost of capital to determine appropriate discount rate range.

Components	%	Management source of information
Risk-free rate (Rf)		Average 10 year - US Treasury Bond Yield for March 22
Equity risk premium (RPM)		Aswath Damodaran database
Beta		Based on size of comparables analysis
Size risk premium (RPs)		Appraiser's judgement on riskiness of projections
Company specific risk premium (RPC)		
Cost of equity ("Ke") Rounded		

Adjustments

Adjust the resulting valuation for all assets and liabilities not accounted for in cash flow projections.

Shadow workings

Perform shadow calculations to check for mathematical accuracy of the model and test for sensitivity of any inputs.

Common Pitfalls - Goodwill Impairment

- What is impairment?
 - Occurs when the carrying amount of goodwill exceeds its fair value/recoverable amount.
 - Established principle that assets should not be carried at above their fair value/recoverable amount.
- Test at which Level?
 - At the reporting unit level.
 - Regularly reviewed by management of the Company.
- When to Test?

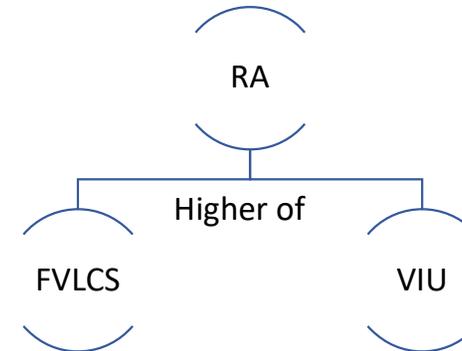
Annual testing

- on an **annual basis**.
- annual test date is selected, **the test is performed as of the same date every year.**

Interim testing (Trigger test)

- Current accounting rules also require that goodwill be tested for impairment between annual tests **in certain circumstances, specifically if it is “more likely than not” that a goodwill impairment exists.**

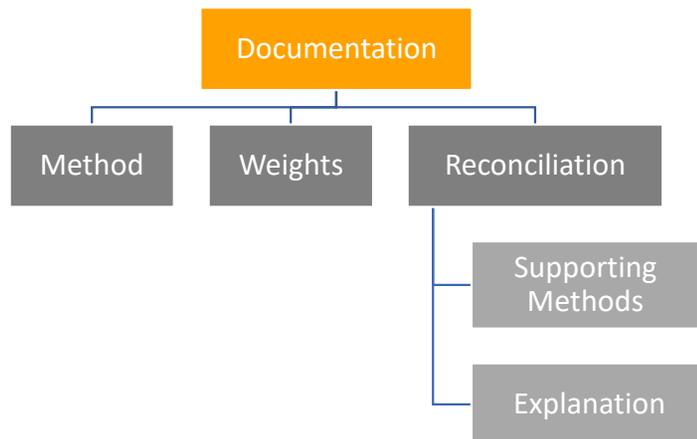
- The Recoverable Amount (RA) of an asset or cash-generating unit is the higher of its Fair Value Less Costs to Sell (FVLCS) and its Value In Use (VIU). To measure impairment, the asset’s carrying amount is compared with its RA.

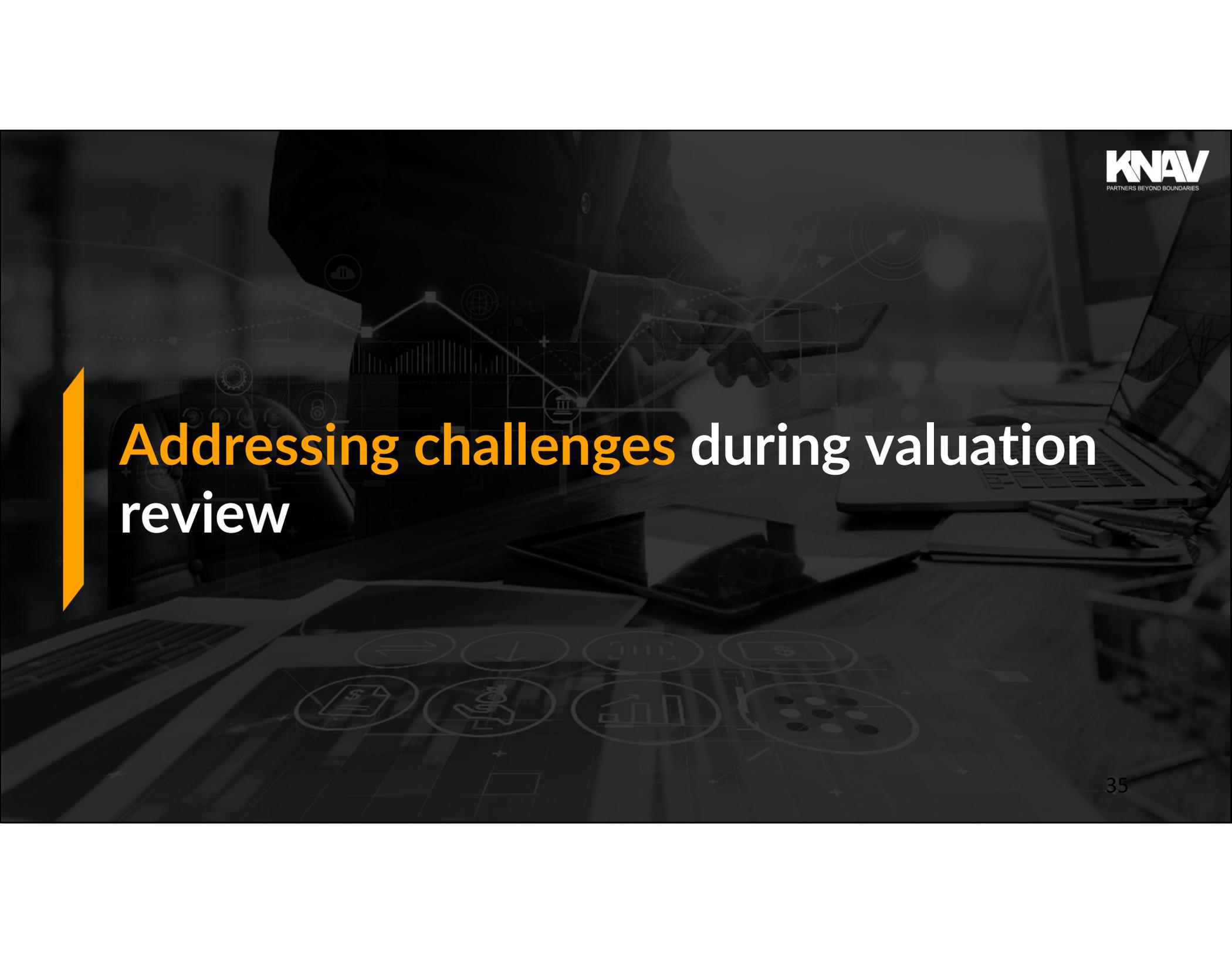


- Fair Value Less Cost to Sell (FVLCS) is the amount obtainable from the sale of the asset in an arm’s length transaction between knowledgeable and willing parties, less costs of disposal.
- Value in Use is the present value of the future cashflows expected to be derived from an asset or CGU.

Common Pitfalls – ESOPs valuation

- Valuation methods –
 - Most common used to value Employee Stock Options is Black Scholes Model.
 - Other valuation models include Binomial Lattice Model, Monte-Carlo (when there exist more complex conditions).
- Black-Scholes Model:
 - Risk Free Rate
 - Tenure / Exercise Period
 - Volatility
 - Expected Dividends
 - Fair Value of common shares (per share value)





Addressing challenges during valuation review

Addressing challenges during review

- **Sole responsibility** for the audit opinion expressed. Use of expert does not reduce the responsibility.
- Auditor's objectives:
 - Determine whether to **use the work** of an auditor's expert; and
 - If using the work of an auditor's expert, to determine whether that **work is adequate** for the auditor's purposes.
- **"Auditor's Expert"** – An individual or organization **possessing expertise** in a field other than accounting or auditing, whose work in the field is used by the auditor to **assist the auditor** in obtaining sufficient appropriate audit evidence.
 - May be either an **auditor's internal expert** (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an **auditor's external expert**
- Definition of **"Expertise"** – Skills, knowledge and experience in a **particular field**
- Definition of **"Management's Expert"** – An individual or organization possessing expertise in a field other than accounting or auditing, whose **work in that field** is used by the entity to **assist** the entity in preparing the financial statements.



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KNAV is a full-service global accounting and consulting firm founded in 1999 with expertise in assurance, taxation, valuations, transfer pricing, accounting advisory, and business advisory services. In our 20+ years of existence, we have won numerous accolades and awards for our exceptional client service.

Today, KNAV is a global organization with 200+ professionals located in six countries: Singapore, the United States, Canada, the United Kingdom, the Netherlands, and India. Also, KNAV is a part of Allinial Global, which is the 2nd largest accounting firm association in the world, further enhancing our ability to deliver seamless, high-quality service to our clients.

KNAV's Asia Pacific focus continues to drive our commitment to developing our practice in Singapore through partnerships and collaborations, and we will always provide exemplary professional services to our clients.

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