Institute of Chartered Accountants of New Zealand

ADVISORY ENGAGEMENT STANDARD 2

INDEPENDENT BUSINESS VALUATION ENGAGEMENTS

Issued by the Council of the Institute of Chartered Accountants of New Zealand

CONTENTS

IMPORTANT NOTE:

The NZICA Code of Ethics (effective from 15 June 2019) (“revised Code of Ethics”) replaces the NZICA Code of Ethics (application 07/2017) (“extant Code of Ethics”). Consequently, any references to provisions of the extant Code of Ethics in this Professional Standard should be read as references to the equivalent provisions in the revised Code of Ethics *[noted in square brackets – for ease of reference]*. Where the text of this Professional Standard is not consistent with the revised Code of Ethics, the revised Code of Ethics shall override the text of this Professional Standard.

Introduction

Purpose

1 The purpose of this Standard is to establish standards and to provide guidance on the performance of an independent business valuation engagement and the preparation of an independent business valuation report.

Applicability

2 This Standard applies when a member is providing a business valuation report in the role of an independent business valuer.

3 This Standard does not apply to:

(a) valuation engagements where independence between the business valuer and the appointing party is not asserted, or reasonably assumed by a user of the report;

(b) indicative valuation engagements, where the valuation conclusion is based upon the consideration of limited information provided to the business valuer, with no requirement to assess the reasonableness of the information or to gather further information, provided that the basis on which the valuation conclusion is to be formed is clearly set out in the terms of engagement and any report produced by the business valuer as a result of the engagement; nor

(c) arbitration awards.

4 While the scope of this Standard is limited to independent business valuation engagements by members of the Institute of Chartered Accountants of New Zealand, much of the guidance contained in this Standard may be of relevance to other business valuation engagements and to other business valuers.

5 Compliance with this Standard is mandatory in terms of paragraph 130.1(b) [NZ R113.1(b)] of the *Code of Ethics* issued by the Institute of Chartered Accountants of New Zealand (the Institute).

6 Mandatory provisions are paragraphs in bold type-face in this Standard. Where appropriate, interpretative guidance or commentary paragraphs in plain type-face follow the mandatory provision.

Effective Date

7 This Standard applies to independent business valuation engagements where a member is appointed on or after 1 April 2002.

Definitions

8 For the purpose of this Standard, the following terms have the meanings specified:

Business Interest means shares, business assets, financial instruments or any other interest in a business.

Independent Business Valuation Engagement means a professional engagement in which a member, acting as an independent expert, forms a conclusion on the valuation of a business interest and which leads to the issue of an independent business valuation report.

Independent Business Valuation Report means any written communication containing a valuation conclusion on a business interest, that is issued as a result of an independent business valuation engagement.

Standards for Independent Business Valuation Engagements

General Principles Relating to an Independent Business Valuation Engagement

9 The member must perform an independent business valuation engagement in accordance with the *Code of Ethics* of the Institute.

10 The *Code of Ethics*, contains the Fundamental Principles which guide members of the Institute in the performance of their professional responsibilities, and express the basic tenets of ethical and professional conduct.

The Fundamental Principles are:

Integrity;

Objectivity;

Professional Competence and Due Care;

Confidentiality; and

Professional Behaviour.

11 When expressing an independent business valuation conclusion, a member must be, and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.

Remuneration

12 When performing an independent business valuation engagement, a member must not contract for or accept a contingent fee.

13 A contingent fee is an arrangement whereby no fee is charged unless a specified finding or result is attained, or where the amount of the fee is otherwise contingent on the findings or results of the engagement or on the success of a transaction to which the valuation relates.

Terms of the Engagement

14 The member must obtain the appointing party's agreement to the terms of the engagement. The terms of the engagement must be recorded in an engagement letter, or other suitable form, and communicated to the appointing party.

15 It is in the interests of both the appointing party and member that the member sends an engagement letter, preferably before the commencement of the engagement, to help avoid misunderstandings with respect to the engagement.

16 The engagement letter documents and confirms the member's acceptance of the appointment, the objective and scope of the independent business valuation engagement, the extent of the member's responsibilities to the appointing party and others, if any, the nature and extent of reporting and the basis on which the member will be remunerated.

17 An engagement letter may not be appropriate for a court-appointed valuation. However, the member must ensure that the terms of the engagement are clearly understood and agreed upon.

Planning

18 A member must plan the independent business valuation work so that the engagement will be performed in an effective manner.

19 When planning the extent of work for a particular engagement, the member should obtain:

(a) Sufficient understanding of the purpose and subject of the business valuation. The member should obtain and review all material documentation which bears on the purpose or subject of the business valuation, including agreements, contracts, company constitutions, letters of understanding, letters of intent and other correspondence;

(b) Sufficient understanding of the underlying business operations and assets, including any recent asset valuations;

(c) Sufficient financial information relating to past results, future prospects and present financial position. The information which should normally be obtained and analysed should include:

- prior years' financial statements for up to five years,
- the most recent operating results and cash flows,
- the most recent statement of financial position, including commitments and contingencies, and
- future-oriented financial information such as budgets, forecasts and projections;

(d) Sufficient understanding of the relevant industry in which the underlying business operates. Depending on the nature of the engagement, this analysis might consider the following:

- critical success factors,
- competitors and respective market shares,
- industry regulations,
- new developments,
- environmental issues,
- trading volumes and price ranges of publicly traded shares, and
- comparable market transactions; and

(e) Sufficient information relating to the general economic conditions affecting the underlying business operations. Such information might normally consist of selected rates of return, inflation rates and other general economic indicators.

Use of Another Expert

20 When neither the member nor anyone within the member's firm, has the professional competence to perform a specific part of the independent business valuation engagement, the member must either decline the engagement or seek technical advice from other experts, such as other Chartered Accountants, lawyers, actuaries, engineers, valuers and those knowledgeable in the relevant industry.

21 Although the member may use the work of another expert as valuation evidence, the member retains responsibility for the business valuation conclusion, subject to any exclusion of liability for the opinion of others referred to in the member's report.

22 When planning to use the work of another expert, the member must assess the professional competence and objectivity of that expert.

23 Assessment of the professional competence of another expert will involve considering the expert's:

(a) professional certification or licensing by, or membership of, an appropriate professional body; and

(b) experience and reputation in the field in which the member is seeking assistance.

24 The risk that an expert's objectivity will be impaired increases when the expert is:

(a) employed by the appointing party or the business being valued; or

(b) associated in some other manner with the appointing party or the business being valued, for example, by being financially dependent upon or having an investment in the business.

25 The member must assess the appropriateness and reasonableness of the expert's work as evidence regarding the business interest being valued.

26 The assumptions, criteria and methods used and their application will be determined by the expert. However, the member will need to obtain an understanding of the assumptions, criteria and methods used and consider whether they are appropriate and reasonable, based on the member's knowledge of the business interest being valued.

Performance Standards and Procedures

27 In performing the independent business valuation, the member must determine the appropriate business valuation approach to be employed.

28 In determining the appropriate business valuation approach, the member should consider:

(a) the fair or fair market standards of value; and

(b) the going concern or liquidation bases.

29 Once a business valuation approach has been determined, the member must select the appropriate business valuation techniques to be employed.

30 Appropriate business valuation techniques may include:

(a) discounted cash flows;

(b) capitalisation of earnings;

(c) capitalisation of dividends;

(d) asset realisation;

(e) market comparison-based techniques; and

(f) other recognised industry-specific valuation approaches and benchmarks.

31 The member must consider key business valuation parameters and assumptions.

32 The key business valuation parameters may include the following:

(a) normalising adjustments;

(b) discount rates;

(c) capitalisation rates or earnings multiples;

(d) income tax issues;

(e) discounts and premiums; and

(f) special purchasers.

33 Sufficient evidence must be gathered by such means as inspection, enquiry, computation and analysis to ensure that the business valuation conclusion and the report are properly supported.

34 When determining the extent of evidence necessary to support the business valuation conclusion, the member should exercise professional judgement, considering both the nature of the business valuation and the use to which the report will be put.

35 The member must carry out sufficient enquiries or examinations to establish reasonable grounds for believing that any profit forecasts, cash flow forecasts and unaudited financial results that are used in the valuation, have been prepared on a reasonable basis. If there are material variations in method of analysis or presentation of such information

from that previously used by the business, then the member must adjust for or comment on them in the report.

36 The member should consider obtaining a representation letter from the appointing party and, if possible, a management representation letter from management or other representatives of the underlying business.

37 Representation letters should normally include a general representation that the author of the letter:

(a) has reviewed a draft copy of the report; and

(b) does not have any information or knowledge which would reasonably be expected to materially affect the business valuation conclusion in the report.

38 Representation letters should normally include representations as to the reasonableness of any profit or cash flow forecasts provided to the member and the consistency of preparation of any unaudited financial results provided to the member.

Documentation

39 The member must document matters which are important in providing evidence to:

(a) support the business valuation conclusion;

(b) justify decisions made in the conduct of the engagement; and

(c) demonstrate that the engagement was carried out in accordance with the Professional Standards of the Institute.

Reporting

40 In determining the form and content of the independent business valuation report, the member must consider:

(a) the purpose of the valuation;

(b) the proposed distribution of the report;

(c) the likely level of knowledge of the readers of the report regarding the business interest and business valuation methodologies; and

(d) the commercial sensitivity or confidentiality of the information.

41 After considering the factors above the member will determine that one or more of the following independent business valuation reports should be produced:

(a) a long-form report;

(b) a short-form report; or

(c) a limited distribution report.

42 When the report is intended for use by third parties external to the management or directors of the business, or in the case of a closely held business, external to the management, directors or owners, then the member must produce either a long-form report, a short-form report or both.

43 If the report is not intended or likely to be disclosed to third parties external to the management or directors of the business, or in the case of a closely held business, external to the management, directors or owners, then a limited distribution report may be produced, instead of the long-form or short-form report.

44 A member should treat a report as likely to be disclosed to third parties, unless the member has otherwise restricted the distribution of the report.

45 On occasions the member will deal with complex issues which would require a long-form report of considerable detail and length. On other occasions, the member may need to include

in a long-form report information which is confidential or commercially sensitive. In these circumstances, the member and the appointing party may agree either:

(a) that an initial long-form report is needed but is not appropriate for publication, and that the member should also provide a summary or short-form report for publication; or

(b) that only a short-form report is required.

46 When deciding on whether both a long-form and short-form report are required or whether only a short-form report will suffice, the member and the appointing party should consider any regulatory requirements applicable to the business valuation engagement.

47 When the terms of the engagement require a member to produce both a long-form report and a short-form report, then the short-form report must be consistent with the long-form report, and must be stated to be so. The member must not permit the appointing party to publish a short-form report, without their consent to the form and content thereof.

Circulation of Draft Reports

48 The member should use professional judgement to maintain independence when communicating with the business and its representatives. The submission of a draft report to the business or its representatives should be for the purpose of correction of factual errors only and not for comment or review as to the methodology or business valuation conclusion.

Content of an Independent Business Valuation Report

49 All independent business valuation reports must contain the following basic elements as a minimum:

(a) a statement that the report is an Independent Valuation Report;

(b) identification of the person or persons to whom the report is addressed (refer paragraph 53);

(c) a statement of the purpose of the report and the nature of the member's mandate;

(d) identification of the business interest being valued;

(e) the valuation date (refer paragraph 54);

(f) the date of the report (refer paragraph 57);

(g) a statement of the approach and techniques used and the rationale for their selection;

(h) a statement of the key assumptions on which the business valuation conclusion is based;

(i) a statement as to whether or not any financial information relied on in the valuation has been audited;

(j) appropriate caveats concerning the achievability of forecast results relied on in the valuation;

(k) a statement of any restrictions on the scope of work (refer paragraph 59);

(l) a statement that the engagement has been completed in accordance with Professional Standards of the Institute;

(m) a statement of any interests or relationships (other than that of valuer) between the member, or any expert relied on, and the business being valued or interested parties to the valuation (refer paragraph 60);

(n) the business valuation conclusion (refer paragraph 62);

(o) a statement of any disclaimers of liability and indemnities;

(p) the signature of the member or member's firm, as appropriate.

50 In addition to the requirements of paragraph 49, a long-form report must contain the following:

(a) a description of the business interest being valued;

(b) summary financial information for the business;

(c) a description of the business valuation calculation; and

(d) a statement of the key sources of information relied on (refer paragraph 64).

51 A member producing a short-form report should consider whether summarised information on the additional reporting requirements in paragraph 50 should be included in the short-form report.

52 The level of detail that should be provided in the report may vary depending on the type of report. The readers of a limited distribution report may be presumed to have a detailed knowledge regarding the business interest and may have agreed with the member that detailed supporting narrative is not required for the valuation conclusion. The readers of long-form and short-form reports may not have any such detailed knowledge of the business interest and would likely not have any input into the terms of the engagement. Long-form and short-form reports should therefore contain more detailed disclosure than a limited distribution report. A short-form report is by its nature summarised and contains less detail than a long-form report.

Identification of the Person or Persons to whom the Report is Addressed

53 The report must set out to whom the report is being provided. If the report is a limited distribution report, or is otherwise restricted in its circulation, the restrictions must be prominently stated in the report.

Valuation Date

54 The valuation date is the specific date at which the member is to establish the value of the business interest. In some engagements the member may be asked to establish the value of a business interest at a specific past date. This "valuation date" will generally be the date at which a specific past event, such as a change in ownership of the business interest occurred. In other engagements the member may be asked to determine a value in order to advise on a potential future transaction. In this latter case, it is likely that the "valuation date" and the "date of the report" will coincide.

55 In performing the valuation, the member considers circumstances at the valuation date and events occurring up to the valuation date. Events that occur after the valuation date should not normally be taken into account in forming the business valuation conclusion. An exception is where a member using professional judgement based on the information that would have been available at the valuation date, could at that date have reasonably anticipated or foreseen that the subsequent events or circumstances would arise.

56 In the rare circumstances where events have occurred since the valuation date which would fundamentally alter the value of the business interest, the member should consider including in the report a note describing the nature of the events.

Date of the Report

57 The report must be dated as of the date the member signs the report. That date must be no earlier than the date when pertinent information (including discussions with management or outsiders) was last obtained and analysed.

58 The date the member signs the report is considered to be the date when the business valuation conclusion is formed.

Statement of any Restrictions on the Scope of Work

59 Where the member has been limited in the scope of review or where information provided to the member was incomplete, disclosure must be made of the limitation, the reasons given and, where possible, the potential impact on the business valuation conclusion.

Statement of any Interests or Relationships Between the Member and the Business or Interested Parties to the Valuation

60 A relationship between the member and the business or interested parties to the valuation, other than that of valuer, may be seen to impair the member's objectivity and/or independence. A statement identifying the existence and nature of any such relationships provides information to users of the report that may dispel any concerns as to the member's objectivity and independence.

61 The member's statement as to any relationship with the business or interested parties to the valuation should include:

(a) relevant relationships that may have occurred in the period from two years prior to valuation date up to the date that the report is signed;

(b) direct financial interests and material indirect financial interests;

(c) relevant relationships or interests of the member, the member's firm and the member's immediate family;

(d) relevant relationships or interests of any experts whose work the member has relied on in relation to a significant part of the business valuation;

(e) relevant relationships with and interests in the business, the appointing party, and other parties to any transaction with which the valuation is associated, other than those that are clearly insignificant.

Business Valuation Conclusion

62 The business valuation ranges developed by the different methods used should be compared and discussed. The member may choose to arrive at the overall conclusion of value based on a single business valuation method, or some synthesis of the valuation conclusions determined under different methods. The member should discuss the reasoning in support of the final business valuation conclusion.

63 The complex valuations in a report often contain significant uncertainties. When this is the case a member who gives a single point value may imply spurious accuracy to the valuation. A member should, however, give as narrow a range of values as possible. A report becomes meaningless if the range of values is too wide. A member should indicate the most probable point within the range of values if it is feasible to do so.

Statement of the Key Sources of Information Relied On

64 A long-form report should include a clear summary of the specific information which was reviewed and relied upon, including a description of the steps taken to assess its reliability. Such disclosure might consist of the documents reviewed, the individuals interviewed, the facilities visited, other expert reports (including business valuation reports or consulting studies carried out in the relevant preceding period) and management representations concerning budgets, projections and interim financial statements.

Appendix

Comparison of AES-2 with International ~~and Australian Standards~~

Neither the International Federation of Accountants ~~nor the Australian accountancy bodies~~ have issued any Standards on independent business valuation engagements.

Acknowledgements

The Institute acknowledges the assistance of the Canadian Institute of Chartered Business Valuators (CICBV) in the preparation of this Standard. The CICBV can be contacted through their Web site at www.businessvaluators.com.