TRANSACTION & VALUATION SERVICES

VALUATION ALERT ISSUE 001/2023

Common Valuation Pitfalls – Part I

The valuation of businesses and assets is integral in financial reporting, IPOs and transactions. Over the years, the HKEX, the SFC and the HKICPA published their views and findings on the common issues identified in the valuation profession and the valuations prepared for financial reporting and transaction purposes. In this article, we briefly summarise the authorities' concerns and five common valuation pitfalls for which valuation practitioners and users should remain vigilant. We will continue to discuss other common valuation pitfalls in our upcoming publications.

HKEX's concerns[1]

The fairness of the reported value of assets. Auditors reported insufficient documentation to justify the assumptions adopted in the asset valuations due to, for example, insufficient historical financial information to support the assumptions used in financial forecasts.

It's found that some issuers omitted to disclose the quantitative information about the significant unobservable inputs and the reasons for the change in valuation technique used in the current year.

SFC's concerns[2]

Lack of independent judgment and accountability:
In some cases where an independent professional valuation was obtained, the directors simply relied on the vendors' forecasts in assessing the consideration for the target businesses. The valuers merely assumed without performing any due diligence or other work that the vendors' projections would materialise. Some valuers completely disclaimed their liabilities for the reliability of the projections.

Quality of earnings:
Analyses of the quality of the target businesses' earnings were not performed and apparent risk factors, such as historical losses, sudden and unexplained increases in sales, unjustifiably high margins compared to industry peers, suspicious non-recurring items and apparently questionable or unsustainable sources of revenue, were largely ignored.

Fair presentation of comparable companies:
Valuers and directors must use their judgment to select companies that have suitably similar characteristics to the target company and ensure that the comparables referred to in the valuation constitute a fair and representative sample. The SFC noted that the directors "cherry-picked" companies that had higher trading multiples and disregarded others with poorer performance. Moreover, the companies chosen for comparison had significantly longer and more profitable track records than the target companies but no adjustments were made.

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1 *Review of Issuers' Annual Reports 2021* https://www.HKEX.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Exchanges-Review-of-Issuers-Annual-Disclosure/rdiar_2021.pdf

2 *Statement on the Conduct and Duties of Directors when Considering Corporate Acquisitions or Disposals, July 2019* https://www.sfc.hk/en/News-and-announcements/Policy-statements-and-announcements/Statement-on-the-Conduct-and-Duties-of-Directors-when-Considering-Corporate-Acquisitions

HKICPA's concerns[3]

- Too many valuers lack sufficient business valuation training, experience, and knowledge of the businesses they are valuing.
- Valuations are not required for certain corporate transactions but are still provided as window dressing to support flawed assumptions and deal structures.
- Lack of professional skepticism by some company directors, financial advisors, auditors and valuers themselves leads to a lack of independence and fosters an image of the "valuer for hire".
- Inexperienced valuers are sometimes insufficiently supervised by experienced valuers.
- Financial reporting is a low priority for quality reporting.

Common pitfall #1 - Inappropriate application of basis of value

For every business valuation, the basis of value should be chosen according to the purpose of the valuation assignment. In practice, this could also mean choosing a particular valuation approach, which could vastly alter the valuation results. Some common basis of value are listed below:

Fair Value (HKFRS 13)	"The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"
Value-in-use (HKAS 36)	"The present value of the future cash flows expected to be derived from an asset or cash-generating unit which is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets"
Fair value less costs of disposal (HKAS 36)	"The arm's length sale price between knowledgeable willing parties less costs of disposal"
Market Value (IVS 104)	"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"
Investment Value (IVS 104)	"The value of an asset to a particular owner or prospective owner for individual investment or operational objectives"
Liquidation Value (IVS 104)	"It is the amount that would be realised when an asset or group of assets are sold on a piecemeal basis. Liquidation value should take into account the costs of getting the assets into saleable condition as well as those of the disposal activity"

For example, to value a business for investment purposes, investment value could be an appropriate basis of value for an internal assessment and feasibility study of a proposed transaction. Under such a basis, factors such as synergetic effect should be considered in the valuation. However, it is quite common that such a synergetic effect is overestimated, which renders the acquirer paying a high consideration for the transaction. Alternatively, to value a business or transaction for public documentation purposes, the fair value or market value would be the appropriate basis of value where a target business is assessed on an arm's length and market participants' basis to ensure (minority) shareholders' interests are reasonably safeguarded.

Where the purpose of a valuation is an impairment assessment following HKAS 36 – *Impairment of Assets*, an asset's recoverable amount should be determined as the higher of its fair value less costs of disposal ("FVLCOD") and its value-in-use. These two valuation bases involve vastly different valuation approaches and considerations. For example, value-in-use is derived with the Income Approach for the net present values of the estimated future cash flows relating to a cash-generating unit. On the other hand, FVLCOD is preferably derived with the Market Approach by referencing quoted prices of similar assets in an active and open market or the considerations of recent similar transactions.

[3] *Hong Kong Business Valuation Quality Initiative, July 2019* https://www.hkicpa.org.hk/-/media/HKICPA-Website/New-HKICPA/News/Hong-Kong-Business-Valuation-Quality-initiative/ConsultationPaperProposedStandardsandProfessionalismFrameworkforBusinessValuationintheHongKongMarket.pdf

In some valuations we reviewed, impairment tests are incorrectly prepared based on the fair value instead of the value-in-use or FVLCOD as stipulated in HKAS36. Fair value and FVLCOD should differ in the direct incremental costs attributable to the disposal of an asset. Comparing to the fair value, value-in-use must be performed using the discounted cash flow method, which typically considers a cash flow projection period of 5 years or a justifiable asset's useful life. It should also exclude expansionary capital expenditures for any asset enhancement. It is apparent that merely recording impairment loss by taking reference from the fair value does not serve and fully comply with the purposes and requirements of the accounting standards.

Common pitfall #2 - Manipulation of premiums and discounts

Premiums and discounts are applied by valuers to make individual adjustments to valuation targets. Common premiums and discounts include the control premium, discount for lack of control ("DLOC") and discount for lack of marketability ("DLOM"), as explained below:

Control Premium	DLOC	DLOM
• A premium that a buyer is willing to pay extra as compared to the current market price for acquiring a controlling interest in a specific company	• A discount that adjusts the price obtained by assuming a control perspective	• A discount applied to a privately held stock, to reflect the lack of marketability as compared to listed stocks that are actively traded
Common sources of reference:		
• "FactSet Control Premium Study" published by Business Valuation Resources, LLC • M&A transaction record from Bloomberg, Wind, etc. • Internal research of disclosed transactions, i.e. the acquisitions of majority control and privatisation of companies	• Implied from the Control Premium with the below formula: $DLOC = 1 - \frac{1}{1 + \text{control premium}}$ • Mergerstat® Review by FactSet Mergerstat, LLC	• "Stout Restricted Stock Study Companion Guide" published by Stout Risius Ross, LLC • Black-Scholes Option Pricing Model • Pre-and post-IPOs valuation studies

While these parameters may significantly impact valuation results, the adopted magnitudes in valuations are often subject to valuers' judgement and lack justifications. It is worth noting that adopting different sources of reference for valuations of the same asset across different valuation dates, or using outdated sources of reference, could be signs of manipulating the valuation results using these premiums and discounts.

(About the DLOM and DLOC, we regularly publish our research and summary of the sources and figures adopted by different valuers for published transactions of Hong Kong-listed companies. For details, please see https://www.moore.hk/publications.)

Common pitfall #3 - Insufficient support for financial projections

Financial projections are the key driver of the valuation results under the Income Approach, but their quality is often overlooked, even for businesses with limited trading records. In practice, most valuers prepare financial projections primarily relying on the business outlook and performance foreseen and projected by their valuation clients or the vendors of the valuation subjects.

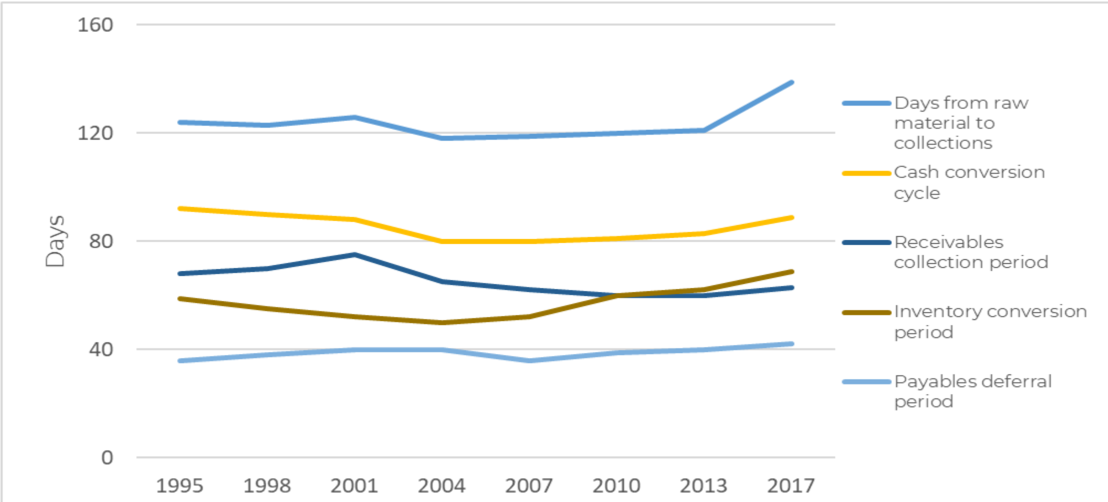
Unfortunately, these financial projections are often overly optimistic regarding revenue growth and profit margins. Still, valuers tend to make minimal adjustments to them which would result in inflated valuations. We believe that macroeconomic and entity-specific factors should be diligently analysed and considered for any financial projections. Particularly, forecasted revenue should be verified with sales contracts or supported by a sound business plan. Also, whether the counterparties of the contracts are independent or related parties should be questioned for newly entered contracts. In reality, huge consecutive year-on-year growth and a significant increase in profit margins are not easily attainable and sustainable.

Valuers should maintain professional scepticism on the financial projections and duly communicate with their clients to obtain fair and reasonable financial projections and valuation results.

Common pitfall #4 - Underestimating the needs for working capital in financial projections

Under the Income Approach, a firm's value is derived by discounting the projected cash flows, of which one of the components is the changes in net working capital ("NWC"), or simply working capital, between years. While such changes can subtly tell the soundness of the business growth and may significantly impact the valuation results, they typically draw lesser attention than other components such as revenue and earnings.

An analysis of the cash conversion cycle of the subject business, which studies the historical turnover days of receivables, payables and inventories, is usually performed to derive the level of working capital required in each forecast year. These turnover days remain generally stable over the years, as shown in the below chart:



Source: Raw Material collected from "My Worst Investment Ever Podcast on 30 March 2022 by Andrew Stotz, PhD, CFA", Moore's working

In case the historical figures fluctuate, references might be made to those of its industry peers. The overall aim of this analysis is to understand how much working capital could be "financed" by the business itself versus how much external finance is required. The following questions are how and how much this external finance will be. From our experience, instead of long-term borrowings, short-term borrowings are often projected to net off the changes in NWC in the forecast period. This is difficult to happen in practice and further investigation into the subject's financing activities is necessary.

Common pitfall #5 - Lack of justifications for the company-specific risk in the WACC

Under the Income Approach, the valuation subject's weighted average cost of capital ("WACC") is usually adopted as the discount rate for discounting the projected cash flows to present values. A WACC is composed of the cost of equity and the cost of debt which are weighted according to the subject's capital structure. A key parameter for deriving the cost of equity, and hence the WACC, is the company-specific risk which can vary from 0% to over 10% from the valuations we have reviewed.

One should note that the compounding effect of an even minor addition or deduction in the WACC could be huge, especially for the cash flow projections in later years. Unfortunately, the company-specific risk is commonplace that valuers provide neither quantitative nor qualitative justifications for the magnitude they chose to adopt, not to mention if there is any industry or literature support.

Adopting a quantitative model to derive an appropriate company-specific risk for a valuation subject is challenging as each valuation subject is unique and most assessments, such as assessment on corporate governance, are qualitative. However, the derivation of a proper company-specific risk should typically account for the followings items which could affect investors' investment decisions:

- **Soundness of internal control and corporate governance**
- **Diversification of customers/suppliers**
- **Geographical diversification of sales**
- **Major outstanding litigation case(s)**
- **Stability of controlling shareholders/key management**
- **Exposure to sanctioned countries**
- **Economic factors of primary markets**
- **Stability of historical business performances**

Conclusion

Valuation issues tend to arise when there is a wide variety of valuation methodologies, approaches, and parameters available. To safeguard the stakeholders' interests, practitioners and users of valuations should stay vigilant to the accounting and valuation standards and beware of the common pitfalls in valuation. We will continue to discuss other common valuation pitfalls in our upcoming publications.

How we can help?

Moore Transaction & Valuation professionals advise clients of any size, from small owner-managed businesses to mid-sized quoted companies and large corporates. Harnessing our local expertise and cross-border capability of our global network, we have built a strong and proven track record of providing advisory services to businesses across a wide variety of industry sectors. Should you wish to obtain guidance on various types of valuations, financial due diligence and other transaction advisory matters, please do not hesitate to contact us.

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