भारतीय दिवाला और शोधन अक्षमता बोर्ड
Insolvency and Bankruptcy Board of India

IOV RVF

SECURITIES OR FINANCIAL ASSETS

VALUATION - SUBJECTS

SECURITIES OR FINANCIAL ASSETS

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IOV Registered Valuers Foundation

This material has been prepared in accordance to the syllabus prescribed by IBBI and for the sole purpose of being the referral study material to the 50 hours Mandatory Education Programme.

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IOV Registered Valuers Foundation
Plot. No.3, 2nd Floor, Aggarwal Square,
LSC JN, 80Ft Rd, Parwana Road,
Pitampura, Delhi-110034.

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Vinay Goel	**Tanuj Kumar Bhatnagar**
Managing Director & CEO	Director

भारतीय दिवाला और शोधन अक्षमता बोर्ड
Insolvency and Bankruptcy Board of India
सत्यमेव जयते
Dr. M. S. Sahoo
Chairperson
7th Floor, Mayur Bhawan, Connaught Place
New Delhi-110001 Tel: +91 11 23462801
E-mail: chairperson@ibbi.gov.in Web.: www.ibbi.gov.in

Preface

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Institutions are the foundations of a well-functioning market economy. Professions constitute a key element of the institutional framework. The nature and extent of professionalisation, to a large extent, determines the competitive edge of nations and sustainability of prosperity.

2. In a market economy, market discovers the price, which usually reflects the worth of an asset (or a liability). It discovers different prices for the same asset in different contexts. Thus, price is not absolute; it is context specific. Often it is neither feasible nor desirable to go through the market to discover the worth of an asset. In such cases, worth of an asset is estimated by a professional outside the market. The worth so estimated is 'value', which is what the price ought to be in the same context. If value of an asset is equal to its price, the valuation or value estimated is considered perfect. It requires specialised knowledge, considerable dexterity and the highest integrity on the part of a professional to take the asset through a simulated market in the given context to estimate its value, which is very close, if not equal, to the price. A market economy needs a cadre of such professionals for valuations of a variety of purposes.

3. The valuation profession has a long history in India. Different statutes and authorities require valuation for different purposes and often prescribe the manner of such valuation. There have been several attempts in the past to develop holistically an institutional arrangement that develops and regulates the profession of valuers who can estimate the value of any asset with full responsibility. It took a concrete shape with enactment of the Companies Act, 2013. Section 247 of the Act provides that where valuation is required to be done under the provisions of the Act, it shall be valued by a person who, having the necessary qualifications and experience, and being a valuer member of a registered valuer organisation (RVO), is registered as a valuer.

4. The Central Government notified the commencement of section 247 of the Companies Act, 2013 with effect from 18th October, 2017. It also notified the Companies (Registered Valuers and Valuation) Rules, 2017 (Rules), which provide for a complete framework for development and regulation of the profession of valuers and manner of valuation, including Valuation Standards and Code of Conduct for Registered Valuers. The Central Government delegated its powers and functions under section 247 of the Act to the Insolvency and Bankruptcy Board of India (IBBI) and specified the IBBI as the Authority under the said Rules.

5. Subject to meeting other requirements, an individual is eligible to be a Rregistered Valuer, if he (i) is a fit and proper person, (ii) has the necessary qualification and experience, (iii) is a valuer member of an RVO, (iv) has completed a recognised educational course as member of an RVO, (v) has passed the valuation examination conducted by the IBBI, and (vi) is recommended by the RVO for registration as a valuer. A partnership entity or a company is also eligible for registration subject to meeting the requirements. The Rules prescribe that with effect from 1st February, 2019, every valuation required under the Companies Act, 2013 and the Insolvency and Bankruptcy Code, 2016 needs to be conducted by valuers registered with the IBBI.

6. The IBBI performs the functions of the Authority under the Companies (Registered Valuers and Valuation) Rules, 2017. It recognises RVOs and registers valuers and exercises oversight over them. It has published the syllabus, format and frequency of the valuation examination for all three Asset Classes, namely, (a) Land and Building, (b) Plant and Machinery, and (c) Securities or Financial Assets, in consultation with the stakeholders. It conducts computer-based online valuation examinations every day from several locations across the country for all three Asset Classes. It has specified the details of educational course for the three Asset Classes, which a member of an RVO is required to complete before taking the valuation examination.

7. The international market is offering a large variety of books, and training programmes for individuals wishing to become valuation professionals or provide any service in the valuation chain. However, there is scope for improving the quality of study material and faculty in Indian context. It is necessary to supplement the efforts of RVOs and the registered valuers - existing and prospective - by making available quality study material relevant to Indian context.

8. The IOV Registered Valuers Foundation (IOV RVF) has developed this study material as per syllabus of the valuation examination for Asset Class - Securities or Financial Assets. I compliment the IOV RVF and the Authors, Subject Editors and Language Editors for putting in very hard work to prepare such comprehensive study material for the benefit of valuation profession. I thank the IOV RVF for its offer to place this study material on the website of the IBBI for free download by users. I am sure, this study material will greatly support development of the fledgling valuation profession in the country and will be useful to those who wish to learn the subject, practise as a professional valuer or provide any other service in the valuation chain. It will motivate more inquisitive minds to delve deeper into various aspects from an interdisciplinary perspective, enriching the Indian literature on valuation in the days ahead.

9. The IBBI, however, does not validate the adequacy, in terms of quality or otherwise, of this study material for any purpose, including preparation for valuation examinations, or any person to take any action or decision, commercial or otherwise, by using this study material. It urges the reader to do her own research and / or seek professional guidance as she may consider necessary for her purpose, while using this study material.

M. S. Sahoo

(Dr. M. S. Sahoo)

A WORD FROM OUR CHAIRMAN

IOV-RVF initiated the training programme for Registered Valuers in India. It brought out a collection of study material last year for the student members of IOV-RVF. The study material predominantly included the IBBI indicated syllabus and was provided to about 3000 members or more who have undergone the IOV-RVF training. The study material was appreciated by faculty members & students alike.

It is pertinent to mention here that the contents of the entire study material were the result of many years of facilitating, researching and contributions of eminent & learned members of the Institution of Valuers (IOV), which has a legacy of 50 golden years of enriching its members by way of monthly journals, seminars, workshops and lectures etc.
Our government through Ministry of Corporate Affairs (MCA) and the regulating authority (IBBI) is continuously making efforts to upgrade the valuation profession by way of amending the rules, and otherwise in respect of registration, valuation examination including syllabus/course curriculum, eligibility requirements and functions of the valuers etc., in consultation with the Registered Valuer Organisations (RVOs) in their monthly meetings held regularly with IBBI.

Due to ever changing hues of valuation arena, developments under IBC, implementation of Companies (Registered Valuers & Valuation) Rules, 2017 and change in examination syllabus for the valuation examination conducted by IBBI, it has become important for IOV-RVF to improvise the content of its study material to upgrade it as per changed environment. It is now the appropriate time to recreate the existing material in a book form for the benefit of aspiring valuers. IOV-RVF believes that a book form can at best be considered as a window to never-ending expanse of knowledge in valuation world.

Valuation involves understanding of vide range of subjects including law, economics, technology, business management etc. that a single person is often found inadequate in producing a comprehensive book on subject. IOV-RVF thought it appropriate to include more number of domain experts to contribute to the book so as to overcome this limitation. The result is a vantage point view of valuation practice in India, cumulating the first hand experience of practicing valuers and domain experts. It is pertinent to understand that valuation is based on scientific methodology encompassing interdisciplinary fields such as engineering, finance, economics, law, social science statistics etc.

The prime motive of valuation method is to understand ways to arrive at conclusive figures to accommodate all the benefits and liabilities that can accrue to owner of property. Accordingly, in order to understand what it means to carry on the profession of valuation, students must develop both a foundation of valuation as a subject and an understanding of the critical issues of the valuation profession. This book provides a framework for learning these necessary topics in a way that emphasizes the uniqueness of each topic and each chapter as per the syllabus. The text also lays emphasis on the necessary skills in building and maintaining the Valuation profession in order to make valuations as per the valuation standards and conducting the valuation assignments in the professional and ethical manner, which is the essence of the government's efforts in institutionalizing and regulating the valuation profession.

This book is primarily aimed at training the aspiring valuers for qualifying IBBI exam by providing them ample opportunities to understand the concepts and absorb first hand experiences which have been illustrated by way of Case Studies and examples.

A structured approach has been followed so that the reader is be exposed to General Valuation Practices in India, its role in corporate valuation, IBC-2016 and other statutory requirements under Companies Act-2013, Valuation methods, Valuation Standards, professional and ethical standards, valuation related laws, economics, understanding of case studies, case laws in valuation, environmental issues concerning valuation and report writing. The book primarily focuses on the indicative syllabus as prescribed by IBBI for the purpose of valuation examination.

This book places a clear emphasis on Valuers' understanding for need of ethics, its role towards fellow professionals and the society at large. Valuers' sensitivity to environmental issues that may create or destroy value of asset has been detailed and amply highlighted. Entire chapter has been contributed to report writing in line with Valuation Rules.

Valuers' task of identifying various interests in property, methods of calculating the monetary value of such interests, marketing propositions of such valued interests under various situations of business cycle have been adequately addressed in this book.

Lastly, since the subject is ever-evolving it shall be our endeavor to incorporate the updated developments on issues related to valuation in our forthcoming editions.

Dr. Goutam Sengupta
Chairman, Governing Board
IOVRVF

CONTENT

MACROECONOMICS | 01

2. National Income Accounting
3. Fiscal Policy
4. Monetary Policy
5. Understanding Business Cycle

MACROECONOMICS | 01

1. NATIONAL INCOME ACCOUNTING

Economics is a branch of knowledge concerned with studying production, consumption and transfer of wealth. According to Robbins, **"Economics is the science which studies human behavior as a relationship between given ends and scarce means which have alternative uses."**

The study of economics is broadly divided into two categories- **Microeconomics and Macroeconomics.** Microeconomics is the study of individual economic behavior whereas macroeconomics studies the economic behavior of the entire country. Microeconomics studies the decisions made by people and businesses with regards to allocation of resources and price determination. Macroeconomics, on the other hand, studies national aggregates and nationwide policies that affect the economy as a whole. For example, microeconomics studies how firms behave in certain economic conditions, like inflation. Macroeconomics studies the forces that lead to such economic condition, like expansionary monetary policy that causes inflation. Both these branches of economics are interdependent and have an influence on each other.

Understanding how national income is created and accounted for is the starting point of macroeconomics. According to Marshall, "The labor and capital of its country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial, including services of all kinds. This is the true net annual income or revenue of the country or national dividend. Thus, national income is defined as the total value of all the final goods and services produced in a country within a specific period of time, usually one year. The national income identity is that the amount received as national income is identical to the amount spent as national expenditure which is identical to what is produced as national output. Thus, throughout the course of studying macroeconomics, the terms income, expenditure and output are interchangeable. Each of these variables can be used to measure national income differently.

National Income consists of various concepts, with each relating todifferent methods of measurement. We will have a look at some of these concepts and methods of measuring national income in the following chapter.

NATIONAL INCOME ACCOUNTING INCLUDES

1. Gross Domestic Product
2. GDP at Factor Cost
3. Net Domestic Product
4. Nominal and Real GDP
5. GDP Deflator
6. Gross National Product
7. GNP at Market Price
8. GNP at Factor Cost
9. Net National Product
10. NNP at Market Price
11. NNP at Factor Cost or National Income
12. Domestic Income
13. Private Income
14. Personal Income
15. Disposable Income
16. Real Income
17. Per Capita Income

NATIONAL INCOME AS A STOCK AND FLOW CONCEPT

1. It refers to the value of an asset at a balance date (point of time), while flow refers to the total value of transactions (income, expenditure, sales, purchases) during an accounting period.
2. Stock refers to a quantity of commodity accumulated a point in time. The quantity of the current production of the company which moves from the factory to the market is called flow.
3. Number of turnovers= $\frac{\textbf{Flow Value of an Economic Activity}}{\textbf{Average Stock Value}}$
4. Two types of Macroeconomic Aggregates:

Stock

- Stock of Capital 'K' is a timeless concept
- Stock is always specified for a specific moment.
- It is an economic variable relating to time

Flow

- Flow refers to income, output, consumption and investment
- A flow variable has the time dimension, it is specified for a unit of time

CONSUMPTION OF GOODS IN AN ECONOMY

1. Consumption of goods and services refers to the quantity of them utilised in a particular time period.
2. Consumption drives the transaction of goods and services, for without demand for consuming goods and services, there would be no supply. It is the intensity of consumer demand which drives the prices.

Let's look at the two main types of goods found in an economy while accounting for national income:

Final Goods	Intermediate Goods
Final goods refer to those goods that are used either for consumption or investment.	Intermediate goods refer to those goods that are used either for resale or for further production that year.
Goods purchased by consumer households for final consumption are included in final goods.	Producer goods or semi-finished goods are included in intermediate goods.
Goods purchased by firm for capital formation or machinery are included in final goods.	These goods are sold between industries for resale and for production of consumer goods.
Final goods are not resold or used for any further transformation in the process of production.	Intermediate goods are used and transformed as inputs in the process of production, thus leading to the production of consumer goods.

CAPITAL

1. In economic terms, capital consists of anything that can enhance a person's power to perform economically useful work.
2. It is an input in the production function.
3. According to Adam Smith, the Father of Economics, capital is "that part of a man's stock which he expects to afford him revenue".
4. At any given point in time, capital stock can be used to refer to the total physical capital owned by a firm.

GROSS DOMESTIC PRODUCT

1. Gross Domestic Product (GDP)refers to the total value of goods as well as services produced in a country during a year.
2. It is calculated at market prices and is known as GDP at Market Prices.
3. In the calculation of GDP, the following goods and services are excluded:
    - Value of intermediate goods
    - Transfer payments
    - Second hand goods
    - Goods dealt in parallel economy
4. Dernberg defines GDP at market price as "the market value of the output of final goods and services produced in the domestic territory of the country during an accounting year."
5. There are three different ways to measure GDP at market price. They yield the same result because National Product = National Income = National Expenditure.

THE THREE WAYS TO MEASURE GDP

Product Method	Nominal GDP	Real GDP
Value of all goods and services produced in different industries during a year is added up	GDP by income is a sum of all the factor incomes, i.e. the income people receive due to the production of GDP.	GDP by expenditure method at market price is calculated as: C + I + G + (X - M)
Also known as Value Added Method	The factors of production are land, labor, capital and entrepreneur. They each earn rent, wages, interest and profits respectively.	Here, C= consumption expenditure, I= investment in fixed capital, G= government expenditure, and, (X- M)= net exports, which can be positive or negative.
It includes all the 3 sectors of the economy- primary, secondary and tertiary. For eg: agriculture and allied services, mining, manufacturing, construction, electricity, gas and water supply, transport, communication, trade, banking and insurance, real estate, public administration, defense and other services.	Thus, this method includes the rewards of each factor of production.	**Note: Can you please specify what are those four factors? I can't find any accurate factors on the net.**

GDP AT FACTOR COST

1. GDP at Factor Cost is the sum of net value added by all the producers in a country.
2. It is the sum of domestic factor incomes and fixed capital consumption.
3. So, GDP at factor cost = Net Value Added + Depreciation
4. It includes:
   - Compensation of employees (wages, salaries)
   - Operation Surplus (Gross Value Added at factor cost – Compensation of Employees-Depreciation)
   - Mixed income of self-employed
5. To calculate GDP at factor cost, indirect taxes are subtracted from the GDP at market price, and subsidies are added to the same. The formula can be termed as:
   - GDP at factor cost = GDP at market price – Indirect Taxes + Subsidies.

6. In India now, due to the changes made by CSO, National Income is now also calculated using GVA (Gross Value Addition) at basic price, which takes into account the value of intermediate goods, government subsidies and indirect taxes like GST. Now, all the industry estimates are calculated and presented using GVA at basic prices.

NET DOMESTIC PRODUCT

1. NDP is the value of the net output of the economy during a year.
2. We arrive at NDP when the value of capital consumption, or, the wear and tear of capital goods, is deducted from the GDP.
3. Thus, NDP = GDP at factor cost – Depreciation.

NOMINAL AND REAL GDP

1. Let us first understand the concept of base year, because real GDP can be calculated only with the help of a base year. The base year acts as a standard year against which the recent economic activity can be compared. It is set to an arbitrary level of 100 for easy comparison.
2. A base year is a year which is not very far from the recent years and accounts for little to no economic instability or fluctuations
3. In India, FY 2011-12 is used as the base year for GDP computation.

Nominal GDP	Real GDP
When GDP is measured at its current price, it is called GDP at current prices or nominal GDP.	When GDP is calculated on the basis of fixed prices in some year, it is called GDP at constant prices or real GDP.
Nominal GDP does not accommodate the rising and falling prices. For example, due to inflation, GDP will be high for that particular year. However, that is not indicative of economic growth. In fact, the actual GDP would have decreased, and the increase is only because of the rising inflation.	Real GDP rectifies the overestimation and underestimation of GDP by choosing a base year with a normal general price level. The prices are set to 100 (or 1) for base year. Real GDP $= \text{GDP for Current Year x } \dfrac{\text{Base Year (100)}}{\text{Current Year Price Index}}$

GDPDEFLATOR

1. GDP Deflator is an index of price changes of goods and services included in the GDP.
2. It is calculated by dividing the Nominal GDP in a given year by the real GDP for the same year and multiplying it by 100.
   3. Thus, GDP Deflator $= \frac{\text{Nominal GDP}}{\text{Real GDP}} \text{ x } 100$
   4. For example, GDP Deflator in 1997-98 = $\frac{1426.7 \text{ crores}}{1049.2 \text{ crores}} x\ 100$ = 135.9
      i. This shows that at constant prices (1993-94), GDP in 1997-98 increased by 135.9% due to inflation.

GROSS NATIONAL PRODUCT

1. GNP is the total measure of the flow of goods and services at market value resulting from current production during a year in a country, including income from abroad.
2. GNP = C + I + G + X + Z
3. Here, C= consumption expenditure, I= investment expenditure, G= government expenditure, X= net exports (imports-exports) and Z= net income earned by domestic residents from foreign investments – net domestic income earned by foreign residents.
4. Thus GNP takes into account net income receipts from abroad, which is not accounted for in GDP computation.
5. GNP includes four types of final goods and services:
   - Consumer goods to satisfy immediate wants of the people
   - Gross private domestic investment in capital goods consisting of fixed capital formation, residential construction and inventories of finished and unfinished goods.
   - Goods and services produced by the Government
   - Net exports of goods and services i.e. difference between the value of exports as well as imports of goods and services.
6. In the concept of GNP, there are certain factors that need to be taken into consideration. They are as follows:
   - GNP is the measure of money. All kinds of goods and services produced in a year in a country are measured in monetary terms at current prices and then added together. To guard against the overestimation or underestimation of GNP due to inflation or deflation, a year with normal prices is taken as base year and GNP at constant prices is calculated in accordance with the index number of that year.
   - The money value of only the final goods and services is taken into account while calculating GNP. This is done to avoid double counting.
   - Goods and services rendered free of charge are not included in GNP since it is not possible to have a correct estimation of their market price.
   - The sale and purchase of old goods, assets, shares and bonds of existing companies is not included in GNP since they are simply transfer goods and make any addition to the national produce of that year.

- The payments made for social security such as pensions, unemployment insurance, interest on public loans, etc. are not included in GNP since there no services offered in lieu of them.
- If they are not responsible for current economic production, the profits or losses incurred on account of changes in capital assets as a result of price fluctuations are not included in GNP.
  - The income earned through illegal activities is not included in GNP.

GNP AT MARKET PRICE

1. GNP at market price refers to the gross value of all the final goods and services produced annually in a country plus net income from abroad.
2. When we multiply the total output produced in one year by their market prices prevalent during that year, we get GNP at market prices.
3. Gross National Product (GNP) at market prices = Gross Domestic Product (GDP) at market prices + Net Income from abroad

GNP AT FACTOR COST

1. GNP at factor cost is the sum of the money value of the income produced by and accruing to the various factors of production in one year in a country.
2. It is the income that the factors of production receive in return for their services alone. It is the cost of production.
3. It includes all the items mentioned under the income method of GNP less indirect taxes plus subsidies.
4. So, Gross National Product (GNP) at factor cost = GNP at market prices – Indirect Taxes + Subsidies

NET NATIONAL PRODUCT

1. NNP includes the value of total output consumption goods and investment goods.
2. For calculating Net National Product (NNP), there is deduction of depreciation from GNP. The word ‘net’ indicates the exclusion of that part of total output which represents depreciation.
3. During the process of production, some fixed equipment wears out, its other components are damaged or destroyed, or still others are rendered obsolete through technological changes. This process is known as depreciation or capital consumption allowance.
4. NNP = GNP – Depreciation
5. NNP is the same as National Income or National Output.

NNP AT MARKET PRICE

1. NNP at market price is the net value of final goods and services evaluated at market prices in the course of one year in a country.
2. Deducting depreciation from GNP at market prices results in NNP at market price.
3. Thus, Net National Product (NNP) at market prices = GNP at market prices – Depreciation.

NNP AT FACTOR COST

1. NNP at factor cost is the net output evaluated at factor prices.
2. It includes income earned by factors of production through participation in the process of production such wages, rent, interest and profits.
3. NNP at factor cost is also called as National Income
4. To arrive at NNP at factor cost, indirect taxes are subtracted and subsidies are added to NNP at market price.
5. Thus, NNP at factor cost = NNP at market price – Indirect Taxes + Subsidies
6. = GNP at market price – Depreciation – Indirect Taxes + Subsides
7. = National Income
8. NNP at factor cost is higher than NNP at market price when indirect taxes exceed government subsidies. However, NNP at factor cost is lesser than NNP at market price when government subsidies exceed indirect taxes.

DOMESTIC INCOME

1. Income generated by the factors of production within the country from its own resources is called domestic income or domestic product.
2. It includes:
   - Wages and Salaries
   - Rents, including imputed house rents
   - Interest
   - Dividends
   - Undistributed corporate profits, including surpluses of public undertakings
   - Mixed incomes including profits of unincorporated firms, partnerships, self-employed persons, etc.
   - Direct taxes
3. Domestic income does not include income from abroad. Therefore,
4. Domestic Income = National Income – Income earned from Abroad
5. Thus, National Income = Domestic Income + Income earned from Abroad

PRIVATE INCOME

1. Private income is the one obtained by private individuals from any source, which is productive or otherwise, and the retained income of corporations.
2. Private Income = National Income (NNP at factor cost) + Transfer Payments + Interest on Public Debt – Social Security – Profits and Surpluses of Public Undertakings

PERSONAL INCOME

1. Personal Income is referred to as total income received by individuals of a nation from all sources, before payment of direct taxes in a year.
2. Personal income is not equal to national income, because, the latter does not include transfer payments that are included in the former.
3. Personal Income = Private Income – Undistributed Corporate Profits – Profit Taxes

DISPOSABLE INCOME

1. Disposable income or personal disposable income means the actual income that can be spent on consumption by individuals and families.
2. For calculation of disposable income, direct taxes are subtracted from the personal income. Thus, Disposable Income = Personal Income – Direct Taxes
3. Thus, Disposable Income= National Income – Business Savings – Indirect Taxes + Subsidies – Direct Tax on Persons – Direct tax on Businesses – Social Security Payments + Transfer Payments + Net Income from Abroad

REAL INCOME

1. Real Income is the national income represented with regards to a general level of prices of a particular year taken as base.
2. National income is the value of goods as well as services produced, as represented in terms of money at current prices. However, it does not include the real estate economy

PER CAPITA INCOME

1. The average income of the people of the country within a year is called Per Capita Income.
2. This concept also includes the measurement of income at current prices and constant prices.
3. $\text{Per Capita Income of Year X} = \frac{\text{National Income of Year X}}{\text{Population of Year X}}$
4. $\text{Real Per Capita Income of Year X} = \frac{\text{Real National Income of Year X}}{\text{Population of Year X}}$

METHODS OF MEASURING NATIONAL INCOME

1. There are four methods for measuring National Income. They are- Product Method, Income Method, Expenditure Method and Value-Added Method.
2. The method used to measure national income depends on the availability of data in a country and purpose at hand.

Product Method	Income Method	Expenditure Method	Value Added Method
The total value of final goods and services produced in a year is calculated at market prices. The data of all productive activities is collected and assessed at market prices.	The net income payments received by all the citizens of a country are added up i.e. net income that accrue to all factors of production byway of net wages, net rent, net interest and net profit. The data is collected from different sources.	Total expenditure incurred by a nation is summed up together and includes net domestic investment, personal consumption expenditure, net foreign investment and government expenditure on goods as well as services.	The value added by industries is another method of measuring national income. If the difference between the material output and input of every industry is added up, we arrive at gross domestic product.
Only the final goods and services are included, intermediary goods and services are left out.	Transfer payments are not included in the calculation of national income.	This is based on the assumption that national income equals national expenditure.	To avoid duplication, the value of intermediate goods used in production is subtracted from total output of each industry.

2. BASICS OF FISCAL POLICY

WHAT IS FISCAL POLICY?

Any ruling government has the ability to influence the manner in which various resources are utilised in the economy. Fiscal Policy is a highly effective tool that enables the government to do so. It is the means through which government uses taxation and it's spends (public expenses) to bring about stability & growth, thereby, influencing the nation's economy. According to Culbarston, "By fiscal policy we refer to government actions affecting its receipts and expenditures which ordinarily as measured by the government's receipts, its surplus or deficit."

The government manages to influence the economy by adjusting the following:

- ✓ **Tax rates (modifying types of taxes and subsequent levels),**
- ✓ **Spending levels (composition and extent of expenditures)**

A suitable example of such adjustment by the government (to influence the economy) can be seen in relation to income tax, that gets levied on citizens of the country (individual taxpayers) based on a slab system in which various tax rates have been prescribed for variety of slabs. These tax rates do keep rising with a corresponding increase in the income slab.
As per Keynesian economics (theory on which Fiscal policy is based), the government may increase / decrease tax rates as well as public expenses to have an effect on the macro-economic productivity levels – leading to inflation control, rise in employment, and stable value of money. This has been one of the theories of John Maynard Keynes, a British economist.

SCENARIOS WHERE FISCAL POLICY CAN PLAY A CRITICAL ROLE

The appropriate usage of Fiscal policy will be achieved by the government by maintaining the right balance between public expenditures and tax levels. Let us consider a scenario where the nation's economy is experiencing slowdown, with higher unemployment rate, lower public expenses, and lower profits for businesses.

Situation is summarized as under:

Economy Slowdown	**High Unemployment**	**Low Public Spending**	**Low Business Profits**

For such a situation, the ideal way for government to use Fiscal policy will be to decrease tax rates that would give more spending power to the population. At the same time, government can pump in more money into the economy by opting to build hospitals, roads, schools, colleges, and so on, thereby creating employment opportunities.
The combined effect of these measures will reduce the unemployment levels and will increase the demand for goods as well as services by the consumers. Thus, businesses will start booming and change the direction of the economy positively. This overall situation is a case of *fiscal expansion* – reduction in tax levels and increment in government spending to increase aggregate demand as well as growth.

Key Fiscal Expansion Measures

Decreased Tax Rates	**More Spending by People**	**More Government Investment**	**More Employment Opportunities**

However, too much money in the economy could increase the customer demand for goods and services beyond control, leading to rise in prices. This could lead to high inflation.

Situation is summarized as under:

Excess Money in Circulation	**Increased Demand for Products**	**Increased Prices**	**Higher Inflation Levels**

This scenario may require the government to slow the economy down by increasing tax rates and decreasing consumer spending capacity, as well as reducing government spending. It would lead to less circulation of money in the economy, and reduce the inflation. This situation is a case of *fiscal contraction* – increment in tax rates and reduction in government spending to decrease aggregate demand and output.

Key Fiscal Contraction Measure:

Increase Tax Rates	**Reduced Spending by People**	**Reduced Government Investment**	**Less Money in Circulation and Lower Inflation**

As seen with above two scenarios, the entire process is cyclical – and based on the situation, government will be able to maintain a fine balance between tax rates and it's spending levels to keep directing the economy in the right manner.

GOVERNMENT BUDGET

A government budget refers to an annual financial statement that outlines the estimated government expenses as well as actual government receipts / revenues for the upcoming fiscal year. These budgets can be of three types:

1. Balanced budget
2. Surplus budget
3. Deficit budget

In case of balanced budget, the estimated government expense equals the expected receipts (by the government) for a specific financial year. This helps the government to keep away from injudicious expenditures, and can help to achieve economic stability if implemented appropriately. This type of budget is not suitable during recession and does not provide any solution to issues like unemployment.

In case of surplus budget, the estimated government expense is exceeded by the expected government receipts / revenues for a specific financial year. In simple terms, the government's spending on public welfare is less than the earnings of the government from taxes levied. This kind of budget is suitable during inflation to reduce demand.

In case of deficit budget, the estimated government expense exceeds the expected government receipts / revenues for a specific financial year. This type of budget is suitable during recession, to generate more demand, improve employment, and boost the economic growth rate. It is ideal for developing economies such as India.

OBJECTIVES OF FISCAL POLICY

After understanding how Fiscal policy works, let us list down the objectives of the same for the government:

List of Fiscal Policy Objectives
To maintain significantly high employment rates.
To curb inflation and bring price stability.
To maintain a proper balance between receivables and expenditures of the government.
To ensure healthy and sustainable economic growth.
To reduce poverty and promote economic development of an underdeveloped nation.
To earn good amount of foreign exchange by promoting exports, and thereby bringing about balance of trade as well as payments.
To ensure balanced regional development of the nation by using a major part of the revenue from tax receipts for less / under developed states.

COMPONENTS OF FISCAL POLICY

The Fiscal Policy comprises of four key **components** as described under:

1. **Taxation Policy**

   Government needs to ensure appropriate tax rates are applied for the economy at any given point in time, as it is able to generate revenue from the taxation applied (direct as well as indirect taxes). A proper balance needs to be maintained because:

- Tax rate if lower than normal would result in more consumer spending capability, which may cause a rise in demand and prices, leading to inflation.
- Tax rate if higher than normal would lead to less consumer spending capacity, which may cause a decrease in demand, investment and production.

2. Expenditure Policy

- In order to pay off external as well as internal debts and corresponding interest, the government plans for expenses on development areas such as infrastructure, health, education, and so on. The government budget helps to fill the gap between government spending (expenses) and income, thereby proving to be an integral component of the Expenditure Policy.
  The Expenditure Policy considers capital expenditure as well as revenue expenditure.

  Capital expenditure leads to asset creation and liability reduction. Relevant examples of capital expenditure include loans to states and union territories as well as foreign governments and public enterprises, defense capital, purchasing lands and building as well as shares, and more.
  Revenue expenditure does not lead to asset creation and liability reduction. Relevant examples of revenue expenditure include grants, subsidies, pension, salaries, interest payments, expenditure on central plans, and so on.

3. Investment & Disinvestment Policy

Optimal domestic and foreign investments are necessary to maintain stable economic growth. For the Investment & Disinvestment policy, FDI (Foreign Direct Investment) becomes highly important for integration of the domestic and global economies.

4. Debt / Surplus Management

Government has surplus when it receives more than it spends (income > expenditure), and incurs deficit (debt) when it spends more than it receives (income < expenditure).
To tackle deficit, the government borrows from domestic as well as international sources. It may even resort to printing of money for handling deficit financing. This concept of deficit financing helps to meet government deficits via the creation of new money.

In a nation like India, deficit financing is used to raise resources for economic development, reducing foreign debt, redemption of public debt, as well as for adjustment of balance of payments.

The different types of deficits encountered by government can be seen in below table:

Type of Deficit	Formula	Explanation	Additional Info
Budgetary Deficit	*Revenue Account Deficit + Capital Account Deficit*	Revenue Account Deficit: when government's revenue expenses exceed their revenue receipts Capital Account Deficit: when government's capital disbursements exceed their capital receipts	Expressed as percentage of GDP
Revenue Deficit	*Revenue Expenditure (planned and unplanned) – Revenue Receipts (tax and non-tax)*	Measures government negative contribution to domestic savings or dissavings (excess amount spent) on government's account	Borrowing or sale of assets enables government to meet this deficit.
Effective Revenue Deficit	*Revenue Deficit – Grants (for creation of capital assets)*	Effective Revenue Deficit: excludes the revenue expenditures that were made in the form of 'grants' for capital asset creation.	
Fiscal Deficit	*Total Expenditure – (Revenue Receipts + Capital Receipts excluding borrowings)*	Fiscal Deficit: Total borrowing needs of the government from all possible sources	Rise in Fiscal Deficit to be tackled by more borrowing, leading to significant internal debt for the government
Primary Deficit	*Fiscal Deficit – Interest Payments*	Primary Deficit: Borrowing needs of government to fulfill fiscal deficit net of interest payments	Enables us to get an overview of how the government conducts its financial affairs in present scenario

All government receipts can be grouped into two main categories:

1. **Revenue Receipts**
   These neither create liability, nor lead to reduction in assets of the government. Revenue Receipts can be from tax as well as non-tax revenue. These refer to current income receipts of government from all potential sources. These receipts can be interest, taxes, and dividend on government investments, as well as cess and similar receipts for services offered (and completed) by the government.
   Revenue Receipts are non-redeemable as government does not have any obligation to return any amount.

2. **Capital Receipts**
   These create liability or result in reduction of assets. Let us consider few examples of Capital Receipts that create liabilities are: *Borrowing* which leads to liability of returning loans, *Fund raising* from PPF or small saving deposits which creates liability of repaying amounts to PPF holders and small savings depositors. *Borrowing* is a debt-creating capital receipt. In this case, government has the obligation to pay back the amount (including interest).
   Examples of Capital Receipts that reduce government assets are: *Disinvestment* to raise funds through partial or total selling of shares (of public sector undertakings), as well as *Recovery of Loans or Advances*. Both of these examples are non-debt creating capital receipts.

3. BASICS OF MONETARY POLICY

WHAT IS MONETARY POLICY?

Just like Fiscal Policy, there exists one more policy which is used in various ways to provide the right direction to the goals of a nation's economy. This is the Monetary Policy, which is more in terms of borrowing, spending as well as consumption by individuals & private businesses, while the Fiscal Policy is more related to government expenditures, borrowing, and taxes.
It is the means (or process) through which the Central Bank (or similar monetary authority of a nation) manages supply of money in the economy. In case of India, this Central Bank is RBI (Reserve Bank of India). Some of the activities involved in managing money supply and interest rates include regulation of foreign exchange rates, purchase or sale of government bonds, changing the interest rate, as well as money required to be maintained as reserves by banks.
All these activities are aimed to achieve macro-economic objectives (of general economic policy) such as ensuring inflation control, price stability, sustainable economic growth and full employment.

Important facets of the economy impacted by Monetary Policy are:

1. Assist overall economic or sector-specific growth
2. Maintain Forex (Foreign Exchange) rates in a manageable range
3. Obtain stability in GDP (Gross Domestic Product) growth rate
4. Reduce unemployment rate

SCENARIOS WHERE MONETARY POLICY CAN PLAY A CRITICAL ROLE

Let us consider couple of scenarios where the monetary authority has an influence on the overall economy through its actions to manage money supply. One scenario is where the overall economy is under recession with less money supply, unemployment rates are high, spending capacity of individuals is minimal, investment / spending capabilities of businesses is considerably reduced, and so on.

Situation is summarized as under:

Recession in Economy + Less Money Supply	High Unemployment	Low Public Spending	Low Business Spending / Investment

For such a situation, the Central Bank (monetary authority) can make use of *expansionary Monetary Policy*, to target reduction of interest rates using various ways that gives rise to consumer spending (and makes saving money less lucrative) capacity and increases demand for different daily goods and services, as well as big investments (like property on loan). This gives a major fillip to short-term growth that gets measured by GDP growth (Gross Domestic Product growth). With lower interest rates on capital, businesses as well as individuals manage to get loans easily, thereby giving a boost to various investments in projects and business-based tasks that generates more employment opportunities.

Thus, the monetary authority is able to drive more money circulation in the market, providing the much-needed boost to the economy and enabling it to rise out of the recession. This is possible through the implementation of *expansionary or easy Monetary Policy* process, which often leads to diminishing of the currency value when compared to other currencies.

Expansionary Monetary Policy Measures

Decreased Interest Rates	More Spending by Consumers	More Demand for Products	More Demand for Big Investments	More Project Investments + Employment

However, this improved situation could soon turn into a not so desirable scenario - as the higher supply of money and improved growth rates may lead to increased demand for goods and services, which would lead to rise in prices, and thus cause higher inflation. Such a scenario results in considerably higher cost of living and higher cost of doing business.
With unexpected higher inflation, debtors stand to gain as they are able to repay creditors with money that is worth less at that point in time (than when they borrowed it). Thus, creditors lose out as they receive less, while the borrowers (debtors) gain from inflation.Those who are holders of savings accounts in banks also tend to get less value for their money (when they invested).

Situation is summarized as under:

High Money Supply	Increased Demand for Products	Increased Prices	Higher Inflation Levels

This is when the monetary authority needs to adopt the *contractionary Monetary Policy* to control the inflation. As per this policy, the interest rates are increased which makes borrowing (getting loans) quite costly. This reduces the spending power of individuals, reduces the demand for goods & services, makes saving of money a favourable option, and decreases the circulation of money in the market. Such a scenario may increase the risk of unemployment and economic slowdown.
However, this process of *contractionary or tight Monetary Policy* when applied in appropriate manner helps to bring down inflation in the favourable range.

Contractionary Monetary Policy Measures

Increased Interest Rates	Less Spending by Consumers	Reduced Demand for Products	Reduced Circulation of Money	Inflation Curbed to Desired

As seen in both these scenarios, the entire process and chain of events is cyclical – based on which the Central Bank / Monetary authority is able to take the necessary steps to boost the economic growth rate or control the inflation.

OBJECTIVES / GOALS OF MONETARY POLICY

The Monetary Policy is more related to the interest rates and availability of credit. This policy is adopted to achieve the following set of goals:

List of Monetary Policy Objectives
To control inflation in the desired range
To bring more liquidity in the economy
To assist overall economic or sector-specific growth
To ensure stable Exchange rate by maintaining Forex (Foreign Exchange) rates in a manageable range
To obtain stability in GDP (Gross Domestic Product) growth rate
To reduce unemployment rate
To ensure price stability
To maintain equilibrium for BOP (Balance of Payments)
To support equal income distribution

Most of India's five-year plans are targeted to achieve growth, stability as well as social justice. Hence, it is quite common that the objectives of these five-year plans are similar to those of the Monetary Policy implemented by the RBI.

FACTORS IMPACTING MONETARY POLICY DECISIONS

As a common practice, many of the Monetary Policy decisions from previous decades have been about coinage and printing paper currency for credit creation. In recent years, several other factors that have started impacting the Monetary Policy decisions are as listed under:

- Short term interest rates
- Long term interest rates
- Velocity of money through the economy
- Exchange Rates
- Quality of Credit
- Equities and Bonds (related to debt as well as corporate ownership)
- Government expenditure / savings versus Private sector expenditure / savings
- Large scale foreign capital flow of money
- Financial derivatives like Future Contracts, Options, Swaps, and so on

MONETARY POLICY TOOLS

The RBI makes use of various tools to achieve its Monetary Policy goals – primarily to manage money supply and liquidity so as to balance inflation as well as support economic growth. Some of the major Monetary Policy tools are listed under:

1. **Cash Reserve Ratio (CRR)**

It refers to the minimum percentage of total deposits of customers in a commercial bank that the bank is required to hold as reserves (either in cash or as deposits) with the RBI (Central Bank).

Advantages

- To effectively control money supply in an overall economy
- To ensure commercial banks do not fall short of money to fulfil the payment needs of their depositors

Impact of CRR

First Situation: When CRR rises

High CRR -> More money of banks with RBI -> Less funds with commercial banks ->Less funds with people -> Decreased demand for goods as well as services -> Reduced prices -> Inflation under control

Second Situation: When CRR falls

Low CRR -> Less money of banks with RBI -> More funds with commercial banks -> More funds with people -> Increased demand for goods as well as services -> Increased prices -> Inflation rises

2. **Statutory Liquidity Ratio (SLR)**

It refers to the percentage of deposits that a commercial bank needs to maintain with them in various forms of liquid assets (over and above the CRR) such as government approved securities (inclusive of government bonds), gold, and cash. This Statutory Liquidity Ratio can be considered by RBI as the percentage of demand as well as time liabilities.

Advantages

- Prevents commercial banks from liquidation of their liquid assets when CRR is raised
- Helps to control bank credit
- Makes banks to invest more in government securities

Impact of Statutory Liquidity Ratio (SLR)

First Situation: When SLR is High

More funds of commercial banks as liquid assets -> Less liquidity with commercial banks -> Less loans offered to people -> Lower consumer spending -> Reduced demand for goods as well as services -> Reduced prices –> Inflation under manageable range

Second Situation: When SLR is Low

Less funds of commercial banks as liquid assets -> More liquidity with commercial banks -> More loans offered to people -> Higher consumer spending -> Increased demand for goods as well as services -> Increased prices –> Inflation may go beyond manageable range

3. **Repo and Reverse Repo Rate**

Repo Rate

It refers to the interest rate at which RBI lends money to a commercial bank against securities (sold and repurchased by RBI), when the commercial bank needs funds. The whole transaction involving selling of securities by the Reserve Bank of India and subsequent repurchasing at a fixed price is known as *Repo*.

Advantages:

- To keep control on inflation rate
- To maintain control on liquidity

Reverse Repo Rate

It refers to the rate at which the Central Bank (RBI in case of India) borrows funds (money) from commercial banks of India. This tool is utilized when there is excess money circulating around in banks. Reverse Repo rate is always going to be lower than the Repo rate, because the Central Bank (RBI) cannot offer more interest on deposits and take low interest on loans.

Advantages:

- To control supply of money in the economy

Impact of Repo and Reverse Repo Rate

First Situation: When Repo Rate is High

High Repo Rate -> Costlier funds for commercial banks ->Higher rate offered to consumers by banks -> Lesser borrowings and credit taken by people -> Reduced liquidity in economy

Second Situation: When Reverse Repo Rate is High

High Reverse Repo Rate -> Higher interest rate earned by banks on RBI borrowings -> More money lending from banks to RBI -> Less money lending to people -> Reduced liquidity in economy.

4. **Bank rate**

It indicates the interest rate at which Reserve Bank of India lends funds (in the form of loans and advances) to commercial banks without pledging any security. Also known as 'discount rate', the bank rate is usually higher in comparison to Repo rate.

Advantages

- To maintain control over inflation and liquidity

Impact of Bank Rate

High Bank Rate -> Increased Interest Rate of loans to banks -> Increased interest rate of bank loans to people -> Less demand for goods as well as services -> Restricted flow of money in economy -> Inflation under control

Comparison of Repo Rate and Bank Rate

While both these are rates at which RBI lends money to commercial banks, there are significant differences between them as described under:

Repo Rate	Bank Rate
Charged against securities repurchased by the RBI from the banks	Charged against advances / loans provided by RBI to banks
Always lower than bank rate	Always higher than Repo Rate
Securities, Collaterals, Bonds, Agreements are involved	No securities or collaterals involved
Rise in this rate doesn't impact the customers directly	Rise in this rate does impact the customers directly

5. Marginal Standing Funding

By this mechanism commercial banks can get loans from RBI for their emergency needs. Commercial banks can take loan only upto 1% of their liabilities and time deposits.

6. Open market operations

It refers to purchase and sale of government securities (and bonds) by the Central Bank (RBI) in order to regulate supply of money in the short term.

When liquidity is to be brought in the market, RBI buys government securities. When the liquidity in the market is in excess and needs to be curbed, RBI sells the government securities to commercial banks, and decreases the cash float that banks may have.

Advantages

To effectively manage liquidity in the overall economy

Impact of purchasing securities

More money in economy → More demand → Higher growth rate

Impact of selling

Less money in economy → Less demand → Lower prices

7. In monetary economics, a **money multiplier** is one of various closely related ratios of commercial bank money to central bank money under a fractional-reserve banking system. Most often, it measures an estimate of the *maximum* amount of commercial bank money that can be created, given a certain amount of central bank money. That is, in a fractional-reserve banking system, the total amount of loans that commercial banks are allowed to extend (the commercial bank money that they can legally create) is equal to an amount which is a multiple of the amount of reserves. This multiple is the reciprocal of the reserve ratio, and it is an economic multiplier.

ALTERNATIVE FOR STANDARD MONETARY POLICY

An unconventional form of monetary policy, it is usually used when standard monetary policy has become ineffective at combating too low inflation or deflation.
Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. **Quantitative easing** (**QE**), also known as **large-scale asset purchases**, is an expansionary monetary policy whereby a central bank buys predetermined amounts of government bonds or other financial assets in order to stimulate the economy and increase liquidity. A central bank implements quantitative easing by buying specified amounts of financial assets from commercial banks and other financial institutions, thus raising the prices of those financial assets and lowering their yield, while simultaneously increasing the money supply. This differs from the more usual policy of buying or selling short-term government bonds to keep interbank interest rates at a specified target value.

4. UNDERSTANDING BUSINESS CYCLES

A business **cycle is the cycle of fluctuations** (upward and downward movement) in the **GDP (Gross Domestic Product)** around its long term growth trend. Also known as the **trade cycle or economic cycle**, the business cycle relates to the expansion as well as contraction in economic activity experienced by the overall economy over time. It denotes the increase and drop in production output of goods as well as services in the nation's economy.
The business cycle is considered to be complete when it undergoes a single boom and a single contraction (recession) in sequence. The corresponding period of time (inclusive of this boom and contraction) is referred to as the length of a business cycle. A boom (or expansion) corresponds to a period of rapid economic growth, while a contraction (or recession) is characterized by a period of relative stagnated economic growth.
Business cycles are usually measured by considering the growth rate of real GDP (Gross Domestic Product), which is inflation-adjusted.

DIFFERENT PHASES OF BUSINESS CYCLE

The various phases of business cycles are the fluctuations experienced by the nation's economy with boom in economic activities in one period and contraction in those activities in the subsequent period. These business cycle phases correspond to the variations in several economic activities with regards to investment, production, wages, employment, prices, and credits (as depicted by the downward and upward fluctuations in the nation's economy).

The 5 major phases of a business cycle include the following:

1. **Expansion**

It is first phase under consideration that corresponds to an increase in various positive economic factors / indicators including income, output, production, employment, wages, profits, sales, demand as well as supply of goods & services. In this *expansion phase*, the debtors are relatively in a good financial condition and repaying their debts on time, the creditors lend funds at high interest rates, the investment is high and so is the flow of money in the economy.

2. **Peak**

The increase in flow of money in an economy and the overall growth achieved during expansion phase reaches a saturation point – which is the maximum limit of growth. This is referred to as the *peak phase*, where the increasing growth rate of a business cycle reaches its optimal (maximum) limit. It is in this phase that the economic indicators (including production, employment, sales, prices) are at their highest and do not rise further. As prices are at their peak, consumers start to restructure their budget for spending and plan to spend less.

The *peak phase* triggers the reversal in the trend of overall economic growth (that started with the *expansion phase*).

3. **Recession (or Contraction)**

The phase that follows the peak phase is the *recession phase (or contraction phase)*. The highest price points touched upon during peak phase lead to consumers deciding to spend less, and thereby reduce the demand for products. This demand continues to fall rapidly during *recession phase*, without the producers noticing the reduced demand instantly, and who continue to produce leading to more supply in the market (than demand). Such a situation leads to fall in prices and as a result, the relevant positive economic indicators like output, income, wages, etc. begin to fall.

4. **Depression**

When the recession phase continues for long, the economic activities start falling below the normal level, thereby making the growth rate of the economy turn negative. This triggers the *depression phase* where there is continuous decline for the economic growth and rise in unemployment.

5. Trough

As the depression phase continues to cause rapid decline in expenditure as well as national income, it gives rise to more debtors who are unable to repay their debts. This result in lowering of interest rates which makes banks to give less preference to lending of money to people, thereby leading to having excess cash balances.

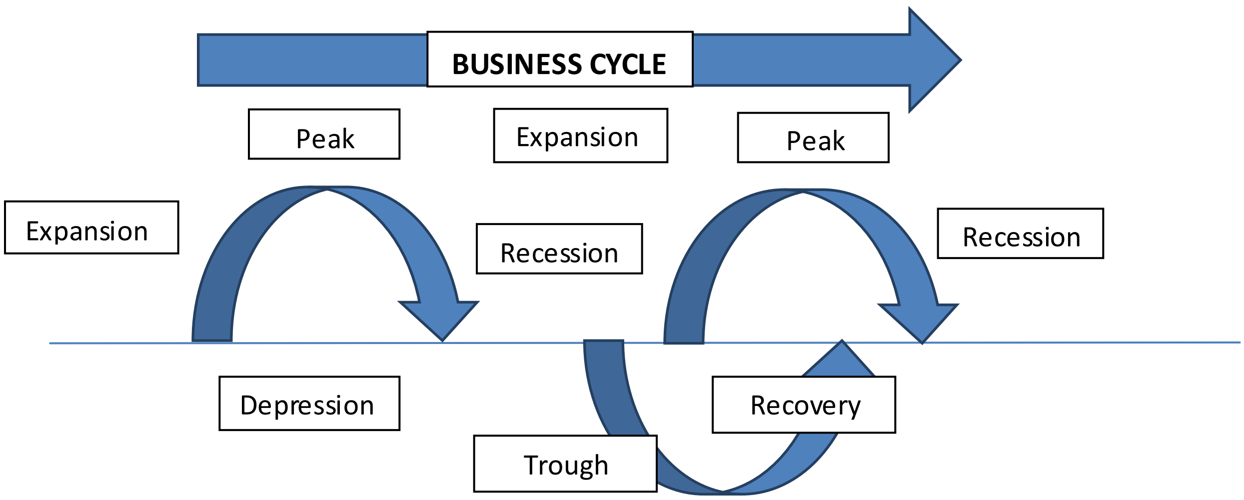
There is a point where the decline reaches its maximum limit, beyond which the economy cannot slide further. This is the *trough phase* that corresponds to the negative saturation point of an economy or the lowest possible level to which an economy shrinks.

6. Recovery

The *recovery phase* is the one that witnesses the turnaround post the *trough phase*, and where the overall economy begins to recover steadily from the negative growth rate.

After an economy shrinks to the lowest level on the negative side of growth rate, there happens a trend change (or reversal) for the business cycle in the positive direction. In this recovery phase (that starts from the labour market), demand for products starts increasing due to the lowest prices and eventually supply is built up as well. The people, companies and overall economy start thinking positively for employment and investment, due to which production starts rising.

This phase continues till an economy comes back to steady growth rate levels, thereby completing one full business cycle of boom and contraction, with peak and trough being the positive saturation point and negative saturation point respectively.



SUMMARY OF A COMPLETE BUSINESS CYCLE

Phase	Characteristics
First phase – Expansion	-Increased employment -Increased economic growth -Upward pressure on prices
Second phase – Peak	-Highest or full employment -Highest economic growth -Inflationary / upward pressure on prices
Third phase – Contraction / Recession	-Reduced employment -Reduced economic growth -Less pressure on prices -Negative Reversal of economic growth
Fourth phase - Depression	-Continuous fall in employment -Economic growth rate turns negative
Fifth phase – Trough	-Lowest employment -Lowest economic growth -No pressure on prices
Sixth phase – Recovery	-Positive Reversal of economic growth -Less pressure on prices -Improving economic growth and employment

While a single business cycle may start from expansion phase and end at recovery phase, the actual measurement of business cycle expansion takes place from trough (bottom) of the earlier cycle to the peak of the current cycle, and the measurement of business cycle recession takes place from peak to the trough of the current cycle.

VIEWS FROM ECONOMISTS ON BUSINESS CYCLE

Economist John Keynes considers the event of business cycles as a consequence of fluctuations in aggregate demand that bring the overall economy to short-term equilibriums which are not the same as full employment equilibrium.

Economists such as John Muth and Robert Lucas (Jr.) have been associated with the RBC theory (Real Business Cycle theory), which is a class of macro-economic models as well as theories.

Understanding Real Business Cycle Theory

The real business cycle theory considers studying business cycles by making the fundamental assumption that these cycles (and their various phases) are entirely driven by technology shocks instead of monetary shocks or modifications in expectations. These technology shocks comprise of bad weather, innovations, strict safety regulations, and more. The technological shocks are believed to be a result of unanticipated technological development which has an impact on productivity.

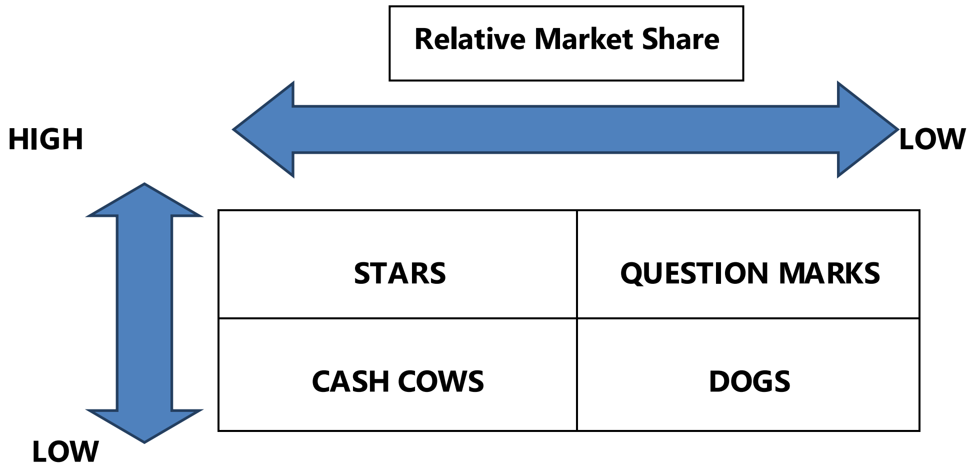
In other words, the RBC theory considers fluctuations of a business cycle against real shocks (and not nominal shocks), that correspond to unpredictable or unexpected events affecting the overall economy.

UNDERSTANDING BCG MATRIX

The Boston Consulting Group Matrix (also known as growth share matrix) enables companies to determine the various areas of their business that require additional investment as well as resources. This is a framework that was created by the Boston Consulting Group to help organizations analyse products as per the growth and market share. This model is along the lines of the product life cycle theory which can be utilized to identify the priorities that need to be given within the portfolio of products for a business unit.

Every company aims for long-term value creation and for this purpose it needs a product portfolio comprising of low growth products which generate plenty of cash along with high growth products that require cash inputs. The objective behind this is faster the growth of a product's market and bigger the market share a product possesses, the better it is for the organization.

The BCG Matrix can be represented by a four-quadrant chart, where the relative market share position is along the X-axis, and business growth rate is along the Y-axis. The four quadrants refer to the Dogs (lower right), Cash Cows (lower left), Question Marks (upper right), and Stars (upper left).



Stars

These are the products that possess the best market share and produce the most cash. The products that come first-time to market as well as monopolies are considered as stars. They take up large amounts of cash because of the high levels of growth rate. Businesses can prefer to invest in stars.

Cash Cows

These are the business products that have higher market share, but lower market growth rate. They tend to consume less cash as compared to the cash they generate. Firms can prefer to invest in cash cows in order to maintain the existing level of productivity.

Dogs

These products have a low market growth rate and a low market share. They neither consume a lot of cash, nor do they earn a lot of cash. Companies can prefer to sell these off, as these business units generally do not bring back anything in return. Hence, these are considered as cash traps as companies have their money tied up in them.

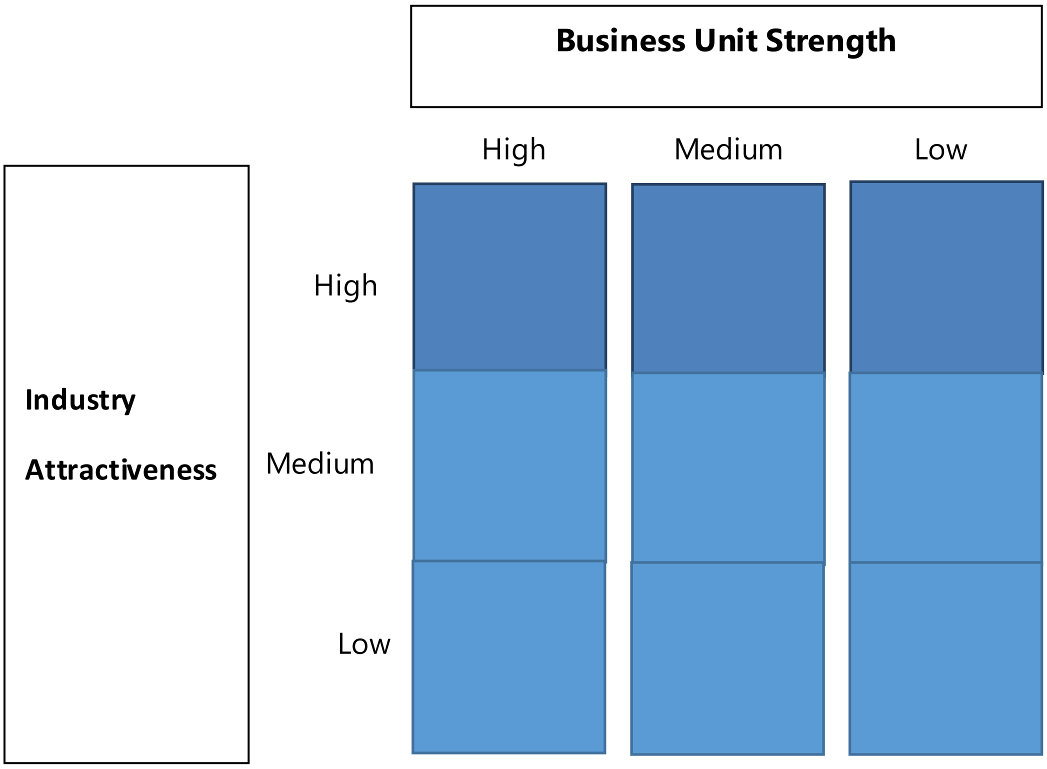
Question Marks

These products have a low market share, against high market growth rate. They take up a lot of cash, but tend to generate little in return, and in fact, lead to loss of money. With their potential to grow at fast pace (because of the high growth prospects) and turn into stars, companies can prefer to invest in them if they spot the growth potential. In case of no growth potential, these can be sold off.

Understanding GE McKinsey Matrix

It is a nine-box matrix for analysis of product portfolio. Every product your business considers will have its own demands and requirements along with the limited resources available – some may require you to invest in them, some may require you to hold them, while may require you to let them go. Such level of decision making is done using the GE McKinsey Matrix. It is quite similar to the BCG Matrix, but, slightly more complex than it. In short, this model is helpful for evaluation of strategic business units for optimal allocation of company resources. This matrix is an improvement over BCG Matrix which only had 4 quadrants and focused only on business unit as well as market share. On the other hand, GE McKinsey Matrix also plots the real market situations / conditions against the company's potential to stand in the existing market.

This matrix does comparison of product groups in regards to market attractiveness as well as competitive strength. This 3x3 grid measures business strength on the X-axis, against the market attractiveness on the Y-axis. This comparison helps to evaluate the strategic business unit's position in the market, as well as determine its category in terms of High, Medium or Low.



The market / industry attractiveness dimension enables to analyze the advantages an organization is likely to get by making an entry and competing within the market. The various factors considered include size of the industry, growth rate, market profitability, pricing trends, and so on.

The business strength dimension enables in understanding of whether a firm possesses the required competence to compete in a specific market by considering various factors like market share, assets, company profitability, brand position, environmental concerns, product differentiation, and more.

Once every product is provided with its value with regards to industry attractiveness and business strength, than it gets plotted at the right place / spot in the graph (in either of the nine boxes of the matrix). Once the product is plotted in its place, the decision about it's strategy can be taken – these strategies are broadly either of Grow, Hold and Harvest.

Grow

When the business unit is strong in terms of strong attractiveness, you can grow the business by taking the decision to invest more resources. The business units for which strategy 'Grow' is ideal are the ones that have high business unit strength and high market attractiveness.

Hold

When the business unit strength is average along with average market attractiveness, you need to adopt the 'Hold' strategy. For scenarios where the market is going downwards or there is too much competition, the business unit may not yield good returns even after plenty of resources are invested. Hence, an appropriate solution would be to wait using the 'Hold' strategy for the business unit, to check if the business unit is able to rise above some of the competitors or the market environment improves.

Harvest

When the business unit strength is low along with unattractive market, you need to sell or liquidate the business or perhaps hold the business for particular residual value that it possesses. You need to harvest the weak businesses and ensure reinvestment of money into business units that are on the move towards growth.

FINANCE & FINANCIAL STATEMENT ANALYSIS | 02

1. Finance
2. Financial Statement Analysis

STATEMENT ANALYSIS I 02

1. FINANCE

For a business, it becomes very important to determine the fair value of the financial assets from a strategic point of view. Appropriate valuation of the business would depend a great deal on the accurate valuation of its securities and financial assets, which could be investment and fund-raising avenues like stocks, bonds, bank deposits, and loans.
A professional valuer will be able to do full justice to the valuation process of financial assets by getting complete clarity on the *basic concepts of finance* and corresponding *decisions in finance*.

BASIC CONCEPTS OF FINANCE

For sustainability and growth of a company, the business management team needs to focus on critical financial aspects like rising of capital (funds) as well as investment in the right projects to get more value of the money they possess. In this regards, it becomes critical to understand the various financial concepts related to capital structure for fund raising and capital budgeting for earning returns (in future) on the investment made at present (by effective consideration of Time Value of Money through understanding of parameters like Net Present Value, Internal Rate of Return, Risk-Return Trade-Off).

1. Time Value of money

Consider a person having two options in front of him:

a) To get INR 5,00,000 at present
b) To get the same amount after a year

Common sense would have the person choose the first option to receive the money in present. Why? Well, by doing so, and simply keeping the money in bank (in a savings account), the person would be able to earn slightly more money at the end of the year. So, it makes no sense for him to opt for the second option. This is clearly because of the earning capacity of the money that the person is bound to receive in present.
This is the basis of Time Value of Money (TVM), one of the founding principles of finance - that money received at present is more valuable as compared to the same amount received at some future time, due to its potentially earning capability. This earning

capability refers to the possibility of the money being invested and earned interest upon.TVM is also known as 'present discounted value', which considers any particular amount of money as worth more when received as soon as possible, subject to the ability of that money to earn interest.

2. Why is the Time Value of Money or Time Preference Relevant?

- **Uncertainty**

  Suppose a person chooses to receive money from a colleague / friend or an agency in future, instead of accepting the money at present. There is the risk of the money not coming to the person in future (uncertainty), if the financial situation of the colleague or agency changes drastically in future.
- **Preference for consumption**

  A person is likely to accept receiving money in present so that he can start using the same for his daily consumption as well as for routine business expenses.
- **Available investment opportunities**

  It is possible to earn some interest over the money invested in any bank or other investment avenues.
- **Inflation**

  The money that is not in the hands of a person at present, carries the risk of losing value and purchasing power due to rise in inflation in the future.

Basic Time Value of Money Formula

One of the most basic TVM formula looks like under:

$$FV = PV \times [\,1 + (\,i / n)\,]^{(n \times t)}$$

It considers following variables such as:

- FV = Future value of money (after earning interest)
- PV = Present value of money
- i = interest rate
- n = number of compounding periods per year (investment period / loan period)
- t = number of years (the time period for which money is held)

TVM Example

Assume a person accepts INR 5,00,000 at present and invests it for a period of 1 year at 10% interest. In such a scenario, the Future Value of money is calculated as:

FV = 5,00,000 x (1 + (10% / 1) ^ (1 x 1) = INR 5,50,000

3. Compounding and Discounting

As seen with TVM, it is all about the present value and future value of money. The two different methods to ascertain the money's worth at different points in time are *compounding* and *discounting*.

Compounding is used to compute the future value of current money (investment), to get clarity on the future values of cash flow at the end of a specific period, at a fixed (definite) rate. This method uses compound interest rates and helps to determine the amount you will get at a future date for some amount of money invested at present (today).
Formula for Compounding (based on TVM formula discussed above):

FV = PV (1+r)^n

Where r = rate of interest on investment
n = number of years

On the other hand, discounting is used to know the current value of future money, to get clarity on the current value of future cash flow, at a specified rate. This method uses discount rates and helps to determine the amount you need to invest currently (today), to earn a particular amount in future.
Formula for Discounting (based on TVM formula discussed above):

PV = FV / (1+r)^n

Where r = discount rate
n = future years

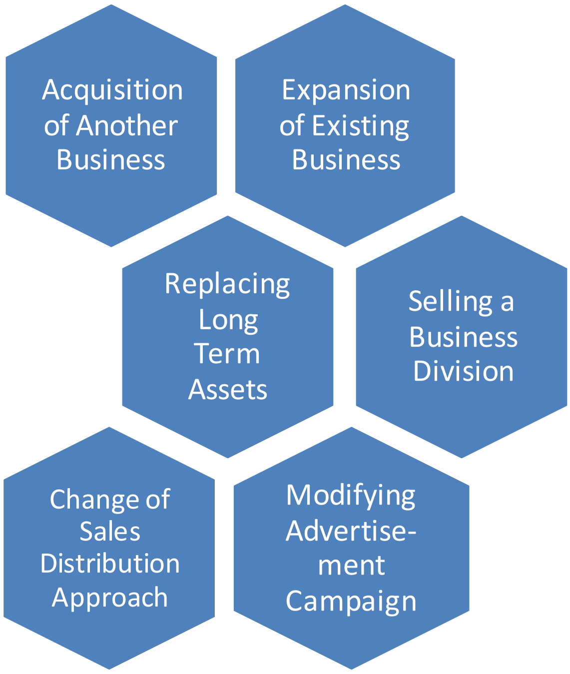
4. **Capital Structure**

This topic is covered in detail later during the chapter in the section on 'Financial Statement Analysis'.

5. **Capital Budgeting**

Capital budgeting plays a very important role in every business, especially with regards to investment decisions. It refers to the decisions on investment - which take its due course of time to mature and need to be based around the returns that investment is likely to give.
Clearly, the investment decisions take into consideration the future value of invested money, or the time period it will take for the investment to give some returns.

Examples of investment decisions or capital expenditure decisions by firmscan be viewed below:



As a capital budget project will take some period of time to yield results (from the investment made), businesses approach this process using a systematic approach towards:

- Identifying long term objectives
- Detailed search and identification of fresh investment opportunities
- Estimation as well as forecast of existing (current) and future cash flows
- Establishment of control over expenses and effective monitoring of critical aspects of project execution
- Having a stable administrative framework possessing the capability to transfer necessary information to the decision level

Capital budgeting involves use of the concept of present value of future investment that needs to be done now. This refers to the TVM (Time Value of Money) concept that has been discussed earlier in this chapter. It basis this application on various techniques like Net Present Value, IRR (Internal Rate of Return), and Risk-Return Trade Off, which will be discussed later.

6. Portfolios and Diversification

An investment portfolio comprises of a collection of investments, which are selected to achieve certain degree of diversification and help the investor fulfill its investment objectives. Typically, an investment portfolio represents a combination of various asset classes like bonds, stocks, as well as cash. These asset classes can be sub-divided as:

- Stocks into international stocks, large cap stocks, mid cap stocks, and small cap stocks.

- Bonds into foreign bonds, short term bonds, intermediate term bonds, and tax-exempt municipal bonds.

7. **Net Present Value (NPV)**

For any business, this value refers to the present (existing) value of all the cash flows that are bound to be incurred during the life span of a project. **Net Present Value** is the difference between present value of all cash inflows and present value of all cash outflows expected to occur over a period of time for a project. It is used during capital budgeting or taking investment decisions to be able to do effective analysis of the profitability of an investment project.

NPV = Discounted Cash Inflows – Discounted Cash Outflows

Positive NPV denotes the maximum possible amount a business would pay for making the investment or it represents the amount at which the business is ready to let go the investment, without actually being in a financially worse situation. Positive NPV highlights that the estimated (projected) earnings generated through a project (investment) is more than the estimated costs. Assumption is that any investment with positive NPV is a profitable preposition, while any investment (project) with a negative NPV is a loss-making preposition.

This forms the basis of the **NPV Rule (Net Present Value Rule)** that states 'to consider only investments with a positive Net Present Value'.

Understanding NPV with an Example

A business is likely to decide about an investment to be made, against the returns it expects to earn over a period of time. Suppose a company is confronted with a situation where it can invest INR 1,00,000 today and earn 10% over it after a year's time, which equates to receiving an amount of INR 1,10,000 after 1 year.

The business would decide to go ahead with this investment today if the investment avenue is reliable and if there is no other investment it can do with that amount (of INR 1,00,000) today that could fetch it more than 10% returns within the same time period of 1 year. This decision on the future capability of earning a particular percentage of returns is the key to any investments that a company makes. The percentage of returns (10% in this example) can be considered as the 'discount rate' that varies depending on the investor.

For example, one business may find this 10% to be enough (and more than anything else it could earn from the same investment amount), while some other business may feel that it could potentially earn say 12% from another reliable investment avenue within the same period of time. For the second business, the discount rate is 12%.

Thus, the discount rate is determined by businesses considering the expected return of other possible investment projects carrying a similar risk level or the cost of borrowing funds required for financing that project. So, a business may take the decision to not go for a project (investment) that is likely to return 10% over a 1 year time period if another project (investment opportunity) is expected to provide 12% returns in the same time period. At the same time, a business may also avoid the project (expected to give 10% return in 1 year) if the cost of borrowing money is equivalent to 11% for financing the project.

Advantages of NPV as an Acceptable Investment Rule

- Accounts for Time Value of Money
- Measure of true Profitability
- Shareholder Value

Limitations of using NPV

- Very difficult to estimate discount rate, cash flow and investment costs
- Room for error / inaccuracy as it relies on several estimations and assumptions
- Difficult to account for unforeseen expenses required by a project

8. Internal Rate of Return (IRR)

IRR (Internal Rate of Return) is the discount rate which makes NPV = 0 for all the cash flows from a specific project. It is quite similar to NPV. IRR is used to estimate the profitability of possible investment opportunities in capital budgeting.

In case of IRR, the discounted cash inflows are equal to the discounted cash outflows – thereby, making NPV = 0.

Internal Rate of Return helps to compare projects (investments) with different life spans (time periods) as well as projects with different capital requirements for investment. So, IRR can be utilized to compare the expected profitability of a project spanning two years and which requires an investment of INR 1, 00,000 with a project spanning five years and that requires an investment of INR 75,000.

As compared to NPV, IRR is considered to make way too many assumptions with regards to reinvestment risk as well as capital allocation. So, it is advisable to not use IRR alone and it should always be used in conjunction with Net Present Value (NPV).

Key Differences Between NPV and IRR

Net Present Value (NPV)	Internal Rate of Return (IRR)
Determines Surplus of the project	Determines the break-even point with no profit and no loss
Accept a project with positive NPV	Accept a project with IRR greater than required rate of return (cut-off rate)
Reject a project with negative NPV	Reject a project with required rate of return (cut-off rate) higher than IRR
Calculation of NPV is in absolute terms	Calculation of IRR is in percentage terms

9. Payback Period

Payback period is one of the important techniques for implementation of capital budgeting. It refers to the time required for recovering the initial cost of an investment made – the number of years required to receive back the initial investment that an investor would have made.

As a method for implementing capital budgeting, payback period helps to compare various projects, and determine the number of years it would take for each of them to get back the initial investment amount. This ultimately helps to select the project which takes minimum number of years to retrieve back the amount invested.

It is the only capital budgeting technique that ignores the time value of money. It is very simple and its simplicity is one of the reasons why it is often used in combination with other capital budgeting techniques for project selection.

10. Risk-Return Trade-off

Any investment decision is based on the two major factors – risk and return. A higher risk is often associated with an investment expected to give higher returns, whereas a lower risk is associated with an investment expected to provide considerably lower returns. Such a trade-off between risk and return as faced by a business (or individual investor) while making investment decisions is referred to as the 'risk-return trade-off'.

It is the relationship between amount of risk taken for an investment and the amount of return gained on an investment and the amount of risk undertaken in that investment. As per this trade-off, the potential return increases or there is a probability of higher return with a rise in risk. It indicates that the investing business (or individual investor) should be ready to accept a higher probability of loss, if it is willing to earn higher profits.

But, there is no guarantee here. So, higher risk doesn't always equate to higher returns. It is just that it gives the investor a probability of earning higher returns in future.

PROFESSIONAL ETHICS & STANDARDS | 03

1. Model code of Conduct for Registered Valuers as notified by Ministry of Corporate Affairs (MCA) under the Companies (Registered Valuers and Valuation) Rules, 2017
2. Ethical Considerations under Terms of Engagements

PROFESSIONAL ETHICS AND STANDARDS | 03

1. MODEL CODE OF CONDUCT FOR REGISTERED VALUERS AS NOTIFIED BY MINISTRY OF CORPORATE AFFAIRS (MCA) UNDER THE COMPANIES (REGISTERED VALUERS AND VALUATION) RULES, 2017

The Ministry of Corporate Affairs, Govt. of India has issued the Model Code of Conduct for Registered Valuers under the Companies (Registered Valuers and Valuation) Rules. This has come into effect from 18th October2017. The Rules provide for the registration of Valuers under the Companies Act, 2013. With this, Section 247 of the Act has come into force. The notification has also provided for the Insolvency and Bankruptcy Board of India (IBBI) to be the responsible authority with respect to registration, recognition and other matters relating to Valuers.

Valuations are an integral part of businesses, governments and capital markets. Credible business and asset valuations aid strategic decision making and improve corporate governance. The field of valuations is a field of diversity and heterogeneity due to the presence of multiple valuation methodologies and practices. As it is, valuation is an inexact science prone to subjectivity. The absence of a central Regulatory Authority and lack of Indian Valuation Standards adds to the subjectivity in valuation conclusions. This of great concern especially with regard to Securities and Financial Assets. The highly sensitive and complex nature of business in this asset class makes standardization and quality control of valuations an urgent need.

The Companies Act, 2013, was brought in to bring the valuation industry in line with international standards. The new Rules and guidelines of 2017 propose to make the Companies Act effective by providing details and modalities for greater standardization to

valuations. The government aims for greater transparency, accountability, and fairness in the professional conduct of the valuers by laying down clear and unambiguous eligibility guidelines and legal requirements for valuers, individual and organization.
To achieve transparency and fairness, as well as to ensure ethical standards are being followed, the Companies Act, 2013, focuses on provisions related to corporate governance, in terms of functioning of independent directors and valuers, composition of the board, enhancing responsibilities for financial reporting, compliance with laws of the land as well as corporate social responsibility. There are certain penalties applicable under the Companies Act as well as SEBI LODR, to ensure compliance for corporate governance provisions as a mandatory affair. The registered valuers are bounded by terms which require them to charge fees only as per the written contract with the person / company to whom they would render their services. Also, any fee structure applicable for the members is determined by the organization. The fees may be applicable for annual membership, application / registration, and during surrender of membership.

Annexure-I (Model Code of Conduct) of the Notification lays down, in considerable detail,

Asset Classes	**Qualification**	**Experience**	**Valuation Examination**
Land and Building	Graduate in Civil Engineering, Architecture or Town Planning of a recognised university	5 year of experience in discipline after completing graduation	As per Rule 5
	Post Graduate in Civil Engineering, Architecture or Town Planning of a recognised university	3 year of experience in discipline after completing post-graduation	As per Rule 5
	Graduate in a discipline specified by the Authority for an RVO in its conditions of recognition and Post Graduate in Valuation of land and building or real estate from a recognised university	5 year of experience in discipline after completing post-graduation	As per Rule 5
Plant and Machinery	Graduate in Mechanical or Electrical Engineering of a recognised university	5 year of experience in discipline after completing graduation	As per Rule 5
	Post Graduate in Mechanical or Electrical Engineering of a recognised university	3 year of experience in discipline after completing post-graduation	As per Rule 5
	Graduate in Valuation of machinery and plant from recognised university and Post Graduate in Valuation of machinery and plant from recognised university	3 year of experience in discipline after completing post-graduation	As per Rule 5
Securities or Financial Assets	Graduate in any stream and Member of Professional Institute (CA/CS/CMA) or MBA/PGDBM specialisation in finance or Post graduate degree in Finance	3 year of experience in discipline after completing graduation	As per Rule 5
	Any other graduate or post graduate level qualification as may be specified by Authority	5 year and 3 year of experience in case of graduate level degree and post graduate level degree respectively	As per Rule 5

the professional and ethical standards expected of the valuer, individual and RVOs.

Key provisions of the Rules are as discussed under:

ELIGIBILITY, QUALIFICATIONS, AND REGISTRATION OF VALUERS

Chapter 2 in the notification provides detailed information on the eligibility criterion. This includes a Valuation Examination as set by the Registration Authority, which will be a mandatory prerequisite for qualifying as a valuer. To be recognized as a valuer, the candidate must possess relevant mentioned academic qualifications and professional certifications and experience. Annexure-IV of the Rules provides an indicative matrix of requisite qualifications and/or experience for different Asset Classes. The absence of convictions and financial solvency will be considered while granting recognition.

Chapter 3 deals with the recognition of valuation professional organizations. The rules mandate that in order to be eligible to register as valuers, apart from other conditions, at least three partners or directors of the organization must be registered valuers.

An organization to be eligible must fulfill the following additional criteria:

- **Conduct educational courses in valuation as specified by IBBI**
- **Conduct training for members**
- **Grant certificates of practice to individuals who meet eligibility requirements**
- **Maintain quality control through regular checks and reviews**

Chapter 4 of the Rules elaborates on Valuation Standards. It provides that, until the government notifies Indian Valuation Standards, valuers shall make valuations as per

- **Internationally accepted valuation methods or,**
- **Valuation standards adopted by a registered valuers' organization or,**
- **Valuation standards specified by the RBI, SEBI or any other statutory regulatory body of India**

It also proposes to set up an Advisory Committee to look into the formulation and prescription of Valuation Standards.

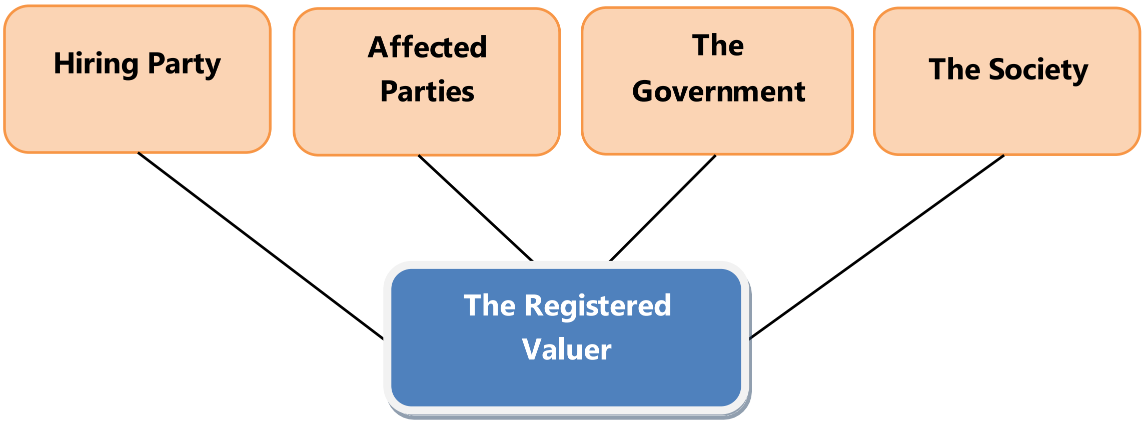
Chapter 5 of the Rules deals with the grounds for suspension and revocation of registration and recognition of valuers.

While delineating valuation standards, syllabus of the valuation education courses, and the content of valuation reports, the Govt. has formulated a model code of conduct for the registered valuers and the RVOs. Schedule 1 of the Rules pertains to the model code of conduct. This section aims to address the need for professionalism, authenticity, and accuracy in the valuation industry in line with the international standards.

ANNEXURE I

MODEL CODE OF CONDUCT FOR REGISTERED VALUERS

Annexure I of the Rules provides a detailed description of what is expected of a registered valuer by in view of the wider impact of the valuers conclusions and decisions:



The need for Model Code of Conduct arises as the work of a valuer may impact not only the parties immediately involved but also other entities indirectly affected. With such significance, it becomes crucial that any exercise of valuation must be conducted with a high level of ethical integrity, fair play, and professional objectivity. The report of the valuer must be able to meet the highest standards of probity. In order to ensure this, Annexure I delineates the following:

1. **Integrity and Fairness**

   These parameters refer to the valuer's quality of being honest, possessing strong moral principles and doing the right things in a highly reliable manner. For example, the valuer shall be responsible to present correct as well as adequate information without misrepresentation of any facts, figures, or scenarios.

   - The valuers shall conduct any investigation with integrity, reporting and evaluating facts with objectivity.
   - They shall maintain the dignity of their profession at all times.
   - Valuers will not indulge in any activity / action that could bring disrepute to the profession.

2. **Professional Competence and Due Care**

These parameters indicate the requirement for the valuers to ensure they remain upgraded with the necessary professional know-how and skills so as to be able to offer competent professional services, whilst maintaining high standards and ensuring proper care is taken. For example, the valuers cannot deny being a part of or responsible for the expertise and special care required in the preparation of valuation reports. However, they can have exception to the extent that those assumptions are simply statements of factual information which are not generated by the valuers, but, are provided by the company involved.

- The valuers shall maintain high standards of professional conduct.
- They shall maintain levels of academic and professional qualifications required for the work.
- The valuers shall keep abreast of the latest rules, guidelines, laws, and regulations pertaining to their fields.

3. **Independence and Disclosure of Interest**

These parameters refer to the valuers ensuring no dependency in their professional relationships, and conducting the valuation without any bias as well as independent of any kind of influences. At all times, the valuers aim will be to avoid any conflict of interests. For example, if a valuer gets valuation assignment of a company he / she or any of his / her relatives are involved in some manner with the company or its assets, then, the valuer should not accept such an assignment.

- The valuers shall conduct their work with due diligence and exercise independent professional judgment free of any bias, coercion or conflict of interest.
- Valuers' work must be in accordance with the regulations of SEBI at all times, when it comes to securities.
- Valuers shall declare past associations with a firm or its assets, if any.
- Valuers shall not indulge in "mandate snatching" or "convenience valuations", nor shall they charge a "success fee".

4. **Confidentiality**

This parameter binds the valuer to keep information, opinions and decisions private (a secret) while conducting valuation of any business / firm.

- The valuers shall maintain the code of confidentiality assiduously for the company / business whose valuation is being done, unless there is a legal or professional requirement to break it.

5. **Information Management**

This parameter entitles the valuer to maintain information supporting his / her decision, and to provide the information as well as related records as required by any people authorized by the Valuation Professional Organization, the Registration

Authority, the Tribunal, or similar statutory regulatory body. For example, if any regulatory authority or their representatives ask a valuer for investigation of any decisions taken related to the valuation assignment of a business, the valuer will have to cooperate with them, appear before them, and share the working papers / records.

- Valuers shall maintain proper written records of decisions taken. The working papers and reports shall be maintained for three years for production before a regulatory authority or for peer review if required.
- Valuers shall provide all records to the Registration Authority, the Tribunal, the Appellate Tribunal or the Valuation Organization with which they are registered or any other statutory authority.

6. Gifts and Hospitality

These parameters refer to the case of a valuer not accepting any benefits / perks (in the form of gifts or financial benefits or hospitality) and not offering them to any public servant, in relation to the valuation work being carried out for the subject company under consideration. The work done by the Valuers is such that it should not involve any influences or bias, and staying away from gifts as well as hospitality empowers valuers to achieve the same.

- Valuers and their relatives shall not accept any gift, hospitality or financial advantage that might influence and impact their independence as valuers.
- Valuers shall not offer the above mentioned to any public or otherwise official in order to gain secure and/or retain an advantage.

7. Remuneration and Costs

These refer to the professional fees / charges that a valuer claims from the business / company to whom it delivers valuation services. It is of prime importance that the valuer doesn't charge anything over and above the transparently agreed / approved charges for the services rendered.

- Valuers shall charge remuneration in a transparent manner and in proportion to the quantum of services provided.

8. Occupation, Employability, and Restrictions

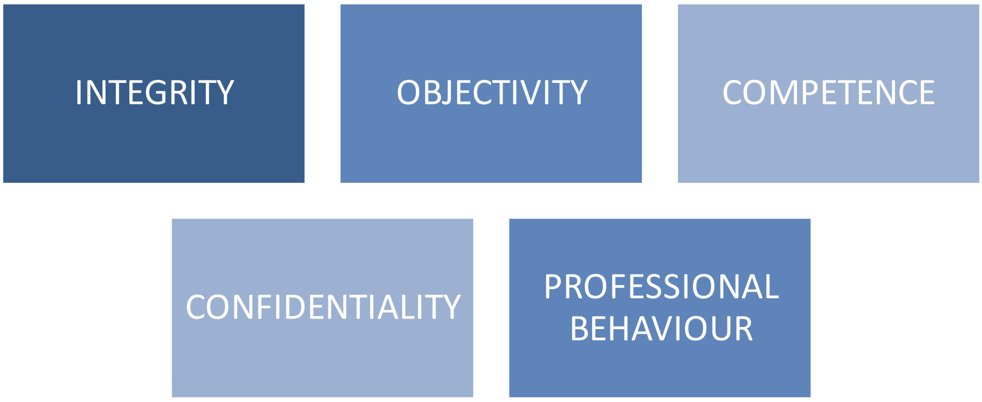
The professional valuers that conduct valuation assignments for companies need to take care of several conditions / restrictions while taking up assignments, and engaging in other employment opportunities.

- Valuers shall give adequate time and attention to assignments and conduct themselves consistent with the reputation of their profession.
- Valuers can engage in other employment only upon temporarily surrendering their membership as valuers with the Valuation professional organization, with which they have registered.
- Valuers need not conduct any business which is not in alignment with the reputation of the profession, as per the opinion of the Registration Authority.

India has a large and growing domestic valuation industry that supports both home and global valuation needs. Besides this, many foreign corporations have shifted their valuation assignments to India due to the presence of talent available in the country. According to the Indian Association of Investment Professionals, the Indian valuation industry has registered a robust growth at CAGR of 8% in the last decade. Keeping this scenario in mind, the Model Code of Conduct aligns with the guidelines laid down by international bodies such as the International Valuation Standards Council and the International Financial Reporting Standards, among others. With this, the government aims to provide greater objectivity and uniformity as well as enhanced efficiency of the valuation process. This will undoubtedly raise stakeholder confidence.

2. ETHICAL CONSIDERATIONS UNDER TERMS OF ENGAGEMENTS

The Model Code of Conduct, as given in the Companies (Registered Valuers and Valuation) Rules, 2017 enjoins upon the valuer to provide the best possible service to the client in a way that neither contradicts the laws of the State, nor brings discredit to the profession of valuation. The ethical principles that must guide the valuer at all times are:



TERMS OF ENGAGEMENTS

Terms of Engagements refers to the conditions that the valuer must agree to before being employed for a valuation project by a client. Terms of engagements enable the valuer and the client to have a clear understanding the nature and scope of the valuation and the limitations set upon it thereof. Ethical considerations become important while finalizing the terms of engagements due to the very nature of valuation exercise.

Valuation is both a science and an art and as such it is contextual. It uses data, facts, reports, assessments, feedback, and responses to arrive at and to perform the mandate conferred by the contract. It is subjective because valuation is, at best, an interpretation of information and thus susceptible to individuality. Terms of engagements delineate the scope and limitations of the valuation work, and the responsibilities, privileges and liabilities of both parties. Keeping ethical considerations in mind, while agreeing upon the terms of engagement, will protect the client and the valuer from possible breach of laws and rules, from miscommunication over expectations, and acknowledge its possible impact on third parties and the wider public as a whole.

Example Format of Engagement Letter for Valuation

<ADDRESS>

Subject: Valuation Services Engagement Letter

Dear <CLIENT NAME>,

The purpose of this letter is to outline and confirm the terms as well as conditions of our Valuation Engagement. The following paragraphs are part of this overall outline:

- Purpose of Engagement
- Scope of Engagement
- Objective of Valuation Service
- Reporting of Business Valuation Conclusion
- Engagement Staffing and Estimated Completion
- Engagement Fees and Billing Arrangement
- Representations by Us
- Your Responsibilities as Client
- Dispute Resolution
- Limitation of Liability
- Legal Action Limitation
- Indemnity Agreement
- Termination of Engagement
- Acceptance of Engagement Terms
- Assumptions and Limitations
- Confidentiality

Yours Sincerely,

<NAME>

THREATS TO ETHICAL STANDARDS

According to the International Valuation Standards Council, a number of circumstances and attributes may compromise a valuation exercise, and the ability of the valuer to guarantee compliance with ethical standards. These are, but not limited to:

Self-Interest- Personal considerations that may inappropriately influence professional judgement

Self-Review- Inability to dispassionately evaluate own decisions and judgements

Client Conflict- When two or more clients have opposing interests in an outcome

Advocacy- When the valuer promotes a position to the point of compromising objectivity

Familiarity- The impact of long and close ties with a client that may impair objectivity and independence of work

Intimidation-Actual and perceived pressures on the valuer in order to influence the outcome of the valuation

Threats that undermine the ethical fundamentals of the valuation may be eliminated or at least mitigated through appropriate safeguards. While some safeguards may be put in place by the State legal and regulatory authorities, others are ensured by organizational laws and rules. Some of these safeguards are:

- Corporate structures and governance
- Statutory licensing
- Third party review
- Eligibility and competency guidelines
- Professional standards compliance
- Operational independence of the valuer
- External review and Peer review
- A well-established complaint and redressal system

ETHICAL CONSIDERATIONS

Certain safeguards are provided by the valuer themselves by adhering to ethical principles.

Integrity | **Objectivity** | **Competence** | **Confidentiality** | **Professional Behavior**

Integrity: The valuer must provide highest level of probity in valuation and maintain straightforward and forthright professional relationship with the client. The principle of integrity towards valuation goes beyond the client to consider its impact on unintended third parties and the wider public.

- The valuer is duty bound to report any discrepancy or breach of law that might be found in the course of the valuation
- There should be no false or exaggerated claims of competence, qualification or experience to obtain business. The valuer must declare past association with the client if any
- The valuer's association with the client must not be in contravention of SEBI (Prohibition of Insider Trading) Regulations, 2015
- The valuer must not indulge in "Mandate Snatching" or "Convenience Valuations"
- The valuer must not charge "Success Fee"
- The valuer must not receive gifts or hospitality that might influence the valuation, or, give any gift or cash in order to influence
- Remuneration charged must correspond to the services rendered and be verifiable

Objectivity: The valuer must be free of any undue influence or personal bias, and be free of any conflict of interest in the discharge of valuation responsibility. The Model Code of Conduct expects the valuer to provide proof of appropriacy of assessments and decisions by maintaining written contemporaneous records for decisions including the information and evidence upon which they were based. These should be available for scrutiny and verification, if required. Appropriate procedural safeguards help reduce threats to objectivity and counter any perception of possible bias. Some procedural safeguards are

- Disclosures of any prior association with the client
- Disclosure of any possible source of conflict of interest
- Providing per-review of valuation, if necessary

Section 247 of the Companies Act, 2013 didn't allow a registered valuer to undertake valuation of any assets where he / she has a direct / indirect interest or gets so interested at any time during or after valuation of the assets. As per the Companies (Amendment) Act, 2017, a registered valuer is prohibited from undertaking the valuation of any assets where he / she has direct / indirect interest or gets so interested at any point of time during 3 years prior to his / her appointment as valuer, or 3 years after the valuation of assets was conducted by him / her.
Valuation reports must be free of any ambiguity. Methodologies, investigations, approaches and reporting must be in accordance with the valuation standards in force.

Competence: The client deserves competent professional service from the valuer. The valuer must maintain the required professional knowledge and competence and be up to date with relevant technical, legal and valuation standards as per government and industry norms. The valuer must be able to provide accurate and verifiable proof of required knowledge and competence to the client. The valuer must conduct valuation with due diligence and exercise independent professional judgement. In case the required competence and experience are not met, the valuer must decline the assignment.

Confidentiality: The valuer must scrupulously maintain confidentiality of the client and of the information obtained during the course of valuation and beyond. The principle of confidentiality is the cornerstone of the client-valuer relationship.

- The valuer must not divulge or disclose information acquired and received from the client as a result of the professional valuation work and business relationship without proper and specific authorization.
- The valuer must not use information thus obtained for personal gain or to the advantage of third parties.
- The principle of confidentiality prohibits the valuer from disclosing or use confidential information related to the client even after the relationship/contract with the client has ended.
- The principle of confidentiality applies vis a vis a prospective client also.

In the circumstances that necessitate disclosure of confidential information, the valuer must consider that if by disclosure

- legitimate interests of all parties including third parties are being harmed, and that appropriate parties are recipients of the information
-
- If the relevant information is true and can be substantiated. If the information involves unsubstantiated and unclear facts and conclusions, professional judgement must be used to decide the extent and manner of disclosure.

While terms of engagement agreed to between the client and the valuer presuppose that the interests of the client shall be paramount, the valuer has a professional duty to uphold the laws of the State and an obligation to the larger public as a whole. The terms of engagement must specifically exclude any promise to maintain confidentiality on the part of the valuer where there is evidence of any infringement of law.

The Model Code of Conduct (2017) provides that,

> *"A valuer, while respecting the confidentiality of information acquired during the course of performing professional services, should maintain proper working papers for a period of three years, for production before a regulatory authority or for peer review. In the event of a pending case before a Tribunal or Appellate Tribunal, the record should be maintained till the disposal of the case." (page 17, point no. 22 of Registered Valuers Rules 2017, The Ministry of Corporate Affairs)*

In the situation when a clear breach of the law has not occurred but there might be potential contravention of law or financial abuse, the valuer must exercise their professional judgment to choose the best possible course of action. The suspected unlawful act must be brought to the notice of the client. The valuer must inform the client in writing of possible illegality or irregularity. The discussion with the client on the matter and instructions issued by the client, if any, must be confirmed in writing. In case of a clear breach of law, and where the client is the perpetrator, the valuer must express inability to continue with the work till the breach is rectified and discontinued.

It has been observed that the valuer may hesitate to break confidentiality when confronted with a suspected abuse. The reasons for this hesitation may be that,

- the legal violation is not quite clear
- there is uncertainty over course of action to be taken
- there is a possible conflict of interest
- a desire not to complicate matters

In situations where overriding the principle of confidentiality needs to be considered or becomes imperative, the valuer must seek legal counsel before proceeding further.

Professional Behavior: Valuation must be conducted in a professional manner in accordance with required legal, technical and professional standards, and with strict adherence to timelines. A valuer must accept only such assignments as can be completed by the valuer with due care and competence and to the satisfaction of the client. The valuer must maintain the decorum of the client's organization and must deal responsibly and courteously towards all involved in the project. The valuer must respond promptly and effectively to all reasonable instructions, requests and complaints. The valuer must desist from indulging in disparaging competitors or fellow valuers. Dignity of the client, of the organization to which the valuer belongs, and of the valuation profession must be maintained by the valuer at all times.

Valuations are a comprehensive and reliable method to determine the worth of an asset or the feasibility of a financial decision. As the Indian economy develops stronger linkages at the global level, the demand for valuation has grown correspondingly. The need for greater transparency has encouraged India to move towards convergence with IFRS and adopt Fair Value Reporting for assessments. Thus, ethical considerations in valuations have acquired an enhanced relevance. Their need can be gauged from the fact that the new Notification of 2017 by the Ministry of Corporate Affairs includes a separate and detailed section on Model Code of Conduct in the Rules governing registered valuers and valuation.

GENERAL LAWS | 04

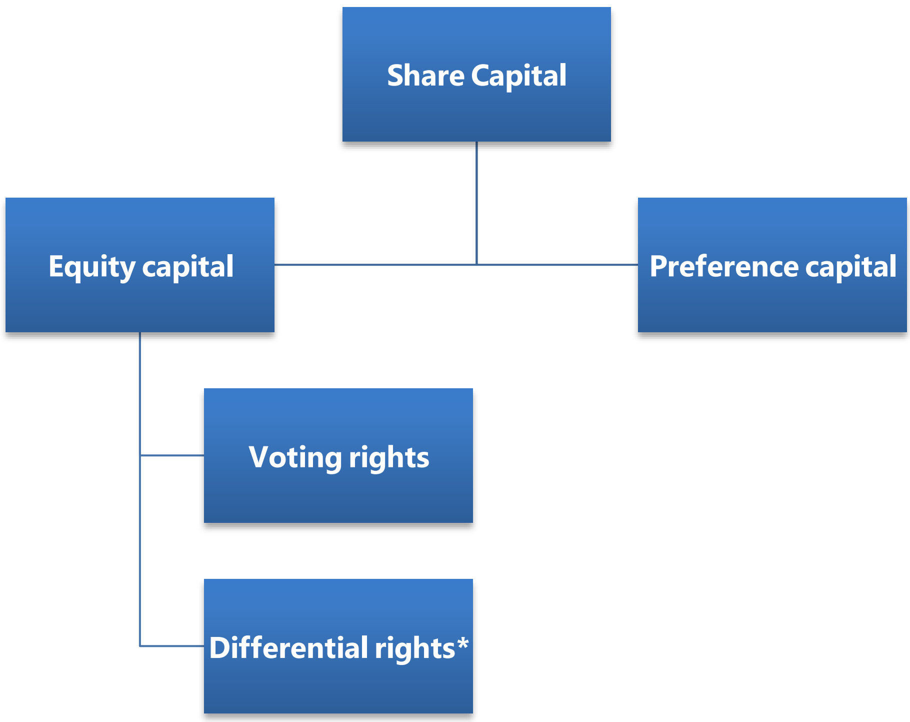
1. THE COMPANY'S ACT, 2013
2. THE INDIAN CONTRACT ACT, 1872
3. THE SALE OF GOODS ACT, 1930
4. THE TRANSFER OF PROPERTY ACT, 1882
5. THE INDIAN STAMPS ACT, 1899
6. THE INCOME TAX ACT, 1961
7. THE INSOLVENCY AND BANKRUPTCY CODE, 2016 (IBC) & REGULATIONS
8. THE SARFAESI ACT, 2002

GENERAL LAWS I 04

1. THE COMPANIES ACT, 2013

CHAPTER IV SHARE CAPITAL AND DEBENTURES

1. **Types of share capital**



**Differential rights can be in terms of dividend or voting power.*

Capital shall be deemed to be preference capital when it is entitled to either or both of:

- Preferential right with respect to dividends
- Preferential right with respect to repayment of capital

2. Basic provisions and requirements

Shares and debentures of a company are required to be movable and transferable in a manner provided in the articles of association

All shares must be identifiable through a distinctive numbers. All holders of shares must be issued a share certificate under the common seal of the company.

A duplicate share certificate can be issued to the holder only if such certificate:

- Is proved to have been lost or destroyed; or
- Have been defaced, mutilated, torn and is surrendered to the company

In case the shares are held through a depository, the records of the depository are prima-facie evidence of the title of the person on such shares.

3. Voting rights

Voting rights for equity shareholders

Section 47 of the Companies Act, 2013 ("the Act"), every member of a company limited by shares and holding equity share capital therein shall be eligible to vote on all resolutions placed before the company. The voting right on the poll shall be proportionate to his share in the paid-up equity share capital of the company

Voting rights for preference shareholders

Every member of a company limited by shares, and holding any preference share capital, shall be entitled to vote, only on those resolutions which:

- Directly affect rights attached to preference shares;
- Resolution for winding up of the company;
- Repayment or reduction of equity or preference capital;

Voting right shall be in proportion to his share in paid up preference capital of the company. As per Section 47(2) of the Act, in case preference shareholders have not been paid dividends for a period of two years or more, such class of preference shareholders shall have a right to vote on all resolutions placed before the company.

Variation of shareholders rights

Where the share capital of a company is divided into various classes, the rights attached to the shares of any class, can be ovaried, only in a separate meeting of such shareholders, with minimum 75% of such shares holders agreeing for such variation. Further, such variation must be:

- authorised by the memorandum of association; or
- must be a part of the conditions of issue of such shares, when they were originally issued.

In case holders of more than 10% of such class of shares do not consent to such variation or vote in favour of the special resolution, they may apply to the Tribunal to have the variation cancelled. Such variation shall not have effect until the Tribunal confirms it. The decision of the Tribunal shall be binding on shareholders.

4. Further issue of share capital

Section 62 (1) (C) - Where, at any time, a company having share capital proposes to increase its subscribed capital by the issue of further shares, such shares shall be first offered:

- To the existing shareholders of the company as right shares;
- Employees under any employee stock option scheme;
- Any other person, provided, such offer is authorised by a special resolution and the price of such shares is determined by a valuation report of a registered valuer.

5. Issue of bonus shares

A company may issue fully paid up bonus shares to its members, in any manner whatsoever, out of:

- Its free reserves,
- Securities premium, or
- Capital redemption reserve

No issue of bonus shares can be made by capitalising reserves arising out of revaluation of assets. Further, bonus shares can be issued only if authorised by the articles of association, and subject to few other conditions as laid down in the act.

6. Reduction in share capital

Subject to confirmation of the tribunal on application by the company, a company limited by shares or guarantee and having share capital, may, by a special resolution, reduce its share capital in any manner. In particular, it may;

- Extinguish its liability on any of its shares in respect of the share capital not paid up;
- Either with or without extinguishing or reducing liability on any of its shares;
  - Cancel any paid up capital which is in excess of wants of the company
  - Pay off ay share capital which is in excess of the wants of the company.

The memorandum of association needs to be altered accordingly.

7. Buyback of shares

A company may purchase its own shares or specified securities out of its:

- Free reserves;
- Securities premium account
- Proceeds of issue of any shares or other specified securities.

No company shall purchase its own shares unless:

- Buy back is authorised by the articles of association;
- Buy back is approved in a general meeting vide special resolution

- Buy back is less than 25% of the or less of the aggregate of paid up free capital and free reserves of the company.

CHAPTER XV- COMPROMISES, ARRANGEMENTS AND AMALGAMATIONS AND THE COMPANIES RULE, 2016

Section 230 (1) - A compromise or an arrangement may be

- between the company and its creditors or any class of them; or
- between the company and its members or any class of them

The Tribunal may, on the application of the company, or the liquidator (in case the company is under liquidation) may order a meeting of the creditors or class of creditors or members or the class of members, with whom the compromise or arrangement is sought. The meeting shall be called, held and conducted in a manner the Tribunal directs.

An application of any scheme for debt restructuring made with the tribunal shall include the following: - the financial positions, details of proposed scheme, including the rights and obligations and responsibility statements of the creditors and members, safeguards for protecting rights of other creditors or members along with a valuation report detailing the value of assets and liabilities of the company, valued by a registered valuer.

Any compromise or arrangement proposed under this section needs approval of atleast 75% of the concerned creditors or class of creditors or members or a class of members. Once the scheme has the requisite approvals, the Tribunal shall pass an order regarding the compromise or an arrangement, which shall be binding on all such creditors or class of creditors or members or class of members.

Provided that no compromise or arrangement shall be sanctioned by the Tribunal unless a certificate by the company's auditor has been filed with the Tribunal to the effect that the accounting treatment, if any, proposed in the scheme of compromise or arrangement is in conformity with the accounting standards prescribed under section 133.

The order of the Tribunal shall be filed with the Registrar by the company within a period of thirty days of the receipt of the order.

The Tribunal shall also have the power to supervise the execution of such arrangements.

1. Mergers and amalgamations

Section 232 of the Act - Requirements outlined above for compromise and arrangements are equally applicable when the compromise or arrangements are a part of a merger or an amalgamation.

Over and above the documents required to be filed with the Tribunal for a compromise or an arrangement, the company also needs to file further documents like details of transfers of assets to the acquiring company, details of the scheme like share swap ration, eligible members, scheme for transfer of employees etc.

If the transferor company is a listed company, and transferee company is an unlisted company, the transferee company shall remain an unlisted entity until it becomes a listed entity.

If the shareholders of the transferor company decide to opt out of the scheme, provisions needs to be made by the company to settle the consideration for such shareholders, based on the valuation report filed by the company.

The scheme of merger or amalgamation shall clearly indicate the date it is meant to be effective from.

2. Mergers or amalgamation between certain companies

As per Section 233 of the Act, a scheme of merger or amalgamation may be entered into between two or more small companies or between a holding company and its wholly-owned subsidiary company or such other class or classes of companies.

Section 2(85) defines small company as a company, other than a public company:

- paid-up share capital of which does not exceed fifty lakh rupees or
- turnover of which as per its last profit and loss account does not exceed two crore rupees

In case of merger or amalgamation of such small companies or Group companies, the requirements are different as compared to above. The concerned companies need to file a solvency declaration with the Registrar, along with the notice of the proposed scheme. The scheme needs to be approved in a General meeting by members holding atleast 95% shares. The scheme also needs approval from creditors representing 90% in terms of value.

If the Registrar or the Official liquidator, as the case may be, has any objections on the scheme, he may communicate the same in writing to the company within 30 days. If there are no objections to the scheme, the Central Government shall register the same and issue a confirmation thereof to the company.

3. Effect of the registration of the scheme

The registration of the scheme shall have the following effects:

- All property and liabilities of the transferor company gets registered in the name of the transferee;
- The charges on property, if any, shall be applicable and enforceable on the transferee company, in the same way as they were applicable to the transferor company;
- Legal proceedings, if any, would be enforceable against the transferee company, as they would be against the transferor company;

- In case the scheme has any dissenting shareholders, the obligation to pay off such shareholders becomes a liability of the transferee company.

4. Merger with foreign company

Merger with or merger of foreign companies needs additional approval of the Reserve Bank of India. The scheme of merger needs to outline additional factors like mode of payment of consideration (cash or depository receipts) to ensure that all foreign exchange regulations are duly complied with, in addition to the other requirements of this section.

The act empowers the Central Government to make additional rules, in consultation with the Reserve Bank of India.

5. Dissenting Shareholder

Dissenting shareholders are shareholder who has not assented to the scheme or contract and any shareholder who has failed or refused to transfer his shares to the transferee company in accordance with the scheme or contract.

In respect of such dissenting shareholders, Section 235 of the Act, grants power to the transferor company to acquire the share from such dissenting shareholder.

Where a scheme or contract involving the transfer of shares or any class of shares in a company (the transferor company) to another company (the transferee company) has, been approved by the holders of not less than 90% in value of the shares whose transfer is involved, other than shares already held at the date of the offer by, or by a nominee of the transferee company or its subsidiary companies, the transferee company may, give notice to any dissenting shareholder that it desires to acquire his shares.

6. Purchase of minority shareholding

Section 236 of the Act - In the event of an acquirer becoming registered holder of 90% or more of the issued equity share capital of a company, by virtue of an amalgamation, share exchange, conversion of securities or for any other reason, such acquirer, person or group of persons, as the case may be, shall notify the company of their intention to buy the remaining equity shares.

The acquirer, person or group of persons shall offer to the minority shareholders of the company for buying the equity shares held by such shareholders at a price determined on the basis of valuation by a registered valuer in accordance with such rules as may be prescribed.

7. Preservation of books and papers

The books and papers of a company which has been amalgamated with, or whose shares have been acquired by, another company under this Chapter shall not be disposed of without the prior permission of the Central Government and before granting such permission, that Government may appoint a person to examine the books and papers or any of them for the purpose of ascertaining whether they contain any evidence of the commission of an offence in connection with the promotion or formation, or the management of the affairs, of the transferor company or its amalgamation or the acquisition of its shares.

CHAPTER XVII- REGISTERED VALUERS

Section 247(1) of the Act mandates that whenever a valuation is required to be made in respect of any property, stocks, shares, debentures, securities or goodwill, or any other asset or the net worth of the company or its liabilities, under the provisions of the act, it shall be valued by a person.

The valuer may be appointed by the audit committee, or in its absence, by the Board of Directors. The terms and conditions of appointment of the valuer are required to be prescribed by the relevant appointing authority.

Valuer so appointed shall:
- Make impartial, true and fair valuation of any assets which may be required to be valued;
- Exercise due diligence while performing the functions as valuer;
- Make valuation in accordance with such rules as may be prescribed;
- Not undertake valuation in cases where he has a conflict, or may have a potential conflict of interest at any time during or after the valuation of assets.

Valuer contravening the provisions of this Chapter shall be liable to a fine of INR 25,000. Further, if it is proved that violation of provisions of this Chapter was with the intent of defraud the company, the valuer shall be punishable with imprisonment for a term which may extend to one year and with fine which shall not be less than one lac rupees but which may extend to five lac rupees.

Section 247(4) states that the valuer shall also be liable to refund the remuneration received by the company and pay damages to the person or the company for any loss arising out of incorrect or misleading statements of particulars made in this report.

THE COMPANIES (REGISTERED VALUERS AND VALUATION) RULES, 2017

The Companies (Registered Valuers and Valuation) Rules, 2017, primarily discuss the following aspects:

- Eligibility, qualifications and registration of valuers
- Recognition of valuation professional organisations
- Valuation standards and valuation report
- Disciplinary proceedings

All the above points are discussed in detail below.

1. Definitions

Some of the critical definition with respect to the Companies (Registered Valuers and Valuation) Rules, 2017 are:

- **Certificate of registration -** means the certificate of registration granted to a valuer under Rule 7(6) and the term "registration" shall be construed accordingly;
- **Certificate of recognition -** means the certificate of recognition granted to a valuation professional organisation under Rule 13 or 14 and the term "recognition" shall be construed accordingly;

  Registered valuer - is a valuer registered with the Registration Authority under Rule 7(6) for carrying out valuation of assets belonging to a class or classes of assets;

2. Eligibility, qualifications and registration of valuers

Eligibility

- Any person practicing as a registered valuer is required to obtain a certificate of registration
- No person shall be eligible for registration as a valuer if he:
  - Has not passed the valuation examination in three years preceding the date of valuation;
  - Does not have the requisite qualifications and experience;
  - Is a minor;
  - Is of unsound mind;
  - Is an un discharged bankrupt, or has applied in the jurisdiction as an bankrupt;
  - Is a person not resident in India
  - Convicted of an offence punishable with imprisonment of a period exceeding 6 months. A person remains disqualified for 5 years from the date of expiry of sentence. Further, if the person is convicted of an offence and sentenced to imprisonment for a period of seven years or more, he shall never be eligible for registration;
  - Is not a valuer member holding certificate of practice of a valuation professional organisation
  - Is not a fit and proper person. In determining this condition, the Registration Authority may take into account, various considerations, including but not limited to;
    - Integrity, reputation and character;
    - Absence of convictions and restrain orders
- In case of a partnership, the partnership shall not be eligible to be a registered valuer if;
  - It or any of its partners have incurred any of the disqualifications mentioned above;
  - Majority of its partners practicing in India are not registered valuers

Qualifications

- Post graduate degree in the specified discipline from a University in India and atleast 3 years experience in the discipline;
- Bachelors degree in the specified discipline from a University in India and atleast 5 years work experience in the discipline;

- Membership of a professional institute set up under an act of parliament and atleast five years experience after such membership.

Registration of valuers

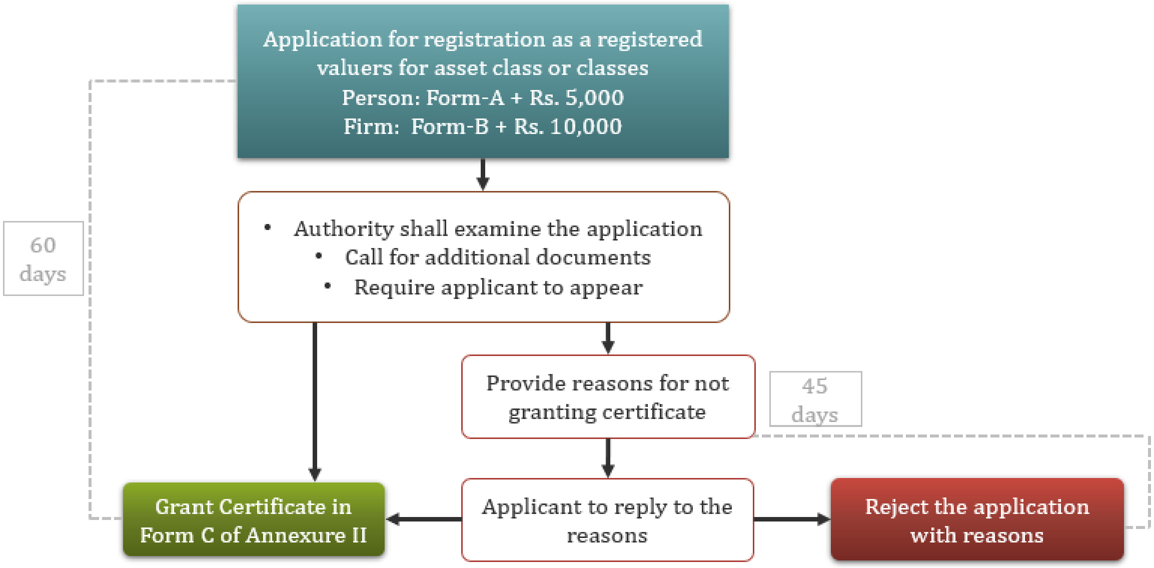
A person desiring to registering himself as a valuer shall make an application with the Registration authority who shall examine the application and give the applicant, an opportunity to remove deficiencies, if any.

The Registering authority has the discretion to reject the application if it is, prima facie of the opinion that the registration cannot be granted. The final decision of course, subject to giving an opportunity to the application, for him to place any additional documents and clarifications.

Pre-requisite conditions for registration

The registration as a valuer imposes the following obligations on the valuer:

- Always comply with the provisions of the Act and Rules;
- Comply with Valuation standards
- Conduct valuation only for those assets and liabilities for which he has been registered;
- Prior permission of the registering authority while shifting its membership from one form to another, along with a no objection certificate from both the firms
- Adequate steps for redressal of grievances raised by clients or the registering authority
- Maintain records of all assignments
- Comply with the relevant code of conducts which may be applicable
- Allow only the partner who is a registered valuer for the class of assets that are being valued, to sign and act on behalf of the firm, where it is a partnership entity;
- In case of a partnership, liability of partners is joint and several;
- Comply with all such rules, regulations and conditions as may be framed by the Registration authority.



An overview of the registration process

3. Recognition of valuation professional organisations

Conditions for an organisation to be recognised as a valuation professional organisation:

- The organisation has been:
    - Set up under an Act of Parliament;
    - Registered under section 25 of Companies Act 1956, or section 8 of Companies Act 2013;
    - Registered as a society under Societies Registration Act 1860;
    - Set up as a trust governed by the Indian Trust Act, 1882.
- Conducts examinations before enrolling professionals as members of the organisation;
- Grants membership or certificate of practice to individual practitioners or partnership entities who fulfil the guidelines so laid out;
- Lays down code of conduct for members;
- Provides for continuing education of individuals who are members;
- Monitors and reviews the functioning, including quality of service, of valuers and its members;
- Has a grievance redressal mechanism, including conducting disciplinary proceedings against members.

Other requirements, i.e. application for recognition, conditions, etc for valuation organisations are fairly similar to those outlined above for valuation professionals.

4. Valuation standards and valuation report

A registered valuer shall make valuations in accordance with the valuation standards notified by the Central Government from time to time.

The Central Government constitute an advisory committee to advise it and the Registering authority on issues relevant information and prescriptions of the valuation standards.

Valuation report

Valuation report issued by the valuer explicitly needs to include the following information:

- Background information of asset being valued;
- Purpose of valuation and appointing authority;
- Identity of the valuer and any other experts involved in the valuation;
- Disclosure of any conflict of interest;
- Sources of information;
- Procedures adopted in varying out the valuation;
- Valuation methodology;
- Major factors that influenced the valuation;
- Conclusion;
- Caveats, limitations and disclaimers.

5. Disciplinary proceedings

The valuation rules empower the Registration authority to take disciplinary action against members/firms who violate any of the conditions of registration or code of conduct or any other rules or requirements laid out by the registering authority.

The Registering authority is first required to give a show cause notice to the concerned valuer, outlining:

- The provisions or act under which such notice is issued;
- The provisions which are alleged to be violated;
- Evidences supporting the allegations made, available with the Registering authority;
- Manner in which the member/firm is expected to respond;
- Consequence of failure to respond;
- Procedure to be followed for disposal of the show cause notice.

The eventual disposal of the show cause notice may provide for:

- No action;
- Warning; or

Suspension/ cancellation of the registration or recognition.

Apart from above rules, the Companies (Registered Valuers and Valuation) Rules, 2017 also provides the following schedule:

Schedule I - Model code of conduct for registered valuers
Schedule II – Form A - Application for registration as a valuer by an individual
Schedule II - Form B - Application for registration as a valuer by a partnership entity
Schedule II - Form C - Certificate of registration
Schedule II - Form D - Application for certificate of recognition
Schedule II - Form E - Certificate of recognition
Schedule III – Part I - Governance Structure and Model Bye Laws for VPOS
Schedule III – Part II - Model Bye-laws of a valuation professional organisation

CHAPTER XX- WINDING UP

1. Winding up by the Tribunal

In the event of a petition filed under Section 272, a company may be wound up by the Tribunal, if:

- If the company is unable to pay its debts
- If the company, by special resolution, has resolved that the company shall be wound up by the Tribunal;
- Company has acted against national interest
- On an application by the Registrar or any other person authorised by the Central Government, if it is of the opinion that the company was formed for fraudulent purpose
- If the company has defaulted in filing its annual accounts and returns with the Registrar for five consecutive years
- If the Tribunal is of the opinion that it is just and equitable that the company be wound up.

Section 272 - Petition for winding up

Petition for winding up can be made by:

- The company
- Any creditor or creditors
- Any contributory or contributories
- The Registrar
- Any person authorised by the Central Government

As per Section 273(1), the Tribunal may, on receipt of a petition for winding up under section 272 pass any of the following orders, namely:—

(a) dismiss it, with or without costs;
(b) make any interim order as it thinks fit;
(c) appoint a provisional liquidator of the company till the making of a winding up order;
(d) make an order for the winding up of the company with or without costs; or
(e) any other order as it thinks fit:

An order under this sub-section shall be made within ninety days from the date of presentation of the petition.

Company Liquidator

For the purpose of winding up by the Tribunal, the Tribunal shall appoint an official liquidator as the company liquidator. The liquidator shall be appointed from a panel maintained by the Central Government. Once the order for winding up has been passed, the Company Liquidator shall take into his custody, all the property, effects and actionable claims to which the company is or appears to be entitled to.

The Act also stipulates that all the Directors, promoters and employees of the company, who are or have been in employment of the company and/or still associated with the company, shall extend full co-operation to the Liquidator in discharging his duties

Implication of an order of winding up

As and when the winding up proceedings are initiated against the company, due to any reason whatsoever, no suit or legal proceedings shall commence against the company. In case of any pending litigation at the time of passing such order, such litigation cannot be proceeded with, except with the leave of the Tribunal.

Submission of report by Company Liquidator

Where a company liquidator is appointed, Section 281 requires the Company liquidator to submit a report to the Tribunal, within sixty days from the order, containing the following particulars, namely:—

(a) the nature and details of the assets of the company held by the company, for which the valuation shall be obtained from registered valuers for this purpose;

(b) amount of capital issued, subscribed and paid-up;
(c) the existing and contingent liabilities of the company along with particulars of the securities given, whether by the company or an officer thereof;
(d) the debts due to the company;
(e) guarantees, if any, extended by the company;
(f) list of contributories and dues, if any;
(g) details of trademarks and intellectual properties, if any;
(h) details of subsisting contracts, joint ventures and collaborations, if any;
(i) details of holding and subsidiary companies, if any;
(j) details of legal cases filed by or against the company; and
(k) any other information which the Tribunal may direct or the Company Liquidator may consider necessary to include.

Final settlement

As per Section 282, the Tribunal shall, on consideration of the report of the Company Liquidator, fix a time limit within which the entire proceedings shall be completed, and the company be dissolved.

On passing the order of winding up, the Tribunal, as soon as possible, needs to:

- Rectify the members register (if required);
- Settle a list of contributories;
- Cause the assets of the company to be applied for discharge of such liabilities.

2. THE INDIAN CONTRACT ACT, 1872

When it comes to valuation of an enterprise, the contracts entered into by an entity play a critical role in the overall valuation exercise. Contracts in question typically provide entitlements (purchase orders for future supplies) or impose obligations on the enterprise (obligation to purchase material, pay lease rentals in the future. A lot of intangible assets are controlled by enterprises by virtue of contractual rights. This makes it essential for a valuer to understand the basic concepts of a contract, including what constitutes a contract, what are the elements of a valid contract, circumstances under which a contract can be enforced in case of a default, contract breaches, among others.

The Indian Contract Act may be broadly studied in the following parts:

OFFER, ACCEPTANCE, REVOCATION

1. Proposal/Offer

When one person signifies to another, his willingness to do, or abstain from doing anything, with a view to obtaining the assent of the other, to such act or abstinence, he is said to make a proposal/offer.

Offer has to be clearly distinguished from invitation to offer. When a salesman displays a product with a particular price tag, it is not considered an explicit offer. It is an invitation to the prospective customer to place an offer to the product at the stipulated price tag.

2. Promise

A proposal/offer when accepted becomes a promise.

3. Acceptance

When the person to whom the offer is made, signifies his assent thereto, the offer is said to be accepted.

4. Promisor and promise

When the proposal is accepted, the person making the proposal is called as promisor and the person accepting the proposal is called as promisee.

5. Consideration

When at the desire of the promisor, the promisee or any other person has done or abstained from doing or does or abstains from doing or promises to do or to abstain from doing something such act or abstinence or promise is called a consideration for the promise. Price paid by one party for the promise of the other.

Consideration is the key pre-requisite for a contract to be valid.

LEGAL CONTRACT, VOID AND VOIDABLE CONTRACTS

1. Agreement

Definition of a contract

A contract is an agreement enforceable by law. Therefore, a contract is an agreement, plus enforceability of that agreement by law.

Definition of Agreement

An agreement is a promise or a set of reciprocal promises made by two parties to each other. A promise is said to be made when a proposal is made by one person and accepted by the other. These mutual promises must form consideration, i.e. something in return to each other.

An agreement, therefore, is a reasonable and definite understanding between two or more persons as to what each party is to do.

Whether an agreement is legally enforceable or not (for it to qualify as a contract) would depend upon two factors-

- Intention of parties to enforce it legally
- Presence of all essentials elements of a contract.

2. Essential Elements of a Valid Contract

All agreements are contracts if they are made by the free consent of the parties competent to contract, for a lawful consideration and with a lawful object, and are not hereby expressly declared to be void (*Sec 10 of Indian Contract Act 1857*).

The essential elements of a valid contract can therefore be summarised as follows:

- Two parties are involved
- A legally enforceable agreement not expressly declared to be void
- Free consent of parties
- Parties to contract are competent
- Lawful object and consideration
- Permissible by law
- Certainty of the meaning and
- Possibility of performance

As per Section 23 - The consideration or object of an agreement is lawful, unless:

- It is forbidden by law; or
- Is of such nature that, if permitted it would defeat the provisions of any law or
- Is fraudulent;
- Involves or implies, injury to the person or property of another; or
- The Court regards it as immoral, or
- Opposed to public policy.

In each of these cases, the consideration or object of an agreement is said to be unlawful. Every agreement of which the object or consideration is unlawful is void.

3. Classification of contracts

- Based on Validity
- Based on formation
- Based on performance

4. Based on validity

Valid contract

A valid contract fulfils all the essential requirements of a contract, as laid down in the Contract Act. These contracts are enforceable by law.

Other contracts

An agreement is enforceable at law when certain essentials stipulated in section 10 of the Indian Contract Act are complied with. It forms a valid contract. If any one or more of the elements is missing, then the agreement may either be void, voidable, illegal or unenforceable. These terms have been elaborated below for better understanding.

5. Void Contracts

Void contracts are contracts that are not enforceable by law. This is typically because they do not fulfil any one or more conditions stipulated by the Contract Act.

A void agreement or a void contract has no legal effect in the eyes of law. It creates no rights or obligations. None of the parties can enforce it in the court of law.

If an agreement fails to meet the basic criteria to become a contract as per section 10 of the Act, it is termed as void ab initio. This means that the contract was never valid and not enforceable, right from inception.

It may be noted here that a void agreement never attains the form of a contract. For example, agreements made by a minor or lunatic, agreements made with unlawful object, agreements made without consideration are void agreements.

There may also be instances wherein the contracts are initially valid, but due to happening or not happening of certain events, the contract becomes void at a later point of time, eg. a singer supposed to perform on a particular date, but meets with an accident and therefore, cannot perform on that particular date.

6. Voidable contract

An agreement which is enforceable by law at the option of one or more of the parties thereto, but not at the option of other or others, is a voidable contract.

The party(s) (either or all) entitled to avoid the contract may or may not do so. If the parties decide to avoid it, it no longer can be enforced in the court of law. If the parties opt not to avoid the contract, it is as good as any other valid contract.

When the consent of one or more of the parties to a contract is obtained by coercion, or undue influence, or misrepresentation, or fraud, the contract becomes voidable at the option of the party(s) whose consent was obtained as such. Such party is termed as aggrieved party.

When a contract contains reciprocal promises, and one party to the contract prevents the other from performing his promise, the contract becomes voidable at the option of the party so prevented.

The idea is that no man can complain of another's failure to do something which he has himself prevented the other from doing or performing.

When time is the essence of a contract and it is required to be performed by a specified time, and a party fails to perform it within this time, the contract becomes voidable at the option of the other party.

7. Illegal contracts

A contract is considered as illegal or unlawful, if its consideration is forbidden by law (eg. promise to beat someone up in lieu of money), defeats the provision of any law, fraudulent, injurious to any person or any other persons property, immoral or against public policy.

8. Void contracts v/s Illegal contracts

An illegal contract is necessarily void. A void contract may be void because of a reason other than illegality.

Void contract is a wider term which encompasses all the contracts which are not enforceable at law for whatever reason. It may be a defect in the formation of contract, or it may be impossibility of performance, or express declaration by the contract law, or it may be illegality of purpose, consideration or performance which makes a contract void.

9. Unenforceable contracts

Unenforceable contracts, though fulfilling all other requirements of a contract, cannot be enforce in a court of law because of some technical defect. For certain types of contracts, there are special provisions of law which require certain formalities to be fulfilled for like getting the contract registered, or attested by notary, or getting it stamped, etc. If such formalities are not observed, the contract cannot be enforced by law. Some of such contracts can be enforced, if the technical defect is subsequently removed.

Based on formation

1. Express Contract

These contracts expressly outline the promises, obligations of both parties and the consideration which forms a part of the contract. Both parties explicitly agree to be bound by the terms of the contract, either orally, or in writing (generally in writing).

2. Implied Contract

An implied contract is an agreement created by actions of parties involved. There is no explicit consent of any/both the parties, but the actions suggest that both the parties have agreed to the terms of the contract. For eg, when a customer purchases any material from a shop, the act of handing over the money to the shopkeeper and the act of the shopkeeper of handing over the material to the customer indicates an implied contract, wherein there may be no other oral or written arrangement to evidence the sale transaction.

3. Quasi Contract

A quasi contract, is again, a contract, that is created by an act of any of the parties, without any previous agreement. These are typically when goods or services are provided to, and more importantly, accepted by a party who did not originally request for these goods or service. For eg. in case a customer is served a wrong order at a restaurant, but instead of returning it, the customer chooses to consume the order received, it places an obligation on the customer to pay for the order he received and consumed, though the order he received was different from the order he originally placed. In this case, the consideration too, would change based on the order actually consumed, and not the order originally placed.

Based on performance

1. Executed Contract

An executed contract is one, wherein both the parties have already completed their part of the obligations and exchanged consideration for the obligations involved in the contract. No further action is required for completion of the contract.

2. Executory contracts

Executory contracts are contracts where the performance cannot be fulfilled immediately and are therefore, required to be fulfilled in the future. This emanates on account of the nature of the contract, wherein the performance cannot be immediately fulfilled. For eg. catering contract for a future date. Executory contracts can further be split into unilateral and bilateral.

3. Unilateral Contract

A unilateral contract typically includes an offer from one party, which becomes a promise only when the other party performs the action. For eg. Police department may announce an award for any person who helps them nab a criminal. The obligation materialises only when the criminal is nabbed. This is a one-sided (unilateral) contract by the police department. No other party is under an obligation to fulfil the contract. Only when any person actually nabs the criminal (or helps in such act), does the police force become liable to pay the amount.

4. Bilateral contracts

This is a regular contract whereby both the parties explicitly agree to fulfil their obligations at a future date.

CONTINGENT CONTRACTS

Contingent contracts are contracts which become enforceable only on happening or not happening of an uncertain future event. Contingent contracts, is therefore, a conditional contract.

Section 31 of the Indian Contract Act, 1872, defines a contingent contract as, "A contingent contract is a contract to do or not to do something, if some event, collateral to such contract, does or does not happen."

It may be inferred from the above that the performance of a contingent contract is dependent on a future uncertain event, and such event should be collateral to the contract.

In an ordinary contract, as soon as the contract is made, its performance becomes due by the respective parties based on the terms of the contract.

When a contract is contingent, i.e. dependent upon the happening or non-happening of a future event, its performance will become due only on the happening or non-happening of such event.

Contingent contracts are practically very relevant for valuers, as many shareholding arrangements have contingent clauses regarding call/put option of the stake of each party. For e.g. a contract may entitle the minority shareholders to compulsorily sell (and make the majority compulsorily buy) the minority stake, at a particular price, subject to the entity earning a minimum profit in a particular span of time.

Certain contracts may mandate payout to employee subject to them remaining in service for a particular span of time. One of the critical components of a business valuation is valuation of future sales/revenue contracts with the entity. Such contracts also need to be evaluated for any contingent clauses, which may need to be fulfilled by the acquiring entity for it to benefit from such contracts. Such contingent clauses can have a significant bearing on the overall valuation of an enterprise.

General principles regarding contingent contracts:

- Contingent contracts cannot be enforced by law until the time that the uncertain event, which makes the contract contingent, has occurred.
- Contract becomes void if the happening or not happening of the uncertain event becomes impossible. This includes events which are time bound, and the time stipulated in the contract has elapsed.
- Contingent events for an impossible event are considered void ab initio

PERFORMANCE OF CONTRACTS & CONSEQUENCES OF BREACH OF CONTRACT

1. Termination/ Discharge of contract

The most common way of discharging a contract is to fulfil the promises made pursuant to the contract. Other ways in which a contract can be discharged is as follows:

Mutual Consent	•Novation •Alteration •Rescission •Remission
Subsequent illegality or impossibility	•Destruction of subject matter •Death or personal incapacity of promisor •Change of law
Other reasons	•Lapse of time •Operating of law •Breach of contract

The above points are briefly discussed below:

Discharge by performance

These are instances where the parties to the contract fulfil their respective promises. Once the promises are complete, the contract is said to be discharged, with no further action required from either party. A contract is said to be performed when parties make:

- **Actual performance**

Party to a contract is said to have performed his promise when has fulfilled all his obligations under the contract. Actual performance brings the contract to an end and no further action remains with respect to that contract.

- **Attempted performance**

On certain occasions, one party is willing to perform his promise and offers to perform the same. However, the other party refuses to accept the same. The objective of "offering to perform" or "tendering to perform" is to perform the promise. Thus, a valid tender of performance is equivalent to performance of promise and discharges a party form his obligations under the contract.

A tender of performance is valid if it satisfies the following condition:

- Performance is unconditional
- The performance must be for the entire contract
- It must be at a proper time and place

- Person making the tender must be willing to perform it
- Tender must provide reasonable opportunity to the other party, to ascertain that the party making the tender is able and willing to perform and the things offered are the same as those agreed in the contract

A contract may be performed by:

- The promisor himself, or
- His legal representative, or
- His agent, or
- A third person, subject to acceptance by the promise

Performance of a contract may be demanded by:

- The promise
- His legal representative

- **Discharge by mutual consent**

On certain occasions, owing to change in circumstances, the parties may agree to mutually terminate the contract or change the terms of the contract.

In certain cases, the parties may choose to discharge the old contract and replace the same with a new contract, agreeing on the terms and conditions afresh. This is termed as **"novation".**

In certain cases, the parties may simply choose to alter or change the existing terms and conditions. This is termed as **alteration**.

The parties may simply choose to cancel the contract and have no further obligations. This is termed as **"rescission".**

One of the parties may choose to waive off a promise made in the original contract or accept a sum lesser than what was originally agreed and consider the contract closed. This is termed as **"remission".**

- **Subsequent illegality or impossibility**

In certain cases, the purpose or the objective for which the contract was entered into, i.e. the subject matter of the contract may become illegal or impossible. In such cases, the contract automatically gets discharged. For e.g., a contract to rent a bungalow for a film shoot automatically gets discharged if the bungalow gets damaged by fire before the shooting date (destruction of subject matter).

A contract entered into by a production house with an actor for acting in films, automatically gets discharged if the actor becomes incapacitated due to any reason or the production house becomes insolvent and ceases to exist (death or personal incapacity of the promisor).

Similarly, contract to supply a particular material automatically get discharged if trading in that material becomes illegal (change of law).

Such scenarios are also termed as termination by frustration, wherein fulfilling the contract becomes impossible due to a supervening event.

- **Other Reasons**

If time is the essence of the contract, the contract may be considered to be discharged on account of lapse of time. For eg. a contract with an artist is considered to be automatically discharged, if he does not reach the performance venue at the stipulated time and the show had to be cancelled and ticket price refunded.

Discharge by operation of law, effectively means that a party did not fulfil its part of the promise (wholly or partly) and the other party did not take any action to enforce fulfilment within the time frame prescribed by law for such enforcement. For eg, if a creditor does not pursue legal action for recovery within 3 years, the debt becomes time barred and the he automatically loses all legal recourse for such recovery.

Contract is also considered to be discharged if there is any breach of contract terms. Breach of contract terms and consequent discharge/termination of the contract is discussed in detail below.

- **Termination on account of frustration or breach of contract**

When the parties enter into a contract, they become liable under law to perform their contractual obligations. Failure to perform the terms stated in the contract can result in a breach of contract. Breach of contract will typically lead to termination of the contract, along with potential litigation and other related liabilities.

In case of a breach of contract, the parties may mutually agree to terminate the contract by any one of the means mentioned above, i.e. remission, rescission, etc.

In case the parties cannot reach a common consensus on the outcome, the aggrieved party has recourse to legal remedies, in order to mitigate the loss arising out of the inability of the other party to fulfil his promise or complete the obligations as per the contract.

Remedies for Breach

- **Specific performance**

The aggrieved party can approach and request the court to direct the other party, to fulfil his promise as per the contract, in case of a breach. Such instances are rare, but unavoidable in certain circumstances, for e.g. in case the dispute arises on account of a unique or a valuable item, which cannot be replaced, the court has to order specific performance in terms of delivery of the unique item to the buyer.

- **Injunction**

Suit for injunction is typically filed when the contract contains a promise "not to do an act", i.e. a negative stipulation. The non defaulting party requests the courts to pass an order, restraining the defaulting party to abstain from specific actions, as per the terms of the contract. For e.g. restraining a party from doing a particular business, where it has signed a non compete clause for similar business.

- **Rescission**

Rescission means the non breaching party is allowed to cancel his responsibilities under the contract. This is mainly on the premise that as one party has defaulted in its obligations, the other party also need not fulfil his obligations. Any consideration exchanged is refunded back.

- **Reformation**

Reformation means a change in the contract terms to more accurately reflect what the parties want to do. This remedy is available only when the contract remains valid. This generally happens when one or both the parties had an incorrect understanding of their obligations under the contract.

- **Other legal remedies**

In case none of the above options work, the aggrieved can choose to file a suit for other legal remedies. Most common example of other legal remedies is demand of a monetary compensation. Few legal remedies are discussed below:

  - **Quantum Meruit**

    The meaning of expression Quantum Meruit is "as much as earned". The principle of quantum meruit suggests that the compensation is awarded in proportion to the work completed by the non defaulting party. The objective of this principle is to place the parties, in the original position, assuming that the contract was never made. This term is also called restitution, which means the act if restoring back to the rightful owner, that which has been taken away or lost.

  - **Compensatory damages**

    The aggrieved party demands monetary compensation to the extent of the amount it would have received, has the defaulting party fulfilled its promise. These damages are typically outlined in the contract itself, or depend on the fair market value of the promises which were fulfilled by the aggrieved party.

  - **Consequential damages**

    Consequential damages are damages that reimburse the non-defaulting party for the indirect costs that resulted from the breach. Such losses are generally estimated, for eg. Loss of profit in business.

  - **Liquidated damages**

    Certain contracts have clauses regarding the quantum of compensation in case of any breach of duties. They are typically part of contracts where the exact quantum of loss due to breach is difficult to quantity, e.g. Breach of a non-compete clause.

  - **Punitive damages**

    Punitive damages are typically levied as a penalty to deter the defaulter from acting in a similar fashion in the future. For punitive damages, the non defaulting party needs to prove more that default of the counter party. It needs to be established that the counter party had malafide or a fraudulent intent in committing a breach and therefore, a penalty needs to be levied on the defaulting party.

AGENCY AGREEMENTS

An agent is defined as a person who is appointed to do any act for another or to represent another in dealing with any third party.
A principal means a person for whom such act is done or who is so represented.

Rights and duties of agent

Rights of agent	Duties of agent
i. Receive remuneration **ii. Lien on goods, in case remuneration is not paid** **iii. Right to indemnity for all costs incurred in course of conducting his duties**	i. Conduct business as per instructions of principal, exercising due skill and diligence ii. Render proper accounts to principal iii. Communicate with principal on key matters iv. Not deal on his own account v. Not to make secret profits vi. Pay sums received on behalf of principal vii. Maintain due confidentiality of transactions with the principal and information received in course of his agency duties

Termination of Agency:

An agency can be terminated in either of the following manner:

- by the principal revoking his authority, or
- by the agent renouncing the business of the agency; or
- by the business of the agency being completed; or
- By either the principal or agent dying or becoming of unsound mind; or
- By the principal being adjudicated an insolvent under the provisions of any Act.

Ratification:

Where acts are done by one person on behalf of another, but without his knowledge or authority, he may elect to ratify or to disown such acts. If he ratifies them, the same effects will follow as if they had been performed by his authority.

A person ratifying any unauthorized act done on his behalf ratifies the whole of the transaction of which such act formed a part.

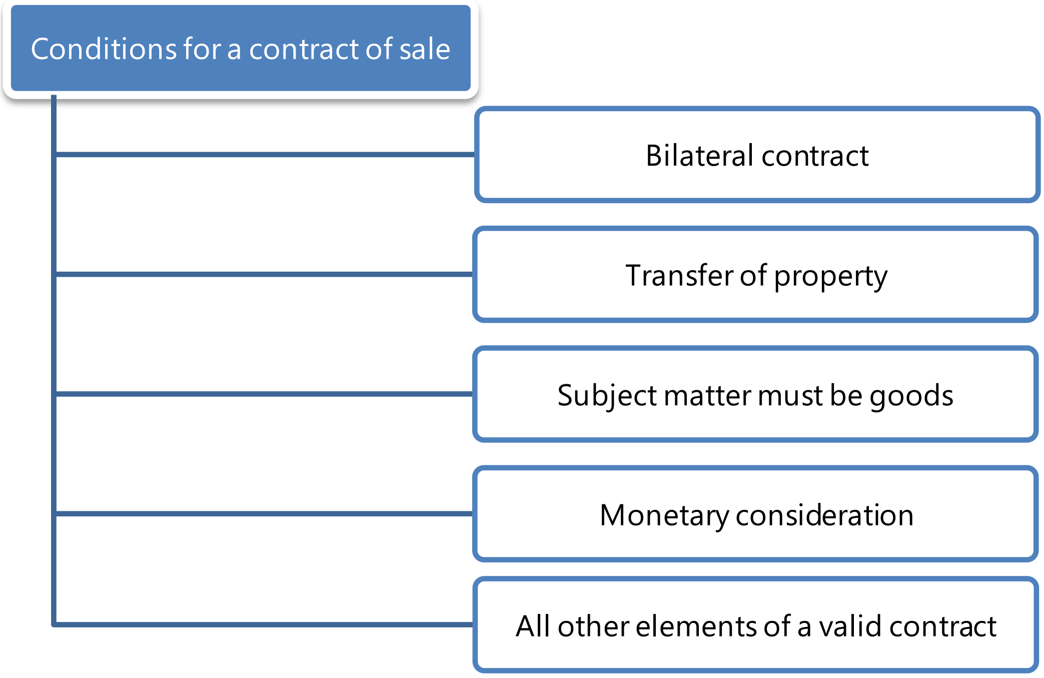
3. THE SALE OF GOODS ACT, 1930

1. Contract of Sale

Definition of a contract of sale of goods

A contract whereby the seller, transfers or agrees to transfer, property in goods, to the buyer, for a monetary consideration, called price.

Key conditions for a contract of sale of goods



A contract for sale of goods is required to be distinguished from an agreement to sell. In an agreement to sell, the transfer in property of goods happens at a future date or is subject to some conditions to be fulfilled.

All other modalities which are applicable for a general contract, are equally applicable for a contract of sale of goods too, for e.g., offer, acceptance, termination due frustration or subsequent illegality or destruction of goods in question, impossibility of performance etc.

2. Definition of goods

Every kind of movable property other than actionable claims and money; and includes stock and shares, growing crops, grass, and things attached to or forming part of the land which are agreed to be severed before sale or under the contract of sale.

3. Price of goods

Price of goods refers to the consideration paid or payable for the property in goods. This consideration has to be in the form of money. If the consideration is in form other than money, it does not qualify to be a sale. If for instance, goods are offered as the consideration for goods, it will not amount to sale. It will be called barter.

The Act applies only when the buyer pays by cash (or by cheque, credit card, etc).

Price if generally agreed to as a part of the contract. Alternatively, it may be determined by course of dealing between parties.

4. Stipulation-Condition and warranties

Before a contract of sale is concluded, certain statements are made by both parties to each other. If a statement is made by the seller, on the reliance of which, the buyer enters into the contract, such a statement will amount to stipulation. A stipulation may be in the form of a condition or a warranty.

Condition

If the stipulation forms the very basis of the contract, it is a condition. Breach of a condition gives the buyer, the right to treat the contract as repudiated, refuse delivery of the goods and recover any advance consideration he may have paid for the goods.

Warranty

A stipulation which is collateral to the main purpose of the contract is a warranty. In case of a breach of warranty, the buyer cannot refuse delivery of goods. He can however, claim damages for warranty.

Implied conditions in a contract for sale of goods

Contract for sale of goods generally comes with certain implied conditions, unless conditions to the contrary are agreed to explicitly by the parties. These can be summarised as follows:

- Seller has adequate legal title to the goods and is thereby, eligible to sell the goods to the buyer,
- Buyer shall have and enjoy quite possession of the goods post the sale transaction,
- The goods shall be free of any charges or encumbrances in favour of third party,
- Goods are reasonable fit for the purpose for which they are being bought by the buyer (in cases where the buyer makes known to the seller, the purpose of purchasing such goods, whether implicitly or explicitly).
- Where goods are bought relying on the description provided by the seller, it is implied that goods are of merchantable quality.

5. Unpaid seller and rights of an unpaid seller

The seller of goods is deemed to be unpaid when the whole price of the goods has not been tendered, or, when tendered through a negotiable instrument (like cheque or a promissory note), such negotiable instrument has been dishonoured.

Unpaid seller has the following rights:

- Lien or right to retention
- Stoppage in transit
- Right to resale
- Withhold delivery

4. THE TRANSFER OF PROPERTY ACT, 1882

1. Definition of Immovable Property

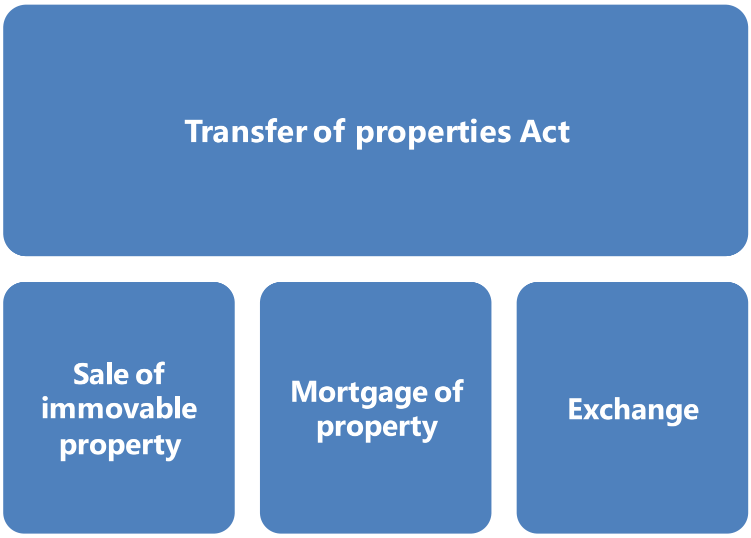
The term immovable property is not precisely defined in the act. The interpretation clause states that unless there is something repugnant in the subject or context "immovable property" does not include standing timber, growing crops or grass.

2. Transfer and Sale of Property

Transfer of property

Transfer of property means an act by which a living person conveys property, in present or in future, to one or more other living persons, or to himself and one or more other living persons; and "to transfer property" is to perform such act.

Principles regarding general transfer of property, whether movable or immovable



What may be transferred?

Property of any nature can be transferred. Few exceptions are outlined in the act, few of which include:

- Right to sue
- Stipend allowed to military, pensions to government officials and political pensions
- Right to future maintenance
- Public office or salary of a public officer
- Any transfer which may be against public interest

The rights mentioned above (along with few other outlined in the act) cannot be transferred.

Person who can transfer property

Any of the following persons who is competent to contract can transfer a property:

- Person entitled to transfer the property by the virtue of ownership
- Person who has the right the transfer the property, unconditionally, through an agency arrangement

Competency of a person to transfer any property is subject to the prevailing law applicable. For e.g. a person, though owning a heritage property, may not be able to transfer the same to any other person, as the law explicitly restricts transfer of any heritage properties.

Nature of transfers

Depending upon the nature of asset and the contractual arrangement, the transfers can be conditional or unconditional, for e.g. a person may get interest in a certain property on after attaining a certain age. The transfer can be contingent on happening or not happening of a particular future event, for e.g. in case of insurance contracts, the insured is compensated only if he incurs a loss.

Sale of immovable property

Sale indicates transfer of ownership from the seller to the buyer.

Sale of tangible immovable property can be made only through a registered instrument. Delivery of tangible immovable property takes place when the seller places the buyer, or his authorised representative, in possession of the property.

As per Section 17 of the Registration Act, 1908, all transactions that involve the sale of an immovable property for a value exceeding Rs 100, should be registered.

3. Rights and Liabilities of Buyer and Seller

Rights and obligations of a seller in case of sale of immovable property

- **Obligations of the seller**
  - Disclose any material defect in the property which the buyer may not be aware of or would not ordinarily care to discover
  - Produce all documents for examination of the title of the property
  - Answer all relevant questions put forward by the buyer
  - ON receiving the payment, execute proper legal documents in favour of the buyer, transferring the legal title of the property
  - Between the date of contract of sale and delivery of the property, exercise due care in handling the property and all documents related to the title of the property
  - Pay all charges and amounts due on account of the property, till the date possession is handed over to the buyer
- **Rights of the seller**
  - Rents and profits from the property till the time ownership passes to the buyer
  - In case the possession of the property is delivered without full settlement of the consideration, the seller is entitled to the balance consideration as well as the interest on such outstanding consideration

Rights and obligations of a buyer in case of sale of immovable property

- **Obligations of the buyer**
    - Discharge the considerations as agreed in the sale contract. The buyer may retain some part of the consideration for any incumbrances on the property existing on the date of the sale
    - Bear all losses and expenses arising from the destruction of the property, post the ownership has passed to the buyer, provided such losses are not caused by the seller
- **Rights of the buyer**
    - Benefit of any improvements of appreciation in value of the property, associated rent and profits, after the ownership has passed to him
    - Refund of any amount paid, in case any damage is caused to the property while the seller is in possession, to the extent of damages. In case the damage caused is such that the sale contract no longer remains valid, the buyer is entitled to all money that has been paid to the seller.

4. MORTGAGE OF PROPERTY

Mortgage (sec - 58) is transfer of interest in a particular, identifiable immoveable property for securing money already advanced or to be advanced as loan or other type of debt or any engagement that can result in a financial liability. The transferee is the mortgagee while the person transferring is the mortgagor. It is not necessary that mortgagor is always the owner of the property. He can be for example leaseholder with right to mortgage for general or specified purpose. Sec 59A further clarifies that the term mortgagor or mortgagee includes all people claiming through him unless it is specifically barred.

Sec 58 of the Transfer of Property gives details of different types of mortgage. But Banks resort to mostly following types of mortgage:

a) **Simple Mortgage** (sec 58(b)) property continues in possession of the borrower (mortgagee), only a personal undertaking acknowledging the loan and agreeing to repay on a specified date is with the mortgagor (bank).

b) **Mortgage by deposit of title deed** (sec 58(f)) where original title documents are deposited with the mortgagee/ bank or an agent specified them to create a security. This TPA Act provides for this option of mortgage in Kolkata, Chennai and Delhi. It leaves discretion to the State government to extend provision to other towns as well.

c) **English Mortgage** (Sec 58(e)) - Mortgagor absolutely transfers the mortgaged property with absolute ownership rights with intention to create a mortgage and also commits to repay the amount on a certain day. But the absolute transfer is done subject to a condition that - the transferee will return the property on return of the money by the mortgagor.

Other mortgages detailed in this section of TPA are:

d) **Mortgage by Conditional Sale (58(c))** - the property is conditionally so - if the amount obtained against this mortgaged is not returned by the specified date, the conditional sale shall become final. Instead if the amount is repaid then the sale shall be cancelled or it may provide that the property will be retransferred back to the seller. Explicitly stating when the amount advanced is returned the property will be returned to seller - only then the deed can operate as a one of mortgage by conditional sale.

e) **Usufructuary Mortgage** - in this possession of the mortgaged property is transferred to the person advancing the money along with the right to collects rent, other income accruing from the property till the repayment fully or partly of the money advanced and interest on it. Usufruct mortgage is different from "*profit a pendere*" which is not a mortgage or a lease but essentially a licence to enter and only collect something from within it e.g. to harvest crop/ pluck fruits.

> Mortgaging has led to the development of a special class of Property Buyers known as "Vulture Buyers" in the United States who as per target owners of distressed properties worried about potential forced sales. Such property owners who have fallen behind on their loan payments know a foreclosure action (where the lender moves in to assert claim on the property given as security) may destroy or severely damage their credit rating and make future loans impossible. The vulture buyers are able to reap handsome profits by purchasing the property directly from the distressed owner either prior to or after a foreclosure action has been initiated merely to help them retain their credit scores.
>
> Bankers in India are referring credit scores of potential buyers generated by Credit Information Bureau Limited (CIBIL) - the credit rating scores more to know existing level of indebtedness. Do you think when CIBIL reports are used more to assess credit worthiness of return capability from past repayment behaviour will such a class of buyers also be seen in India.

f) **Anomalous Mortgage** - A mortgage that does not fall in any of the foregoing categories is an Anomalous Mortgage.

Why the other types of mortgage are not resorted to by banks will be best known to the financial institution. Banking Regulation Act (Sec 9 on Non-banking asset) states 'no banking company shall hold any immovable property howsoever acquired, except such as is required for its own use, for any period exceeding seven years from the acquisition thereof". Perhaps some forms of mortgage like mortgage by conditional sale or

Usufructuary mortgage may not be as common with banks because of this provision and the requirement.

Mortgages involving principal amount of Rs. 100 or more has to be executed by a registered document which is signed by two witnesses (except a mortgage by deposit of title deed which does not have to be registered). It is important to remember that by its very definition, mortgage refers to an immoveable property. **A pledge refers to a "moveable property"** which is delivered to the pagdee as a security. In case of default in due repayment, in pledge, the lender i.e. the holder of the immoveable asset can sell it. In case of hypothecation too moveable asset is involved but unlike in pledge it is not delivered to the person taking the loan (i.e. lender), it remains with the hypothecator.

ICICI Bank Ltd. Vs. Sidco Leathers Ltd. DOJ 28/04/2006, SC held that the dues of the workmen and the debt due to the secured creditors are treated *pari passu* with each other, but that does not dilute the concept of inter se priorities amongst the secured creditors. Such a valuable right, therefore, must be held to have been kept preserved.

The State's Debts ranks above bank dues: This is derived from the English rule of Crown debt preceding others. In Central Bank Of India vs. State of Kerala DOJ 27/02/2009 the Supreme Court held the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 and the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARAFESI or Securitisation Act) do not create first charge in favour of banks, financial institutions and other secured creditors.

As per Sec 48 of the Transfer of Property Act, 1882 Act, the claim of the first charge holder shall prevail over the claim of the second charge holder. Hence property valuation reports need to reflect the nature of the security and the value of the earlier charge on it.

Mortgage default insurance is meant to cover normal risks as also catastrophic risks - latter being foreclosure occurring due to economic depression. The risk horizon is long - 15 years or more. Inflation here reduces the risk of mortgage insurer's loss (Blood, n.d.).

Credit Rating Information Services of India Ltd. CRISL as per (Blood, n.d.) has staff and competency in rating new general lines insurers and carriers that choose to engage in writing mortgage default insurance. CRISL has rated HFCs, banks and builders.

Entities like Housing Development Finance Corporation (HDFC) amongst the largest Housing Finance Company in India - are reported to have studied mortgage insurance business anticipating deregulation of insurance sector and allowing of other entities to engage in it, yet such mortgage default insurance is not common. As of now borrowers are insured for default due to death through the financial institution mandating an insurance policy.

5. Rights & Liabilities of mortgagor and mortgagee

Rights of Mortgagor

Sec 60 TPA deals with the right to redeem the mortgaged property and associated documents and a court case filed to enforce this right is called a suit for redemption. At any time after the principal money has become due, the mortgagor has a right, on payment or tender, at a proper time and place, of the mortgage-money, to require the mortgagee (a) to deliver to the mortgagor the mortgage-deed and all associated documents of the mortgaged property till then with the mortgagee, (b) to deliver possession of the property where applicable to the mortgagor and at the cost of the mortgagor either to re-transfer the title of the mortgaged property to him or to such third person as he may direct, or to execute and if mortgage was vide a registered deed, then also register a mortgage release deed.
For this act to apply the parties should not have acted to extinguish mutual rights stemming from lease deed. If the time of payment of principal is passed or not fixed, the mortgagee in equity is entitled to a reasonable notice before payment or tender of such money necessitating release of the property/ documents.
When there is more than one mortgagor of the property, part release by one mortgagor or any person interested through him by paying his proportionate share of the mortgage amount is not allowed.

Sec 60A states that by virtue of his redemption rights a mortgagor may assign the mortgage debt and transfer the mortgaged property to a third person; and the mortgagee shall be bound to accordingly transfer to the third person as directed by mortgagor. The section also details the right can be enforced by or the mortgagor or by any encumbrance holder. But encumbrance holder's claim is prior to that of mortgagor and between encumbrances holders, the requisition of a prior encumbrance shall prevail over that of a subsequent encumbrance. Section does not apply to a mortgagee who was or has been in possession.

As long as a mortgagor's right of redemption subsists, mortgagor shall be entitled at all reasonable times after requesting can make copies at this cost or inspect the documents relating to the mortgaged property which are in the custody or power of the mortgagee.

Sec 61 clarifies where two or more property are mortgaged to same mortgagee at the option of the mortgagor he can seek to redeem one first or can redeem both together.

Sec. 62 Right of Usufructuary mortgagor to recover possession on clearing dues.

In a Usufructuary mortgage, the mortgagor has a right to recover possession of the property together with the mortgage-deed/ documents with the mortgagee on payment of the mortgaged money from rents/ profits or if he is authorised to pay himself from such rents and profits or if the period has expired but the money not recovered then when mortgagor pays or tenders to the mortgagee the mortgage-money balance thereof or deposits it in court.

As per sec 63where there is any in the mortgaged property in possession of the mortgagee redemption shall, in the absence of a contract to the contrary, be entitled as against the mortgagee to such accession.

Sec 63A where mortgaged property in the possession of the mortgagee has, during the continuance of the mortgage, been improved, the mortgagor, upon redemption, shall, in the absence of a contract to the contrary, be entitled to the improvement. If such improvement was paid for by the mortgagee and was necessary to preserve the property from destruction or deterioration or was necessary to prevent the security from becoming insufficient, or was ordered by a government or a public authority, the mortgagor shall, in the absence of a contract to the contrary, be liable to pay the proper cost thereof as an addition to the principal money with interest at the same rate as is payable on the principal, or, where no such rate is fixed, at the rate of nine per cent per annum, and the profits, if any, accruing by reason of the improvement shall be credited to the mortgagor.

Where mortgaged property is a lease, and the mortgagee obtains a renewal of the lease, the mortgagor, upon redemption, shall, in the absence of a contract by him to the contrary, have the benefit of the new lease.

Liabilities of Mortgagor

Sec 65 sets out the implied contracts by mortgagor. It states in the absence of a contract to the contrary, the mortgagor shall be deemed to have contracted the following with the mortgagee-

- The mortgagor has the power to transfer the said interest in the property and the interest continues to subsist
- Should it be needed the mortgagor will defend his interest during the mortgage and when the mortgagee is in possession of the property, then mortgagor will help the latter to defend title
- Till the time mortgagee is in possession of the mortgaged property, the mortgagor must pay all public charges
- If a leased property is mortgaged, the mortgagor is deemed to be holding out that the dues payable and condition set under the lease deed have been duly complied, including the condition about renewal of deed. Till the mortgagee is in possession, the mortgagor shall clear all dues. For all past dues not paid, the mortgagor will indemnify the mortgagee against all the claims that may ensue
- Sometimes a mortgaged property is re-mortgaged again: in such case the mortgagor undertakes to clear interest dues accruing under the prior encumbrance on the property and also discharge the principal when due.

- Rights of mortgagee may be enforced by every person in whom that interest is for the whole or any part thereof from time to time vested for whatever reason.

Sec 65A deals with powers of a mortgagor who is in possession to further lease the property and it shall be binding on mortgagee. The lease will take effect within six months from date of leasing. The lease shall comply with local custom and rules. No premium shall be paid or promised and no rent shall be payable in advance nor make any commitment about process of renewals

In the case of a lease of buildings, whether leased with or without the land on which they stand, the duration of the lease shall in no case exceed three years and including a condition of re-entry if rent is not paid on time.

As per TPA a property offered as security is deemed insufficient unless the value of the mortgaged property exceeds by one-third, or, if consisting of buildings, exceeds by one-half, the amount for the time being due on the mortgage.

Rights of Mortgagee

Sec 67 TPA read with the explanation deals with the right of mortgagee by conditional sale or a mortgagee under an anomalous mortgage having right to foreclose, to foreclose or sell the mortgaged property as per process set in TPA. To foreclose means to take away the right of mortgagors to redeem their mortgaged property. Unless the mortgage deed states otherwise, and subject to the conditions set in TPA, at any time after the mortgage money has become due and before the money is actually paid or a court passes a decree for the redemption of the mortgaged property, the mortgagee has a right to obtain from the court a decree that the mortgagor shall be absolutely debarred of his right to redeem the property, or a decree that the property should be sold. Such a suit is called a suit for foreclosure.

Liabilities of Mortgagee

- The mortgagee by conditional sale cannot institute a suit for foreclosure as such before the happening of the condition.

- A mortgagor who holds the mortgagee's rights as trustee or legal representative of mortgagee, cannot institute a suit for foreclosure even if he had the right to sue for a sale of the property as per trust deed/ mortgage deed
- Mortgagee in case of a railway, canal, or other work in the maintenance of which the public are interested, to institute a suit for foreclosure or sale
- When there is more than one mortgagee in a deed, a suit for foreclosure cannot be filed for one mortgagee's interest in the mortgaged property till the time they have first separated severed their interests under the mortgage.

TPA also casts a duty on the person acquiring immovable property or any share/interest by mortgage or otherwise as being presumed to have notice of the title of any other person who was in actual possession of such property.

All sales, mortgages (other than by way of deposit of title deeds) and exchanges of immovable property are required to be registered by virtue of the Transfer of Property Act.

As held in **Tarab Ghose vs. Laxmi Agarwal AIR 1984 All 180** "mere occupation is not possession, although every actual physical possession is occupation". Possession does not refer merely to occupation of the property. It refers to a legally defensible possession. Date of commencement and period of possession is relevant and needs to be proved specifically and is not always the same as the date of occupation.

In the event of apparent conflict between two statutes in which neither statute establishes precedence of one statute over the other, the focus is to assume both Acts are valid. The interpretation has to be such as to avoid repugnancy.

In **Suraj Lamp & Industries (P) Ltd. Vs. State Of Haryana DOJ 11/10/2011 Supreme Court** reiterates that immovable property can be legally and lawfully transferred/ conveyed only by a registered deed of conveyance. Courts will not treat transactions under Sale Agreement/General Power of Attorney/Will (GPA sales) as completed or concluded transfers or as conveyances, since they neither convey title nor do they create any interest in an immovable property. They cannot be recognized as deeds of title (except to the limited extent of s. 53A of the TP Act) nor can they be relied upon or made the basis for mutations in Municipal or revenue records.

Banks require the Building and the land appurtenant to it to be separately valued in the same report. Normally the two should be valued together synergistically giving expression to potential and its advantage as decided by SC in the case State of Kerala vs. PP Hassan Koya DOJ 19/03/1968.

6. GIFT OF IMMOVABLE PROPERTY

As per sec. 122 TPA, a "Gift" is the transfer of certain existing moveable or immoveable property made voluntarily and without consideration, by one person, called the donor, to another, called the donee, and accepted by or on behalf of the donee. The gift has to be to a defined number and definite number of people, to be a valid gift.

Acceptance must be made during the lifetime of the donor and while he is still capable of giving to be a valid deed. Conversely, if the donee (recipient) dies before acceptance, the gift is void. It is possible that gift was accepted and its acceptance can be proved but the transferor soon after died and hence the transfer in interest was not registered via mutation during lifetime of the transferor. Then the transfer vide gift is held as valid.

A transfer of property is critical to constitute a "gift". Thus creation of a trust and transferring property to it for the benefit of someone is not gift to the recipient if the trust generally gives beneficial interest to the beneficiary while the property remains with the trust. But a gift to an idol or for religious institution is valid (Santi Swaroop vs. Radhaswami Satsang Sabha AIR 1969 All 248). Under Mitakshara property system, the co-parceners hold the property jointly. One or some of the co-parceners cannot transfer their share without consent of the other co-parceners.

Sec. 123 of Transfer of Property Act, 1882 clarifies transfer via gift deed of immoveable property is to be made only through a registered instrument signed by the donor or his representative, and attested by at least two witnesses.
In case of a gift of movable property, registration of the deed is optional. It can also be done by delivery of the property in a manner goods in sales are delivered.

Since the days of Transfer of Property Act, the concept of "property" has evolved. Transferable Development Rights (TDR) is only a tradable privilege that originates in one property which can be transferred to another area and property:

TDR is a certificate issued against land acquired for public purposes either by the Central or State Government in consideration of surrender of land by the owner without monetary compensation and free from all encumbrances or by way of declared incentives by State Government, which are transferable in part or whole. It is issued by the ULB's Urban Local Body (Municipal body, Urban Improvement Trust, Urban Development Authority).

Care is taken to back TDR rights legally. Government of Karnataka amended the Karnataka Town and Country Planning Act, 1961 in order to empower the local bodies (Corporations / Planning Authorities) to permit additional FAR for the land. Likewise, a new sec 14B was inserted in the A.P Town and Country Planning Act 1920. The land prohibited by order of any court or lands under acquisition are not eligible. TDR certificate can have name of a nominee and is usable by nominee on the death of the holder and is tradable.

Maharashtra regulations required part of the FSI increase is be used in remainder portion of the same plot whose portion of which was acquired for road widening etc. If needed a further FSI can be purchased from other holders and used

As per a note on TDR prepared by Ministry of Urban Development, GOI in Aug 2015 for Telengana Govt., TDR is resorted to for the following reasons:

- To facilitate development of affordable houses under State Affordable Housing Policy In lieu of Floor Area Ratio (FAR) granted as per the Policy - TDR shall be calculated on the total plot area being reserved for affordable housing project (including Economic Weaker Section EWS / Low Income Group LIG) subject to the norms as prescribed in Affordable Housing Policy. The maximum TDR shall not be more than 1.5 times of the total land area but in case of Affordable Housing projects the developer shall be provided double of the permissible FAR (e.g. at the time of launch of Affordable Housing Policy permissible FAR was 1.67/1.80 hence the double FAR for both the cases will be 3.50) in case of slum rehabilitation scheme under Slum Development Policy, 2012 maximum permissible FAR is 4.0 but TDR shall not be more than 1.5 and developer shall consume the maximum FAR on the proposed project site provided all planning parameters and provisions of Building Regulations are fulfilled. The unutilized FAR subject to maximum 1.5 can be taken as TDR

- Development of Green spaces - Parks/ Open Spaces/Playgrounds /Water Bodies etc. as per the provision of Master Plan/ Sector Plan.
- Development of Master Plan/ Sector Plan roads including road widening
- Development of Public Parking lots.
- Development of City level Facilities/other public purposes as per Master Plan proposals.
- Slum rehabilitation scheme under Slum Development
- In lieu of land surrendered for other purposes as specified by State Government

TDR policy can help to reduce time and money needed to acquire land - notification, hearing, payment of compensation etc. By one estimate for the land acquisition for the Peripheral ring road to be financed by a Japan agency, Bangalore Development Authority needs Rs. 8100 crores a kind of resource it does not have. Often TDR is preceded by reduction of the FAR applicable to the area. The idea is to introduce TDR: "For instance, the floor area that includes balconies and staircases built on a 30 ft. X 40 ft. plot should not exceed 1200 sq.ft. To make any addition to this floor area, one will have to buy TDR at twice the cost of guidance value as proposed in the new amendments." "Most parts of Mumbai, where space is in high premium and has been traditionally a vertical city, the FAR is 1. Bengaluru is growing horizontally. A FAR of 1 creates a huge market for TDR making it a viable option for land losers"

Telangana government is considering this route for acquiring half an acre land for a 40 feet road along Banjara Hills of the Annapurna Studios in Hyderabad, owned by the late Tollywood actor Akkineni Nagarjuna, which is part of 22 acres allotted at a nominal price ranging from Rs 7,500 to Rs 8,000 per acre. The land is now worth up to Rs 30 crore per acre.

7. Lease

In Sec 105 TPA the term "lease" is defined. A lease of immoveable property is a transfer of a defined right to enjoy such property, made for a certain time, or in perpetuity. It could be clearly stated or implied and in consideration of a price (paid or promised), or of money, a share of crops, service or any other thing of value, to be rendered periodically or on specified occasions to the transferor by the transferee, who accepts the transfer on such terms.

The transferor of the right to enjoy such property, is called the lessor, the transferee is called the lessee. The price paid or promised is called the premium. The 'money, share, service or other thing to be so rendered usually at predetermined periodicity in return is called the 'rent'.

	Lease	*Licence*
Governing statutory provision	Sec 105 of Transfer of Property Act and also relevant sections of the corresponding Rent Control/ Premises tenancy Act of the State governing lease of premises	*Sec 52 of Easement Act, 1882*
Granted to	To an identified individual/ body of individuals	*To an identified individual/ body of individuals*
What is the lesser/ grantor allowing	Delivery of exclusive possession of the property along with a defined interest in the property. Transfer of interest is the defining distinction	*A person, permits another a right to do or continue to do upon a property which in absence of such right would be unlawful* *Only a permission to use the immoveable property of the grantor. No interest in the said property is created.* *Normally without right to exclusive possession. However even if defined exclusive possession is granted other elements of licence like mere permission to use/ no interest created is point of determination*
Nature of the rights	The rights are assignable/ inheritable within terms of the lease deed	*Licence rights are not attached to the property and do not travel along with change of ownership of the underlying property. It is granted to a person. Hence licence is not inheritable nor can it be assigned. The licensee's right dies with the license holder.* *Unless specifically permitted or an integral element of it, licence rights cannot be transferred nor exercised by assignees, servants or employees of licence holder. Exception for example include a movie ticket which gives licence to enter theatre to watch the chosen movie in a manner acceptable to the theatre manager. Its nature is such that it can be transferred. But other licences on immoveable property are not transferable.*
		Can be created not necessarily only by the owner, but even by tenant/ leaseholder but not exceeding their own tenure (period).

		Life interest holder too can create but not for a period beyond his life time
Fate on termination	Continuation governed by provision of the lease deed and otherwise the TPA. Lease deed may get automatically continued for the same period again on termination of the lease period if monthly payment continues to be received. In some lease it may convert to year-on-year lease when payment continues to be accepted. It is possible to transfer the right of re-entry on expiry of the lease or on breach/ violation subsequently of a condition set during grant of lease	*If granted for specific period, on expiry of lease period licensee loses right to continue to occupy. It expires with death of the holder.* *On termination of license by passage of time, the exiting licensee can seek time to leave the property and also to remove building materials etc.* *If licensed property is transferred by the licensee to some other person against the terms of the licence, the transferee is a trespasser against the transferor/ property owner/ original grantor.*
Example	– **State continues to levy a leasehold rent on flats developed in land owned by Delhi Development Authority**	• ***At times a licence can be converted to lease by way of one deed - a developer is granted licence to build and then after completion will convert as leaseholder for part of the building to run office or other purpose*** • ***A person cultivates the land of another, shares the produce of agriculture with the owner but has no right on the land*** • ***Right to cut grass, collect and take away leaves, bamboo are examples of licence*** • ***Allowing person to continue in possession till the time the land is used for the exclusive purpose of running a school***

In distinguishing Agreement *to* Lease vs. Agreement *for* Lease Supreme Court has held a confirming third party (in this case a company) in agreement to lease a property did not create a lease subject to Bombay Stamp Duty Act 1958 as relationship of lessor and lessee was not established between the company and the State. It was only an agreement *to* lease and thus does not fall under sec 2(n) of Bombay Stamp Duty Act 1958 [State of Maharashtra vs Atur India (P) Ltd. 1995(2) Bom CR 31 (SC))

The disrepair for which a leaseholder or tenant is usually liable for mainly commercial properties when he has agreed to return premises in good repair is called Dilapidations. No property can usually be returned in the same condition as received. But when the building continues in possession of leaseholder/ tenant, deterioration may continue. It is important to track if the building is notified for being pulled down. For example, section 354 of the Brihan Mumbai Municipal Corporation (BMC) Act deals with removal of dangerous structures authorises demarcating even private buildings and for evacuation to prevent human lives from being compromised due to shaky structures.

A tenant or lessee has liability to maintain hedges, boundaries, doors, premises etc. It is thus breach of lease covenants relating to the condition of a property, and the process of remedying those breaches. Landlord can demand being made good for the loss or demand actual repairs being done. This is of special significance in UK jurisprudence where in the event of disputes appraisers review case laws to argue their preferred position.

Lease deeds were traditionally executed by two ways: written document where the lessor executes a lease patta with recipient signing or the recipient i.e. lessee executing a *kabuliyat* admitting to the receipt or orally along with delivery of possession.

Section 106 of TPA gives the period of lease in the absence of contract or local law or usage stating otherwise

- A lease of immovable property for agricultural or manufacturing purposes is deemed to be year to year that can be terminated by either side on six month notice
- A lease of immovable property for any other purpose is a lease from month-to-month that can be terminated by either side on fifteen days' notice.

It also states the start date of notice of six month/ 15 days will be counted from date of receipt of notice by the other side. If the period of notice falls short of the required period then it is not a failing if the suit seeking recovery has been filed with delay. The notice has to be served in writing, duly signed by issuer and sent by post or delivered in person to the other side or handed to one of his family members or servants at his residence or affixed to a conspicuous part of the property.

5. THE INDIAN STAMPS ACT, 1899

BASICS OF INDIAN STAMP ACT

Under the Stamp Act, the central government levies stamp duty on specific transactions of instruments like bills of exchange, cheques, promissory notes, transferof shares. Under Constitution of India, charging stamp duty is a matter of State list, so the rate of stamp duty on the instruments varies from state to state.

Instruments chargeable to duty

Stamp act provides Schedule I under which instrument are mentioned on which stamp duty is chargeable. Some of the examples are:

- Order for payment of any sum of money payable periodically, i.e. daily, monthly, weekly
- Letter of credit
- Bill of lading
- Bond
- Conveyance - includes a conveyance on sale and every instrument by which property, whether movable or immovable, is transferred inter-vivos and which is not otherwise specifically provided for by Schedule I
- Deed
- Marketable security
- Mortgage deed
- Insurance policy
- Lease contract
- Any other type of contracts

The act requires payment of duty on any document by which any rights or obligations are created, transferred, extended, extinguished or recorded.

Therefore, all documents mentioned above (the above is an indicative list) along with other types of documents like memorandum and articles of association.

Exemption from duty

- Transactions/documents/deeds, wherein the government would be liable to pay duty
- Instrument for carrying out transactions in a SEZ
- Transactions related to transfer of rights in a ship or vessel registered under the Merchant Shipping Act.

Mode of payment of stamp duty

Stamp duty can be paid in various, depending on the nature of contract and the requirement of the Act with respect to the contracts in question. Common modes of payments of stamp duty are:

- Adhesive stamps available at collectors office
- Stamping the instrument with impressed stamp (eg. franking)
- Cash, in rare cases where the collector is satisfied that sufficient stamps are not available. This exception, however, has become practically redundant.

An **adhesive stamp** is a postage stamp.

Impressed stamp includes-
(a) labels affixed and impressed by the proper officer, and
(b) stamps embossed or engraved on stamped paper;

Franking - The document for which stamp duty is to be paid is printed on plain paper, before the parties sign it, and a stamp is affixed on the paper indicating the value of the stamp duty paid.

Timing of stamping

For instruments executed in India, the instrument needs to be stamped before or at the execution date

For instruments executed outside India but chargeable to duty inside India, within 3 months of the instrument being bought into India.

VALUATION FOR DUTY

According to Section 20, where an instrument is chargeable with ad valorem duty in respect of any money expressed in any currency other than that of India, such duty shall be calculated on the value of such money in the currency of India, according to the current rate of exchange on the date of the instrument

Section 21 provides that in the case of an instrument chargeable with ad valorem duty in respect of any stock or any marketable or other security, such duty shall be calculated on the value of such stock or security according to the average price or the value thereof on the date of the instrument.

Section 23 provides that where interest is expressly made payable by the terms of the instrument, such instrument shall not be chargeable with a duty higher than that with which it would have been chargeable, had no mention of interest been made therein.

According to Section 24, where any property is transferred to any person in consideration (wholly or in part) of any debt due to him, or subject either certainly or contingently to the payment or transfer of any money or stock, (whether being or constituting a charge or incumbrance upon the property or not), such debt, money or stock is to be deemed the whole or part, (as the case may be), of the consideration in respect whereof the transfer is chargeable with ad valorem duty.

Section 25 deals with the manner of computation of duty in the case of annuities. Valuation of an annuity will be material, where the payment of annuity or other sum payable periodically is secured by an instrument or where the consideration for a conveyance is an annuity or other sum payable periodically. In such cases, the amount secured by such instrument or the consideration for such conveyance, as the case may be, shall be deemed to be:

(i) where the sum is payable for a definite period so that the total amount to be paid can be previously ascertained-such total amount;

(ii) where the sum is payable in perpetuity or for an indefinite time not terminable with any life in being at the date of such instrument or conveyance-the total amount which, according to the terms of such instrument or conveyance, will or may be payable during the period of twenty years calculated from the date on which the first payment becomes due; and

(iii) where the sum is payable for an indefinite time terminable with any life in being at the date of such instrument or conveyance-the maximum amount which will or may be payable as aforesaid during the period of twelve years calculated from the date on which the first payment becomes due.

Section 26 deals with cases where the value of the subject matter is indeterminate. The object of this section is to protect the revenue, in cases where an instrument is chargeable with ad valorem duty, but such duty cannot be ascertained by reason of the fact that the amount of value of the subject matter of the instrument cannot be determined at the time of the execution of the instrument. This object is sought to be achieved by providing, that the executant can value the instrument as he pleases, but he shall not be entitled to recover under such document any amount in excess of the amount for which the stamp duty is sufficient.

Section 27 provides that the consideration and all other facts and circumstances affecting the chargeability of any instrument with duty or the amount of duty with which it is chargeable shall be fully and truly set forth in the instrument. "Value of any property" would mean that real value of the property in the open market at the time the document was executed and not at the time when the executant acquired it.

Section 28 prescribes certain rules for apportionment of the consideration, in cases of certain conveyances arising out of a property being contracted to be sold and thereafter conveyed in parts etc.

INSTRUMENTS ON WHICH DUTY IS LEVIED

Person liable to pay stamp duty

It is upto the parties to the contract to decide who will be bearing the stamp duty expense. However, in case of no specific arrangement between the parties, the act stipulates the party responsible for making the stamp duty payment. Certain requirements laid out by the Act are outlined as follows:

- In case of instruments like bills of exchange, custom bonds, debentures and bonds, indemnity bond, mortgage deed, transfer of shares or debentures, the stamp duty is required to be paid by the person drawing, making or executing such instrument
- In case of insurance policy other than fire insurance, the person effecting the insurance
- In case of fire insurance policy, the person issuing the policy
- In case of instrument of exchange, equally by both the parties

- In case of certificate of sale of property, by the purchaser of such property
- In case of instrument of partition, by the parties to the partition, in proportion of their respective shares.

Implications of instrument not stamped

In case any instrument is not duly stamped as per the requirement of the act, the subject matter of that instrument does not have legal enforceability, i.e. the parties cannot use such instrument as a valid evidence to enforce their rights in the court of law.

In case of any technical defaults, eg. the instrument is stamped but with the wrong amount, if the default is made good at a subsequent date, it would be presumed that the instrument was valid from the initial stamping date itself.

6. THE INCOME TAX ACT, 1961

TAXES ON INDIVIDUALS & COMPANIES

In any commercial transaction income tax is an aspect that cannot be overlooked. Even for the purpose of valuation of any security or financial assets valuer needs to factor the tax implication of the transaction, without which the valuation arrived may not be appropriate.

Thus, it is imperative that valuers have a fair understanding of the taxation law of the country in which the asset is located and the country where the transaction is affected.

In this chapter, we will explore the essential concepts from the Indian Income tax Act, 1961 and International taxation for Previous Year ("PY") 2018-19 corresponding to Assessment Year ("AY") 2019-20.

Taxability of income

Overview of tax calculation:

Coverage		Particulars	Amount	Amount
5 - Heads of Income		Total Income • Salary income • Income from House Property • Income from Business / Profession • Capital Gains • Income from Other Sources	 xx xx xx xx xx	
		Total Income		**xx**
	Less:	Deductions	xx	(xx)
		Taxable income		**Xx**
Part A		**Segregation of taxable income**		
		Income taxed at special rate		
		Balance income taxed at general rate		
Part B		Tax as per special rate (based on nature of income)	**A**	
Part C	Add:	Tax as per general rate (based on TAXABLE income slabs)	**B**	
		Total tax	**C**	**A + B**
Part D	Less:	**Rebate** (Resident Individuals with TAXABLE income up to Rs. 3.5 lacs rebate will be lower of the tax amount or Rs. 2,500)	**D**	
		Tax liability	**E**	**C – D**
Part E	Add:	**Surcharge (as a % of Total tax)** (rate is determined based on TOTAL income slabs)	**F**	**% of E**
		Total tax + surcharge	**G**	**E + F**
Part F	Add:	**Health and Education Cess** **4% of (total tax + surcharge)**	**H**	**4% of G**
		Total Tax Payable	**I**	**G + H**

Let us break-down the above table and see how tax will be calculated.

Part A: Segregation of Taxable income

After the taxable income is assessed the same needs to be segregated into two buckets:

a. Income taxed at special rate and

b. Balance income taxed at general rate

The above bifurcation is needed as certain incomes are taxed at different rates. Below is the segregation

Two broad types of tax rates

Incomes Taxed at Special Rates:	General Tax Rates:
- Capital gains - Dividend Income from Company - Winning from lottery, horse races, etc.	The balance income i.e. Taxable income less the income taxed at special rate will be taxed as per the general tax rates.

Part B: Special Tax Rates

Income	Nature	Special Tax Rate
Equity shares of listed Domestic company and Equity oriented Mutual Funds	Short Term Capital Gains (STCG)	15% of the capital gains
	Long Term Capital Gains (LTCG)	10% of capital gains exceeding Rs. 1 lakh with 31 Jan 2018 as grandfathered* provision
Capital gains on sale of non-financial assets	Short Term Capital Gains (STCG)	General tax rates
	Long Term Capital Gains (LTCG)	20% with indexation
Capital gains, other than mentioned above	Short Term Capital Gains (STCG)	General tax rates
	Long Term Capital Gains (LTCG)	10% without indexation OR 20% with indexation
Dividend from Domestic Company	Income from other sources	10% on income in excess of Rs. 10 lakhs. (Not taxable in hands of a domestic company)
Winnings from lottery, horse races, etc.	Income from other sources	30% on income

* Grandfathered Provision explained with the help of example below

Example: 1 Let us take examples to understand the situation of how tax will be calculated on gain on sale of equity share or equity oriented mutual funds.

Particulars	Mr. D'souza	Mr. Shah	Mr. Chaturvedi
Date of purchase	1 Oct 2017	1 Oct 2017	1 Oct 2017
Purchase Price (A)	10,00,000	10,00,000	10,00,000
Dale of Sale	30 April 2018	30 Nov 2018	31 Dec 2018
Sale Value (B)	20,00,000	19,00,000	30,00,000
Share value on 31 Jan 2018 (C)	18,00,000	18,00,000	18,00,000
Profit (D = B-A)	10,00,000	9,00,000	20,00,000
Nature of Gain	Since shares are sold in less than 1 year the gains are short term	Since shares are sold after 1 year of purchase the gains are long term	Since shares are sold after 1 year of purchase the gains are long term
Taxable profit **Step 1 - Gains made till 31 Jan 18 (E = C – A)** **Step 2 – Additional gain after 31 Jan 2018 (F = D – E)** **Step 3 – Net Gains over Rs. 1 lac (F – 100,000)** **Taxable amount**	Short term capital gains are fully taxable Rs. 10,00,000	Gains till 31 Jan 2018 are exempt i.e. gain of Rs. 8,00,000 is exempt. Balance gain of Rs. 1,00,000 (9,00,000 – 8,00,000) Gain up to Rs. 100,000 is again exempt Rs. Nil	Gains till 31 Jan 2018 are exempt i.e. gain of Rs. 8,00,000 is exempt. Balance gain Rs. 12,00,000 (20,00,000 – 8,00,000) Of this, gains of Rs. 1,00,000 is exempt and balance is taxable Rs. 11,00,000
Tax rate	15% of Rs. 10,00,000 Rs. 1,50,000	10% of Rs. Nil Nil – No tax	10% of Rs. 11,00,000 Rs. 1,10,000

Part C: General Tax Rates

For Individuals:

General Public (Below 60 Years of Age)			Senior Citizens (60 – 80 Years of Age)			Very Senior Citizens (More than 80 Years of Age)	
Taxable Income	**Tax**		**Taxable Income**	**Tax**		**Taxable Income**	**Tax**
Up to Rs. 2.5 lakhs	Nil		Up to Rs. 3 lakhs	Nil		Up to Rs. 5 lakhs	Nil
Rs. 2.5 – 5 Lakhs	5%		Rs. 3 – 5 Lakhs	5%		Rs 5 – 10 Lakhs	20%
Rs 5 – 10 Lakhs	20%		Rs 5 – 10 Lakhs	20%		Above Rs. 10 lakhs	30%
Above Rs. 10 lakhs	30%		Above Rs. 10 lakhs	30%			

For Companies:

Domestic Company	Tax Rate	Foreign Company	Tax Rate
Turnover or Gross receipts during PY 2016-17 up to Rs. 250 crores	25%	Irrespective of turnover or gross receipts	40%
Other cases	30%		

Part D: Rebate

Section 87A of the income tax act provides for rebate which reduces the tax liability.

Who is eligible	Condition	Rebate limit
Resident Individuals	Taxable income, i.e. income after considering deductions under section 80 is upto below Rs. 3.5 lacs	Lower of the following: a) Tax amount b) Rs. 2,500

Part E: Surcharge

Both general tax rates and surcharge depends on the nature of person,i.e. whether you are an individual or a company. Further, there are slabs rates for each person so that the person earning higher income pays higher taxes and vice-a-versa.

Surcharge = **X** % * (Tax under Special rate + Tax under General Rate)

Individual	Surcharge	Domestic Company	Surcharge	Foreign Company	Surcharge
Total Income **exceeds Rs. 50 lakhs,** but not exceeding Rs. 1 crore	10%	**Total Income** exceeds Rs. 1 crore, but not exceeding Rs. 10 crores	7%	**Total Income** exceeds Rs. 1 crore, but not exceeding Rs. 10 crores	2%
Total Income **exceeds Rs. 1 crore**	15%	**Total Income** exceeds Rs. 10 crores	12%	**Total Income** exceeds Rs. 10 crores	5%

Surcharge is subject to marginal relief u/s 89

Points to remember:

1. General rate - The slabs provided are to be verified against your "**Taxable Income**". Taxable income is income after considering deduction.

2. Surcharge – The slabs provided are to be verified against your "**Total Income"**. Total income is your income before considering deductions.

Part F: Health and Education Cess

Health and Education cess is calculated at 4% of the tax calculated till now i.e.

Health and Education cess = 4% * (Tax under Special rate + Tax under General Rate – Rebate + Surcharge)

The aggregation of all the taxes is the tax liability for the previous year.

Example: - Calculation of tax liability for individual

Mr. Manoj, 32 years old is a resident of India who has earned a total taxable income of Rs. 24,00,000 during the PY 2018-19. The break-up of the same is as follows:

a) Income from Salary – 15,00,000
b) Short term capital gains on sale of shares – 2,00,000
c) Long term capital gains on sale of mutual funds – 3,00,000
d) Dividend income from Domestic companies –4,00,000

Calculate the tax liability (ignore grandfathered provision in respect of long term gains)

Solutions:

Calculation of tax liability of Mr. Manoj, age 32 for PY 2018-19 (AY 2019-20)

Particulars	Tax Rate	Amount
Segregation of taxable income		
Income taxed at special rate		
Short term capital gains on sale of shares	15%	2,00,000
Long term capital gains on sale of mutual funds (subject to grandfathered provision)	10% in excess of Rs. 1 lac	3,00,000
Dividend income from Domestic companies	10% if exceeds Rs. 10 lacs	4,00,000
Balance income	**General Rate**	**15,00,000**
Tax calculation		
Short term capital gains (15% of Rs. 2,00,000)		30,000
Long term capital gains (10% of (Rs. 3,00,000 – Rs. 1,00,000))		20,000
Dividend income (No tax as income does not exceed 10 lacs)		Nil
Tax on balance income (refer below table)		2,62,500
Total Tax		**3,12,500**
Surcharge (NA as total income below Rs. 50 lacs)		**Nil**
Health and Education cess	**4% of (tax + surcharge)**	**12,500**
Total Tax liability		**3,25,000**

Working for tax as per general tax rate:

General Public (Below 60 Years of Age)			
Taxable Income	**Tax**	**Calculation**	**Amount**
Up to Rs. 2.5 lakhs	Nil	Nil	
Rs. 2.5 – 5 Lakhs	5%	5% * (5,00,000 – 250,000)	12,500
Rs 5 – 10 Lakhs	20%	10% * (10,00,000 – 500,000)	1,00,000
Above Rs. 10 lakhs	30%	30% (15,00,000 – 1,000,000)	1,50,000
		Total	**2,62,500**

Example: - Calculation of tax liability for Domestic Company

PQR Ltd, a paper manufacturing company registered in India has recorded a gross turnover of Rs. 50 crores for the PY 2018-19. Against this gross turnover the company has earned a profit of Rs. 3 crores and additionally earned dividend income of Rs. 13,00,000.

Turnover of the company during PY 2016-17 was less than 250 crores.

Calculate the tax liability for AY 2019-20.

Solutions:

Calculation of tax liability of PQR Ltd. for PY 2018-19 (AY 2019-20)

Particulars	Tax Rate	Amount
Segregation of taxable income		
<u>Income taxed at special rate</u>		
Dividend income received from Domestic companies	Not taxable for Domestic Company	13,00,000
Balance income	25% as turnover less than 250 crores in PY 2016-17	3,00,00,000
Tax calculation		
Dividend income		Nil
Tax on balance income (25% of Rs. 3 crores)		75,00,000
Total Tax		**75,00,000**
Surcharge (7% of Rs. 75,00,000)	7% as total income exceeds Rs. 1 crore	5,25,000
Health and Education cess (4% of Rs. 80,25,000)	4% of (tax + surcharge)	3,21,000
Total Tax liability		**83,46,000**

HEADS OF INCOME

Income earned by any person needs to be bifurcated into 5-heads of income. The Act has specific provision for income from each head with respect to the calculation of what and how much is taxable. Hence classification of income under the correct head is critical to avail the benefits available under that head of income.

Following is what gets covered under each of the head of income:

Income from Salaries	Income from House Property	Profit and Gains of business or profession	Capital Gains	Income from other sources
Income arising in the hands of an employee by way of salary, pension, bonus allowances and other employment benefits	Income in the form of rental income by letting out a house property.	Income derived from carrying on any business or profession.	Profit from transfer of a capital asset.	This is a residuary head of income. The income which does not fall under the four heads of income will be taxable as income from other sources.

Let us understand what goes under each of the heads of income:

A. Income from Salaries:

Salary under section 17(1) includes

i) wages;

ii) any annuity or pension;

iii) any gratuity;

iv) any fees, commissions, perquisites or profits in lieu of or in addition to any salary or wages;

v) any advance of salary (including any payment received for leave not availed);

vi) the annual accretion to recognized provident fund;

vii) the aggregate of all sums that are comprised in a recognized provident fund;

viii) the contribution made by the Central Government or any other employer in the previous year, to the account of an employee under a pension scheme referred to in section 80 CCD

The vital point to note is that there should exist an employer and employee relationship. Unless there is an employer-employee relationship, the income cannot be considered as salary income.

Salary income is taxable on due or receipt basis whichever is earlier.

Against the salary income following deductions are available:

Sr	Deductions	Details	Exemption Limit
1	Standard Deduction	A flat relief against salary income	Rs. 40,000
2	Professional Tax	Professional tax also called astax on employment. Annually an amount up to Rs. 2,500 is paid by an employer on behalf of the employee.	Tax amount that is paid

Example – Computation of income from salaries:

Mr. Bajaj, employed as a sales head in Alpha Ltd, provides the following information for the PY 2018-19:

a) Salary up to 31 October 2018 – Rs. 50,000 pm
b) Salary from 1 November 2018 – Rs. 75,000 pm (however additional 25,000 pm to be received in April 2019)
c) Commission – Rs. 30,000 (received in December 2018)
d) Bonus – Rs. 70,000 (received in January 2019)
e) Professional Tax paid – Rs. 2,500

Calculate the taxable income from salaries

Solution:

Calculation of Income from Salaries of Mr. Bajaj for PY 2018-19 (AY 2019-20)

Particulars	**Remarks**	**Amount**
Salary received	April – Oct 2019 (50,000 * 7 month) Nov – Mar 2020 (50,000 * 5)	6,00,000
Salary Arrears	Salary increment although to be received in April 2020 will be income for 2019-20 on due basis Nov – Mar 2020 (25,000 * 5)	1,25,000
Commission	Received as part of employment and hence taxable under this head	30,000
Bonus		70,000
Total		**8,25,000**
Less: Deductions		
Standard Deduction		(40,000)
Professional Tax		(2,500)
	Income from Salaries	**7,82,500**

B. Income from House Property:

Any rental income received from renting of house property is chargeable to tax under "Income from house property".

Following conditions should be met for income to be called Income from House Property:

a. Property must be building, or land attached to a building. Building means residential building, factory building, offices, shops, godowns and other commercial premises. Land attached to building can be in the form of garden, garage, etc
b. The property must be registered under your name.
c. If it is a jointly held property, then the income is taxable in the hands of all the holders, to the extent of their respective shares in the property.
d. The house property may be used for any purpose except by the owner for the purpose of running his own business or profession.

Against the house property income following expenses and deductions are eligible:

Sr	**Expenses / Deductions**	**Details**	**Exemption Limit**
1	Municipal Taxes	Taxes paid against the house property	For let-out property - To the extent actually paid
2	Standard Deduction	NAV = Gross Annual Value (GAV) Less municipal taxes paid	30% of Net annual value (NAV)
3	Interest expenses	Interest on loan taken for purchase or construction of house property	For let-out property - Actual interest amount For self-occupied property – Rs. 30,000 or Rs. 200,000 based on specified conditions

Example – Computation of income from house property:

Nisha has 2 house properties the details of which are as below:

Particulars	**House Property 1**	**House Property 2**
Rental income	Rs. 12,000 pm	Nil
Municipal Taxes paid	Rs. 2,000	Rs. 1,500
Interest on loan taken for construction / purchase	Rs. 80,000	Rs. 1,00,000

Calculate the taxable income from house property

Solution:

Calculation of Income from House Property of Ms. Nisha for PY 2018-19 (AY 2019-20)

Particulars	**Remarks**	**LOP**	**SOP**
GAV	Rental income (Rs. 12,000 * 12)	1,44,000	Nil
Municipal Taxes	Only for LOP to the extent paid	2,000	Nil
NAV	Net of GAV and municipal taxes	**1,42,000**	**Nil**
Standard Deduction	30% of NAV	**42,600**	**Nil**
Interest expenses	For let-out property - Actual interest amount For self-occupied property – Rs. 30,000 or Rs. 200,000 based on specified conditions	**80,000**	**1,00,000**
	Income / (Loss) from House Property	**19,400**	**(1,00,000)**

C. Profits and Gains of Business or Profession:

For determining the profit and gain from business or profession certain expenses are eligible for a deduction against the business income. Below is an illustrative list of what is considered as income, what expensesare allowed against the income. Also, covered are expenses which are not allowed to be deducted in determining your taxable income.

Income

- Income from sale of goods or services.
- Interest income on loan given to staff

Note: Interest income on bank deposit or Fixed deposit shall be chargeable to tax under **Income from Other Sources**

Admissible Expenses

- **Depreciation** on assets used in business / profession (as per rates and block of assets method specified under the Act)
- Special deduction under section 35AD
- Preliminary expenses
- Expenses related to **Building/ equipment/ furniture / other assets** used for profession
- Bad Debts
- Interest on borrowings
- Employee related expenses
- General expenses incurred for the purpose of business

Inadmissible Expenses

These expenses are not allowed to be reduced from income:

- Contingent liabilities
- Illegal expenses
- Legal expense for illegal activities
- Interest on Income tax law
- Penalties
- Expenses of personal nature
- Advertisement in documents of political party
- Expenses paid without payment of TDS
- Payments above Rs. 10,000 made in cash

Depreciation (Section 32): -

Below illustration shall help you to understand the depreciation calculation:

Block of assets	Opening	Additions		Sales	Depreciations			Closing
	WDV	**> 180 days**	**< 180 days**	**Proceeds**	**Rates**	**Calculation**	**Amount**	**WDV**
Tangibles assets								
Residential Buildings	-	-	-	-	5%	-	-	-
Commercial Buildings	10,00,000	-	-	-	10%	10,00,000 x 10%	1,00,000	9,00,000
Furniture and fittings	50,000	30,000	-	-	10%	50,000 +30,000 x 10%	8,000	72,000
Machinery and plant	2,00,000	-	20,000	30,000	15%	2,00,000 – 30,000 x 15% Add: (20,000 x 15% / 2)	25,500 + 1,500 = 27,000	1,63,000
Computer including computer software	50,000	10,000	20,000	-	40%	50,000 +10,000 x 40% Add: 20,000 x 40% / 2	24,000 +4,000 =28,000	52,000
Professional books	20,000	5,000	3,000	2,000	40%	20,000 +5,000 –2,000 x 40% Add: 3,000 x 40% / 2	9,200 +600 = 9,800	16,200
Intangible assets (such as know-how, patent, licenses, etc.)	30,000	-	-	5,000*pt 2	25%	-	-	-

Let us dissect each of the part of the above table and understand it:

a. **Block of assets** – Depreciation under income tax follow the block concept i.e. same class of assets with same rates of depreciation are clubbed together.
b. **Tangible assets** – Assets which can be seen and touched are called tangible assets
c. **Intangible assets** – Assets other than tangible assets are called intangible assets
d. **Opening WDV** – "WDV" stands for Written Down Value of block of assets. The closing WDV of last year becomes the opening WDV for current year
e. **Additions** – The actual cost of new purchases of any tangible and intangibles assets will be added to the respective block value. The additions should be split based on the time off which it is used in the year. If the asset is used for less than 180 days than the depreciation will by half of the rate, else it will be full depreciation.
f. **Sales proceeds**– The amount received on sale of asset is reduced from the block of asset.
g. **Depreciation rate** – The rates of depreciation are provided under the income tax act and the same should be used.
h. **Depreciation calculation** – Full depreciation is calculated on the (Opening WDV + Addition for more than 180 days - Sale proceeds). Half depreciation is eligible on the Additions for less than 180 days.
i. **Closing WDV** – This is the closing balance of the block value. This is calculated as Opening WDV + Additions – Sales proceed – Depreciation.

<u>Specific instances</u>:

1. **Sale value more than block value**: In case the sale consideration of depreciable asset is more than amount of asset in the block than the difference is treated as short term capital gains.
   For instance, if an asset block whose total value of asset is Rs. 25,000 and the sale value is Rs. 30,000. Even if there are assets in the block, the block WDV will be Nil and the difference of Rs. 5,000 will be treated as short-term capital gains.

2. ***No assets in the block**: If all the assets in the block are sold then the difference between the amount in the block and sale consideration will be treated as short-term capital gain/loss and the closing value for the block will be Nil.

   In case of assets block "Intangible assets" the total value of asset is Rs. 35,000 and the sale value is Rs. 5,000. If for Rs. 5,000 all the assets in the block are sold then the closing WDV will be Nil. The difference of Rs. 20,000 shall be treated as short-term capital loss.

Section 40(b) Remuneration to working partners:
Salary, bonus, commission, remuneration paid to working partner is permissible as per below limits:

a. On first Rs. 3 lakh of book profit or in case of a loss – Rs. 1,50,000 or 90% of profits whichever is higher
b. On balance book profit – 60% of profit

Salary payment should be authorized by the partnership deed.

Example – Computation of profit from business:
Ranjeet has provided the below income statement for his manufacturing business for the year 2018-19. Compute the taxable income as per Income Tax Act.

Particulars	Amounts
Revenue from sale of products	1,50,00,000
Interest on Income Tax Refund	10,000
Employee salaries	25,00,000
Factory Rent	30,00,000
Repairs to building	5,00,000
Interest expenses	13,00,000
Provision for bad debts	2,00,000
Purchases (Rs. 80,000 paid in cash)	56,00,000
Penalties for violation for environment norms	9,00,000
Profit for the year	**10,10,000**

Calculate the taxable income from Business and profession

Solution:

Calculation of Profit from Business of Mr. Ranjeet for PY 2018-19 (AY 2019-20)

Particulars	Remarks	Amount
Profit as per income statement		10,10,000
Provision for bad debts	Provision is not eligible for deduction	2,00,000
Purchases (Rs. 80,000 paid in cash)	Payment in cash for more than 10,000 is not eligible for deduction	80,000
Penalties for violation of environment norms	Penalties are not eligible for deduction	9,00,000
	Profit from business as per IT Act	**21,90,000**

D. Capital gains:

Capital assets are –

Sr	Definition	Terminology	Example
a.	Property of any kind, whether or not connected with your business or profession	Non-Financial Assets	Land, Building, Machinery, Factory, Patents, Jewelry, etc.
b.	Any securities	Financial Asset	Equity shares/ stocks, preferences shares, debentures, mutual fund units and such other securities

All the above assets are called capital assets and any gain on sale of these assets will be covered under this head of income.

The calculation and taxability of profits (capital gains) on the sale of above assets depend on whether these assets were held for short term or for longterm. Hence let us understand how the assets are classified as short term and long term.

Asset Type	Long Term	Short Term
Non-Financial Assets (Other than specified below)	Held for MORE than 36 months	Held for LESS than 36 months
Financial Assets (Other than specified below)	Held for MORE than 12 months	Held for LESS than 12 months
Land & Building and Unlisted Shares	Held for MORE than 24 months	Held for LESS than 24 months

Against the sale value of the capital asset following expenses and deductions are eligible:

Sr	**Expenses / Deductions**	**Short Term**	**Long Term**
1	Expenses incurred against the sale of capital asset of transfer	Yes	Yes
2	Cost of assets acquisition	Yes	Yes (with indexation)
3	Cost of improvement	Yes (only for non-financial assets)	Yes (only for non-financial assets, with indexation)

Example – Computation of capital gains:

Mr Raj had bought a house property in Sept 2004 for a price of Rs. 1.20 crores. In the year 2010-11, he renovated the house for which he incurred Rs. 30 lakhs. He sold the house property for a price of Rs. 4 crores on 5 May 2018. He incurred a brokerage cost of Rs. 4 lakhs.

CII for 2004-05: 113 CII for 2010-11: 167 CII for 2018-19: 280

Solution:

Calculation of Capital Gains of Mr. Raj for PY 2018-19 (AY 2019-20)

Capital Asset: Non-financial, House property

Holding Period: Date of sale: 5 May 2018; Date of Purchase: Sept 2004. That means the holding period is more than 24 months (for land and Building). Hence this is a long-term asset.

Particulars	Amount	Amount
Sale consideration	4,00,00,000	
Less: Expenses of Transfer	(4,00,000)	
Net Consideration		3,96,00,000
Less: Indexed Cost of acquisition **Cost of acquisition x CII for year of Transfer** **CII for year of acquisition** **= 1,20,00,000 x 280** **113**	2,97,34,513	
Less: Indexed Cost of improvement **Cost of improvement x CII for year of Transfer** **CII for year of improvement** **= 30,00,000 x 280** **167**	50,29,940	3,47,64,453
Long Term Capital Gains (LTCG)		**48,35,547**

Due to indexation the cost of Rs. 1.20 crore increased to Rs. 2.97 crore and thus reduced the taxable income significantly.

Exemptions to reduced taxable capital gains

In case of capital gain, certain exemptions are available based on fulfilment of conditions.

Criteria	**Section 54**	**Section 54 F**	**Section 54 EC**
Criteria for the asset sold:			
Asset sold	Residential House Property	Any capital asset other than residential house Property	Land or Building or both
Assessee	Individual or HUF	Individual or HUF	Any assessee
Nature of asset	Long term capital asset	Long term capital asset	Long term capital asset

Criteria for claiming exemptions:			
Investment	Acquisition of 1 new residential House Property is eligible for deduction.	Acquisition of 1 new residential House Property. Should not hold more than one residential property other than the new residential property to be purchased.	Invest in notified bonds of NHAI / RECL and others up to a Maximum amount of Rs. 50 lakhs
Time period for investment	Purchase – within 1 year before or 2 years after the date of sale OR Construction within 3 years	Purchase – within 1 year before or 2 years after the date of sale OR Construction within 3 years	Investment should be made within 6 months of the sale of asset
Exemption amount	**Lower of:** Amount invested in the new property OR Capital Gains	Amount of net sale proceeds. If less amount is invested than exemption shall be: Amount invested x Capital gains / net sales proceeds	**Lower of:** Amount invested in bonds OR Capital Gains
Holding period for new asset	3 years from date of acquisition or construction	3 years from date of acquisition or construction	5 years from date of investment

E. Income from Other Sources:

Any income earned which does not fit into the earlier four heads of income and is not exempt shall be chargeable to tax under the head "Income from Other Sources". Below is an illustrative list of incomes classified under this head:

1. Interest income on bank deposit
2. Interest on loans
3. Interest income on Income tax refunds
4. Income from sub-letting of House Property
5. Casual income
6. Agricultural income from land outside India
7. Rent from vacant piece of land
8. Dividend Income
9. Gift (if certain conditions are met and exceeds Rs. 50,000) (Refer details below)
10. Income from Undisclosed Sources

11. Income from winning lottery, horse races, card game, game shows, etc.

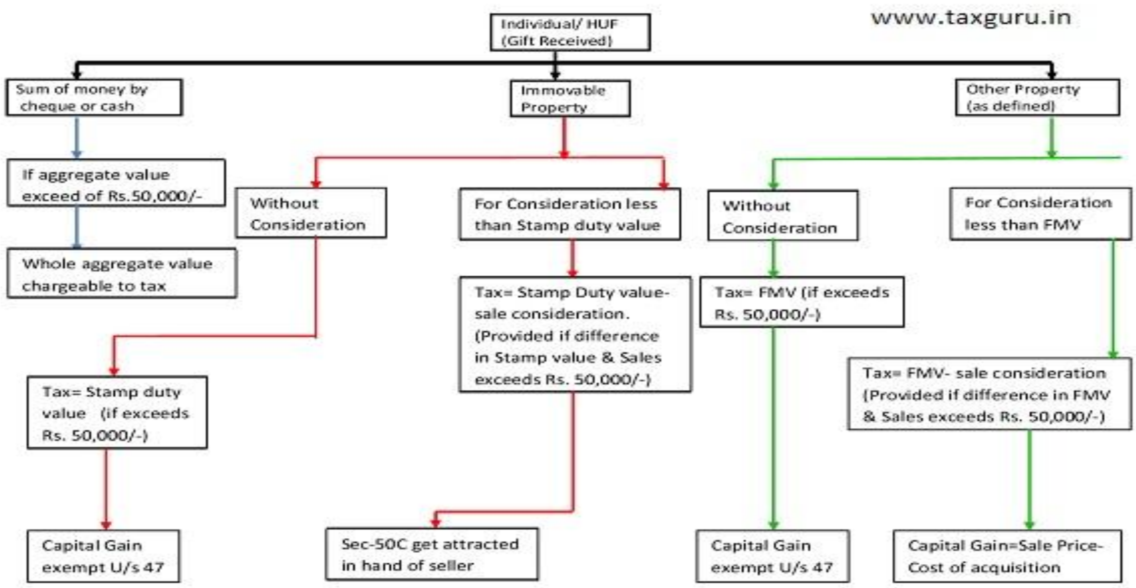
Against the income from other source, expenses which can be directly related to the income are deductible.

Instance of such expenses are:

a. Any commission or remuneration paid for realizing dividend or interest income
b. Repairs, insurance and depreciation of building, furniture and plant and machinery from which income under the head "Income from Other Sources" is earned
c. Interest on borrowed loan which is used for investing in shares and securities

Note: Personal expenses and expenses in connection with winnings from lottery, puzzles, game shows, gambling and betting are not eligible for deduction.

Gift:



* Immovable property means – land or building or both

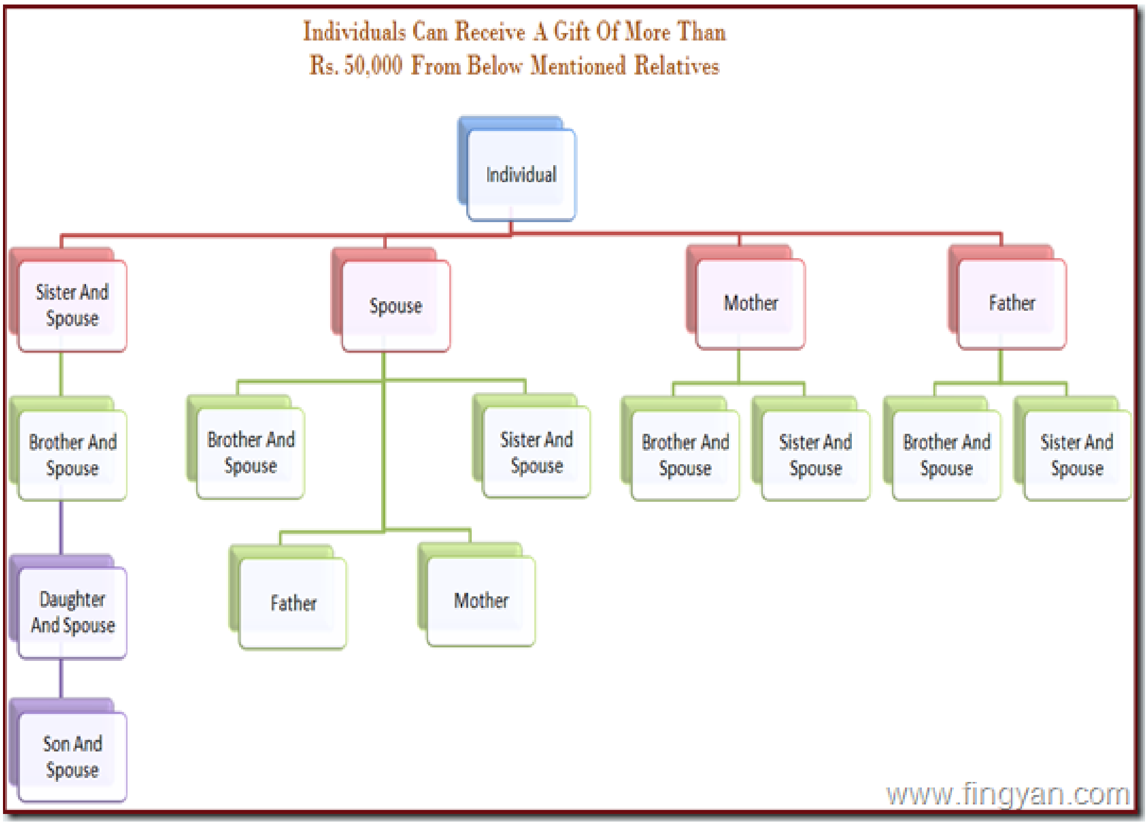
** Property means capital assets of the assessee:
a. Shares and securities
b. Jewelry and bullion
c. Drawings, paintings, sculpture or any work of art

Exception: Gifts received from following persons / situation is not taxable:

a. From a relative (refer diagram below)
b. On occasion of marriage of the individual
c. Under a will or by way of inheritance
d. In contemplation of death of the payer or donor
e. From any local authority
f. From any fund / foundation / university / educational institution / hospital / other medical institution / trust / institution referred under section 10 (23C)

g. From any trust / institution registered under section 12AA

For the purpose of this section, relative mean:



Example – Evaluation taxability of gift

Neerja received gifts of Rs. 1,00,000 from her father-in-law and Rs. 5,000 from her 5 friends at the time of her marriage. Is it taxable?

Solution –

Gifts received on occasion of marriage are exempt from tax. Further, gift received from father-in-law is considered as a relative, and hence the same too is not taxable.

CLUBBING

After from the income earned by an individual, there are certain incomes which although not earned by him/her are added to his/her taxable income. Such incomesare covered by the clubbing provision of the Income Tax Act.

The income which is clubbed will be included under the head "income from other sources". Below areincomes which will be clubbed in the hands of the assessee:

Section	Details	Taxable in hands of
60	**Transfer of income without transfer of assets**	Transferor
61	**Revocable transfer of asset**	Transferor
64 (1) (ii)	**Remuneration to Spouse:** Remuneration received by spouse from a concern in which individual has Substantial Interest unless the remuneration is reasonable, as per the knowledge, experience etc. of the receiver	Spouse who has Substantial interest If both the spouses have substantial interest then, remuneration would be clubbed in the hands of spouse whose total income excluding remuneration is greater.
64 (1)(IV) 64 (1)(VI) 64 (1)(VII) 64 (1)(VIII)	**Assets transferred for inadequate consideration:** Income from asset transferred for inadequate consideration to spouse/son's wife/third person (forthe benefit of spouse or son's wife)	Transferor
64 (1A)	**Minor child's Income:** Income earned by a minor is clubbed and taxed in the hand of the parents. Exemption u/s 10(32) uptoRs.1500 is allowed to parent in whose income minor's income is clubbed.	Minor's income is clubbed in the hands of that parent whose income is greater. If marriage of parent does not subsist then Minor's income is clubbed in the hands of that parentwho maintains the minor child.

Example – Computation of Income from other sources:

Mr. Shah has 3 daughters aged 20, 15 and 10 who have earned the following income during the year 2018-19.

1st Daughter (age 20) – Rs. 20,000
2nd Daughter (age 15) – Rs. 10,000
3rd Daughter (age 10) – Rs. 1,000

How much of the income will be clubbed with the income of Mr. Shah?

Solution: -Amount to be clubbed in the hand of Mr. Shah:

Since Daughter 1 is major by age, her income will not be clubbed with her father.

Particulars	Daughter 2 (Age 15)	Daughter 3 (Age 10)
Income for the year	10,000	1,000
Exemption u/s 10(32) (maximum 1,500 per child)	1,500	1,000
Income to be clubbed	8,500	Nil

Hence Rs. 8,500 will be clubbed with the income of Mr. Shah.

SET-OFF PROVISIONS

In case of losses incurred in any year under any of the heads of income, the same can be set-off (adjusted) against income from specific head only. Below is a table of set-off provisions in a nut-sell:

Section	Nature of loss	Details of set-off	Conditions / Exceptions
LOSS FOR THE YEAR AND PERMISSIBLE SET-OFF			
70	Loss under any head of income	Loss under a head of income can be **set-off against another income under the <u>same head</u>**. For eg. loss from one business can be set off against profit from another business.	Long Term Capital Loss (LTCL) can be set-off only against Long Term Capital Gains (LTCG), however, Short term capital loss can be set-off against both short term as well as long term capital gains. Note: Loss from speculation cannot be set-off against any income other than speculation income.
71	Loss under any head of income	Loss under a head of income can beset-off **against income under the <u>other head</u>**. For e.g. loss from house property can be set off against income from salaries.	Following set-offs are **not permissible**: 1. Loss from speculation business against any head 2. Loss from capital gains against any head 3. Loss from business or profession against income from salaries
BROUGHT FORWARD (b/f) LOSSES AND PERMISSIBLE SET-OFF: **(loss incurred in an earlier year to the extentnot set-off can be carried forward to next year)**			
71B	b/f loss from House	Set-off only against income from house property	The loss can be c/f for 8 AY.

	property		
72	b/f loss from business and profession	Set-off only against profit or gains from business or profession	The loss can be c/f for 8 AY provided Return of Income has been filed on time
32(2)	b/f unabsorbed depreciation	Set-off against **<u>any head</u>** of income	No limit on carrying forward
73	b/f loss from speculative business	Set-off only against income speculative business	The loss can be c/f for 4 AY provided Return of Income has been filed on time
74	b/f loss from capital gains	Set-off only against income from capital gains	STCL can be set-off against any capital gains; however, LTCL can be set-off against LTCG only. The loss can be c/f for 8 AY provided Return of Income has been filed on time

Example – Computation of Income from other sources:

Following data is given by an assessee for preparation of his income tax return for AY 2019-20:

a) Loss under the head Business – 1,00,000
b) Long – Term Capital Gains on sale of House Property – 2,00,000
c) Short-Term Capital loss on sale of shares – 50,000
d) Loss on self-occupied house property – 10,000
e) Loss on a let-out property – 25,000
f) Brought forward loss from business from AY 2013-14 – 60,000

Calculate net taxable income for the year

Solutions:

Calculation of Taxable Income for PY 2018-19 (AY 2019-20)

Particulars	**Amount**	**Amount**
Long Term Capital Gains		2,00,000
<u>Income from House Property:</u> ***Loss from self-occupied property*** ***Loss from let-out property*** ⇨ ***Loss from House Property can be set off against LTCG***	 (10,000) (25,000) 	 (35,000)
<u>Profit and gains from business or profession:</u> ***Current year loss from business*** ⇨ ***Loss from business can be set off against LTCG***	 (1,00,000) 	 (1,00,000)
<u>Capital Gains:</u> ***Short-term capital loss***	 (50,000)	

⇨ ***Loss from STCL can be set off against LTCG***		(50,000)
Net available gains for adjustment of b/f losses		**15,000**
<u>Brought forward losses:</u> ***Business loss*** ⇨ ***B/f business loss can be set off only against profit from business***	(60,000)	**Nil**
Total Taxable Income		**15,000**

DOUBLE TAXATION AVOIDANCE AGREEMENT (DTAA)

If a person is a resident of one country and earns income from a foreign country, there are likely possibility that the income is taxed by both the countries. This is called double taxation, whereby tax is levied on the same income twice.

In order to avoid such double taxation government of countries enter into Double Tax Avoidance Agreements (DTAA). These are essentially bilateral agreements entered into between two countries to achieve the following basic objectives:

a) Avoid double taxation of income

b) to promote economic trade and investment between countries

In case there are conflicting provisions between the Income Tax Act and the DTAA, a tax payer can take advantage of either of the provision which is more beneficial to them. Evaluation of DTAA provisions are an essential element of any cross-border financial decisions making.

Areas that are covered in the Double Taxation Avoidance Agreements are:

- Method for granting relief under the DTAA and method of avoidance of double taxation.
- Determing the rate of withholding tax, procedure to be followed in case of tax deduction and how to claim tax credits.
- Procedure for recovery of tax under the Indian Income Tax Act and under the corresponding law in force in foreign country.
- Methodology for exchange of information between the countries to prevent the evasion or avoidance of income tax in India and the foreign country.
- Procedure for investigation of cases of tax evasion or avoidance.

Section 90 (1) provides that the Central Government may enter into an agreement with the government of any country outside India or specified territory outside India-

- For the granting of relief in respect of –
    - income on which income tax has been paid both in India and in that country or specified territory; or

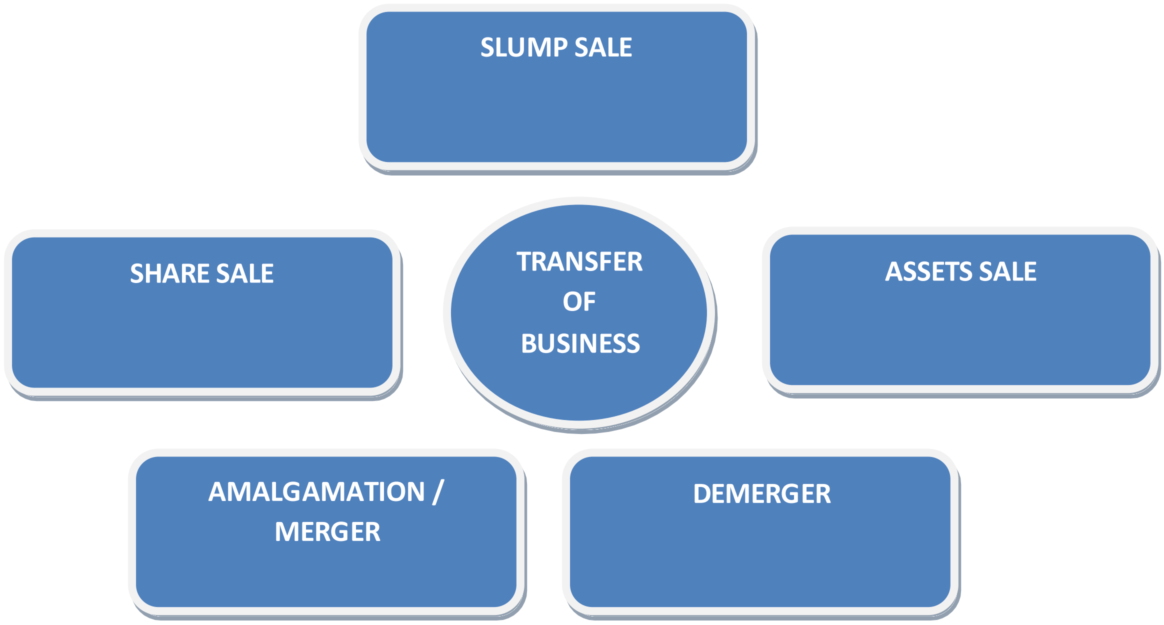
- o income-tax chargeable under this Act and under the corresponding law in force in that country or specified territory to promote mutual economic relations, trade and investment; or

- for the avoidance of double taxation of income under this Act and under the corresponding law in force in that country or specified territory; or
- for exchange of information for the prevention of evasion or avoidance of income-tax chargeable under this Act or under the corresponding law in force in that country or specified territory, or investigation of cases of such evasion or avoidance, or
- for recovery of income-tax under this Act and under the corresponding law in force in that country or specified territory, as the case may be,
- and make such provisions as may be necessary for implementing the agreement.

Instance where any income of a resident of India is taxed in the other country then, such income will be included in his total taxable income in India as per the provisions of the Income-tax Act, 1961, and relief u/s 91(1) shall be granted.

TAXATION ON TRANSFER OF BUSINESS

A business transfer can be effective in one of the following ways:



An overview of the differences and the tax implication for the above form of business transfer is summarized below:

A. Slump Sales:

In this form of business transfer, a particular unit / undertaking / business is sold off for a lump sum consideration. There is no allocation of the consideration to each of the assets and liabilities to the hived off business. The assets and liabilities are transferred as a going concern, i.e. operational.

This transfer does not require any court approval.

This transaction is considered assale of assets (business unit); hence such a transfer attracts capital gains tax. The capital gain is taxed as long term if the unit is held for more than 36 months, else it shall be taxed as short-term. However, no indexation benefit will be available even if the assets are long term.

Losses in relation to the sold unit cannot be carried forward.

B. Share Sale:

Under this form, the shares of a running business are acquired either through the open market or through a private placement. By virtue of this transaction, the acquired becomes the holding company / shareholder and shall control the assets and liabilities of the acquire company

This transaction does not require any court approval. From a taxationperspective, this will be treated as sell of shares by the erstwhile shareholders. They shall be liable to long-term or short-term capital gains taxation depending upon their holding period.

The losses of the company can be carried forward if the change in shareholding does not exceed 49%

C. Asset Sale:

Similar to the slump sale, however here each of the assets to be sold are identified and values are assigned. Due to each tax liabilities for each asset is separately determined depending on the nature (depreciable / non-depreciable) and holding period (short-term and long-term) of the assets.

D. Amalgamation / Merger:

One company is merged into another company, or more than one company are merged to form a new company. Such transaction required approval from the court in compliance with section 391 to 394 of Companies Act 1956.

All the assets and liabilities in the merging company are transferred to the amalgamated or newly formed company.

Companies can avoid capital gains tax if it is structured as a tax neutral amalgamation and is in compliance with covered by section 47 of the Income Tax Act.

The losses of the company can be carried forward if conditions under section 72A are complied with.

E. Demerger:

Under this form, a particular unit / undertaking is hived off and formed into a new company for effective management and administration. Such transaction required approval from the court in compliance with section 391 to 394 of Companies Act 1956.

All the assets and liabilities from the existing entity are transferred to a new company.

Companies can avoid capital gains tax if it is structured as a tax neutral demerger and is in compliance with covered by section 47 of the Income Tax Act. The losses of the company can be carried forward if conditions under section 72A are complied with.

Example – Taxation of a slump sale

V & Co. (firm) sold, after 10 years of operations, all its assets and liabilities as a slump sale during the year 31 March 2019 to R & Co. (firm) for a lump sum consideration of Rs. 700 lakhs. The statement of affairs of V & Co. as on the date of slump sale was as below:

Liabilities	**Lakhs**	**Assets**	**Lakhs**
Capital	677	WDV of Plant and Machinery (WDV as per IT Rs. 200 lakhs)	250
Unsecured Loans	25	Land at cost (Market value Rs. 400 lakhs)	100
Bank Borrowings	200	Sundry Debtors	380
Sundry Creditors	80	Loans and Advances	2
		Closing Stock	250
Total	**982**	**Total**	**982**

Compute the taxable capital gains from the slump sale

Solution

Calculation of Profit from capital gains of V & Co. for PY 2018-19 (AY 2019-20)

Particulars	**Lakhs**
Plant and Machinery (WDV as per IT Act)	200
Land (market value to be ignored)	100
Other assets (380 + 2+ 250)	632
Less: all liabilities (25 + 200 + 80)	(305)
Net worth	**627**

Particulars	**Lakhs**
Sale consideration	700
Less: Cost of acquisition (net worth from above)	627
Net worth	**73**

Note: The firm has operated for 10 years hence Rs. 73 lakhs will be treated as long-term capital gain; however, indexation benefit will not be available. Since this is a long-term capital gain the same will be taxed at 20%.

TRANSFER PRICING ISSUES

Commercial transactions between the different parts of the multinational groups may not be subject to the same market forces shaping relations between the two independent firms. One party transfers toother goods or services, for a price. That price is known as "transfer price".

This may be arbitrary and dictated, with no relation to cost and added value, diverge from the market forces. Transfer price is, thus, a price which represents the value of good; or services between independently operating units of an organisation. But, the expression "transfer pricing" generally refers to prices of transactions between associated enterprises which may take place under conditions differing from those taking place between independent enterprises. It refers to the value attached to transfers of goods, services and technology between related entities. It also refers to the value attached to transfers between unrelated parties which are controlled by a common entity.

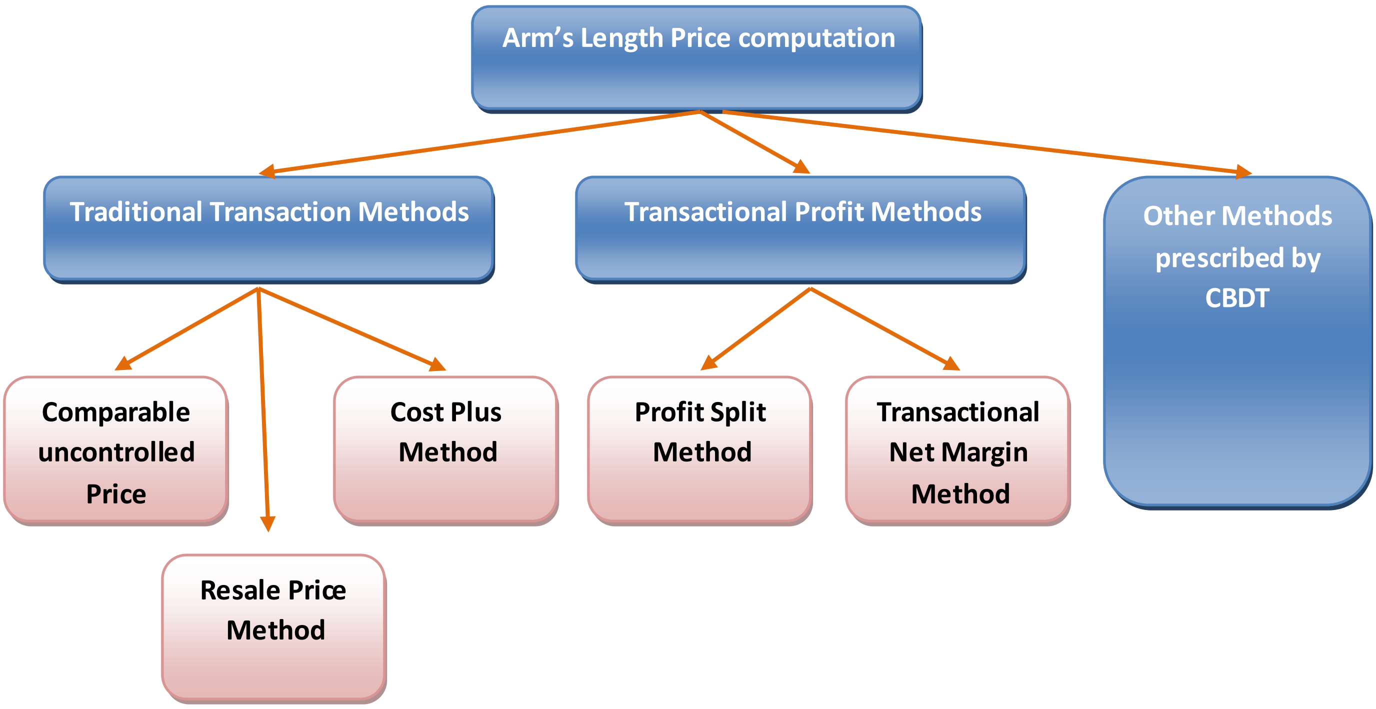
Suppose a company A purchases goods for 100 rupees and sells it to its associated company B in another country for 200 rupees, who in turn sells in the open market for 400 rupees. Had A sold it directly, it would have made a profit of 300 rupees. But by routing it through B, it restricted it to 100 rupees, permitting B to appropriate the balance. The transaction between A and B is arranged and not governed by market forces. The profit of 200 rupees is, thereby, shifted to the country of B. The goods is transferred on a price (transfer price) which is arbitrary or dictated (200 hundred rupees), but not on the market price (400 rupees).

Thus, the effect of transfer pricing is that the parent company or a specific subsidiary tends to produce insufficient taxable income or excessive loss on a transaction. For instance, profits accruing to the parent can be increased by setting high transfer prices to siphon profits from subsidiaries domiciled in high tax countries, and low transfer prices to move profits to subsidiaries located in low tax jurisdiction. As an example of this, a group which manufacture products in a high tax country may decide to sell them at a low profit to its affiliate sales company based in a tax haven country. That company would, in turn, sell the product at an arm's length price, and the resulting (inflated) profit would be subject to little or no tax in that country. The result is revenue loss and also a drain on foreign exchange reserves.

Areas that are covered in the Transfer Pricing are:

- The Transfer Pricing provisions cover international transactions (transactions between a resident and non-resident) in respect of purchase, sale, transfer, lease or use of tangible and Intangible property, capital financing transactions, exchange of goods and services and business re-structuring arrangements.
- Defines which parties are considered as associated enterprises
- Notifies the tax treatment on international transactions
- Methods for determination of Arm's Length Price and factors for selection of the appropriate method.
- Safe Harbour Rules
- Procedures and penalties for compliance of the Transfer Pricing regulations
- Maintaining documentation and Audit requirements

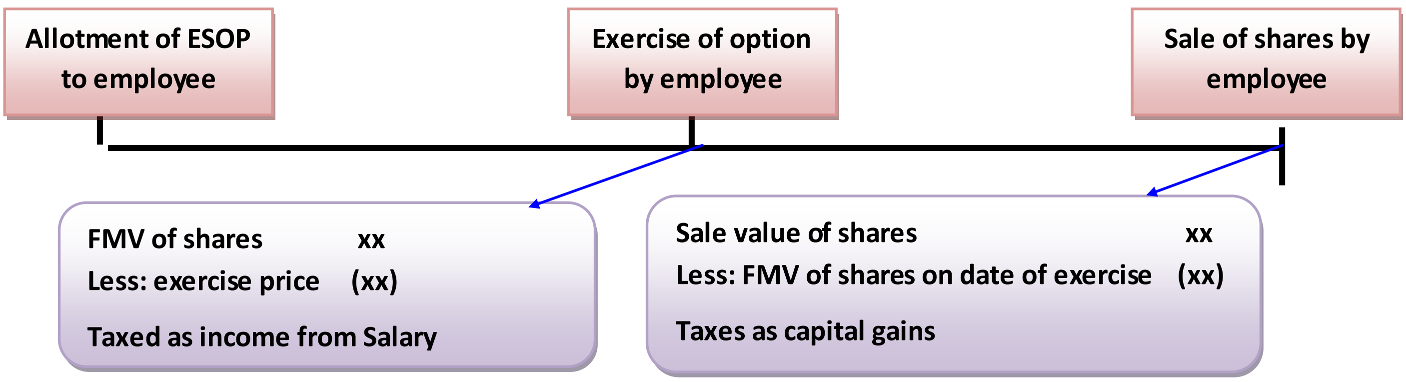
An arm's-length price for a transaction is a price of that transaction that would be quoted in an open market. Various methods for computation of arm's length price u/s 92C are as below:



EMPLOYEES' STOCK OPTION PLAN OR SCHEME

Employee Share Options Plan or ESOP is an option provided by a company to its employees. These options provide an option to the employees to purchase the company's shares on future dates at a pre-determined price. ESOPs are gaining popularity as part of salary offer especially in case of a start-up.

Taxability of ESOP can be summarized in the below chart:



As can be seen above the ESOP are taxed at 2 stages:

1. **On exercise of option –** The difference between the market value of the share and the amount paid by the employee to purchase the shares is the benefit earned by the employee. This is included as part of the employee salary, and tax is liable to be paid the year of exercise of the option

2. **Sale of shares –** This is treated like any other capital gains on sale of assets and the same will be short-term or long-term depending on the holding period. Normally, in the calculation of capital gains, the cost of acquisition is deducted from the sale considered, however in the case of ESOP the cost of share will be the fair value on the date of exercise of the option. This is because the employee already paid tax on the fair value on the date of exercise.

Example - on taxability of ESOP

Under the ESOP scheme of ABC Ltd, employee X was allotted 20,000 shares on June 1, 2016. An employee can exercise the option at the end of 2 years, i.e. June 1, 2018, and the exercise price was fixed at Rs. 40.

On June 1, 2018, the market value of the share of PQR Ltd was Rs. 90.

X decides to sell all the shares at Rs. 110 each on February 10, 2019.

Solution:

Taxation on ESOP on exercise of the option:

Perquisite value of ESOP = (FMV – Exercise price) x number of shares allotted

Perquisite value of ESOP = (90-40) x 10,000 = 500,000

The amount of Rs. 4,00,000 will be taxable in the year of exercise, i.e. PY 2018-19 and shall form part of income from salary.

Capital gains on sale of shares:

Capital gains = Sale consideration Less FMV of shares at the time of allotment

Capital gains = (110 - 90) x 10,000 = Rs. 200,000

Since the holding period of shares is less than 12 months, the gains will be classified as Short-term Capital Gains.

7. THE INSOLVENCY AND BANKRUPTCY CODE, 2016 (IBC) & REGULATIONS

PART I OF IBC: PRELIMINARY

The Insolvency and Bankruptcy code came into existence on 28 May 2016. IBC is an act to consolidate and amend the laws relating to reorganization and insolvency resolution of corporate persons, partnership firms and individuals in a time bound manner for maximization of value of assets of such persons, to promote entrepreneurship, availability of credit and balance the interests of all the stakeholders including alteration in the order of priority of payment of Government dues and to establish an Insolvency and Bankruptcy Board of India, and for matters connected therewith or incidental thereto.

Applicability of the code:
The provisions of this Code shall apply to—

a) any company incorporated under the Companies Act, 2013 or 1956
b) any company governed by any special Act,
c) any Limited Liability Partnership;
d) any other body incorporated under any law as notified by the Central Government
e) partnership firms and individuals, in relation to their insolvency, liquidation, voluntary liquidation or bankruptcy.

The salient feature of the Insolvency and Bankruptcy Code, 2016 are:
1. Consolidation and amendment of all existing insolvency related laws and legislation. The code will override all other laws relating to Insolvency & Bankruptcy.
2. Establishment of an independent body for the administration and governance of Insolvency &Bankruptcy Law
3. Define the priority of payment mechanism.
4. The code proposes a paradigm shift from the existing 'Debtor in possession' to a 'Creditor in control' regime.
5. Introduction of a qualified insolvency professional (IP) who shall act as an intermediary to oversee the various processes.
6. The code aims to resolve insolvencies in within 180 days (extendable up to 270 days) for the Company. However, in case of fast track case of corporate debtors (low income and assets) the period shall be 90 days (extendable up to 135 days)).
7. Insolvency professional to take control over the management of the Company.
8. The law also provides process for resolving cross border insolvency.
9. Importance of identifying the reasons for financial failures and maximizing the asset value of insolvent firms.
10. Investigation of material transactions and in case of illegal diversion of assets, personal contribution can be ordered by court.

PART-II OF IBC: INSOLVENCY RESOLUTION AND LIQUIDATION FOR CORPORATE PERSONS

One needs to understand the difference between Insolvency, Bankruptcy and Liquidation as illustrated below:

INSOLVENCY	BANKRUPTCY	LIQUIDATION
It is a state of financial difficulties of a person due to which it is unable to pay the bills as they become due and is unable to run its business at its current pace.	When a person is legally declared incapable of paying their dues and obligations	The process of winding up of a corporation

Insolvency precedes bankruptcy and liquidation follows bankruptcy. The IBC 2016 has laid down procedures and processes for:

1. Insolvency resolution
2. Liquidation
3. Voluntary liquidation

Key definition used in the code with respect to Insolvency Resolution and Liquidation for Corporate Persons are listed below:
"**Corporate Person**" means and includes the following:

a) Company as defined in section 2(20) of the Companies Act, 2013,
b) a limited liability partnership, as defined in section 2(1)(n) of the Limited Liability Partnership Act, 2008,
c) any other person incorporated with limited liability under any law for the time being in force but shall not include any financial service provider

Thus, by definition, IBC will be applicable to companies, LLPs and other body corporates except for financial service providers.
"Corporate Debtor" means a corporate person who owes a debt to any person;

"Corporate Applicant" means—

a) corporate debtor; or
b) a member or partner of the corporate debtor who is authorized to make an application for the corporate insolvency resolution process under the constitutional document of the corporate debtor; or
c) an individual who is in charge of managing the operations and resources of the corporate debtor; or
d) a person who has the control and supervision over the financial affairs of the corporate debtor

"Financial Creditor" means any person to whom a financial debt is owed and includes a person to whom such debt has been legally assigned or transferred to

"Initiation Date" means the date on which a financial creditor, corporate applicant or operational creditor, make an application to the Adjudicating Authority for initiating corporate insolvency resolution process.

"Operational Creditor" means a person to whom an operational debt is owed and includes any person to whom such debt has been legally assigned or transferred

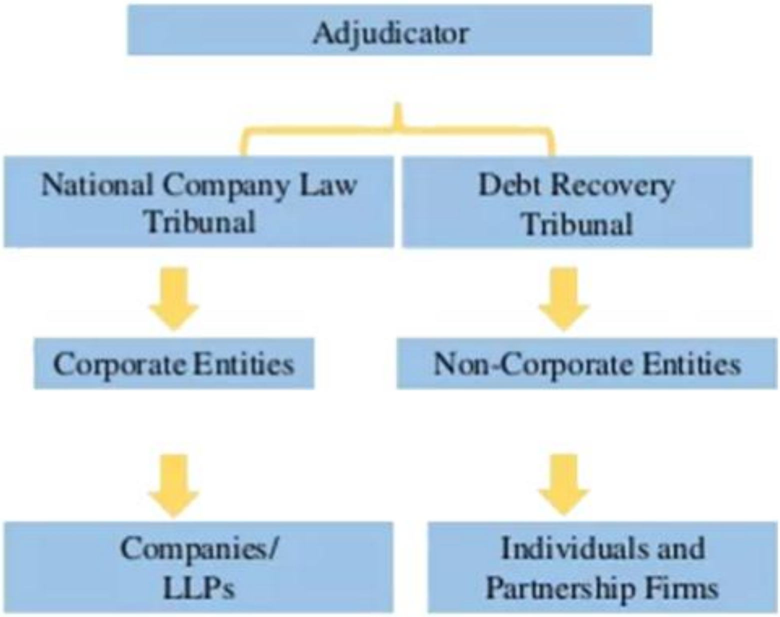
"Related Party", in relation to a corporate debtor, means—

a) a director or partner of the corporate debtor or a relative of a director or partner of the corporate debtor;
b) a key managerial personnel of the corporate debtor or a relative of a key managerial personnel of the corporate debtor;
c) a limited liability partnership or a partnership firm in which a director, partner, or manager of the corporate debtor or his relative is a partner;
d) a private company in which a director, partner or manager of the corporate debtor is a director and holds along with his relatives, more than two per cent of its share capital;
e) a public company in which a director, partner or manager of the corporate debtor is a director and holds along with relatives, more than two per cent. of its paid-up share capital;
f) anybody corporate whose board of directors, managing director or manager, in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the corporate debtor;
g) any limited liability partnership or a partnership firm whose partners or employees in the ordinary course of business, acts on the advice, directions or instructions of a director, partner or manager of the corporate debtor;
h) any person on whose advice, directions or instructions, a director, partner or manager of the corporate debtor is accustomed to act;
i) a body corporate which is a holding, subsidiary or an associate company of the corporate debtor, or a subsidiary of a holding company to which the corporate debtor is a subsidiary;
j) any person who controls more than twenty per cent. of voting rights in the corporate debtor on account of ownership or a voting agreement;
k) any person in whom the corporate debtor controls more than twenty per cent of voting rights on account of ownership or a voting agreement;
l) any person who can control the composition of the board of directors or corresponding governing body of the corporate debtor;
m) any person who is associated with the corporate debtor on account of—

    a. participation in policy-making processes of the corporate debtor; or
    b. having more than two directors in common between the corporate debtor and

such person; or

c. interchange of managerial personnel between the corporate debtor and such person; or
d. provision of essential technical information to, or from, the corporate debtor;



THE INSOLVENCY AND BANKRUPTCY BOARD OF INDIA (INSOLVENCY RESOLUTION PROCESS FOR CORPORATE PERSONS) REGULATIONS, 2016

Where any corporate debtor commits a default, a financial creditor, an operational creditor or the corporate debtor itself may initiate corporate insolvency resolution by making an application with National Company Law Tribunal (NCLT).

However, before an operational creditor approach NCLT, they should provide a 10 days demand notice to the corporate debtor to honour the outstanding payables. In case of failure by the corporate debtor, the operational creditor can make an application with NCLT.

When the application for insolvency is admitted, the NCLT shall appoint an Insolvency Resolution Professional (IRP) within a period of 14 days. The appointed IRP take control and custody of an asset over which the corporate debtor has ownership rights as recorded in the balance sheet of the corporate debtor. The IRP holds a term of 30 days within which the IRP shall gathers collect all information relating to the assets, finances and operations of the corporate debtor for determining the financial position of the corporate debtor .

Immediately after the appointment of the interim resolution professional, a public announcement shall be made about the initiation of Corporate Insolvency Resolution Process ("CIRP") and call for other creditors also to come forward for submission of their claims.

The IRP shall after collation of all claims received against the corporate debtor and determination of the financial position of the corporate debtor, constitute a committee of creditors. The committee of creditors shall comprise all financial creditors of the corporate debtor. All decisions of the committee of creditors shall be taken by a vote of not less than seventy-five per cent of voting share of the financial creditors.

The first meeting of the committee of creditors shall be held within seven days of the constitution of the committee of creditors. The committee of creditors, may, in the first meeting, by a majority vote of not less than seventy-five per cent. of the voting share of the financial creditors, either resolve to appoint the interim resolution professional as a resolution professional or to replace the interim resolution professional by another resolution professional.

A resolution applicant may submit a resolution plan to the resolution professional prepared on the basis of the information memorandum. The resolution professional shall examine each resolution plan received by him to confirm that each resolution plan meets the prescribed conditions.

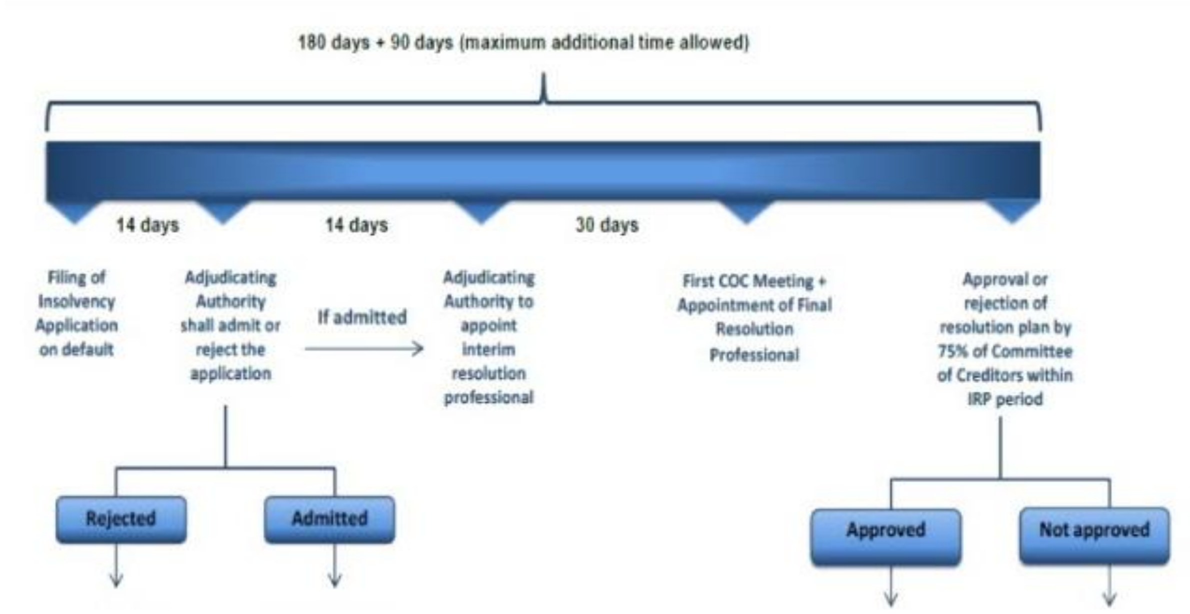
The resolution professional shall present to the committee of creditors for its approval such resolution plans which confirm the conditions. The committee of creditors may approve a resolution plan by a vote of not less than seventy-fiveper cent of voting share of the financial creditors.

The resolution professional shall submit the resolution plan as approved by the committee of creditors to the Adjudicating Authority. If the Adjudicating Authority is satisfied that the resolution plan as approved by the committee of creditors 30 meets the required conditions, it shall by order approve the resolution plan which shall be binding on the corporate debtor and its employees, members, creditors, guarantors and other stakeholders involved in the resolution plan.

The entire corporate insolvency resolution process shall be completed within a period of one hundred and eighty days from the date of admission of the application to initiate such process. However, on an application for extension made by of committee of creditors by a vote of seventy-five per cent, the Adjudicating Authority may grant an extension of not more than ninety days. Such an extension can shall not be granted more than once.

Note: In the entire process if the financial creditor is a related party, then such a party shall not have any right of representation, participation or voting in a meeting of the committee of creditors

The above process is summarised in the below flow chart:



Note: The CIRP must be concluded within 180 days from the date of initiation in the NCLT. Once the application for insolvency is accepted the claims of the Creditors shall be frozen for during this period. Unless a resolution plan is made or liquidation process is initiated, no legal claim can be sought against the corporate debtor in any other forum or Court.

Example – Mr. Sharma was appointed as the interim resolution professional (IRP) in respect of CIRP of A2Z company. The adjudicating authority proposed appointment Mr. Rao as the Resolution Professional (RP). The committee passed a majority vote after 10 days confirming the appointment of RP. If the appointment valid?

Solutions – As per the code, appointment of RP needs to be approved by majority vote of the committee of creditors within 10 days of the proposal. Failing to do so the adjudicating authority shall direct IRP to continue as RP.

THE INSOLVENCY AND BANKRUPTCY BOARD OF INDIA (LIQUIDATION PROCESS) REGULATIONS, 2016

The liquidation process gets initiated in either of the following circumstances:

1. The Creditors Committee fails to submit a resolution plan within the defined time frame.
2. The Resolution Plan submitted to the adjudicating authority is rejected as the prescribed conditions are not met.
3. The Creditor's Committee pass a majority vote for liquidating the assets
4. The corporate debtor passes resolution for liquidation

"Insolvency commencement date" means the date of admission of an application for initiating corporate insolvency resolution process by the Adjudicating Authority (National Company Law Tribunal constituted under section 408 of the Companies Act, 2013).

On passing of the order for liquidation by Adjudicating Authority, the resolution professional appointed for the corporate insolvency resolution process shall act as the liquidator. On the appointment of a liquidator, all powers of the board of directors, key managerial personnel and the partners of the corporate debtor, shall cease to have effect and shall be vested in the liquidator.

The liquidator shall hold the liquidation estate (which shall comprise of all the properties, whether financial or immovable, of the corporate debtor) in relation to the corporate debtor as a fiduciary for the benefit of all the creditors. Like-wise the liquidator shall receive or collect and determine the value of the claims of creditors within a period of thirty days from the date of the commencement of the liquidation process.

Section 35 (1) of the Regulation requires the liquidator to consider the average of the estimates of the values arrived under regulation 35 of the Insolvency and Bankruptcy Board of India (Insolvency Resolution Process for Corporate Persons)Regulations, 2016 or regulation 34 of the Insolvency and Bankruptcy Board of India(Fast Track Insolvency Resolution Process for Corporate Persons) Regulations, 2017,as the case may be, for the purposes of valuations under these regulations.

In cases not covered under sub-regulation (1), the liquidator shall within seven days of the liquidation commencement date, appoint two registered valuers to determine the realisable value of the assets or businesses of the corporate debtor.

The liquidator shall verify all the claims received within a period of 14 from the receipt of the claims. In case the claim is rejected the claimant should be intimated within 7 days. In that case the claimant may appeal to NCLT within a period of 14 days.

Section 36 of the Regulation required the liquidator to prepare an asset sale report in respect of said asset, to be enclosed with the Progress Reports, containing -

(a) the realized value;
(b) cost of realization, if any;
(c) the manner and mode of sale;
(d) if the value realized is less than the value in the asset memorandum, the reasons for the same;
(e) the person to whom the sale is made; and
(f) any other details of the sale.

The proceeds from the sale of the liquidation assets shall be distributed in the following order of priority:

a) the insolvency resolution process costs and the liquidation costs paid in full;
b) the following debts which shall rank equally between and among the following :—
   i. workmen's dues (as defined in sec 326 of companies Act, 2013) for the period of twenty-four months preceding the liquidation commencement date; and
   ii. debts owed to a secured creditor in the event such secured creditor has relinquished security;
c) wages and any unpaid dues owed to employees other than workmen for the period of twelve months preceding the liquidation commencement date;
d) financial debts owed to unsecured creditors;

e) the following dues shall rank equally between and among the following:—
   i. any amount due to the Central Government and the State Government for the period of two years preceding the liquidation commencement date;
   ii. debts owed to a secured creditor for any amount unpaid following the enforcement of security interest
f) any remaining debts and dues;
g) preference shareholders, if any; and
h) equity shareholders or partners, as the case may be

At each stage of the distribution of proceeds in respect of a class of recipients that rank equally, each of the debts will either be paid in full or will be paid in equal proportion within the same class of recipients, if the proceeds are insufficient to meet the debts in full.

Where the assets of the corporate debtor have been completely liquidated, the liquidator shall make an application to the Adjudicating Authority for the dissolution of such corporate debtor.

STAGE 1 : PRE – LIQUIDATION STAGE

- Initiation of the liquidation process
- Appointment of liquidator
- Liquidator taking over the power of the management of the corporate

STAGE 2: REALISATION OF ASSETS

- The liquidator to hold the liquidation estate
- Realisation from the sale of assets

STAGE 3: ADJUDICATION OF CLAIMS & DISTRIBUTION OF FUNDS

Liquidator to determine the value of the claims of creditors. The proceeds from the sale of the liquidation assets shall be distributed in the order of priority:

Priority	Disbursement
1	Insolvency resolution process costs and the liquidation costs
2	• workmen's dues pending for last twenty-four months • debts owed to a secured creditor who have relinquished security
3	Wages and any unpaid dues to employees for the period of twelve months
4	Financial debts owed to unsecured creditors;
5	• Central and State Government dues for last two years • Unpaid debts of secured creditor after enforcement of security interest
6	Any remaining debts and dues;
7	Preference shareholders, if any
8	Equity shareholders or partners

STAGE 4: DISSOLUTION OF COMPANY

- Liquidator to make an application to the Adjudicating Authority for the dissolution.
- Adjudicating Authority to pass order that the corporate debtor shall be dissolved
- Copy of an order within seven days be forwarded to the registrar

8. THE INSOLVENCY AND BANKRUPTCY BOARD OF INDIA (VOLUNTARY LIQUIDATION PROCESS) REGULATIONS, 2017

A corporate person who intends to liquidate itself voluntarily and has not committed any default may initiate voluntary liquidation proceedings, provided following conditions are met:

a) a declaration from majority of the directors of the company confirming:

- that either the company has no debt or that it will be able to pay its debts from the proceeds of assets to be sold; and
- the company is not being liquidated to defraud any person;

b) the declaration shall be accompanied with the following

- audited financial statements and record of business operations of the company for the previous two years or for the period since its incorporation, whichever is later;
- a report of the valuation of the assets of the company, if any prepared by a registered valuer;

Within 4 weeks of the declaration from directors, the member of the company shall pass a special resolution requiring the company to be liquidated voluntarily and appointing an insolvency professional to act as the liquidator.

The above resolution passed by the members should be approved by the creditors of company if their debt represents more than two-thirds in value of the debt of the company. Such an approval shall be obtained within a period of 7 days from the date of the members resolution.

The company shall notify the Registrar of Companies and the IBC about the resolution to liquidate the company within seven days of such resolution. A voluntary liquidation for a corporate person shall be deemed to have commenced from the date of passing of the resolution. The corporate person shall from the voluntary liquidation commencement date cease to carry on its business except as far as required for the beneficial winding up of its business.

Where the affairs of the corporate person have been completely wound up, and its assets completely liquidated, the liquidator shall make an application to the Adjudicating Authority (National Company Law Tribunal constituted under section 408 of the Companies Act, 2013) for the dissolution of such corporate person. Whereby the Adjudicating Authority shall allow for dissolution of the corporate debtor

A copy of the order shall be submitted with the authority with which the corporate person is registered within fourteen days from the date of such order.

THE SARFAESI ACT, 2002

Valuation of and sale of immovable secured assets are referred under Rule 8 of Security Interest (Enforcement) Rules, 2002 as under:

Before effecting sale of the immovable property referred to in sub-rule (1) of rule 9, the authorized officer shall obtain valuation of the property from an approved valuer and in consultation with the secured creditor, fix the reserve price of the property and may sell the whole or any part of such immovable secured asset by any of the following methods:

i. By obtaining quotations from the persons dealing with similar secured assets or otherwise interested in buying such assets; or

ii. By inviting tenders from the public; or

iii. By holding public auction; or

iv. By private treaty.

Rule 2(d) of Security Interest (Enforcement) Rules, 2002 defines "Approved Valuer" which means a valuer approved by the Board of Directors or Board of Trustees of the secured creditor, as the case may be.

In case of immovable property valuation by an approved valuer and fixing of reserve price is mandatory.

FINANCIAL REPORTING UNDER INDIAN ACCOUNTING STANDARDS (IND AS) | 05

1. Indian Accounting Standard (Ind AS) 113, Fair Value Measurement

FINANCIAL REPORTING UNDER INDIAN ACCOUNTING STANDARDS (IND AS) I 05

IND AS 113 – FAIR VALUE MEASUREMENT

The Ministry of Corporate Affairs (MCA) issued a notification on 16 February 2015, announcing a roadmap for implementation of Indian Accounting Standards (Ind AS) converged with International Financial Reporting Standards (IFRS).

Ind AS has changed the entire reporting dynamic in Indian corporate environment. Financial prepared under Ind AS are likely to have implication on the financial positions and valuations. One of the Ind AS which can have direct implication on the valuation of financial assets, as presented in the financial statement is Ind AS 113 – Fair Value Measurement.

The objective of the Ind AS 113 is as follows:

- defines fair value;
- sets out in a single Ind AS a framework for measuring fair value; and
- requires disclosures about fair value measurements.

This Ind AS applies when another Ind AS requires or permits fair value measurements or disclosures about fair value measurements (and measurements ,such as fair value less costs to sell, based on fair value or disclosures about those measurements). Some standards which require the application of Ind AS 113 are:

- Ind AS 109 – Financial instruments
- Ind AS 16 – Property, plant and equipment
- Ind AS 40 – Investment property
- Ind AS 103 – Business combination

Fair value is referred to as the price that would be received to sell an asset or paid in order to transfer a liability in an orderly transaction between market participants at the measurement date. Critical aspects from the definition of fair value are:

a) **Asset / liability specific** - A fair value measurement is for a particular asset or liability. Therefore, when measuring fair value an entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability at the measurement date.

b) **Transaction** - A fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place either:
   - in the principal market for the asset or liability; or
   - in the absence of a principal market, in the most advantageous market for the asset or liability.

Principal market is the market with the greatest volume and level of activity for the asset or liability.

c) **Orderly Transaction** - A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (e.g. a for cedliquidation or distress sale).

d) **Market Participants**– Buyers and sellers in the principal (or most advantageous)market for the asset or liability that have all of the following characteristics:
   - They are independent of each other, ie they are not related parties as defined in Ind AS 24, although theprice in a related party transaction may be used as aninput to a fair value measurement if the entity has evidence that the transaction was entered into at market terms.
   - They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
   - They are able to enter into a transaction for the asset or liability.

   Whether the asset or liability is a stand-alone asset or liability, a group of assets, a group of liabilities or a group of assets and liabilities for recognition or disclosure purposes depends on its unit of account. Unit of account is the level at which an asset or a liability is aggregated or disaggregated in an Ind AS for recognition purposes.

In order to determine the Fair value, following aspects are required to be considered:

1. A fair value measurement is for a particular asset or liability
2. Price in the principal (or most advantageous) market
3. Highest and best use for non-financial assets
4. Valuation techniques
5. Fair value hierarchy

A fair value measurement is for a particular asset or liability

Fair value at initial recognition

When an asset is acquired or a liability is assumed in an exchange transaction for that asset or liability, the transaction price is the price paid to acquire the asset or received to assume the liability (an entry price). In contrast, the fair value of the asset or liability is the price that would be received to sell the asset or paid to transfer the liability (an exit price). Entities do not necessarily sell assets at the prices paid to acquire them. Similarly, entities do not necessarily transfer liabilities at the prices received to assume them.

However, the transaction price might not represent the fair value of an asset or a liability at initial recognition if any of the following conditions exist:

a) The transaction is between related parties
b) The transaction takes place under duress or the seller is forced to accept the price in the

transaction.

c) The unit of account represented by the transaction price is different from the unit of account for the asset or liability measured at fair value.

The market in which the transaction takes place is different from the principal market(or most advantageous market).

Price in the principal (or most advantageous) market

Fair value is the price that would be received to sell an asset or paid to transfer aliability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price)regardless of whether that price is directly observable or estimated using another valuation technique.

The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. Transaction costs shall be accounted for in accordance with other Ind ASs. Transaction costs are not a characteristic of anasset or a liability; rather, they are specific to a transaction and will differ depending on how anentity enters into a transaction for the asset or liability.

Transaction costs do not include transport costs. If location is a characteristic of the asset (as might be the case, for example, for a commodity), the price in the principal (or most advantageous) market shall be adjusted for the costs, if any, that would be incurred to transport the asset from its current location to that market.

Highest and best use for non-financial assets

The highest and best use of a non-financial asset takes into account the use of the asset that is physically possible, legally permissible and financially feasible, as follows:

a) A use that is physically possible takes into account the physical characteristics of the asset that market participants would take into account when pricing the asset (eg the location or size of a property).
b) A use that is legally permissible takes into account any legal restrictions on the use of the asset that market participants would take into account when pricing the asset (eg the zoning regulations applicable to a property).
c) A use that is financially feasible takes into account whether a use of the asset that is physically possible and legally permissible generates adequate income or cash flows (taking into account the costs of converting the asset to that use)to produce an investment return that market participants would require from an investment in that asset put to that use.

Valuation Techniques

An entity shall use appropriate valuation techniques for the prevalent circumstances and for which sufficient data are available so as to measure fair value, thereby maximising the use of relevant observable inputs as well as minimising the use of unobservable inputs.

The valuation techniques used to measure fair value shall maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

Observable inputs mean - Inputs that are developed using market data, such as publicly available information about actual events or transactions, and that reflect the assumptions that market participants would usewhen pricing the asset or liability.

Unobservable inputs mean - Inputs for which market data are not available and that are developed using the best information available about the assumptions that market participants would use when pricing the asset or liability.
Depending upon the type of inputs used in fair valuation the fair values are classified into 3 level. More details on this under the "Fair value Hierarchy" section.
Three widely used valuation techniques are:

A. Market Approach:

The market approach makes use of prices and other relevant information that is generated by market transactions consisting of identical or comparable (i.e. similar) assets, liabilities or a group of assets and liabilities, such as a business.

For example, valuation techniques consistent with the market approach often use market multiples derived from a set of comparables such as EBITDA multiples, revenue multiples, etc.

B. Cost Approach:

The cost approach corresponds to the amount that would be required in current scenario in order to replace the service capacity of an asset (that is often referred to as current replacement cost).

From the perspective of a market participant seller, the price that will be received for the asset is based upon the cost to a market participant buyer for acquiring or constructing a substitute asset of comparable utility, adjusted for obsolescence.

C. Income Approach:

The income approach converts future amounts (such as cash flows or income and expenses) to a single current (i.e. discounted) amount. When the income approach is adopted, the fair value measurement reflects current market expectations regarding those future amounts. For example – option pricing models, present value techniques, and multi-period excess earnings method.

Change in valuation techniques

Valuation techniques that are used to measure fair value shall be applied on a consistent basis. However, a change in a valuation technique or even its application (say a change in its weightage when multiple valuation techniques are utilised, or a change in an adjustment applied to a valuation technique) is appropriate if the change does result in a measurement which is equally or more representative of fair value in the circumstances. This might be the case if any of the following events take place (example scenarios):

a. new markets develop;
b. new information becomes available;
c. information previously used is no longer available;
d. valuation techniques improve; or
e. market conditions change

Fair Value Hierarchy

To increase consistency and comparability in fair value measurements and related disclosures, this Ind AS establishes a fair value hierarchy that categorises into three levels depending on the inputs to valuation techniques used to measure fair value.

Hierarchy	Inputs used in measurement	Examples
Level 1	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.	• Treasury bills • Government debt • Listed equities • Gold Bullion
Level 2	a. Quoted prices for similar assets or liabilities in active markets. b. Quoted prices for identical or similar assets or liabilities in markets that are not active. c. inputs other than quoted prices that are observable for theasset or liability d. Market-corroborated inputs	• Quoted prices in an inactive market • Values linked to observable inputs (interest rates, default rates, yield curves, etc.) • Certain OTC derivatives.
Level 3	Unobservable inputs for the asset or liability such as: • Financial forecasts • Historical volatility	• Distressed debt • Private equity shares • Complex derivatives.

Disclosures

An entity shall disclose information which helps users of its financial statements assess both the following:

a. For assets and liabilities that are measured at fair value on a recurring or non-recurring basis in the balance sheet after initial recognition, the valuation techniques and inputs used to develop those measurements.

b. For recurring fair value measurements using significant unobservable inputs (Level 3), the effect of the measurements on profit or loss or other comprehensive income for the period.

Reference: http://mca.gov.in/Ministry/pdf/INDAS113.pdf

OVERVIEW OF VALUATION | 06

1. Indian Meaning of Value
2. Premise of Valuation
3. Purpose of Valuation
4. Valuation Standards
5. Valuation Engagements – Scope of Work
6. Valuation Process
7. Valuation Report
8. Valuation Documentation

OVERVIEW OF VALUATION I 06

"A VALUE HAS A VALUE, ONLY IF ITS VALUE IS VALUED" - AUTHOR UNKNOWN

Valuation profession has undergone a lot of changes these days. Gone are those days when you would just look up for someone who came in the profession because he could not fit into mainstream. Valuation is gaining recognition, is becoming regulated and is starting to get the respect that it deserves.

In the international context, there is a well-developed market for valuation professionals. There are established valuation standards these professionals follow and there are guilds in each country which focus on training and development.

When we come to India, we see that valuation domain till date was highly unregulated. Mostly dominated by engineers and chartered accountants, it was rarely considered as a mainstream profession. There were few regulations, no entry barriers and it was pretty much a residual profession.

However, in the wake of government starting to revamp the old laws, valuation was something which came out as glaringly noticeable. Government realized that valuation played a very critical role in not just businesses but also from the standpoint of economy as a whole. Most banks give out loans based on valuer's report. Most transactions take place when valuer certifies the value of various assets.

Such a critical aspect of economy, if left unregulated, can distort the realm of country's growth and development. At the same time, it can divert the funds of the banks to undesirable channels in large sums. Thus, government decided to regulate the profession. It is interesting to note that how this whole thing came in to the lime light.

Recent History of Valuation

Government was in the process of setting things right in the insolvency and bankruptcy domain. Where they stumbled upon a major problem of liquidating the assets of the company undergoing liquidation. What they realised, that there was a large perceived gap between was bank thought was the valuation, when it gave out the loan and what actually was realisable when government started to liquidate it in the market.

The **Insolvency and Bankruptcy Board of India (IBBI)** was challenged in getting the values correct. That is where they realised that they need to get the valuation right. Once they got this realisation, it also came to their mind that there would be no quick fix for this one. They immediately got together and provided suggestions to the central government to revamp the entire gamut of valuation domain.

The government then created a committee under the IBBI and empowered IBBI to become the governing body of the same. IBBI then went out to find out the best practices in the valuation field across the globe and how to customize those practices to our country.

What they came out was something very interesting. They came up with a solution, that valuation needs to be divided in to different asset classes. By doing so, they can utilize the expertise of various domain experts, who can then, in turn come up with accurate valuation of various assets. Hence, valuation was divided into three major asset classes: Land & Building, Plant & Machinery, and Securities & Finance.

An individual shall have the following qualifications to be eligible for registration under Rule 5 -

(i) post-graduate degree, in the specified discipline, from a University established, recognized or incorporated by law in India and at least three years of experience in the discipline thereafter; or

(ii) a Bachelor's degree, in the specified discipline, from a university established, recognized or incorporated by law in India and at least five years of experience in the discipline thereafter; or

(iii) membership of a professional institute set up under an Act of Parliament and at least five years' experience after such membership.

Explanation: The 'specified discipline' referred to in (i) and (ii) shall mean the specific discipline which is relevant for valuation of the class of asset for which the registration is sought and a valuation professional organisation recognised under these rules.

While the preferred valuer qualifications are indicative, IBBI would continue to tweak the eligibility criteria as the valuation profession moves towards more maturity. This move has triggered a lot of activity amongst the fraternity in valuation profession. Many of the seasoned valuers were caught by surprise.

IBBI has also come up with elaborate procedure to become **"Registered Valuer"**. Registered Valuer is a new term, which will become household soon. IBBI has been working with all the relevant government and non-government stakeholders, to align their laws and policies in such a way, that wherever valuation services are required, they must use the services of registered valuers, registered under IBBI only.

While it is an uphill task for IBBI to convince all of them to come to a common standard, it has been highly successful in rolling it out with the active support of the government. There were a few initial hiccups, but baring those, the rollout has been smooth so far.

In order to facilitate the regulation of registered valuers, IBBI has created **Registered Valuer Organisations (RVOs)**. These organisations are not for profit entities dedicated to helping professionals to become registered valuers. RVOs have in turn created **Registered Valuer Foundation (RVFs)** for member enrolment and development.

The first challenge that the RVOs faced was in enrolling the existing members into the registration program. IBBI has come up with a proper framework to capture qualifications and experience of existing valuation professionals to get them to become registered valuers. There are different set of guidelines for young students who want to develop themselves as valuers by entering into valuation profession.

Procedure to Become Registered Valuers

The following procedure is required by valuation professionals to become registered valuers:

1. Ascertain that they have minimum qualification and relevant experience in their respective asset class to apply for membership.
2. Apply for membership with relevant documents with any one of the RVFs.
3. Attend 50 hours mandatory classroom training program conducted by the RVF after paying the registration and training fees.
4. Upon completion of 50 Hours of training, pay the exam fees and appear for a multiple-choice type examination at the nearest BSE Training Centre. IBBI has tied-up with Bombay Stock Exchange training Centres pan India for the same.
5. Once exam is passed, they will have to fill up "Form A" on the IBBI website and apply for Registration of membership. Once the form A is submitted, it will be verified by IBBI and will be approved.
6. On approval, the person shall become **"Registered Valuer"**.
7. Once a person becomes registered valuer, he / she needs to attend a six-hour classroom training on **"Valuation Code of Conduct & Ethics".**
8. This will make them eligible for getting **"Certificate of Practice"**.
9. Once they receive Certificate of Practice, they can practice as registered valuers.

1. MEANING OF VALUE

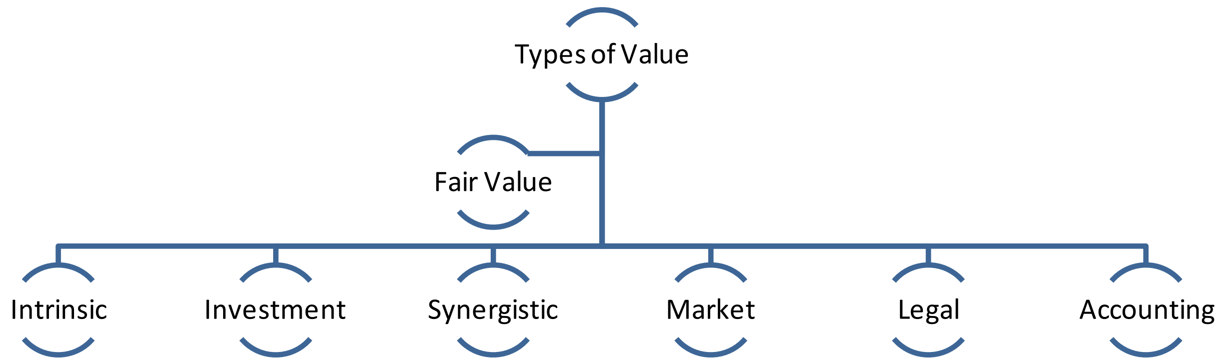
Value has different meanings in different contexts:

1. **Value in Use**:
   Value which a person would derive by usage of the asset in consideration.
2. **Value in Exchange**:
   Value which person looks for when he / she exchanges the asset under consideration for money or money's equivalent in terms of any other asset.This is the most common form of value referred to. It is also called as price in common parlance.
3. **Value in Store**:
   When a particular asset is stored, it has a value, which changes with the passage of time. For e.g. Rice & Wheat stored in warehouses will be valuable a year from the date they are stored.
4. **Value in Specific situations**:
   The value of assets or items can change drastically based on the situations or circumstances. For e.g. value of vegetables post curfew or value of life saving drugs during epidemics could have a completely different perception.

Also, some terms of value in valuations needs to be defined:

1. **Fair Value:**
   Fair value is defined as, "when knowledgeable buyer & knowledgeable seller are willing to enter into a transaction."
2. **Intrinsic Value:**
   Intrinsic value is the value referred to as true value of the asset arrived at by factoring both tangible and intangible factors of the underlying.
3. **Investment Value:**
   Investment value is the purchase price of the investor. It is also referred to as "historical cost" in accounting parlance.
4. **Synergistic Value:**
   Synergistic value is arrived at by using the combination of two assets. For example, bread & butter has a more combined value than stand alone. It is also referred to as "marriage value".

5. **Market Value:**
   Market value is the value at which the asset can be sold in the market at present time.
6. **Legal Value:**
   Valuation is mostly done to arrive at a value is tenable in the eyes of law. Most court cases and in legal proceeding they would like to have opinion of the valuer on the legal value of the asset or business in consideration.
7. **Accounting Value:**
   Accounting value or book value refers to the carrying cost of asset in the balance sheet. Typically, tangible non-current assets are subjected to depreciation and intangible non-current assets are subjected to amortization. So, the book value is arrived at by using Cost less depreciation/ amortization.



Let's understand how the equation of Value works. We assign very high value to a small pin, which can open sim slot of our mobile phone, when the sim is not working or needs to be changed. In most other situations, we don't care, as to what is the value of the pin. Another example could be value of water in desert.

However, one need to understand, that value of any asset would differ based on the purpose, use, situation, quality and people. Then there are other factors which affect value as well. Vegetables come from the farms, get assembled in central markets and then are transported to different part of the city. Upscale areas the prices are generally high, for similar quality of vegetables. However, remote suburbs would have lower prices, due to affordability of people.

Value in exchange is also affected by perceptions. Buyer would always hunt for bargain houses in better areas. Sellers would always feel that his home should get more value because of up keep. Brokers can twist values based on who they are talking to. To buyers they would say that this is the best area to stay in and the house which you saw, is one of the last ones going on sale. To the seller, he would say that this area is so saturated, that no transactions are happening and hence, he cannot expect much value when he goes out to sell.

2. PREMISE OF VALUATION

Valuation has a certain premise or what we commonly called as basic presumption. This enables a valuer to value the asset and the party getting the valuation done can reliably carry out the transaction on the value so derived by the valuer. To understand this better, we need to go back to the basic concepts and conventions of accounting. They are beautifully spelt out in Framework of IFRS (International Financial Reporting Standards).

1. **Going Concern**:
   One of the fundamental presumptions of book keeping is that a company or a specific legal entity is expected to continue its operations in the near future. This helps the valuer to derive value factoring the usability of the asset in consideration. It also facilitates in arriving at depreciation or amortization of the asset over a period of its useful life, thereby ensuring accuracy of value year on year.
2. **Liquidation**:
   This happens when the first presumption of going concern is violated. The moment going concern gets out of picture, all the assets are required to be valued at their disposal or resale value and all the liabilities at their settlement value. This happens for many reasons. Unviable future operations, accumulated losses, dis-interest of owners or changing regulations.

3. PURPOSE OF VALUATION

While we have understood the premise of valuation, purpose of valuation is vital for every valuer to understand. Nothing is of any significant value till the time somebody decides to use it. A lot of barren land was lying vacant without any use, till the time the government decided to build airport on it.
Let us understand, in today's business scenario, what are the key reasons or purposes of Valuation.

1. **Sale of Business as a going concern**:
   When a business is sold, it is more complex compared to other asset classes. You can always come back and say that fair value of assets minus the fair value of liabilities is something what a purchaser should pay, and seller should get. However, negotiations on business sale are way beyond that. There are many considerations, including who needs it more, is it a strategic fitment for the buyer, or is buyer eyeing on the assets or accumulated losses and more. At times, if seller is desperate to get out, then the negotiation may sway accordingly.

   However, we still need a basic value to start with, when the negotiation begins. This value is provided by the valuer. In practical situations, there might be two valuers, one appointed by the seller and one by the buyer and their valuation may significantly differ in its value.

Once the transaction is done, the buyer would compare the price paid with the net book value. i.e. book value of assets purchased less the book value of liabilities undertaken. There are three possible outcomes in this case:

a. Buyer paid exactly as per book value and there was no element of profit or loss to him. While this is possible, but a rare phenomenon so to say.

b. Buyer paid more than the net book value and the resultant difference need to be identified as two components. One is the intangibles like market reach, customer network, strategic benefit and the two, the residual one, as goodwill. This is most likely scenario in regular takeovers.

c. Buyer paid less price compared to book value and got a bargain on purchase. It is rightly called, "bargain purchase" and gets reflected in the income statement of the buyer.

2. **Business Valuation for Taxation Purposes**:
   Business valuation is also sometimes required to be done for the purpose of arriving at proper tax treatment. While this gets triggered mostly when there are significant disagreements between tax authorities and business, it does turn out to be a legitimate purpose. Valuer could be appointed by either business or tax authorities, as the case may be. In both these situations, a valuer needs to weigh the circumstances of the situation, understand the facts of the matter in detail before providing any kind of valuation to the asset under consideration.

   In fact, the valuer's role here is very critical in dispute resolution and hence, it becomes very challenging for the valuer to arrive at the valuation objectively. This shows the importance of valuation profession in the society.

3. **Business Valuation for liquidation Purposes**:
   Businesses are also valued for the purposes of liquidation or winding up. The purpose of valuation here is to close down the business, realize all the assets and pay off all the creditors of the business. This was in fact the purpose from which the entire regulation mechanism of valuation has emerged in the country.

   Again, in this case a valuer plays a very critical role of making sure that the creditors are getting their fair dues and there is residue left for the owners as well. It may not be possible to arrive at such a scenario every time, but valuer would definitely provide clarity with fairness to the entire situation.

There might be a few other reasons for valuation like banks or insurance companies would need it or any specific incident or situation might trigger it. However, in this book, we have covered the key reasons.

There are also a few concepts of valuation which merit consideration when we are understanding the purpose of valuation:

A] Undervaluation

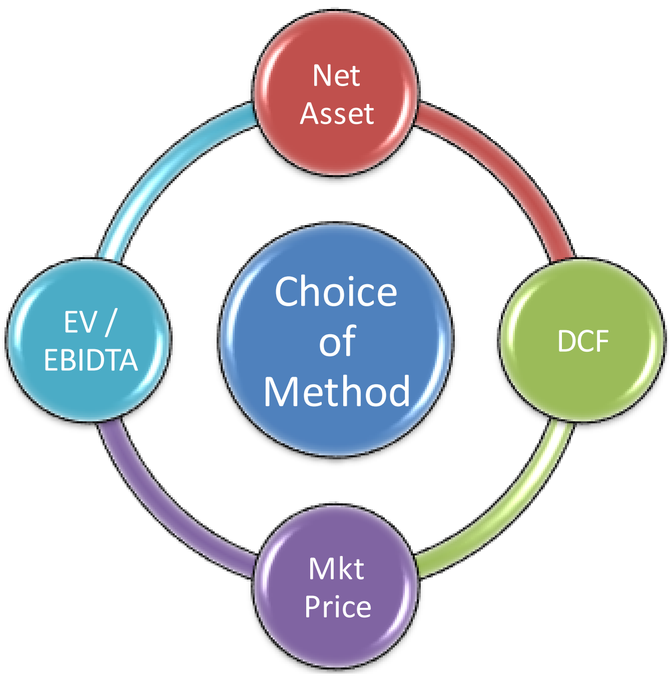
When the value of the asset arrived is lower than the value at which it is currently reflected in book, it refers to undervaluation. This may sometimes happen due to wear & tear, reduction in market value, technological obsolescence and so on.

B] Overvaluation

Overvaluation refers to a situation where the asset value is more than book value. This would happen mostly to older assets which have the tendency to appreciate in value. Examples would include land and building.

The most critical aspect in the valuation process is to arrive at appropriate valuation model. There are many techniques that a valuer may use to value a Company / Business. Even if different values are arrived under various methods, it is necessary for a valuer to arrive at a fair value. As mentioned earlier, selecting of appropriate valuation methods also depends on the purpose of valuation. If the valuation is for the purpose of liquidation, the valuer would use the Realizable Value of the Net Assets of the Company and not the future Earnings Capacity as in this case the Company will not exist and the shareholders will be left with the Net Assets. Similarly, during a Merger, the valuer would value the companies involved in a similar manner to arrive at a relative value.

The generally accepted methodologies for valuation of shares / business are Net Asset Method, Discounted Cash Flow Method, Earnings Capitalization Method, EV/EBIDTA Multiple Method, Comparable Transaction Method and Market Price Method. Each method proceeds on different fundamental assumptions, which have greater or lesser relevance, and at times even no relevance to a given situation. Thus, the methods to be adopted for a particular valuation must be wisely chosen.



4. VALUATION STANDARDS

Valuation standards are those which are accepted by the valuation fraternity as generally accepted valuation practices and over a period of time are recognised by the government bodies all over the world as "standards". They basically provide framework and rules on how the valuation exercise needs to be carried out in various situations and cases.

Globally valuation bodies have come together to formulate international standards for valuation, which are accepted by Institute of Valuers as best practice for the purposes of carrying out valuation in India as well. More about valuation standards in detail can be found at https://www.ivsc.org/.

5. VALUATION ENGAGEMENTS – SCOPE OF WORK

Valuation engagements are those which valuer will get as assignment from the clients. It is very important for valuer to draft proper engagement letter in order to safeguard his and his client's interest. Most of the time the valuation reports are used in legal parlance and are admissible in the court of law, the drafting of engagement letter becomes a critical process.
The following pointers must be the part of engagement letter as best practice:

List of Best Practice Pointers for Engagement Letter
Confidentiality Clause
Scope of Work
Indemnity Clause
Standard Disclaimer
Purpose of Valuation
Terms of Engagement
Liability of the Valuer
Restrictive Covenant of Usage of the Report
Validity Period (if any)
Background under which the Assignment is Taken and More

The above pointers will help a valuer draft extensive engagement letter for taking up valuation assignments and carry out his / her work effectively.

6. VALUATION PROCESS

This is an important aspect of valuation and is heart of every valuer. The process followed by valuer will enable him / her to carry out his / her duties effectively. While there are many models available across the world, but even so, valuation is a ***scientific art***. The approach taken by each and every valuer and the process adopted may look similar on the outside but can significantly change the outcome in the valuation report when compared from one valuer to the other.

Following points merit consideration or guidelines of the kind of process the registered valuer must follow to arrive at proper valuation:

1. **Planning of the assignment**:
   "If you fail to plan, you are planning to fail" -so as the famous saying goes (as supposedly quoted by Benjamin Franklin). Planning is the first and the most critical activity of any valuation assignment. Planning needs to be done in terms of time, efforts and resources that are required to be committed to each assignment that comes to a valuer. Many a time, work pressure gets unnecessarily generated due to lack of planning. Every hour of planning can save days of execution for the valuation professional and his / her team.
2. **Gathering the background information**:
   While it is valuation and not investigation, gathering of background information is a must for any valuation assignment. It ensures the completeness and accuracy of the valuation done. Each valuer should not only focus on gathering the background information but also cross verify the same from various different independent sources. It requires the effort of that ***extra mile to walk***, but it saves a lot of heart burn at a later date. Not to mention that information so gathered, must be documented in the working sheets and kept as a record for future reference.
3. **Clearly documenting the purpose of valuation**:
   Documentation is an insurance policy for a valuer practicing in our country. The service liability sometimes can be so huge, that even insurance cannot cover it. In no circumstances, a registered valuer should be held for professional negligence on account of lack of or less documentation. In this case, a thumb rule can be easily followed. **"When in doubt, don't forget to document."**
4. **Establishing the premise of valuation**:
   Premise of valuation is very critical for every assignment. If the basic premise of valuation is a "going concern" then the future earning capacity of the firm plays a major role in valuation. However, if the purpose is liquidation, valuer would have to focus more on the realizable values to satisfy all the stakeholders.
5. **Identifying the stakeholders involved**:
   Every valuation assignment will have multiple stakeholders. The usual ones would include client, the counter party, bank and government. Many a times other stakeholders like employees, shareholders, creditors may also get affected by the valuation. Hence, stakeholder identification empowers the valuer to assess the impact of valuation on each one of them. He / she can factor it while preparing the valuation report.
6. **Documenting the findings of the study carried out**
   Once the valuer and his / her team start applying his / her mind on the assignment, findings would emerge. The findings need to be carefully documented to formulate an opinion on arriving at appropriate valuation. These findings need to be collated harmoniously and analysed to assign a final value to the asset under consideration.

7. **Arriving at first stage valuation**
   Once the findings are collated, they need to be analysed to arrive at first stage valuation. First stage valuation should be based on all the findings of study carried out in previous step. The first stage valuation must cover all the aspects such that very minimum or no modifications are required at a later date.

8. **Evaluating the valuation so arrived for secondary evidence and empirical testing**
   This stage is the most important stage. This is the stage where the valuer and his team need to thoroughly test the valuation done by them and challenge every aspect of the finding, such that, their valuation should stand the test of purpose for which it is prepared. An experienced valuer would spend majority of his time in critical review and evaluation.

9. **Drafting the valuation report**
   Once the valuation is arrived at, report needs to be prepared as a final deliverable for the client. The first draft of the report must be prepared extensively incorporating the specific elements of the particular assignment. Templatization in report creation should be avoided to kill creativity. Each report should be specific, relevant and to the point for the client.

10. **Finalizing the report by revisiting it for completeness and accuracy**
    The draft report, if prepared by a junior, must be reviewed by the senior valuer or otherwise a peer review must be done. It helps in putting the valuation in the right perspective and ensures that not many perspectives are missed out during preparation.

If the steps mentioned above are followed religiously, there would be very little chances of errors in the valuation exercise. The best practice mentioned here must be followed as a policy of valuation practice, leading to a valuation firm with a global mindset.

7. VALUATION REPORT

This is the final deliverable provided to the client by the valuer. It must be kept in mind that valuation report by itself is not much, but valuation is. The report is the medium to convey client the valuation done by the valuer.

Since report is the carrier of the main service deliverable to the client, it must be crafted carefully. A valuation report should be the ambassador of valuer's work and his professional skill and expertise. A well drafted report not only serves the purpose of conveying the valuation mentioned in it, but also creates the goodwill in the mind of readers about the valuer and his firm.

Many firms have acquired global reputation in the valuation domain by the quality of service they provide. Valuation report is the foremost tool to differentiate and highlight the high quality of work done by a valuer.

Points to Keep in Mind for Drafting a Professional Valuation Report

While there are several videos available on YouTube on how to draft an excellent report and what should be the contents of ideal report, given below is an illustrative list which every valuer must keep in mind to come up with a professional report:

1. **Title& Executive Summary**:
   Title and executive summary of the report would provide a bird's eye view to the reader of the report. The busy CXOs, who have very little or no time to go through the report, find it very useful and are happy to grasp the valuer's perspective from the summary itself. Summary should be drafted in a manner where all the important points are covered, and trivial ones are kept out.

2. **Assumptions taken while carrying out valuation**:
   It is very important for a reader to understand as to what are the assumptions taken while preparing the valuation report. Assumptions provide the framework under which the valuation premise is held valid. Without mentioning the assumptions, a valuer would leave the report to the mercy of reader's interpretation and a reader, from a different background may perceive a completely different meaning of the report and the valuation.

3. **Deliverables delivered through the report**:
   It is very important to specify to the readers of the report that what are the clear deliverables presented, which were agreed in the scope of work of the engagement letter. Clients would usually cross verify the completeness of service by comparing the scope provided in engagement vis-à-vis deliverables provided in the valuation report. Other stakeholders will find the information useful in grasping the entire hold of the report when deliverables are clearly mentioned.

4. **Timelines in terms of valuation date, report generation and submission date**:
   Timelines here would have several meanings. Many a times, valuation is done a date and the report would come out much later. May a time, it may also happen that, when the valuation is carried out discounting the future to present, the timelines will have a significant impact on the overall valuation itself. Providing timeline would give appropriate perspective to the reader of the report for sound understanding of the same.

5. **Milestones, in case of long-term assignment**:
   Business Valuation is a long-term assignment. Valuers are needed frequently to evaluate various facets of business to provide their opinion. Many times, because the government insist on them and many other times because they are a business need. In such cases, it is

important for the valuer to disclose the milestone adhered to in the interim or continuing report provided by him.

6. **Approach(es) of Valuation**:
   There are three popular approaches usually followed for the purpose of carrying out valuation. They are:
   a. Market Approach
   b. Income Approach &
   c. Cost Approach

   We will learn more about these approaches in detail later. However, it is important for the reader of the report to know as to which approach was followed by the valuer to arrive at proper valuation. It will enable the reader to determine the course of action to be followed.

7. **Valuation Method Applied**:
   There are several methods used by valuers in arriving at valuation. One of the key hallmarks of a professional valuer is that he will disclose the method of valuation used in the report itself. It displays the kind of transparency and professionalism the valuer has. Also, the method used has relevance to stakeholders and can also be used for the purpose of justification in the court of law. Later in the book, we will see several case laws to that effect.

8. **Key inputs used in report**:
   There are several factors which drive the valuation. Many key inputs like timing of cash flows, required rate of return and tenure of cash flows play a vital role in arriving the value of asset or business in consideration. It is important for valuer to provide this information to give clarity to the reader of the report. The reader's opinion about valuation can be affirmed if the key inputs are provided beforehand.

9. **The estimates / projections used in the report**:
   When valuation is based on future, it is imperative for a valuer to rely on projections and estimates. These projections and estimates form the very basis on which the valuation is carried out. These are more mandatory things which must go in the report for report to make any sense at all.

These points mentioned here are illustrative. There are many more things that go in to a valuation report and some of the above can also be removed from it on a case to case basis. As mentioned earlier, valuation being a scientific art, the liberty of choosing the parts of the report completely lie with the valuer concerned.

CONTENTS OF VALUATION REPORT AS PER ISV 2017:

Where the report is the result of an assignment involving the valuation of an asset or assets, the report must convey the following, at a minimum:

(a) the scope of the work performed, including the elements noted in para 20.3 of IVS 101 Scope of Work, to the extent that each is applicable to the assignment,

(b) the approach or approaches adopted,

(c) the method or methods applied,

(d) the key inputs used,

(e) the assumptions made,

(f) the conclusion(s) of value and principal reasons for any conclusions reached, and

(g) the date of the report (which may differ from the valuation date).

Some of the above requirements may be explicitly included in a report or incorporated into a report through reference to other documents (engagement letters, scope of work documents, internal policies and procedures, etc).

CONTENTS OF VALUATION REVIEW REPORTS AS PER ISV 2017:

Where the report is the result of a valuation review, the report must convey the following, at a minimum:

(a) the scope of the review performed, including the elements noted in para 20.3 of IVS 101 Scope of Work to the extent each is applicable to the assignment,

(b) the valuation report being reviewed and the inputs and assumptions upon which that valuation was based,

(c) the reviewer's conclusions about the work under review, including supporting reasons, and

(d) the date of the report (which may differ from the valuation date).

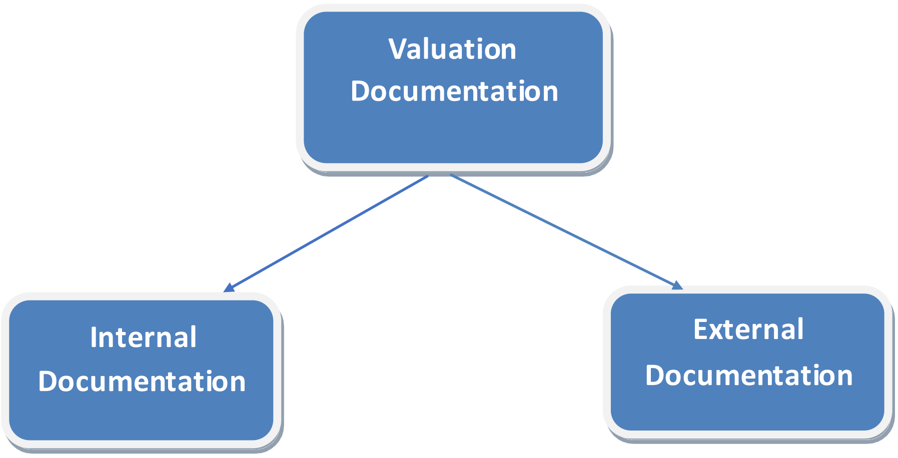
Some of the above requirements may be explicitly included in a report or incorporated into a report through reference to other documents (e.g. engagement letters, scope of work documents, internal policies and procedures, etc).

8. VALUATION DOCUMENTATION

Documentation is the insurance policy of every valuer. The value of this statement can never be under-estimated. Without documentation, it is impossible for a valuer to substantiate, forget even justifying his actions and report.

Documentation provides reference material to the valuer in case of audits, investigations, legal matters and other places where a valuer is required to defend his valuation. While valuation remains an exercise of judgement for the valuer, documentation is the manifestation of that judgement in reality.

Types of Documentation



1. **Internal Documentation**:
   Internal documentation refers to working file, emails, samples, and other documents collected in the due course of valuation assignment carried out by the valuer. These documents serve as record for the professional valuation carried out by the valuer.
2. **External Documentation**:
   External documentation refers to the data collected by the valuer from the external sources for the purpose of formulation of opinion to arrive at valuation. It refers to research reports, government papers, statutory filings, media reports etc. collected from various sources to substantiate the findings which would lead to final valuation. This documentation is required by the valuer to explain to authorities and various other stakeholders, in case if they need to know, as to how the valuer arrived at a particular value.

Documentation includes but is not limited to:

1. Scope of Work document
2. Proof of process of valuation
3. Record of information sources

4. Financial Statement Analysis
5. Due Diligence and findings thereof
6. Substantiation of conclusion of valuation.

Documentation is very essential for valuation because it is not just the proof of valuation carried out, but also serves as evidence and trail of the work carried out by valuer and the primary basis of valuation report. It also helps the readers to understand that valuation as an exercise was carried out by valuer in accordance with valuation standards and other generally accepted valuation principles.

Thus, this chapter provides the overview of valuation. In the upcoming chapter we will see more details about various approaches of valuation and practicalities of how a valuer must carry out valuation.

VALUATION APPROACHES I 07

1. Meaning of Value
2. Premise of Valuation
3. Purpose of Valuation
4. Valuation Standards
5. Valuation Engagements-Scope of Work
6. Valuation Process
7. Valuation Report
8. Documentation

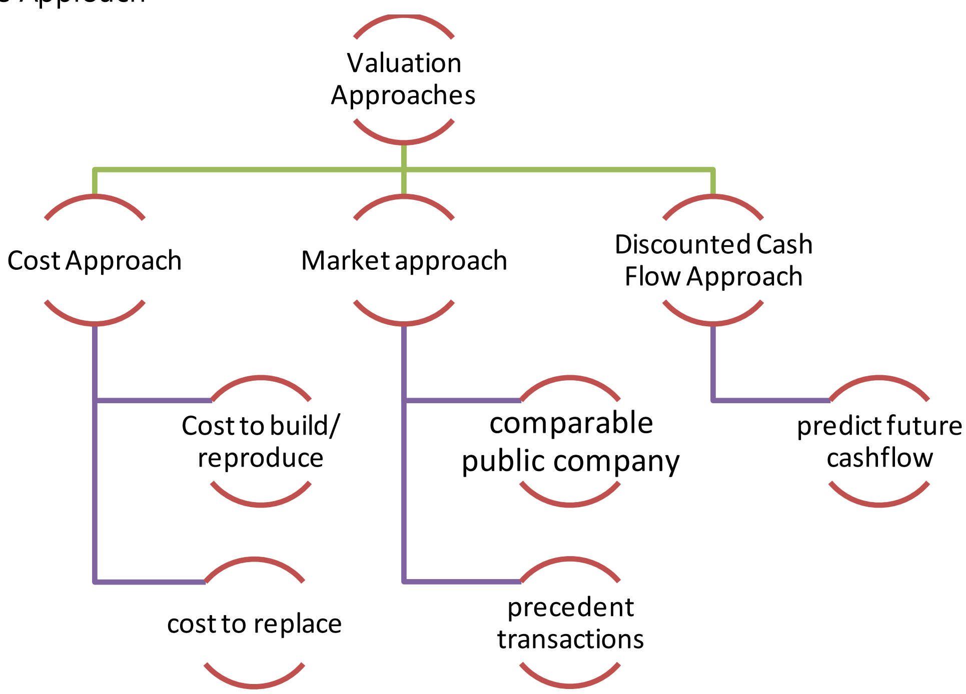
VALUATION APPROACHES I 07

The need to carry out valuation of a business may arise due to various reasons. Some of these reasons could be:

- Need to sell the business owing to family issues or health issues or even retirement.
- Need to determine the share value for adding a new shareholder or maybe buyout by one or more existing shareholders.
- Need to attract potential investors for equity or debt financing due to cash flow crunch or expansion of business.

Irrespective of the reason behind business valuation, the actual worth of a business depends on numerous parameters including the existing state of the economy through balance sheet of the business. However, this is a very critical activity, and needs the right approach used by professional valuers to determine a fair price for the overall business.
A valuation approach is the method used to determine the value or attractiveness of an investment opportunity or business. There are three types of valuation approaches as listed under:

1. Cost Approach
2. Market Approach
3. Income Approach



1. COST APPROACH

The cost approach, also known as the asset-based approach, is able to derive value through the combined FMV (Fair Market Value) of the business's net assets (assets less its liabilities). In simple terms, this approach tends to determine the business value on the basis of value of assets of the business. It is specifically useful for asset intensive firms, valuing holding companies as well as distressed entities that are not worth more than their overall net tangible value.

The cost approach is based on the inherent assumption that the value of a business or investment can be determined based on the cost to rebuild or replace the business. A cost-based approach is often divided into two broad categories, cost to build, and cost to replace. However, under the cost to build, there are two subdivisions. These are the valuation of net assetsand the sum of parts analysis.

NET-ASSET VALUATION

This approach determines a company's net asset value (NAV) or fair market value (FMV) of its total assets minus total liabilities. It values a business based on what it would cost to replace the assets owned by a business. It creates a financial chart of the business based on its asset values. This method is seldom used in corporate finance as it is considered to be incomplete in its assessment of a business' value.

The steps in asset-based valuation are as follows:

- Examine balance sheets and other financial records
- Audit the balance sheet values
- Draw up an economical balance sheet- an economical balance sheet is one that records asset values based on current market prices
- Value assets and liabilities
- Calculate the market value of equity capital- this is the market value of a company's assets after deducting the market value of a company's liabilities.

$$Net\ Asset\ Value = \frac{Assets - Liabilities}{Total\ no.of\ common\ shares}$$

The fair market value of a company's total assets minus the fair market value of a company's total liabilities is the fair market value of a business. This approach is most commonly used when a company is focussed on holding on to investments or real estate as it is non-operational or generating losses. It reflects the potential equity that a business owns although it may not be an accurate measure of profitability.

APPLICATIONS OF THE ASSET-BASED APPROACH

- This approach is most often used for determining the value of special use properties such as libraries, schools, etc. which have a single use and generate negligible income.
- This approach is also used for insurance appraisals. It is because only the value of improvements can be insured and it is distinct from the total value.
- It cannot be used for valuing residential real estate, except in the case where the property has been under or over improved. In this case, the value of improvements may be determined using a cost-based approach to calculate the true value of the property after accommodating the improvements.

DRAWBACKS OF THE ASSET-BASED APPROACH

- Company history is not taken into account.
- Intangible assets, discounts or contingent liabilities are not accounted for in this approach.
- The books reflect the acquisition costs of assets;however, the current asset values may be completely different.
- Impact of competitors on the market is not accountedfor.
- Valuation of a sole proprietorship is pretty difficult using this approach as assets in such a setup are in the business owner’s name, and it is difficult to separate them on the criteria of business or personal usage (a situation that won’t arise in a corporation business where all assets can easily be included in the sale of the business as they belong to the company).

To avoid wildly inaccurate results, book values are appropriated to current asset values. For example, land may value at INR 20,00,000 at the time of purchase. However, if its current market value has appreciated to INR 40,00,000, this value would be considered for asset valuation.

SUM OF THE PARTS (SOTP) APPROACH

This method is often used for valuing multi-divisional companies, holding companies or conglomerates. This method is used to adjudge the value of a company based on the sale value of the different parts or divisions of a business. This method is therefore also referred to as a break-up analysis. The stand-alone or individual value of each of the business units is determined and the total enterprise value (TEV) is calculated as an aggregate of these.

$$SOTP = Value\ of\ segment\ n_1 + Value\ of\ segment\ n_2 \ldots . -(ND) - (NL) + (NA)$$

In this equation,
ND = Net Debt
NL = Non-operating Liabilities
NA = Non-operating Assets

The value of each business unit can be calculated using a discounted cashflow approach, asset-based approach or revenue-based valuations and operating profit margins. We will explore discounted cashflow in detail later on in this chapter.

APPLICATIONS OF THE SOTP APPROACH

- The sum of the parts approach is often used as a negotiating strategy to prevent a hostile takeover by proving that the value of a business is more than just the sum of its parts. Thisis often used in technological companies whose intellectual assets are often worth more than its tangible business units.
- This approach can also be usedto determine the value of a company after restructuring.

DRAWBACKS OF THE SOTP APPROACH

- It does not take into account tax implications which is an important factor while spinning off a business.

One of the things to keep in mind concerning the cost approach is its relation to the market price. If the cost valuation is below market price, it signifies an overheated market. When the cost valuation is above market price, this is a good time to invest.

2. MARKET APPROACH

The market approach is a method of valuation that appraises a business, intangible asset, business ownership interest or security by considering the price of a recent transaction, or the price of comparable assets. The market approach is based on the value of comparable assets, which is then appropriated, by taking into consideration size, quantities, qualities, and other factors, to determine the value of an asset.

This technique helps to determine the business value through comparison of a business (under valuation) to similar other businesses which have got sold in recent times.

For example, when investing in the stock market, buyers look at the prices of similar stocks that have been recently sold. Since the stocks of the same company are owned by the same entity, it is easy to compare the stocks and determine the price or fair market value of the new one.

There are two types of market valuation techniques: determining the value of comparable assets, or basing the value off the precedent set by a recent transaction of similar assets.

PRECEDENT TRANSACTIONS

This approach, known as the precedent transaction approach or the price of recent investment method determines the value of a business or asset using price multiples of observed recent transactions of companies in the industry of the company in which you are trying to invest, also known as the subject company. This method is used when comprehensive financial data is not available ,but you can ascertain the value of a business based on a recent comparable transaction.

There are existing metrics of measuring precedent transactions, such as Standard Industrial Classification (SIC) codes. There are also several databases that note the prices of transactions and historical precedents of transactions which may be considered while using this approach. This method is best used when there are similar transactions from companies within the same industry. The more the comp transaction data available, the more accurate the valuation will be. This valuation method is valid for only a limited time after the recent comparable transaction. This is because the prevailing market conditions may have changed if a lot of time has passed. If the market is too diverse, then this method may not be full proof.

APPLICATIONS OF PRECEDENT TRANSACTIONS APPROACH

- This method is often used for mergers and acquisitions.
- It is also valuable as part of the exit strategy of the management of a company. It is used to justify the business price during a buyout.
- This method is often used to determine a market-clearing price that shareholders would be willing to accept.

COMPARABLE PUBLIC COMPANY

The comparable public company or relative valuation approach values a business based on the value of a publicly traded company in the same industry. The inherent drawback of this method is that publicly traded companies are necessary of a larger scale and therefore cannot be the model for your business valuation.
This model uses a contextual approach to derive the value of a business or asset, as opposed to absolute valuation methods that value a company internally based on cash flow and other factors, without any comparisons. Direct comparability is hard to achieve and can only be achieved in a few industries. Selecting, adjusting and applying data from publicly traded companies requires a skilled appraisal. A company selection is based on some factors including similar demand and supply factors, operational processes, financial composition, etc.

To estimate the fair value of an enterprise, known as enterprise value (EV), a multiple of revenue or earnings approach may be used. This method is often used as a metric to assess the value of the intrinsic value of a company. That is, methods such as analysing cash flow of a company are used to determine the intrinsic value of the company. This value is then compared with the market value. Using the two methods in conjunction with one another enables buyers to determine if the intrinsic value is greater than or less than the market value. If it is greater than the market value, the stock is considered undervalued.

Conversely, if the industry value is lesser than the market value, it is considered to be overvalued. Relative comparisons help develop an industry mean or benchmark. Some of the common methods of comparable analysis are:

- Enterprise value to sales (EV/S)
- Price to earnings (P/E)
- Price to book (P/B)
- Price to sales (P/S)

If the company's value ratio is higher than the industry average, the stock is overvalued. Conversely, if the ratio is lesser than the industry average, it is undervalued.

GUIDELINES FOR USING THE MULTIPLES VALUATION TECHNIQUE

- Apply an appropriate and reasonable multiple, accounting for size, risk profile and earnings growth prospect of the underlying company, to the indicator of value (earnings/ revenue).
- Derive an adjusted enterprise value after accounting for surplus, non-operating assets, excess liabilities and other relevant contingencies.
- From the adjusted enterprise value, deduct the financial instruments that place higher than the highest-ranking instrument of that fund in the case of a liquidation. Any instrument that would dilute the fund's investment should be deducted. This will result in attributable enterprise value.
- The attributable enterprise value must then be apportioned among the relevant financial instruments depending on the perspective of market participants.
- When there is a difference in company size of the subject entity and its comparable entity, a specific risk premium (SRP) is used to scale the multiples. This risk premium varies on a case by case basis.

BELOW IS A LIST OF FACTORS TO CONSIDER WHILE SELECTING A COMPARABLE COMPANY

- They should be a part of the same industry as the subject entity
- Similar in size
- Offering identical services and products
- Do either of the companies operate in multiple industries
- Location of the businesses
- Whether the businesses are competitors
- Comparability of profits

ADVANTAGES OF THE MARKET APPROACH

- Easy to calculate
- Data is publicly available
- Subjectivity is minimised

DISADVANTAGES OF THE MARKET APPROACH

- Tough to find an appropriate comparable company
- Minimal flexibility
- Quality of available data may not be favourable

3. INCOME APPROACH

The income approach is used for valuing a business at the present / current value of its future earnings / cash flows. This approach calculates the net operating income (NOI) of business and divides it by the capitalisation rate.

WHAT IS THE NET OPERATING INCOME (NOI)?

Net operating income refers to a company's total revenue minus all reasonable operating expenses. This approach is considered reliable since it is difficult to manipulate it given that it is based only one two factors. To determine the NOI, the market sales of comparable companies are used to calculate the capitalisation rate. Before we explore the various income approach methods, let us consider a few key terms.

WHAT IS THE CAPITALISATION RATE?

It is the rate of return expected from a business. The capitalisation rate (expressed as a percentage) is determined by subtracting the growth factor from the Weightage Average Cost of Capital (WACC) or discount rate of a company. It is the blended rate of return on the blended capital of business including its debt and equity. The inverse of the capitalisation rate is called the multiple. The factors taken into consideration while evaluating the capitalisation rate are:

- Returns on equity- a function of a business' operating risk minus its financial risk
- Long term capital structure of debt versus equity
- The marginal income tax rate at which interest expenses are subtracted.

WHAT IS THE COST OF CAPITAL?

Cost of capital refers to the opportunity cost of investing in a business. It would be the potential rate of return if the same amount of money were alternatively used in a different opportunity of equal risk. If the cost of capital is too high, then the investment is not advisable. Cost of capital includes the cost of debt and cost of equity. It refers to the cost of equity if a company is financed solely through equity or to the cost of debt if it is financed solely through debt. It is called WACC or Weighted Average Cost of Capital, if a mix of debt and equity is used.

Discounted Cashflow

The discounted cash flow (DCF) projects future earnings and discounts them by an annual rate to derive a present value. It is equal to the sum of cashflow in a financial quarter or period divided by one plus the discount rate, raised to the power of the period number.

$$DCF = \frac{CF}{(1+r)^1} + \frac{CF}{(1+r)^2} + \cdots \frac{CF}{(1+r)^n}$$

In this equation,
CF = Cash Flow in that period
n = Period Number
r = Rate

The cashflow refers to the free cash payments an investor receives in a given period for owning security (bonds, shares, etc.). The unlevered free cash flow refers to this. In valuing bonds, the interest or principal payments would refer to the cash flow. The weighted average cost of capital is referred to as the discount rate. It represents the expected required rate of return. The period may be evaluated as a financial quarter or a set number of months. The discounted rate is either used on a mid-year basis or an end-year basis.

Terminal Value

The value of an investment at the end of a period including a specified interest rate is called the terminal value. The Gordon Growth model which is most popularly used values a business in terms of its perpetuity. Perpetuity refers to an infinite amount of time. It is a constant stream of financial cashflows that has no end. Under this theory, the cashflow is continued forever at constant growth.

Adjusted Present Value

This approach is very similar to the DCF approach. It is the net present value of a project financed only by equity and the present value of financing benefits. It uses the cost of equity as the discount rate. It accounts for tax shields provided by deductible interests. This method is beneficial for highly leveraged transactions. If tax implications are likely to heavily affect the outcome, this is the preferred alternative.

InternalRate of Return

The internal rate of return helps to as certain the profitability of investments for capital budgeting. It equates the net present value of all cash flow to zero.

Capitalisation of Earnings

This method calculates the net present value of expected future profits or cashflows. The company's future earnings divided by the capitalisation rate yields the estimate of earnings. It values a business based on current cashflow and the annual rate of return.

APPLICATIONS OF THE INCOME APPROACH

- An income approach is ideal for established and profitable businesses, as it is based on the ability of the business to generate future economic benefits.
- It is suited for companies with stable cash flow / earnings, especially using the capitalisation of earnings technique.
- Suitable for appraising real estate to determine its selling price in current market considerations while investing. The potential risk of repayment is also calculated in case an investor is taking out a mortgage on the investment.

FACTORS TO KEEP IN MIND WHILE USING THE INCOME APPROACH

- This approach does not rely on any similar transactions from the past, and is therefore more effective as compared to market approach. Inputs related to growth rate as well as required rate of return need to be appropriate as the valuation is sensitive to this estimation.
- For a real estate business, the condition of the property needs to be considered - if the property comes with a great number of repairs, this may cut into future profits. At the same time, the operational efficiency needs to be considered – which means rent should be higher than the expenses required to maintain the property.

VALUATION APPLICATION | 08

1. Equity / Business Valuation
2. Fixed Income Securities
3. Option Valuation
4. Valuation of other Financial Assets and Liabilities
5. Intangible Assets
6. Situation Specific Valuation

VALUATION APPLICATION **I 08**

1. EQUITY/BUSINESS VALUATION

ANALYSIS OF BUSINESS ENVIRONMENT

What is Business Environment?

There are various factors inside or outside an organization that have a direct or indirect impact on its business processes and. Business Environment is nothing but a collection of all these factors summed up. A careful analysis of these factors enables to identify opportunities, optimize resource utilization, sustain modifications, assist in planning and thus, improve performance.

Business Environment Analysis Overview

Success of a business is directly linked to its environment. Environmental analyses refer to understanding these factors and determine how they affect the business and its growth.

Internal Factors	External Factors
Business Principles	Political – Government/Policies
Policies	Economic – Market
Standards	Technological
Guidelines	Legal
Marketing & Financial Resources	Consumers/Competitors

Table for Business Environment Factors

Business Environment Analysis or BEA is a strategic tool. It is a process to understand the factors both internal (strengths and weakness of the entity) and external (opportunities and threats outside the organization) which may affect the organization's performance. It makes the first step of any strategic business management. The analysis entails assessing the level of threat or opportunity the factors might present (both internally as well as externally). These evaluations help assess risks and align business strategies and decision-making processes with respect to these environment induced risks.

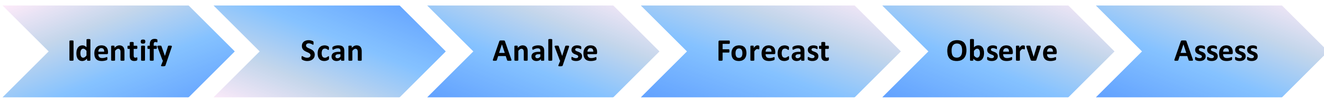
With the fast-paced technology and world economics, the business environment is changing rapidly. In order to maintain growth and success organizations must keep a thorough check on the market conditions and the situational factors which may have day to day impact. Therefore, businesses must always keep an eye on the trade environment and the market. A constant check helps to streamline the process of identifying the best course of action.

ADVANTAGES OF BUSINESS ENVIRONMENT ANALYSIS

Apart from detecting threats at an early stage and align organizational objectives, BEA also helps ascertain employee performance, customer satisfaction, identify new opportunities, find new customers, adapt to the latest technology etc.

Overall it helps decision makers to take a positive course of action and build better strategies for business survival and gain competitive advantage.

Different Phases of Environmental Analysis



Identify: This step involves gathering relevant and important information regarding factors that are affecting the business and need to be checked for future decision making and strategy building. This is a very important step and requires a thorough knowledge of the business environment factors and their impact on business processes. For example, a new technology used by competitors to improve product quality or employee dissatisfaction due to some internal policies would be considered information for business environmental analysis.

It involves observation of various factors present in the environment which need to be analyzed and monitored. This information collected could be written and/or verbal as long as it is an element of the business environment.

Scan: Once the information is gathered, the analyst needs to scan and examine it. This step helps to give a structure to the entire process and build a rough sketch as to what are the conditions most suitable for the business in given circumstances. Once streamlined, strategies can be built to improve the environmental factors and simultaneously keep looking for other relevant information.

Types of Environmental Scans:

- Ad-Hoc: Usually performed in response to a crisis. Not in-depth.
- Periodic: Tied to the planning cycle. In-depth in nature.
- Continuous: Also called Continuous Learning. Structured, in-depth data collection and analyses by specifically appointed staff. Comprehensive.
- At times when traditional information gathering techniques fail Spying technique is resorted to. The Spying technique is mostly used in cases of business rivalry to collect competitive information and get a competitive edge over the competitors.

Analyze: This step involves thorough scrutiny of the environmental factors and their impact on different levels of the business processes and the organization as a whole. Some of the most common analysis tools and techniques are SWOT (Strengths Weaknesses Opportunity and Threats), PEST (Political, Economic, Social and Technological), SOAR (Strengths Opportunities Aspirations Results) etc. Based on the business needs and environmental factors, the analyst can choose amongst any of these tools and techniques to attain maximum advantage and accuracy.

Forecast: A business thrives on the way its future is planned and projected. This is why a sound plan and forecast is really important. While scanning and analysis give us an outline of the past and the present, forecasting helps formulate key strategies for the future. It requires a scientific study of how business and its environmental factors (like the market, technology, trends, society etc.) are going to change in the future. Thus, giving decision makers a window to expand and make key changes to flourish in the future. There is a lot of technical advancement taking place currently to help strategists and analysts with forecasts. Artificial intelligence tools and machine learning are giving this phase a new dimension.

Observe: A sincere effort while observing the environmental factors and business can do miracles. This step helps to understand what and how the factors impacted the business at different levels and at a given point of time. This is very important to determine what factors must and mustn't be involved while making strategies and business plans.

Assess: Assessment of the factors and how they have impacted or will impact the business in the future is equally important. It is a continuous process that helps mitigate short term challenges. It helps the decision-makers to determine how and why the current and the projected factors impact the business and the strategies. Its main aim is to provide answers to critical queries like what are key issues present in the environment and what are the implications?

Overall, Business Environment Analysis helps:

- Development of necessary infrastructure
- ii) Development of a proposed or adopted course of action, rule, principle or law.
- iii) Helps management determine the future direction of the organization.

ENTITY'S BUSINESS STRATEGY ANALYSIS

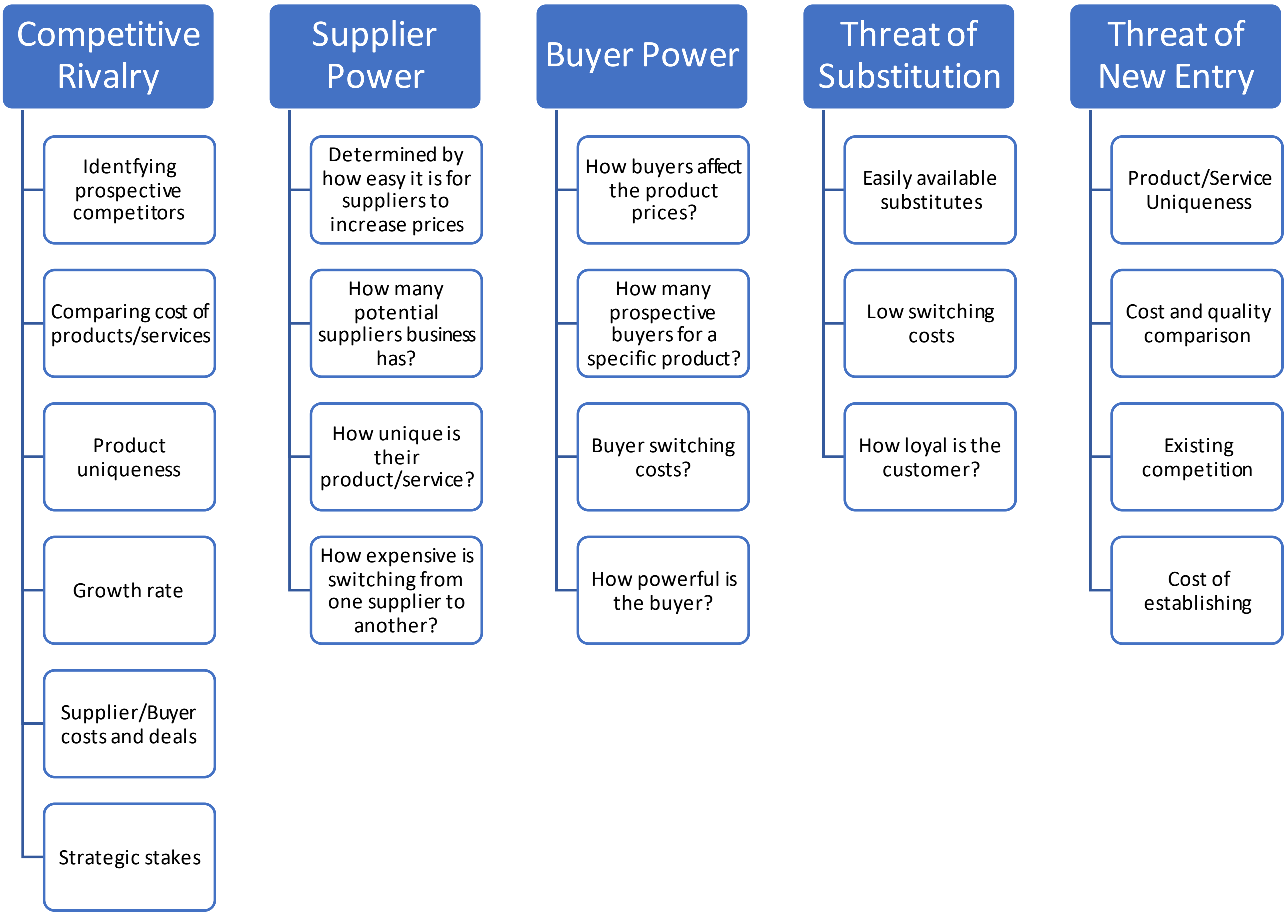
The main aim of any business is to stay ahead of its competitors and make a consistent growth. To achieve this, the managers and decision-makers keep devising various strategies. These strategies need to be well calculated, constructive and identified, evaluated and forecasted based on several business environmental factors.

There are various tools and techniques available for strategic analysis.

1) According to Michael Porter, organizations must

- Keep a close watch on their rivals
- Look beyond the actions of their competitors
- Examine what other factors could influence the business environment

Porter's five forces help construct a competitive environment, which can devour your profitability. These are:



2) The SWOT (Strengths, Weaknesses, Opportunities, and Threats) analysis:

As the name suggests, it is a strategic planning technique used to help a person or Organization identify various environmental factors related to business, competition or project planning. It aims to ascertain the business objectives and identify the current or prospective environmental factors that may affect these objectives.

SWOT aims at answering questions related to the following categories and helps generate meaningful insights to gain competitive and strategic advantage over the rivals:

- ***Strengths:*** What are the key characteristics of the business or project that give it an advantage over others?
- ***Weaknesses:*** What are the characteristics of the business that place the business or project at a disadvantage relative to others?
- ***Opportunities:*** What are the elements in the environment that the business or project could exploit to its advantage?
- ***Threats:*** What are the elements in the environment that pose threat to the business or project?

3) PEST analysis (political, economic, socio-cultural and technological):

It describes a framework of macro-environmental factors used in the environmental scanning component of strategic -management. It is a strategic tool for understanding market trends, business placement, potential and direction for operations.

The basic PEST analysis includes four factors:

- Political
- Economical
- Socio-cultural
- Technological

Let us understand how PEST analysis works through an example of Coca-Cola ref1:

Coca-Cola is a world-renowned soft-drinks company, known for its finest technology in production and customer satisfaction.

Political:

- Coca Cola's product range is subject to FDA rules and must strictly adhere to its policies.

- No-adherence may lead to a ban on product line distribution and sale.

Economical:

- Coca Cola has a huge customer base from around the world. The challenge is to keep customer preferences on priority and provide the best quality products.

- It must also keep a track of customer preference change and latest trends and attitude.

Socio-Cultural:

- Coca Cola introduced more than 30 alternative flavors in Japan & China due to regional customer preferences.
- Customers these days prefer healthy drinks. Coca Cola capitalized on this and introduced a new range of drinks for interested customers.

Technological:

- Coca Cola has a dedicated technological lab in the UK that helps create the finest products in a short time.
- The brand moved on from traditional promotions and successfully exploited social media for marketing campaigns.

This is how PEST helps analyze what factors influence the business and find answers to some critical questions related to business strategies and plans.

4) The GE McKinsey matrix:

Also known as, the 9-box matrix helps multi-business corporations evaluate business portfolios and prioritize investments among different business units in a systematic manner. This technique helps manage the product life cycle and also marketing and promotions. The analysis helps to identify new product lines based on the latest market trends and consumer interests and how and what segments to invest in the future.

The GR McKinsey analysis has a two-dimensional matrix with multi factorial dimensions that span into nine industry attractiveness measures and twelve business strength measures. It is a 3×3 grid. The Y-axis measures industry attractiveness while the x-axis measures the business position. The scale is high, medium and low. Following are some of the prerequisites for creating this matrix:

i) List the entire range of products created or sold by a particular strategic business unit.
ii) Identify the factors that make a specific market attractive.
iii) Evaluate the strategic business unit's position in the market.
iv) Calculate the business strength and market attractiveness.
v) Determine the strategic business unit's category: High, Medium or low.

5) The Arthur D Little (ADL) Strategic Condition Matrix:

This technique offers a different perspective on strategy formulation. ADL has two main features – competitive position and industry maturity.

Competitive Position: The sectors or segments in which a Strategic Business Unit (SBU) operates drive it. The product or service that it markets, and the accesses it has to a range of geographically dispersed markets, make up an organization's competitive position i.e. product and place.

Industry maturity: It is very similar to the Product Life Cycle (PLC) and could almost be renamed an 'industry life cycle.' It not only considers the industry but also the segments.

The competitive position has five main categories:

1. Dominant – Determines how strong is the business placed. It is often associated with some form of monopoly position or customer lock-in e.g. Microsoft Windows being the dominant global operating system.
2. Strong – Here companies have a lot of freedom since the position in an industry is comparatively powerful e.g. Apple's iPod products.
3. Favorable – Companies with a favorable position tend to have competitive strengths in segments of a fragmented market place. No single global player controls all segments. Product and geographical strength have a key role to play in this segment.
4. Tenable – Here companies may face erosion by stronger competitors that have a favorable, strong or competitive position. The business finds it difficult to compete with no substantial competitive advantages over rivals.
5. Weak – This is the most undesirable space for any business as the name suggests. Of course, there are opportunities to change and improve, and therefore to take an organization to a more favorable, strong or even dominant position.

BUSINESS COMBINATIONS

The main objective of a business combination is to expand the size of the company. The acquirer rightfully buys the control and authority over another business through transactions either acquisition or merger.

There are various types of business combination depending on the nature of the transaction:

Horizontal Combination	Units produce same product at same stage of production. Deal in the same market.
Vertical Combination	Various departments of big industrial units combine under one management
Diagonal Combination	Business entities performing subsidiary services join themselves
Circular Combination	Two or more business units dealing in different products

IFRS3 sets the foundation of business combinations based on recognition and measurement of acquired assets and liabilities, ascertains goodwill and the necessary disclosures.

Method of Business Combination comprises of four key parameters as follows:

- Identification of Acquirer
- Set up the acquisition date
- Asset/Liabilities/Non-controlling Interest Recognition
- Determine goodwill and important disclosures

Forms of Business Combination

A] Amalgamation: Amalgamation is a combination of two or more businesses, engaged in similar businesses or perform similar operations, into a separate new entity. From the accounting perspective, Amalgamation leads to a combination of financial statements.

Amalgamation mostly has two broad categories:

- When there is a genuine pooling of not just the assets and liabilities of the amalgamating companies but also of the businesses and shareholders stakes as well. This type of amalgamation ensures that the resulting assets, liabilities, capital, and reserves represent the sum of the amalgamating companies.
- The other type is a means through which one company acquires another company. In this type of combination, the stakeholders of the acquired company lose proportionate share in the equity of the resultant company, or the business of the company acquired does not intend to be continued.

Accounting of Amalgamation:

Pooling of Interest: In this method, assets, liabilities, and reserves of the transferor company are transferee company at their existing carrying amounts. Any conflict in the policies of the companies involved must be resolved and adopted through uniform policies.

Purchase Method: In this method, the transfer company incorporates the assets and liabilities at their existing carrying amounts or by considering individual asset and liability of the transferred company on the fair value at the time of amalgamation.

The need for amalgamation is mostly to acquire new cash resources, eliminate competition, save tax, risk mitigation, and enhance managerial productivity, thus gain financially and achieve growth.

However, there could be disadvantaged to amalgamation, for example:

- May eliminate healthy competition
- Could lead to additional debt
- Could lead to a negative image in the market
- Goodwill and identity of old companies is lost

Some well-known examples of amalgamation are:

- Satyam Computer and Tech Mahindra
- Maruti Motors and Suzuki amalgamated to form a new company Maruti Suzuki Ind. Ltd.

B] Merger & Acquisition: An agreement that lets two existing companies combine into a single entity is, known as a Merger. There can be various factors leading to merger and acquisitions:

- When companies wish to expand their reach and also processes
- When one company is weak and fears sustainability issues, it agrees to be merged for its survival
- Adds to the shareholder value and competitive advantage of the purchaser

There is a slight difference between merger and acquisition though. While merger happens when two business of a similar size decide to go ahead as a single entity, an acquisition is a purchase where one company takes over another and declares itself as the new and sole owner. A merger is also referred to as 'merger of the equals'. Both the entities surrender their respective stocks and new company stock is issued instead. One of the most significant merger examples is that of Daimler-Benz and Chrysler when the former brands ceased to exist and a new name Daimler-Chrysler was created.

A merger is a mutual consensus where both parties wish to join hands and grow as a single entity, whereas acquisitions are mostly quite unfriendly and a show of power.

By merging the businesses, both the parties try to enhance their benefits using the following:

- Staff Reduction: Mergers mean job losses and which in return mean money saved for the business endeavors.
- Improved purchasing power: Power of two business together increases the purchasing bandwidth and in return save on costs.
- Acquiring new technology: A simple example of this would be a larger company buying a smaller but technically advanced entity and gain a competitive edge.
- Expanding market reach and visibility: One of the most important factors of a merger is to exploit new horizons. To expand the business into new domains and growth in revenues and earnings.

The success of both merger and acquisition is based on the fact of whether synergy is achieved or not. Synergy is often described as the force that enhances the performance of the new business and defines whether the transaction was justified or not.

Synergy is achieved through rigorous planning and analysis. The due-diligence process ensures that synergy is achieved and what are the key factors that will help to reach it. But, there's more to synergy than meets the eye. Once the merger/acquisition is done, key strategic decisions regarding processes to keep or close, how to retain key employees and designate forces to ensure that synergy is maintained becomes a key process.

C] De-Merger: When a business aims to restructure itself by either splitting off its various segments or brands to invite or prevent an acquisition or sell off components to raise capital for key components is a De-Merger. In short, de-merger is a strategy, which lets a business focus on its most productive, and profitable segments/brands, generate better shareholder value and avoid the risk of acquisition. It is a good way to filter out and discard under-performing wings and product lines and keep maintain the company performance.

A key strategic move to de-merge certain segments of the company is attributed to vigilant management that understands the internal issues even before the market predictions. In such cases, de-mergers prove to be quite beneficial for a company's finances.

Key Terms related to De-merger:

- Demerged company: Business unit or product line or brand that is being undertaken by another company is known as Demerged.
- Resulting Company: Company that received the above-mentioned undertakings is the resulting company.

De-merger can take place in two ways:

- Spin-off
- Split-up

Spin-Off: In this de-merger, the parent company offers shares of the business unit to be spun-off to its existing shareholders, in form of a special dividend at a pro rata basis. Existing stakeholders benefit by holding shares from both the entities in this strategy. The parent company gains no monetary considerations. The spun-off unit is independent of the parent company and has its own management and processes.

Split-off: Similar to the spin-off strategy, this method too offers shares to the existing stakeholders. The only difference here is that these stakeholders need to choose either the parent company or the subsidiary. They cannot hold shares in both of them like the above strategy. A split-off happens through IPO offerings of the subsidiary shares. A split-off is sort of a stock buyback for the parent company except that in this scenario it is the subsidiary's shares rather than cash.

Wipro's IT wing separating itself from non-IT business is a classic example of De-merger.
With this de-merger, Wipro hived-off three units, namely, Wipro Consumer Care & Lightning, Wipro Infrastructure Engineering and Medical Diagnostic Product & Services business - into a separate unlisted company called Wipro Enterprises. Wipro's IT segment that contributed 86% of total company revenue remained a public listed company. This de-merger led to a positive impact on the stock and increased the profit margins. A separate IT wing changed the face of marketing campaigns and investments. It led to accelerated investments and new opportunities.

D] Arrangement: As the name suggests, an Arrangement is a form of mutual obligation between two private parties, enforced by law. The basic elements required for an arrangement to be legally enforced are:

- Mutual consent between parties
- Valid offer and acceptance
- Adequate consideration, capacity, and legality. A valid substitute can satisfy the element of consideration in some cases.
- Remedies for breach of arrangement. This includes general damages, consequential damages, and specific performance.

Contracts are undertakings that the law will enforce. Contract law falls under the state Common Law. While general contractual laws are almost similar everywhere, there may be some specific court interpretations of an arrangement that may vary from state to state.

The law enforcement guarantees relief to the harmed party in case of breach, most often in form of monetary damages, or in some cases in the form of specific promises made in the arrangement.

An example of a successful business arrangement would be as under:
A construction company enters into a joint venture with another larger company to bid on a highway construction project. The two companies sign an agreement specifying various

conditions, including a mechanism to split the revenue. The venture is considered competitive because the government agency building the highway encourages such arrangements.

Publicizing successful arrangements helps in building brand image and gives a competitive as well as credibility edge over competitors. This in return attracts investors and new ventures.

E] Restructuring: Restructuring refers to the re-organization of operational, structural, financial and various other segments of a business. The need for restructuring is driven by debts, financial losses, buyout, merger, preparing for a sale etc.

A company can discard unprofitable business segments or product lines through restructuring. Many businesses restructure in order to bring forth their most favourable, cost-effective and profitable segments to the forefront. For example, a company plans to shut off a specific product line that is no longer in demand to make way for other products and minimize losses.

Every business at some point faces debt issues that pose a threat to its functioning or existence. In such cases, business restructuring is a viable option through which corporates can escape. Various ways to restructure in such cases could be employee layoff, selling assets and/or reduction in employee benefits. The main objective here is to map the equity ratio back to help businesses sustain.

Businesses need to adapt to newer trends and consumer requirements. For example, a fashion brand restructures one of its product lines by discarding old fabrics and styles and brings in new technology that is more productive and efficient.

Meeting regulatory changes also require restructuring. One of the most relatable examples is that of the banking industry. Regulatory changes influenced by the crisis of 2009 led to a major restructuring throughout the industry.

Due-Diligence: Due-diligence is defined as a process, investigation or exercises a person or business must strictly perform before signing an agreement or contract with another party. It is mostly voluntary but can be a legal condition under specific circumstances.

The most common example of due-diligence is the process of information gathering and/or evaluating a prospective company for its assets by an acquirer for a merger or acquisition. Due-diligence contributes significantly by providing key information and enhancing its value and quality to be used by decision-makers for analysing. It is an extensive process that the acquirer must undertake in order to make better agreements/M&A.

Due-diligence has different forms based on its purpose:

- Scrutinizing a potential target for merger/acquisition, privatization, or similar financial transactions normally by a buyer. (This can include self-due-diligence or an assessment of a company by a third party on behalf of the company, prior to taking the company to market.)

- A concise investigation focusing on future matters.
- An examination achieved by asking certain key questions, including, how do we buy, how do we structure an acquisition, and how much do we pay?
- Investigating current practices and policies.
- Examining various principles of valuation and shareholder value to determine an acquisition decision.

Overall, due-diligence helps businesses asses risks involved in a merger or a private agreement. Due-diligence not only sets the context for entering a new business deal but also a conscientious while integrating or introducing new consumers or suppliers into the processes.

A well performed due-diligence benefits in many ways:

- It helps in designing the corporate objectives
- Helps gather and validate key information
- Conduct risk assessment
- Helps to screen various prospects
- Helps establish a monitoring plan

The first step in risk assessment is setting up the context. This restricts the number of hazards imposed, followed by identifying key information which is useful for strategic planning and forecast. It also helps determine the potential assets or parties that may be affected by threats. In cases where statistical records are available, they may be used for risk evaluation.

Financial Statement Analysis: It is a process of evaluating and analyzing a company's financial statements and uses its derivatives to make better decisions. These statements range from, income statements to balance sheets to cash memos.
Objectives of financial statement analysis:

- Performance assessment and Current Position: Performance assessment helps determine the business progressions and how it looks in the future. It helps formulate key decisions for the future based on past performance and possible indicators for the future.
- Income and Growth Forecast: Financial analysis helps in predicting the earning prospects and growth rates in the future. They build the base for financial and business forecasts.
- Predictions related to bankruptcy and failure: By looking at financial analysis results decision makers can determine how bad the current position of the company is and help make appropriate strategies to mitigate such threats.
- Strategic financial decisions: Various financial institutions take advantage of financial analysis to make loan or credit decisions. It helps in determining credit risk and other factors that may jeopardize the investment in the future.

FORECASTING

Forecasting is an organized study of various business aspects that layout the foundation for any key strategic decisions or plans. Forecasting involves various statistical formulas and methodologies to predict the future scope of the business or market trends, how the business progresses, identifies potential threats and alerts the management.

In the ever-changing fast-paced world economy, businesses find it challenging to keep a track of trends and ups and downs. Business forecasting has become a precious tool for organizations to keep a check on market trends and their product lines and operations with respect to these inputs.

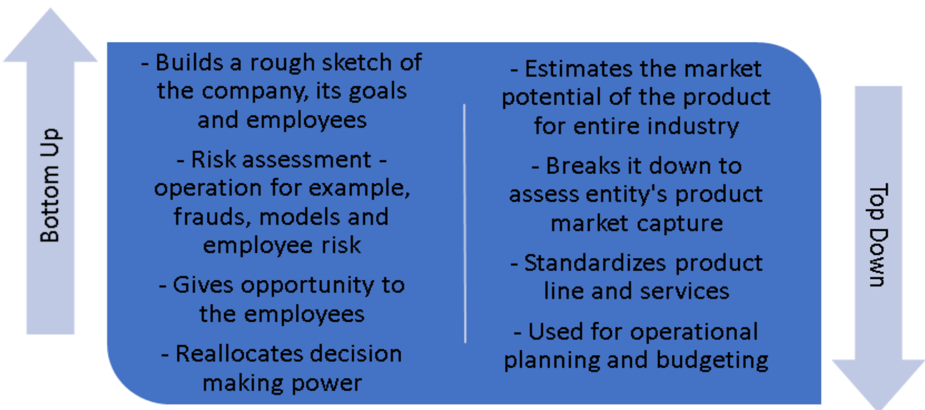
For example, a business forecast predicts that a certain product line is about to suffer given the consumer shift and trend, it gives an advantage to the company to be ahead of the market and manage the production of its products. It helps minimize risks and losses gives the management some time to plan alternative operations to maintain revenues by focusing on other major segments.

MAJOR APPROACHES TO FORECASTING

There are two major approaches to forecasting:

- Top-Down Approach: This approach undertakes the assessment of the entire product line sale, for example, the range of models and their versions available at all business units. Then it applies relevant statistical methods and equations to determine and predict the market for an individual model or version relative to its location and regional market and consumer trends. From the management point of view, it helps the decision-makers analyze and eliminate threats or risks and help them amplify the profitability.

- Bottom-Up Approach: In contrast to the previous method, this approach first calculates and analyzes each product or product line (disregarding the industry or market as a whole) for future trends, sales, and revenue. This approach involves lower and middle-level employees to generate plans and then channels upwards. The result is a consolidated graph to project the overall sales forecast.



The various steps involved in business forecasting are:

- Determining the basis: This the foundation of all the business forecasts. This step determines the basis of assessing economic conditions, the position of industry and products. It results from this investigation form the base for all further sales and business operations.
- Calculate future business operation: This step gives a direction to all the predictions by estimating and analyzing conditions and the course of future events in the industry. It helps management draw a clear picture of quantitative estimates for future sales and operation.
- Regulating forecast: The forecast results are fact-checked against the actual results to determine deviations and set the corrective measures.
- Review: This is an important step since it keeps a check on the results of forecasts and keeps directing further actions to keep the operations on track by calculating the deviations and eliminate them.

Techniques for business forecasting

There are four primary techniques for business forecasting:

<u>Delphi Technique:</u>

- Involves a set of questionnaires presented to a group of business experts
- Experts express their individual thoughts, unaware of other's opinion
- The results from the first set of questionnaire consolidated form the basis for the second questionnaire and so on
- Till a narrow range of opinions is achieved

<u>Scenario Writing:</u>

- A hypothetical approach to determine response to volatile market conditions
- Breaks away from traditional forecasting keep pace with ever-changing markets
- Experts sketch out probable scenarios of how the market will change and the possible effects on the business and operations
- Helps the management prepare for worst-case scenarios and react to unprecedented condition more efficiently and quickly
- Uses sophisticated technological advancements to deduce better options and results

<u>Subjective Approach:</u>

- Involves brainstorming sessions to generate ideas and solve problems
- Outcomes are based on subjective thoughts and ideas
- Mostly used when time crunch prohibits an objective analysis and forecast
- They may be subjected to biases and must be observed skeptically by the management

<u>Time-Series Forecasting:</u>

- Data gathered over a time frame is analysed quantitatively to identify trends
- Data could be gathered yearly, monthly, weekly or even hourly

- Focuses on data's gradual shift over time
- Represents increasing or decreasing trends
- Cyclical components are represented above or below the trend line and keep repeating.
- Seasonal components are repetitive but occur yearly.
- Irregular events can happen at any interval and can't be predicted

CASH FLOW ANALYSIS

Business is all about income(cash-i nflow) and sale(out-flow) over a period of time. Cash flow analysis helps keep a track of all the financial transactions in and out of the business to determine the overall value of the company. Cash flow analysis examines how the money is generated, from where it is generating, how it is used to make a calculated idea of a company's position over a year.

Cash Flow Statement and Components

The investors and businesses use the Cash flow statement to determine how much cash was generated and spent during a period through various investing activities, financial activities, and operational activities. Cash flow analysis is also used to analyze the value of individual segments of a large company to assess how much excess cash they produce. Cash flow analysis is really important to ascertain the liquidity and long term solvency of the company. The cash flow statement is based on cash-based accounting instead of accrual accounting. This is one key feature from a solvency point of view since a company may accrue accounting revenues but receive zero cash. So keeping a track on cash accounting provides resources to stay solvent.

How to calculate Cash Flow?

There are plenty of options available to calculate the cash flow of a company, the simplest being deduced from the company's quarterly and annual reports.

The initial step would be to calculate the cash flow ratio. It is determined by dividing the total current liabilities in the balance sheet by the company's cash flow from operations. This helps investors and business determine if theirs is enough cash for the company to pay liabilities.

Also known as, EBDA, calculating the accounting cash flow is another important step, determined by adding the company's net income to amortization and depreciation.

Determining the earnings before interest, amortization and depreciation, also known as EBITDA, represents the cash flow available for payments to investors, creditors, and owners.

Discounted Cash Flow (DCF)

In this analysis, businesses determine the value of projects, assets or the company against time value of money. It is the foundation for all other valuations. It is based on expected cash flows and associated discount rates of a company, which also attributed to risks. Unlike other methods, DCF depends on free cash flow, which makes it more reliable and eliminates subjective accounting policies. Calculates the closest estimate of a stock's value.

A DCF has several methodologies to perform the valuation. End year convention treats cash flows as if they occur annually at the end of the year. Opposed to this mid-year convention lets discount future cash flows to a present value. This way a mid-year discount assumes that all the cash comes halfway. Thus treating cash flows as if they occurred in the mid-year.

APPROPRIATE COST OF CAPITAL/RATE OF RETURN

The appropriate Cost of capital refers to the opportunity cost of making a specific investment. For example,

Let us assume a company is considering whether to introduce new advanced systems. This will cost INR 50 million and is expected to save INR 10 million per year over the next 5 years. There is some risk that the update will not save the company a full INR 10 million per year. Alternatively, the company could use the INR 50 million to buy equally risky 5-year bonds in ABC Company, which gives a return 12% per year.

Because the update is expected to return 20% per year, it is a good use of capital, because the 20% return exceeds the 12% required return, the company could have gotten by taking the same risk elsewhere.

Thus, it is determined as the rate of return that could have been earned by investing elsewhere. When given a choice, an investor would always choose to invest where the rate of return is more. Thus, the Cost of capital signifies the risk investors take in order to gain more profits. A key point is to never equate the cost of capital with the interest rate in that money. Since the cost of capital does not depend on how it was raised.

A rate of return is defined as profit or loss on an investment over a specified time period. In other words, it is the percentage of the investment's cost. Profits are defined as income received plus any capital gains realized on the sale of the investment.

The formula for the rate of return is:

Rate of Return = [(Current price - Original price) / Original price] x 100

The rate of return can also be defined as the net amount of discounted cash flows received on an investment.

Capital Asset Pricing Model (CAPM):

CAPM is used to calculate the expected return on investment. It is based on the fact that investors have an idea of systematic risk (also known as market risk) and must be compensated for it in order to attract them. The compensation is usually greater than the risk-free rate – also known as Risk Premium. The key attraction for any investor is the rate of return, and a higher return always makes up for the risk taken.

The formula for calculating CAPM is: Expected Return = Risk-Free Rate + (Beta x Market Risk Premium)

The Beta here is a measure of the volatility of returns reflected by measuring the variation of its price changes with respect to the entire market.

The Weighted Average Cost of Capital (WACC):

WACC is a calculation of a firm's cost of capital in by weighing each categoryproportionately. A WACC constitutes,

- All capital sources
- Common stock
- Preferred stock
- Bonds
- Long term debts

A firm's WACC is directly proportional to the Beta and Rate of Return. A higher WACC means a decrease in valuation and an increase in risk. WACC is the average of costs of various types of financing weighed against its proportionate use in a given situation.

VALUATION ADJUSTMENTS

To understand Valuation Adjustments, we first need to understand what Valuation means.

Valuation is the process to determine the present or expected value of a business or its assets. To predict a value to a given business the analyst must take note of the management, capital structure and its composition, prospective future earnings etc. Valuation often needs a fundamental analysis. One of the ways is CAPM.

There are various valuation methods, like, discounted cash flow analysis that determined the value of a business against its earnings. Other methods include analysis of similar transactions done in past or compare the business with a similar entity and their valuations to determine one's position.

Valuation adjustment mechanisms, or VAM agreements, is used in mergers and acquisition deals. VAM agreements made a stronghold in M&A transaction with large premiums, though the made significant contribution to private equity and venture capital initially. These adjustments can be made to the price of a derivatives trade, reflecting counterparty risk, own-default risk, funding, capital and margin. Institutions that ignore valuation adjustments are at risk of mispricing a trade; institutions that include them are at risk of never winning a trade but pragmatism matters too.

Discounts for Lack of Marketability (DLOM)

Valuation Discounts for lack of marketability (DLOM) is highly considered when there is minority perspective of a publicly traded stock and the private nature of the target entity respectively.

When there are two separate equity interests in two similar kind of businesses, the participants pay higher price for and equity that can be converted into cash. DLOM, must be considered if the target is a private entity.

Approach	Measurement Rationale
Financial Modelling: put option methods	A put option represents the value of a right to sell a stock. Theoretically, it matches the DLOM concept of an inability to exercise a right to sell. This method type measures DLOM by dividing the put option value with the current stock value. Few examples – Chaffe model (1993), Longstaff model (1995), and Finnerty model (2003)
Empirical studies: pre-IPO stock studies	The IPO stock price is compared with the stock price in a private transaction sometime prior to the IPO when the entity is still not public. For example – Emory studies, Williamette Management Associate studies, and Valuation Advisors studies.
Empirical studies: Restricted stock studies	A publicly traded entity issues non-trading stocks directly to an investor in a private placement. Due to laws and regulations, these privately placed stocks cannot be freely traded in a public market for a period of time. Prices of the liquid stocks and the restricted stocks are compared. Few examples – SEC Institutional Investors studies, FMV Opinions studies, and Williamette Management Associate studies.
Court Cases Reference	No universal consensus and depends on precedent cases in each jurisdiction.

Discount for Lack of Control (DLOC)

A controlling ownership interest is typically more valuable than a pro-rata share of a minority interest. This is because the minority owner does not have control over important business decisions like declaring dividends, determining compensation, setting policies and deciding to sell or liquidate. To account for this disadvantage, an appraiser can apply a discount for lack of control to a minority interest.

Approach	Measurement Rationale
Empirical studies: acquisition premium studies	Premiums paid for acquisitions of listed entities compared with trading prices of the listed entities prior to acquisition announcements are studied. For example – Mergerstat studies.
Empirical studies: NAV discount studies	If reasonable estimation of NAVs of listed entities can be done at transaction dates, the percentage of discount observed in minority interest transactions as compared to underlying NAV of listed entities are studied.
Empirical studies: Voting and non-voting stock studies	Studies comparing trading price of stocks with as well as without voting rights.
Court Cases Reference	No universal consensus and depends on precedent cases in each jurisdiction.

2. FIXED INCOME SECURITIES

TYPES OF FIXED INCOME SECURITIES

Fixed income securities are various schemes provided by a government or corporation or any other entity to expand and finance their operations.

- Bonds
- GICs
- Preferred Stock
- Cumulative Preferred Stock
- Non-Cumulative Preferred Stock
- Participating Preferred Stock
- Convertible Preferred Stock

Various types of Fixed Income Securities are as follows:

A] Bonds: There are two parties involved, investor and issuer. Major issuers of bonds are governments and corporations. A bond is an agreement or loan made by the investor to the issuer. The issuer in return to the investment promises to repay the face value i.e., the principal amount on a fixed maturity date along with scheduled (usually half-yearly) interest payments.

B] Guaranteed Investment Certificates (GICs): GICs are investment offers that promise a guaranteed rate of return over a fixed period of time. They are the most common issues by trusts or banks. The rate of return is generally low due to a low-risk profile. The rate of return varies based on interest rates by banks and also the length of the term. The principal amount is not at risk until the bank defaults.

C] Preferred Stock: A preferred stock is a preferential class of stakeholding in a corporation. The shareholders have a higher claim on the assets and earnings than the general stocks in case the corporation defaults. The rate of dividend is mostly fixed, expressed as a percentage and is mostly cumulative unless explicitly stated otherwise. This means that in case the corporation fails to pay the amount, it will accrue to the stockholder and pay at the next date. The stocks do not enjoy voting rights or carry any other rights to participate in any profits except the dividend rates. These rules are mostly laid out in the beginning through a corporate memorandum.

Some preferred stocks are convertible in nature. These stocks can be exchanged for a fixed number of common stocks under given circumstances. The profit depends on the current rate of common stocks in the market.

For example, a corporation has issued preferred stock with an annual dividend of 5$ per year. The holders are entitled to $5 per share dividend each year. But the preferred shareholders will get no more than the $5 dividend, even if the corporation's net income increases. The catch here is that they must be paid before common stockholders.

D] Cumulative Preferred Stock: These are a type of preferred stocks with a right over dividend payments even before it's paid to other preferred stocks or common stocks. This usually happens in the case of dividend payment failure and the corporation is subjected to the cumulative payment of these dividends on the next payment date.

Cumulative Preferred Stock is calculated as below:

Cumulative Preferred Stock = (Current Price of Security – Original Price of Security) / Original Price of Security

E] Non-Cumulative Preferred Stock: In contrast to the cumulative preferred stocks, this preferred stock enjoys no rights over non-payable dividends. This means if the corporation does not pay dividends in any given circumstance, the stocks have no right to demand them in the future.

Cumulative vs Non-Cumulative Preferred Stock

The major difference between Cumulative and Non-Cumulative Preferred Stocks is the impact on dividend value. While in cumulative stocks a company must keep track of all the past failed payments and multiply them by the dividend rate for the stock, there is absolutely no calculation required in the case of non-cumulative stocks. The cumulative stocks have a greater value over non-cumulative stocks when the company is in turmoil.

Due to less risk factor of the cumulative stocks and are often offered at lower rates when compared to non-cumulative stocks. Non-cumulative stocks are mostly issued by companies that have a strong history and that can afford the stocks without increasing the cost of capital.

F] Participating Preferred Stock: Participating stocks are a type of preferred stock where the holders have a right to dividend payment with respect to the specified rate plus an additional dividend based on the agreement before it is paid to any other stockholders. In the case of liquidation, the participant stocks get preference over other stocks. Private investors or venture capital firms mostly finance these stocks. Participating stocks bridge the gaps between a company and venture capital firm that disagree on valuation rates.

There are also shares that do not enjoy the right over profits after payment to equity stockholders. No extra dividend is paid and has no right over surplus profits. These are called Non-Participating Preferred Stocks.

G] Convertible Preferred Stock: Some preferred stocks are convertible in nature. At a fixed price these stocks can be exchanged for a fixed number of common stocks under given circumstances. The profit depends on the current rate of common stocks in the market.

The preferred stockholders do not enjoy the benefit of higher dividend values when the market is good. However, they are covered during low times. Convertible Preferred Stocks give an added advantage to stockholders through a right to participate in the price appreciation.

TYPES OF DIFFERENT DEBT INSTRUMENTS

A debt instrument is a legal (paper or electronic) agreement that enables the issuer to raise funds to repay an investor the face value of the invested amount with interest, in a stipulated time.
They are important because:

- The repayment is legally enforced
- Increases the transferability

There are various types of Debt Instruments. Some of them are as detailed below:

Sovereign Bonds

Local / Municipal Bonds

Semi-Government Bonds

Corporate Bonds

Certificate Of Deposit

Asset Backed Security

A] Sovereign Bonds: National governments issue bonds either in the local denomination or foreign denominations. These bonds are known as Sovereign bonds. The governments often wish to offer bonds in the local denomination but due to higher risks fail to do so. An unstable country will offer Sovereign bonds in denominations of a stronger and stable economy to yield better returns. Due to higher risks, Sovereign bonds are offered at catchy discounts. The International debt market calculated and represents the risk of Sovereign bonds by the yield the bond offers. Riskier bonds mean higher yields.

B] Local/Municipal Bonds: These bonds are issued by various government bodies such as states, cities, counties etc. to raise funds which in return are used to build highways, schools, hospitals, sewer systems, and other public beneficiary projects. By buying these bonds, investors are lending money to the states which promise to pay a specified interest (usually every 6 months) and the principal amount on a fixed maturity date. Sovereign bonds are mostly denominated in local currencies. This makes sure that no matter the circumstance; the state cannot default and has to make payments. Cases where the states choose to default, it is called a Sovereign debt crisis.

C] Semi-Government Bonds: These bonds too are issues by governments with a different objective. The investment from these bonds is used to fund infrastructure and other major financial commitments. Like regular bonds, semi-government bonds vary in rate of interests and maturity cycles. The issuers in the case of semi-government bonds have a credit rating. This helps investors determine which states have a better record and choose wisely.

The rates of return on these bonds are usually higher than a regular bond which reflects the higher risk imposed by the local over national governments. The traded bonds are not widely published thus impose a complexity to determine which yields are better.

D] Corporate Bonds: A corporation wishes to expand its operations or needs capital for M&A. They can do so by issuing bonds in order to receive investments, known as Corporate Bonds. These bonds usually have a maturity period of at least one year and come under longer-term debt instruments. The corporate bonds with a maturity period less than a year are referred to as Commercial paper.

All obligations except the government offerings are referred to as corporate bonds, thus, there are no strict definitions surrounding it. Corporate bonds deal in decentralized, dealer-based, over the counter markets. Dealers act as intermediaries between buyers and sellers in case of over the counter trading.

Corporate bonds are divided into two categories depending on the credit rating and the rate of return. Depending on the distinction these bonds are traded through different desks.

For example, many pension funds and insurance companies are prohibited from holding more than a token amount of High Yield bonds (by internal rules or government regulation). The distinction between High Grade and High Yield is also common to most corporate bond markets.

E] Certificate of Deposit (CD): Also known as Commercial Papers, these are saving certificates with a fixed rate of interest and fixed maturity date. CD can be issued in any denomination and restricts the use of funds till maturity date. These certificates are highly unsecured and offered by corporations to raise immediate funds for operations, expansion or other short term liabilities.

F] Asset-Backed Security: From the investor's point of view, asset-based security is an alternative to corporate debt. A pool of assets such as loans, leases, royalties or receivables endorses the financial security of ABS. The underlying assets of ABS are usually illiquid and can't be sold on their own. But pooling these similar assets through financial security enables the owners to make them marketable. Issuers of ABS can be as creative as they desire. For example, ABS has been created based on cash flows from movie revenues, royalty payments, aircraft leases and solar photovoltaic. Just about any cash-producing situation can be securitized into an ABS.

TERMS USED IN FIXED INCOME SECURITIES

Fixed income security is an investment where the issuer in return for the amount invested, promises a fixed rate of interest plus the principal amount on a fixed maturity date or over a period of time. Against the unpredictable nature of variable-income security, income from fixed income schemes is known in advance.

Some of the most important terms related to fixed income securities are as below:

A] Bond Indenture

This is a legal document issued by the issuer to an investor (bondholder) listing all the terms, conditions and obligations of the deal. A bond indenture has the following features:

- Defines benefits owed to the bondholder
- Details the rights of ownership
- Details the rights of the bondholder to receive interest and principal payments

B] Issuer

An Issuer can be a corporation, trust, local or foreign governments. The issuer is responsible to develop, register and sell securities to finance its operations. They are responsible for all legal obligations and reporting all financial conditions and activities as stated by the jurisdiction.

For example, Company ABC in order to raise some capital in order to finance its operations sells its common shares to the general public. This entitles ABC as an issuer and makes them responsible to file with regulators, such as the Securities and Exchange Commission. They are also responsible for disclosing relevant financial information about the company.

C] Security Holder

Anyone who owns an interest in the corporation is a Security Holder. It could be debt or equity. Both mean that the holder as an interest in the company's well-being.

D] Covenant

A covenant is a type of agreement that works contract in which the covenanter makes a promise to a covenanted to do (affirmative covenant) or not do some action (negative covenant). In real property law, the term real covenant is used for conditions tied to the use of land.

E] Maturity

Maturity or Maturity date refers to the period or date of completion of the instrument. It signifies when the issuer will pay the principal amount and the interest. It also helps to keep a check on missed payments and calculations with respect to future payment.

F] Par Value

It is the face value at which an issuer is obliged to pay. In other words, it is the face value of the bond. Par value is critical in terms of understanding the maturity value of the fixed income instrument as well as the dollar value of the coupon. The market value of a bond can be below or above par. This depends on the level of interest rates and the bond's credit status. It is also known as nominal value or face value.

G] Coupon Rate

It is the yield paid by fixed income security. The coupon rate is the annual payment relative to the bond's par value. It is the yield paid on the bond's issue date. It keeps changing with the value of the bond until it reaches maturity.

H] Clean Price

Clean price accounts for the discounted future cash flows. It is the price of a coupon bond without accrued interest. It is calculated by subtracting the accrued interest from the dirty price.

Clean Price = Dirty Price – Accrued Interest

I] Dirty Price

It is the bond pricing quote that denotes the price of a coupon bond including the present value of all future cash flows. It is inclusive of accrued interest on the next coupon payment. Dirty price is the amount an investor pays to acquire the bond.

J] Re-purchase Agreement

It is a short-term borrowing for dealers in government offerings. Which are further sold to investors usually on an overnight basis and bought back the following day. It is called a repo with regards to the party selling and agreeing to re-purchase it. Similarly, it is a reverse repurchase for the party buying and agreeing to resell it in the future. They are most commonly used to raise short-term capital.

K] Yield to Maturity (YTM)

It is termed as the internal rate of interest earned by the investor who buys the bond at present market rate assuming that bond will be held until maturity. It is based on the assumption that all the payments (coupon and principal) will be made as promised. YTM is the discount rate at which the sum of all the future cash flows from the bond is equal to the current price of the bond.

L] Forward Rate

Forward rate represents the present expectations of future interest rates or currency exchange rates. The forward rate is calculated based on interest rates for various maturities, typically through a graph representation as a yield curve.

M] Spot Rate

Also called as 'Spot Price', it is the spontaneous rate at which commodity, security or currency is settled. It is based on the current value of an asset at the moment of the quote. It is defined by how much the seller is willing to accept and how much the buyer is willing to pay. The process in itself depends on factors such as current and future market value. This sometimes results in drastic changes in the spot rates.

CREDIT RATING OF BONDS

Credit rating represents how credible corporate or government bonds are. A credit rating is carried out by a rating agency. The rating is the ability of a debt issuer to make full and timely payments of financial obligations. In other words, it is a risk assessment based on finances, industry, business, and management skills that may impose a threat on the issuer's ability to service debt.

Quite often the issuers are unhappy with the rating process and disregard it. However, the credit rating agencies deal with similar kinds of criteria and are thorough and consistent with the examination process. The only factor that separates the various agencies is how they weigh individual categories of the credit analysis. The assessment of industry risk will, to some extent, determine which factors take priority in the overall evaluation.

For example, when you consider global level, Moody's assigns bond credit ratings as Aaa, Aa, A, Baa, Ba, B till C, whereas, Standard and Poor's & Fitch assign them as AAA, AA, A, BBB, BB, B till C.

In addition to the general industry risk, the company may be more or less able to withstand certain risk factors depending on its position in the market. Significant factors in this evaluation will be:

- Market share.
- Competitiveness.
- Diversification in terms of products and key customers.
- The ability to maintain or dictate prices in the market.

A bond is considered fit for investment if the credit rating is at least BBB. Ratings play a critical role in determining how many companies and other entities that issue debt (including sovereign governments) have to pay to access credit markets, i.e., the amount of interest they pay on their issued debt. The threshold between investment-grade and speculative-grade ratings has important market implications for issuers' borrowing costs.

EMBEDDED OPTIONS

An embedded option offers specific yet useful rights to the issuer to be used at a later stage. They can be special conditions, embedded options that make an inseparable part to security, like a bond, but not trade on its own. Embedded options are listed in trust indentures, highlighting the guidelines issuer, investor and trustee must oblige to at any given point of time.

For example, a company issues bonds with an embedded option to convert from preferred to common stock. The holder here has the right to convert bonds into shares of the company stock in a conversion ratio of say INR 10,000 par value per X amount of shares. These conversions are available in the indentures.

Apart from bonds, convertible preferred stocks (as mentioned above) and MBS have embedded options. The options vary in the form of conversion of stocks to common stocks or prepayments etc.

There are majorly two types of risks involved with embedded options:

Risk of Reinvestment	Limited price appreciation
Evident through party receiving the proceeds may not be able to reinvest them profitably	They always depreciate a security's potential rate appreciation due to call price or specific conversions at the time of market fluctuation

Security is entitled to have several embedded options and may offer the right to redemption or disposal to the security holder.

For example, in call provisions, the holders enjoy the right over-redemption of bonds before scheduled maturity. Convertible stocks, on the other hand, have the provision to exchange the preferred shares with common shares.

The point at which buyers set maximum prices to buy and sellers the minimum selling price for a security or exchange is called *Call Auction*. Exercising this process decreases volatility and increases liquidity. It is also referred to as the *Call market*.

There is another option known as *Put option* which is opposite to the *Call Auction*. A *Put option* gives the owner the right to sell a specified amount of security at a specified rate and time frame.

INTEREST RATE DERIVATIVE PRODUCTS

A derivative is a financial security with a value that is reliant upon or derived from an underlying asset or group of assets. It is a contract between multiple parties based upon the assets, the price of which is determined by the variations in said asset.

Most common examples are: stocks, bonds, commodities, currencies, interest rates and market indexes.

Types of Derivatives

Futures Contracts	• **Most common derivatives.** • **Agreement between parties for selling an asset at agreed upon prices** • **Widely used to as protection against risks during a particular time**
Forward Contracts	• Similar to Futures Contracts except that they are mostly over the counter exchanges and not on exchanges
Swaps	• Agreement between multiple parties to trade loan terms • For example, a fixed interest loan can be switched with a variable interest loan under this derivative.
Options	• It is exactly similar to Futures Contracts • It is an agreement between multiple parties on agreed upon rates • The difference is that in Options, the buyer has the right to revoke and is not obliged to perform the transaction
Credit Derivative	• Loan sold to a prospective buyer at discounted rates. • The original lender expects lower returns due to price reduction but selling the loan will regain the most of the capital • This money can be used to issue a new more profitable loan.
Accrual Swaps	• Payment of Interest rates occurs if reference rate is above or below a certain level. • This option is a time-switch in which interest on one side increases only • One party pays the standard floating reference rate, and in turn receives the reference rate plus a spread. • The interest payment to the other party will happen only on days when they remain in the specified range. • The investors and company using accrual swap assume that interest rate will remain in a specified range. • The broader the range, greater is the risk, which is typically the expectation since the interest will not accrue.

RELATED FIXED INCOME MONEY MARKET & DERIVATIVES ASSOCIATION OF INDIA (FIMMDA) CIRCULARS

A] Non-SLR Papers:

- Include bonds issued by Public Sector Undertaking and other corporate bodies.
- Issued as debt instruments by PSU, semi-government, state governments, city corporations, municipalities, trusts.
- Other entities like IDBI, IFCI, Housing Boards are also authorized to issue bonds.

B] Traded Bonds:

As per RBI Master Circular – Prudential Norms for Classification and Operation of Investment Portfolio by Banks dated July 1 2015, "where the debentures/ bonds are quoted and there have been transactions within 15 days prior to the valuation date, the value adopted should not be higher than the rate at which the transaction is recorded on the stock exchange".

For example: When a bond is traded on more than one exchange, the weighted average price of all exchanges is considered. So, if a bond is traded on more than one occasions in last 15 days, the latest VWAP is considered.

Face Value (in INR)	Price Quoted As	Market Price (in INR)	The Bond is Trading at
1000	100	1000	Par
1000	102	1020	A premium to par
1000	98	980	A discount to par
5000	99	4950	A discount to par

C] Non-Traded Bonds: As per RBI guidelines, all non-traded debentures/ bonds should be valued on the YTM basis. Such debentures/ bonds may be of different companies having different ratings. These will be valued with appropriate mark-up over the YTM rates for Central Government Securities as put out by PDAI/ FIMMDA periodically. The mark-up will be graded according to the ratings assigned to the debentures/ bonds by the rating agencies subject to the following:

The rate used for the YTM for rated debentures/ bonds should be at least 50 basis points above the rate applicable to a Government of India loan of equivalent maturity.

D] BONDS NOT RATED BY A RATING AGENCY BUT A CORRESPONDING RATED BOND OF THE ISSUER EXISTS

As per RBI guidelines, the rate used for the YTM for unrated debentures/ bonds should not be less than the rate applicable to rated debentures/ bonds of equivalent maturity. The mark-up for the unrated debentures/ bonds should appropriately reflect the credit risk borne by the bank.

Explanation: Bonds and debentures, which are NOT rated by a rating agency or have become "unrated" during their tenor, but a corresponding rated bond of the issuer exists, then the unrated bonds will be valued by marking up the credit spread by a minimum of 25% over the equivalent rated long term bond of the same issuer.

E] Floating Rate Bonds (Non-SLR): These are bonds with variable coupon rates. These rates are determined using a certain predetermined method. Crucial to the concept of a floating rate bond is the "Benchmark Rate", which is a market determined interest rate, used for the computation of the coupon rate from time to time. The frequency at which the coupon rate is reset is called the reset frequency, while the frequency at which coupon payment takes place is the coupon payment frequency.

3. OPTION VALUATION

GENERAL PRINCIPLES

Option valuation involves mathematical modeling to determine the free market value or a fair value of an option. It is used by investors to derive the optimum returns on investment by carefully taking into account the various factors that influence pricing in the market. With option pricing an investor is likely to make more informed choices as it uses all known variables to estimate the worth of an option.

An option is a type of security or a derivative product that can be bought or sold for a non-refundable deposit. Anoption allows an investor to buy or sell a specific quantity of an asset at a fixed price (strike price) at or within a specified period of time or expiration of that option. With options, unlike futures contracts, the buyer has the right, but not the obligation to buy or sell at the pre-determined price.

OPTIONS: CALL OR PUT

A Call option allows the investor to buy an asset at the strike price. If at the expiration the value of the asset exceeds that of the strike price, then the investor buys the option at the strike price. A Put option allows the asset to be sold at a strike price. If the price of the asset is less than the strike price, the owner of the Put option will sell the stock at the strike price. In both the cases the buyer pays a price for the right. Profit is determined by the difference between the gross profit and the price of the call/put initially paid. Gross profit is the difference between the value of the asset and the strike price.

Gross Profit = Value of the Asset − Strike Price

Profit = Gross Profit − Price of Call/Put

- A Call or Put option is said to be In-the–Money when the investor gains by exercising it
- A Call or Put option is said to be Out-of–Money when the investor will lose by exercising the option
- A Call 0r Put option is At-the Money when the investor neither gains nor loses upon exercising the option

The minimum value of an option is zero. The value of an option is zero when no economic benefit can be derived from it. The maximum value of an option is equal to the value of the underlying asset. Valuation methods of options depend on whether the options are marketable or non-marketable.

FACTORS AFFECTING OPTIONS

The price of an option is determined by the following factors:

The intrinsic value of an option is its minimum value. It is the value of the option that is independent of time. Time value is the value of the option beyond its intrinsic value. This value depends on the amount of time till the expiry of the option. An option will, as a general rule, lose 1/3rd of its value in the first half of its life and 2/3rd during the second half of its life. The time value of an option is directly dependent on the volatility of the stock in the market. The greater the volatility, the higher the time value and vice versa. The total value of an option is the sum of its intrinsic value and its time value.

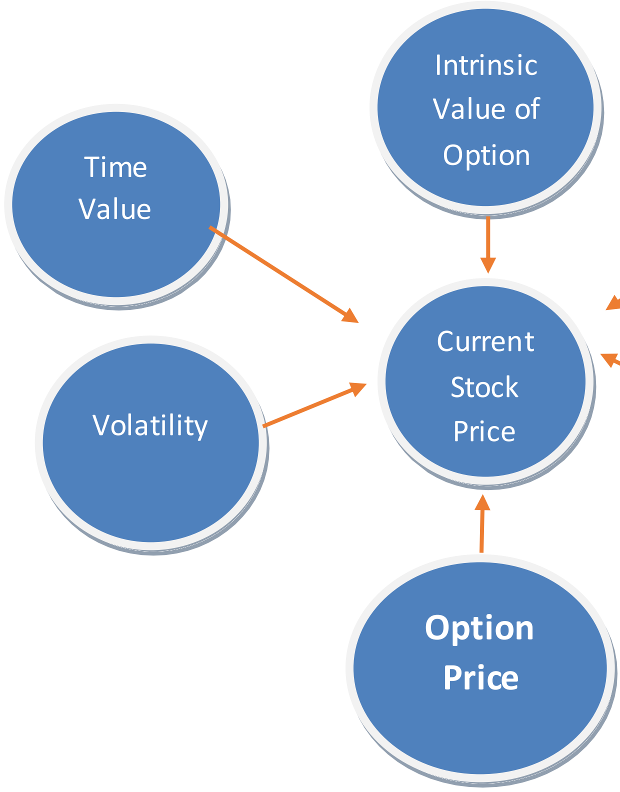
Types of Option Pricing

There are two types of option pricing most widely used:

A] European Option: In this, the option may be exercised only at the date/time of expiration

B] American Option: In this, the option may be exercised anytime between purchase and expiration date The American option allows more flexibility making the option more valuable. However, it is more difficult to value as compared to the European option. Indian market uses the European options.

Option pricing is a complex exercise that calls for sound grasp of trading and investment practices and scenarios, as well as, a constant observation of market fluctuations. It is attractive for investors as it lets them use options for leveraging and hedging thereby protect and profit from market volatility.



OPTION VALUATION MODELS

Option valuation methodologies are mathematical models that use certain parameters and work with certain assumptions to arrive at a theoretical fair value of an option.

Option Valuation models use a number of parameters such as the underlying value of the asset, the exercise price of the option, the expiry date of the option, and volatility to determine the fair value of the option. The fair value is not the same as the market value. It is an estimation of the value of the option. The most widely used option valuation models are Black-Scholes Merton Model, the Binomial Tree Model, and the Monte Carlo Simulation.

Black – Scholes Merton Model

Black-Scholes Merton Options Pricing Model is a mathematical model to derive European call option. Developed in 1973, the model was originally applied to non-dividend paying stocks. This model is applied only at expiration date so is not suitable for American option. Initially, Fischer Black and Myron Scholes formulated a partial differential equation known as the Black-Scholes equation. Later, Robert Merton used Stochastic calculus to arrive at a mathematical understanding of the Black- Scholes formula. Both Myron Scholes and Robert Merton received the Nobel Prize in Economics in 1997. Fischer Black was mentioned as a contributor.

The original Black-Scholes model did not factor in the effects of dividends paid during the span of the option. The model can be adapted to take into account dividends by taking the ex-dividend date value of the stock.

Black- Scholes Merton (BSM) model assumes that the price of heavily traded assets follows a geometric Brownian motion of constant drift and volatility. While calculating price options, the model makes certain assumptions

Assumptions on the Asset

- Risk-free rate of interest: the rate of interest is known and constant
- Stock returns are log-normally distributed: continuously compounded returns on the stock are normally distributed and independent over time
- The stock does not pay a dividend: Future dividends are known
- Volatility: the volatility of the continuously compounded return is known and constant over time
- Random walk: At any given moment, the price of the stock may move up or move down with equal probability. Market direction cannot be predicted

Assumptions on the Market

- There are no arbitrage opportunities
- The risk-free rate of interest is known and constant
- There are no transaction costs or taxes
- It is possible to short -sell with no cost and to borrow at risk-free rate
- The markets are efficient and frictionless

Black-Scholes Merton formula is based on the following parameters

- Current underlying price of the asset
- Strike price of the option
- Time until expiration
- Implied volatility
- Risk-free interest rates

The Black-Scholes Merton model can be depicted mathematically as follows:

$$\mathrm{C} = \mathrm{S}_t N(d_1) - K e^{-rt} N(d_2)$$

where:

$$\mathrm{d}_1 = \frac{ln \frac{S_t}{K} + (r + \frac{\sigma_v^2}{2})\ t}{\sigma_s\ \sqrt{t}}$$

and

$$\mathrm{d}_2 = d_1 - \sigma_s\ \sqrt{t}$$

Where:

- C is the call option price;
- S is the current stock (or other underlying) price;
- K is the strike price;
- r is the risk-free interest rate; and
- t is the time to maturity.
- N denotes a normal distribution

Despite its popularity and wide usage, Black-Scholes Merton model suffers from limitations that negatively impact its accuracy in the real world.

- It assumes that volatility and risk-free rate of return will remain constant
- It ignores liquidity risk and brokerage charges and assumes continuous and costless trading
- It ignores large price swings expecting stock prices to follow lognormal pattern or random walk
- Is unsuitable for American option as is applicable only at the expiration of the option
- It also assumes the absence of taxes, penalties on short-selling, arbitrage opportunities
- Large price changes, frequency of changes, the occurrence of the volatility smile, can lead to significant swings in option valuations.

Nevertheless, its limitations notwithstanding, the Black-Scholes Merton model has wide acceptance in financial markets for the following reasons:

- It is simple to use and provides readymade value
- It is very predictive and its extensive usage means that its assumptions come closer to reality
- It is particularly helpful in analysing the direction in which prices move
- It is the basis for more refined models
- It helps investors make their portfolios more efficient by allowing them to calculate hedge ratios.

Black-Scholes Merton model is a complex mathematical model. And, it is not applicable to American options and other exotic options. The Binomial Option pricing model developed in 1979, is a simpler construct that is applicable to American options that can be exercised at any time in a given span as well as to Bermudan options that are exercised at a particular point of time in a span.

Binomial Tree Option Pricing Model

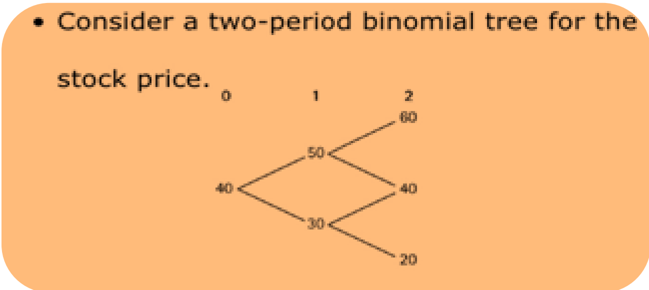
The Binomial Option Pricing model was developed by Cox, Ross, and Rubenstein as a relatively simple and easily implementable model. Binomial model is useful for longer-dated options on securities with dividend payments. The model uses iterative valuation represented in the form of a lattice or a tree for a number of time steps between valuation and expiration. Valuation is done by starting at the final time-step (at the time of expiration) and working backwards to the first time-step (at valuation).

The model uses a three- step calculation:

- First, create the binomial price tree
- Next, calculate the option price at the final time-step or node
- Then, calculate the option price at each preceding time-step or node

This gives the varying option price of the underlying financial instrument over a span of time.

The Binomial Tree is a graphic representation of the Binomial Option Pricing Model.



The Binomial Option Pricing model operates with certain assumptions

- There are only two possible prices for the underlying financial asset- up price and down price
- The asset pays no dividend
- The rate of interest remains constant during the life of the option
- There are no taxes and no transaction cost. The markets are frictionless
- Investors are risk neutral

The iterative nature of the Binomial Option Pricing Model allows it to generate a string of valuations for a derivative over a period of time. It is also more user friendly as compared to the Black-Scholes Merton Option Pricing Model and has a broader range of applications. The Binomial model however is not suitable for highly complex options or where there may be multiple sources of uncertainty. Since Binomial model uses discrete time units, sampling errors may occur.

Monte Carlo Simulation

Monte Carlo Simulation is another mathematical model that uses stochastic modelling to calculate the value of an option. Monte Carlo Simulation incorporates randomness into the modelling, making it a more appropriate method for complex valuations as compared to either Black-Scholes Merton or the Binomial Option Pricing models. It scores over other models by allowing for a wide range of possibilities. It allows for calculation of the value of an option with complicated features and multiple sources of uncertainty. Monte Carlo Simulation is flexible so risk assumptions can vary for all parameters.

Monte Carlo simulation was first used in 1977 for European options. In 1996, Monte Carlo Simulation began to be used for pricingAsian options. Monte Carlo Simulation for pricing American option was put in place by 2002. The Least Square Monte Carlo Approach is used to optimally exercise an American option.

To find the value of the option, first, a large number of potential future asset prices are generated between valuation and expiry. The average of discounted returns over all paths is calculated. The discount rate is the risk-free interest rate as the option is priced under risk-neutral measures. Ideally, simulation must run into infinity to find the perfect answer. That however, is impractical. So, variance reduction techniques are employed to reduce the number of simulations to generate an accurate option price.

Monte Carlo simulation uses a three- step process to arrive at a value of an option

1. Calculate the potential future prices of the underlying asset
2. Calculate the payoff of the option for each of the potential underlying price paths
3. Discount the payoffs to today and average them to determine the expected price.

The simulated asset paths can now be used to price the option by performing the following actions:

1. Average the asset price of each simulated path
2. Apply the formula
3. Average the payoffs of all the paths

Monte Carlo Simulation is particularly effective when dealing with exotic options. For e.g.

The formula for Asian option is

$$\text{Payoff}_{\text{CALL}} = \text{Max}(A - X, 0)$$

Where,
A= average value of the asset price over the life of the option
X= the strike price

Monte Carlo Simulation has increasingly been used in many areas of the financial sector. It is very flexible and can be extended and developed as required. It is especially effective in handling large complexities and randomness. However, Monte Carlo Simulation is data intensive and cannot produce results without a sizeable amount of empirical information. Finally, the results are only an approximation and the simulation may produce large variance.

Option Valuation models or option pricing models have brought in the element of scientific rigour to the stock market and the financial sector. The computation of these models and the ease of use has made them popular instruments in financial planning and hedging. The boom in derivatives trading is attributed in a good measure to the availability of these tools for predicting and estimating future values of assets. However, these complex mathematical models require a level of understanding and training that the ordinary investor lacks. Blind application of these models does not result in accurate predictions as they assume conditions that might not be present in the real market.

4. VALUATION OF OTHER FINANCIAL ASSETS AND LIABILITIES

INTANGIBLE ASSETS

Nature and Classification of Intangibles

- Intangible Assets are similar to Tangible Assets as they also play a pivotal role in the operations of a business entity. However, there is a difference between the two. The difference being, while tangible assets are physically present assets that can be employed in the production and business process, intangible assets are non-physical assets.
- Intangible assets are non-monetary assets without physical substance like other assets. Intangible assets can demonstrate special characteristics such as control and economic benefits.
- Intangible assets are usually classified as noncurrent (long-term) assets because positive repercussions of these assets are experienced over several years.
- These assets are extremely valuable and significant from a business perspective because they provide rights and privileges to their owners.
- Some examples of intangible assets are: trademarks, copyrights, patents, franchises, customer lists and goodwill.
- The key characteristics of intangible assets are explained as follows:

Identifiability	**-An intangible asset must be identifiable so as to distinguish it from goodwill.** **-This asset can be either separated / divided from entity, licensed, rented, or exchanged.**
Control	-An intangible asset must be controlled by the entity. -The asset must have the power to get future economic benefits under the operation of the entity and direct the flow to the entity.
Future Economic Benefits	-Entity must give future economic benefits to the intangible assets. -This can be in the form of cost savings, revenue from sales, etc.

Following are the types of Intangible Assets:

1. ***Goodwill:*** It is the type of intangible asset recognized when one business acquires another business. Goodwill equals the cost of purchase of the business by the purchasing company minus the value of net assets of the company being purchased. It reflects the business reputation of a company.
2. ***Franchise Agreements:*** They grant the legal right to a business to operate using the name of another company or sell a product/service developed by another company. The monetary gains thus earned classify franchise agreements as assets, intangible nonetheless.
3. ***Patents:*** They grant a business the exclusive right to manufacture, sell, or use a specific invention. This patent can either be purchased from another company or can be received for a new product invented by the company.
4. ***Copyrights:*** They grant an extensive right to the business to reproduce and sell a software, book, journal, magazine, etc. It secures legal protection by preventing other from reproducing or publishing the author's work.
5. ***Trademarks:*** They legally prevent others from using a business's name, logo or other branding items. It is a design, logo or symbol used for a particular product or business.

IDENTIFICATION OF NATURE OF INTANGIBLE ASSETS

- An intangible asset is an asset that lacks physical substance, unlike physical assets such as machinery and building. It is very difficult to evaluate such assets.
- As discussed previously, it includes patents, copyrights, franchises, trademarks and goodwill. The general interpretation of intangible assets also extends towards software and other intangible computer-based assets.
- Contrary to other assets, they generally suffer from typical market failures of non-rivalry and non-excludability. This, however, may not necessarily be the case all the time.
- Just like in tangible assets, intangible assets also have a useful life. This is basically an estimate of the average number of years an asset is considered usable before its value is fully depreciated.

PURPOSE OF INTANGIBLES VALUATION

- The Asset Value:
    1. An intangible asset is a non-physical asset with a useful life that extends beyond a single period. It includes patents, copyrights, trademarks, franchise agreements, customer lists, literary works, etc.
    2. Intangible assets are literally classified and defined as "assets". Therefore, it should appear in a company's balance sheet.
    3. The balance sheet is the aggregate of all of the company's assets, liabilities and shareholders' equity.
- Taxability:
    1. Section 32 of the Act explicitly includes, among others, know-how, patents and trademarks within the definition of intangible assets with deductible depreciation.

2. In September 2012, it was declared by the Supreme Court of India that "goodwill" would fall under the expression "any other business or commercial rights of a similar nature" under clause (b) of Explanation 3 of Section 32(i) of the Income Tax Act, 1961. Therefore, goodwill is considered to be tax deductible as well.
3. Intangible assets are grouped into a block of assets and can be amortized at a common fixed rate of 25% for tax purposes.

- Estate and Gift Tax:
  1. The total of all taxable gifts given during a person's lifetime is subjected to a unified estate and gift tax.
  2. This tax is also applicable on taxable amounts transferred upon a person's death.
- Licensing/Franchising:
  1. In a typical licensing agreement, the licensor grants the licensee the right to sell goods, apply a brand name or trademark, or use patented technology owned by the licensor.
  2. This is done in exchange for payments paid to the licensor by the licensee for the use of such rights.
  3. In a franchising agreement, the franchisor also offers know-how and access to a business system in addition to branding and products already offered by the franchisor to the franchisee.
- Corporate Insolvency Resolution:
  1. Valuation of assets is one of the core features of the corporate insolvency resolution process under the Insolvency and Bankruptcy Code, 2016.
  2. However, there are various clarifications that are yet to be provided by the Insolvency and Bankruptcy Board of India. These clarifications would be in relation to the provisions pertaining to the valuation of assets as provided under the Code and Regulations.
  3. One of the prominent controversies in relation to the valuation of assets is the lack of clarity surrounding the interpretation of the term 'liquidation value' under the Code.

VALUATION APPROACHES

- Excess Earnings Method: The process of valuing a firm based on the excess earnings method includes the estimation of the value of the company's net intangible assets. This value is then multiplied by a fair rate of return in order to calculate the earnings that could be attributed to the company's tangible assets.
- Relief-from-Royalty Method: Under this method, the value of the assets is considered to be the same as the value of the royalty payments from which the company is relieved due to ownership of the asset. Hence, one must determine the appropriate royalty rate, thereby allowing the estimation of the future royalty income stream.
- Premium Profits Method: In this method, one looks at the additional profits or cost savings availed by the owner of the right due to the mere ownership of the right, as opposed to the owner not possessing the right. When valuing trademarks, the value of a

branded product is typically looked at in a more favorable light than that of a non-branded product.

- Greenfield Method: This method is a modified form of the Discounted Cash Flows Analysis and an Acceptable method used to value intangible assets. By way of background, the Greenfield method assumes that the subject asset is the only asset owned by the entity as of the valuation date. Assumptions are made regarding the start-up costs and capital investment required to utilize the subject asset. The motive behind making these assumptions is to develop an operation comparable to the one in which the subject asset is actually utilized. Thus, the Greenfield method forecasts the cash flows that can be attributed to the subject asset by subtracting necessary investments. Keeping this context in mind, the Greenfield method is sometimes called the Build-Out method. The projected cash flows are then discounted back to the present value using a discount rate commensurate with the subject asset's risk.
- The DM takes into consideration market observations of both wholesalers and distributors, in order to obtain inputs during the valuation of customer relationships. The DM utilizes wholesale and distributor related companies, for whom the primary asset is not customer relationships. It is assumed that the relationships held by a distributor with its customers are similar to those held by a company whose primary asset is something other than customer relationships, like, brands, technology, capital assets, and so on. The distributor and the company that is being acquired (target company) have the same key driver, the ability to provide a desired product or service in a timely manner. As such, distributor inputs can be a reasonable proxy when valuing the relationships of the target company. To understand this better, let's consider two companies selling their products via a supermarket. One has a low value brand and earns a profit margin of 8%. The other has a dominant brand and earns a profit margin of 20%. This is where we understand the importance and valuation of customer relationships and brands. It is quite likely that the second product has a higher margin due to the strength of the brand.
- The three approaches employed in the valuation of assets or business include Income approach, Market approach and Cost approach. The focal point of this discussion is on the several Income approach methods used for the valuation of intangible assets and corresponding business enterprises. The discussion also revolves around the measurement of the discount rate that is applied within Income approach valuation methods.
- The rate of return is the gain or loss of an investment over a specified period of time, expressed as a percentage of the investment's cost. Gains on investment are defined as income received plus any capital gains realized on the sale of the investment. Rate of return can also be defined as the net amount of cash flows received over investment. The formula for rate of return is:
  [(Current Price - Original Price)/ Original Price] x 100
- The Income approach is a valuation method that provides an estimate of the fair value of an asset, based on the cash flows that an asset (or business) can be expected to generate over its remaining useful life.

5. SITUATION SPECIFIC VALUATION

DISTRESSED ASSET VALUATION

The valuation of a business entity is a difficult task as it is, but when the business is in distress, the valuation of such a business becomes even more difficult. There are a lot of complexities involved particularly in the valuation of distressed business assets. It is often necessary for the parties involved in the undertaking of a business to have a fair idea of the value of the business, irrespective of it being distressed. That is why; distressed asset valuation is an important step while trying to ascertain the value of the business, the distribution of the assets among the undertakers and the further course of action with the company's business.

Uncertainties associated with the value of such a distressed business can arise due to two types of reasons, referred below as strategic factors and structural factors.

Strategic Factors:

1. The strategic factors leading to valuation uncertainty arise because those holding senior claims have an incentive to undervalue the company's business, whereas junior claimants have an incentive to overvalue it.
2. For example, consider the reorganization of X Plc, under which its business would be transferred to Y Plc. The debt claims against X will be swapped with the equity claims in Y. Suppose that there are two types of debt claims against X- Junior and Senior. If the present value of the X's business is found to be higher than X's Senior liability, then both Junior and Senior would have valuable claims against it, which means both classes would have to be offered shares in Y. However, if the value is less than X's Senior liability, then Senior claimants would get the entirety of Y's equity, with Junior claimants being shut out altogether assuming that they have no economic interest in X. It follows that Senior claimants have an incentive to argue for a lower business value, so as to maximize their share of Y's equity. Similarly, if some of X's managers stand to gain a share due to the proposed reorganization of X by Y, they too have analogous incentive to underestimate the business value. Junior claimants could vouch for a higher business value, since this would help them obtain a larger proportion of Y's equity.

Structural Factors:

1. The structural factor of causing valuation uncertainty comes from the fact that exposing the company's business to the market might result in undervaluation if the market is depressed because:
    a) Potential buyers are not looking to expand
    b) There are other similar businesses in the market
    c) It is difficult to assemble a large and well-resourced group of investors
    d) The reputation might be at stake

2. Since the market price of the business does not reflect its true value, there is uncertainty surrounding the true value of the business. This holds a fortiori, where it is considered futile to expose the business to the market.
3. One the company becomes distressed, fewer analysts follow the company's stock than before, considering that there will be more regulations and fewer market interest to capitalize on that data of shares. Thus, the superior estimates of the company are no longer available, leading to uncertainty.

START-UP ENTITIES VALUATION

- Business valuation is never easy for any venture. However, when you are a start-up, it becomes particularly difficult to get a business valuation done, with little-or-no revenue or profits and less-than-certain futures.
- For mature, publicly listed businesses who have a steady revenue and earnings, it's a matter of valuing them as a multiple of their earnings before interests, taxes, depreciation,212and amortization (EBITDA) or based on any other multiples specific to various industries.
- However, it is very difficult to value start-up ventures that are not publicly listed and do not make steady sales or earnings.
- If you are planning to invest into a start-up company or are trying to raise the capital worth of your start-up, it is necessary to ascertain the business value of your venture.
- Below are three approaches mentioned towards the valuation of start-up entities:

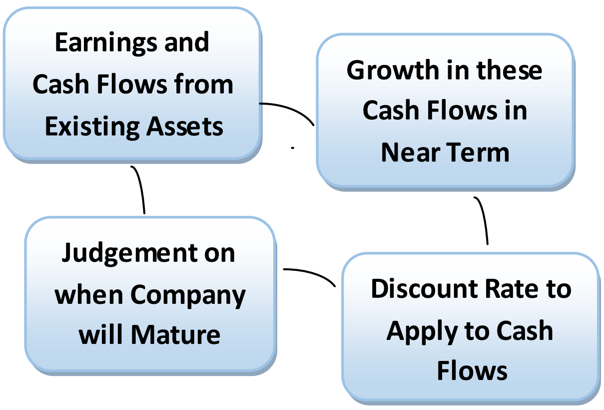
1.Going Concern Value
-This value focuses on the overall earning potential of business entities. -This value makes the assumption that business is a perpetual entity which is different from its promoters and will not be affected by any such external events.
2.Liquidation Value
-It represents the amount received on selling off all the assets as well as settling liabilities. -Intangible assets like goodwill, brand value, and so on, are certain important assets that need to be calculated appropriately in such method. -It enables to set a benchmark below which the business should not be valued, as the same would not yield any gain for the shareholders.
3.Market Value
-It relates to the companies listed at the stock market. It represents the price at which the company is trading at a recognized stock exchange. -For this method, it needs to be considered that the price of the security trading on the stock exchange is more a representation of the market sentiment instead of the actual state of business. This price cannot provide a complete picture of the fundamentals and potential of the security / stock.

VALUATION OF SMALL AND MEDIUM ENTERPRISES

- The demand for business valuation can be divided mainly into two primary parts:
    1. Requirements for statutory rules
    2. Contractual agreements
- The other reasons for business valuation depend on the needs of the proprietor.
- Valuations for contractual reasons take place particularly when partners join or leave the partnership, with regards to the addressing the inheritance disputes and settlements, as well as settlements made in accordance with the family law.
- Business valuations can also be made for entrepreneurial reasons. For example, such valuations form the basis of entrepreneurship initiatives such as the sale or purchase of businesses, mergers, additions to equity or third-party capital, contributors of non-monetary assets (which includes the transfer of the entire net assets of businesses), initial public offerings, management buy-outs or anything associated with the values of management and its concepts.
- Commercial and tax law valuation questions are also some of the factors fuelling the conduction of business valuations.
- When calculating the business value of small and medium scale enterprises, particular attention should be paid to what specifically makes up the business that is being valued, what does this value comprise of, determination of management remuneration as a part of management valuation, and, the reliability of the sources of information.

VALUATION OF CYCLICAL FIRMS

- The discounting cash flow of a company rests on four inputs:



- Keeping this framework in mind, we will develop two ways of adapting discounted cash flow valuations for cyclical and commodity companies:

A] First Approach:

-Normalize your estimates for all of the four inputs.

-It can be done utilising normalised cash flows, growth rates as well as discount rates, giving us an estimate of normalised value of the company.

B] Second Approach:

-Adjust the growth rate in cash flows so as to reflect your status in the overall cycle.

-As an example, you can set it to low value or perhaps negative values around the peak of the cycle, thereby reflecting an expectation about decline of earnings in future, and you can even set it to high values at the bottom of the cycle.

VALUATION OF INVESTMENT ENTITIES

- An investment entity is an entity that obtains funds from investors for the purpose of providing those investors with investment management services, facilitating returns from capital appreciation and investment income.
- It also measures and evaluates the performance of substantially all of its investments on a fair value basis.
- Within the common valuation lexicon for investment entities, there are three approaches to the valuation of business, as explained below:

The Asset Approach	The Income Approach	The Market Approach
• The methodologies under this bracket involve the market valuation of the subject company's assets net of its liabilities. • For an RIA, the primary assets of the company get on the elevator and go home every night. • It may be useful, in some contexts, to evaluate the worth of a company's trade name, assembled workforce, customer list, or other intangible assets. • The balance sheet can help in ascertaining the presence of non-operating assets and liabilities or excessive levels of working capital. • However, the value of any professional services firm, including asset managers, is usually better evaluated via the income and market approaches	• The methodologies under this bracket are usually the discounted cash flow method or the single period capitalization method. • The discounted cash flow (or DCF) method involves projecting the expected profitability of a company over some term and then pricing that profitability using an expected rate of return, also known as the discount rate. • The single period capitalization method involves estimating an ongoing level of profitability which is then capitalized using an appropriate multiple that is based on the subject company's risk profile and growth prospects. • This approach requires a thorough analysis of the risks and opportunities involved. • For the valuation of asset managers, this approach is useful to delineate issues unique to the industry and the specific economy.	• The methodologies under this bracket involve looking at the valuation multiples implied by the outright sale of similar businesses, or, observing the trading activity in shares of publicly held companies. • This approach is the most compelling out of all the three approaches to valuation due to the high availability of pricing data. • Although the most useful for valuation of asset managers, this approach is also the most misused one. • It is possible to find transactions involving investment entities or publicly traded trust banks and RIAs that are similar to a given RIA, but what requires greater attention is the need to identify and isolate what is different about the subject company that can affect its value.

VALUATION FOR INSURANCE COVERAGE

- There is a provision in certain insurance policies that specifies the amount of money the policy holder will receive from the insurer in the wake of an insured event occurring. Insurance coverage valuation stipulates a fixed amount of money that the owner will receive for the insured property in the event of a loss.
- Several types of valuation clauses can be written, including replacement cost, actual cash value, stated amount and agreed value.
- An insurance policy's valuation clause is important because it determines the total money amount that will be paid in the event of a loss.
- Due to the existence of various types of insurance valuation clauses, it is advisable for policyholders to review the insurance policy details in order to determine whether the adequate coverage is in place.
- Following are the different types of valuation clauses, or the basis of such clauses:
    1. Replacement Cost: The cost to repair or replace property using the same level of quality as in the original property.
    2. Actual Cash Value: The cost of repairing or replacing the property, minus any depreciation.
    3. Stated Amount: The maximum value of an insured item.
    4. Agreed Value: A fair market value to which the insurer and the insured agreed.

REGULATIONS RELEVANT TO FINANCIAL ASSETS VALUATION | 09

1. The Securities and Exchange Board of India Regulations
2. RBI and FEMA Regulations

REGULATIONS RELEVANT TO FINANCIAL ASSETS VALUATION I 09

1. THE SECURITIES AND EXCHANGE BOARD OF INDIA REGULATIONS

THE SEBI (ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2018– CHAPTER V AND SCHEDULE XX

On 11 September 2018, the Securities and Exchange Board of India (SEBI) notified the SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 ("ICDR Regulations"). The ICDR Regulation 2018 shall supersede the earlier ICDR Regulation 2009.

The amended ICDR Regulations aims at simplifying the language and structure of the regulation. Under the amended regulation the erstwhile chapter has been restructured. Two of the chapters covered here are:

Chapter Name	ICDR Regulations, 2018	ICDR Regulations, 2009
Conditions and manner of providing an exit opportunity to dissenting shareholders	Schedule XX	Chapter VI-A
Preferential issue	Chapter V	Chapter VII

Applicability of the regulations

These regulations apply to the following:

- A public issue;
- A rights issue, where the total value of specified securities offered is fifty lakh rupees or more;
- A preferential issue;
- An issue of bonus shares;
- A qualified institutions placement;
- An issue of Indian Depository Receipts

Chapter V: Preferential Issue

A preferential issue is issuance of equity shares or convertible securities under Section 62(1)(c) of the Companies Act, 2013. Company's consider preferential issues as it is one of the faster ways to raise equity capital. In order to raise capital through the preferential issue a company must comply with the Companies Act and the requirements laid down in Chapter V of the SEBI (ICDR) regulations which inter-alia include pricing, disclosures in notice etc.

Conditions for preferential issue – A listed issuer making a preferential issue shall ensure that:

a) Only fully paid equity shares can be allotted by way of preferential issue
b) A special resolution passed by shareholders;
c) all equity shares held by the proposed allottees in the issuer are in dematerialised form;
d) the issuer is in compliance with the conditions for continuous listing of equity shares as specified in the listing agreement
e) the issuer has obtained the Permanent Account Numbers of the proposed allottees

Relevant date:

Thirty days prior to the date of shareholders meeting is considered date for the proposed preferential issue.

Tenure of convertible securities:

In the case of convertible securities, the tenure of the security cannot exceed eighteen months from the date of allotment.

Schedule XX: Conditions and manner of providing exit opportunity to dissenting shareholders

The provisions of this schedule will apply to an exit offer made by the promoters or shareholders in control of an issuer to the dissenting shareholders.

"**Dissenting shareholders**" are those shareholders who have voted against the resolution for change in objects or variation in terms of a contract relating to objects, referred to in the offer document of the issuer.

The schedule provides provisions related to the conditions for an exit offer, pricing of the offer, manner of providing an exit, etc.

Conditions for exit offer

- At least 10% of shareholder dissent the proposal for a change in objects or variation; and
- Less than 75% of the amount raised will be utilized for objects other than mentioned in the offer document.

Exit price

The 'exit price' is the price that is payable to the dissenting shareholders. The regulation provides various mechanism in which the exit price should be determined.

Manner of providing exit to dissenting shareholders

(1) The notice proposing the change of the objects of the issue shall contain information about the provision for an exit offer to the dissenting shareholders.

(2) Promoter/shareholders shall provide explanatory statement that an exit opportunity will be to the dissenting shareholders.

(3) After passing of the special resolution for change of the objects of issue, the issuer shall submit the voting results to the stock exchange(s).

(4) The issuer shall also submit the list of dissenting shareholders, as certified by its compliance officer, to the stock exchange(s).

(5) The promoter /shareholders shall appoint a merchant banker and finalize the exit offer price in accordance with these regulations.

(6) The issuer shall intimate the stock exchange(s) about the exit offer to dissenting shareholders and the price at which such offer is being given.

(7) The stock exchange(s) shall disseminate the information to the public.

(8) The promoter or shareholders shall create an escrow account and deposit the aggregate consideration in the escrow account at least two working days prior to opening of the tendering period.

(9) The tendering period shall start not later than seven working days from the passing of the special resolution and shall remain open for ten working days.

(10) The dissenting shareholders who have tendered their shares in acceptance of the exit offer shall have the option to withdraw such acceptance till the date of closure of the tendering period

(11) The promoter /shareholders shall facilitate tendering of shares by the shareholders and settlement of the same through the stock exchange.

(12) The promoter /shareholders within a period of ten working days from the last date of the tendering period, make payment of the consideration to the dissenting shareholders who have accepted the exit offer.

(13) Within a period of two working days from the payment of the consideration, the issuer shall furnish to the stock exchange(s), disclosures giving details of aggregate number of shares tendered, accepted, payment of the consideration and the post-offer shareholding pattern of the issuer and a report by the lead manager(s) that the payment has been duly made to all the dissenting shareholders whose shares have been accepted in the exit offer.

Resources: Securities And Exchange Board Of India (Issue Of Capital And Disclosure Requirements) Regulations, 2018

THE SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 2015

The new Regulations, 2015 lays down stricter legal and enforcement provisions for prevention of Insider Trading. The penalties imposed for non-compliance of these Regulations are huge.

These provisions apply in respect of companies or securities listed or proposed to be listed on any stock exchange. Covered below are some of the critical provisions of under this Regulation:

Restrictions on communication and trading by insiders

- No insider shall communicate, provide, or allow access to any unpublished price sensitive information to any person.
- No person shall procure from or cause the communication by any insider of unpublished price sensitive information.
- No insider shall trade in securities that are listed or proposed to be listed on a stock exchange when in possession of unpublished price sensitive information
- If an insider intends to trade in securities, then he/she can formulate a trading plan and present it to the compliance officer for approval and public disclosure pursuant to which trades may be carried out. The compliance officer shall review the trading plan to assess whether the plan would have any potential for violation of regulations. The trading plan once approved shall be notified to the stock exchange and be irrevocable and will have to be mandatorily implemented by the insider without any deviation from the plan.

Disclosures of trading by insiders

- Every person on being appointed as key managerial personnel (KMP) of the company shall disclose his holding of securities of the company as on the date of appointment within 7 days of appointment.
- Every company shall notify the particulars of the incremental transaction by the KMP when the transactions effected after the prior disclosure cross the specified thresholds

Codes of fair disclosure and conduct

- Companies shall formulate the code of conduct for fair disclosure of unpublished price sensitive information. This shall cover the following aspects:

    - Prompt public disclosure of unpublished price sensitive information that would impact price discovery no sooner than credible and concrete information comes into being
    - Uniform and universal dissemination of unpublished price sensitive to avoid selective disclosure
    - Appropriate and fair response to queries on news reports and requests for verification of market rumours by regulatory authorities

- Companies shall formulate the code of conduct to regulate, monitor and report trading by insiders. This should cover a minimum of the following:

    - the compliance officer shall report to the board of directors, Chairman of the Audit Committee, or to the Chairman of the board of directors at a stipulated frequency.

    - All information shall be handled within the organisation on a need-to-know basis.

    - The compliance officer shall make use of a notional trading window as an instrument which can be used to ensure compliance of the regulation. The trading window shall be closed during the time of unpublished information. During the closed training window period the employees/directors are not allowed to trade in the company's securities. Some instance when the training window is closed are:

        - Declaration of (quarterly, half-yearly and annual) Financial results
        - Declaration of (interim and final) dividends
        - Issue of public/ rights/bonus shares
        - Plans for expansion or execution of new projects

    - The trading window shall be opened only after 24 hours of dissemination of the price-sensitive information to the public.

    - When the trading window is open, trading by designated persons shall be subject to preclearance by the compliance officer, if the value of the proposed trades is above thresholds stipulated by the board of directors may stipulate.

Few examples of insider trading:

An executive of Company PQR who buys shares of the company based on a pending demerger announcement is engaging in illegal insider trading.

However, once the Company has announced the demerger publicly, insiders such as executives, employees and others may legally trade in the shares of the company.

Resources: The SEBI (Prohibition of Insider Trading) Regulations, 2015

THE SEBI (SUBSTANTIAL ACQUISITION OF SHARES AND TAKEOVERS) REGULATIONS, 2011

These regulations regulate the direct and indirect acquisition of shares or voting rights in, or control over a target company (Public listed company). The purpose of these regulations is to protect the interest of all stakeholders of the target company.

Critical Provisions of this Regulation

- The acquisition can be made by acquiring along with person acting in concert
- If the acquisition of share, along with existing holding enables the holder to exercise 25% voting right then, the acquisition cannot be done unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company.
- An acquired who holds a voting right of more than 25%, but less than 75% can acquire up to 5% of voting rights in a financial year without making a public announcement
- Irrespective of acquisition or holding of shares or voting rights in a target company, no acquirer shall acquire, directly or indirectly, control over such target company unless the acquirer makes a public announcement of an open offer for acquiring shares of such target company.
- In the event, the acquirer intends to delist the company post-acquisition the same should be declared in the public announcement
- An acquirer, who have made a public announcement to acquire shares of a target company shall not be entitled to acquire any shares of the target company for a period of six months after completion of the open offer except pursuant to another voluntary open offer.
- The open offer size shall be of at least 26% of the total shares of the target company
- The regulation provides various methods for determination of open offer pricing for direct and indirect acquisition

Transactions Exempted from making an Open Offer

- Transfer of shareholding and voting power between:
    - immediate relatives,
    - promoters named in the shareholding pattern in less than 3 years prior to the proposed acquisition,
    - a company, its subsidiaries, its holding company, other subsidiaries of such holding company, persons holding not less than fifty per cent of the equity shares of such company
    - persons acting in concert for not less than three years prior to the proposed acquisition.

- Acquisition in the ordinary course of business by:
    - an underwriter registered with the Board by way of allotment pursuant to an underwriting agreement
    - a stock broker registered with the Board on behalf of his client in exercise of lien over the shares purchased on behalf of the client

- Acquisitions at subsequent stages, by an acquirer who has made a full disclosure in public announcement of an open offer for acquiring shares in subsequent stages

- Acquisition pursuant to any scheme such as:
    - Sick Industrial Companies (Special Provisions) Act, 1985

  - reconstruction of the target company, including amalgamation, merger or demerger, pursuant to an order of a court or a competent authority under any law or regulation
- Acquisition pursuant to the provisions of the SARFAESI Act, 2002
- Acquisition pursuant to the provisions of the SEBI (Delisting of Equity Shares) Regulations, 2009;
- Acquisition by way of transmission, succession or inheritance

Reference: Securities and Exchange Board Of India (Substantial Acquisition Of Shares And Takeovers) Regulations, 2011

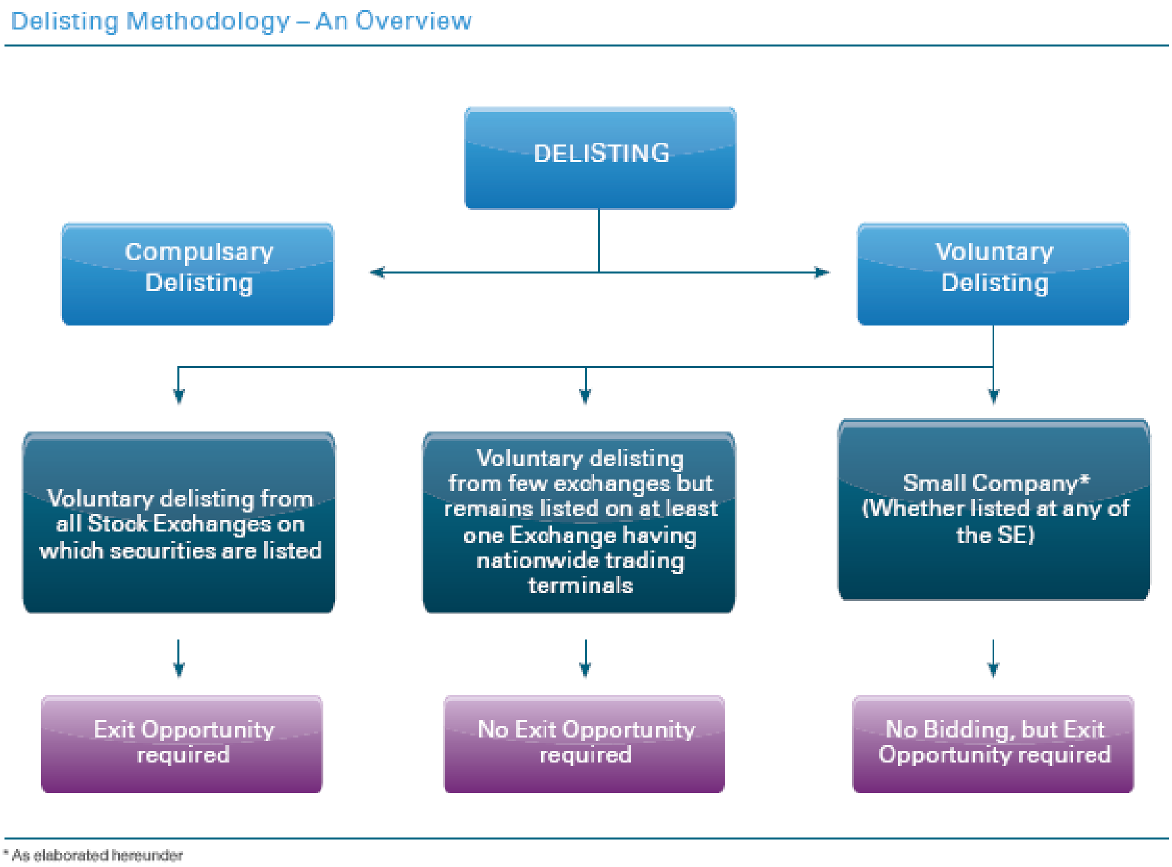
THE SEBI (DELISTING OF EQUITY SHARES) REGULATIONS, 2009

Delisting of securities means the removal of listed securities from the stock exchange consequent to which the securities can no longer be traded on that stock exchange.

Companies decide to delist their securities for several reasons such as:
- Gain complete control of the company
- Lack of training of the company's stock
- Reduce the compliance and cost associated with being listed
- Corporate restructuring
- Insufficient fundraising from the stock market

The regulation surrounding delisting of securities has undergone many changes to ease regulatory compliances and to protect investors.

Overview of the delisting options



Compulsory Delisting

SEBI may compulsorily delist securities of a company as a punitive measure for companies who are non-compliant of various regulations such as:

- Non-compliance with the requirements of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015,
- non-redressal of investor complaints
- unfair trading practices and
- other malpractices as are prescribed.

In accordance with the SEBI circular dated 7 September 2016, the directors and promoters of such compulsorily delisted companies will have the following restrictions:

- Accessing the securities market, directly or indirectly, for a period of 10 years
- Cannot become directors of any other listed company
- All equity shared held will be frozen until an exit option is provided to public shareholders.
- Dissemination Board of the Exchange will take over the company for a period of 5 years

Voluntary Delisting of Securities

a. Where an Exit Opportunity is Required

Voluntary Delisting means removal of securities from all stock exchanges. The need for an exit opportunity arises only in case the securities are to be delisted from all the stock exchanges. This would require the company to perform many processes such as:

- Seek approvals from Shareholders, Board of Directors, and concerned Stock Exchange.
- Appointment of a Merchant Banker
- Determination of the Floor price and Final Price,
- Making Public Announcements,
- Fixing the Bid Opening and Closing Date
- Acceptance of Exit Price by the Acquirer

The offer to accept shares from public shareholders will remain open for a period of one year.

b. Where No Exit Opportunity is Required

In a situation where the company continues to be listed on at least one exchange, it shall not be required to give an exit opportunity to shareholders. In such a case the regulation provides a more straightforward process as compared to the once where exit opportunity is required.
Under such a delisting the company's' board is required to pass necessary resolutions, issue a public notice, making an application for delisting from the exchange and disclose the event in its annual report.

Special Provisions for Small Companies

A Small Company is defined as:

- A Company having a paid-up capital not exceeding Rs. 10 Crore;
- Net Worth not exceeding INR 25 crores as on the last date of preceding financial year;
- Less than 10% of the company’s shares were traded during the last 12 calendar months; and
- The trading of the company's shares has not been suspended due to non-compliance in the last one year.

In case of the delisting related to ‘Small Companies’ the regulation provides with a shorter process of:

- Obtaining approval of the Board of Directors and
- Passing of a special resolution by a majority vote from public shareholder through postal ballot.

Reference: The SEBI (Delisting of Equity Shares) Regulations, 2009

THE SEBI (SHARE-BASED EMPLOYEE BENEFITS) REGULATION, 2014: EMPLOYEE STOCK OPTION SCHEMES, EMPLOYEE STOCK PURCHASE SCHEMES AND STOCK APPRECIATION RIGHTS SCHEMES

The Securities and Exchange Board of India (SEBI) has notified the SEBI (Share-Based Employee Benefits) Regulations, 2014 (New ESOP Regulations) have been implemented for the following objectives:

- Provide guidelines for ESOP schemes to be introduced by companies
- Regulate the ESOP schemes by way of necessary committees
- Facilitate smooth operation of such schemes
- prevent any possible manipulation.

The provisions of these regulations shall apply to the following:

i. **Employee Stock Option Schemes(ESOS)** – a scheme under which a company grants employee stock option directly or through a trust.

ii. **Employee Stock Purchase Schemes (ESPS)** -a scheme under which a company offers shares to employees, as part of the public issue or otherwise, or through a trust where the trust may undertake secondary acquisition for the purposes of the scheme.

iii. **Stock Appreciation Rights (SAR) schemes** - right given to an employee entitling him to receive appreciation for a specified number of shares of the company where the settlement of such appreciation may be made by way of cash payment or shares of the company.

iv. **General Employee Benefits Schemes (GEBS)** -any scheme of a company framed in accordance with these regulations, dealing in shares of the company or the shares of its listed holding company, for the purpose of employee welfare including healthcare benefits, hospital care or benefits, or benefits in the event of sickness, accident, disability, death or scholarship funds, or such other benefit as specified by such company.

v. **Retirement Benefit Schemes (RBS)** - a scheme of a company, framed in accordance with these regulations, dealing in shares of the company or the shares of its listed holding company, for providing retirement benefits to the employees subject to compliance with existing rules and regulations as applicable under laws relevant to retirement benefits in India.

The provisions of these regulations shall apply to any company whose shares are listed on a recognised stock exchange in India,and has a scheme:

- for direct or indirect benefit of employees; and
- involving dealing in or subscribing to or purchasing securities of the company, directly or indirectly; and

- satisfying, directly or indirectly, any one of the following conditions:
    a. the scheme is set up by the company or any other company in its group;
    b. the scheme is funded or guaranteed by the company or any other company in its group;
    c. the scheme is controlled or managed by the company or any other company in its group.

Implementation of schemes through a Trust

<u>Formation:</u>

- A company may implement schemes either directly or by setting up an irrevocable trust
- If the scheme is to be implemented through a trust the same has to be decided upfront at the time of taking approval of the shareholders for setting up the schemes
- If the scheme involves secondary acquisition or gift or both, then it is mandatory for the company to implement such scheme(s) through a trust(s).
- A company may implement several schemes as permitted under these regulations through a single trust
- SEBI may specify the minimum provisions to be included in the trust deed
- The trust deed and any modifications thereto shall be mandatorily filed with the stock exchange where the shares of the company are listed.

<u>Constitution:</u>

Following persons can be appointed as trustee of the trust:

- A director, key managerial personnel or promoter of the company or its holding, subsidiary or associate company or any relative of such director, key managerial personnel or promoter
- A person who beneficially holds ten per cent or more of the paid-up share capital of the company.

If individuals or one-person company are appointed as trustees, there shall be a minimum of two such trustees, and in case a corporate entity is appointed as a trustee, then it may be the sole trustee.

<u>Functioning:</u>

- The trustee should ensure that appropriate approval from the shareholders has been obtained by the company in order to enable the trust to implement the scheme(s) and undertake secondary acquisition for the purposes of the scheme(s).
- The trust shall not deal in derivatives and shall undertake only delivery-based transactions.
- The company may lend monies to the trust on appropriate terms and conditions to acquire the shares either through a new issue or secondary acquisition, for the purposes of implementation of the scheme(s).
- Secondary acquisition of shares in a financial year shall not exceed two per cent of the paid-up equity capital as at the end of the previous financial year.
- The total number of shares under secondary acquisition held by the trust shall at no time exceed the below limits as a percentage of the paid-up equity capital as at the end of the

financial year immediately prior to the year in which the shareholder approval is obtained for such secondary acquisition:
For ESOS, ESPS, SARS <= 5%
For GEBS, RBS <= 2%
For all the Schemes in aggregate <=5%

- The trust shall be required to hold the shares acquired through secondary acquisition for a minimum period of six months
- The trust shall not sell the shares in the secondary market except under prescribed circumstances

Reference: Securities and Exchange Board Of India (Share-Based Employee Benefits) Regulations, 2014

2. RBI AND FEMA REGULATIONS

FEMA (TRANSFER OR ISSUE OF SECURITY BY A PERSON RESIDENT OUTSIDE INDIA), REGULATIONS, 2017

This regulation came into effect in November 2017, and it prescribes the procedure, limits, compliances, penalty, etc. in respect investment made by a person resident outside India in either of the following manners:

- **Foreign Direct Investment (FDI)** - investment through capital instruments in an unlisted Indian company; or in 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed Indian company;
  Fully diluted basis means the total number of shares that would be outstanding if all possible sources of conversion are exercised
- **Foreign Portfolio Investment(FPI)** - any investment made through capital instruments where such investment is less than 10 per cent of the post-issue paid-up share capital on a fully diluted basis of a listed Indian company or less than 10 per cent of the paid-up value of each series of capital instruments of a listed Indian company;

It is worth to note the difference between FDI and FPI
If the investment made by a person resident outside India in a listed Indian Company is:

a) less than 10 per cent of the post-issue paid-up share capital on a fully diluted basis or
b) less than 10 per cent of the paid-up value of each series of capital instruments
then the investment is considered as FPI

Whereas, if the above investment is above the 10% limit or exceeds the 10% limit then the investment will be treated as FDI.

Permission for making an investment by a person resident outside India

Any investment made by a person resident outside India shall be subject to the following conditions as laid down in the regulation:

Entry routes – There are 3 routes by which investments can be made in Indian companies by a person resident outside India:

- **Automatic Route** - entry route which does not require the prior Reserve Bank approval or Government approval.

- **Government Route** - entry route which requires prior Government approval. Foreign investment received under this route shall be in accordance with the conditions stipulated by the Government in its approval.

- **Aggregate Foreign Portfolio Investment** up to 49 per cent of the paid-up capital on a fully diluted basis or the sectoral/ statutory cap, whichever is lower, will not require Government approval or compliance of sectoral conditions.

Sectoral caps/investment limits– The total foreign investment in the specified sectors shall not exceed the sectoral/ statutory cap as prescribed in the regulation.

A person resident outside India may make an investment as under:

1. Subscribe, purchase or sell capital instruments of an Indian company in the manner and subject to the terms and conditions specified in Schedule 1.
2. A Foreign Portfolio Investor (FPI) may purchase or sell capital instruments of a listed Indian company on a recognised stock exchange in India in the manner and subject to the terms and conditions specified in Schedule 2.
3. A Non- Resident Indian or an Overseas Citizen of India may on repatriation basis purchase or sell capital instruments of a listed Indian company on a recognised stock exchange in India, in the manner and subject to the terms and conditions specified in Schedule 3.
4. A Non- Resident Indian or an Overseas Citizen of India may, on non-repatriation basis, purchase or sell capital instruments of an Indian company or purchase or sell units or contribute to the capital of a LLP or a firm or proprietary concern, in the manner and subject to the terms and conditions specified in Schedule 4.
5. A person resident outside India, permitted for the purpose by the Reserve Bank in consultation with Central Government, may purchase or sell securities other than capital instruments in the manner and subject to the terms and conditions specified in Schedule 5.
6. A person resident outside India, other than a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan, may invest, either by way of capital contribution or by way of acquisition/ transfer of profit shares of an LLP, in the manner and subject to the terms and conditions as specified in Schedule 6.
7. A Foreign Venture Capital Investor may make an investment in the manner and subject to the

terms and conditions specified in Schedule 7.

8. A person resident outside India, other than a citizen of Bangladesh or Pakistan or an entity incorporated in Bangladesh or Pakistan, may invest in units of an Investment Vehicle, in the manner and subject to the terms and conditions specified in Schedule 8.
9. A person resident outside India may invest in the Depository Receipts (DRs) issued by foreign depositories against eligible securities in the manner and subject to the terms and conditions as specified in Schedule 9.
10. A Foreign Portfolio Investor or Non- Resident Indian or an Overseas Citizen of India may purchase, hold or sell Indian Depository Receipts (IDRs) of companies resident outside India and issued in the Indian capital market, in the manner and subject to the terms and conditions specified in Schedule 10.

Transfer of capital instruments of an Indian company by or to a person resident outside India

A person resident outside India holding capital instruments of an Indian company or units may transfer such capital instruments or units so held by him subject to the terms and conditions specified hereunder;

1. Transfer by way of sale or gift the capital instruments of an Indian company or units held by him to any person resident outside India
2. An NRI or an OCI holding capital instruments of an Indian company or units on repatriation basis may transfer the same by way of sale or gift to any person resident outside India;
3. Transfer of securities by way of sale/ gift or may sell the same on a recognised stock exchange in India in the manner prescribed by Securities and Exchange Board of India;
4. Transfer of securities to a person resident outside India by way of sale, subject to the adherence to entry routes, sectoral caps/ investment limits, pricing guidelines and other attendant conditions
5. Instruments or units held by an eligible investor as per Schedule 4 of these Regulations may transfer the same to a person resident outside India by way of gift with the prior approval of the Reserve Bank
6. An eligible investor under Schedule 4 of these Regulations may transfer the securities by way of gift another eligible investor under Schedule 4 of these Regulations who shall hold it on a non-repatriable basis;
7. Instruments containing an optionality clause may be exited without any assured return, subject to the pricing guidelines prescribed in these Regulations and a minimum lock-in period of one year or minimum lock-in period as prescribed in these Regulations, whichever is higher;
8. An erstwhile Overseas Corporate Body (OCB) may transfer capital instruments subject to directions issued by the Reserve Bank from time to time in this regard.
9. In case of transfer of capital instruments between a person resident in India and a person resident outside India, an amount not exceeding twenty-five per cent of the total

consideration can be paid by the buyer on a deferred basis within a period not exceeding eighteen months from the date of the transfer agreement; or

can be settled through an escrow arrangement between the buyer and the seller for a period not exceeding eighteen months from the date of the transfer agreement; or

can be indemnified by the seller for a period not exceeding eighteen months from the date of the payment of the full consideration, if the total consideration has been paid by the buyer to the seller.

Provided the total consideration finally paid for the shares shall be compliant with the applicable pricing guidelines.

10. In case of transfer of capital instruments between a person resident in India and a person resident outside India, a person resident outside India may open an Escrow account in accordance with the Foreign Exchange Management (Deposit) Regulations, 2016. Such Escrow account may be funded by way of inward remittance through banking channels and/ or by way of guarantee issued by an authorised dealer bank, subject to terms and conditions as specified in the Foreign Exchange Management (Guarantees) Regulations, 2000.
11. The pricing guidelines prescribed in these Regulations shall not be applicable for any transfer by way of sale done in accordance with Securities and Exchange Board of India regulations where the pricing is prescribed by Securities and Exchange Board of India.
12. The transfer of capital instruments of an Indian company or units of an Investment Vehicle by way of pledge is subject to the terms and conditions as laid down in the regulation.

Acquisition through a rights issue or a bonus issue.

A person resident outside India and having investment in an Indian company may make investment in capital instruments (other than share warrants) issued by such company as a rights issue or a bonus issue provided that:

(1) The offer is in compliance with the provisions of the Companies Act, 2013;
(2) Such issue shall not result in a breach of the sectoral cap applicable to the company;
(3) The shareholding on the basis of which the rights issue or the bonus issue has been made must have been acquired and held as per the provisions of these Regulations;
(4) In case of a listed Indian company, the rights issue to persons resident outside India shall be at a price determined by the company;
(5) In case of an unlisted Indian company, the rights issue to persons resident outside India shall not be at a price less than the price offered to persons resident in India.
(6) Such investment made through rights issue or bonus issue shall be subject to the conditions as are applicable at the time of such issue.
(7) The amount of consideration shall be paid as inward remittance from abroad through banking channels or out of funds held in NRE/ FCNR(B) account maintained in accordance

with the Foreign Exchange Management (Deposit) Regulations, 2016.

The above conditions shall also be applicable in case a person resident outside India makes investment in capital instruments (other than share warrants) issued by an Indian company as a rights issue that are renounced by the person to whom it was offered.

Issue of shares under Employees Stock Options Scheme to persons resident outside India.

An Indian company may issue “employees’ stock option” and/ or “sweat equity shares” to its employees/ directors or employees/ directors of its holding company or joint venture or wholly owned overseas subsidiary/ subsidiaries who are resident outside India, provided that:

(1) The scheme has been drawn either in terms of regulations issued under the SEBI Act, 1992 or the Companies (Share Capital and Debentures) Rules, 2014;
(2) The option/shares so issued under are in compliance with the sectoral cap applicable to the said company;
(3) Issue of option/shares shall requrie prior approval of the Government if:
    a. Company where investment by a person resident outside India is under the approval route
    b. Options/shares are issued to citizen of Bangladesh/ Pakistan

A person resident outside India exercising an option which were issued when he/she was a person resident in India shall hold the shares so acquired on a non-repatriation basis.

Merger or demerger or amalgamation of Indian companies.

In case of merger or amalgamation of, the transferee or new company, may issue capital instruments to the existing holders of the transferor company who are resident outside India. However such issue of capital instruments will be subject to the following conditions:

(a) The transfer or issue is in compliance with the entry routes, sectoral caps or investment limits. However, if the percentage is likely to breach the Sectoral caps or the attendant conditionalities, necessary approvals will have to be obtained from the Central Government.
(b) The transferor company or the transferee company or the new company shall not engage in any sector prohibited for investment by a person resident outside India; and

Where a Scheme of Arrangement for an Indian company has been approved by National Company Law Tribunal (NCLT)/ Competent Authority, the Indian company may issue non-convertible redeemable preference shares or non-convertible redeemable debentures out of its general reserves by way of distribution as bonus to the shareholders resident outside India, subject to the following conditions:

(a) the original investment made in the Indian company by a person resident outside India is in accordance with these Regulations and the conditions specified in the relevant Schedule;

(b) the said issue is in accordance with the provisions of the Companies Act, 2013 and the terms and conditions, if any, stipulated in the scheme approved by National Company Law Tribunal (NCLT)/ Competent Authority have been complied with;
(c) the Indian company shall not engage in any activity/ sector in which investment by a person resident outside India is prohibited.

Reference: Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017. Notification No. FEMA 20(R)/ 2017-RB dated November 07, 2017.

FOREIGN DIRECT INVESTMENT (PRICING GUIDELINES)

This section of the FEMA regulation governs the pricing in case of issuance of securities to a person resident outside India or in case of transfer of securities by a person resident outside India. The transaction involving securities of India companies undertaken by a person resident outside India must comply with the pricing guidelines as described below.

1. **Pricing for capital instruments issued by an Indian company to a person resident outside India shall not be less than:**
   a. **Listed company or company in the process of delisting** - Price as per the relevant SEBI guidelines
   b. **Unlisted company** - Valuation as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practising Cost Accountant.

2. **Pricing of capital instrument transferred from a person resident in India to a person resident outside India shall not be less than:**

   a. **Listed company** - Price as per the relevant SEBI guidelines
   b. the price at which a preferential allotment of shares can be made under the SEBI Guidelines
   c. **Unlisted company** - Valuation as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI registered Merchant Banker or a practising Cost Accountant.

3. **Pricing of capital instruments transferred by a person resident outside India to a person resident in India shall not exceed:**

   a. **Listed company** - Price as per the relevant SEBI guidelines
   b. the price at which a preferential allotment of shares can be made under the SEBI Guidelines
   c. **Unlisted company** - Valuation as per any internationally accepted pricing methodology for valuation on an arm's length basis duly certified by a Chartered Accountant or a SEBI

registered Merchant Banker or a practising Cost Accountant.

4. **Pricing in case of a swap of capital instruments**

   Subject to the condition that irrespective of the amount, valuation involved in the swap arrangement will have to be made by a Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country.

5. **Pricing where shares in an Indian company are issued to a person resident outside India**

   The company will have to comply with the provisions of the Companies Act, 2013, by way of subscription to Memorandum of Association, such investments shall be made at face value subject to entry route and sectoral caps.

6. **Pricing in case of share warrants**

   Their pricing and the price/ conversion formula shall be determined upfront.Provided these pricing guidelines shall not be applicable for investment in capital instruments by a person resident outside India on non-repatriation basis.

Reference: Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2017. Notification No. FEMA 20(R)/ 2017-RB dated November 07, 2017.

DIRECT INVESTMENT BY RESIDENTS IN JOINT VENTURE/ WHOLLY-OWNED SUBSIDIARY ABROAD

Overseas investments (or financial commitment) in Joint Ventures (JV) and Wholly Owned Subsidiaries (WOS) have been recognised as important avenues for promoting global business by Indian entrepreneurs.

In keeping with the spirit of liberalisation, which has become the hallmark of economic policy in general, and Foreign Exchange regulations in particular, the Reserve Bank has been progressively relaxing the rules and simplifying the procedures both for current account as well as capital account transactions.

The guidance for investment by residents in Joint Venture/ Wholly - Owned Subsidiary abroad has been provided by RBI through its Master Direction no. 15/2015-16 dated January 1, 2016. The Master Direction complies all the regulations and various amendment related to foreign investments.

Prohibitions – the RBI prohibits following investments (or financial commitments) by Indian Residents:

a. In foreign entity engaged in real estate or banking business, without the prior approval of the Reserve Bank.

b. An overseas entity offering financial products linked to Indian Rupee (e.g. non-deliverable trades involving foreign currency, rupee exchange rates, stock indices linked to an Indian market, etc.) without the specific approval of the Reserve Bank.

General Permission - General permission has been granted to person residents in India for purchase/acquisition of securities in the following manner:

a. out of the funds held in RFC account;
b. as bonus shares on an existing holding of foreign currency shares; and
c. when not permanently resident in India, out of their foreign currency resources outside India.

General permission is also available to sell the shares so purchased or acquired.

Automatic Route allows the Indian party to investment (or make a financial commitment) in a foreign entity which is an overseas Joint Ventures (JV) / Wholly Owned Subsidiaries (WOS) without any prior approval from the RBI. However, they are required to meet the conditions prescribed in the Master Direction. Some of the conditions are enumerated below:

1. The investment / financial commitment is within the ceiling prescribed by the Reserve Bank from time to time.

2. The Indian Party should approach an Authorised Dealer Category - I bank with an application in Form ODI (Master Document on Reporting) and prescribed enclosures/documents for effecting such remittances.

3. The total financial commitment of the Indian Party in all the Joint Ventures / Wholly Owned Subsidiaries shall comprise of the following:

   - 100% of the amount of equity shares and/ or Compulsorily Convertible Preference Shares (CCPS);
   - 100% of the amount of other preference shares;
   - 100% of the amount of loan;
   - 100% of the amount of guarantee (other than performance guarantee) issued by the Indian Party;
   - 100% of the amount of bank guarantee issued by a resident bank on behalf of JV or WOS
   - 50% of the amount of performance guarantee issued by the Indian Party

4. The investments / financial commitments are subject to the following conditions:

   a. The Indian Party/entity may extend loan/guarantee only to an overseas JV / WOS in which it has equity participation.

      - All the financial commitments, including all forms of guarantees and creation of charge, are within the overall ceiling prescribed for the Indian Party.
      - No guarantee should be 'open-ended,' i.e. the amount and period of the guarantee should be specified upfront.
      - In cases where invocation of the performance guarantee breaches the ceiling for the financial commitment, the Indian Party shall seek the prior approval of the Reserve Bank before remitting funds from India, on account of such invocation.
      - all guarantees are required to be reported to the Reserve Bank in Form ODI-Part II.

   b. The Indian Party should not be on the Reserve Bank's Exporters' caution list/list of defaulters to the banking system circulated by the Reserve Bank / Credit Information Bureau (India) Ltd.

   c. All transactions relating to a JV / WOS should be routed through one branch of an Authorised Dealer bank to be designated by the Indian Party.

   d. In case of partial / full acquisition of an existing foreign company, where the investment is more than USD 5 million, valuation of the shares of the company shall be made by a Category I Merchant Banker registered with SEBI or an Investment Banker / Merchant Banker outside India registered with the appropriate regulatory authority in the host country; and, in all other cases by a Chartered Accountant or a Certified Public Accountant.

   e. In cases of investment by way of swap of shares, irrespective of the amount, valuation of the shares will have to be made by a Category I Merchant Banker registered with SEBI or an Investment Banker outside India registered with the appropriate regulatory authority in the host country. Approval of the Foreign Investment Promotion Board (FIPB) will also be a prerequisite for investment by swap of shares.

   f. In case of investment in overseas JV / WOS abroad by a registered Partnership firm, where the entire funding for such investment is done by the firm, it will be in order for individual partners to hold shares for and on behalf of the firm in the overseas JV / WOS if the host country regulations or operational requirements warrant such holdings.

Reference: Direct Investment by Residents in Joint Venture/ Wholly - Owned Subsidiary abroadMaster Direction no. 15/2015-16 dated January 1, 2016.

PRUDENTIAL NORMS FOR CLASSIFICATION, VALUATION AND OPERATION OF INVESTMENT PORTFOLIO BY BANKS

The Reserve Bank of India has issued guidelines for the investment portfolio of the banks, keeping in view the developments in the financial markets and taking into consideration the evolving international practices. Below is an overview of the prudential norms for classification, valuation and operation of investment portfolio by banks as per the guidelines/circulars provided by RBI.

Investment Policy

- Banks should frame Internal Investment Policy Guidelines and obtain the Board's approval. The investment policy may be suitably framed/ amended to include Primary Dealer (PD) activities also. Within the overall framework of the investment policy, the PD business undertaken by the bank will be limited to dealing, underwriting and market–making in Government Securities. Investments in Corporate/PSU/FI bonds, Commercial Papers, Certificate of Deposits, debt mutual funds and other fixed income securities will not be deemed to be part of PD business. The investment policy guidelines should be implemented to ensure that operations in securities are conducted in accordance with sound and acceptable business practices. While framing the investment policy, the guidelines provided under the regulation Master circular must be adhered to.

- Banks should clearly lay down the broad investment objectives to be followed while undertaking transactions in securities on their own investment account and on behalf of clients, clearly define the authority to put through deals, procedure to be followed for obtaining the sanction of the appropriate authority, procedure to be followed while putting through deals, various prudential exposure limits and the reporting system. While laying down such investment policy guidelines, banks should obtain the approval of respective Boards and strictly observe Reserve Bank's detailed instructions on the following aspects:

  i. STRIPS
  ii. Ready Forward (buy back) deals in G-Sec
  iii. Transactions through Subsidiary General Ledger A/c
  iv. Use of Bank Receipts
  v. Retailing of Government Securities
  vi. Internal Control System
  vii. Dealings through Brokers
  viii. Audit, Review and Reporting

The aforesaid instructions will be applicable mutatis mutandis, to the subsidiaries and mutual funds established by banks, except where they are contrary to or inconsistent with specific regulations of Securities and Exchange Board of India (SEBI) and the Reserve Bank, governing their operations.

Non-SLR Investment

Apart from giving loans to individuals and businesses, RBI allowed banks to invest in various capital market instruments issued by public and private sector companies and commercial papers. Further, banks are also allowed to invest in various mutual fund schemes. Unlike SLR investments, there is no compulsion on banks to invest in these instruments. Investments are entirely guided by commercial considerations and many such investments are in accordance with the prescribed guidelines.

These Prudential guidelines on investment in Non-SLR securities cover banks' investments in non-SLR securities issued by corporates, banks,FIs and State and Central Government sponsored institutions, Special Purpose Vehicles (SPVs)etc., including capital gains bonds, bonds eligible for priority sector status. The guidelines willapply to investments both in the primary market as well as the secondary market.

Some of the guidelines on investment in Non-SLR are:

- Banks should not invest in Non-SLR securities of original maturity of less than one-year,other than Commercial Paper and Certificates of Deposits and NCDs with original or initialmaturity up to one year issued by corporates (including NBFCs), which are covered under RBIguidelines.
- Banks should undertake usual due diligence in respect of investments in non-SLRsecurities.
- RBI regulations preclude banks from extending credit facilities for certainpurposes. Banks should ensure that such activities are not financed by way of funds raisedthrough the non-SLR securities.
- Banks must not invest in unrated non-SLR securities. However, the banks may invest inunrated bonds of companies engaged in infrastructure activities, within the ceiling of 10 per centfor unlisted non-SLR securities
- While making investments in non-SLR debt securities, banks should ensure that such investments are made only in listed debt securities of companies which comply with the requirements of the SEBI.
- Banks should ensure that their investment policies, duly approved by the Board ofDirectors, are formulated after taking into account all the relevant issues specified in theseguidelines on investment in non-SLR securities.
- Boards of banks should review the following aspects of non-SLR investment at least at quarterly intervals:
    a) Total business (investment and divestment) during the reporting period.
    b) Compliance with the prudential limits prescribed by the Board for non-SLR investment.
    c) Compliance with the prudential guidelines issued by the Reserve Bank on non-SLRsecurities.
    d) Rating migration of the issuers/ issues held in the bank's books and consequentdiminution in the portfolio quality.
    e) Extent of non-performing investments in the non-SLR category.

Classification
The entire investment portfolio of the banks (including SLR securities and non-SLR securities) should be classified under three categories viz. Held to Maturity, Available for Sale and Held for Trading.

A. Held to Maturity

- The securities acquired by the banks with the intention to hold them up to maturity will be classified under 'Held to Maturity (HTM)'.
- Banks are allowed to include investments included under HTM category up to 25 per cent of their total investments. This limit can be exceeded provided conditions are met
- Profit on sale of investments in this category should be first taken to the Profit & Loss Account, and thereafter be appropriated to the 'Capital Reserve Account'.

B. Available for Sale & Held for Trading

- The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under 'Held for Trading (HFT)'.
- The securities which do not fall within the above two categories will be classified under 'Available for Sale (AFS)'.
- The banks will have the freedom to decide on the extent of holdings under HFT and AFS.
- The investments classified under HFT would be those from which the bank expects to make a gain by the movement in interest rates/market rates. These securities are to be sold within 90 days.
- Profit or loss on sale of investments in both the categories will be taken to the Profit & Loss Account.

Banks should decide the category of the investment at the time of acquisition, and the decision should be recorded on the investment proposals.

Valuation

A. Held to Maturity

- Investments classified under HTM need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.
- Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/ joint ventures. Such diminution should be determined and provided for each investment individually.

When the need to determine whether impairment has occurred arises in respect of a subsidiary, joint venture or a material investment, the bank should obtain a valuation of the investment by a reputed/qualified valuer and make provision for the impairment, if any.

B. Available for Sale

- The individual scrips in the Available for Sale category will be marked to market at quarterly or at more frequent intervals.
- Investments to be classified into five classifications (viz. Government securities (including local authorities), Shares, Debentures & Bonds, Subsidiaries and/or joint ventures abroad and Other investments (to be specified)).
- Investment in a particular classification, both in domestic and foreign securities, may be aggregated for the purpose of arriving at net depreciation/appreciation of investments under that category.

- Net depreciation, if any, shall be provided for. Net appreciation, if any, should be ignored.
- Net depreciation required to be provided for in any one classification should not be reduced on account of net appreciation in any other classification.

C. Held for Trading

- The individual scrips in the Held for Trading category will be marked to market at monthly or at more frequent intervals and provided for as in the case of those in the Available for Sale category.

Reference: Master circular – Prudential norms for classification, valuation and Operation of investment portfolio by banks, RBI/2015-16/97, DBR No BP.BC.6 /21.04.141/2015-16, dated July 1, 2015

GUIDELINES ON SALE OF STRESSED ASSETS BY BANKS

In a bid to further strengthen banks' ability to resolve their stressed assets effectively, RBI has put in place an improved framework governing sale of such assets by banks to SCs/RCs/other banks/Non-Banking Financial Companies /Financial Institutions etc.

Policy on Sale of Stressed Assets

The guidelines by RBI requires the board of banks to lay down detailed policies and guidelines on sale of their stressed assets to Securitisation Companies (SCs)/Reconstruction Companies (RCs). The policy shall cover the following aspects:

i. Financial assets to be sold;
ii. Norms and procedure for sale of such financial assets;
iii. Valuation procedure to be followed to ensure that the realisable value of financial assets is reasonably estimated;
iv. Delegation of powers of various functionaries for taking decision on the sale of the

financial assets; etc.

In order to enhance transparency in the entire process of sale of stressed assets, RBI has decided as under:

- Banks to lay down policy for identification of stressed assets beyond a specified value. Banks should follow a top-down approach, i.e., the head office/corporate office of the bank shall be actively involved in identification of stressed assets. Early identification will help in low vintage and better price realisation for banks;
- At least once in a year, preferably at the beginning of the year, identify and list internally the specific financial assets identified for sale to other institutions, including SCs/RCs;
- At a minimum, all assets classified as 'doubtful asset' above a threshold amount should be reviewed by the board/board committee on periodic basis and a view.
- Banks may offer the assets to other banks/NBFCs/FIs, etc. who have the necessary capital and expertise in resolving stressed assets.
- In order to attract a wide variety of buyers, the invitation for bids shouldpreferably be publicly solicited so as to enable participation of as manyprospective buyers as possible.
- Banks must provide adequate time for due diligence by prospective buyerswhich may vary as per the size of the assets, with a floor of two weeks;
- Banks should have clear policies with regard to valuation of assets proposedto be sold. In case of exposures beyond Rs.50 crore, banks shallobtain two external valuation reports;
- The cost of valuation exercise shall be borne by the bank;
- The discount rate used by banks in the valuation exercise shall be spelt out inthe policy.

Banks shall review the efficacy of their extant policies on sale of NPAs, with focus on valuation of stressed assets, and rework their policies by appropriately adopting the above principles.

Disclosure of Investment in SRs

Banks shall make following additional disclosures pertaining to their investments in security receipts:

	Particulars	SRs issued within past 5 years	SRs issued more than 5 years ago but within past 8 years	SRs issued more than 8 years ago
(i)	Book value of SRs backed by NPAs sold by the bank as underlying			
	Provision held against (i)			
(ii)	Book value of SRs backed by NPAs sold by other banks / financial institutions / non-banking financial companies as underlying			
	Provision held against (ii)			
Total (i) + (ii)				

Buy-Back of Financial Assets

In cases where SCs/RCs have successfully implemented a restructuring plan for the stressed assets acquired by them, banks may take over such assets after the specified period.

Banks may frame a board approved policy containing various aspects governing such take over viz., type of assets that may be taken over, due diligence requirements, viability criteria, performance requirement of asset, etc. However, a bank cannot at any point of time take over from SCs/RCs the assets they have themselves earlier sold.

Reference: Guidelines on Sale of Stressed Assets by Banks, RBI/2016-17/56, DBR.No.BP.BC.9/21.04.048/2016-17 dated September 1, 2016

JUDICIAL PRONOUNCEMENTS ON VALUATION | 10

1. Miheer H. Mafatlal Vs. Mafatlal Industries Ltd. (1997) 1 SCC 579
2. Hindustan Lever Employees' Union Vs. Hindustan Lever Limited And Ors.
3. Brooke Bond Lipton India Ltd.td. [1999] 98 Comp Cas 496 (Cal)
4. Dinesh Vrajlal Lakhani Vs. Parke Davis (India Ltd.) (2005) 124 Comp Case 728 (Bom HC)
5. Dr. Mrs. Renuka Datla Vs. Solvay Pharmaceutical B.V. & Ors. G.L. Sultania and Another Vs. The Securities and Exchange Board of India

JUDICIAL PRONOUNCEMENTS ON VALUATION

1. MIHEER H. MAFATLAL VS. MAFATLAL INDUSTRIES LTD. (1997) 1 SCC579

FACTS OF THE CASE

Mafatlal Fine Spinning and Manufacturing Company Limited ('MFL') being the transfer or company was proposed to be amalgamated with Mafatlal Industries Limited ('MIL') the transferee and respondent company.

The proposal for amalgamation of the two companies was approved by the directors of both the companies pursuant to which the detailed scheme of amalgamation was submitted to High courts for their approval.

MFL, a company located in Bombay moved the Bombay High Court for seeking approval on the scheme of amalgamation which was sanctioned by the court.

MIL, a company, located in Ahmadabad approached the Gujarat High court for seeking approval on the scheme. At this stage, the appellant filed objection to the scheme of amalgamation under section 391 of the Act.

Important point to note here is that the appellant is the director of MFL as well as the Shareholder of MIL, who did not raise objection when the scheme was approached for sanction in Bombay High Court but raised an objection during approval of the scheme in Gujarat High court.

CONTENTIONS RAISED BY THE APPELLANT

1. The respondent-company MIL, while putting the scheme for approval of the equity shareholders in their meeting did not disclose the interest of the directors.
2. The proposed Scheme was unfair to the minority shareholders.

3. The Scheme was otherwise unfair to the equity shareholders of MIL as the exchange ratio of equity shares of the transferor, and transferee companies were ex facie unreasonable and unfair.
4. The appellant represented a distinct class of equity shareholders of MIL, and consequently, separate meeting of his group should have been convened by the Company Court.

JUDGEMENT PASSED BY SUPREME COURT

Contention No.1: If the special interest which the director has is in any way likely to be affected by the Scheme and if non-disclosure of such an interest is likely to affect the voting pattern of the class of creditors or shareholders who are called upon to vote on the scheme, then only such special interest of the director is required to be communicated to the voters as per Section 393(1)(a).

Consequently, the interest of Director in the shareholding or in the future impact thereon by the litigation was out of the scope of proposed scheme , therefore was not necessarily require to be communicated to the voters.

Contention No.2: It is a matter for the shareholders to consider commercially whether amalgamation or merge is beneficial or not. The court is really not concerned with the commercial decision of the shareholders until and unless the court feels that the proposed merger is manifestly unfair or is being proposed unfairly and/or to defraud the other shareholders.

Supreme Court declared that the scheme is neither unfair nor unreasonable as the same has been approved by majority of shareholders of the company, and it is also not proved that the interest of minority is prejudiced by the scheme.

Contention No.3: Reference was made to a decision of the Gujarat High Court in Kamala Sugar Mills Limited, which dealt with an identical objection about the exchange ratio. Once the exchange ratio of the shares of the transferee-company to be allotted to the shareholders of the transferor-company has been worked out by a recognised firm of chartered accountants who are experts in the field of valuation and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio on the ground that it will be determined to their interest.

Contention No.4: Unless a separate and different type of Scheme of Compromise is offered to a subclass of a class of creditors or shareholders otherwise equally circumscribed by the class no separate meeting of such sub-class of the main class of members or creditors is required to be convened.

Quoting Palmer in this Treatise Company Law 24th edition, it was held that unless a separate and different type of scheme of compromise is offered to a sub class of a class of creditors or shareholders no separate meeting is required to be convened.

CONCLUSION

In Miheer H. Mafatlal Vs. Mafatlal Industries Ltd, contentions raised by the appellant were put down as the scope of court is limited and can only intervene, when it is not just and fair. Also Individual personal interest of minority shareholder is of no concern unless it is affecting class interest of such shareholders.

Hence the appeal failed and was dismissed.

Reference: https://www.sci.gov.in/jonew/judis/15118.pdf

2. HINDUSTAN LEVER EMPLOYEES' UNION VS. HINDUSTAN LEVERLIMITED AND ORS.

FACTS OF THE CASE

Merger under the Companies Act, 1956 of the two big companies - one, Hindustan Lever Limited (HLL), a subsidiary of Uni Lever (UL), London based multi-national company, and other Tata Oil Mills Company Ltd. (In brief 'TOMCO').

A few rather nominal shareholders of TOMCO, Federation of Employees Union of both the TOMCO and HLL, Consumer Action Group and Consumer Education land Research Centre opposed the merger on various grounds ranging from statutory violation, procedural irregularities, ignoring effect MRTP Act, 1969, undervaluation of Shares, preferential allotment, failure to protect the interest of employees and above all being violative of public interest.

CONTENTIONS ON VALUATION

Attempt was made to show that the determination of valuation was vitiated as the chartered accountant to whom the duty was entrusted did not perform its functions objectively and in accordance with settled financial norms and practice and its action was vitiated as he was one of the directors of the TOMCO.
Comparative figures of the shares of the two companies then-market' value, their holding in the market etc. were placed on demonstrating that the calculation was vitiated.

JUDGEMENT PASSED BY SUPREME COURT

- The jurisdiction of the Court in sanctioning a claim of merger is not to ascertain with mathematical accuracy if the determination satisfied the arithmetical test. A company court does not exercise an appellate jurisdiction. It exercises a jurisdiction founded on fairness.

- It is not required to interfere only because the figure arrived at by the valuer was not as better as it would have been if another method would have been adopted.
- What is imperative is that such determination should not have been contrary to law and that it was not unfair for the shareholders of the company which was being merged.
- The Court's obligation is to be satisfied that valuation was in accordance with law and it was carried out by an independent body.
- The High Court appears to be correct in its approach that this test was satisfied as even though the Chartered Accountant who performed this function was a director of TOMCO, but he did so as a member of renowned firm of chartered accountants.
- More than 95% of the shareholders who are the best judge of their interest and are better conversant with market trend agreed to the valuation determined it could not be interfered by courts.

CONCLUSION

Hindustan Lever Employees' Union Vs. Hindustan Lever Limited and Ors, contentions raised by the appellant were put down as the scope of court is limited and can only intervene, when it is not just and fair.

On valuation of share for exchange ratio the Court found that a well reputed valuer of a renowned firm of chartered accountants and a director of TOMCO determined the rate by combining three well known methods, namely, the net worth method, the market value method and the earning method,which was widely accepted by majority of shareholders.

Hence the appeal failed and was dismissed.

Reference: https://www.sci.gov.in/jonew/judis/19582.pdf

3. BROOKE BOND LIPTON INDIA LTD.TD. [1999] 98 COMP CAS 496 (CAL)

FACTS OF THE CASE

An application was made to the Calcutta High Court for approval of the scheme of amalgamation between Brooke Bond Lipton India Ltd., the transferor-company and Hindustan Lever Ltd., the transferee-company.

Both the transferor and the transferee are subsidiaries of Unilever plc., a very large multi-national corporation. Both the transferor and the transferee are under common management and have several common directors.

The scheme of amalgamation was approved by majority of the shareholder of the companies.

CONTENTION NO. 1 -

Contentions on Valuation

The main objections raised by a minority shareholder with respect to valuation are as follows:

- The exchange ratio has not been properly or fairly determined.
- The valuation report does not value the assets of the company properly in that the value of the brands has not been taken into account.

CONTENTION NO. 2

The learned advocate for the petitioner has relied upon the judgment and decision in William Currie and Co. v. James Curie, 15 RPC 339. In the aforesaid decision it was held that with the transfer of assets of the business including its goodwill is also transferred.

Moreover, it is well-recognised that the brands are part of the goodwill of the business and cannot be valued separately, also if a business is closed or transferred the brand goes with it, separate mention is not required.

Judgement Passed by Calcutta High Court

Once the exchange ratio of the shares of the transferee-company to be allotted to the shareholders of the transferor-company has been worked out by a recognised firm of chartered accountants who are experts in the field of valuation and if no mistake can be pointed out in the said valuation, it is not for the court to substitute its exchange ratio, especially when the same has been accepted without demur by the overwhelming majority of the shareholders of the two companies or to say that the shareholders in their collective wisdom should not have accepted the said exchange ratio on the ground that it will be detrimental to their interest.

If the ratio of exchange has been fixed by an experienced and reputed firm of chartered accountants, then in the absence of any charge of fraud against them, the court will accept such valuation and ratio of exchange

CONCLUSION

In Brooke Bond Lipton India Ltd.td. [1999] 98 Comp Cas 496 (Cal) contentions relation to valuation were put down as the exchange ratio worked out was accepted by majority of shareholders and value of brands, recognized as part of goodwill does not require separate mention.

Hence the appeal failed and was dismissed

Reference: https://indiankanoon.org/doc/719101/

4. DINESH VRAJLAL LAKHANI VS. PARKE DAVIS (INDIA LTD.) (2005) 124 COMP CASE 728 (BOM HC)

FACTS OF THE CASE

An application was made to the Bombay High Court for approval of the scheme of amalgamation between Scheme of Amalgamation of Parke-Davis (India) Ltd. Transferor-company with Pfizer Limited transferee-company.

CONTENTIONS ON VALUATION

Before the Learned Company Judge, there were 16 objectors, shareholders of the transferor who opposed the Scheme of Amalgamation. The objections raised by the objectors were:

- The swap ratio proposed in the Scheme of Amalgamation was unfair to the shareholders and against the interest of a minority of shareholders of the transferor;

- The Chairman had not conducted the proceedings properly; he was the Chairman of the Board of Directors of the transferor and an alternate Director of the transferee, besides being a partner of Crawford Bayley & Co. Solicitors, who are Solicitors of both the transferor and transferee. It was contended that the Chairman had a vested interest in the Scheme of Amalgamation and his acting as Chairman of the meeting was prejudicial to the interest of the members of the Company;

JUDGEMENT PASSED BY BOMBAY HIGH COURT

- The Learned Judge held that while considering a Scheme of Amalgamation, the Court does not exercise an appellate jurisdiction, but a jurisdiction founded on fairness. The Court would not interfere with the swap ratio adopted on the advice of an expert unless it was contrary to law.

- The Court will not, for instance, interfere only because the valuation adopted by the valuer may have been improved upon had another method been adopted. The Court is neither a valuer nor an appellate forum to reappreciate the merits of the valuation. What the Court has to ensure is that the determination should not be contrary to law or unfair to the shareholders of the Company which has been merged.

- In so far as the conduct of the Chairman was concerned, the Learned Single Judge held that there was no substance in the objection.

CONCLUSION

In Dinesh Vrajlal Lakhani Vs. Parke Davis (India Ltd.) (2005) 124 Comp Case 728 the contentions were put down as the court would not interfere with the swap ratio adopted and agreed by majority of shareholders unless it contravenes the law.

Hence the Appeal was dismissed.

Reference: https://indiankanoon.org/doc/978236/

5. DR. MRS. RENUKA DATLA VS. SOLVAY PHARMACEUTICAL B.V. & ORS.

FACTS OF THE CASE

According to the terms of settlement, M/s. Solvay Pharmaceuticals and Mr. Vasant Kumar have agreed to purchase 4.91% shares held by the petitioners in the two companies namely Duphar Pharma India Ltd. (DPIL renamed as Solvay Pharma India Ltd.) and Duphar Interfran Ltd. (DIL), the petitioners had agreed to sell the said shares.
The Valuer considered three methods of valuation. (1) Asset-based (2) Earning based (3) Market-based. While working out the earning-based valuation, the value on the basis of capitalisation of past earnings was adopted. The discounted cash flow method which is the commonly used methodology for future earnings-based valuation was eschewed from consideration.

CONTENTIONS ON VALUATION

The petitioners have objected to the valuation as follows:

- That the control premium has not been added
- The value of the various brands has not been included in the valuation
- Discounted cash flow method has not been adopted though it is a generally accepted method, even according to the Valuer.

JUDGEMENT PASSED BY SUPREME COURT

- As rightly contended by the learned senior counsel for the respondents, if the parties wanted a special treatment to be given to these shares and a control premium or the like has to be added, it should have been specifically and expressly mentioned in the terms of settlement. What has not been said in the terms of settlement in specific and clear terms cannot be superimposed by the Court while interpreting the terms of settlement. If the petitioners had insisted on the incorporation of such a provision, it could very well be that the other party or parties would not have agreed to such stipulation. The Court cannot, therefore, give any direction in regard to control premium.

- The said brand of drugs are not the existing assets of DIL. The assets as per the relevant records have to be taken into account by the Valuer and that has been done. Court, therefore, find no apparent error in excluding those brands.

- If the data and projections furnished by the parties is not reliable the Valuer should have secured the relevant data from independent sources or could have called for further particulars. The DCF method is adopted while resorting to valuation based on future earnings. The petitioners have not placed any facts and figures to show that such method of valuation would result in a definite increase in the share value going by independent projections. When there are vast discrepancies between the projection given by the parties and independent projections have not been provided, the Valuer has chosen the best possible method of evaluation by capitalizing the past earnings. No prejudice whatsoever is shown to have been caused to the petitioners by the earnings based valuation.

CONCLUSION

In Dr. Mrs. Renuka Datla Vs. Solvay Pharmaceutical B.V. &Ors. the contention raised by the appellent was put down because the Valuer approached the question of valuation having due regard to the terms of settlement and applying the standard methods of valuation. The valuation has been considered from all appropriate angles. No case has been made out that any irrelevant material has been taken into account or relevant material has been eschewed from consideration by the Valuer.

Hence the appeal was dismissed.

Reference: https://www.sci.gov.in/jonew/judis/19426.pdf

6. SULTANIA AND ANOTHER VS. THE SECURITIES AND EXCHANGE BOARD OF INDIA

FACTS OF THE CASE

The petition was in relation to the offer for takeover of Hindustan National Glass and Industries Ltd. by ACE Glass Containers Ltd and C.K. Somany. The petitioner argued that there was an undervaluation of shares and the principles laid down by Hindustan Lever's case did not apply to the facts of the case.

CONTENTIONS ON VALUATION

The grievance of the appellants before the Securities Appellate Tribunal was that the Securities and Exchange Board (hereinafter referred to as the 'Board') as well as the Merchant Banker had not properly valued the shares of the target company in accordance with the parameters laid down in Regulation 20(5) of the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (hereinafter referred to as the 'Takeover Code').

The appellants complained to the Board that the price offered for the shares in the public announcement was very low and had not been determined in accordance with the parameters laid down in Regulation 20(5) of the Takeover Code.

JUDGEMENT PASSED BY SUPREME COURT

Unless it is shown that some well-accepted principle of valuation has been departed from without any reason, or that the approach adopted is patently erroneous or that relevant factors have not been considered by the valuer or that the valuation was done on a fundamentally erroneous basis or that the valuer adopted a demonstrably wrong approach or a fundamental error going to the root of the matter, this court would not interfere with the valuation of an expert.

As noticed in Miheer H. Mafatlal (supra), valuation of shares is a technical and complex problem which can be appropriately left to the consideration of experts in the field of accountancy. So many imponderables enter the exercise of valuation of shares.

Having considered all aspects of the matter, the court is satisfied that the valuer have not committed any such error which may justify court interference. They have considered all the factors relevant under Regulation 20(5)) of the Takeover Code and have adopted a reasonable approach.

CONCLUSION

In Sultania and Another Vs. The Securities and Exchange Board of India, no merit was found in the appeal and was dismissed as no principle of valuation has been departed from and court will not interfere with the valuation of an expert.

Reference: https://www.sci.gov.in/jonew/judis/29048.pdf

GLOSSARY

TERM	DEFINITION
National Income (ref chapter 1)	Total value of all the final goods and services produced in a country within a specific period of time, usually one year
Capital (ref chapter 1)	Anything that can enhance a person's power to perform economically useful work
Gross Domestic Product (ref chapter 1)	Total value of goods as well as services produced in a country during a year
National Domestic Product (ref chapter 1)	Value of the net output of the economy during a year
Gross National Product (ref chapter 1)	Total measure of the flow of goods and services at market value resulting from current production during a year in a country, including income from abroad
Net National Product (ref chapter 1)	Value of total output consumption goods and investment goods
Domestic Income (ref chapter 1)	Income generated by factors of production within the country from its own resources
Private Income (ref chapter 1)	Income obtained by private individuals from any source, which is productive or otherwise, and the retained income of corporations
Per Capita Income (ref chapter 1)	Average income of the people of the country within a year
Fiscal Policy (ref chapter 1)	Government actions affecting its receipts and expenditures which ordinarily as measured by the government's receipts, its surplus or deficit
Monetary Policy (ref chapter 1)	Means through which the monetary authority of a nation manages supply of money in the economy
Cash Reserve Ratio (ref chapter 1)	Minimum percentage of total deposits of customers in a commercial bank that the bank is required to hold as reserves (either in cash or as deposits) with the Central Bank (like RBI)
Statutory Liquidity Ratio (ref chapter 1)	Percentage of deposits that a commercial bank needs to maintain with them in various forms of liquid assets (over and above the CRR) such as government securities
Repo Rate (ref chapter 1)	Interest rate at which RBI lends money to a

	commercial bank against securities, when the commercial bank needs funds
Reverse Repo Rate (ref chapter 1)	Rate at which the RBI borrows money from commercial banks of India
Bank Rate (ref chapter 1)	Interest rate at which RBI lends funds to commercial banks without pledging any security
Business Cycle (ref chapter 1)	Cycle of fluctuations (upward and downward) in the Gross Domestic Product around its long term growth trend
Capital Budgeting (ref chapter 2)	Decisions on investment - which take its due course of time to mature and need to be based around the returns that investment is likely to give
Net Present Value (ref chapter 2)	Existing values of all the cash flows that are bound to be incurred during the life span of a project
Payback Period (ref chapter 2)	Time required for recovering the initial cost of an investment made – the number of years required to receive back the initial investment that an investor would have made
Capital Structure (ref chapter 2)	Process of how a company manages to finance its long-term operations as well as growth by usage of various sources of funds
Certificate of Registration (ref chapter 4)	Certificate of registration granted to a valuer under Rule 7(6)
Certificate of Recognition (ref chapter 4)	Certificate of recognition granted to a valuation professional organisation under Rule 13 or 14
Registered Valuer (ref chapter 4)	Valuer registered with the Registration Authority under Rule 7(6) for carrying out valuation of assets belonging to a class or classes of assets
Contract (ref chapter 4)	Agreement enforceable by law
Agreement (ref chapter 4)	A promise or a set of reciprocal promises made by two parties to each other
Contract of Sale of Goods (ref chapter 4)	A contract whereby the seller, transfers or agrees to transfer, property in goods, to the buyer, for a monetary consideration, called price
Goods (ref chapter 4)	Every kind of movable property other than actionable claims and money
Fair Value (ref chapter 5)	Price that would be received to sell an asset or paid in order to transfer a liability in an orderly transaction between market participants at the measurement date

Intrinsic Value (ref chapter 6)	Value referred to as true value of the asset arrived at by factoring both tangible and intangible factors of the underlying
Investment Value (ref chapter 6)	The purchase price of the investor
Market Value (ref chapter 6)	The value at which the asset can be sold in the market at present time
Accounting Value or Book Value (ref chapter 6)	The carrying cost of asset in the balance sheet
Valuation Approach (ref chapter 7)	The method used to determine the value or attractiveness of an investment opportunity or business
Cost Approach (ref chapter 7)	Ability to derive value through the combined FMV (Fair Market Value) of the business's net assets (assets less its liabilities)
Market Approach (ref chapter 7)	Method of valuation that appraises a business, intangible asset, business ownership interest or security by considering the price of a recent transaction, or the price of comparable assets
Income Approach (ref chapter 7)	Method of valuing a business at the present / current value of its future earnings / cash flows
Net Operating Income (ref chapter 7)	A company's total revenue minus all reasonable operating expenses
Capitalisation Rate (ref chapter 7)	Rate of return expected from a business
Cost of Capital (ref chapter 7)	Opportunity cost of investing in a business
Due-Diligence (ref chapter 8)	A process, investigation or exercises a person or business must strictly perform before signing an agreement or contract with another party
Rate of Return (ref chapter 8)	Profit or loss on an investment over a specified time period
Spot Rate (ref chapter 8)	The spontaneous rate at which commodity, security or currency is settled
Merger (ref chapter 8)	Mutual consensus where both parties wish to join hands and grow as a single entity
Acquisition (ref chapter 8)	A purchase where one company takes over another and declares itself as the new and sole owner
De-Merger (ref chapter 8)	A strategy, which lets a business focus on its most productive, and profitable segments/brands, generate better shareholder value and avoid the risk of acquisition
Forecasting (ref chapter 8)	Organized study of various business aspects

	that layout the foundation for any key strategic decisions or plans
Delisting of Securities (ref chapter 9)	Removal of listed securities from the stock exchange consequent to which the securities can no longer be traded on that stock exchange
Foreign Direct Investment or FDI (ref chapter 9)	Investment through capital instruments in an unlisted Indian company; or in 10 per cent or more of the post-issue paid-up equity capital on a fully diluted basis of a listed Indian company;
Foreign Portfolio Investment or FPI (ref chapter 9)	Any investment made through capital instruments where such investment is less than 10 per cent of the post-issue paid-up share capital on a fully diluted basis of a listed Indian company or less than 10 per cent of the paid-up value of each series of capital instruments of a listed Indian company;

IOV REGISTERED VALUERS FOUNDATION

PLOT NO. 3, 2ND FLOOR, AGGARWAL SQUARE, LSC JN, 80FT RD, PARWANA ROAD, PITAMPURA, DELHI-110034.

WEBSITE : WWW.IOVRVF.ORG