feature

A perfect valuation report for tax purposes: **missing pieces of the puzzle**

There have been many articles written and debates about what makes a good business valuation report, especially when determining a market value for Australian taxation purposes. I, like many valuation professionals, believe this is not just high mathematics where each input and variable can be easily defended by the logic of readily available theorems. It requires: extensive knowledge of businesses and industries; an understanding of economic, financial and political environments; technical proficiency in applying both quantitative and qualitative judgment; and wisdom in writing a meaningful report.

However, sometimes knowing and understanding all the essential pillars of valuation science does not seem enough; and we continuously, year after year, seek an answer on what makes a perfect market valuation report that guarantees unquestionable acceptance by the Australian Taxation Office (Tax Office).

During my 6 years of heading up the Corporate Valuation Unit (CVU) of the Australian Valuation Office (AVO) within the Tax Office, I was often asked about my views and expectations of taxpayer valuation reports. Everyone seemed to be trying hard to deliver on what was technically required – and yet – the outcome was, in the majority of cases, a request for a more comprehensive report or further explanations. Thus, the purpose of this article is not to point out the ways to better calculate your discount rates and project cash flows, but to share my experience of key findings and observations in the valuation assessment process undertaken by the AVO – something you might find useful when preparing (or engaging someone to prepare) your next valuation for tax purposes.

Overview

Business valuations and valuation related advice is relevant to all stages of the economic cycle. Whether for small or medium enterprises, large public groups and internationals, or high wealth individuals, valuation input is required in considerations of transfers to superannuation funds, mergers and acquisitions, employee share schemes, transfer pricing audits, consolidation implementation reviews, Taxation of Financial Arrangements (TOFA), Capital Gains Tax (CGT), philanthropy program valuations and so many other areas regulated by tax law.

The Market Valuation Guide for Tax Purposes published by the Tax Office provides a good coverage of the processes required to estimate a market value for taxation purposes, relevant instructions and expectations of the Tax Office. However, the guide is generic, and could not possibly cover all the circumstances of taxpayers – be it valuation of goodwill or an assessment of an arm's length royalty payment. Thus a question becomes a problem: how to produce a report that could undoubtedly convince the Tax Office's compliance team of the accuracy of the valuation exercise?

Compliance framework

When it comes to market valuations, consideration should be given to the Tax Office's compliance process which consists of:

- contemplation of the tax risks associated with the market value; and
- the risk in the market valuation process itself.

The first is related to the likelihood of non-compliance with a tax law and the consequences related to that non-compliance. Consideration is given to the type of assets involved, their value, the complexity of the valuation process and the documentary evidence supporting the valuation. The work is mainly undertaken by assurance and audit teams based on their internal business line's compliance cycle and framework.

And the second – was and is primarily undertaken by independent valuers – by CVU (previously) and a panel of specialised valuation firms that meet Tax Office valuation procurement requirements. CVU assessed valuations for compliance purposes are based on the Valuation Processes Risk Matrix (see Table 1) providing numbered risk ratings for material aspects of the valuation and an overall risk rating with brief comments relating to key findings and recommendations to the compliance team and/or taxpayer.

Table 1: Valuation Processes Risk Matrix

Criteria vs Risk	Risk Levels			Ranking
	Low (1)	Medium (2)	High (3)	*(sample only)*
Integrity of the valuation process and compliance with APES 225	➤ valuation undertaken as per APES 225 ➤ documented and clear basis of the engagement subject to external regulation ➤ professional relationship ➤ access to information	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	2
Qualifications of person undertaking valuation	➤ appropriate knowledge and industry experience ➤ professional membership ➤ subject to external regulation ➤ retains specialist advice where appropriate, and ➤ holds appropriate and current licences or authorities	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	3
Appropriateness of methodologies and methods selected	➤ methods are consistent over similar asset types ➤ methodology and methods are the most appropriate, and reliable data was used	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	2
Use of supporting methods	➤ shows consideration of other methods where appropriate ➤ justifies the selection of the chosen method ➤ application of second (cross-check) method where appropriate	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	1
Assumptions applied	➤ are clearly justified and basis of application appears to be reasonable ➤ references to reliable sources	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	2
Overall context of the report	➤ description of the assets that enables the identification of the assets ➤ clear purpose and subject of valuation ➤ specific date or the period valuation relates to ➤ date of the valuation exercise ➤ information the valuation is based upon	Taxpayer/or valuer demonstrates most of the factors mentioned	Taxpayer/or valuer demonstrates none of the factors mentioned	2
Weighted Average:				2
Risk Magnitude:	**< 1.45**	**Insignificant**		
	> 1.46 but < 2.45	**Moderate**		
	> 2.46	**Major**		

Moderate and major risk ratings are more likely to initiate an investigation or an audit process from compliance teams.

Communication

As part of my role I undertook an analysis of Tax Office valuation referrals to CVU for Preliminary Risk Assessments (PRA) and Valuation Critiques. Interestingly, the weaknesses in valuation reports and processes were not caused as much by the discrepancies in the Capital Asset Pricing Model (CAPM) or the Weighted Average Cost of Capital (WACC) formulas used, but rather in the provision of supporting documentation and/or unwillingness to justify the assumptions applied. For example:

- 30% of valuation reports referred to CVU had an unclear or irrelevant purpose of the valuation; and/or substantial discrepancies between the actual valuation date and the date a report was written. For example, an interval of 15 months can significantly impact the value of the company particularly during times of major financial and economic reforms.
- 50% of valuation reports had no consideration or application of a secondary methodology (yet it was appropriate and necessary to have a cross-check); and
- 70% of valuation reports did not have sufficient information or supporting documentation to justify the valuation conclusions.

Conclusively, valuation reports with the most advanced Discount Cash Flow (DCF) models or applications of Earnings Before Interest and Tax (EBIT) multiples were only as good as the quality and reliability of the supporting information provided to justify the assumptions and adjustments made.

To give you an example from my own experience, in 2010, I attended a joint meeting with the Tax Office compliance team and the taxpayer's representatives to discuss a valuation report provided to the Tax Office in relation to some share disposals in 2 entities at the time of a CGT event. The concerns from a valuation perspective were:

- no working papers provided to support the determined market value;
- no formal valuation by a qualified valuer was undertaken; and
- lack of independence between the provider of the valuation report and the party requiring valuation.

Above all, it took 3 months and many meetings and data requests to get some basic information about the company's restructuring plans and some supporting material to justify and understand the DCF model adopted by the taxpayer.

In the private sector, I attended a meeting with the same client, dealing with a different issue. Déjà vu one would say, only this time I was a private adviser, and not a government official. I was pleasantly surprised how much information was provided and how quickly it was arranged. If I could have had the same transparency and disclosure in 2010, it would have saved all the parties significant time and money.

By comparing my experiences in both organisations I can see clearly the "*disconnect*"; why is it that while the taxpayers and their advisers are working hard to produce complex financial models and to deliver perfect valuation reports, the Tax Office appears to be still dissatisfied with the results?

Perhaps the solution to our problem lies with the way we explain our valuation opinions and conclusions to the Tax Office. Do we really underestimate the importance of the information provided and communication with our compliance representatives?

In the words of the American journalist Sydney J Harris: "*The two words 'information' and 'communication' are often used interchangeably, but they signify quite different things. Information is giving out; communication is getting through.*" You need to do both.

Pieces of the puzzle

The more comprehensive and reliable the information provided, the higher the chance that the Tax Office compliance teams will arrive at the same conclusion as the valuer.

The Key Valuation Principles (see Table 2) represent essential components of the valuation process and considerations required by the valuer.

Table 2: Key Valuation Principles

Consideration	Relevance
I. Value definition:	
• Market value/Fair Market Value	✓
• Special Value	
• Book Value	
• Replacement Value, etc	
II. Market value concepts:	
• Open/non-restricted market	✓
• Knowledgeable buyer and seller	✓
• Association between vendor and purchaser (acting at arm's length)	✓
• No compulsion to buy or sell	✓
III. Purpose of the valuation:	
• Clarity of the purpose of valuation and agreed terms/particular applicable circumstances	✓
• Letter of Engagement	✓
IV. Clarity of the subject:	✓
• Equity Value?	
• Enterprise Value?	
• Shares/Debts/Conglomerated investment portfolios?	
V. Valuation process:	
• Understanding the business, market and industry	✓
• Analyses of competitors; SWOT/PESTLE/Porter's 5 Forces/etc	✓
• Selecting methodology and providing consideration to support the method adopted	✓
• Date of valuation vs date of the report	✓
• Consideration of variables & assumptions	✓
• Determination of the result (as a range)	✓
• Application of second valuation methodology/method to cross-check the results	✓
VI. Supporting documentation:	
• All assumptions are clearly explained and supported by the documentation	✓
• Shows consideration of all relevant factors, and not just the selected ones	✓
• Provided in accessible and easy to read format	✓
VII. Adherence to APES 225 of the Accounting Professional & Ethical Standards Board	✓

By ticking all the right boxes, your pieces of the puzzle will form a clear picture that should stand any scrutiny.

The majority of referrals to the AVO were related to the calculation of the capital gain or loss from the CGT event: *a requirement to determine the market value in regards to the CGT event and where the market value differs from the capital proceeds receivable to replace the capital proceeds with the market value pursuant to the application of the market value submission rule – modification 1 s 116–30(2)(b) of the ITAA 1997.*

Taxation Determination 10 advises that where the market value of an asset needs to be determined, a taxpayer can either:

a. obtain a detailed valuation from a qualified valuer; or
b. compute their own valuation based on reasonably objective and supportable data.

Such reasonably objective and supportable data would include: clear considerations and determination of key data values such as maintainable earnings, earning multiples, control premium and discount factors; including consideration of risk and return. Reliable explanations should be given for any adjustments; and advice or commentary with regards to the comparable transactions or any cross-checks is essential. The requirement is not just to provide the information relied on, but also to evaluate this information.

The complexity of valuation reports can vary significantly depending on the industry (mining, infrastructure), the life cycle of the business (new organisation or new line of product), company structure and its type (trust, partnership, franchise).

Approximately 50% of the complex valuation referrals received by the CVU comprised issues relevant to intangible assets. This included valuation of contracts, agreements, customer relationships, licensing agreements, royalty and standstill agreements, trademarks and trade names. Some requests were referred as a part of the consideration under Div 13 (transfer pricing) of the ITAA 1936 and Div 820 (thin capitalisation) of the ITAA 1997.

Due to the relatively complex nature of such assessments, the expectations were to extend the list of supporting information to include (but not limited to) the following documentation:

- Reports and papers on the structure of the business, organisational charts, management structures, delegation authorities.
- Business, stage and other strategic plans relevant to the ongoing business activities.
- Overview of relevant current and future projects, budgets and forecasts by product line.
- Relevant measures of performance and measures of economic profitability of the business.
- Documentation outlining the corporate financing and issues of securities (if relevant).
- International/domestic risk management controls in place.
- Contracts and Agreements with customers and suppliers.
- Demonstration of the synergies between the intangible assets and other assets owned by the entity; legal rights or restrictions; or ability/inability to use intangible assets in specific geographic areas.
- Costs of marketing and any other costs that would be borne by a licensee in utilising the asset; relevant contributory asset charges (if any) and so on.

Therefore by communicating effectively with Tax Office compliance teams, one can potentially reduce information problems, lowering the likelihood that your conclusion of a value range will be misunderstood and unnecessarily challenged.

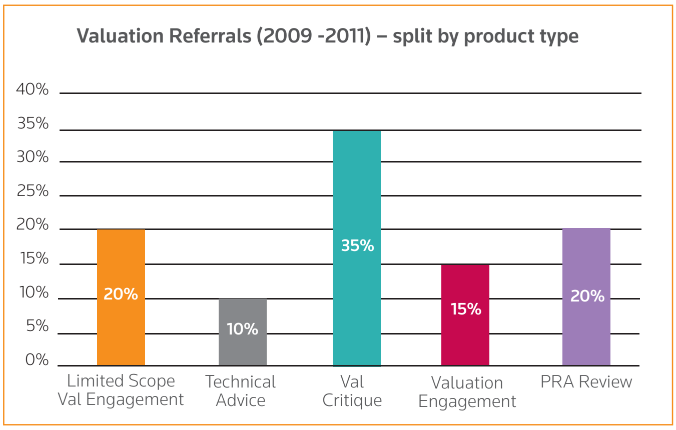
Conclusion

In my opinion, the Tax Office is increasing its advice to taxpayers on its expectations and requirements; and in response, taxpayers (or their valuers) are improving the quality of valuation reports submitted.

While in the AVO, I ensured that Valuation Case and Quote Registers were maintained. Some of the data input in these registers included: dates of referrals, their nature, product type, tax risks associated with them, and the length of services provided. The data was very useful for the understanding and monitoring of Tax Office valuation compliance needs.

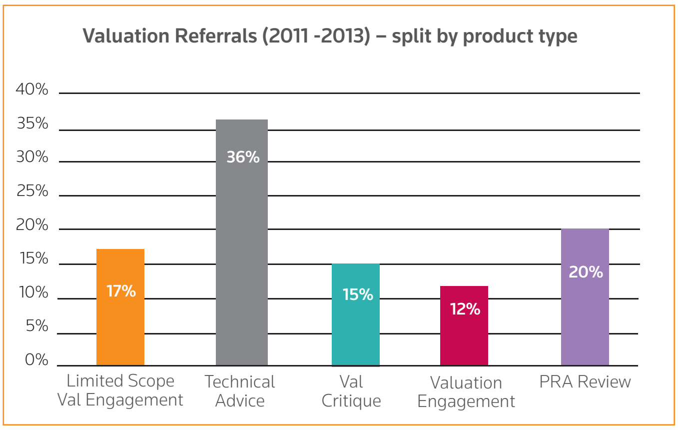
Analysis of the data for 2009-10 and 2010-11 showed that 35% of all valuation referrals were requests for Valuation Critiques of the taxpayers' valuation reports and only 10% for technical valuation related advice. The intent of the valuation critiques was to assess the appropriateness of the valuation methodology, information relied on and assumptions employed in arriving at the market value within the valuation. The deliverable for this service was a report providing commentary on the assessment of each material aspect of the valuation report. Commentary would also include the results of any financial analysis undertaken including quantification of the impact of alternative assumptions/information on the valuation outcome.

Chart 1: Valuation referrals split by product type: 2009–10 and 2010-11



The same data analysis for 2011-12 and 2012-13 indicated that while a number of referrals for Preliminary Risk Assessments (PRA), Limited Scope Valuation Engagement (LSVE) and Valuation Engagement (VE) remained relatively the same, there was a shift in the volume of referrals for valuation critiques and technical advice purposes.

Chart 2: Valuation referrals split by product type: 2011-12 and 2012-13



The majority of technical advice requests were related to the clarification of relationships between growth of the business and discount rates, assessment of reasonableness of applied assumptions, questions relevant to the evaluation of the information provided by taxpayers and explanations of reasons for valuation methods adopted – something that could have been answered by valuers'/taxpayers' working papers in the first place.

Undoubtedly, a perfect valuation report for tax purposes includes your ability to go beyond the maths. But perhaps the answer is not in the art of applied valuation science, but rather in providing information and getting it through? Maybe *the problem is that we always look for the missing piece of the puzzle instead of finding a place for the one in our hand?*

Leadenhall was established in 1982 and is a leading Australian independent corporate advisory firm specialising in the valuation of businesses, intangible assets and intellectual property.

Elena joined Leadenhall Corporate Advisory in late 2014 after 6 years leading the CVU within the Tax Office. Elena was a major contributor to the Tax Office's MRRT (Mining Resource Rent Tax) Valuation Manual and was the AVO's representative to the National Tax Legislation Sub Committee and Tax Office National Technical Conferences.

[NOTE: At the time of going to press, the Government released the Inspector-General of Taxation's "Review into the ATO's administration of valuation matters". The Tax Office is currently in the process of reviewing recommendations made by the Inspector-General which aim to take a more practical approach to valuations processes and administration. It would be interesting to see over the next few months how the Tax Office will respond to the recommendations.]

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