

IN THE INCOME TAX APPELLATE TRIBUNAL

“B” BENCH : BANGALORE

BEFORE SHRI A. K. GARODIA, ACCOUNTANT MEMBER
AND

SHRI LALIET KUMAR, JUDICIAL MEMBER

ITA No.1278/Bang/2018
(Assessment year : 2014 – 15)

M/s. Innoviti Payment Solutions Pvt. Ltd.,
No. 41, 2nd & 3rd Floor, NGR The Edge,
III Main, V Cross, Sai Baba Mandir Road,
Halasuru, Bengaluru – 560008.
PAN. AABCI0504M

Appellant

Vs

The ITO, Ward – 3 (1) (1),
Bengaluru.

Respondent

Assessee by : Shri B. M. Tambakar, C. A.

Revenue by : Shri R. N. Sidappaji, Addl. CIT (DR)

Date of hearing : 07 – 12 – 2018

Date of pronouncement : 09 – 01 – 2019

ORDER

PER BENCH:

This appeal is filed by the assessee which is directed against the order of CIT (A) – 3, Bangalore dated 23.02.2018 for A. Y. 2014 – 15.

2. The grounds raised by the assessee are as under:-

“1. GROUNDS RELATING TO NATURAL JUSTICE

The Learned Income Tax Officer 3(1)(1) (hereinafter "AD") and the Learned Commissioner of Income Tax (Appeals) - 3 (hereinafter "CIT-A") have erred in passing the order without considering all the submissions and / or without appreciating properly the facts and circumstances of the case and law applicable.

2. GROUNDS RELATING TO REJECTION OF EQUITY SHARES VALUATION REPORT ISSUED BY INDEPENDENT CHARTERED ACCOUNTANT

The order of the Learned AO passed under section 143(3) of the Income Tax Act, 1961 ('the Act') and confirmed by Learned CIT-A is erroneous in reckoning that share premium collected is above fair market value and thereby liable to tax in pursuance to section 56(2)(viib) by adopting Rule 11UA(a) to the exclusion of the option under Rule 11UA(b) as opted by the assessee without taking

cognizance of the facts submitted and on the following grounds namely:

a) The valuation report provided by appellant shows that the Accountant has taken haze cash flow as certified by the management. No verification of projections and assumptions adopted by management was made by valuer, whereas Para 2.4 of the valuation report outlines that analysis, review and inquiry has been carried out for issuing report.

b) Appellant has failed to provide any information, which formed the basis of its projection for various years, whereas Para 3 of the valuation report outlines the Basis of Valuation and past business performance forming basis of projections have been submitted;

c) Comparison of projections with actual data, hindsight information not available to the appellant is used to make unfair comparison and extending the scope beyond the realm of law;

d) Mandates of regulatory changes disclosed has been alleged to have intentionally ignored while making projections, the allegation is without basis and does not appreciate the intricacies of technological challenge and business constraints.

e) Appellant has merely adopted the values provided by the management clearly ignoring factors such as performance, growth prospects, earnings capacity, whereas average actual monthly revenue from April 13 to Sept 13 was Rs. 1.52 Crores, an arithmetic extrapolation of annual revenue is Rs. 18.24 crores and the projections have assumed annual growth between 15% to 25% which is realistic assumption as compared to past actual growth rates, further the growth projections are corroborated with an independent report "Payment Systems in India: Vision 2012-2015 prepared from public information source — www.rbi.org.in".

f) Appellant has not been able to point out justification of application of DCF, the provisions of Income Tax allow an assessee the option to adopt DCF method without giving any reasons and more so for a technology company DCF method is more apt and suitable vis-à-vis the net asset value method.

g) The data used is totally unreliable, without any surety of accuracy or completeness, this allegation is devoid of facts in the light of submissions made.

3. The appellant submits that each of the above grounds / sub-grounds are independent and without prejudice to one another. The appellant craves leave to add, alter, vary, omit, substitute or amend the above grounds of appeal, at any time before or, at the time of hearing of the appeal, so as to enable Income Tax Appellate Tribunal to decide the

*appeal according to law.
The appellant prays accordingly.”*

3. Brief facts are that the AO has noted on page 2 Para 4 of the assessment order that the assessee company has collected premium of Rs. 245,02,463/- as securities premium. He further noted that the securities premium shares were allotted during this year in December 2013. The AO has also noted complete details of such shares issued on premium of Rs. 23.50 per shares and noted that the face value of shares at Rs. 10/- per share. He has noted that to 11 persons, 10,42,658 such shares were issued for a total consideration of Rs. 349,29,043/-. The AO noted that from this year, the provisions of section 56 (2) (vii b) are applicable and if the shares are issued at a price which is more than fair market value then the amount received in excess of fair market value of shares will be charged to tax in the hands of the company as income from other sources. The AO asked the assessee to substantiate the share premium so collected. The assessee vide its letter furnished the copy of the certificate issued by a chartered accountant dated 10.11.2013 and said that this is the basis for valuing the shares. The valuation adopted by the assessee was found to be as per DCF (Discounted Cash Flow) method. The AO has reproduced the computation table in Para 6 of the assessment order. As per the same, actual revenue for F. Y. 2012 – 13 was considered at Rs. 1,933 Lacs. In F. Y. 2013 – 14, the revenue was estimated at Rs. 2,222 lacs with an estimated increase of 15%. Thereafter, in F. Y. 2014 – 15 and 2015 – 16, with estimated increase of 25% in each year, the revenue was estimated at Rs. 2,778 Lacs and Rs. 3,473 lacs respectively. Thereafter, in F. Y. 2016 – 17 and 2017 – 18, with estimated increase of 15% in each year, the revenue was estimated at Rs. 3,993 Lacs and Rs. 4,592 lacs respectively. In the same manner, the expenses were also estimated and PBT and PAT were worked out for each year. Net margin for F. Y. 2012 – 13 was noted at 5% but the same was @ 6% in F. Y. 2013 – 14 to 2015 – 16 and 8% in F. Y. 2016 – 17 and 9% in F. Y. 2017 – 18. After making adjustments on account of depreciation, Increase/Decrease in current assets, noncurrent assets, capital expenditure and current liabilities, net cash flow was worked out and the same was discounted @ 15%. Such present value of cash flow was worked out at Rs. 549 lacs. To this, terminal value was added at Rs.

1,322 Lacs and in this manner, Enterprise value was worked out at Rs. 1,871 Lacs. Fair value of each share was worked out at Rs. 42/- per share. The AO has noted and reproduced the relevant portion of the certificate issued by the Chartered Accountant which says that the projections are as per the estimate of the management and the Chartered Accountant provides no assurance that this information or the assumptions on which this information has been prepared by the management are accurate. As per Para 9 of the Assessment order, the AO has stated that the submission of the assessee did not bring out any scientific basis for arriving the projected figures and the valuation report of the CA was on the basis of the projected figures provided by the assessee. He worked out the value of each share by adopting the net asset value at Rs. 632,97,815/- by deducting book value of liabilities from book value of assets and dividing the same by the no. of shares i.e. 44,35,953 already issued and paid up. The AO has also compared the projected sales for F. Y. 2013 – 14 to 2015 – 16 with actual sales of these three years and found that actual sale is 55.4% of the projected sale in F. Y. 2013 – 14 and the same has further reduced to 30.7 % in F. Y. 2014 – 15 and 26.7% in F. Y. 2015 – 16. The AO has also compared the projected profits before tax PBT for F. Y. 2013 – 14 to 2015 – 16 with actual PBT of these three years and found that actual PBT is -385.32 Lacs as against projected PBT of Rs. 141 lacs in F. Y. 2013 – 14 and hence, the same having difference of Rs. 526.32 Lacs in that year and the difference has further increased to Es. 730.25 Lacs in F. Y. 2014 – 15 and Rs. 1206.65 Lacs in F. Y. 2015 – 16. The AO held in Para 13 of the assessment order that the valuation of the assessee cannot be accepted without verifying the credibility of data provided by the assessee. The AO restricted the addition to the extent of excess amounts received from the residents as provided in law. The AO noted that an amount of Rs. 112,21,109/- was received from the residents in excess of fair market value of share worked out by the AO and this amount was added. Being aggrieved, the assessee carried the matter in appeal before CIT (A) but without success and now, the assessee is in further appeal before us.

4. In course of hearing before us, various arguments were made by the learned AR of the assessee. At this juncture, it was pointed out by the bench that as per the detail available on page 570 of the paper book, during first six months of the

F. Y. 2013 – 14, there was fall in revenue in each month. The bench observed that under this factual position, how the projections of 15% & 25% increase in turnover can be accepted. In reply, learned AR of the assessee made various arguments but no basis could be provided by him to estimate sales of Rs. 1270 Lacs in the next six months of F. Y. 2013 – 14 i.e. October 2013 to March 2014 as against sale of Rs. 915 Lacs in the first six months of the present year and 1147 Lacs in corresponding six months of the preceding year. He simply argued that in corresponding six months from April to September of the preceding year i.e. F. Y. 2012 – 13, the sales was Rs. 754 Lacs and hence, in spite of fall in these six months of F. Y. 2013 – 14, the sales is Rs. 915 Lacs and hence, there is increase of 21.35% in this period also as compared to same six months of the preceding year and therefore, the projection of growth of 15% and 25% is justified. Reliance was placed on a tribunal order rendered in the case of Ozoneland Agro Pvt. Ltd. [TS-6963-ITAT-2018(MUMBAI)-O], (2018) 64 ITR 6 (MUMBAI) and in the case of M/s. Rameshwaram Strong Glass (P) Ltd. vs. The ITO, copy on pages 49 to 67 of the paper book. Reliance was placed on one more tribunal order rendered in the case of M/s Vani Estates Pvt. Ltd. vs. ITO in ITA No. 1352/Chny/2018 dated 27.08.2018 copy available on pages 740 to 748 of the paper book and in particular, our attention was drawn to Para 7.3 & 7.4 of this tribunal order.

5. As against this, learned DR of the revenue supported the orders of the authorities below. It was also submitted that the tribunal orders cited by the learned AR of the assessee are not applicable in the facts of the present case. He placed reliance on another tribunal order rendered in the case of Agro Portfolio (P.) Ltd. as reported in 94 Taxmann.com 112 (Delhi). He submitted a copy of this tribunal order. In particular, our attention was drawn to Para 13 to 16 of this tribunal order and it was pointed out that in Para 16, the tribunal held that if the correctness of data supplied by the assessee to the merchant banker cannot be determined than the AO can reject DCF method and go to NAV method to determine FMV of the shares. He submitted that the facts in the present case are identical except one difference that the certificate in that case was obtained by the assessee from merchant banker and in the present case, the assessee has obtained the certificate from a chartered accountant. He

submitted that this difference is immaterial and therefore, this tribunal order should be followed in the present case.

6. We have considered rival submissions and gone through the material available on record. We find that there is no dispute on this factual aspect that the certificate issued by the Chartered Accountant is on the basis of information about future projections provided by the management and it could not be conclusively established by the assessee that such projection/estimation by the management is on a scientific basis although an attempt was made in this regard.
7. In view of this factual position, we first examine the law on this issue and also take note of the guidelines issued by research committee of The Institute of Chartered Accountants of India (ICAI) as reproduced by CIT (A) in Para 4.6 of his order. We first reproduce the provisions of section 56 (2) (viib) and Rule 11U & 11UA as under:-

“Income from other sources.

56(2) (viib) *where a company, not being a company in which the public are substantially interested, receives, in any previous year, from any person being a resident, any consideration for issue of shares that exceeds the face value of such shares, the aggregate consideration received for such shares as exceeds the fair market value of the shares:*

Provided that this clause shall not apply where the consideration for issue of shares is received—

- (i) *by a venture capital undertaking from a venture capital company or a venture capital fund; or*
- (ii) *by a company from a class or classes of persons as may be notified by the Central Government in this behalf.*

Explanation.—For the purposes of this clause,—

(a) *the fair market value of the shares shall be the value—*

- (i) *as may be determined in accordance with such method as may be prescribed²; or*
- (ii) *as may be substantiated by the company to the satisfaction of the Assessing Officer, based on the value, on the date of issue of shares, of its assets, including intangible assets being goodwill, know-how, patents, copyrights, trademarks, licences, franchises or any other business or commercial rights of similar nature,*

whichever is higher;

(b) *"venture capital company", "venture capital fund" and "venture capital undertaking" shall have the meanings respectively assigned to them in clause (a), clause (b) and clause (c) of Explanation to clause (23FB) of section 10;”*

“Meaning of expressions used in determination of fair market value.

11U. For the purposes of this rule and rule 11UA,—

- (a) ~~1~~[***]
- (b) "balance-sheet", in relation to any company, means,—
- (i) for the purposes of sub-rule (2) of rule 11UA, the balance-sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn up on the valuation date which has been audited by the auditor of the company appointed under section 224 of the Companies Act, 1956 (1 of 1956) and where the balance-sheet on the valuation date is not drawn up, the balance-sheet (including the notes annexed thereto and forming part of the accounts) drawn up as on a date immediately preceding the valuation date which has been approved and adopted in the annual general meeting of the shareholders of the company; and
- ^{14aa}[(ii) in any other case,—
- (A) in relation to an Indian company, the balance-sheet of such company (including the notes annexed thereto and forming part of the accounts) as drawn up on the valuation date which has been audited by the auditor of the company appointed under the laws relating to companies in force; and
- (B) in relation to a company, not being an Indian company, the balance-sheet of the company (including the notes annexed thereto and forming part of the accounts) as drawn up on the valuation date which has been audited by the auditor of the company, if any, appointed under the laws in force of the country in which the company is registered or incorporated;]
- (c) "merchant banker" means category I merchant banker registered with Securities and Exchange Board of India established under section 3 of the Securities and Exchange Board of India Act, 1992 (15 of 1992);
- (d) "quoted shares or securities" in relation to share or securities means a share or security quoted on any recognized stock exchange with regularity from time to time, where the quotations of such shares or securities are based on current transaction made in the ordinary course of business;
- (e) "recognized stock exchange" shall have the same meaning as assigned to it in clause (f) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);
- (f) "registered dealer" means a dealer who is registered under Central Sales Tax Act, 1956 or General Sales Tax Law for the time being in force in any State including value added tax laws;
- (g) "registered valuer" shall have the same meaning as assigned to it in section 34AB of the Wealth-tax Act, 1957 (27 of 1957) read with rule 8A of Wealth-tax Rules, 1957;
- (h) "securities" shall have the same meaning as assigned to it in clause (h) of section 2 of the Securities Contracts (Regulation) Act, 1956 (42 of 1956);
- (i) "unquoted shares and securities", in relation to shares or securities, means shares and securities which is not a quoted shares or securities;
- [(j) "valuation date" means the date on which the property or consideration, as the case may be, is received by the assessee.]”

“Determination of fair market value.

11UA. [(1)] For the purposes of section 56 of the Act, the fair market value of a property,

other than immovable property, shall be determined in the following manner, namely,—

(a) valuation of jewellery,—

- (i) the fair market value of jewellery shall be estimated to be the price which such jewellery would fetch if sold in the open market on the valuation date;
- (ii) in case the jewellery is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the jewellery shall be the fair market value;
- (iii) in case the jewellery is received by any other mode and the value of the jewellery exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;

(b) valuation of archaeological collections, drawings, paintings, sculptures or any work of art,—

- (i) the fair market value of archaeological collections, drawings, paintings, sculptures or any work of art (hereinafter referred as artistic work) shall be estimated to be price which it would fetch if sold in the open market on the valuation date;
- (ii) in case the artistic work is received by the way of purchase on the valuation date, from a registered dealer, the invoice value of the artistic work shall be the fair market value;
- (iii) in case the artistic work is received by any other mode and the value of the artistic work exceeds rupees fifty thousand, then assessee may obtain the report of registered valuer in respect of the price it would fetch if sold in the open market on the valuation date;

(c) valuation of shares and securities,—

(a) the fair market value of quoted shares and securities shall be determined in the following manner, namely,—

- (i) if the quoted shares and securities are received by way of transaction carried out through any recognized stock exchange, the fair market value of such shares and securities shall be the transaction value as recorded in such stock exchange;
- (ii) if such quoted shares and securities are received by way of transaction carried out other than through any recognized stock exchange, the fair market value of such shares and securities shall be,—

(a) the lowest price of such shares and securities quoted on any recognized stock exchange on the valuation date, and

(b) the lowest price of such shares and securities on any recognized stock exchange on a date immediately preceding the valuation date when such shares and securities were traded on such stock exchange, in cases where on the valuation date there is no trading in such shares and securities on any recognized stock exchange;

¹(b) the fair market value of unquoted equity shares shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner, namely:—

the fair market value of unquoted equity shares = (A+B+C+D - L) × (PV)/(PE), where,

A= book value of all the assets (other than jewellery, artistic work, shares, securities and immovable property) in the balance-sheet as reduced by,—

- (i) any amount of income-tax paid, if any, less the amount of income-tax refund claimed, if any; and*
- (ii) any amount shown as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;*

B = the price which the jewellery and artistic work would fetch if sold in the open market on the basis of the valuation report obtained from a registered valuer;

C = fair market value of shares and securities as determined in the manner provided in this rule;

D = the value adopted or assessed or assessable by any authority of the Government for the purpose of payment of stamp duty in respect of the immovable property;

L= book value of liabilities shown in the balance sheet, but not including the following amounts, namely:—

- (i) the paid-up capital in respect of equity shares;*
- (ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;*
- (iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;*
- (iv) any amount representing provision for taxation, other than amount of income-tax paid, if any, less the amount of income-tax claimed as refund, if any, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;*
- (v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;*
- (vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;*

PV= the paid up value of such equity shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;]

- (c) the fair market value of unquoted shares and securities other than equity shares in a company which are not listed in any recognized stock exchange shall be estimated to be price it would fetch if sold in the open market on the valuation date and the assessee may obtain a report from a merchant banker or an accountant in respect of which such valuation.*

[(2) Notwithstanding anything contained in sub-clause (b) of clause (c) of sub-rule (1), the fair market value of unquoted equity shares for the purposes of sub-clause (i) of clause (a)

of Explanation to clause (viib) of sub-section (2) of section 56 shall be the value, on the valuation date, of such unquoted equity shares as determined in the following manner under clause (a) or clause (b), at the option of the assessee, namely:—

(a) the fair market value of unquoted equity shares = $\frac{(A-L)}{(PE)} \times (PV)$,

where,

A = book value of the assets in the balance-sheet as reduced by any amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act and any amount shown in the balance-sheet as asset including the unamortised amount of deferred expenditure which does not represent the value of any asset;

L = book value of liabilities shown in the balance-sheet, but not including the following amounts, namely:—

- (i) the paid-up capital in respect of equity shares;
- (ii) the amount set apart for payment of dividends on preference shares and equity shares where such dividends have not been declared before the date of transfer at a general body meeting of the company;
- (iii) reserves and surplus, by whatever name called, even if the resulting figure is negative, other than those set apart towards depreciation;
- (iv) any amount representing provision for taxation, other than amount of tax paid as deduction or collection at source or as advance tax payment as reduced by the amount of tax claimed as refund under the Income-tax Act, to the extent of the excess over the tax payable with reference to the book profits in accordance with the law applicable thereto;
- (v) any amount representing provisions made for meeting liabilities, other than ascertained liabilities;
- (vi) any amount representing contingent liabilities other than arrears of dividends payable in respect of cumulative preference shares;

PE = total amount of paid up equity share capital as shown in the balance-sheet;

PV = the paid up value of such equity shares; or

(b) the fair market value of the unquoted equity shares determined by a merchant banker²[***] as per the Discounted Free Cash Flow method.]

8. Now we reproduce Para 4.6 from the order of CIT (A) because in this Para, learned CIT (A) has reproduced the relevant portion of 'Technical guide on Share valuation (issued in 2009) by research committee of The Institute of Chartered Accountants of India (ICAI). The same is as under:-

“4.6 In order to examine this issue of valuation, it is important to know as to what is Discounted Cash Flow method. Relevant part of the information available on this issue in 'Technical Guide on share valuation' (Issued in 2009) by research committee of the institute of chartered accountants of India is reproduced as follows:

"1.1 The valuation of the shares of a company involves use of judgement, experience and knowledge. The accountant undertaking this work should possess knowledge of the analysis and interpretation of financial statements backed by a practical appreciation of business affairs and investments. A valuation based on quantitative information alone will not be adequate for a real valuation. It should also be recognised that the method of valuation of shares would vary, depending on the purpose for which it is to be used.

1.2 A clear understanding of the purpose of valuation is undoubtedly important, but an equally important imperative is to have a full appreciation of the 'value' emanating from common principles. This 'general purpose value' may be suitably modified for the special purpose for which the valuation is done. The factors affecting that value with reference to the special purpose must be judged and brought into final assessment in a sound and reasonable manner.

1.4 Valuation, being a complex subject, is limited to experts and is surrounded by a number of myths. Some of the very common generalities about valuation are discussed below:

(a) Valuation models are quantitative and focus on earnings, assets, etc. However, it does not necessarily imply that valuation is free from the subjectivity and bias of a valuer. The fact is that valuation models are driven by the inputs that are prone to subjective judgments and the bias of a valuer. For instance, a target company may typically tend to overvalue itself while valuing.

(b) Valuation is riddled with a commonplace notion that a detailed valuation exercise will provide a precise estimate of value. The truth is that any valuation is as good as its underlying assumptions, which, in turn, are the function of a number of present and forward-looking factors. A careful valuation exercise, at best, can give an indicative range of value subject to the reasonableness of the assumptions.

(c) Valuation is pertinent to a particular point of time and varies with changes in business, industry and macroeconomic environment. E.g., the movement of US Dollar against Indian Rupee has led to a substantial change in the valuation of IT and other export-driven companies.

2.1 The potential earning power of a company is generally a paramount factor for valuation of share but there may be occasions, especially in valuations for compensation, where other considerations become relatively more important. In the absence of any other special motive, an investor is principally interested in a company's ability to continue earning profits.

2.4 *The Income Approach indicates the value of a business based on the value of the cash flows that a business is expected to generate in future. This approach is appropriate in most going concern situations as the worth of a business is generally a function of its ability to earn income/cash flow and to provide an appropriate return on investment.*

2.5 *The Income approach includes a number of models/techniques, such as Discounted Cash Flow, Maintainable Profits Basis, Dividend Discount Model, and others, which are discussed in detail in the following paragraphs.*

2.6 *Discounted Cash Flow model indicates the fair market value of a business based on the value of cash flows that the business is expected to generate in future. This method involves the estimation of post-tax cash flows for the projected period, after taking into account the business's requirement of reinvestment in terms of capital expenditure and incremental working capital. These cash flows are then discounted at a cost of capital that reflects the risks of the business and the capital structure of the entity.*

2.7 *Discounted Cash Flow is the most commonly used valuation technique, and is widely accepted by valuers because of its intrinsic merits, some of which are given below:*

(a) Theoretically, it is a very sound model because it is based upon expected future cash flows of a company that will determine an investor's actual return.

(b) It is based on expectations of performance specific to the business, and is not influenced by short-term market conditions or non-economic indicators.

(c) It is not as vulnerable to accounting conventions like depreciation, inventory valuation in comparison with the other techniques/approaches since it is based on cash flows rather than accounting profits.

(d) It is appropriate for valuing green-field or start-up projects, as these projects have little or no asset base or earnings which render the net asset or multiple approaches inappropriate. However, it is important that valuation must recognise the additional risks in such a case (e.g. project execution risk, lack of past track record, etc.) by using an appropriate discount rate.

2.8 *Though the Discounted Cash Flow model is one of the widely used models for valuation because of its inherent benefits, it still has its share of drawbacks. Major shortcomings of this model are as follows:*

(a) It is only as good as its input assumptions. Following the "garbage in, garbage out" principle, if the inputs - Cash Flow Projections,

Discount Rate, and Terminal Value - are wide off the mark, then the value generated by using this model does not reflect the fair value.

(b) It does not take into account several other factors, such as investment risk associated with opportunity cost, i.e. investments that could return greater cash flow yields would add an unrealised element of risk, unforeseen variations in future cash flow, and other non-financial factors.

2.9 In this technique valuation of shares is based on three things: Cash Flow Projections, Discount Rate and Terminal Value.

2.10 The first and most critical input of the Discounted Cash Flow model is the cash flow projections. As stated earlier, the Discounted Cash Flow value is as good as the assumptions used in developing the projections. These projections should reflect the best estimates of the management and take into account various macro and micro-economic factors affecting the business. Some of the important points to be kept in mind with regard to cash flow projections based on the projection of the profitability are stated below:

(a) Cash flow projections should reasonably capture the growth prospects and earnings capability of a company. The earning margins of a company should be determined based on its past performance, any envisaged savings, pressure on margins due to competition, etc.

(b) Discontinuation of a part of the business, expansion programmes and any major change in the policies of the company may provide occasions for making a break with the past.

(c) The discontinuation of a part of the business can be easily dealt with by a valuer. A part of the profits earned by such business in the past will have to be excluded from the projections.

(d) The effect of expansion schemes can present more complex problems. For these, the valuer will have to use his judgment about their profitability. The state of execution at the time of valuation should be given due consideration. Mere paper plans for expansion should not be taken into account. If reasonable indications of expected future profit are available, then such profits taken on a reasonable basis — to take care of the risk and uncertainty involved - may be included in the projections of the company. If, however, the profits are expected to be realised after a lapse of some years or if material amounts have yet to be incurred before profits are realised, due consideration will have to be given to these circumstances. In such circumstances, separate value may be given to such new investments and the same is added to the value of the existing stream of business.

(e) In turnaround cases, the uncertainty of higher profits is much greater. Careful evaluation of the steps actually taken to implement a turnaround strategy must be undertaken before a valuer accepts management's claims that in future the company will earn profits. If necessary, reports of technical or other consultants should be called for.

(f) In case of companies witnessing cyclical fluctuations, care should be taken to select the forecast period, which should necessarily cover the entire business cycle of a company.

(g) Effects of change in the policy of the company may be taken into account if such changes are known in advance and the effects are capable of being quantified. Changes in the utilisation of the productive capacity, changes in the organisational set-up, changes in the product-mix, changes in the financing policy are some examples of the situation that may have to be faced by a valuer. Their treatment in the projection of future profits will depend entirely upon the effect which in the opinion of the valuer, such changes will have on such future profits.

(h) An appropriate allowance must be made for capital expenditure in projections. They should not include capital expenditure only for capacity expansion or growth but also for maintenance of the existing capacity.

(i) Working capital requirement forms another important component. Projections should appropriately account for working capital needs of the business in its different phases.

(j) Income tax outflow also impacts the value of a business and should incorporate any tax benefits like tax holiday, accumulated losses, etc. In making projections, notional tax calculated at the rates expected to be applicable to the company in future should normally be deducted. For instance, the rate may change if the company is planning to undertake activities on which tax incidence is lower. Where such rates are not available, the current rates of taxes may be considered a good indicator. Tax benefits due to accumulated losses, accumulated development rebates or allowance, investment allowance, unabsorbed depreciation etc. should not generally be adjusted to the tax rate; instead, these should be considered separately. The past unabsorbed tax shelter is valued by using discounted cash flow method, for the actual years in which the tax shelter would be availed of a reduction in the effective tax rate due to exemptions for new industrial unit relief export profits etc., should be very carefully considered, depending on the period for which they would be available. A cautious valuer would perhaps compute an effective tax rate each year for the forecast period, based on the current year's tax rate and statutory deductions available and a

reasonable view of profits.

Discount Rate

2.11 The next step in the Discounted Cash Flow model is the determination of an appropriate rate to discount future cash flows. Discount rate is the aggregate of risk-free rate and risk premium to account for riskiness of the business. Key inputs or adjustments for calculating the discount rate are discussed below:

(a) Theoretically, risk-free rate is the rate of return on an asset with no default risk. In practice, long-term interest rates on government securities are used as a benchmark.

(b) It is quite natural to assume that the riskier investments should have a higher return. This necessitates the incorporation of an appropriate risk premium in the discount rate. There exist a number of models for determination of risk premiums, such as the capital asset pricing model, arbitrage pricing model, multi-factor model, etc. Risk premium is also adjusted to incorporate risks associated with the stage and size of business and other company or project-specific risks.

(c) The rate estimated by using the above will provide the discount rate, assuming only equity financing or the cost of equity. For a leveraged company, discount rate should be adjusted for leveraging. Practically speaking, discount rate for a leveraged company is the weighted average cost of capital with appropriate weightages to cost of equity and post-tax cost of debt, considering existing or targeted debt-equity ratio, industry standards and other parameters.

(d) In the case of a company carrying on two or more different businesses, their cash flow projections should be estimated separately, and apply the discount rates appropriate to the individual businesses.

Terminal Value

2.12 Since a business is valued as a going concern, its value should account for the cash flows over the entire life of a company, which can be assumed to be infinite. Because the cash flows are estimated only for the forecast period, a terminal value is estimated to reflect the value of the cash flows arising after the forecast period. Terminal value can be computed in a number of ways; some prominent ones are discussed below:

(a) Perpetual growth model assumes that a business has an infinite life and a stable growth rate of cash flows. Terminal value is derived mathematically by dividing the perpetuity cash flows (cash flows which are expected to grow at a stable pace) with the discount rate as reduced by the stable growth rate. Estimation of the stable growth rate is of great significance because even a minor change in stable growth rate can change the terminal value and the business value too. Various factors like the size of a company, existing growth rate,

competitive landscape, profit reinvestment ratio, etc. have to be kept in mind while estimating the stable growth rate.

(b) Multiple approach involves the determination of an appropriate multiple to be applied on perpetuity earnings or revenues. Multiple is estimated by an analysis of the comparable companies. Though this approach is simpler and brings in the advantages of market approach, it does not qualify as a preferred approach because it mixes the discounted cash flow approach which provides intrinsic or company-specific valuation with the market approach.

(c) In valuations that assume a finite life of a business, terminal value is estimated to be the liquidation value, which is based on the book value of the assets adjusted for inflation. But this does not reflect the earning power of the assets. Alternatively, discounting expected cash flows from sale of such assets at an appropriate discount rate would provide a better estimation of liquidation value.

6.1 Selection of an appropriate approach - Income, Market, or Net Assets - as well as the technique/model within the selected approach by a valuer is dependent on the facts and circumstances of the case. In practice, however, a combination of all the approaches is used by assigning appropriate weightage to each approach.

6.6 While valuing shares, a number of situations may arise in which special consideration has to be given to several important factors.

6.24 Though valuation is mainly driven by financial factors like earnings, assets, etc., some other factors require careful evaluation as an integral part of the mechanics of share valuation. The most noteworthy of these are:

(a) The nature of a company's business

A company's business may depend on the success of other industries (as with the producer of raw materials for other manufacturers), seasonal conditions, etc.

(b) The caliber of managerial personnel

A business managed by professional managers allied to people with similar ability would command a premium when compared to another which is crucially dependent for its success on a single executive, however outstanding he might be.

(c) Prospects of expansion

A case in point would be that of ancillary small-scale units, which have the potential for growth as they can supply inputs to large companies that are dependent on their products.

(d) Competition

A business may prosper when nurtured under sheltered circumstances (e.g. import restrictions), but may flounder under 'open market' conditions.

(e) Government policy

Government policy in general and in relation to particular industry (as with restriction or banning of manufacture of alcohol in the case of alcohol based chemical industries).

(f) Prevailing political climate

Political climate in an area can affect the prosperity of a business, e.g. tourism trade is directly affected due to breakdown in the law and order situation in a state.

(g) Risk of obsolescence of items manufactured

In case the products manufactured by an enterprise face a higher risk of obsolescence, it may influence the value of its shares adversely.

(h) Existence of convertible rights

Existence of convertible rights would also affect the value of a share.

(i) The effect of other external factors

The value of shares is also affected by factors such as war, embargo or other restrictions on international trade or disruptions in international trade.

9.2 While preparing a Report, it is important that one states its purpose explicitly and ensures that the facts are presented with clarity so that the reader of the Report appreciates it in that context.

9.3 The factors that have been considered for arriving at the ultimate valuation should be clearly spelt out.

9.4 While it is difficult to specify the exact form of the Report, the following illustrative outline may be useful.

(a) Introduction/purpose of valuation

This may contain background information about the report and its purpose, say, merger. share buy back, etc.

(b) Valuation date

The valuer may state the valuation date clearly at the outset. As the valuation is time-specific, this information is critical for the reader of the report.

(c) History

This section may deal with the history of a company (or companies, in case of merger). The matter may be divided into sub-sections that deal

with the date of incorporation, whether listed or not, authorised, and paid up capital, turnover, profits, dividend and asset base.

(d) Business of the company

This part would explain the business of a company, i.e., whether trading or manufacturing, the items dealt in or manufactured, the location of the factory, factors peculiar to the business, and such other matters.

(e) Sources of information

This section may state the sources of information obtained for the purpose of valuation, such as Articles of Association, audited accounts, profit projections, realisable value of assets, other secondary sources of information, period for which or date on which data is obtained, and other relevant sources.

(f) Methodology

This part may contain the methodology adopted for valuation. It should also include the rationale for appropriateness or otherwise of a particular approach(s) used.

(g) Key valuation considerations

This part may deal with the valuation considerations critical to the valuation process. Some of the factors considered in valuing the shares which may be included in the report are:

(i) Discussion on the financial projections of a company, highlighting main assumptions and management representations.

(ii) Discussion on discount rate, growth rate used for computing terminal value considered in the valuation, including the methodology for arriving at the discount rate, sources of information, etc.

(iii) Any adjustment on account of accumulated losses/ unabsorbed depreciation.

(iv) Any adjustment for valuing a controlling or minority stake, discount for illiquidity, etc.

(v) Brief analysis of the peer set companies used in relative valuation.

(vi) Adjustments to the multiples based on the peer set company, including rationale for the same.

(vii) Details of the surplus assets and treatment thereof in the valuation.

(viii) Any other special factors, such as government subsidy, tax breaks, etc.

(h) Fair Value

This paragraph should deal with the valuation of shares on the basis of discussion in the preceding part of the Report (and in case of amalgamation, also the exchange ratio). This paragraph should also offer justification for the approaches actually adopted. It could also deal with the justification of adjustments considered necessary for arriving at the value, for example, of the discounting due to restriction on transfer of shares; reduction made in the net maintainable profit due to changed circumstances; or weightage given to certain recent years in arriving at the fair value, etc.

(i) Computation

Usually, the report should also contain annexures giving information regarding the working of the approaches employed for valuation.

(j) Limiting conditions

This paragraph should contain the appropriate caveats which limit the scope of valuation. Few indicative caveats are; (i) The valuer should state any scope limitations and also the non-availability of any pertinent information and its possible effect on valuation. (ii) It is important to draw reader's attention to the fact that the valuation is specific to the time and purpose of valuation. It should also be mentioned that the valuation is not an exact science and the conclusions arrived at in many cases will be subjective and dependent on the exercise of individual judgment.

(iii) It is also important to mention the extent of reliance placed by the valuer on the information provided by the management and information available in the public domain.

(iv) Under appropriate circumstances, a valuer should also limit his liability by restricting distribution of report to the management/company.

(v) A valuer should highlight the fact that valuation does not include the auditing of financial data provided by the management and, therefore, does not take any responsibility for its accuracy and completeness. Further, valuation should not be considered as an opinion on the achievability of any financial projections mentioned in the report.”

9. As per Para 2.10 of this report of research committee of (ICAI) as reproduced above, the first and most critical input of DCF model is the Cash Flow Projections. It is also noted in the same Para of this report that the DCF value is as good as the assumptions used in developing the projections. It is also noted that these projections should reflect the best estimates of the management and take into account various macro and micro economic factors affecting the business. In the

same Para of this report, some important points to be kept in mind with regard to cash flow projections are also noted. At this point, we feel it proper to take note of two judgments of Hon'ble apex court rendered in the case of Bharat earth Movers vs. CIT, 245 ITR 428 and in the case of Rotork Controls India (P) Ltd. vs. CIT, 314 ITR 62. In the first case, the issue in dispute was regarding estimation of future liability of leave encashment and it was held by Hon'ble apex court in this case that the liability should be capable of being estimated with reasonable certainty though the actual quantification may not be possible. It was held that if this is satisfied than the liability is not a contingent liability. In the second case, the issue in dispute was about provision of warranty expenses to be incurred in future. Para 10 of this judgment is very relevant and therefore, it is reproduced herein below:-

10. What is a provision ? This is the question which needs to be answered. A provision is a liability which can be measured only by using a substantial degree of estimation. A provision is recognized when : (a) an enterprise has a present obligation as a result of a past event; (b) it is probable that an outflow of resources will be required to settle the obligation; and (c) a reliable estimate can be made of the amount of the obligation. If these conditions are not met, no provision can be recognized.

10. From this Para of this judgment, it is seen that it was held that if a reliable estimate cannot be made than the provision cannot be recognized. In the present case in connection with DCF, we have seen that estimate/ projection of future cash flow has to be made and as per Para 2.10 of this report of research committee of (ICAI) as reproduced above, the first and most critical input of DCF model is the Cash Flow Projections. Hence, in our considered opinion, by the same analogy, it has to be seen and ensured that such projection is estimated with reasonable certainty and if it is not established by the assessee that this is a reliable estimate achievable with reasonable certainty, the same cannot be recognized and if the future cash flow cannot be recognized than the DCF method is not workable.

11. As per various tribunal orders cited by the learned AR of the assessee, it was held that as per Rule 11UA (2), the assessee can opt for DCF method and if the assessee has so opted for DCF method, the AO cannot discard the same and adopt other method i.e. NAV method of valuing shares. In the case of M/s. Rameshwaram Strong Glass (P) Ltd. vs. The ITO (Supra), the tribunal has reproduced relevant portion of another tribunal order rendered in the case of ITO vs. M/s Universal Polypack (India) Pvt. Ltd. in ITA No. 609/JP/2017 dated 31.01.2018. In this case, the

tribunal held that if the assessee has opted for DCF method, the AO cannot challenge the same but the AO is well within his rights to examine the methodology adopted by the assessee and/or underlying assumptions and if he is not satisfied, he can challenge the same and suggest necessary modifications/alterations provided the same are based on sound reasoning and rationale basis. In the same tribunal order, a judgment of Hon'ble Bombay High Court is also taken note of having been rendered in the case of Vodafone M-Pesa Ltd. vs. PCIT as reported in 164 DTR 257. The tribunal has reproduced part of Para 9 of this judgment but we reproduce herein below full Para 9 of this judgment.

"9. We note that, the Commissioner of Income-Tax in the impugned order dated 23rd February, 2018 does not deal with the primary grievance of the petitioner. This, even after he concedes with the method of valuation namely, NAV Method or the DCF Method to determine the fair market value of shares has to be done/adopted at the Assessee's option. Nevertheless, he does not deal with the change in the method of valuation by the Assessing Officer which has resulted in the demand. There is certainly no immunity from scrutiny of the valuation report submitted by the Assessee. Therefore, the Assessing Officer is undoubtedly entitled to scrutinise the valuation report and determine a fresh valuation either by himself or by calling for a final determination from an independent valuer to confront the petitioner. However, the basis has to be the DCF Method and it is not open to him to change the method of valuation which has been opted for by the Assessee. If Mr. Mohanty is correct in his submission that a part of demand arising out of the assessment order dated 21st December, 2017 would on adoption of DCF Method will be sustained in part, the same is without working out the figures. This was an exercise which ought to have been done by the Assessing Officer and that has not been done by him. In fact, he has completely disregarded the DCF Method for arriving at the fair market value. Therefore, the demand in the facts need to be stayed."

12. As per above Para of this judgment of Hon'ble Bombay High Court, it was held that the AO can scrutinize the valuation report and he can determine a fresh valuation either by himself or by calling a final determination from an independent valuer to confront the assessee. But the basis has to be DCF method and he cannot change the method of valuation which has been opted by the assessee. Hence, in our considered opinion, in the present case, when the guidance of Hon'ble Bombay high Court is available, we should follow this judgment of Hon'ble Bombay High Court in preference to various tribunal orders cited by both sides and therefore, we are not required to examine and consider these tribunal orders. Respectfully following this judgment of Hon'ble Bombay High Court, we set aside the order of CIT (A) and restore the matter to AO for a fresh decision in the light of this judgment of Hon'ble Bombay High Court. The AO should scrutinize the valuation report and he

should determine a fresh valuation either by himself or by calling a final determination from an independent valuer and confront the same to the assessee. But the basis has to be DCF method and he cannot change the method of valuation which has been opted by the assessee. In our considered opinion and as per report of research committee of (ICAI) as reproduced above, most critical input of DCF model is the Cash Flow Projections. Hence, the assessee should be asked to establish that such projections by the assessee based on which, the valuation report is prepared by the Chartered accountant is estimated with reasonable certainty by showing that this is a reliable estimate achievable with reasonable certainty on the basis of facts available on the date of valuation and actual result of future cannot be a basis of saying that the estimates of the management are not reasonable and reliable.

13. Before parting, we want to observe that in the present case, past data are available and hence, the same can be used to make a reliable future estimate but in case of a start up where no past data is available, this view of us that the projection should be on the basis of reliable future estimate should not be insisted upon because in those cases, the projections may be on the basis of expectations and in such cases, it should be shown that such expectations are reasonable after considering various macro and micro economic factors affecting the business.

14. In nutshell, our conclusions are as under:-

(1) The AO can scrutinize the valuation report and if the AO is not satisfied with the explanation of the assessee, he has to record the reasons and basis for not accepting the valuation report submitted by the assessee and only thereafter, he can go for own valuation or to obtain the fresh valuation report from an independent valuer and confront the same to the assessee. But the basis has to be DCF method and he cannot change the method of valuation which has been opted by the assessee.

(2) For scrutinizing the valuation report, the facts and data available on the date of valuation only has to be considered and actual result of future cannot be a basis to decide about reliability of the projections.

(3) The primary onus to prove the correctness of the valuation Report is on the assessee as he has special knowledge and he is privy to the facts of the company and only he has opted for this method. Hence, he has to satisfy about the

correctness of the projections, Discounting factor and Terminal value etc. with the help of Empirical data or industry norm if any and/or Scientific Data, Scientific Method, scientific study and applicable Guidelines regarding DCF Method of Valuation.

15. In the result, the appeal of the assessee is allowed for statistical purposes.

Order pronounced in the open court on the date mentioned on the caption page.

Sd/-
(LALIET KUMAR)
Judicial Member

Sd/-
(ARUN KUMAR GARODIA)
Accountant Member

Bangalore,
Dated, the 9th January, 2019.
MCN*/MS/

Copy to:

- | | |
|---------------|------------------------|
| 1. Appellant | 4. CIT(A) |
| 2. Respondent | 5. DR, ITAT, Bangalore |
| 3. CIT | 6. Guard file |

By order

Assistant Registrar,
Income Tax Appellate Tribunal,
Bangalore.