Recent Developments in Business and Intangible Asset Valuation in the U.S.

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Overview of Presentation

- Status of Valuation Profession
  - Financial Reporting
  - Tax, ESOP and SBA Developments
- Accounting Developments
  - Status of Proposed Convergence of IFRS and US GAAP
  - Recent Accounting Developments
  - Documents Providing Fair Value Guidance
- Business Valuation Updates
  - Cheap Stock Practice Aid
- Intangible Asset Valuation Updates
  - IPR&D Practice Aid
  - Customer-Related-Assets Discussion Draft

Developments in the Valuation Profession

The Regulatory Environment – Financial Reporting

- Appraisals prepared for financial reporting purposes are being reviewed more frequently and in more detail
  - Securities and Exchange Commission (SEC)
  - Public Company Accounting Oversight Board (PCAOB)
- Accounting requirements driving valuations are generally increasing
  - ASC 805, 350, 360 and 805 among others over prior years
  - Some discussions of possible undue cost and burden on financial statement preparers
- Increased focus on value of assets of financial institutions
- Increased focus on valuation of investments of venture capital and private equity funds

SEC Comments on Valuation Profession – Paul Beswick, Deputy Chief Accountant, SEC, December 2011

- "The broadening application of fair value . . . and the 2008 financial crisis have cast the spotlight on valuation professionals. At last count, valuation professionals in the US can choose among five business valuation credentials available from four different organizations, each with its own set of criteria for attainment. Risks created by the differences in valuation credentials that exist today range from the seemingly innocuous concerns of market confusion to the more overt concerns of objectivity of the valuator and analytical inconsistency."

SEC Comments on Valuation Profession – Paul Beswick, December 2011 *(cont'd)*

- "One potential solution to consider is whether there should be, similar to other professions, a **single set of qualifications with respect to the education level and work experience, a continuing education curriculum, standards of practice and ethics, and a code of conduct**. One could also contemplate whether a comprehensive inspection program and a fair disciplinary mechanism should be established to encourage proper behavior and enforce the rules of the profession in the public interest."

PCAOB Inspection Reports and Valuation Matters

- Public Company Accounting Oversight Board (PCAOB) is a quasi-governmental agency which audits the work of audit firms (pcaobus.org)
- Inspections of the Big 4 accounting firms in 2009 resulted in 37 audits containing an audit “deficiency” . Of these, 26 (70%) involved fair value measurements.

– Financial instruments	11
– Goodwill impairment	8
– Long-lived asset impairment	3
– Inventory valuation	2
– Other	2
– Total	26

- Deficiency relates to audit files that do not contain adequate evidence of audit procedures performed or audit evidence / procedures that are insufficient. A deficiency does not necessarily suggest a restatement of financial statements.

The Regulatory Environment – Tax and ESOP Valuations

- Internal Revenue Service (IRS) increase in penalties and sanctions
  - Definitions of qualified appraisal and qualified appraiser
  - Financial penalties on appraiser for significant over or under valuations
  - Potential sanctions to prevent future valuation work
- US Department of Labor has responsibility for Employee Stock Ownership Plans (ESOP).
  - ESOPs are a mechanism to incentivize employees of private companies through participating in increases in the value of a private company employer.
  - Recent draft legislation to include appraisers as a fiduciary. Responsibilities of a fiduciary are complex and may be inconsistent with the role of an independent appraiser. Area of current discussion prior to finalization of changes in rules.

The Regulatory Environment – Small Business Administration Valuations

- US Small Business Administration (SBA) provides a variety of services to small businesses including loans and loan guarantees.
  - Some businesses are primarily real estate oriented (hotels and motels, nursing homes, other) but have differing degrees of intangible value.
  - Valuations are required in connection with the loan guarantee. In some cases, the business may be valued by real estate rather than business appraisers.
  - The Appraisal Institute developed a mandatory course for real estate appraisers appraising these "real estate oriented" businesses. SBA requirements for mandatory course attendance for real estate appraisers performing these valuations.
  - Following review, the course requirement was withdrawn. Development of appropriate course as well as determination of when a real estate appraiser is competent (or a business appraiser is required) is presently being assessed as an area for further consideration.

Accounting Developments Impacting the Valuation Profession

Assessment of Possible Convergence of US GAAP and IFRS – July 13, 2012 SEC "Staff Report"

- On July 13, 2012, the Staff of the SEC's Office of the Chief Accountant published its final report (the "Staff Report") on its IFRS Work Plan.
  - Report does not include a final policy decision, or recommendation, on incorporation of IFRS into the US financial reporting system
  - Companies should not be permitted to adopt IFRS early, because it would compromise comparability with US companies applying US GAAP
  - Staff Report states that adopting IFRS as authoritative guidance in the United States is not supported by the vast majority of participants in the US capital markets, and would not be consistent with the methods of incorporation followed by other major capital markets
  - IFRS is generally perceived to be of high quality. Areas where gaps remain (accounting for rate-regulated industries and oil and gas industries), and inconsistencies exist in the application of IFRS globally
  - Improvements can be made to the IFRS interpretative process and the enforcement and coordination activities of regulators across territories

Convergence of US GAAP and IFRS *(cont'd)*

- US GAAP and IFRS are reasonably converged in certain areas
  - *Fair Value Measurement* standards (IFRS 13 and ASC 820) are essentially identical
  - *Business Combinations* standards (IFRS 3R and ASC 805) are also substantially similar
  - Accounting standards impacting areas requiring valuations do have differences
    - Goodwill impairment
      - > US GAAP (ASC 350) has a "step two" calculation for impairment
      - > IFRS (IAS 36) has a single step calculation
      - > Differences in premise – IFRS fair value or value-in-use and US GAAP only fair value
      - > Other
    - Other differences

Recent Accounting Developments - Overview

- Goodwill and indefinite lived assets – addition of a “qualitative” test. Intent is to reduce measurement burden of registrants. (Accounting challenges associated with a qualitative rather than a quantitative test)
  - Accounting Standard Update (“ASU”) 2011-08, *Testing Goodwill for Impairment* issued September 2011
  - ASU 2012-02, *Testing Indefinite-Lived Intangible Assets for Impairment* issued July 2012
- Accounting and valuation guides under development
  - *Assets Acquired to be Used in Research and Development Activities*
  - *Valuation of Privately-Held-Company Stock Issued as Compensation*
  - *Testing Goodwill for Impairment*
  - *Business Combinations*
- Audit guide under development
  - *Special Considerations in Auditing Financial Instruments*

Testing Goodwill for Impairment Guide

- Working draft issued November 2011. Final expected in 2013.
- Includes step one and step two examples – DCF, guideline public company and guideline transactions method
- Will include a chapter with guidance on qualitative assessments
- Guidance on assets shared by reporting units
- Guidance on developing market participant assumptions

Other Guides in Development

- *Business Combinations* Guide is at a very early stage
  - Task group formed
  - Scope of project being discussed
- *Special Considerations in Auditing Financial Instruments* Audit Guide
  - Purposes
    - Provide background information on financial instruments
    - Provide audit guidance
  - Expected issuance in late 2012

Control Premiums in Financial Reporting

- Correct interpretation of “control premiums” has been an area of challenge for several decades in the US.
  - Control premiums used to quantify lack of control discounts for gift tax valuations. Concern that high control premiums lead to high lack of control discounts to reduce gift tax liability
  - Measurement is challenging as control premiums can be influenced by stock price movements, choice of measurement dates, other factors
- Expected introduction of term “Market Participant Acquisition Premium” (MPAP) rather than prior concept of a control premium
  - Recognizes that premiums are not paid for control per se but for other elements of value
- Quantification of MPAP focused on
  - Cash flow impact – revenues, margins, capital expenditures
  - Risk (discount rate) impact (larger size, better access to capital, enhanced financing mix)
  - Not simply a percentage to be added based on transactions that may or may not be comparable

Business Valuation Developments

Updates in Technical Guidance – AICPA Cheap Stock

1. Discussion draft issued in August 2012. Final guide expected for release in 2013.
2. Wide ranging discussion on preferred methodologies for enterprise valuation.
3. Discussion of methodologies for valuation of debt
   a) Separate valuation of debt and subtraction from enterprise value, or
   b) Inclusion in a model for the allocation of the value of the enterprise to debt and equity securities
4. Detailed discussion of means of determining values for different elements of a complex capital structure (possibly multiple types of preferred stock, options, common stock)
5. Provides framework for assessing whether transactions in the shares of a company are meaningful
   a) Depth of trading
   b) Knowledge of parties
   c) Motivation of parties

Intangible Asset Valuation Developments

Updates in Technical Guidance

- Documents providing detailed discussions of intangible asset valuation include:
    1. The Appraisal Foundation, Best Practices for Valuations in Financial Reporting: Intangible Asset Working Group, "*The Identification of Contributory Assets and the Calculation of Economic Rents*", issued May 31, 2010
    2. AICPA Practice Aid entitled *"Assets Acquired to Be Used in Research and Development Activities*", working draft released November 18, 2011. Final version expected for release in 2013
    3. The Appraisal Foundation, "*The Valuation of Customer-Related Assets*", discussion draft issued June 5, 2012
    4. Control Premiums in Financial Reporting – initial discussion draft is pending
    5. Contingent Consideration – study group recently formed

Assets Acquired to Be Used in Research and Development Activities (IPR&D Guide)

- This document will update a prior version released in 2001. Valuation of in-process technology has been an area of concern with wide divergence in practice.
- Discussion draft eliminated prior concept of “core technology” and focused more on technology migration
  - Firms may have multiple technologies that have different lives
- Discussion of Discount Rate Adjustment Technique (DRAT) vs. Expected Present Value Technique (EPVT)
  - For DRAT, risk is considered through an adjustment to a discount rate (WACC plus or minus a premium).
  - For EPVT, risk is captured by weighting a variety of scenarios (potentially broad range from failure to success). This allows use of WACC and reduces concern about reasonably quantified a potentially large risk adjustment
  - EPVT is conceptually superior. DRAT is still frequently observed.

The Valuation of Customer-Related-Assets Guide

- Discussion draft issued in June 2012
- Discusses various methodologies
  - MPEEM
  - Distributor Method
  - With and Without Method
  - Cost Approach
- Provides insights on a variety of matters
  - Attrition
  - Backlog
  - Deferred revenue
  - Overlapping customers

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