Technical Best Practices for Completing Business Valuations

September 12, 2016

Contents

Learning Objectives

1. Recognize key elements of USPAP valuation standards and their relationship to Mandatory Performance Framework (MPF)
2. Understand the purpose / scope of MPF
3. Discuss documentation requirements for a valuation report and a valuation work file
4. Explain concepts of professional skepticism, evidence-skepticism and self-skepticism
5. Recognize areas of business valuation subject matter guidance
6. Describe MPF and documentation requirements for
    a. Analysis of Prospective Financial Information
    b. Discount Rate Derivation
    c. Growth Rates
    d. Terminal Value Multiple Methods/Models
    e. Selection of, and Adjustments to, Valuation Multiples
    f. Selection of Guideline Public Companies or Comparable Company Transactions
    g. Discounts and Premiums

Introduction

- Competition between appraisers to obtain valuation projects and the lower valued added nature of many financial reporting valuations can lead to significant fee competition to obtain valuation assignments.
- Price competition and low project fees can increase the risk that appraisers may not perform adequate valuation due diligence in completing projects.
- USPAP provides high level standards on the sufficiency of procedures required to complete an appraisal.
- To help appraisers perform and report projects with an adequate degree of effort, a Mandatory Performance Framework document is being developed to provide guidance for certain financial reporting valuations.

Valuation Standards - Introduction

- Key organizations in the valuation profession include:
- **Valuation Standard Setting Bodies**
  - The Appraisal Foundation (“TAF”)
    - USPAP (2015 – 2016 Edition)
      - Standard 9 – Business Appraisal, Development
        - » Standards Rules 9-1 to 9-5
      - Standard 10 – Business Appraisal, Reporting
        - » Standards Rules 10-1 to 10-4
  - International Valuation Standards Council (“IVSC”)
    - International Valuation Standards
- **Valuation Professional Organizations and Related Standards**
  - AICPA *Statement on Standards for Valuation Services* No. 1 (SSVS)
  - ASA *Business Valuation Standards*
  - Royal Institute of Chartered Surveyors (“RICS”) – *Professional Standards* (2014)

Valuation Standards – Introduction *(cont'd)*

- Under USPAP, an **appraisal** is defined as an **opinion of value**. The scope of work associated or the reliability and credibility of the appraisal are separate elements from this basic term.
  - An informal discussion between friends of the value of Google's stock could constitute an "appraisal".
- USPAP indicates that an appraisal must be "**credible within the context of its Intended Use**".
- USPAP also provides that a **credible appraisal is worthy of belief**.
- A **credible appraisal would presumably reflect a sufficient scope of work** – USPAP defines **Scope of Work as "the extent of research and analysis**".

Valuation Standards – General and Ethical Standards – Key Elements

- There are numerous ethical considerations in the completion of valuation projects. Key among these are:
  1. Integrity and objectivity
  2. **Professional competence**
  3. **Due professional care**
  4. Planning and supervision
  5. **Sufficient relevant data**
  6. Absence of financial personal interest (independence)
- The items highlighted in bold are key items that relate to the technical performance of a valuation assignment.

Valuation Standards – Scope of Work

- A Fair Value Quality Initiative ("FVQI") is focused on enhancing the quality of certain valuations prepared for financial reporting purposes. The FVQI is focused on a variety of items impacting the quality of valuations. Among these are efforts to insure an adequate scope of work is performed to complete an assignment.
- USPAP defines scope of work as follows:
  - **Scope of Work**: the type and extent of research and analyses in an appraisal or appraisal review assignment.
- The following two slides present the entirety (interpretive comments excluded) of USPAP's Scope of Work Rule.

Valuation Standards – USPAP – Scope of Work Rule

- For each appraisal and appraisal review assignment, an appraiser must:
  1. identify the problem to be solved;
  2. **determine and perform the scope of work necessary to develop credible assignment results**; and
  3. disclose the scope of work in the report.
- An appraiser must properly identify the problem to be solved in order to determine the appropriate scope of work. The appraiser must be prepared to **demonstrate that the scope of work is sufficient to produce credible assignment results**.
- <u>Problem Identification</u>
- An appraiser must gather and analyze information about those assignment elements that are necessary to properly identify the appraisal or appraisal review problem to be solved.
- <u>Scope of Work Acceptability</u>
- The **scope of work must include the research and analyses that are necessary to develop credible assignment results**.

Valuation Standards – USPAP – Scope of Work Rule *(cont'd)*

- An appraiser must **not allow assignment conditions to limit the scope of work to such a degree that the assignment results are not credible in the context of the intended use**.
- An appraiser must not allow the intended use of an assignment or a client's objectives to cause the assignment results to be biased.
- <u>Disclosure Obligation</u>
- The **report must contain sufficient information to allow intended users to understand the scope of work performed**.

Valuation Standards – USPAP Standards Rule 9-1

- In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must:
- **Standards Rule 9-1**
- (a) be aware of, understand, and **correctly employ those recognized approaches, methods and procedures that are necessary to produce a credible appraisa**l;
- (b) **not commit a substantial error of omission or commission that significantly affects an appraisa**l; and
- (c) **not render appraisal services in a careless or negligent manner**, such as by making a series of errors that, although individually might not significantly affect the results of an appraisal, in the aggregate affect the credibility of those results.

Valuation Standards – USPAP Standards Rule 9-2

- In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must:
  a) identify the **client** and other intended users;
  b) identify the **intended use** of the appraiser's opinions and conclusions;
  c) identify the **standard (type) and definition of value and the premise of value**;
  d) identify **the effective date** of the appraisal;
  e) identify the **characteristics of the subject property** that are relevant to the standard (type) and definition of value and intended use of the appraisal, including:
     i. the subject business enterprise or intangible asset, if applicable;
     ii. the interest in the business enterprise, equity, asset, or liability to be valued;
     iii. all buy-sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and similar features or factors that may have an influence on value;

Valuation Standards – USPAP Standards Rule 9-2 and 9-3

iv. the extent to which the interest contains elements of ownership control; and

v. the extent to which the interest is marketable and/or liquid;

f) identify any **extraordinary assumptions** necessary in the assignment;

g) identify any **hypothetical conditions** necessary in the assignment; and

h) **determine the scope of work necessary to produce credible assignment results** in accordance with the SCOPE OF WORK RULE.

- **Standards Rule 9-3**
- In developing an appraisal of an equity interest in a business enterprise with the ability to cause liquidation, an appraiser must investigate the possibility that the business enterprise may have a higher value by liquidation of all or part of the enterprise than by continued operation as is. If liquidation of all or part of the enterprise is the indicated premise of value, an appraisal of any real property or personal property to be liquidated may be appropriate.

Valuation Standards – USPAP Standards Rule 9-4

- In developing an appraisal of an interest in a business enterprise or intangible asset, an **appraiser must collect and analyze all information necessary for credible assignment results**.
  a) An appraiser must develop value opinion(s) and conclusion(s) by use of **one or more approaches that are necessary for credible assignment results**.
  b) An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of:
    i. the nature and history of the business enterprise or intangible asset;
    ii. financial and economic conditions affecting the business enterprise or intangible asset, its industry, and the general economy;
    iii. past results, current operations, and future prospects of the business enterprise;

Valuation Standards – USPAP Standards Rule 9-4

iv. past sales of capital stock or other ownership interests in the business enterprise or intangible asset being appraised;

v. sales of capital stock or other ownership interests in similar business enterprises;

vi. prices, terms, and conditions affecting past sales of similar ownership interests in the asset being appraised or a similar asset; and

vii. economic benefit of tangible and intangible assets.

c) An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of buy-sell and option agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and similar features or factors that may influence value.

d) An appraiser must, when necessary for credible assignment results, analyze the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid.

Valuation Standards – USPAP Standards Rule 9-5

- In developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must:
  a) **reconcile the quality and quantity of data available and analyzed within the approaches, methods, and procedures used**; and
  b) **reconcile the applicability and relevance of the approaches, methods and procedures used to arrive at the value conclusion**(s).

Mandatory Performance Framework

Mandatory Performance Framework - Introduction

- Financial reporting valuations involving public companies have extremely high degrees of third party reliance associated with them.
- Given the complexity of many technical elements of valuations, Working Groups assisted by The Appraisal Foundation and Task Forces assisted by the AICPA have developed various technical guides.
- USPAP provides high level standards on the sufficiency of procedures required to complete an appraisal.
- To help appraisers perform and report certain financial reporting projects with an adequate scope of work, two Mandatory Performance Framework documents are being developed to provide guidance. These include:
  - Mandatory Performance Framework for the Fair Value Quality Initiative ("FVQI")
  - Application of the Mandatory Performance Framework for the FVQI

Mandatory Performance Framework – Overview

- Subsequent slides include key information from the draft MPF documents dated May 24, 2016.
- For each technical valuation topic included in the Application of the MPF document, we present a listing of the documentation requirements. For some of these topics, we also include a brief discussion of the Mandatory Performance Requirements.

Mandatory Performance Framework for Fair Value Quality Initiative

Mandatory Performance Framework - Elements

- Elements of the draft MPF document include:
  1. Preamble – overview of MPF purpose and scope
  2. Valuation Engagement Guidance - establishes the parameters of the performance and documentation requirements that valuation professionals must adhere to
  3. Mandatory Performance Framework Glossary – listing and definitions of key terms
  4. Authoritative and Technical Guidance – listing of various accounting, auditing and valuation standards and certain technical literature
- A separate document address the Application of the MPF. Key elements include:
  1. General Valuation Guidance
  2. Business Valuation Guidance
  3. Valuation of Intangible Assets, Certain Liabilities and Inventory Guidance

MPF - Preamble

MPF – Preamble – Elements of Preamble

- Elements of the Preamble include:

1. Introduction – detailed discussion of key elements
2. Applicable Business Valuation Standards – brief listing and summary discussion
3. Applicable Accounting and Audit Standards Relevant to Business Valuation & Intangible Assets – brief overview
4. Scope of the Mandatory Performance Framework
5. Exceptions from the Mandatory Performance Framework – very brief discussion of possible conflict of MPF and other guidance

MPF – Preamble – Purpose of MPF

- **1.1** The Mandatory Performance Framework is a document that provides guidance to professionals who have earned the new Fair Value Quality Initiative credential (referenced throughout the MPF as **VALUATION PROFESSIONALS**). This guidance is a **set of parameters that indicates how much, in terms of scope of work and documentation, should be prepared or obtained when designing, implementing, and conducting valuations used to support management assertions made in financial statements issued for public interest reporting purposes.**

MPF – Preamble – Scope of the Mandatory Performance Framework

- **1.2** Financial statements issued for public interest reporting encompasses financial reports issued in registration statements or disclosures required by the U.S. Securities and Exchange Commission (SEC).
- **1.3** The primary goal of the MPF is to provide valuation professionals with parameters of **how much work should be performed** and **how to effectively and efficiently identify valuation documentation requirements** in order to meet the changing needs of clients and other potential stakeholders, mitigate engagement risk, and support and document sound decision making. This Framework is a set of interrelated and interacting elements that valuation professionals can use in conjunction with the relevant valuation standards and technical guidance to promote quality, consistency, and auditability. It is not intended to address valuation theory or to be a "how to" regarding valuation steps.

MPF – Preamble – Written Documentation

- **1.4** Written documentation within the engagement file that supports a final conclusion of value (referenced in the MPF as 'work papers'), and the final valuation report will be referenced collectively as the **WORK FILE** unless otherwise specified.
- The **MPF requires that the valuation professional provide within the work file sufficient documentation to support a conclusion of value such that an experienced valuation professional not involved in the valuation engagement could review and understand the significant inputs, analyses, and outputs and how they support the final conclusion of value.**
- The **MPF sets forth minimum scope of work and documentation requirements for valuation professionals**. Circumstances where a valuation professional has agreed to comply with more stringent scope of work and documentation requirements are not negated by this Framework.

MPF - Preamble – Applicable to Valuation Professionals that Develop Public Interest Fair Value Estimates

- Paragraph 1.5 of the Fair Value Quality Initiative, Mandatory Performance Framework (May 24, 2016 draft) provides
  - **1.5** Valuation professionals [defined term in the MPF] who perform valuation services for their clients, employers, or as part of another engagement, are required to adhere to the MPF.
  - **The definition of a Valuation Professional is set forth in Glossary of the MPF**
    - **Valuation Professional** – an individual who has obtained the new Fair Value Quality Initiative credential and is in compliance with the Mandatory Performance Framework requirements.

Valuation Engagement Guidance

MPF –Documentation Requirements for Fair Value Engagements

- **2.3** The valuation professional **must conduct each engagement** or part of an engagement to estimate fair value of a subject interest to assist in management's preparation of financial statements for public interest reporting **in accordance with the documentation guidance** defined in this Framework.
- **2.4 Documentation is the written record within the final valuation report, supporting work papers, or both, that is used to support a conclusion** of value or a range of values to be used by management in their assertions of fair value and their preparation of **financial statements issued for public interest reporting**.
- **2.5** Documentation provides evidence that the valuation engagement was planned, performed, and reviewed in accordance with this MPF.
- **2.6 Written documentation may include paper, electronic files, or other forms of recorded media**. Examples include, but are not limited to: letters of engagement, correspondence with clients (for example, email, recordings of calls, voice messages), client-provided documents, representation letters, field notes, electronic spreadsheets, and **internally prepared memoranda to the work file.**

MPF – Documentation Requirements for Fair Value Engagements

- **2.7** Documentation comprises two key components:
  - 2.7.1 **SOURCE DOCUMENTS** including, but not limited to, data and information (including interview notes) collected from both **company sources** and **external third-party data** accumulation resources relating to the company, its financial position, its competitors, the industry it competes in, its customers and suppliers, the state of the economy, financial markets, and risk factors.
  - 2.7.2 **ANALYSIS DOCUMENTS** including, but not limited to, exhibits, schedules, and work-papers that **numerically set forth the analysis** that was performed, and **memos to file or other narratives, that document and explain the valuation professional's reasoning** behind such matters as the: selection of methods, selection of inputs used in applying methods, and judgments made regarding valuation assumptions.
  - Source documents that are relevant to the analysis but indicate **contrary evidence to the conclusion of value should also be retained in the work file** along with the valuation professional's **explanation of how this information was considered**.

MPF – Documentation Requirements for Fair Value Engagements

- **2.9** Analysis documents generally fall into two sub-categories:
  - 2.9.1 **Computational analysis** (for example, spreadsheets, database use). To the extent that this type of analysis provides evidential support (or contradictory indications) to an input, process, or output, they are required to be included in the work file (that is, supporting work papers, final valuation report). This analysis demonstrates "what" the valuation professional did.
  - 2.9.2 **Narrative based documents**. These documents complement the computational analyses by **providing commentary on "why" the valuation professional elected certain methods, inputs, and judgments within the work-product**. For example, narrative based documents **could be included in** (not a complete list):
    - The narrative of the **report**
    - The **analysis documents** (for example, footnotes, narrative fields)
    - **Memoranda to the work-file.**

MPF – Valuation Engagement Guidance – Extent of Documentation

- **2.10** The valuation professional must support the conclusion of value with sufficient detail to provide a clear and well organized link from the data and information gathered to the final conclusion of value. **An experienced professional** (for example, audit professional, client, and **valuation** professional) **reviewing the final work file who has no involvement with the engagement must be able to**:
  - 2.10.1 Understand the nature, extent, and results of the valuation procedures performed.
  - 2.10.2 **Understand all approaches and methods used** in the valuation analysis, and if applicable, understand **why commonly used approaches and methods were not used** in the valuation analysis.
  - 2.10.3 **Understand the inputs, judgments, and assumptions** made and the rationale for their use.
  - 2.10.4 Determine **who performed the work and their qualifications** (for example, valuation professional, subcontractor, management).
  - 2.10.5 Identify the **intended users** of the valuation report
  - 2.10.6 Identify the **measurement date**

MPF – Valuation Engagement Guidance – Professional Skepticism

- **2.16 Every valuation professional must exercise professional skepticism during each engagement** where the valuation professional is providing a conclusion of value that will be used to support management's assertions in financial statements issued for public interest reporting.

MPF – Valuation Engagement Guidance – Professional Skepticism *(cont'd)*

- **2.17** Professional skepticism requires the valuation professional have an attitude that:
  - 2.17.1 **Emphasizes EVIDENTIAL SKEPTICISM.** Valuation professionals must exercise due professional care that requires the valuation professional to **continuously question and critique information and data provided by management for bias or misstatement, or both**. The valuation professional must also consider the experience of management and the sufficiency of the documentation and analyses provided by management throughout the valuation engagement. The valuation professional should not presume management is biased; however, the valuation professional should not accept and rely on less-than-persuasive evidence because the valuation professional believes management is unbiased. This requirement extends to third-party specialists retained by management and their competence and the sufficiency of their work product.
  - 2.17.2 **Emphasizes SELF-SKEPTICISM.** The valuation professional must continuously **monitor his or her own client-based presuppositions that can detract from evidencing skepticism because of comfort level or familiarity with the client, industry or both**.

MPF – Valuation Engagement Guidance – Professional Skepticism *(cont'd)*

- **2.18** Each valuation professional must ensure the **work file documents the valuation professional's consideration and implementation of professional skepticism** with the understanding that the sufficiency of the conclusions reached in the report will be subjected to review (for example, the client, external auditors, regulators).

MPF – Valuation Engagement Guidance – Valuation Reports

- 2.20 Engagements performed for public interest reporting purposes, in general, **must include a complete valuation analysis that conforms to the MPF requirements**, but the **report type can vary according to the requirements of the engagement**.
- 2.20.2 The comprehensive valuation report provides sufficient information for the intended users of the report to identify the data, analyses and rationale used by the valuation professional in order to arrive at a conclusion of value. An **abbreviated valuation report condenses this information based on criteria agreed upon by the client and the valuation professional but may not contain sufficient details for the intended users or expected recipients to understand the data, analysis and rationale for the value conclusions**. Therefore, in order to enhance auditability, the valuation professional must **prepare the work file in alignment with the MPF to ensure sufficient detail exists to support the conclusion of value.**

MPF – Valuation Engagement Guidance – Valuation Reports *(cont'd)*

- Regardless of the type of valuation report that will eventually be issued, the valuation professional **must include the analysis and accompanying explanatory narrative for all internally prepared analyses, findings and conclusions within the work file**. This documentation may take the form of **internally prepared memoranda** or **narrative that will be used to develop the valuation report**.

MPF – Valuation Engagement Guidance – Content of Final Valuation Report

- **2.24** The final valuation report represents the planning, execution, and conclusion of the valuation professional's services for a client. For purposes of the MPF, **valuation professionals must prepare their work file, which includes the final valuation report, in accordance with the guidance provided in this section** for all engagements to estimate fair value used to support management assertions made in financial statements issued for public interest reporting purpose.
- **2.27** In order for a comprehensive valuation report to be prepared in accordance with this Framework, the valuation professional must, at a minimum, include the following components, where relevant, within the final valuation report.

1. Client information
2. Purpose and intended use of the valuation report
3. Intended users
4. Measurement Date
5. Valuation Report Date
6. Subsequent Events
7. Identification of the subject interest
8. Sources of information

MPF – Valuation Engagement Guidance – Content of Final Valuation Report *(cont'd)*

9. **Reliance on client-provided information**
   - When the valuation professional relies on other client-provided information (this includes information prepared by third-party specialists retained by the client), and does not assess or evaluate it for reasonableness (for example, reviewing for accuracy and completeness), the **valuation professional must clearly describe in the valuation documentation the information he or she relied on and the rationale for the reliance**.
   - **Important:** When the client provides information (for example, prospective financial information) to the valuation professional, the **valuation professional must use his or her professional skepticism and judgment to assess the relevance and reliability of the information and the extent to which he or she will rely on the information** in the assessment of fair value.
10. Valuation approaches and methods

MPF – Valuation Engagement Guidance – Content of Final Valuation Report *(cont'd)*

11. Alternative approaches and methods
12. Limitations on Scope of Research and Analysis
13. Disclosure of limitations
14. Disclosure of scope changes
15. **Non-assured financial statements (includes tax returns)**
16. Financial information adjustments
17. **Significant assumptions and estimates**
18. **Subcontractors retained by valuation professional**
19. Third party specialist – retained by client
20. Valuation report representation or certification
21. Valuation report signature

Application of Mandatory Performance Framework for Fair Value Quality Initiative

Application of the Mandatory Performance Framework – General Outline of Topic Discussion

- The **outline used for each topic in the MPF application document includes**:
  A. Topic **overview**
  B. Documentation requirements

- In many cases, the topic overviews are relatively straightforward. As a result, they are not presented. In a few instances, we include a summary discussion of the topic overview where clarification of the topic presented may be helpful.
- Given the importance of the documentation requirements, these requirements are presented for each topic.

MPF – Selection of Valuation Approaches and Methods – Topic Overview

- A1.3.2 In **determining the appropriate valuation method**(s), the valuation professional should **consider**, among other things, **valuation guidance, the history and nature of the subject interest, academic research, market participant disclosure, and approaches utilized for similar business entities or assets.**
- A1.3.3 **For many valuation engagements, valuation professionals will rely on multiple valuation approaches and methods to estimate a fair value**. For example, in a business valuation of a sufficiently-profitable operating company, it is common for one form of the income approach (such as discounted cash flow method) and two methods of the market approach (guideline public company method and guideline transaction method) to be completed. **If developed correctly and with good information, the results from each approach or method should provide indications of fair value that are reasonably consistent with each other. If the results are not reasonably consistent, further analysis is generally required to determine if an error has been made in one method or the other, or if there is good reason why they would be significantly different.**

MPF – Selection of Valuation Approaches and Methods – Documentation Requirements

- A1.3.4 The valuation professional, at a minimum, must document in writing within the work file:
  - i. Where applicable, **process and rationale for selecting the valuation method(s) or excluding common valuation methods** to estimate the fair value of the subject interest.
  - ii. The **process and rationale for selected weighting** (or emphasis on) each approach and/or method in reconciling various indications of value to reach the final conclusion of value (if more than one approach/method is used).
  - iii. A reconciliation of the results should include among other things:
    - a. A **supporting narrative about the applied methods and their applicability and usefulness to the valuation assignment**; the reliability of the underlying data used in their preparation; and an explanation of inputs and assumptions

MPF –Selection of Valuation Approaches and Methods – Documentation Requirements *(cont'd)*

b. An **assessment of the reliability of the results obtained and whether any of the results used to reach a conclusion of value are deemed more or less probative of fair value** based on information gathered throughout the engagement (note: the extent of documentation should be commensurate with the level of judgment and qualitative analysis involved in supporting the positive assertion).

c. A clear explanation discussing any apparent inconsistencies in the analysis relative to external or internal documentation and/or data (for example, contrary evidence). This may then take the form of arithmetic/mathematical calculations when using quantitative weighting.

iv. An explanation, based on the results of items i-iii, that identifies whether the conclusion of value is based on the results of one valuation approach and method, or based on the results of multiple approaches and methods.

MPF – Prospective Financial Information (PFI) – Introduction

- One of the most important and challenging areas in valuation involves the use of projections of future financial results. This area can be challenging for all valuations.
- The description of PFI from MPF draft document follows:
  - A1.4.1 **Prospective financial information (PFI) is a broad term that encapsulates several types of forward-looking financial information. PFI is any financial information about the future.** The information may be presented as complete financial statements or limited to one or more elements, items, or accounts. Common categories include, but are not limited to, break-even analyses, feasibility studies, forecasts, or projections. This type of information is commonly prepared for external financing, budgetary purposes, or calculating the expected return on investments. Furthermore, how the PFI is expected to be used will usually dictate the type of PFI prepared.

MPF –PFI – Introduction *(cont'd)*

- A1.4.2 **Since PFI represents future expectations, it is, by its very nature, imprecise**. Therefore, the assumptions used in preparation of the PFI must be reasonable and supportable. In order for the valuation professional **to determine if a PFI is reasonable** he or she must **compare it to the expected cash flows of the subject** interest or entity (for example, **expected cash flows might be determined by using a probability-weighted scenarios of possible outcomes**). In order to achieve this, the **valuation professional must incorporate the most reliable objective information available.**
- A1.4.3 Valuation professionals should understand and **document how the PFI was developed by management**. Management may prepare PFI using a "top-down" method or a "bottoms-up" method or some combination of the two.

MPF –PFI – Introduction *(cont'd)*

- A1.4.4 **Valuation professionals should be aware of the purpose for which PFI is prepared**. In addition, valuation professionals should **understand whether the PFI was prepared using market participant assumptions**. Valuation professionals should strive for objective, reasonable, and supportable PFI relevant for use in the valuation process with the understanding that management bias may exist and, if present, should be properly adjusted to expected cash flows in the analysis.

MPF – PFI Procedures to Assess

- A1.4.6 Part of the valuation professional's responsibility is to evaluate the PFI provided by management for reasonableness in general, as well as in specific areas. Factors to consider and common procedures to apply when performing this assessment include, but are not limited to:
  - **Comparison of PFI to expected values of the cash flows**
  - **Frequency of preparation**
  - **Comparison of prior forecasts with actual results**
  - **Mathematical and Logic Check**
  - **Comparison to historical trends**
  - **Comparison to industry expectations**
  - Forecasts that vary from historical performance or industry trends
  - **Check for internal consistency**

MPF – PFI – Documentation Requirements

1. A1.4.7 The valuation professional, at a minimum, must document in writing within the work file:
   i. The identification of the party or **parties responsible for preparation** of the PFI**.**
   ii. The **process used to develop the PFI** from the perspective of a market participant.
   iii. The **explanation of key underlying assumptions** utilized in the PFI such as revenue forecasts, percentage of market share captured by the entity or how the projected profit margins compare to those of other market participants.
   iv. The **steps used in, and results of, testing the PFI for reasonableness** including, but not limited to: a) a comparison of the PFI to expected cash flows, b) a comparison of the PFI to historical performance, b) a comparison of prior year's PFI against actual historical results (when prior PFIs are available), c) an analysis of the forecast relative to economic and industry expectations.

MPF – PFI – Documentation Requirements *(cont'd)*

v. An evaluation of any differences between the PFI and expected cash flows.
vi. An analysis of any evidence that contradicts management's assumptions or conclusions used in their PFI.
vii. The rationale for any adjustments made to management's PFI.
viii. Evidence that a mathematical and logic check was performed.
ix. The components of the prospective balance sheet, and if available, cash flow statements.
x. The prospective capital structure.

Mandatory Performance Framework - Business Valuation Subject Matter Guidance

MPF – Business Valuation Subject Matter Guidance

- Sections included in the MPF for Business Valuation Subject Matter Guidance include:
  1. Discount Rate Derivation
  2. Growth Rates
  3. Terminal Value Multiple Methods/Models
  4. Selection of, and Adjustments to, Valuation Multiples
  5. Selection of Guideline Public Companies or Comparable Company Transactions
  6. Discounts and Premiums

- Documentation requirements in each of these areas are presented in the following slides

MPF – BV Guidance – Discount Rate Derivation – Documentation Requirements

- A2.2.2 The valuation professional, at a minimum, must document in writing within the work file:
- *Cost of Equity*

i. The rationale for the selection of a model.
ii. The source of the risk free rate used (when applicable) in the calculation and explain the rationale for its selection.
iii. The source or calculation of the equity risk premium (when applicable) and rationale for its use.
iv. An explanation of the calculation of beta of the guideline companies and the rationale for the method used (or rationale for the use of another source of beta) when using CAPM.
v. The rationale for selecting the specific beta when using CAPM, including 'adjusted betas'.
vi. The amount of size premium, the source of the premium data (if applicable), and the rationale for selecting the concluded premium (even if that premium is zero) when applicable.

MPF – Discount Rate Derivation – Documentation Requirements *(cont'd)*

vii. The **amount of company-specific risk adjustment**, if any, the rationale for application of the adjustment, and the **objective and quantitative data sets used to develop the specific concluded adjustment**. Qualitative factors may be considered in determining whether a company-specific risk adjustment should be applied; however, **quantitative support must also be provided to support the amount of the adjustment** (note: this type of support **should not include the valuation professional's judgment** or the level of company-specific risk premiums observed in other valuations). This is typically the most subjective part of the derivation of the cost of equity capital and, therefore, documentation related to this feature should be the most extensive. Comparisons to IRR calculations or to the results of other discount rate models may aid in supporting a company-specific risk adjustment. **In certain instances it may be appropriate for the valuation professional to explain why no company-specific risk premium was used.**

viii. The amount of **country-specific risk adjustment**) (if applicable), the source of the adjustment data (if applicable), and the rationale for selecting the concluded adjustment (even if that adjustment is zero).

ix. Other significant assumptions should be clearly explained and documented as well as other inputs that may apply depending on the models chosen by the valuation professional.

MPF – Discount Rate Derivation – Documentation Requirements *(cont'd)*

- *Cost of Debt*
  - x. The source(s) of data used and the rationale for use of the source(s) (for example, yields based on interest expense divided by debt balance, or interest rates cited in the guideline company's annual reports).
  - xi. The rationale to support the selection of the pretax cost of debt and any additional source documents
  - xii. The rationale for the effective tax rate used to adjust the pretax rate to an after tax rate.
- *Capital Structure*
  - xiii. The capital structures of the guideline companies and rationale for selection of the time frame over which they are measured.
  - xiv. The capital structure selected in the calculation of the WACC and rationale for its selection.

MPF – Discount Rate Derivation – Documentation Requirements *(cont'd)*

xv. When other discount rate models are used instead of CAPM or WACC, the valuation professional must provide within the work file details on:

a. the model specification,

b. inputs chosen and the sources of those inputs,

c. sub-methodological selections made, and

d. why, if applicable, any adjustments were made to the model results

MPF – Growth Rates – Documentation Requirements

- A2.3.2 The valuation professional, at a minimum, must document in writing within the work file:

  i. The **rationale, support, and reasonableness assessment** for the selected growth rate(s) used in the analysis.

  ii. The rationale for all inputs that comprise the terminal or long-term GR.

  iii. When estimating the valuation of an entity, the rationale to capitalize into perpetuity a particular GR at the point in time where the business had achieved a steady state of operation. For instance, **if company management provides a five-year forecast, the valuation professional should not assume the terminal GR is appropriate after the forecasted period without performing additional analysis.**

  iv. Consideration of other models (for example, the H-model, also referred to as the “fading growth” model) when growth at the end of the projection period is not expected to be sustainable.

MPF – Terminal Value Multiple Methods / Model – Documentation Requirements

- A2.4.2 The valuation professional, at a minimum, must document in writing within the work file:

i. The rationale for selecting the appropriate terminal exit multiple(s) or model(s).

ii. The rationale and support for each key assumption used in the terminal method or model such as, as applicable:
   a. the discount rate
   b. terminal or perpetual growth rate
   c. second-stage or high-growth growth rate for the H-Model and two-stage model
   d. high growth stage duration/life for the H-Model and two-stage model
   e. terminal market multiple (exit multiple)

iii. If more than one terminal method or model is utilized, the rationale for the selected weighting assigned to each terminal method/model and to reconcile the various indications of terminal values.

MPF – Selection of, and Adjustments to, Valuation Multiples – Documentation Requirements

- A2.5.3 The valuation professional, at a minimum, must document in writing within the work file:

i. The market multiples of the guideline companies and the source of the data used. The exhibit should **include the numerators and denominators used in each multiple**. Include a discussion of any assumptions necessary for these calculations.

ii. The **process used to select a multiple** based on a consideration of all the comparative analyses performed, and the rationale for judgments along the way. This should include, but not limited to, discussion of:

a) the decision regarding **equity versus invested capital multiples**,

b) the decision regarding the **time frame** of earnings or other metrics,

c) analysis of the comparative performance measures and how it affected the selection of the multiples applied to the subject entity,

MPF – Selection of, and Adjustments to, Valuation Multiples – Documentation Requirements

d) the comparative **qualitative and quantitative analysis that affected the selection** of the multiples applied to the subject entity,

e) the selection of the starting point of the multiples within the range, and

f) the **rationale for adjustments**, if any, to the starting point multiples to determine multiples applicable to the subject entity.

iii. The **identification of each significant accounting difference and adjustments made**, if any, for better comparability.

iv. The calculation of the multiples of the entire company (if reporting units are being analyzed in a publicly traded company) and rationale for differences in the multiples used.

v. The **calculation of multiples implied in a recent transaction and rationale for differences in the multiples used**.

MPF – Selection of GPC or Transactions – Documentation Requirements

- A2.6.3 The valuation professional, at a minimum, must document in writing within the work file:

i. The understanding of the subject entity, including identification of **which characteristics are appropriate for selection of guideline public companies or comparable company transactions**.

ii. The process used in the selection of the guideline public companies or comparable company transactions, and an indication of specific criteria used in that selection. This would include the **rationale for the inclusion or exclusion** of specific guideline public companies or comparable transactions if that selection was based on subjective factors (instead of specific criteria such as SIC code, transaction date, or existence of a certain level of profitability).

iii. The **identification and description of the selected guideline** public companies or comparable company transactions.

MPF – Discounts and Premiums – Documentation Requirements

- A2.7.2 The valuation professional, at a minimum, must document in writing within the work file:

i. The understanding of the subject company's capital structure and concomitant rights and obligations of, and restrictions on, each class of capital.

ii. The **rationale for why a premium or discount is appropriate for the subject interest** with proper references to supporting documentation (for example, executed contracts, registration statements, corporate documents, state law, and so forth).

iii. The **rationale for selection of methodology** used to determine appropriate magnitude of premium or discount.

MPF – Discounts and Premiums – Documentation Requirements *(cont'd)*

iv. A discussion of how market evidence/data is used and adjusted for application to the subject interest.

v. How the discount or premium was applied to the valuation method (for example, to the equity component of the TIC multiple, the entire multiple or value indication, and so forth).

vi. Identification, and description where necessary, of each significant input used to arrive at the applied premium or discount. This should include, at a minimum:

   a. Resources used to determine input (for example, company specific data, commercial or governmental data bases, and so forth)

   b. Clear description of how inputs into a model were calculated (for example, inputs used to determine volatility, adjustments made for survivorship bias, and so forth)

   c. Any other quantitative and qualitative considerations.

Conclusion

- USPAP provides principles based guidance on the adequate scope of work required to be performed to complete a credible valuation.
- The draft Mandatory Performance Framework documents provide more specific guidance on specific elements that must be completed and included in performing certain valuations for financial reporting.

Questions

Appendix

MPF - Glossary – Key Terms

- **PROFESSIONAL STANDARDS** are standards that encourage professional behavior (for example, codes of ethics, codes of conduct, acting competently, independently, objectively, transparently). These can also be considered standards that define a professional: ethical, independent, objective, having requisite skills, educated, experienced, tested, trained, and credentialed/licensed. Professional standards focus on characteristics of the individual professional and the conduct of their behavior.
- **TECHNICAL STANDARDS** are standards that address the “how to” of work that must be done to prepare a “professional” work product. These standards address the technical “correctness” of the work product by considering appropriate input factors, application of methods and techniques, and reporting guidelines. Both mandatory standards and voluntary guidance have been developed around technical issues in valuation in general and, to a lesser extent, around fair value measurement (FVM).

MPF – Glossary – Key Terms *(cont'd)*

- **Abbreviated Valuation Report** – As compared to a comprehensive valuation report, an abbreviated report contains fewer details within the report in order to comply with a client's request or focus the reader's attention towards specific content. While the content of the report may be less detailed than a comprehensive report, valuation professionals are still expected to apply their own analyses, reasoning, and support for the conclusions presented and **provide the proper documentation in the work files.**
- **Analysis Documents** – generally comprise two types of documents: i) **Computational analysis**. These analyses may include spreadsheets, database analyses, for example. This documentation and analysis demonstrates "what" the valuation professional did. ii) **Narrative based documents**. Examples of this type of analysis may include narratives within the report, footnotes, and **memoranda to the work-file**. This documentation and analysis demonstrates "why" the valuation professional elected certain methods, inputs, and/or judgments within the actual analyses.

MPF – Glossary – Key Terms *(cont'd)*

- **Binding Requirement** – An **unconditional mandatory requirement** that must be met, followed or adhered to by the valuation professional, indicated by the use of the word **"must".**
- **Evidential Skepticism.** Evidential skepticism requires valuation professionals to **continuously question and critique information and data provided by management for bias or misstatement, or both**, taking into consideration the experience of management and the sufficiency of the documentation and analyses provided by management throughout the valuation engagement.
- **Mandatory Performance Framework** - A set of interrelated and interacting elements that valuation professionals must use to establish quality objectives and establish best practices that are needed to ensure the MPF is followed and its objectives are achieved. It **delineates requirements that govern the scope of work and extent of documentation**.
- **Public Interest Reporting** - Financial statements issued for public interest reporting encompasses financial reports issued in registration statements or disclosures required by the U.S. Securities and Exchange Commission (SEC).

MPF – Glossary – Key Terms *(cont'd)*

- **Self-Skepticism-** Self-skepticism is **awareness and monitoring of one's own client-based presuppositions** that can detract from evidencing skepticism because of comfort level or familiarity with the client, industry or both.
- **Valuation Practitioner** – an individual who provides valuation services (for example, management specialist, subcontractor, third-party specialist) who may or may not have the new Fair Value Quality Initiative credential.
- **Valuation Professional** – an **individual who has obtained the new Fair Value Quality Initiative credentia**l and **is in compliance with the Mandatory Performance Framework requirements**.
- **Work File – Written documentation within the engagement file that supports a final conclusion of value**. **This includes work papers (documentation not included in the final valuation report that is retained by the valuation professional in the engagement file that supports the final valuation report), and the final valuation report**. These are collectively referred to as the work file within the MPF. Written documentation may include paper, electronic files, or other forms of recorded media.

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- Ray is a Managing Director in the Irvine, California office of Globalview Advisors. He has over 35 years of financial valuation expertise and is a recognized leader in the valuation of businesses, securities interests, and intangible assets.
- Ray has performed valuation projects for financial (both US GAAP and IFRS) and tax reporting, transactions, and litigation projects. In addition to performing valuations, Ray has extensive experience in the review of third-party and management prepared valuations.
- Ray has a wealth of experience in a wide range of industries. In recent years, much of his work has focused on technology and Internet firms. Other industries where he has significant project expertise include consumer products, entertainment and media, food services, health care, and manufacturing, in addition to early stage, rapid growth firms.
- Prior to joining Globalview Advisors in 2012, Ray was a Director in the Valuation Services Practice at PricewaterhouseCoopers LLP. He was also a Senior Manager in the Valuation Services Practice at KPMG LLP and KPMG Consulting, Inc., as well as a Manager at Arthur Andersen & Company.
- Ray received his MBA from the University of Southern California and his BS in Business Administration, cum laude, from the University of Kansas. He is an accredited senior Member of the *American Society of Appraisers (ASA)* in the business and intangible assets valuation disciplines as well *as* Appraisal Review and Management, and is also a Chartered Financial Analyst (CFA).

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