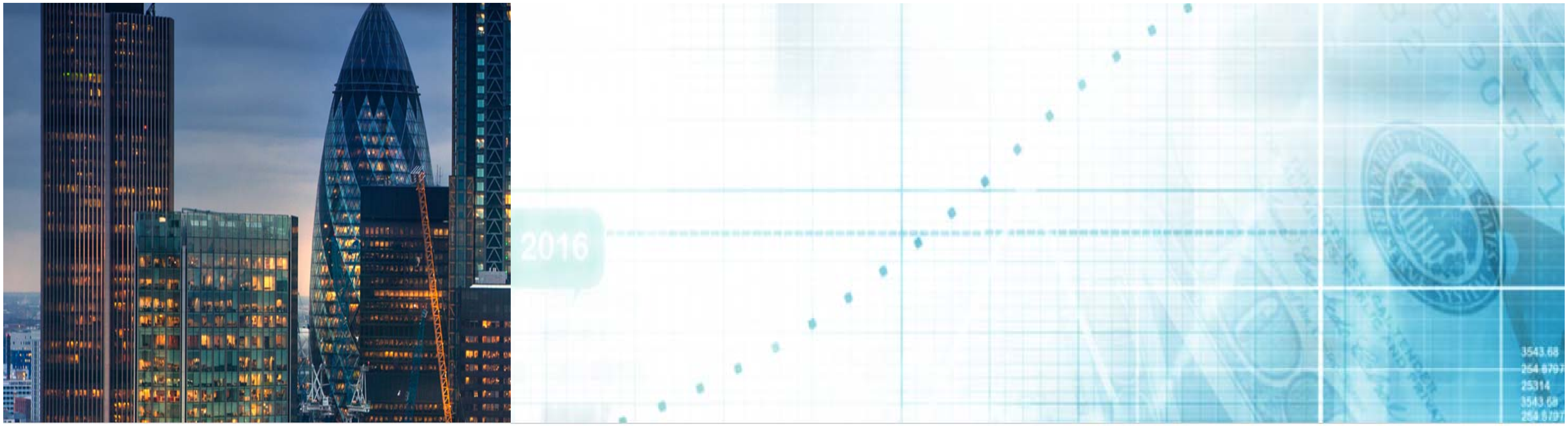

Fair Value Reporting Update

CalCPA – Orange County/Long Beach Chapter

October 20, 2016

Presented by:

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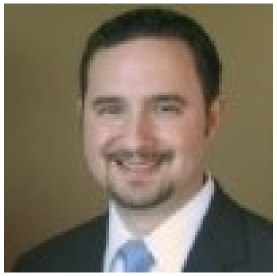

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Ray Rath, ASA, CFA

Ray is a Managing Director in Globalview's Los Angeles office and is a recognized leader in the valuation of businesses, securities interests, and intangible assets. Ray has performed and reviewed third-party valuation projects for financial (both U.S. GAAP and IFRS) and tax reporting, transactions, and litigation projects.

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 has testified in Federal Bankruptcy and Civil Courts on valuation matters, and has been named as an expert witness in numerous matters.

Ray is extremely active in enhancing the quality of valuation practice both domestically and internationally. He has organized and moderated conferences for the American Society of Appraisers (ASA) on fair value issues including presentations by staff of the SEC, PCAOB, FASB, and IASB and has led efforts resulting in an education and certification program for an Intangible Assets valuation specialty designation.

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), and is also a Chartered Financial Analyst (CFA).

Jeremy Burnstein, CVA, FP&A

Jeremy is a Director in Globalview's Irvine Office. He has nearly 15 years of valuation experience involving business enterprises, capital stock, and intangible assets for various purposes including allocations of purchase price, corporate acquisitions and divestitures, fairness and solvency opinions, fresh start accounting, goodwill impairment, litigation, and financial and tax reporting.

Jeremy rejoined Globalview Advisors in 2009. He was previously employed with Globalview Advisors as a Valuation Consultant from 2002 to 2006. Prior to 2002, Jeremy held similar positions with the valuation firms American Appraisal Associates, Inc. and FMV Opinions, Inc. He was also a Credit Officer with Bayview FMAC and Citicorp North America, Inc., where he underwrote senior secured term loans for acquisitions, expansion, debt restructuring, and recapitalizations.

Jeremy received his MS in Finance from Seattle University and his BA in Business Administration from California State University, Fullerton, where he serves as a finance instructor. He is a member of the National Association of Certified Valuators and Analysts (NACVA) and is a Certified Valuation Analyst (CVA). Jeremy is also a member of the Association for Financial Professionals (AFP) and is a Certified Corporate FP&A Professional (FP&A).

FASB Update

FASB Update

- Clarifying the Definition of a Business
- Recognition of Internally Generated Intangible Assets
- Assessing Impairment of Goodwill
- Accounting for Down-Rounds

Clarifying the Definition of a Business

- Classification as an Asset or a Business has accounting differences on acquisition
  - Initial measurement
    - Asset – allocated cost on a relative fair value basis
    - Business – measured at fair value
  - Contingent consideration
    - Asset – accounted for per ASC 815, ASC 450
    - Business – fair value with changes recognized through earnings post-acquisition
  - In-process research and development
    - Asset – expensed as incurred unless it has alternative future use
    - Business – measured at fair value as an indefinite-lived asset until completion or abandonment

Clarifying the Definition of a Business *(cont'd)*

- Classification as an Asset or a Business has accounting differences on acquisition
  - Transaction costs
    - Asset – capitalized
    - Business – expensed
  - Goodwill / bargain purchase
    - Asset – not recognized; over/underpayment allocated to identifiable assets/liabilities on a relative fair value basis
    - Business – recognized; bargain purchase recognized immediately in earnings as a gain

Clarifying the Definition of a Business *(cont'd)*

- Classification as an Asset or a Business has accounting differences on derecognition
  - Control
    - Asset – assessed per new revenue standard
    - Business – consolidation guidance determines control
  - Variable consideration
    - Asset – included in transaction price subject to ASC 606 constraint
    - Business – recognized at fair value or as contingency is resolved (FAS 5)
  - Existence of contract
    - Asset – must evaluate ASC 606 guidance includes collectability
    - Business – no such consideration

Clarifying the Definition of a Business *(cont'd)*

- Classification as an Asset or a Business has accounting differences on derecognition
  - Goodwill allocation
    - Asset – disposals do not impact goodwill
    - Business – goodwill is allocated to disposals
  - Measurement of retained interest in NCI
    - Asset – tentative Board decision phase 2: measure at fair value
    - Business – fair value

Recognition of Internally Generated Intangible Assets

- FASB hasn't permitted recognition due to the following factors:
  - Matching: At the time costs are incurred, is there evidence that those costs will generate future economic benefit?
  - Future economic benefit: Was there an economic resource created and, if so, how certain is the future benefit that is expected to be generated?
  - Measurability: Can the future economic benefit by measured with a reasonable degree of certainty?
  - Correlation: Is there any direct relationship between the amount spent and the future economic benefit?

Recognition of Internally Generated Intangible Assets
(cont'd)

- Concerns with Current GAAP
  - Differences in recognition model for IGIA compared to those acquired in a business combination
  - Accounting for IA does not have an overarching framework, which creates a lack of comparability for similar intangible items
  - Financial statements are incomplete because they are missing information about intangibles
- Amount spent on creation of IGIA can help inform user expectations of the relative performance of companies within a peer group

Recognition of Internally Generated Intangible Assets
(cont'd)

- What does IFRS do?
  - Draws distinction between research costs and development costs
    - Research costs cannot be capitalized
    - Development costs can be capitalized after certain qualitative thresholds are met
  - After initial recognition, development costs need to be assessed for impairment using the impairment model for all other non-financial assets
  - Criticisms
    - Development costs in certain industries may not be capitalized due to high recognition threshold and evolution of practice
    - The model is not applied consistently, which creates comparability issues

Recognition of Internally Generated Intangible Assets
(cont'd)

- Potential outcomes for intangible assets
  - FASB Invitation to Comment feedback encourages Board to revisit, options include:
    - Add a project to create a model to recognize IGIA or research and development costs on the balance sheet
    - No change in recognition models, but increased quantitative and/or qualitative disclosures for IGIA
    - Others…
  - A project to revisit recognition will be difficult due to user confidence issues in reported fair values
  - Very preliminary

Assessing Impairment of Goodwill

- Goodwill accounting framework
  - All entities
    - Goodwill is not amortized
    - Test for impairment at least annually
    - Reporting unit level
    - Optional qualitative assessment (step zero)
    - Two-step impairment test

Assessing Impairment of Goodwill *(cont'd)*

- Goodwill accounting framework
  - PCC alternative
    - Amortize over 10 years or less
    - Test for impairment upon triggering event
    - Entity level or reporting unit level
    - Optional qualitative assessment
    - One-step test

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Assessing Impairment of Goodwill *(cont'd)*

- FASB's Current Goodwill Projects
  - Project on goodwill for Public Business Entities (PBEs) and Not-For-Profit (NFP) entities added when FASB endorsed the private company alternative in 2013
  - Objective to address concerns over cost and complexity of current model
  - In October 2015, the Board divided the project into two phases
    - Phase 1 – simplify current impairment test
    - Phase 2 – continue to consider whether additional changes should be made to the accounting model concurrent with the similar IASB project

Assessing Impairment of Goodwill *(cont'd)*

- Current Goodwill Impairment Model

Step 0 (optional): Is it more likely than not that the carrying amount of the reporting unit > fair value?

No → No further work necessary

Yes ↓

Step 1: Is the carrying amount of the reporting unit > fair value?

No → No further work necessary

Yes ↓

Step 2: Is the carrying amount of goodwill > fair value?

No → No further work necessary

Yes ↓

Impair the reporting unit's carrying amount of goodwill to its fair value

Assessing Impairment of Goodwill *(cont'd)*

- Goodwill Impairment Model out for Exposure

Step 0 (optional): Is it more likely than not that the carrying amount of the reporting unit > fair value?

No → No further work necessary

Yes ↓

Step 1: Is the carrying amount of the reporting unit > fair value?

No → No further work necessary

Yes ↓

Impair the reporting unit's goodwill to a value that results in the carrying value and fair value of the reporting unit being equal

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Accounting for Down-Round Features

- What is a Down-Round?
  - A feature most commonly found in warrants issued by private companies that prevent investor interests from being diluted
  - Example
    - ABC Co issues warrants to Investor Z with a strike of $10 per share that contain a down-round feature
    - Subsequently, ABC completes additional round of financing via warrants issued to Investor X with a strike of $7 per share
    - Due to issuance of warrants to Investor X at a strike below that within the warrants issued to Investor X, down-round feature in Investor Z's warrants allows the strike price of be reduced to $7 per share

Tentative Board Decisions on Down-Rounds

- Classification
  - Current accounting – liability
  - Proposed accounting – down round does not impact classification; may be equity or liability based on instrument and other features
- Initial measurement
  - Current accounting – fair value
  - Proposed accounting – no accounting for the down round feature on Day 1; accounting for instrument depends on if its equity or liability classified

Tentative Board Decisions on Down-Rounds *(cont'd)*

- Subsequent measurement
  - Current accounting – fair value, P&L impact
  - Proposed accounting – only account for the down round feature when triggered:
    - If equity classified, then dividend
    - If liability classified, then P&L impact
- Scope
  - Instrument that reduces the strike price of an issued instrument if the issuer sells shares of its stock for an amount less than the current strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the current strike price of the issued financial instrument.

Contingent Consideration

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What is Contingent Consideration?

- ASC 805 Definition
  - Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.
- Reasons for use
  - Bridge valuation gap between buyer and seller; risk allocation
  - Source of financing
  - Provides incentives to retain key employees

Contingent Consideration Structures

- Common contingent consideration structures as noted by a Duff & Phelps 2012 study of 120 transactions from 2009-2011
  - Metrics
    - 60% top-line
    - 38% earnings-related
    - 26% non-financial (technical, regulatory, R&D) milestone
  - Structures
    - 73% cap
    - 70% threshold
    - 30% multiple tiers

Fair Value of Contingent Consideration

- Accounting
  - Initial measurement at fair value
  - Subsequent measurement if classified as asset or liability
  - Changes in fair value recognized in earnings
- Valuation challenges
  - Payoffs are contingent on future events
  - Risk/uncertainty underlie future events
  - Payoff functions may be non-linear and path dependent
  - As a result, sophisticated valuation techniques need to be used

Fair Value of Contingent Consideration *(cont'd)*

- Common types
  - Function form of underlying metrics perspective
    - Linear: payout of 10% EBITDA
    - Non-linear: payout of 10% EBITDA if EBITDA is at least $5 million
  - Systematic v. unsystematic risk exposure perspective
    - Systematic risk (business/market based milestones): payout of 10% EBITDA if sales are at least $20 million
    - Unsystematic risk (technical milestones): payout of $10 million on FDA approval of new drug

Fair Value of Contingent Consideration *(cont'd)*

- Common types
  - Exercise and path dependency perspective
    - European/American exercise type: (American) payout of 10% EBITDA at the time EBITDA reaches at least $10 million in any of the next 5 years
    - Path dependency: payout of $3 million at the end of the 3rd year if the average EBITDA over the period is at least $50 million

Fair Value of Contingent Consideration *(cont'd)*

- Appraisal Foundation
  - Based on the recommendation of senior valuation professionals, in 2013 the Appraisal Foundation formed a Working Group on the valuation of contingent consideration (known as WG4)
  - Current status of WG4
    - Consensus reached
      - Use of a probabilistic/OPM valuation model for non-linear payouts
      - The credit risk of the buyer should be considered in the discounting
      - Discounting at the cost of debt if the underlying is nonsystematic or diversifiable
    - Continuing discussions regarding alternative risk quantification techniques
    - Exposure draft expected this fall

Fair Value of Contingent Consideration *(cont'd)*

- Proposed Methodologies
  - Payoff profile: linear
    - Business/market underlying metric: scenario-based model (SBM)
    - Multi-metric (e.g., technical and market based) underlying: SBM
  - Payoff profile: thresholds and caps
    - Business/market: SBM or option pricing model (OPM) via Monte Carlo simulation
    - Technical/development metric: SBM
    - Multi-metric: SBM + OPM

Fair Value of Contingent Consideration *(cont'd)*

- Proposed Methodologies
  - Payoff profile: path dependent
    - Business/market underlying metric: OPM
    - Technical/development metric: SBM
    - Multi-metric: SBM + OPM
- Overcoming Misconceptions
  - OPM not used in a deal making environment
  - Confidence in probability assessments
  - Concerns over log-normal distribution assumptions

Fair Value Quality Initiative

FVQI: Overview

- The US Securities and Exchange Commission in its role as a capital markets regulator has raised questions regarding the quality of valuations prepared for financial reporting.
- Several not-for-profit valuation professional organizations (VPOs), non-membership organizations and others have worked to develop a framework to advance the quality of financial reporting valuations.
- As a part of the framework, a credential "Certified in Entity and Intangible Valuation" ("CEIV") has been trademarked. Key elements associated with the credential include:
  - To be issued by approved VPOs
  - Issued to individuals who perform fair value measurements for financial reporting for SEC-registered US public companies
  - Requirements to obtain to credential discussed in subsequent slides

FVQI: Overview *(cont'd)*

- Key elements of a VPO infrastructure that would govern individuals conducting fair value measurements should include:
  - Professional Qualification
  - Accreditation and Reaccreditation
  - Performance Requirements (i.e., Mandatory Performance Framework)
  - Quality Review and Discipline Process
  - Ethics and Enforcement

FVQI: Qualifications

- As a part of the FVQI, a credential (Certified in Entity and Intangible Valuation) is being developed for issuance by approved VPOs for individuals who perform fair value measurements for financial reporting by SEC registrants.
- The credential will be available only to individuals that are members of qualified VPOs.
- Requirements to obtain the credential include:
  - Hold approved business valuation credential
  - Experience - Minimum 3,000 hours of fair value measurements
  - Education – Undertake education offered by the VPOs on fair value measurement Body of Knowledge
    - Accounting and regulatory environment
    - Technical guidance
    - Auditing requirements
    - Mandatory performance framework requirements
- Credential holders will have ongoing requirements for the credential.

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FVQI: Quality Control

- Quality control procedures will be put into place as a framework used by the VPOs to assess the work-product of credentialed individuals.
- Quality control procedures will include:
  - CPE requirements
  - Review of fair value for financial reporting work performed
  - Complaints protocol pertaining to CEIV credential holders

FVQI: Documents

- Assessment of the Current Professional Infrastructure Governing Fair Value Quality, Spring 2016 Progress Report, AICPA, ASA and RICS.
- Proposed Mandatory Performance Framework for the Fair Value Quality Initiative, discussion draft dated May 24, 2016.
- Proposed Application of Mandatory Performance Framework for the Fair Value Quality Initiative, discussion draft dated May 24, 2016.

Mandatory Performance Framework (MPF)

- Competition between appraisers to obtain valuation projects and the compliance nature of fair value estimates can lead to significant price competition in order 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 certain financial reporting projects with an adequate degree of effort, two Mandatory Performance Framework documents are being developed to provide guidance.

MPF: Overview

- Given the high level guidance provided in USPAP Standard 9, two documents are being developed in conjunction with the Fair Value Quality Initiative to provide more specificity on valuation efforts that are required. These include:
  - Mandatory Performance Framework for the Fair Value Quality Initiative (“FVQI”)
  - Application of the Mandatory Performance Framework for the FVQI
- Subsequent slides include key information from the draft MPF documents dated May 24, 2016. For technical guidance, our primary focus is on areas where there is less guidance in the valuation literature.
- 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.

MPF: Elements

- Elements of the draft MPF document include:
  - Preamble – overview of MPF purpose and scope
  - Valuation Engagement Guidance - establishes the parameters of the performance and documentation requirements that valuation professionals must adhere to
  - Mandatory Performance Framework Glossary – listing and definitions of key terms
  - 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:
  - General Valuation Guidance
  - Business Valuation Guidance
  - Valuation of Intangible Assets, Certain Liabilities and Inventory Guidance

MPF: Preamble

- Elements of the Preamble include:
  - Introduction – detailed discussion of key elements
  - Applicable Business Valuation Standards – brief listing and summary discussion
  - Applicable Accounting and Audit Standards Relevant to Business Valuation & Intangible Assets – brief overview
  - Scope of the Mandatory Performance Framework
  - Exceptions from the Mandatory Performance Framework – very brief discussion of possible conflict of MPF and other guidance

MPF: Preamble - Purpose

- 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

- 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 – Applicability

- 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.

MPF: Engagement Guidance – Documentation

- 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.

MPF: Engagement Guidance – Documentation

(cont'd)

- 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.
- 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.

MPF: Engagement Guidance – Documentation
(cont'd)

- 2.7 Documentation comprises two key components:
  - 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: Engagement Guidance – Documentation

(cont'd)

- 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: Engagement Guidance – Documentation

(cont'd)

- 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.

MPF: Engagement Guidance – Documentation

(cont'd)

- 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:
  - 2.10.4 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

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MPF: Engagement Guidance – Professionalism

- 2.12 A valuation professional, prior to accepting an engagement, must conclude that he or she can reasonably expect to complete the engagement with professional competence. Professional competence includes, but is not limited to, compliance with the Fair Value Quality Initiative's requirements for education, qualifications, quality control, and adherence to the MPF outlined herein.
- A valuation professional must be able to demonstrate, at a minimum, the following criteria that align with or complement these requirements:
  - 2.12.1 The appropriate academic and professional qualifications demonstrating technical competence.
  - 2.12.2 The appropriate level of experience, including specific industry experience, to identify the problem to be addressed.

MPF: Engagement Guidance – Professionalism

(cont'd)

- A valuation professional must be able to demonstrate, at a minimum, the following criteria that align with or complement these requirements:
  - 2.12.3 The appropriate level of experience in valuing the type of business interest or asset that is the subject of the engagement and in completing engagements for a similar purpose.
  - 2.12.3 Membership in a professional body whose guidelines incorporate a commitment to ethical standards.
  - 2.12.4 Recognition of, and compliance with, country or state laws and regulations that apply to the valuation engagement or valuation professional.

MPF: Engagement Guidance – Professionalism

(cont'd)

- 2.13 If a valuation professional determines prior to accepting an engagement, or during the course of an engagement, that he or she does not have the required level of subject interest expertise to competently complete the engagement, the following steps should be considered:
  - 2.13.1 When possible, assemble and use appropriately qualified subject interest specialists within his or her firm or company.
  - 2.13.2 Retain an appropriately competent and qualified subcontractor.
  - 2.13.3 Do not accept the engagement or withdraw from the engagement if already accepted.

MPF: Engagement Guidance – Professionalism
(cont'd)

- 2.14 If a subcontractor is used, as contemplated in MPF section 2.13.2, the valuation professional must:
  - 2.14.1 Provide written notification to and obtain written approval from the client (for example, may be done within the letter of engagement, addendum to a letter of engagement (LoE) if identified after the initial LoE is executed, or email).
  - 2.14.2 Document in the report the level of responsibility, if any, being assumed by the primary valuation professional and the subcontractor.
  - 2.14.3 Assemble and evaluate relevant information from the retained subcontractor and retain such relevant information and interpretation in the work file

MPF: Engagement Guidance – Professionalism

(cont'd)

- 2.15 When more than one valuation professional has undertaken or contributed to the valuation, a list of each contributor must be retained in the work papers, together with a confirmation that each person has complied with the MPF. Also, in accordance with existing valuation standards (as defined by relevant VPOs, non-membership organizations, or both), contributing valuation professionals must either sign or be identified in the certification and representation of the valuation professional signing such certification or representation.
- 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: Engagement Guidance – Professionalism
(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.

MPF: Engagement Guidance – Professionalism
(cont'd)

- 2.17 Professional skepticism requires the valuation professional have an attitude that:
  - 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.
- 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: 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: 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: Engagement Guidance – Engagement Letters

- 2.21 When valuation professionals are engaged by an entity, firm, or individual, other than their employer (for example, internal engagements), they must obtain a signed LoE with every engagement that results in the valuation professional providing a conclusion of value. An executed LoE between the valuation professional and the client must contain following components (to the extent they are applicable):

MPF: Engagement Guidance – Engagement Letters
(cont'd)

Identification of the client	Measurement date
Type of Report	Standard of value
Scope of Work	Premise of value
Client responsibility	Description and listing of items to be valued
Identification of the intended use of the report	Fee, timing and deliverable
Identification of the intended users and expected recipients	Assumptions, extraordinary or hypothetical assumptions or limiting conditions

MPF: Engagement Guidance – Final Report Content

- 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.

MPF: Engagement Guidance – Final Report Content

(cont'd)

- 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: Engagement Guidance – Final Report Content
(cont'd)

- 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.

  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: Engagement Guidance – Final Report Content

(cont'd)

- 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.

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

MPF: Application – Outline of Topic Discussion

- The outline used for each topic in the MPF application document includes:
  - Topic overview
  - 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/Methods

- 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.

MPF: Selection of Valuation Approaches/Methods

(cont'd)

- 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/Methods
(cont'd)

- A1.3.4 The valuation professional, at a minimum, must document in writing within the work file:
  - 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.
  - 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).
  - A reconciliation of the results should include among other things:
    - 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/Methods

(cont'd)

- A1.3.4 The valuation professional, at a minimum, must document in writing within the work file:
  - 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).
  - 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.
- 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)

- 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.
- 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: Prospective Financial Information (PFI)

(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: Prospective Financial Information (PFI)

(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: Prospective Financial Information (PFI)
(cont'd)

- 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: Prospective Financial Information (PFI)
(cont'd)

- A1.4.7 The valuation professional, at a minimum, must document in writing within the work file:
  - The identification of the party or parties responsible for preparation of the PFI.
  - The process used to develop the PFI from the perspective of a market participant.
  - 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.
  - 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.

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MPF: Prospective Financial Information (PFI)

(cont'd)

- A1.4.7 The valuation professional, at a minimum, must document in writing within the work file:
  - An evaluation of any differences between the PFI and expected cash flows.
  - An analysis of any evidence that contradicts management's assumptions or conclusions used in their PFI.
  - The rationale for any adjustments made to management's PFI.
  - Evidence that a mathematical and logic check was performed.
  - The components of the prospective balance sheet, and if available, cash flow statements.
  - The prospective capital structure.

MPF: Business Valuation Subject Matter Guidance

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

MPF: BV Guidance – Discount Rate Derivation

- A2.2.2 The valuation professional, at a minimum, must document in writing within the work file:
- Cost of Equity
  - The rationale for the selection of a model.
  - The source of the risk free rate used in the calculation and explain the rationale for its selection.
  - The source or calculation of the equity risk premium and rationale for its use.
  - 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.
  - The rationale for selecting the specific beta when using CAPM, including 'adjusted betas'.
  - The amount of size premium, the source of the premium data, and the rationale for selecting the concluded premium.

MPF: BV Guidance – Discount Rate Derivation
(cont'd)

- Cost of Equity
  - 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.

MPF: BV Guidance – Discount Rate Derivation
(cont'd)

- Cost of Equity
  - 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).
  - 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: BV Guidance – Discount Rate Derivation

(cont'd)

- Cost of Debt
  - 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).
  - The rationale to support the selection of the pretax cost of debt and any additional source documents
  - The rationale for the effective tax rate used to adjust the pretax rate to an after tax rate.
- Capital Structure
  - The capital structures of the guideline companies and rationale for selection of the time frame over which they are measured.

MPF: BV Guidance – Discount Rate Derivation

(cont'd)

- Capital Structure
  - When other discount rate models are used instead of CAPM or WACC, the valuation professional must provide within the work file details on:
    - the model specification,
    - inputs chosen and the sources of those inputs,
    - sub-methodological selections made, and
    - why, if applicable, any adjustments were made to the model results

MPF: BV Guidance – Growth Rates

- A2.3.2 The valuation professional, at a minimum, must document in writing within the work file:
  - The rationale, support, and reasonableness assessment for the selected growth rate(s) used in the analysis.
  - The rationale for all inputs that comprise the terminal or long-term GR.
  - 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.
  - 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: BV Guidance – Terminal Value Methods

- A2.4.2 The valuation professional, at a minimum, must document in writing within the work file:
  - The rationale for selecting the appropriate terminal exit multiple(s) or model(s).
  - The rationale and support for each key assumption used in the terminal method or model such as, as applicable:
    - the discount rate
    - terminal or perpetual growth rate
    - second-stage or high-growth growth rate for the H-Model and two-stage model
    - high growth stage duration/life for the H-Model and two-stage model
    - terminal market multiple (exit multiple)
  - 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: BV Guidance – Use of Valuation Multiples

- A2.5.3 The valuation professional, at a minimum, must document in writing within the work file:
  - 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.
  - 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:
    - the decision regarding equity versus invested capital multiples,
    - the decision regarding the time frame of earnings or other metrics,
    - analysis of the comparative performance measures and how it affected the selection of the multiples applied to the subject entity,

MPF: BV Guidance – Use of Valuation Multiples
(cont'd)

- A2.5.3 The valuation professional, at a minimum, must document in writing within the work file:
    - the comparative qualitative and quantitative analysis that affected the selection of the multiples applied to the subject entity,
    - the selection of the starting point of the multiples within the range, and
    - the rationale for adjustments, if any, to the starting point multiples to determine multiples applicable to the subject entity.
  - The identification of each significant accounting difference and adjustments made, if any, for better comparability.
  - 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.
  - The calculation of multiples implied in a recent transaction and rationale for differences in the multiples used.

MPF: BV Guidance – Use of GPCs / Transactions

- A2.6.3 The valuation professional, at a minimum, must document in writing within the work file:
  - The understanding of the subject entity, including identification of which characteristics are appropriate for selection of guideline public companies or comparable company transactions.
  - 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).
  - The identification and description of the selected guideline public companies or comparable company transactions.

MPF: BV Guidance – Discounts & Premiums

- A2.7.2 The valuation professional, at a minimum, must document in writing within the work file:
  - The understanding of the subject company's capital structure and concomitant rights and obligations of, and restrictions on, each class of capital.
  - 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).
  - The rationale for selection of methodology used to determine appropriate magnitude of premium or discount.

MPF: BV Guidance – Discounts & Premiums *(cont'd)*

- A2.7.2 The valuation professional, at a minimum, must document in writing within the work file:
  - A discussion of how market evidence/data is used and adjusted for application to the subject interest.
  - 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).
  - Identification, and description where necessary, of each significant input used to arrive at the applied premium or discount. This should include, at a minimum:
    - Resources used to determine input (for example, company specific data, commercial or governmental data bases, and so forth)
    - 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)
    - Any other quantitative and qualitative considerations.

Concluding Observation

- 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.

Market Participant Acquisition Premium (MPAP)

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Introduction

- The concept of a control premium is familiar to most appraisers and many individuals (estate planning attorneys, others) that work frequently with business appraisers.
  - *Control*—the power to direct the management and policies of a business enterprise.
  - *Control Premium*—an amount or a percentage by which the pro rata value of a controlling interest (CI) exceeds the pro rata value of a noncontrolling interest (NCI) in a business enterprise to reflect the power of control.
- Views on control premiums are changing as there is increasing recognition that premiums reflect transaction synergies and not simply the value of "control".

Introduction *(cont'd)*

- The use of a control premium impacts some fair value measurements.
- The SEC staff also indicated that while judgment may result in a range of reasonably possible premiums, they expect the rigor of documentation to increase as the magnitude of the premium increases.
- Control premium development and use has been the subject of divergence in practice.

The Appraisal Foundation: Working Group 3

- The Appraisal Practices Board of The Appraisal Foundation released an Exposure Draft dated September 1, 2015, The Measurement and Application of MPAP ("MPAP Exposure Draft").
  - There is limited guidance and significant divergence in practice in the measurement and application of "control" premiums.
- Lack of understanding on whether the premium is being paid for:
  - Control,
  - Market participant synergies,
  - Buyer-specific synergies, and/or
  - Excess premium without a financial basis.

Contents of Exposure Draft on MPAP

- Background
- Introduction and Scope
- Market Participant Acquisition Premium
- Conceptual Considerations
- Business Characteristics Influencing MPAP
- Analytical Methods
- The Fair Value Context
- Selecting and Assessing MPAP – Examples
- Reconciliation of Market Capitalization (Revised Carrying Value Example)

Acquisition Price: What Does it Reflect?

Excess Premium

Synergistic Premium

Control Premium

Standalone Value

The Acquisition Premium, the amount in excess of the target's standalone value, is comprised of one or more of the following elements:

1) **Control premium** – the incremental value of the enterprise under different stewardship.
2) **Synergistic premium** – the incremental value stemming from a business combination.
3) **Excess premium – the incremental price paid that has no financial basis.**

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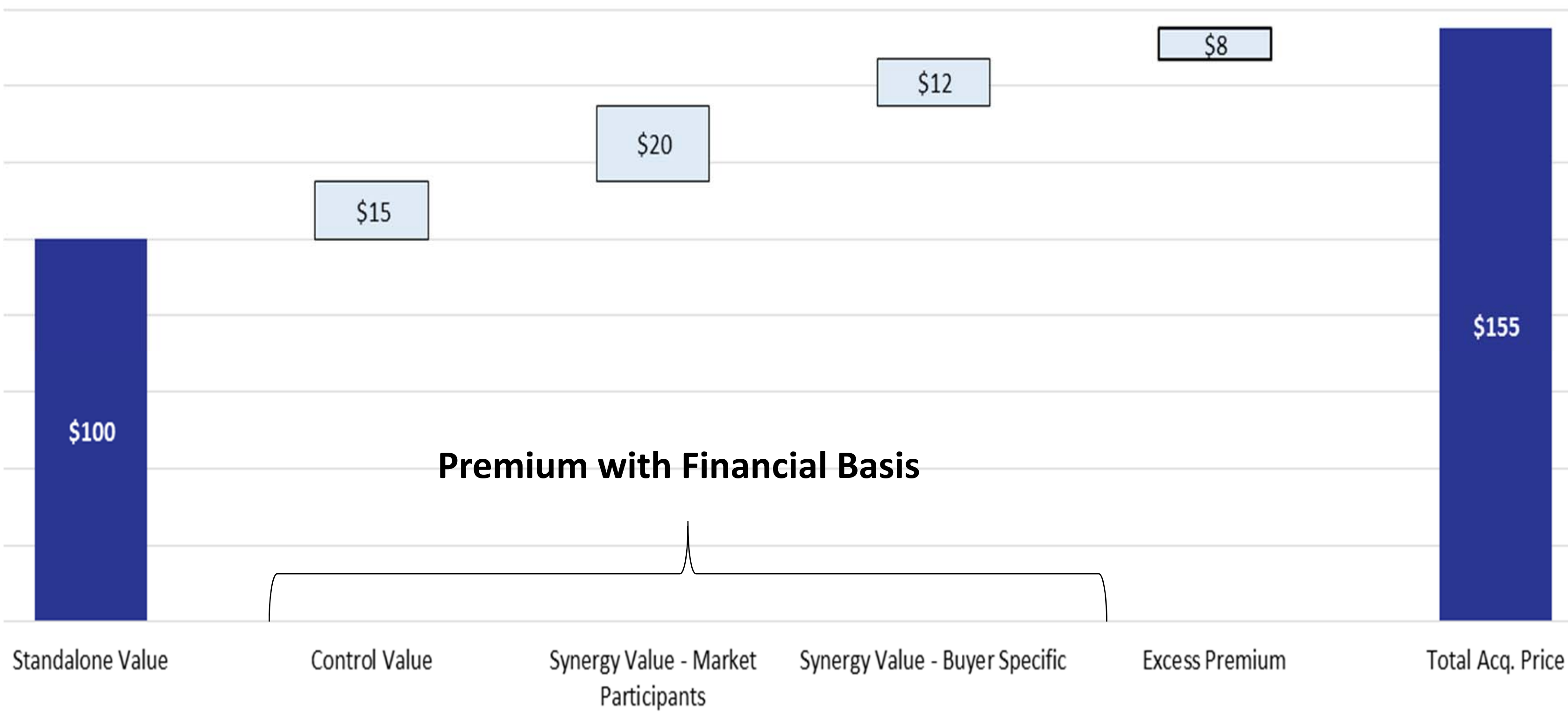
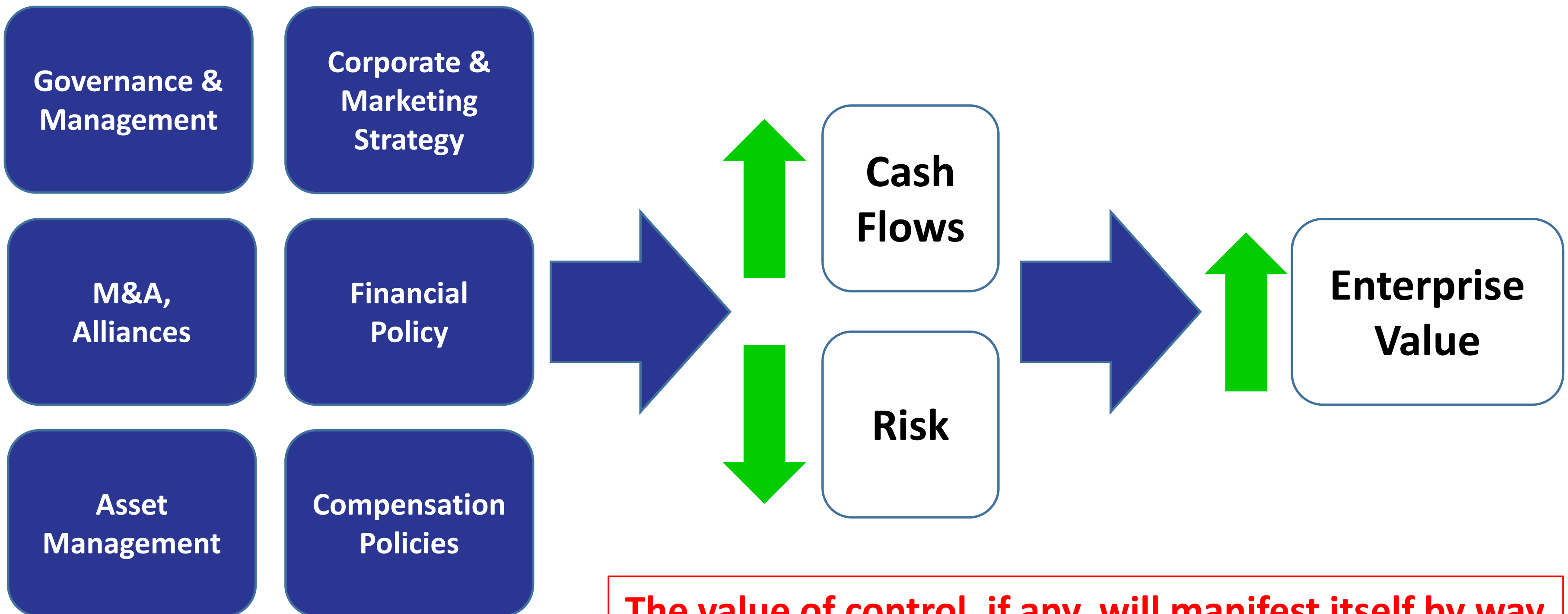
Components of the Acquisition Price



Control Value: What is it Worth?



The value of control, if any, will manifest itself by way of higher cash flows and/or lower risk. It is incremental value as a result of better stewardship.

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Synergistic Value: You Mean 1+1=3, Right?

- "Synergy is the additional value that is generated by combining two firms, creating opportunities that would not been available to these firms operating independently." – "The Value of Synergy," Dr. Aswath Damodaran, Professor of Finance, NYU
- Synergies are significant motivators for M&A transactions
- The extent to which each transacting party realizes the benefit of the synergies is subject to market and negotiation dynamics.

How Can Synergies Add Value?

Enhanced Cash Flows	Lower Required Rate of Return
Superior Revenue Growth (O, F)	Optimized Capital Structure (F)
Increased Operating Margins (O)	Company Size Benefits (F)
Lower Income Taxes (F)	Reduced Operating Risk (O)
Working Capital Efficiencies (O, F)	
Capital Expenditure Efficiencies (O)	

(F) = financial synergy; (O) = operating synergy

Refining the Terminology

- In the M&A market for public companies, a "Control Premium" is calculated by comparing the transaction price to the "unaffected" (NCI) price.
- Since the transaction price *could* include synergistic and excess premiums, the term "Acquisition Premium" is a more accurate term.
- Further, the Acquisition Premium could include buyer-specific synergies, which is inconsistent with the definition of Fair Value. Hence, we will use the term "Market Participant Acquisition Premium (MPAP)" to describe the price paid by market participants in order to acquire a controlling interest in that context.

MPAP Definition

- An MPAP is the difference between:
  - The pro rata fair value of the subject controlling interest and its "Foundation".
  - Foundation is measured with respect to the current stewardship of the enterprise.
- The Working Group believes that valuation specialists most commonly associate the Foundation with the pro rata fair value of marketable, non-controlling equity interests in the enterprise. Therefore, for publicly traded companies, the Foundation is equal to the quoted market price for the company's shares.
- As will be discussed subsequently, **an MPAP measured with an "Equity Foundation" is viewed as less meaningful than one measured using an "Total Invested Capital Foundation**"

Controlling Interests & Marketability Discounts

- Controlling interests should not be held to the same standard of marketability as publicly traded equities because the markets (and associated marketing periods) differ. For controlling interests in business enterprises, the usual and customary marketing activities may be time-consuming. [The markets for small blocks of public equities differ dramatically from the market for a control block.]
- The Working Group believes that it is usually inappropriate to apply discounts for lack of marketability when measuring the fair value of controlling interests.

MPAP in a Fair Value Context

- Valuation is context dependent and based on a standard of value for the given purpose.
- Per ASC 820, fair value is defined as “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement.”

Fair Value Concepts

- Exit price
- Principal (or most advantageous) market for the subject asset
  - Market with the greatest volume and level of activity for the asset
  - Market to which the subject asset has access as the measurement date
  - With respect to controlling interests in business enterprises, the WG believes that the principal market is that for M&A
- Market participants
  - Sufficient knowledge
  - Ability to engage in a transaction involving the subject asset
  - Willing to transact
  - Valuation inputs are to be based on market participant behavior/assumptions

Fair Value Concepts *(cont'd)*

- Highest and best use
  - Should be physically possible, legally permissible, and financially feasible
  - In conjunction with other assets and liabilities ("in use") or on a standalone basis ("in exchange")
  - Evaluated from market participant's perspective even if different from intended use by the reporting entity
- Asset characteristics
  - Condition and location
  - The degree of control vested in the interest of a business enterprise

FV Measurement of a CI in Business Enterprises

- Goodwill impairment testing
  - Most common
  - Unit of account is the reporting unit
  - ASC 350: "Substantial value may arise from the ability to take advantage of synergies and other benefits that flow from control over another entity…[t]he control premium may cause the fair value of a reporting unit to exceed its market capitalization. The quoted market price of an individual equity security, therefore, need not be the sole measurement basis of the fair value of a reporting unit."
- Portfolio valuation (ASC 946)
- Acquisition method for step acquisitions (ASC 805)

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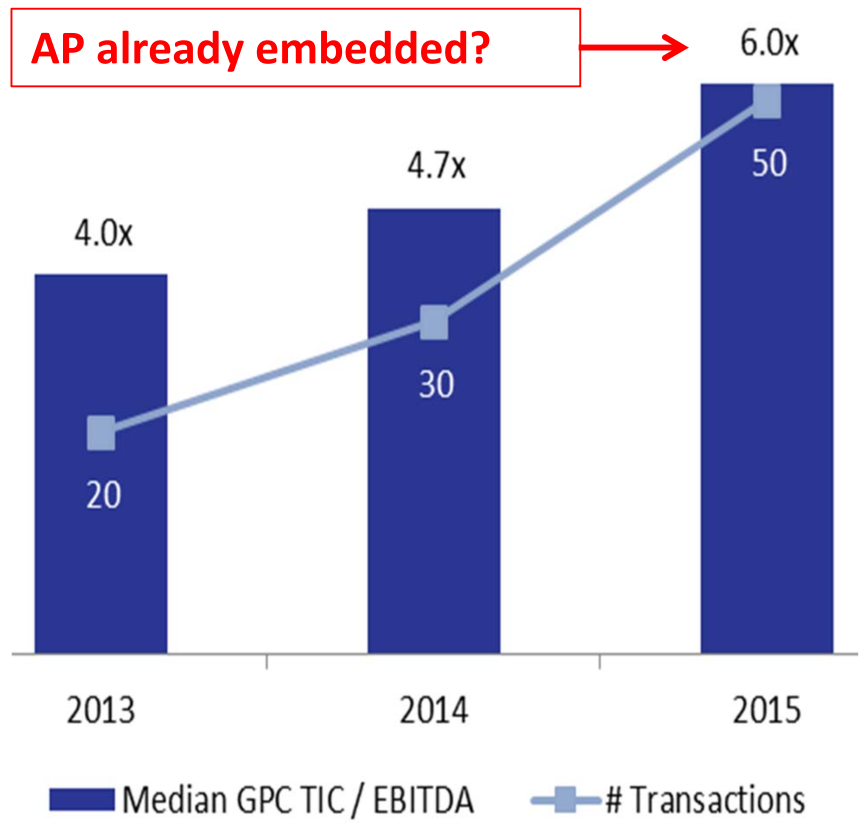
Business Characteristics Influencing the MPAP

- External to Target
  - Acquisition activity in the industry
  - Market participant attributes
  - Regulatory factors
- Internal to Target
  - Stage in company life cycle
  - Balance of information
  - Management objectives
  - Quality of management team
  - Transaction structure

MPAP Factor: Industry Acquisition Activity

- Activity fluctuates over time
- Robust activity may increase number of MPs; selling owners may be able to realize a greater portion of the economic benefits with the combination
- Investor expectations of imminent change of control transactions may be reflected in the NCI value (multiples), which would lead to a smaller MPAP



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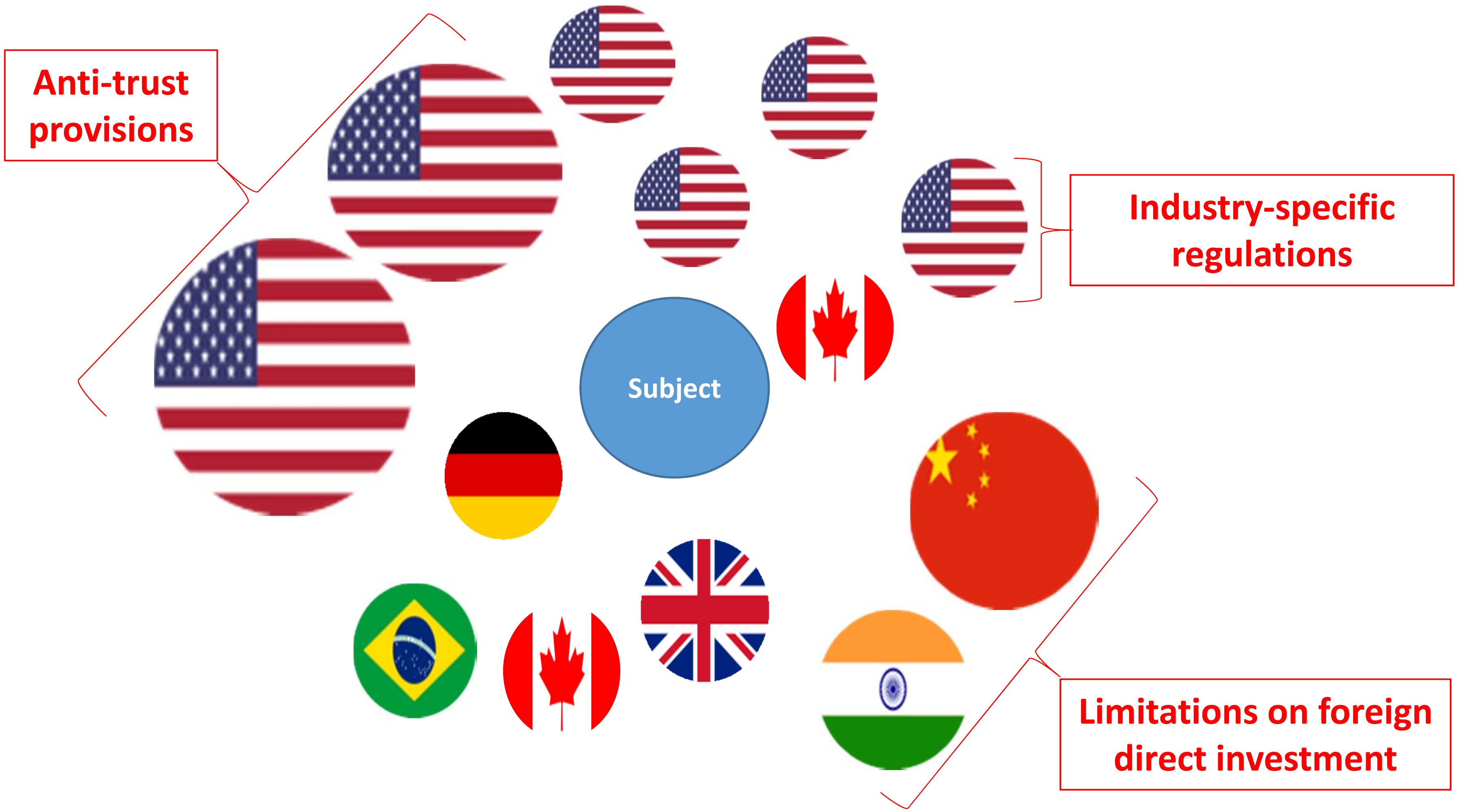
MPAP Factor: Market Participant Attributes

- General categories
  - Strategic buyers
  - Financial buyers
  - Conglomerate buyers
  - Lines may not be so clear (e.g., financial buyer with a platform company)
- Size
  - Often larger than targets
  - In turn, presents greater opportunity to extract incremental economic benefits
  - MPAP may be positively related to the size of the MPs for the subject controlling interest as larger buyers may be able to realize more synergies than smaller buyers

MPAP Factor: Regulatory Impact on MPAP



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MPAP Factor: Other Considerations

- Target's stage in company life cycle
  - Growth stage companies may not have developed key asset (e.g., distribution networks).
  - Mature companies may present fewer enhancement opportunities.
- Capital structure
- Management objectives
  - Overly conservative financial policies.
  - Above-market salaries or lease rates.
- Transaction structure
- Balance of information

MPAP Assessment: Interaction of Buyers

- In each case, the task of the valuation specialist is to identify and evaluate the feasibility of the available strategies from the perspective of market participants for the subject interest. The appropriate MPAP considers not only the magnitude of the available economic benefits, but also the degree to which such potential benefits will influence the price paid by market participants for the subject controlling interest in an orderly transaction at the measurement date.

MPAP Assessment: Interaction of Buyers

(cont'd)

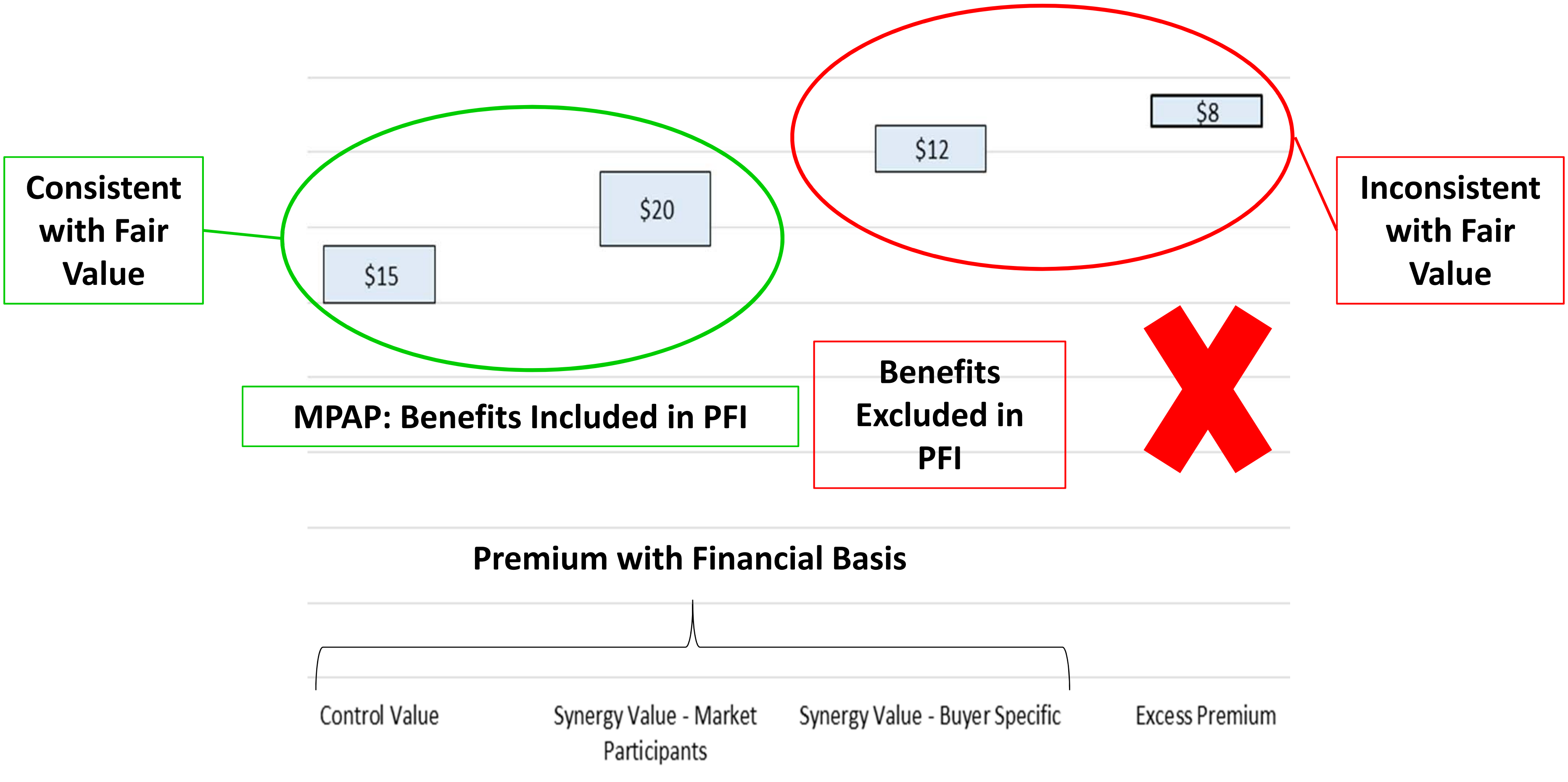
- The Working Group cautions that it **may not be appropriate to assume that market participants will always incorporate all economic benefits of control into the price paid** for a controlling interest in a subject business, even if such benefits exist. In other words, **market participants ordinarily do not give away all of their upside** - the incremental economic benefits - that may arise from a transaction. How much of the upside is included in the transaction price **depends, in part, on the competitive dynamics of the sale process**.
- The market participant would be unwilling to pay more than the value of the economic benefits available to the next most advantageously positioned market participant.

MPAP Assessment: Interaction of Buyers

(cont'd)

- Assume a group of prospective buyers have the following investment values for the equity of an operating business (firm is debt-free).
  - Q1: Discuss the likely fair value for the equity of the company
    - SB1 $200
    - SB2 $190
    - SB3 $189
    - FB1 $170
    - FB2 $160
    - Other FB $120 to $150
    - Seller $150
  - Q2: Assume the investment value to the seller is $210. At what price will the business transact?
  - Q3: What is the maximum transaction price that is economically viable to SB1?

Assessing Premiums in a Fair Value Context



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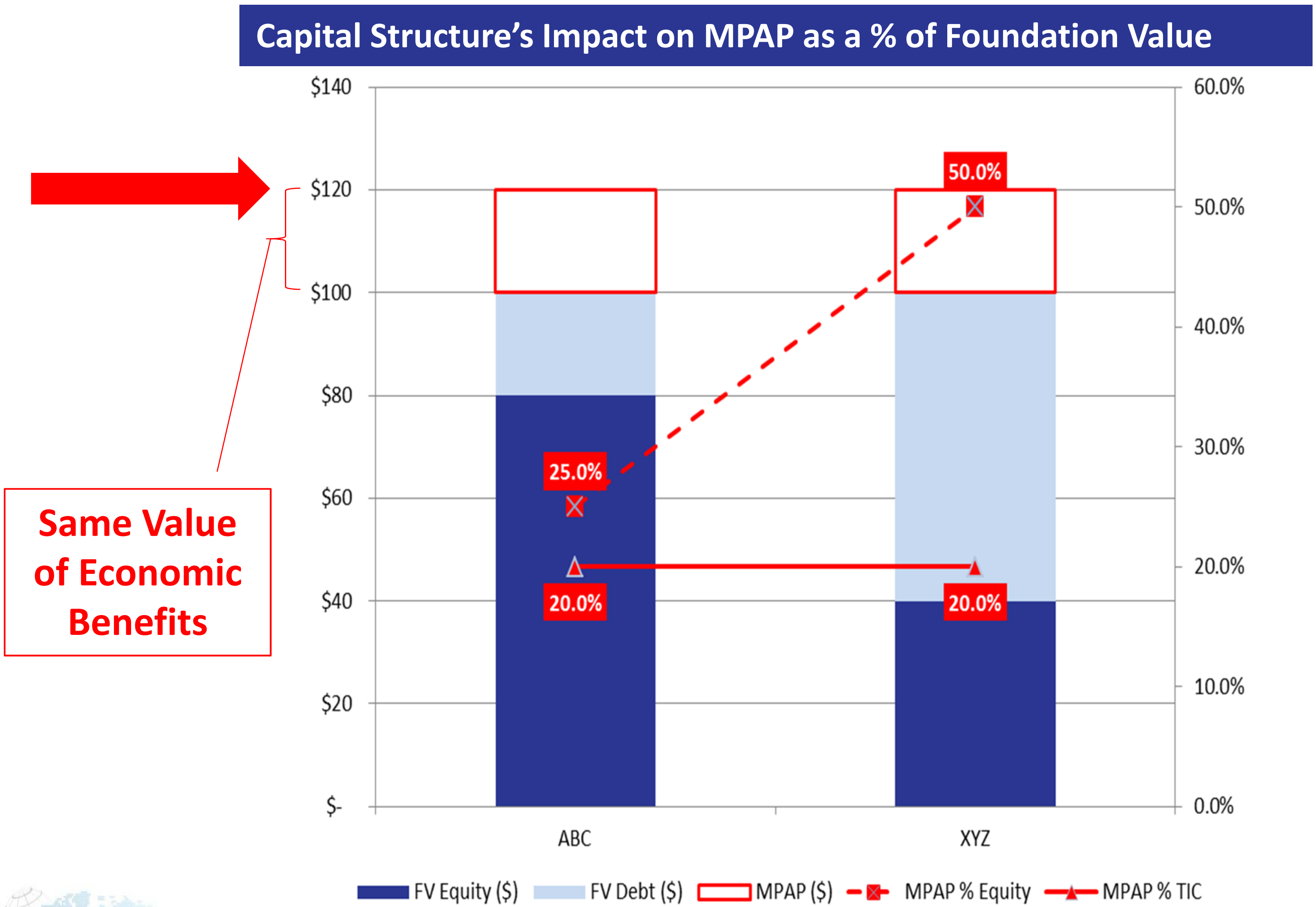
MPAP: Expression

- The exposure draft notes a preference to express and apply MPAP to Total Invested Capital (TIC) rather than Equity Value.
  - Economic benefits enhance fair value of the enterprise not just the equity
  - Improves comparability for companies with different capital structures
- Measurement based on business enterprise value enhancement on a before and after basis and not simply the application of a control premium to a preliminary value indication.
- The example on the following slide highlights potential MPAP measurement differences depending on choice of the Foundation.

MPAP: Expression *(cont'd)*



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Valuation Methods and the MPAP

- Inclusion of an MPAP will vary depending on the method used to develop the Foundation value estimate.
- Cost Approach – Adjusted book value method – MPAP would not be included (Cost Approach is rarely used to value a going concern).
- Market Approach
  - Guideline Transactions Method – Included in the transaction multiples – no MPAP would be required. What synergies do the transaction multiples incorporate?
  - Guideline Public Company Method – An MPAP adjustment should be considered. Generally included as a percentage premium above the base value. Procedures to confirm reasonableness of premium would be required (cash flow and risk benefits).
- Income Approach – DCF Method – Cash flows should reflect a market participant perspective including any synergies consistent with a market participant perspective. An MPAP would not be necessary.

MPAP Application: Income & Market Approaches

Control Value Indication: Income Approach	**$740.0**
Minority, Non-Control Indication: Market Approach	$630.0
Concluded MPAP, TIC Basis	13.0%
Control Value Indication: Market Approach	**$711.9**
Concluded Fair Value of Subject Co.	**$730.0**

Market participant PFI incorporates MPAP

Provided market approach valuation is not based on market participant PFI, the addition of a MPAP may be appropriate. How is that MPAP estimated?

MPAP Estimation: Historical Premium Data

Date Effective	2Month Premium	1Month Premium	1Week Premium	1Day Premium	Mergerstat Control Premium	Shares Acquired	Consideration	Transaction Purpose
6/30/2016	112.5%	104.8%	123.7%	117.9%	117.9%	100%	C	Strategic
6/24/2016	30.6%	37.6%	38.1%	43.6%	43.6%	100%	C,S	Strategic
4/29/2016	41.5%	55.4%	54.7%	52.9%	52.9%	100%	C	Strategic
3/31/2016	46.3%	49.9%	38.8%	49.9%	49.9%	100%	C	Strategic
3/3/2016	1.1%	-10.9%	4.0%	1.9%	1.9%	72%	C	Financial
2/3/2016	15.6%	-12.2%	-14.4%	-3.6%	-3.6%	100%	C,S	Strategic
10/19/2015	52.7%	41.7%	35.9%	32.1%	32.1%	100%	S	Strategic
10/15/2015	-21.7%	-22.3%	-12.1%	-19.7%	35.1%	100%	C	Financial
10/15/2015	57.2%	55.3%	78.1%	70.8%	70.8%	100%	C,X	Strategic
10/12/2015	22.1%	18.1%	18.6%	15.9%	15.9%	100%	C	Financial

- A **benchmark control premium** resulting from the analysis of guideline transactions typically **should not serve as the sole input** for the estimation of subject control value.

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MPAP Estimation: Historical Data Limitations

Date Effective	2Month Premium	1Month Premium	1Week Premium	1Day Premium	Mergerstat Control Premium	Shares Acquired	Consideration
3/31/2016	46.3%	49.9%	38.8%	49.9%	49.9%	100%	C
3/3/2016	1.1%	-10.9%	4.0%	1.9%	1.9%	72%	C
2/3/2016	15.6%	-12.2%	-14.4%	-3.6%	-3.6%	100%	C,S

Market conditions compared to measurement date

1) Stock price/volume fluctuations prior to announcement; 2) transaction process; 3) stated rationale for transaction; 4) selection bias/negative premiums

Other: 1) financial condition of seller; 2) relationship between parties

Control is not absolute; limitations for <100%

Transaction structure and value of non-cash consideration; reflects buyer-specific synergies

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MPAP: Quantitative Assessment

	2017	2018	2019
Revenue Growth Rates			
Standalone	3.0%	3.5%	4.0%
Control Value	3.5%	4.0%	4.5%
Synergistic - Market Participant	**4.5%**	**5.0%**	**5.5%**
Synergistic - Buyer-Specific	4.8%	5.3%	5.8%
EBITDA Margin			
Standalone	8.0%	8.1%	8.2%
Control Value	9.5%	9.6%	9.7%
Synergistic - Market Participant	**9.5%**	**10.1%**	**10.2%**
Synergistic - Buyer-Specific	9.8%	10.4%	10.5%

- MPAP, as applied to the market approach-derived Foundation Value, can be estimated by way of cash flow analysis
- MPAP is the difference between the TIC values from the standalone DCF analysis and market participant-based DCF analysis
- This percentage difference can be compared with transaction data

MPAP: Measurement Example

	Foundation Value	Fair Value
Expected 5-yr Compound Annual Revenue Growth	6.1%	8.0%
Gross Profit Margin	60.0%	60.0%
Operating Expenses:		
Research & Development	5.0%	5.0%
Distribution Expenses	13.5%	13.5%
Selling Expenses	17.5%	17.5%
Other General & Administrative	7.0%	7.0%
EBITDA Margin	17.0%	17.0%
Weighted Average Cost of Capital	10.5%	10.0%
Total Invested Capital Value	$657	$740
TIC / Trailing Revenue	1.1	1.2
TIC / Trailing EBITDA	7.1	8.0
MPAP implied by the Cash Flow Analyses		**12.7%**

Source: MPAP Exposure Draft

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MPAP: Assessing Reasonableness

- **Relative Value Measures** - Does comparison of the implied multiples to the guideline public company multiples reveal a coherent narrative?
- **Prospective Return Analysis** – Does the implied discount rate make sense when compared to Market Participant WACC?
- **Calibration to Prior Transactions in Subject Entity** – Is the estimated new value in line with value paid previously and observed changes in the subject entity and the market?

MPAP: Importance to Fair Value Measurement

- Degree of documentation for applied MPAP is dependent on its impact on a fair value measurement.
  - Does the outcome of a ASC 350 step 1 test hinge on a MPAP?
- Quick assessment of MPAP importance:
  - TIC Carrying Value / MVIC – if >1, then MPAP will impact outcome.
  - TIC Carrying Value / financial metrics.
    - Calculate TIC carrying value multiples (revenues, EBITDA, EBIT).
    - If these threshold multiples are significantly less than observed GPC/GTM multiples, then MPAP may not influence outcome of the test.

MPAP Summary

- The Working Group believes that **MPAPs should be supported by reference to either enhanced cash flows or a lower required rate of return from the market participant perspective**. The referenced economic benefits should be sufficient to provide market participants with an adequate return on the concluded fair value of the controlling interest.
- The Working Group acknowledges the **merit of analyzing historical data regarding observed premiums** from closed transactions. Such data might provide some examples of the extent to which buyers have expected improvement in cash flows or reduction of risk in specific transactions. However, to conform to best practices, valuation specialists should **critically evaluate the quality and relevance of such benchmark premium data to assess its applicability** to the valuation subject. It is inconsistent with best practices to rely solely on benchmark premium data to evaluate the reasonableness of the MPAP in a fair value measurement.

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