



TO: All Interested Parties

FROM: Rick Baumgardner, Chair
Appraisal Practices Board

RE: Exposure Draft – *The Measurement and Application of Market Participant Acquisition Premiums*

DATE: September 1, 2015

The Appraisal Practices Board (APB) was officially formed by The Appraisal Foundation Board of Trustees on July 1, 2010. The APB has been charged with the responsibility of identifying and issuing voluntary guidance on recognized valuation methods and techniques, which may apply to all disciplines within the appraisal profession. As applied to valuation for financial reporting purposes this responsibility has been extended to best practices. The APB has prioritized topics to offer guidance in areas that appraisers and users of appraisal services have identified as the most pressing issues facing the profession.

Originally facilitated by The Appraisal Foundation, the work of the Valuation for Financial Reporting Work Groups is now formally adopted and published through the APB.

The Working Group on Control Premiums has developed this exposure draft on *The Measurement and Application of Market Participant Acquisition Premiums*.

The APB is seeking public comment in response to this exposure draft and, based on the comments received, may make revisions to the guidance and issue subsequent exposure drafts. Once the Board believes it has received all relevant comment on this topic, it may vote to adopt the material as official guidance from the APB.

All interested parties are encouraged to comment in writing to the APB before the deadline of **November 30, 2015.** Respondents should be assured that each member of the Working Group will thoroughly read and consider all comments.

Written comments on this exposure draft can be submitted by mail, email and facsimile.

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IMPORTANT NOTE: All written comments will be posted for public viewing, exactly as submitted, on the website of The Appraisal Foundation. Names may be redacted upon request.

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The Appraisal Practices Board and The Appraisal Foundation wish to express our utmost gratitude to the *Working Group on The Measurement and Application of Market Participant Acquisition Premiums* for volunteering their time and expertise in contributing to this document. Specifically, sincere thanks to the following individuals:

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The views set forth in this exposure draft are the collective views of the members of this Working Group and do not necessarily reflect the views of any of the firms that the Working Group members are associated with.

The Appraisal Foundation served as a sponsor and facilitator of this Working Group. The Foundation is a non-profit educational organization dedicated to the advancement of professional valuation and was established in 1987 by the appraisal profession in the United States. The Appraisal Foundation is not an individual membership organization, but rather, an organization that is made up of other organizations. Today, over 110 non-profit organizations, corporations and government agencies are affiliated with The Appraisal Foundation. The Appraisal Foundation is authorized by the U.S. Congress as the source of appraisal standards and appraiser qualifications.



Exposure Draft

The Measurement and Application of Market Participant Acquisition Premiums

Date Issued: September 1, 2015

Application: Business Valuation, Intangible Assets

Background: In recent years there have been increased requirements in the identification and recognition of assets and liabilities measured at fair value in financial statements. These requirements, promulgated by the Financial Accounting Standards Board (FASB), include:

- Statement of Financial Accounting Standards No. 141(R), predecessor to Accounting Standards Codification (ASC) 805 *Business Combinations*; and
- FASB Statement No. 142, predecessor to ASC 350 *Intangibles - Goodwill and Other* (ASC 350) and Accounting Standards Update (ASU) 2011-08.

Moreover, there has been increased focus on fair value measurement since the FASB issued Statement No. 157 (predecessor to ASC 820 *Fair Value Measurement*) in 2006 and ASU 2011-04 in 2011.

Furthermore, the FASB and the International Accounting Standards Board (IASB) have been working on a convergence project with an objective of having a consistent set of accounting standards that can be used globally. In that regard, the IASB has issued International Financial Reporting Standards 3 (revised) (IFRS 3R) *Business Combinations* and *IFRS 13 Fair Value Measurement*, both of which are largely similar to the same statements issued by the FASB. During the creation of this document, members of the International Valuation Standards Council (IVSC) have participated in certain discussions.

Because of the need for financial statements to be both reliable and relevant, valuation practices must provide reasonably consistent and supportable fair value conclusions. To this end, it is believed that guidance regarding best practices surrounding certain specific valuation topics would be helpful. The topics are selected based on those in which the greatest diversity of practice has been observed. To date, four Working Groups have been sponsored by The Appraisal Foundation and its Appraisal Practices Board (APB). The products of these Working Groups are referred to as APB Valuation for Financial Reporting (VFR) Advisories. The first Working Group addressed the topic of contributory assets and charges in APB VFR Advisory #1, *The Identification of Contributory Assets and Calculation of Economic Rents* dated May 31, 2010. A second Working Group is addressing the general topic of customer-related assets. This third Working Group is addressing the topic of the control premiums as applied in valuations done for financial reporting purposes. A fourth Working Group was recently formed to address the topic of valuing contingent consideration.

This document is intended to present helpful guidance for those that are preparing fair value measurements; however, this paper is not intended to be an authoritative valuation standard. It is the belief of the Working Group that the valuation of assets is a complicated exercise that requires significant judgment. The Working Group believes that consideration of the facts and circumstances related to the asset(s) that are being valued may sometimes support a departure from the recommendations of this document. This paper seeks to present views on how to approach and apply certain aspects of the valuation process appropriate for measuring the fair value of controlling interests.

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BACKGROUND

1 Premiums for control have long been a focus in business valuation.

2 Through the early 1990's, it was generally accepted that the publicly traded price of a company's
3 shares represented the value of a minority interest and that, if the goal was to value a control
4 interest, a "premium for control" would be added to the value of equity indicated by that publicly
5 traded price. That premium generally came from market evidence in which the price paid to
6 acquire an entire company was compared to the publicly traded price of that same company's
7 shares prior to the acquisition.

8 However, in the late 1990's, this concept came into question and views have since been
9 changing. Various points have been made regarding why the control value of an entity might be
10 no greater than that indicated by its publicly traded price.

11 In any case, it has become widely accepted that the market evidence supplied by comparing the
12 acquisition price to the publicly traded price does not represent a premium for conceptual control
13 but, rather, represents a premium linked to actual changes that can be made by exercising that
14 control. Control, and whether one has it, is not really the focal point. What matters is that, after
15 an acquisition, the acquired company is now under different management/stewardship. A price
16 higher than the publicly traded price might be reasonable if the new management and/or
17 combined entity expect(s) improved cash flow or growth; or reduced risk. If no improvements or
18 risk reduction could reasonably be expected, there may be little ability for an acquirer to pay a
19 price higher than the publicly traded price and still generate a reasonable return on its investment.
20 In such cases, the control value may approximate the publicly traded price.

INTRODUCTION AND SCOPE

21 This *VFR Advisory* document sets forth best practices for certain issues encountered in measuring
22 the fair value of controlling interests in business enterprises for financial reporting purposes.
23 When valuing controlling interests in business enterprises, valuation specialists often reference
24 the concept generally referred to as the control premium. The Appraisal Foundation's Subject
25 Matter Expert Group on Best Practices for Valuations in Financial Reporting has identified the
26 use of control premiums in fair value measurement as an area of considerable diversity in
27 appraisal practice.

28 The most common instances of such fair value measurements include Step 1 of the goodwill
29 impairment test, portfolio valuation for investment companies, and application of the acquisition
30 method of business combinations for step acquisitions. Of these, the Working Group believes
31 Step 1 of the goodwill impairment test is most prevalent.

32 In a 2008 Securities and Exchange Commission (SEC) speech, the topic of control premiums
33 was raised. It was stated that, in cases where higher control premiums are used, the level of
34 documentation required to support the control premium would also increase.¹

35 In fulfilling its mandate to provide best practices in the context of measuring fair value for
36 financial reporting purposes, the Working Group has elected to introduce the term Market
37 Participant Acquisition Premium (MPAP). The purpose of introducing this new term is twofold:
38 (1) to emphasize the importance of the market participants' perspective when measuring fair
39 value, and (2) to distinguish this premium from the more general (and occasionally controversial)
40 notion of the control premium. The best practices presented in this *VFR Advisory* have been
41 developed for measuring fair value for financial reporting and are not intended for other
42 valuation contexts.

43 This *VFR Advisory* is the result of deliberations by the Working Group and input received from
44 interested parties.

¹ Robert G. Fox III, Speech by SEC Staff: Remarks before the 2008 AICPA National Conference on Current SEC and PCAOB Developments, Goodwill Impairment, December 8, 2008

MARKET PARTICIPANT ACQUISITION PREMIUM

45 **Concepts**

46 Valuation specialists have long believed that the value of a business ownership interest is
47 influenced by the degree of control available to the subject interest's owner. *The International*
48 *Glossary of Business Valuation Terms*² defines control as "the power to direct the management
49 and policies of a business enterprise."³ Both intuition and empirical observation suggest that the
50 presence (or absence) of the so-called prerogatives of control may influence the value of a
51 business ownership interest. In short, one would usually prefer to exercise control than not. As a
52 result, investors might be willing to pay more for a controlling interest than for an otherwise
53 comparable non-controlling interest in the same enterprise.

54 To induce a rational investor to pay more for a controlling interest, the prerogatives of control
55 must give rise to the potential for incremental economic benefits. In other words, the
56 prerogatives of control have little inherent value, but rather have value to the extent that their
57 exercise enhances the economic benefits available to the owner of the subject controlling interest.
58 Control may be valuable if the exercise of control will enhance the enterprise's cash flows and/or
59 reduce the enterprise's risk. *The International Glossary of Business Valuation Terms* defines a
60 control premium as "an amount or percentage by which the pro rata value of a controlling
61 interest exceeds the pro rata value of a non-controlling interest in a business enterprise, to reflect
62 the value of control."

63 Historically, the concept and/or measurement of the control premium has proven to be vexing
64 and contentious to valuation specialists. Those of a more empirical disposition point to the range
65 of premiums observed in closed transactions as a starting point for analysis, while others observe
66 that the much larger population of public companies that are not acquired each year supports the
67 theory that control premiums for most publicly traded companies either do not exist or are too
68 small to justify the costs and uncertainties associated with an attempted acquisition. In the
69 context of fair value measurement, the Working Group desires to reorient discussion and analysis
70 to the reasonable expectations of the relevant pool of market participants regarding cash flow
71 enhancement and risk reduction at the measurement date.

² *The International Glossary of Business Valuation Terms* contains valuation terms and definitions adopted by five North American professional organizations that recognize business valuation as a professional discipline: American Institute of Certified Public Accountants, American Society of Appraisers, National Association of Certified Valuation Analysts, The Canadian Institute of Chartered Business Valuators, and The Institute of Business Appraisers.

³ The Working Group believes that this definition is consistent with instances where definitions of control appear in U.S. Generally Accepted Accounting Principles.

72 **Definition**

73 In this VFR Advisory the Working Group has introduced the (MPAP, defined as the difference
74 between (1) the *pro rata* fair value of the subject controlling interest and (2) *its foundation*.
75 Foundation is measured with respect to the current stewardship of the enterprise. In other words,
76 the foundation contemplates that the prerogatives of control will continue to reside with the
77 existing controlling shareholder or group of shareholders. The Working Group believes that
78 valuation specialists most commonly associate the *foundation* with the *pro rata* fair value of
79 marketable, non-controlling interests in the enterprise. Therefore, for publicly traded companies,
80 the foundation is equal to the quoted market price for the company's shares.

81 Foundation value does not give consideration to discounts for lack of marketability.

82 Also, while the preceding describes an MPAP Equity Foundation concept, later in this document
83 the Working Group introduces an alternative way to think about the MPAP. It proposes that
84 instead of utilizing the Equity Foundation to determine an MPAP, usage of a Total Invested
85 Capital (TIC) Foundation may be more appropriate. (For clarity and emphasis, this use of the
86 word "Foundation" will be capitalized in subsequent sections.)

87 **Control and Marketability**

88 The MPAP definition does not ascribe a particular degree of marketability to the subject
89 controlling interest. The issue of marketability for controlling interests is a source of diversity in
90 practice, as some valuation specialists apply discounts for lack of marketability to derive the fair
91 value of controlling interests in privately held companies, while others do not. The Working
92 Group believes that it is usually inappropriate to apply discounts for lack of marketability when
93 measuring the fair value of controlling interests. In most cases sellers would have access to a
94 market as a forum to transact.

95 Among the prerogatives of control is the discretion to pursue an orderly sales process in order to
96 realize the (undiscounted) value of the interest while enjoying the benefits of ownership.
97 Although transaction costs would not be considered part of fair value, fair value contemplates the
98 usual and customary marketing activities for such interests. Controlling interests should not be
99 held to the same standard of marketability as publicly traded equities because the markets (and
100 associated marketing periods) differ. For controlling interests in business enterprises, the usual
101 and customary marketing activities may be time-consuming.

102 **Illustrative Examples**

103 Two examples serve to clarify the MPAP definition. First, consider a business enterprise that is
104 not publicly traded. The company's founder owns 70% of the outstanding shares and continues
105 to exercise control over the enterprise. The remaining 30% of the outstanding shares are held by
106 a number of investors, none of whom own more than 5%. Despite the availability of numerous
107 investment opportunities with indicated positive net present values, the founder demonstrates
108 little interest in growth and is averse to the use of debt financing. The price per share paid by
109 market participants for a controlling interest is likely to exceed that paid for a non-controlling
110 (albeit hypothetically marketable) interest reflecting current stewardship of the company. In
111 other words, there is likely to be an MPAP. Its magnitude likely will be influenced by the
112 perceived ability of market participants to exercise the prerogatives of control to increase the
113 cash flows and/or reduce the discount rate applicable to the subject interest. Available strategies
114 include making investments to spur revenue and earnings growth (thereby potentially increasing
115 cash flow), and employing a more typical financing mix for the industry (thereby reducing the
116 weighted average cost of capital). Some market participants may also expect cost savings from
117 eliminating redundancies. For privately held companies, much more so than publicly traded
118 companies, there might also be cost savings from adjusting compensation and other costs to
119 market rates.⁴

120 Second, consider a business enterprise that is publicly traded. The business is generally believed
121 to be well-managed, reporting operating margins in line with industry peers. The company has
122 created and marketed a unique technology and has generated significant historical revenue
123 growth. In this case, opportunities to generate economic benefits by exercising the prerogatives
124 of control are more limited. However, market participants may own complementary
125 technologies that, if marketed alongside that of the subject entity, would increase revenue
126 growth. Alternatively, market participants may have existing distribution networks capable of
127 handling the subject entity's products that would enhance profit margins. Similar to the other
128 example, market participants' perceptions of how prerogatives of control translate into value
129 influence the investment decision.

130 In each case, the task of the valuation specialist is to identify and evaluate the feasibility of the
131 available strategies from the perspective of market participants for the subject interest. The
132 appropriate MPAP considers not only the magnitude of the available economic benefits, but also
133 the degree to which such potential benefits will influence the price paid by market participants
134 for the subject controlling interest in an orderly transaction at the measurement date. The
135 Working Group is not stating that the economic benefits must be precisely quantified in each
136 case. Rather, at a minimum, analysis should be performed to identify which form(s) of economic
137 benefit market participants would reasonably expect to enjoy and some general magnitude of the
138 effects of those benefits on value.

⁴ Whether such cost savings would contribute to the MPAP depends on how the above-market compensation and other costs were treated in measuring the foundation value. There is diversity of opinion in the profession as to where such "normalizing" adjustments are appropriate. The resolution of that controversy is beyond the scope of this Valuation Advisory.

139 **Concluding Observations**

140 The Working Group believes that MPAPs should be supported by reference to either enhanced
141 cash flows or a lower required rate of return from the market participant perspective. The
142 referenced economic benefits should be sufficient to provide market participants with an
143 adequate return on the concluded fair value of the controlling interest. The Working Group
144 anticipates that such benefits will not be reliably identifiable in all instances, in such cases
145 resulting in either no, or a small, premium.

146 Notwithstanding the emphasis on cash flow and risk differentials in supporting MPAPs in fair
147 value measurement, the Working Group acknowledges the merit of analyzing historical data
148 regarding observed premiums from closed transactions. Such data might provide some examples
149 of the extent to which buyers have expected improvement in cash flows or reduction of risk in
150 specific transactions. However, to conform to best practices, valuation specialists should
151 critically evaluate the quality and relevance of such benchmark premium data to assess its
152 applicability to the valuation subject. It is inconsistent with best practices to rely solely on
153 benchmark premium data to evaluate the reasonableness of the MPAP in a fair value
154 measurement.

CONCEPTUAL CONSIDERATIONS

155 The Working Group believes that a persuasive fair value measurement for a controlling interest
156 in a business enterprise should be supported by a clear explanation of the incremental economic
157 benefits available to market participants. In this section of the VFR Advisory, we discuss the
158 prerogatives of control that are the means for generating economic benefits and provide examples
159 of the economic benefits typically associated with changing control of a business enterprise. The
160 Working Group also discusses the characteristics of a business enterprise that are likely to
161 influence the magnitude of the economic benefits available to market participants.

162 Prerogatives of Control

163 The prerogatives of control refer the rights possessed by the owner of a controlling interest in a
164 business enterprise to direct the management and policies of a business enterprise. Following is
165 a non-exhaustive list of the specific means by which such control is exercised⁵:

- 166 1. Appointing or changing operational management
- 167 2. Electing members of the board of directors
- 168 3. Determining management compensation and perquisites
- 169 4. Setting operational and strategic policy for the business
- 170 5. Acquiring, leasing, or liquidating business assets
- 171 6. Selecting suppliers, vendors, and subcontractors
- 172 7. Negotiating and consummating mergers and acquisitions
- 173 8. Liquidating, dissolving, selling, or recapitalizing the company
- 174 9. Selling or acquiring treasury shares
- 175 10. Registering the company's equity securities for an initial or secondary public offering
- 176 11. Registering the company's debt securities for public offering
- 177 12. Declaring and paying dividends
- 178 13. Changing the articles of incorporation or bylaws
- 179 14. Selecting joint venture and other business partners
- 180 15. Making product and service offering decisions
- 181 16. Making marketing and pricing decisions
- 182 17. Entering into licensing and other agreements regarding intellectual property
- 183 18. Blocking any or all of the above actions

184 The Working Group believes that the prerogatives of control noted above have no inherent value,
185 but are rather the means through which market participants implement strategies designed to
186 generate economic benefits. For example, the bare ability to select a company's suppliers
187 conveys no particular economic benefit to market participants, and therefore does not influence
188 the fair value of a controlling interest. However, if selecting suppliers with whom market
189 participants have existing relationships allows market participants to achieve a lower cost of
190 sales, that economic benefit will potentially influence the MPAP.

⁵ Most, if not all, of these items are based on a list appearing in *Business Valuation Discounts and Premiums*; by Shannon P. Pratt, CFA, FASA, MCBA, John Wiley & Sons, Inc., Second Edition, 2009, pg 17-18.

191 **Economic Benefits that Support MPAP**

192 The Working Group believes that the economic benefits that support MPAPs ultimately manifest
193 in two ways: (1) enhanced cash flows or (2) lower required rates of return. The task of the
194 valuation specialist is to identify the economic benefits available to market participants and
195 support a magnitude of the amount by which such benefits may reasonably be expected to
196 increase the price paid by market participants for the subject interest over its Foundation value.
197 Usually cash flows and the applicable required rate of return (i.e., the discount rate) are
198 interrelated. Therefore, any incremental risks associated with achieving cash flow enhancements
199 should be appropriately reflected in the required rate of return.

200 **Enhanced Cash Flows**

201 Market participants contemplating purchase of a controlling interest in a business enterprise often
202 anticipate implementing business strategies that are not currently being implemented, or are not
203 available to be implemented, by the current owners. These strategies may increase cash flows or
204 improve investment returns through other strategy revisions. As stated previously, the Working
205 Group will refer to the concept of cash flow improvement to denote all forms of value-enhancing
206 investment and operational strategies. In all cases, an acquisition premium would only be
207 supported by changes believed to enhance the total return on investment. Potential improvements
208 may include the following areas, which are illustrative and not intended to be an all-inclusive list:

- 209 • *Superior revenue growth.* Market participants may have greater financial capacity and/or
210 willingness to invest more in positive net present value projects in order to fuel future
211 revenue growth than the incumbent ownership group. Alternatively, market participants may
212 have complementary products or services that are expected to increase sales of the subject
213 entity, the market participants, or both. Market participants may anticipate enhanced pricing
214 power following the acquisition of a competitor. They may have existing relationships with
215 customers that have previously been inaccessible to the subject entity. In addition, market
216 participants may have existing distribution networks that are broader than those of the subject
217 entity that could contribute to superior revenue growth.
- 218 • *Increased operating margins.* Market participants may anticipate increasing operating
219 margins by eliminating redundant operating costs or achieving economies of scale through
220 the addition of incremental sales volume. Larger companies are often able to negotiate
221 superior terms with suppliers, resulting in lower cost of sales. For privately held companies,
222 market participants might expect increased margins through the normalization of
223 compensation and contract amounts that had not been at market-based rates.⁶
- 224 • *Working capital efficiencies.* Relative to the subject entity under current stewardship, market
225 participants may expect to maintain lower cash balances, negotiate more favorable payment
226 terms or inventory delivery schedules with suppliers, or have tighter credit policies.

⁶ Whether such cost savings would contribute to the MPAP depends on how the above-market compensation and other costs were treated in measuring the foundation value. There is diversity of opinion in the profession as to where such “normalizing” adjustments are appropriate. The resolution of that controversy is beyond the scope of this Valuation Advisory.

227 • *Capital expenditure efficiencies.* Market participants may have more favorable ongoing
228 access to necessary capital equipment, or they may be able to consolidate production and
229 distribution capacity.

230 Regardless of the source, to be relevant in differentiating the fair value of a controlling interest,
231 the enhanced cash flows must be incremental to those expected by the subject entity under
232 current stewardship. In other words, enhanced cash flows giving rise to an MPAP are
233 incremental to prospective financial information that reflects the ongoing operations of the
234 business enterprise absent a change of control transaction.

235 Furthermore, implementation of strategies expected to generate cash flow benefits may require
236 the acquirer to incur significant costs. For anticipated revenue synergies, such costs may include
237 investments in incremental production capacity and/or distribution infrastructure. Anticipated
238 cost savings may be realized only after severance costs have been incurred. In all cases, the
239 anticipated cash flow benefits that contribute to MPAP should be assessed net of required costs
240 to implement the corresponding strategy.

241 **Lower Required Rate of Return**

242 When evaluating the purchase of a controlling interest in a business enterprise, market
243 participants may have a lower required rate of return than investors contemplating the purchase
244 of an otherwise comparable non-controlling interest in the entity under current stewardship. The
245 Working Group believes there are several reasons market participants may have a lower required
246 rate of return for a controlling interest, including:

247 • *Optimized capital structure.* If the subject entity employs a suboptimal mix of debt and
248 equity financing, the weighted average cost of capital may be reduced by adjusting the
249 subject entity's capital structure. While it may be more common for companies to use a less-
250 than-optimal amount of debt financing, the costs of financial distress may also cause an over-
251 leveraged company to have an unfavorable cost of capital. Judgments as to the optimal
252 capital structure for the subject entity may be made with reference to the observed capital
253 structures of companies in the subject entity's industry.

254 • *Company size benefits.* Most valuation specialists agree that, all else being equal, larger
255 companies enjoy lower costs of capital than smaller companies. Often, market participants
256 are larger than the subject entity and therefore have a lower cost of capital.

257 • *Reduced operating risk.* Market participants may perceive opportunities to reduce the
258 operating risk of the business through strategies designed to reduce the volatility of raw
259 material pricing, adopting a more variable cost structure, mitigating customer concentrations,
260 or securing more long-term customer contracts, among others. Such measures may reduce
261 the operating risk, and cost of capital, for the business enterprise.

262 Such effects will influence the magnitude of the MPAP only to the extent that market participants
263 are willing to credit the subject entity with the economic benefits resulting from a lower cost of
264 capital.

265 Many valuation professionals are unclear about market participants' views of the size of the
266 target and how it influences the discount rate to be used in a valuation. Some believe that market
267 participants use a cost of capital commensurate with the size of the target. Others believe that
268 market participants use a cost of capital reflecting the benefits of the increased size and
269 diversification of the combined entity post-transaction. Through the Working Group's outreach
270 efforts, it was made clear that valuation professionals believe both perspectives are relevant in
271 the determination of the appropriate discount rate.

272 When views about the applicability of the appropriate size premium differ, and thus result in a
273 wide range of value indications, the importance of the valuation specialist's judgment increases.
274 Valuation specialists might consider applying the following concepts in an effort to reflect the
275 appropriate market participants' perspective when estimating a size premium.

276 • As a practical expedient, valuation specialists could bookend their income approach using the
277 differing possible perspectives of market participants' risk to generate two valuation
278 indications. One would reflect the size of the target. Another would reflect the size of the
279 combined entity. The valuation specialist would select a point within the range, taking into
280 account the accounting standards requiring the analysis.

281 • Apply other valuation techniques under the market or cost approaches. When this is done the
282 point in a range where there seems to be the most consensus across approaches could provide
283 relevant insights implying which is the stronger size premium case.

284 • The valuation specialist may be able to calibrate the risk measure by looking at the
285 accounting exercise (e.g. business combination valuation) that recorded the subject.

286 • The valuation specialist may be able to calibrate the risk measure by looking at the
287 accounting exercise (e.g. business combination valuation) that recorded investments in
288 similar subjects.

289 **Other Key Points**

290 The Working Group cautions that it may not be appropriate to assume that market participants
291 will always incorporate all economic benefits of control into the price paid for a controlling
292 interest in a subject business, even if such benefits exist. In other words, market participants
293 ordinarily do not give away all of their upside - the incremental economic benefits - that may
294 arise from a transaction. How much of the upside is included in the transaction price depends, in
295 part, on the competitive dynamics of the sale process.

296 Furthermore, the Working Group believes that it is incorrect to assume that the public market has
297 “underpriced” non-controlling interests in the subject entity in measuring the magnitude of an
298 MPAP for a controlling interest. For example, stock analysts frequently publish price targets for
299 the shares of publicly traded companies. The existence of price targets in excess of the
300 prevailing stock price does not provide direct evidence of the MPAP. In such cases, the
301 valuation specialist should investigate the investment thesis underlying the price target. If the
302 price target is premised on the expectation that the company may soon be “in play” for a change
303 of control transaction or an expectation that a controlling interest buyer would implement
304 strategies to increase the economic benefits generated by the firm, such price targets may provide
305 indirect support for an MPAP. If, on the other hand, the price target reflects an expected future
306 change in market sentiment for non-controlling interests in the subject entity, the price target will
307 provide only limited or no support for an MPAP.

BUSINESS CHARACTERISTICS INFLUENCING MARKET PARTICIPANT ACQUISITION PREMIUM

308 As valuation specialists evaluate the potential economic benefits that may be derived by market
309 participants from exercising the prerogatives of control in a manner different from current
310 ownership, it is important to assess the reasonableness of the assumed economic benefits in the
311 context of the characteristics of the subject business enterprise and the industry in which it
312 operates. The following discussion is not intended to be comprehensive, but is representative of
313 the factors that valuation specialists should consider in estimating the price market participants
314 would pay for the subject controlling interest.

315 Acquisition Activity in the Industry

316 The number of change of control transactions in a given industry fluctuates over time. When the
317 frequency of transactions in an industry increases, it may signal that market participants perceive
318 greater opportunities to generate economic benefits by exercising the prerogatives of control.
319 For example, regulatory or other changes may favor a smaller number of larger industry players,
320 prompting a round of consolidation. Alternatively, acquisition activity may increase because
321 economic turmoil is causing the financially weaker members of the industry to seek to be
322 acquired by more stable and less financially distressed companies.

323 Robust acquisition activity in the industry may increase the number of market participants that
324 would contemplate acquiring a controlling interest in the subject entity. As a result, the selling
325 shareholders may be able to realize a greater portion of the economic benefits available to market
326 participants, thereby increasing the fair value of the controlling interest and, by extension, the
327 MPAP.

328 As a consolidation trend for an industry is confirmed by an increasing number of announced
329 transactions, the fair value of non-controlling interests in the subject entity may increase as
330 investors come to expect that a change of control transaction on favorable terms is imminent. In
331 such cases, the MPAP may be reduced as the difference between the fair value of controlling and
332 non-controlling interests is compressed.

333 Stage in Company Life Cycle

334 Growth-stage target companies generally offer greater opportunities for realizing economic
335 benefits than more mature companies. For example, market participants may be able to leverage
336 existing distribution networks that growth-stage companies have not yet had the opportunity or
337 financial resources to develop, providing opportunities for superior revenue growth and/or
338 enhanced operating margins. Mature target companies, on the other hand, are likely to present
339 fewer opportunities for enhanced cash flows or lower cost of capital. As a result, the appropriate
340 MPAP may be lower for such companies.

341

342 **Market Participant Attributes**

343 Market participants are commonly classified into three general categories:

- 344 • *Strategic acquirers* already operate in the same business as the subject entity. Revenue
345 synergies and cost savings tend to be the most important economic benefits available to
346 strategic acquirers exercising the prerogatives of control. Strategic acquirers may be
347 competitors of, suppliers to, or customers of the subject entity.
348
- 349 • *Financial acquirers* do not have any existing complementary business operations. Financial
350 acquirers, such as private equity funds, are less likely to identify significant revenue
351 synergies or operating cost savings than strategic acquirers. Financial acquirers may possess
352 financing advantages relative to strategic acquirers.
353
- 354 • *Conglomerate acquirers* are operating companies that acquire the subject entity to increase
355 the diversification of the acquirer's existing revenues and cash flows. While there may be
356 some administrative efficiencies that are expected to contribute to enhanced cash flows, the
357 expectation of diversification benefits, and thus lower risk, causes the benefits available to
358 conglomerate acquirers to more closely resemble financial rather than strategic acquirers.

359 While this classification is helpful for evaluating the attributes of market participants and the
360 nature and magnitude of economic benefits they will expect from owning control of the subject
361 entity, the Working Group emphasizes that the boundaries between the categories are permeable.
362 For example, financial acquirers often acquire controlling interests in companies to “bolt on” to
363 existing portfolio investments, thereby resembling strategic acquirers in many respects. In
364 addition, financial acquirers may anticipate significant cash flow enhancements from replacing
365 what they perceive to be an inept management team, or from the eventual sale to a strategic
366 acquirer, or through taking the entity public with favorable initial public offering pricing.
367 Likewise, strategic or conglomerate acquirers may have access to financing arrangements on
368 terms at least as favorable as financial acquirers.

369 Valuation specialists should identify market participants' attributes and correlate the expected
370 economic benefits of control to the likely strategies of such acquirers. In many cases, strategic,
371 financial, and conglomerate acquirers compete with one another for the same targets and the fair
372 value of controlling interests could appear to encompass a mix of strategic and financial benefits.

373 **Size of Market Participants Relative to Subject Entity**

374 Market participants are often larger than the subject entity. This is unsurprising, as larger
375 companies may be positioned to realize economic benefits that are not available to a smaller
376 company on a stand-alone basis. For example, other factors being equal, larger companies are
377 more likely to have favorable access to capital, existing distribution infrastructure and
378 administrative capacity, and superior negotiating leverage with suppliers and customers. As a
379 result, the larger market participants may be able to extract greater economic benefit from the
380 subject entity than the current owner(s) – and in a shorter period of time. As a result, the MPAP
381 may be positively related to the size of the market participants for the subject controlling interest.

382 **Balance of Information**

383 Market participants forecast the economic benefits to be realized from an acquisition on the basis
384 of information discovered during due diligence procedures. Assuming the subject entity is a
385 willing party to the selling process, the due diligence associated with acquisition of a controlling
386 interest is likely to yield information not available to investors in non-controlling interests in the
387 subject entity. The Working Group has identified three varieties of information asymmetry that
388 can influence the fair value of a controlling interest, and by extension, the MPAP, in certain
389 circumstances:⁷

390 1. *Information available to market participants for controlling interests, but not market*
391 *participants for non-controlling interests.* In general, the subject entity’s Equity Foundation
392 reflects only publicly available information regarding the subject entity. However, at the
393 measurement date, there may be relevant information regarding the results of operations or
394 other factors that are disclosed to market participants for controlling interests but not yet
395 publicly disseminated. For example, if the measurement date coincides with the end of the
396 subject entity’s reporting period, operating results for the period are likely known by the
397 company with a considerable degree of certainty although the company may have issued only
398 limited guidance to analysts and investors so that the publicly traded share price does not
399 reflect the information. The existence of non-public information favorable to the subject
400 entity may support a larger MPAP; if the non-public information is unfavorable, that may
401 indicate a lower MPAP.

402 *Information known to the subject entity but not market participants.* If the information is
403 favorable to the subject entity, it is likely to be disclosed to the market participants during due
404 diligence. Under the definition of fair value, market participants are assumed to be
405 “knowledgeable, have a reasonable understanding about the asset or liability and the
406 transaction based on all available information, including information that might be obtained
407 through due diligence efforts that are usual and customary.”⁸ As a result, even if the subject
408 entity would prefer that market participants not be aware of unfavorable information, such
409 information is assumed to be known in measuring fair value resulting in a comparatively
410 lower MPAP. The Working Group believes the *good news* scenario revealed to the market
411 participants but not reflected in the Equity Foundation would increase the MPAP.

412 2. *Information known only to a single market participant, but not the subject entity.* A
413 particular market participant may be able to take advantage of unique revenue synergies or
414 cost savings. If this information is truly specific to a single market participant, the effect on
415 the fair value of the subject controlling interest is likely to be modest as the market
416 participant would be unwilling to pay more than the value of the economic benefits available
417 to the next most advantageously positioned market participant. In other words, if such
418 information constitutes a buyer-specific synergy, it should be excluded from the estimation of
419 fair value.

⁷ This discussion is in the context of publicly traded entities.

⁸ ASC 820-10-20.

420 In considering information asymmetries, the valuation specialist should be careful to not double
421 count the impact of such items. For example, the impact of any information asymmetries
422 discussed in the first and second situations might already be reflected in the typical inputs (i.e.,
423 cash flows and/or required rates of return). However, the information asymmetries discussed in
424 the first and second situations may be useful in explaining a portion of the MPAP implied from
425 the estimated fair value (e.g., in the process of reconciling to market capitalization). The
426 Working Group cautions that the existence and magnitude of most information asymmetries is
427 difficult to support. Further, the degree to which the balance of information contributed to
428 historically observed transaction premiums will, in most cases, be impossible to discern.

429 **Capital Structure of Subject Entity**

430 Among the prerogatives of control is the ability to adjust the subject entity's capital structure. As
431 discussed previously, shifting to a more optimal capital structure is one strategy for reducing the
432 weighted average cost of capital. The farther the subject entity's capital structure is from the
433 optimal financing mix, the greater the potential MPAP.

434 **Management Objectives**

435 Privately held companies often are managed with objectives that differ from those of publicly
436 traded companies. This is not necessarily a matter of differing "quality" of management
437 (addressed in the next section), but instead might be a matter of differing goals. Such differences
438 might include above-market compensation paid to the private company owner, lease rates that do
439 not reflect market conditions, avoidance of the use of debt financing, net working capital at levels
440 above industry norms, and other similar factors.

441 Depending on how these factors are addressed in determining the Foundation value, the MPAP
442 for such a privately held company might exceed that measured for many publicly traded entities.

443 **Quality of Management**

444 Another prerogative of control is the ability to change the subject entity's management team. If
445 the quality of the incumbent management team is perceived by market participants to be less than
446 optimal, it may be more likely that strategies to enhance cash flows or reduce the cost of capital
447 can be successfully implemented. Such strategies might contribute to a larger MPAP.
448 Conversely, if the quality of the management team is acknowledged to be high, opportunities to
449 realize further economic benefits are likely to be limited, resulting in a smaller MPAP.

450 While the notion of management quality is inherently subjective, there are objective metrics that
451 can provide insight regarding the effect of current management policies. Metrics such as growth,
452 profitability, asset utilization, and cost of capital can be benchmarked against peer companies to
453 provide insight regarding the quality of incumbent management. However, such measures must
454 be interpreted in the context of the management team's tenure and firm-specific factors, such as
455 contracts, facilities, and other assets that were inherited from prior management teams.

456 The Working Group observes that poor quality management is unlikely to be a factor cited in
457 support of an MPAP since it rarely will be acknowledged by the management team responsible
458 for the fair value measurement. Nonetheless, it is an important consideration and highlights the
459 importance of comparative financial analysis when evaluating the economic benefits that may be
460 available to market participants exercising control over a business enterprise.

461 **Regulatory Factors**

462 Regulatory factors can be significant considerations in business combinations. In addition,
463 regulatory factors can mitigate or amplify the degree of control exercised by a particular
464 ownership interest. Purchase prices and acquisition premiums in transactions outside the United
465 States can differ significantly from those inside the United States because of different regulatory
466 environments.

467 There are a variety of regulatory factors that may be relevant to the analysis of the MPAP:

468 • *Regulations governing merger and acquisition activity.* Some regulations, such as anti-trust
469 provisions designed to limit the potential for monopoly power, may directly affect which
470 market participants are potential acquirers of the subject entity. Regulatory provisions that
471 significantly reduce the number of potential bidders for the subject entity may have a
472 dampening effect on the MPAP.

473 • *Limitations on foreign direct investment.* As with anti-trust provisions, those aimed at
474 limiting the ability of foreign market participants to acquire a controlling interest in the
475 subject entity may reduce the MPAP applicable to the subject entity.

476 • *Investor protection measures.* Investor protection measures such as uniform accounting
477 standards and corporate securities laws are generally designed to protect non-controlling
478 investors. Some measures may even grant non-controlling shareholders in a business
479 enterprise the right to block the controlling owner's ability to unilaterally exercise certain of
480 the prerogatives of control. Since the MPAP measures the difference between the fair value
481 of controlling and non-controlling interests, regulations that increase the fair value of non-
482 controlling interests will, all else being equal, reduce the MPAP.

483 • *Industry-specific regulations.* Some industries, such as banking and telecommunications, are
484 governed by a host of industry-specific regulations that govern the conduct of, and
485 competition among, firms within the industry. Such industry regulations can shift with
486 economic conditions and the political environment. Industry-specific regulations that are
487 perceived to promote consolidation activity may increase the MPAP. If, instead, the
488 prevailing regulatory stance is one of limiting acquisition activity, the MPAP may be lower.

489 The influence of regulatory factors should be evaluated relative to observed transaction activity
490 in the subject entity's industry.

491 **Corporate By-Laws and Governing Documents**

492 Valuation specialists should consult the subject entity's corporate by-laws and other governing
493 documents to determine whether there are any provisions that may restrict the ability of the
494 subject interest to exercise control over the business enterprise.

495 The Working Group believes it is a mistake to conceive of control as being absolute; rather,
496 control of the enterprise should be evaluated along a continuum extending from substantial
497 minority investments to complete ownership of all equity share classes. For example, the subject
498 entity's governing documents may grant preferred shareholders the right to vote as a class on
499 certain corporate actions, or to elect a certain number of corporate directors. In other cases, a
500 supermajority vote of the common shares may be required to approve a sale of the business.

501 Some companies issue both voting and non-voting shares with the economic rights of the non-
502 voting shares being identical to the voting shares. Observed differences between trading prices
503 for non-controlling interests in the two share classes are typically very small. Because this is
504 based on a comparison of the prices of non-controlling interests, such data is of little use in the
505 analysis of MPAP.

506 **Transaction Structure**

507 The structure of a transaction can exert a significant influence on the nominal price paid for a
508 controlling interest. The tax characteristics of a transaction, including the availability of
509 amortization benefits to the market participants, can affect the purchase price. The Working
510 Group observes that ASC 350 requires consideration of whether fair value reflects a taxable or
511 non-taxable transaction structure.

512 Controlling interest acquisitions often include contingent consideration arrangements.
513 Depending on how the contingent consideration is measured, the nominal purchase price may be
514 overstated or understated. Recent changes to the accounting for business combinations that
515 include contingent consideration have – at least temporarily – increased the difficulty of
516 interpreting market data from completed transactions.⁹

517 Valuation specialists should carefully consider the influence of transaction structure on both
518 observed transaction multiples and control premiums, as well as fair value measurement of the
519 subject controlling interest. Unfortunately, important details that would permit careful analysis
520 of closed transactions are usually unavailable to the valuation specialist.

⁹ The Working Group notes that contingent consideration arrangements are less common in acquisitions of public companies (the basis for observed transaction premiums).

521 **Summary**

522 In summary the Working Group believes this section illustrates many of the factors that valuation
523 specialists would consider in estimating the price market participants are willing to pay for the
524 subject controlling interest. The preceding listing and discussion of business characteristics and
525 considerations is not intended to capture all factors that may influence an MPAP. Instead, the
526 Working Group focused on topics that - based on its collective professional experiences - are
527 encountered most often in practice. Consideration of these concepts may be helpful when
528 performing original analysis to develop an MPAP. These concepts may also be useful in
529 assessing the reasonableness of another party's MPAP analysis, such as in a peer or specialist
530 review context.

531 **Conclusions**

532 A well-supported fair value measurement for a controlling interest in a business enterprise should
533 include consideration, from the market participants' perspective, of the incremental economic
534 benefits of control. The prerogatives of control may lead to economic benefits in many areas and
535 the valuation specialist should review the typical business characteristics likely to influence the
536 magnitude of the benefits available to market participants.

537 The Working Group believes that use of the framework discussed will provide an important
538 context for review of the valuation results, and will increase the relevance and reliability of the
539 associated fair value measurement.

ANALYTICAL METHODS

540 The remaining sections of this VFR Advisory address some of the important analytical methods
541 involved in expressing MPAPs, analyzing observed premiums from historical transactions, and
542 assessing the reasonableness of the concluded MPAP.

543 Expressing the Market Participant Acquisition Premium

544 Although the MPAP may be expressed as a dollar amount (the difference between the *pro rata*
545 fair value of a controlling interest and its Foundation), valuation specialists customarily express
546 valuation premiums and discounts as the percentage difference. This is intuitive and facilitates
547 the comparison of premiums across companies of different sizes.

548 Valuation specialists have traditionally used the Equity Foundation to calculate the transaction
549 premium as a percentage. This is consistent with the methodology for reporting premiums used
550 by *Mergerstat Review* which the Working Group observes (based on its experiences) to be the
551 most widely cited source of historical control premium data. It is also consistent with the way in
552 which premiums are commonly reported in the financial press.

553 In deliberating the MPAP, the Working Group concluded that the traditional method of
554 calculating transaction premiums is potentially misleading. This is because the economic
555 benefits realized through exercising the prerogatives of control enhance the fair value of the
556 enterprise as a whole, not just the fair value of the equity.¹⁰

557 Further, expressing the MPAP as a percentage of the Equity Foundation distorts the
558 comparability of the MPAP among companies with different capital structures. For example,
559 assume Foundation TIC value for both Company A and Company B is \$100 million. Company
560 A has \$10 million of interest-bearing debt outstanding and Company B has \$50 million of
561 interest-bearing debt outstanding. Assume further that, from the perspective of market
562 participants, the magnitude of economic benefits from exercising the prerogatives of control for
563 Company A is identical to that for Company B, such that the MPAP applicable to each company
564 is \$20 million.

565

¹⁰ When there is a change of control transaction, the debt typically is due at its face amount, and its book amount approximates or equals fair value.

566 As shown in the following table, the traditional method of expressing the premium as a
 567 percentage of the Equity Foundation will cause the MPAP for Company A to appear smaller than
 568 that of Company B. However, when expressed as a percentage of the TIC Foundation, the
 569 MPAPs – which are economically equivalent (the same dollar amount) – are identical.

| | <u>Company A</u> | <u>Company B</u> |
|---|------------------|------------------|
| Fair Value of Interest-Bearing Debt | \$10.0 | \$50.0 |
| Fair Value of Equity | 90.0 | 50.0 |
| Fair Value of Total Invested Capital <i>(Marketable, Non-controlling Interest Basis)</i> | \$100.0 | \$100.0 |
| Fair Value of Total Invested Capital <i>(Controlling Interest Basis)</i> | \$120.0 | \$120.0 |
| Market Participant Acquisition Premium | \$20.0 | \$20.0 |
| <u>Traditional Method</u> | | |
| Market Participant Acquisition Premium | \$20.0 | \$20.0 |
| Fair Value of Equity <i>(Marketable, Non-controlling Interest Basis)</i> | 90.0 | 50.0 |
| Market Participant Acquisition Premium (%) | 22.2% | 40.0% |
| <u>Total Invested Capital Method</u> | | |
| Market Participant Acquisition Premium | \$20.0 | \$20.0 |
| Fair Value of Total Invested Capital <i>(Marketable, Non-controlling Interest Basis)</i> | 100.0 | 100.0 |
| Market Participant Acquisition Premium (%) | 20.0% | 20.0% |

570 The Working Group believes that best practices include expressing as well as applying the
 571 MPAP in the context of a TIC Foundation.¹¹ The Working Group acknowledges that following
 572 this best practice will require the restatement of observed transaction premiums that have been
 573 traditionally expressed based on an Equity Foundation. Nonetheless, the Working Group
 574 believes that the benefits of doing so (alignment with the underlying economic benefits giving
 575 rise to the MPAP and greater comparability across firms with different capital structures)
 576 outweigh the incremental effort. The Working Group notes that since the observed transaction
 577 premiums relate to publicly traded companies, the information is ordinarily available to enable
 578 expression of the observed transaction premiums using a TIC Foundation.

¹¹ Concepts of TIC level premiums may not be applicable for certain industries (e.g., certain types of financial services entities).

579 **Analyzing Historical Premium and Transaction Data**

580 Transactions in which the buyer acquires a controlling interest in a publicly traded company
581 afford opportunities to observe the magnitude of transaction premiums paid by acquirers.
582 Valuation specialists often reference observed premiums when estimating or supporting the
583 MPAP for the subject entity. Although similar transaction premiums presumably also exist in
584 the acquisition of private companies, the absence of an observable Foundation price for the
585 acquired company precludes calculating reliable premiums. However, such transactions may
586 yield reliable multiples of revenue, earnings measures, or other relevant metrics that are
587 indicative of the fair value of a controlling interest.

588 The Working Group cautions that exclusive reliance on observed transaction premium data
589 provides, in most cases, insufficient support for a concluded MPAP. Nonetheless, observed
590 transaction premium data may be valuable. The Working Group believes that observed historical
591 premiums provide potentially relevant (albeit indirect) evidence of the appropriate magnitude of
592 the incremental economic benefits anticipated by market participants. The observed premiums
593 can be used to corroborate (or question) the reasonableness of the cash flow forecasts and
594 discount rates underlying fair value measurements within the income approach. However,
595 exclusive reliance on observed transaction premiums without careful analysis of the subject
596 entity's relative financial performance, valuation multiples, and other metrics can result in an
597 unreliable fair value measurement.

598 The Working Group believes that the valuation specialist may consider the qualitative factors
599 discussed in the earlier section – *Business Characteristics Influencing Market Participant*
600 *Acquisition Premium* – to narrow the range of observed premiums from the transaction data that
601 may be applicable for the subject entity. Analysis of these factors may also support the
602 incremental benefits assumed in a quantitative analysis of the MPAP.

603 **Assessing the Underlying Data Set – Transaction Data**

604 Valuation specialists should carefully analyze available transaction data, considering various
605 factors specific to the acquired company, the seller, the acquirer, or the transaction that may
606 warrant adjustments to the data. Factors valuation specialists should consider include the
607 following:

- 608 • *Size of Interest Transacted.* The valuation specialists should attempt to ascertain whether the
609 interest transacted represents 100% ownership of the company. As discussed previously,
610 there is a continuum of control, and ownership interests of less than 100% may not be able to
611 unilaterally exercise the prerogatives of control.
- 612 • *Financial Condition of Seller.* Transactions involving sellers motivated by financial distress
613 or bankruptcy usually do not provide reliable evidence for fair value measurement.
- 614 • *Relationship of Buyer and Seller.* If the parties to the transaction have some pre-existing
615 relationship, it may indicate that the transaction terms do not reflect arm's-length negotiation,
616 which would limit the usefulness of the transaction data when measuring fair value.

617 • *Stated Rationale for Transaction.* When available, analysts should review press releases and
618 other corporate announcements describing the transaction to determine if the price paid (and
619 therefore the multiples and premiums observed) reflected any buyer-specific synergies, or if
620 any other characteristics of the transaction render it unsuitable for use in a fair value
621 measurement.

622 • *Changes in Market Conditions.* Unlike guideline public company data, guideline transaction
623 data rarely lines up with the measurement date. Rather, some amount of time will have
624 elapsed between the occurrence of the observed transaction and the measurement date.
625 Depending on the length of the gap, analysis of changes in market, economic or industry
626 conditions (as reflected in pertinent market indices or economic series) between the two dates
627 may be appropriate to assess the relevance of the observed transaction data to the fair value
628 measurement.

629 • *Stock Price and Volume Fluctuations Prior to Announcement.* In some cases, the stock of the
630 target company may exhibit unusual volatility and/or increased trading volume prior to the
631 formal announcement of the transaction. The existence of such phenomena may indicate that
632 the implied acquisition premium should be calculated with reference to an earlier, unaffected,
633 stock price.

634 • *Transaction Structure.* Especially for transactions involving private companies, an array of
635 transaction structure concerns can distort the reported data. For example:

- 636 ○ Acquirers may purchase either the stock or the assets of the target company.
- 637 ○ Certain corporate assets such as cash or real estate may not be included in the transaction.
- 638 ○ The consideration may include a note bearing interest at other than a market rate.
- 639 ○ The fair value of contingent consideration arrangements is often difficult to measure at
640 the transaction date (and may be excluded altogether from a reported price).

641 • *Transaction Process.* The valuation analyst should endeavor to ascertain whether the
642 transaction was the culmination of a deliberate selling and marketing effort administered by
643 competent investment bankers, a hostile takeover, a bidding war, or negotiation with a single
644 acquirer.

645 • *Transaction Status.* Referenced transactions may have been announced, but not yet closed at
646 the measurement date. In such cases, valuation specialists should carefully consider how
647 much weight to give to such transactions.

648 Given the limited availability of data regarding most change of control transactions, it is unlikely
649 that valuation specialists will be able to obtain a comprehensive understanding of the factors
650 described above for each transaction relied on. Nonetheless, by considering these factors,
651 valuation specialists might be able to exclude transaction data that is misleading for the subject
652 fair value measurement.

653 **Other Considerations – Historical Premium Data**

654 Available data regarding observed premiums in historical transactions present additional
655 challenges for valuation specialists.

656 In many cases, there will be a trade-off between the quantity of available premium data and the
657 quality of the data (in other words, the data's relevance to the fair value measurement).
658 Valuation specialists should evaluate the relevance of referenced premium data by considering
659 the degree to which the target company is comparable to the subject entity, and whether the
660 acquirer is representative of market participants for the subject entity at the measurement date.

661 The number of referenced transactions can be increased by considering those occurring during a
662 longer window preceding the measurement date. However, transactions more proximate to the
663 measurement date are generally preferable, especially when consolidation trends within the
664 subject entity's industry have evolved. When evidence from transactions near the measurement
665 date is limited or not available, valuation specialists may wish to consider industry premiums
666 over a longer period, such as one, three, or five years prior to the measurement date. However,
667 when doing so, valuation specialists should be careful to consider what effect, if any, changes in
668 economic, market, or industry factors may have had on the level of observed premiums over the
669 period analyzed.

670 The reported magnitude of the observed premium from a transaction is affected by the date
671 selected to serve as the basis for expressing the premium (the date of the Foundation price).
672 Valuation specialists should review the target company's public share trading volume and price
673 fluctuations for the weeks leading up to the transaction announcement date to identify any
674 unusual or unexplained market activity. For example, if the target company had retained a
675 financial advisor to explore strategic alternatives, or negotiations with potential acquirers are
676 known to the public, it is preferable to calculate the transaction premium using a price from a
677 date before such information began to be incorporated into the target company's publicly traded
678 stock price.

679 Valuation specialists routinely consider premiums calculated from public stock prices one to
680 thirty days prior to the transaction announcement date. Valuation specialists may also calculate
681 transaction premiums based on the average stock price over a period. The Working Group
682 believes that, if applied consistently, such techniques can be used to improve the relevance and
683 reliability of historical premium data.

684 **Limitations Inherent in Observed Premium and Transaction Data**

685 As noted in the previous sections of this VFR Advisory, valuation specialists considering
686 observed premium and transaction data must be vigilant to ensure that the data has been
687 evaluated for comparability and relevance to the subject entity.

688 Beyond these issues, valuation specialists should be aware of more fundamental concerns that
689 may limit the usefulness of such data when measuring the fair value of a controlling interest,
690 such as:

691 • *Selection bias.* Acquisition premiums and other transaction data may be subject to selection
692 bias since the population of observed transactions is limited to those companies that have
693 been acquired. Some valuation specialists emphasize that such companies typically represent
694 only a small portion of the universe of companies available to be acquired. While not subject
695 to empirical verification, one potential conclusion from this observation is that the control
696 value of the much larger population of companies not acquired is not greater than the
697 companies' market capitalization because control would offer no incremental economic
698 benefits to induce an acquirer to seek control.

699 In any case, since the premiums and transaction multiples applicable to the companies not
700 acquired cannot be observed, application of observed premiums or implied transaction
701 multiples to the subject entity may introduce an upward bias in the resulting fair value
702 measurement. Stated alternatively, transaction data may be drawn from a sample limited to
703 those companies for which the premiums would be highest. As a result, the valuation
704 specialist must carefully assess whether the subject entity is comparable to acquired
705 companies in the sample. The Working Group believes that the valuation specialist may
706 consider the qualitative factors discussed in the earlier section – *Business Characteristics*
707 *Influencing Market Participant Acquisition Premium* – to narrow the range of observed
708 premiums from the transaction data that may be appropriate for the subject entity.

709 • *Acquirer-specific synergies.* Setting aside the potential for selection bias, data from closed
710 transactions may reflect acquirer-specific synergies that are not available to the relevant pool
711 of market participants. Specific synergies that are not available to market participants are
712 excluded from the definition of fair value. In most cases, the specific considerations
713 motivating the parties to the transaction cannot reliably be discerned from the available
714 transaction data. As a result, it is difficult for valuation specialists to precisely determine the
715 degree to which the observed premiums and transaction multiples are relevant when
716 measuring the fair value of the subject controlling interest.

717 • *Negative observed transaction premiums.* Referenced sources of transaction premium data
718 often include negative premiums. Negative transaction premiums are observed when the
719 price per share paid for a controlling interest is less than the contemporaneous Foundation
720 price. The Working Group believes that negative observed transaction premiums should be
721 disregarded when measuring fair value. The Working Group believes that, absent anomalous
722 circumstances with respect to either the market for the subject entity's shares or the
723 transaction process for the controlling interest (neither of which would be relevant in
724 measuring fair value), market participants would be unwilling to sell to a controlling interest
725 acquirer at a price less than the Foundation price.

726 Each of these concerns underscores the importance of careful analysis of the incremental
727 economic benefits available to market participants through exercising the prerogatives of control
728 in a manner different from the prior owners. The Working Group affirms the value of identifying
729 and referencing observed historical transaction premiums and other transaction data; however,
730 exclusive reliance on such data is not consistent with best practices for fair value measurement.

731 **Assessing the Reasonableness of the Concluded Market Participant Acquisition**
732 **Premium**

733 A credible fair value measurement should include an assessment of the overall reasonableness of
734 the measurement, including the MPAP applied or implied by the analysis. While premiums are
735 conventionally expressed as a percentage of the Equity Foundation, or in some cases the TIC
736 Foundation, the Working Group believes that the overall reasonableness of the fair value
737 measurement should be assessed more broadly.

738 Defined as the difference between two measures of fair value (the controlling interest and
739 Foundation), the MPAP is – strictly speaking – a byproduct of the valuation process rather than
740 an exogenous input. While valuation specialists commonly estimate the MPAP as an input in
741 measuring the fair value of a controlling interest (when using the guideline public company
742 method, for example), the level of rigor of analysis would depend on the importance of the
743 MPAP to the fair value measurement.¹² Valuation specialists may consider using the following
744 techniques to evaluate the reasonableness of the fair value measurement of a controlling interest
745 in a business enterprise:

746 • *Relative value measures.* When feasible, valuation specialists should calculate ratios of total
747 invested capital to relevant performance measures, such as revenue, Earnings Before Interest,
748 Taxes, Depreciation and Amortization (“EBITDA”), or other industry-relevant metrics.
749 When an MPAP has been added to a Foundation value, comparison of the resulting relative
750 value measures to transaction multiples observed from the available transaction data might
751 assist the valuation specialist in confirming the reasonableness of the selected premium.

752 • *Prospective Return Analysis.* The MPAP is a function of the incremental economic benefits
753 anticipated by market participants from exercising the prerogatives of control. If the
754 guideline public company approach is the primary method used in measuring fair value, the
755 valuation specialist might consider calculating the discount rate implied by the effective
756 earnings multiple. Comparing the implied discount rate to the weighted average cost of
757 capital for market participants can help confirm the reasonableness of the MPAP.
758

759 • *Calibration to prior transactions in the subject entity.* In some instances, transactions for
760 debt or equity interests in the subject entity will have occurred during a relevant period of
761 time leading up to the measurement date. Market transactions may include those involving
762 the subject controlling interest, a non-controlling interest in the subject entity, or other debt or
763 equity securities of the subject entity. The valuation specialist should carefully assess
764 whether the market transactions were arm’s-length and orderly, and if so, calibrate the fair
765 value measurement to the terms of the market transaction, taking into account changes in the
766 market since the transaction and fundamental differences between the subject controlling
767 interest and the interest transacted.

¹² The Working Group believes that the discounted cash flow method (when using market participant cash flows and discount rates) and the guideline transaction method yield controlling interest indications; in such cases, application of a discrete market participant acquisition premium is inappropriate.

768 • *Comparison to public market capitalization.* When measuring the fair value of reporting
769 units of public companies, the Working Group believes that the concluded aggregate fair
770 value of the reporting units (on a controlling interest basis) should be compared to the market
771 capitalization of the company on the measurement date. The MPAP for the entire company
772 implied by such a comparison might be a barometer of the overall reasonableness of the fair
773 value measurement. However, there are cases in which there would reasonably be a
774 difference between the aggregate control value of the reporting units and the control value of
775 the total company, such as a conglomerate for which the parts might be worth more or less
776 than the whole or a company whose shares are not actively traded.

777 Valuation specialists may consider myriad value indications when several valuation
778 methodologies are available and relevant for consideration in appraising a single valuation
779 subject. ASC 350-20-35-22 states that “the market price of an individual equity security (and
780 thus the market capitalization of a reporting unit with publicly traded equity securities) may not
781 be representative of the fair value of the reporting unit as a whole.” ASC 350-20-35-23 further
782 states that “measuring the fair value of a collection of assets and liabilities that operate together
783 in a controlled entity is different from measuring the fair value of that entity’s individual equity
784 securities...The quoted market price of an individual equity security, therefore, need not be the
785 sole measurement basis of the fair value of a reporting unit.”

786 However, when the fair value of reporting units are estimated for ASC 350 purposes, whether for
787 entities with one or several reporting units, the entity’s market capitalization has been commonly
788 referenced as indirect value evidence even in cases where the unit of account prescribed by ASC
789 350 (i.e., the reporting unit) may be different from the quoted unit of measurement (i.e., the
790 individual shares of the entity). In the case of multiple reporting units, additional adjustments
791 have been made to present the best apples-to-apples comparison. In other words, the strength of
792 quoted evidence was compelling enough to consider even with an understanding that the quoted
793 price was not necessarily directly linked to the valuation subject.

794 In 2008, during the economic crisis, the market for, and fair value of, many assets and companies
795 declined and the level of difficulty for measuring value increased. At the 2008 AICPA National
796 Conference on Current SEC and PCAOB Developments, the SEC Staff offered its view of how
797 market capitalization may be used when assessing goodwill impairment. In particular, the SEC
798 staff indicated that they would expect objective evidence to support the reasonableness of
799 implied transaction premiums, whether a quantitative or qualitative analysis (or both) was used.
800 The SEC staff also indicated that while judgment may result in a range of reasonably possible
801 premiums, they expect the rigor of documentation to increase as the magnitude of the premium
802 increases.¹³

¹³ Robert G. Fox III, *Goodwill Impairment on December 8, 2008*, AICPA National Conference on Current SEC and PCAOB Developments

803 Whereas the practice of referencing market capitalization was in place before the 2008 SEC
804 speech, the Working Group believes the SEC staff's views increased the usage of the market
805 capitalization reconciliation and it became more prevalent in audits of such entities. Since that
806 time, the FASB issued FASB ASU 2011-08. In the Basis for Conclusions in that document, the
807 FASB noted that the use of the qualitative screen will result in companies applying judgment on
808 when and how to perform the market capitalization reconciliation.¹⁴ Notwithstanding the
809 potential difficulty, the Working Group believes it is a best practice to perform an analysis of the
810 conclusion relative to the market capitalization.

811 The Working Group believes that, in most cases, for publicly traded entities it would be
812 beneficial to perform a comparison of the estimated fair values of the reporting units in aggregate
813 with the entity's market capitalization and analyze the implied MPAP, if any. In such cases, the
814 reasonableness of the implied MPAP should be supported through quantitative and qualitative
815 analyses. The rigor of the supporting analyses and documentation will depend upon the
816 magnitude of the implied control premiums, particularly if the implied MPAP affects the
817 conclusion regarding whether the reporting unit is impaired.

818 The Working Group believes that the majority of the implied premium will likely be supported
819 through the enhancement in cash flows or reduction in risk (or both), as discussed previously.
820 The illustrative examples presented in a subsequent section of this VFR Advisory provide a
821 potential quantitative framework that may be considered to support the implied premium.
822 Additionally, the qualitative factors discussed in the earlier section – *Business Characteristics*
823 *Influencing Market Participant Acquisition Premium* – may be considered to support the implied
824 MPAP relative to the range of observed premiums from the transaction data that may be
825 applicable for the subject entity. In certain situations, albeit rare, what appears to be an implied
826 MPAP may result from transactions in the company's stock that are not orderly; e.g., a distressed
827 sale¹⁵. This would render the comparison between the market capitalization and the estimated
828 fair value to be not very meaningful.

829 The Working Group believes that use of techniques like those described above is a vital part of
830 measuring the fair value of controlling interests in business enterprises. These tests of
831 reasonableness allow the valuation specialist to demonstrate to auditors, regulators, and other
832 interested parties that the MPAP is grounded in identifiable incremental economic benefits
833 available to the relevant pool of market participants, thereby increasing the relevance and
834 reliability of the associated fair value measurement.

835 The Working Group has included an illustrative example for analyzing MPAPs (see *Selecting*
836 *and Assessing Market Participant Acquisition Premiums – Example*; a subsequent section of this
837 paper located on page 42).

¹⁴ BC34. The Board recognizes that many public entities reconcile the sum of the fair values of each reporting unit to the entity's market capitalization. The Board acknowledged that the amendments in this Update may result in entities applying more judgment about when and how to perform this evaluation; however, it concluded that this factor should not prohibit an entity from utilizing the qualitative assessment.

¹⁵ ASC 820-10-35-54D

THE FAIR VALUE CONTEXT

838 Valuation is context dependent. Valuation specialists refer to standards of value to define the
839 relevant context for valuation. The objective of this Working Group is to develop best practices
840 for the valuation of controlling interests in business enterprises under the standard of fair value
841 for financial reporting. The following sections of this VFR Advisory provide commentary on the
842 definition of fair value and identify the most common instances in financial reporting requiring
843 measurement of the fair value of controlling interests in business enterprises.

844 The Fair Value Definition

845 Accounting Standards Codification Topic 820, *Fair Value Measurement* (ASC 820) defines fair
846 value (in its glossary) as “The price that would be received to sell an asset or paid to transfer a
847 liability in an orderly transaction between market participants at the measurement date.”

848 The definition of fair value and associated guidance create a unique lens through which to view
849 the valuation of controlling interests in business enterprises. A comprehensive and detailed
850 review of the fair value definition is beyond the scope of this VFR Advisory and the Working
851 Group assumes that readers have a basic understanding of the standard. However, given the
852 fundamental significance of fair value to the subject of this VFR Advisory, it is important to
853 briefly review a number of key fair value concepts.

854 Exit Price

855 Fair value is defined as the price received to sell an asset; in other words, fair value is an exit
856 price from the perspective of a market participant holding the asset. In contrast, an entry price
857 would be the price paid to acquire an asset. Despite the conceptual distinction, entry and exit
858 prices for a subject controlling interest in a business enterprise may often be indistinguishable.
859 Nonetheless, valuation specialists should acknowledge that the objective of a fair value
860 measurement is to determine the exit price as of the measurement date and be alert for situations
861 in which the exit and entry prices may differ.

862 Principal (or Most Advantageous) Market

863 According to ASC 820, the assumed transaction underlying the fair value measurement occurs in
864 the principal market for the subject asset. The principal market is the market with the greatest
865 volume and level of activity for the asset. Further, the principal market is one to which the
866 reporting entity has access at the measurement date. In the absence of a principal market, ASC
867 820 specifies that fair value should be measured as the price in the market in which the price
868 received to sell the subject asset is maximized (the most advantageous market).

869 With respect to controlling interests in business enterprises, the Working Group believes that the
870 principal market is that for mergers and acquisitions, in which strategic, financial, and
871 conglomerate buyers evaluate controlling interests in business enterprises with a view toward the
872 economic benefits expected from ownership of such interests in the context of the perceived risk
873 and expected rewards of the investment.

874 **Market Participants**

875 ASC 820 defines market participants as buyers and sellers in the principal (or most
876 advantageous) market for the subject asset. First, market participants are assumed to possess
877 sufficient knowledge regarding the subject asset. In other words, market participants are
878 competent to assess and understand information regarding the subject asset that would be
879 obtained through usual and customary due diligence. This attribute of market participants also
880 implies that the subject asset has had appropriate exposure to the relevant market.

881 Second, market participants have the ability, and/or financial wherewithal, to engage in a
882 transaction involving the subject asset. In other words, market participants are not subject to
883 external financial constraints that would impinge upon their ability to purchase the subject asset.
884 Market participants are, however, subject to the internal financial constraint of rational economic
885 behavior and the requirement that expected return be commensurate with perceived risk. Finally,
886 market participants are willing to transact for the subject asset. Market participants are motivated
887 to transact by potential financial returns, but are not under any external compulsion or force.

888 Fair value is to be measured from the perspective of market participants, and valuation inputs
889 observed directly from the behavior of market participants are given greater weight than those
890 that are unobservable. Even when specifying unobservable inputs, valuation specialists are
891 required by the guidance in ASC 820 to make assumptions consistent with the assumptions
892 market participants would make, not necessarily those of the reporting entity.

893 The Working Group elected to introduce the MPAP in this VFR Advisory, in part, to emphasize
894 the importance of market participants' perspectives when measuring the fair value of a
895 controlling interest in a business enterprise.

896 **Highest and Best Use**

897 The fair value of non-financial assets (such as controlling interests in business enterprises) is
898 measured with respect to the highest and best use of the assets, as that use is evaluated from the
899 perspective of market participants. ASC 820 states that the value of non-financial assets may be
900 maximized by their use (1) in conjunction with other assets and liabilities (previously referred to
901 as the "in use" valuation premise), or (2) on a standalone basis (previously referred to as the "in
902 exchange" valuation premise).¹⁶ ASC 820 stipulates that, when measuring the fair value of a
903 non-financial asset, the asset's highest and best use should be evaluated from the market
904 participants' perspective, even if such use differs from that intended by the reporting entity. The
905 assumed highest and best use of the asset should be physically possible, legally permissible, and
906 financially feasible.

¹⁶ ASU 2011-04 clarifies that the concepts of "highest and best use" and "valuation premise" do not apply to financial assets or liabilities.

907 **Asset Characteristics**

908 Fair value measurement should incorporate those characteristics of the subject asset that market
909 participants would consider in valuing the asset, such as condition and location. With respect to
910 an ownership interest in a business enterprise, the degree of control vested in the interest is a
911 relevant characteristic that would be considered by market participants and should, therefore, be
912 reflected when measuring fair value. Transaction costs are not characteristics of the subject asset
913 and, hence, should not be considered when measuring fair value, although transactions costs are
914 considered when identifying the most advantageous market.

915 ASC 820 clarifies, however, that entity-specific assumptions that are not consistent with the
916 market participants' perspective are in no case relevant to fair value measurement.

917 **Fair Value Measurements of Controlling Interests in Business Enterprises**

918 As noted in the previous section, the relevance of a valuation adjustment such as the MPAP in
919 measuring fair value is determined by the characteristics of the subject asset that would be
920 considered by market participants in valuing the asset. The defining boundaries of the subject
921 asset are delineated with respect to the unit of account, defined in ASC 820 (the glossary) as “the
922 level at which an asset or liability is aggregated or disaggregated in a Topic for recognition
923 purposes.”

924 The Working Group has identified three instances where the value of a controlling interest might
925 need to be estimated: goodwill impairment testing, portfolio valuation, and accounting for
926 business combinations in step acquisitions (Step Transactions).

927 **Goodwill Impairment Testing**

928 The Working Group observes that goodwill impairment testing is the most common fair value
929 measurement on a controlling interest basis. ASC 350 provides guidance regarding periodic
930 goodwill impairment testing. The unit of account for such testing is the reporting unit, which is
931 defined as an operating segment or one level below an operating segment (i.e., a component).
932 One of the attributes of an operating segment is that it engages in business activities from which
933 it may earn revenues and incur expense. In other words, the conduct of an operating segment can
934 be measured in the form of discrete financial information that is regularly reviewed by the chief
935 operating decision maker in assessing performance and allocating resources. In short, the unit of
936 account is a business enterprise.

937 Consistent with the unit of account, ASC 350 acknowledges that the fair value of a controlling
938 interest in a reporting unit may exceed the Foundation. ASC 350 explicitly acknowledges the
939 relevance of valuation premiums when measuring the fair value of reporting units. Using the
940 terminology adopted in this VFR Advisory, an MPAP may be appropriate when measuring the
941 fair value of a reporting unit. ASC 350 states:

942 “Substantial value may arise from the ability to take advantage of synergies and other
943 benefits that flow from control over another entity. Consequently, measuring the fair value
944 of a collection of assets and liabilities that operate together in a controlled entity is different
945 from measuring the fair value of that entity’s individual equity securities. An acquiring
946 entity often is willing to pay more for equity securities that give it a controlling interest than
947 an investor would pay for a number of equity securities representing less than a controlling
948 interest. That control premium may cause the fair value of a reporting unit to exceed its
949 market capitalization. The quoted market price of an individual equity security, therefore,
950 need not be the sole measurement basis of the fair value of a reporting unit.”

951 **Portfolio Valuation**

952 Investment companies such as private equity funds, hedge funds and venture capital funds are
953 generally required to report the fair value of investment holdings in accordance with Accounting
954 Standards Codification Topic 946, *Investment Companies* (ASC 946). The funds of these
955 companies often own assets which would be valued using Level 2 or Level 3 inputs under the fair
956 value hierarchy established by ASC 820 because current market prices are not readily available.
957 As a result, in estimating the fair value of these assets, the issues of control and MPAP are often
958 considered. Due to the often complex ownership structures of the underlying companies as well
959 as relationships among the investors, the Working Group believes that understanding control and
960 the related effect on fair value can be particularly challenging for these investments.

961 In addition to the guidance that is provided below, the Working Group would encourage the
962 valuation analyst working in this area to read and understand the concepts outlined in the AICPA
963 Guide “*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*.”
964 Although the Working Group notes that this guide has been published for a different purpose, the
965 Working Group suggests that the valuation analyst refer to Chapter 7 “Control and
966 Marketability” which discusses many of the issues encountered when studying control in a
967 capital structure with multiple owners and classes of equity.

968 Consistent with the guidance in ASC 820, the Working Group believes that consideration of an
969 MPAP is appropriate when measuring the fair value of a controlling interest owned by an
970 investment company because (1) the application of an MPAP reflects the characteristics of the
971 asset being measured (i.e., a controlling interest) and (2) market participants acting in their
972 “economic best interest” would consider an MPAP when transacting for the asset. The Working
973 Group also believes that the existence of an MPAP is not inconsistent with guidance found in
974 ASC 946. In addition, the price at which an investment company acquires a controlling interest
975 in a private company often implies a premium to the fair value of a minority interest in the
976 subject entity under prior ownership. Upon exiting the investment through a sale to other market
977 participants, the investment company generally expects the price received to reflect a comparable
978 premium.

979 Even in situations where an investment company has a minority investment, the investment
980 company often has different contractual rights, such as information rights, rights to a board seat,
981 right of first refusal, tag-along and drag-along rights, which may not be available to the typical
982 minority shareholder. In addition, the investment company typically has access to a principal
983 market that is broader than that which is available to other minority holders. In other words,
984 investment companies often view other investment companies as part of their principal market.
985 These unique rights and privileges of an investment company often warrant special
986 considerations in the application of an MPAP. For instance, the information rights of an
987 investment company would allow it to take a potential buyer through a due diligence process that
988 is typically not available to other minority shareholders. The MPAP may result from the
989 difference in perspectives between the former and the latter.

990 In understanding control and the related MPAP in the context of an investment company, there
991 are several unique items to consider. Some examples of these considerations are addressed by
992 AICPA Technical Practice Aids, in particular TIS Section 6910.34, “*Application of the Notion of*
993 *Value Maximization for Measuring Fair Value of Debt and Controlling Equity Positions*” and
994 TIS Section 6910.35, “*Assessing Control When Measuring Fair Value.*”

995 At the date of this writing, the AICPA Private Equity/Venture Capital Task Force was
996 developing an Accounting & Valuation Guide for investment companies. This guide will
997 reportedly describe leading practices regarding the valuation of equity and debt investments of
998 privately held enterprises and certain enterprises with traded securities. The Working Group
999 strongly recommends that readers monitor developments in this area.

1000 **Acquisition Method for Step Acquisitions**

1001 In certain transactions, control is gained and business combination accounting is required but
1002 some portion of the target equity is not acquired by the new controlling owner on the acquisition
1003 date. ASC 805 prescribes the accounting treatment for business combinations achieved in stages
1004 (referred to as step acquisitions), as well as for partial acquisitions where control is gained. For
1005 such transactions, the relevant guidance requires the acquirer to measure all of the identifiable
1006 assets and liabilities of the target, any non-controlling interest in the target that remains in the
1007 hands of the other owners, and any previously held equity interest.

1008 For example, if in the initial step of the transaction, the acquirer purchases 60% of the
1009 outstanding shares of the target, the acquirer is required to measure the fair value of the non-
1010 controlling interest held by others (the 40% interest not acquired). The fair value of the non-
1011 controlling interest affects the amount of goodwill (or gain from bargain purchase) at the
1012 acquisition date.

1013 When a non-controlling interest is present in a transaction, the fair value of that interest may
1014 reflect a potential reduction in value from the *pro rata* share of the value of the business on a
1015 controlling interest basis. As noted in ASC 805: “The acquirer usually is the combining entity
1016 that pays a premium over the pre-combination fair value of the equity interests of the other
1017 combining entity or entities.” If the market participants for the non-controlling interest are not
1018 expected to have access to the full range of incremental economic benefits anticipated by the
1019 controlling interest acquirer, the fair value of the non-controlling interest should reflect the

1020 associated decrement to value. If applicable, incremental return requirements for market
1021 participants evaluating a non-controlling interest would likewise be expected to reduce the fair
1022 value of the non-controlling interest.¹⁷

1023 Whether the fair value of the non-controlling shares is measured directly through a valuation
1024 model or through adjustment of the indicated fair value of the controlling interest acquired in the
1025 transaction, the difference between the two fair value measurements should be supported
1026 following the best practices for MPAPs set forth in this VFR Advisory.

¹⁷ The Working Group notes that, if the pro rata fair value of the non-controlling interest differs from the pro rata value of the controlling interest, the sum of the two positions will be less than 100% of the enterprise value. In other words, the decrement to the fair value of the non-controlling interest does not accrue to the benefit of the controlling interest.

SELECTING AND ASSESSING MARKET PARTICIPANT ACQUISITION PREMIUMS – EXAMPLES

1027 The following examples are provided to illustrate best practices in both estimating MPAPs and
1028 reviewing the reasonableness of MPAPs implied by a fair value measurement in accordance with
1029 ASC 820.¹⁸ The level of analytical detail appropriate to support a given fair value measurement,
1030 and any related MPAP, is a matter of judgment, and should be selected with regard to factors
1031 relevant for the accounting measurement under consideration. Relevant factors for consideration
1032 under ASC 350, goodwill impairment testing would include:

1033 • The magnitude of the premium implied by comparison of the fair value and the market
1034 capitalization (for publicly traded entities). The Working Group believes the higher the
1035 implied premium, the higher level of supporting analysis required.

1036 • The magnitude of the difference between the fair value measurement and the carrying
1037 value of the reporting unit. Larger “cushions” between carrying value and fair value will
1038 generally require less analytical support for the MPAP (whether implied or directly
1039 applied). On the other hand, smaller cushions will generally result in greater scrutiny,
1040 indicating that more analytical detail is appropriate. In cases in which impairment would
1041 be indicated but for the MPAP, valuation specialists should anticipate that auditors will
1042 require the most substantive support of the MPAP.

1043 • The magnitude of the premium implied by the difference between the indicated value
1044 under the discounted cash flow method (using market participants’ control level cash
1045 flows) and the indicated value under the guideline public company method (prior to
1046 application of an MPAP). The greater the implied premium, the more detailed the
1047 procedures required to substantiate the implied premium.

1048 The following examples address two similar fact patterns related to a Step 1 goodwill impairment
1049 test. The first addresses a case in which the MPAP included is critical to the pass/fail result of
1050 the test. The second addresses the same company and basic fact pattern, but assumes a
1051 significantly lower carrying value, resulting in a test for which the MPAP is not a determining
1052 factor. Note that in both examples, the tests are the same in terms of the fundamental methods
1053 considered. However, the level of detail provided in support of MPAP-related assumptions in
1054 the second example is reduced to reflect the lack of MPAP significance in relationship to the test
1055 result.

1056

¹⁸ The assumed fact pattern was selected to provide the greatest clarity and ease of exposition. Practitioners are unlikely to encounter such circumstances; however, the Working Group believes the presentation applies to a broad range of situations.

1057 **Conglomerate, Inc. and Subject Co. Reporting Unit**

1058 Conglomerate, Inc. (Conglomerate) comprises three wholly owned subsidiaries, each of which is
1059 a separate reporting unit for purposes of ASC 350 compliance. The shares of Conglomerate are
1060 listed on a public exchange. At the date of Conglomerate's goodwill impairment test, the shares
1061 of Conglomerate traded at \$10.00 per share, with 105.0 million shares outstanding and total
1062 interest-bearing debt with a fair value of \$817 million. Therefore, market value of invested
1063 capital (MVIC) for Conglomerate is established at \$1.867 billion. The following discussion will
1064 address the analysis of one of the three reporting units, Subject Co., as well as the overall market
1065 capitalization reconciliation analysis for Conglomerate. The analyses of the second and third
1066 reporting units are not shown here but, for purposes of the market reconciliation discussion, are
1067 assumed to have been performed in a manner similar to that described for Subject Co.

1068 **Scenario One Example**

1069 **Initial MPAP Consideration**

1070 As a first step in the analysis of the Subject Co. and other Conglomerate reporting unit fair
1071 values, the general facts and circumstances are reviewed to assess the likely level of importance
1072 of the MPAP to the overall test result. The following facts are observed:

1073 • Conglomerate MVIC: \$1,867 million

1074 • The reporting unit carrying values:

| | Subject Co. Reporting Unit | Reporting Unit 2 | Reporting Unit 3 | Conglomerate Total |
|---------------------------------|-------------------------------|---------------------|---------------------|-----------------------|
| 1075 Carrying Values (millions) | \$690 | \$420 | \$870 | \$1,980 |

1076 • Premium over MVIC if Conglomerate FV equals carrying value = $\$1,980/\$1,867 - 1 =$
1077 6.1%

1078 • Aggregate Conglomerate LTM Revenue and EBITDA are \$1,750 million and \$295
1079 million, respectively

1080 • Guideline public company information for Conglomerate as a whole indicates a range of
1081 multiples as follows:

1082 LTM Revenue: .59X – 1.23X

1083 LTM EBITDA: 4.5X to 7.0X

1084 • Implied multiples if Conglomerate FV equals carrying value =

1085 Carrying value/LTM Revenue: $\$1,980/\$1,750 = 1.13X$

1086 Carrying value/LTM EBITDA: $\$1,980/\$295 = 6.71X$

1087 As the minimum premium over MVIC required for Conglomerate to pass the ASC 350 Step 1
1088 test is 6.1%, and the carrying value-implied LTM multiples are in the high end of the range of
1089 observed guideline company multiples, the MPAP is likely to require a substantial level of
1090 support if a passing conclusion is reached for the Step 1 test. Note that the MPAP and multiples
1091 required to pass all reporting units in a Step 1 test are likely to be higher than the “minimum
1092 required” levels calculated in this way as the aggregate company value is not likely to be
1093 distributed in exact proportion to the reporting unit carrying values.

1094 **Income Approach – Subject Co.**

1095 Following the initial MPAP considerations as described, a discounted cash flow analysis is
1096 performed to obtain a fair value indication for Subject Co. for use in Step 1 of the annual
1097 goodwill impairment test. Consistent with the guidance in ASC 820, the assumptions underlying
1098 this discounted cash flow analysis must reflect the perspective of market participants. Therefore,
1099 all available information is considered in assessing the appropriate cash flow forecast for use in
1100 the analysis. This information includes current management budgeting and forecasting
1101 processes, historical performance levels and historical performance vs. budget/forecast, guideline
1102 company performance metrics, and other specific facts and circumstances relevant to Subject
1103 Co.’s expected performance.

1104 In assessing the appropriate controlling market participants’ forecast, three specific areas of
1105 economic benefit are considered as possibly accruing to the control buyer of Subject Co. and
1106 gather the following information regarding each:

1107 • Revenue Synergies: Research regarding the likely market participants for Subject Co.
1108 indicates that most of the buyers would benefit from revenue synergies related to inclusion of
1109 Subject Co.’s products in the broader, more well-marketed product offerings of the buyer
1110 companies. The estimated revenue increase related to this benefit is reflected in higher
1111 revenue growth rates in forecast years one through five of 2.5%, 2.5%, 2.0%, 1.5%, and
1112 1.0%, respectively. These figures represent incremental growth above growth expected for
1113 Subject Co. on a standalone basis. As the market participant group is dominated by
1114 companies that would benefit from this synergy, it is appropriate to include the related cash
1115 flow benefits in the Subject Co. forecast. Note that for purposes of this example, the
1116 simplifying assumption is made that costs are fully variable in relation to the revenue
1117 synergy.

1118 • Operating Expense Savings: The possibility of a control acquisition generating cost savings
1119 from elimination of duplicative support functions and/or economies of scale in purchasing is
1120 considered. However, a high percentage of these expenses are variable in nature and the
1121 fixed portion, which could give rise to acquisition synergies, is insignificant in relation to the
1122 value of the Company. Regarding potential economies of scale, the materials and services
1123 required by the Subject Co. operations are substantially different from those required in the
1124 operations of all but one of the market participant group. Therefore, no operating expense-
1125 related market participant synergies are included in the Subject Co. forecast.

1126 • Cost of Capital: The Company’s credit rating is below that of the market participants,
1127 resulting in a higher cost of debt. It is determined that market participants would approach
1128 pricing decisions regarding Conglomerate or the separate reporting units using cost of debt
1129 assumptions in line with their own long-term financing costs as the target operations would
1130 be closely integrated with the buyers’ existing operations and financial risk would be
1131 reduced. Therefore, in estimating the appropriate Weighted Average Cost of Capital (WACC)
1132 for use in the Subject Co. analysis, the cost of debt is reduced to the observed market
1133 participants’ level to reflect the economic benefits of acquisition relative to financing
1134 synergies.

1135 As shown in Exhibit A (see appendix), the indicated fair value of the Subject Co. total invested
1136 capital indicated by the discounted cash flow analysis is \$740 million. This analysis has been
1137 simplified for the purposes of this VFR Advisory, and it is assumed that commonly accepted
1138 valuation methods and procedures would be followed in the determination of fair value.

1139 **Market Approach – Subject Co.**

1140 Where meaningfully comparable market information is available, it should be included in the fair
1141 value analysis. The following exhibit includes a form of market approach analysis, which is
1142 included in the determination of the final value conclusion for Subject Co. on a controlling basis.
1143 The income and market approaches should be used in a detailed, quantitative manner in instances
1144 where the MPAP is significant to the accounting outcome (assuming sufficient and reliable
1145 information is available to perform both approaches). In instances where the MPAP is not
1146 significant to the accounting outcome, the Working Group believes that best practices would still
1147 include consideration of both income and market value concepts, but would allow for a less
1148 detailed, qualitative application of one or more portions of the analysis. This fact pattern is
1149 discussed in the Scenario Two example in a subsequent section. Note that where guideline
1150 transaction data is available, it should be used in line with standard valuation practices.
1151 However, for purposes of simplification of this VFR Advisory, the transaction method has been
1152 omitted and only the guideline public company method of the market approach is shown.

1153 The following table summarizes relevant performance and valuation measures for the group of
1154 guideline public companies and the resulting TIC Foundation Value for Subject Co.

| Guideline Public Company Data | | | | | | | |
|---|--------------------|-------------------|--------------------------------|---------------------------------|--|-----------------------|----------------------|
| | LTM Revenue | LTM EBITDA | Projected EBITDA Margin | Est. 5-Yr Revenue Growth | Market Value (Invested Capital) | MVIC / Revenue | MVIC / EBITDA |
| Company A | \$29,000 | \$5,220 | 18.0% | 5.0% | \$31,320 | 1.08 | 6.0 |
| Company B | \$5,100 | \$893 | 17.5% | 6.0% | \$6,248 | 1.23 | 7.0 |
| Company C | \$13,200 | \$2,508 | 19.0% | 5.0% | \$13,794 | 1.05 | 5.5 |
| Company D | \$2,400 | \$408 | 17.0% | 4.5% | \$2,040 | 0.85 | 5.0 |
| Company E | \$9,000 | \$1,170 | 13.0% | -2.0% | \$5,265 | 0.59 | 4.5 |
| MEDIAN | \$9,000 | | 17.5% | 5.0% | | 1.05 | 5.5 |
| AVERAGE | \$11,740 | | 16.9% | 3.7% | | 0.96 | 5.6 |
| Selected Multiple | | | 17.1% | 6.1% | | 1.10 | 6.5 |
| Subject Company | | | | | | | |
| LTM Revenue | \$600 | | | | | \$660 | |
| LTM EBITDA | | 93 | | | | \$605 | |
| Concluded Value - Marketable, Non-control basis (TIC Foundation Value) | | | | | | \$630 | |

Note: All in US\$ Millions

1155 Using this information, additional analysis of the guideline company characteristics, and other
1156 traditional market approach considerations not shown, it is determined that revenue and EBITDA
1157 multiples appropriate for application in the fair value analysis of Subject Co., as indicated by the
1158 guideline public company analysis, are 1.10X and 6.5X, respectively. A Subject Co. TIC
1159 Foundation Value indication of \$630.0 million is concluded. The application of an MPAP to this
1160 Foundation Value is then considered to obtain a market-derived value indication on a controlling
1161 basis.

1162 **MPAP Estimation – Cash Flow Value**

1163 A first step in determining the MPAP for application to the market-derived Foundation Value, is
1164 a review of the market participants' acquisition synergies included in the cash flow analysis, as
1165 described in the Income Approach section above. The range of market premiums paid in recent
1166 control acquisitions of public companies is also reviewed.

1167 To quantify the premium implied by the market participants' synergies included in the cash flow
1168 analysis, a second cash flow analysis is run excluding these benefits. This analysis, shown in
1169 Exhibit B (see appendix), eliminates the revenue growth enhancements described for years one
1170 through five related to inclusion of Subject Co.'s products in the broader, more well-marketed
1171 product offerings of the market participants. This analysis also shows an increase in the discount
1172 rate from 10.0% to 10.5%, reflecting the elimination of the debt financing benefits attributable to
1173 acquisition.

1174 The following table compares the metrics underlying the cash flow based fair value measurement
1175 of Subject Co. with those underlying the Foundation Value cash flow analysis, as derived from
1176 comparison of the market participants' and Foundation cash flow analyses (Exhibits A and B).

| | 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% |

1177 Based on the results shown, the MPAP indicated by the cash flow analyses described is 12.7% on
1178 a TIC basis (22.7% on an equity basis at Conglomerates' actual debt/equity ratio of 44/56)¹⁹.

1179 **Observed Transaction Premiums**

1180 Consideration of premiums observed in guideline transactions is often appropriate; however,
1181 such comparisons should be made very carefully.

1182 Observed transaction premiums (using an Equity Foundation, as traditionally stated) for three
1183 guideline transactions range from 25.0% to 58.7%, as shown below.

| Guideline Control Premiums | | | | | | | | |
|-----------------------------------|--------------------|--------------------|--------------------|-----------------|--------------------|-------------------|--------------------|--------------------|
| | Transaction | | Transaction | Interest | Transaction | Unaffected | Observed | Observed |
| | Price Per | Shares | Value | Bearing | Value | Price Per | Transaction | Transaction |
| | Share | Outstanding | (Equity) | Debt | (TIC) | Share | Premium | Premium |
| | | | | | | | (Equity) | (TIC) |
| Company F | \$37.50 | 53.7 | \$2,013 | \$3,500 | \$5,513 | \$30.00 | 25.0% | 7.9% |
| Company G | \$61.00 | 153.4 | \$9,360 | \$0 | \$9,360 | \$45.00 | 35.6% | 35.6% |
| Company H | \$25.00 | 280.8 | \$7,020 | \$0 | \$7,020 | \$15.75 | 58.7% | 58.7% |
| MEDIAN | | | | | | | 35.6% | 35.6% |
| AVERAGE | | | | | | | 39.8% | 34.1% |

Note: All in US\$ Millions Except Per Share Amounts

¹⁹ $\text{Equity Premium\%} = (\text{TIC Premium\%}) / (\text{Equity\%}) = 12.7\% / 56.0\% = 22.7\%$

1184 This fact pattern demonstrates that relying only on observed transaction premiums to support a
1185 concluded or implied MPAP is potentially misleading. Since such premiums have traditionally
1186 been expressed as a percentage of Equity Foundation, differences in leverage between Subject
1187 Co. and the acquired companies can produce unreliable fair value measurements. For example,
1188 Company F is highly leveraged, causing the observed premium using an Equity Foundation to be
1189 materially higher than when expressed as a percentage TIC Foundation. When sufficient data is
1190 available to permit the calculation, expressing premiums as a percentage of total invested capital
1191 provides a more reliable basis of comparison across companies and is consistent with best
1192 practices. When expressed on a total invested capital basis, the implied premium for Subject Co.
1193 is 12.7%.

1194 If an analyst compared the equity-based MPAP for Subject Co. (22.7%) to the range of observed
1195 equity-based premiums for the guideline transactions (25.0% to 58.7%), the analyst might
1196 conclude that the fair value of Subject Co. is understated. However, on a total invested capital
1197 basis, the implied MPAP for Subject Co. falls within the range of the guideline premiums.

1198 Each acquiree presents a different set of potential economic benefits that may or may not be
1199 comparable to those of Subject Co. For example, assume Company H reported a historical
1200 EBITDA margin of 13%, below that of Subject Co. and at the low end of the public peer group.
1201 The relatively low margins of Company H may correspond to superior cash flow enhancement
1202 opportunities, and therefore a higher MPAP. In this instance, applying an MPAP equal to the
1203 transaction premium observed for Company H to Subject Co. would potentially result in an
1204 overstatement of fair value.²⁰

1205 However, as discussed earlier, observed transaction premium data may be informative. The
1206 observed transaction premiums provide a composite view of the control benefits of cash flow
1207 enhancements and/or lower required rates of return perceived by the acquirers in the observed
1208 transactions. This may help to establish the reasonableness of the cash flow benefits assumed (or
1209 implied) by the fair value measurement under consideration. However, exclusive reliance on
1210 observed transaction premiums without careful analysis of relative financial performance,
1211 valuation multiples, and other metrics can result in an unreliable fair value measurement.

1212 **MPAP Conclusion**

1213 Multiple cash flow and cost of capital sources of MPAP for Subject Co. were reviewed, as well
1214 as the range of premiums observed in relevant recent transactions. Based on this analysis, a TIC-
1215 basis MPAP of 13% is selected for application in the guideline company market approach. This
1216 determination is supported primarily by the cash flow synergies that market participants would
1217 be expected to consider in pricing an acquisition of Subject Co. Additional supporting evidence
1218 was shown in the effects on the WACC as well as recent market transaction premiums paid for
1219 similar companies.

1220

²⁰ The Working Group observes that it may be appropriate to augment such analysis with a multi-year perspective on financial results.

1221 **Subject Co. FV Conclusion**

1222 Based on the income and market analyses described, a fair value of \$730.0 million is concluded
 1223 for Subject Co., which passes the Step 1 ASC 350 test, as follows:

| | | |
|---|-------------|----------------|
| 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 |
| Carrying Value: Subject Co. | | \$690.0 |
| ASC 350 Pass/(Fail) | Pass | \$40.0 |
| Note: All in US\$ Millions | | |

1224 **Reconciliation to Market Capitalization**

1225 Conglomerate is a publicly traded company comprising three reporting units. Following the
 1226 procedures described for the Subject Co. reporting unit, Fair Values have been estimated for each
 1227 of the three units. The total concluded value of all three of the Conglomerate reporting units is
 1228 \$2,080,000 and all three units are concluded to have passed the Step 1 test. A critical step in the
 1229 valuation specialist's review of the reasonableness of the initial conclusions is a reconciliation of
 1230 the results to Conglomerate's market value.

1231 The MVIC of Conglomerate as of the testing date, as described in the Initial MPAP
 1232 Consideration section above, is \$1,867 million. Therefore, the premiums implied by the initial
 1233 value conclusions are as shown in the following table.

| | | |
|---|--|------------------|
| Concluded Fair Value of Conglomerate TIC (sum of reporting units) | | \$2,080.0 |
| Test date price of Conglomerate shares | | \$10.0 |
| Outstanding Conglomerate shares (millions) | | 105.0 |
| Conglomerate Equity Market Capitalization | | \$1,050.0 |
| Fair Value of Conglomerate Debt | | \$817.0 |
| MVIC of Conglomerate | | \$1,867.0 |
| MPAP Implied by Fair Value Conclusion | | \$213.0 |
| MPAP Implied by Fair Value Conclusion (Equity Foundation basis) | | 20.3% |
| MPAP Implied by Fair Value Conclusion (TIC Foundation basis) | | 11.4% |
| Note: All in US\$ Millions | | |

1234 The reconciling 11.4% TIC Foundation MPAP (20.3% on an Equity basis) is shown to be
 1235 reasonable based on the following:

- 1236 • Specific cash flow benefits analysis (the cash flow benefits seen in the value differential
 1237 supported in Exhibits A and B)
- 1238 • Cost of capital benefits of acquisition described for Subject Co.

1239 Note that the economic benefits described for the Subject Co. reporting unit are also assumed to
 1240 be present at the same approximate level in the other reporting units not shown.

1241 **Scenario Two Example**

1242 As discussed above, the level of detail appropriate to support MPAP-related assumptions is
 1243 related to the significance of the MPAP in relationship to the test result. For example, if it is
 1244 unlikely that the MPAP will be a determining factor in the pass/fail result of an ASC 350 step
 1245 one test, then the level of detail may be reduced from that included in the analysis shown in the
 1246 Scenario One example in the prior section. To illustrate this concept, the Scenario One example
 1247 is reconsidered with revision to the carrying values of the reporting units. The carrying value
 1248 revisions, which represent the only change to the Subject Co. fact pattern described previously,
 1249 are shown in the following table:

| | Subject Co. Reporting Unit | Reporting Unit 2 | Reporting Unit 3 | Conglomerate Total |
|------|--|---------------------|---------------------|-----------------------|
| 1250 | Carrying Values (millions) Revised for Scenario Two | | | |
| | \$440 | \$350 | \$500 | \$1,290 |

1251 **Initial MPAP Consideration (revised carrying value example)**

1252 With the lower carrying values shown, the Specialist's first step assessment of the likely level of
 1253 importance of the MPAP to the overall test result provides the following revised fact pattern:

- 1254 • Conglomerate MVIC: \$1,867 million (unchanged)
- 1255 • The reporting unit carrying values:

| | Subject Co. Reporting Unit | Reporting Unit 2 | Reporting Unit 3 | Conglomerate Total |
|------|-------------------------------|---------------------|---------------------|-----------------------|
| 1256 | Carrying Values (millions) | | | |
| | \$440 | \$350 | \$500 | \$1,290 |

- 1257 • Premium over MVIC if Conglomerate FV equals carrying value = $\$1,290/\$1,867 - 1 =$
 1258 -30.9%
- 1259 • Aggregate Conglomerate LTM Revenue and EBITDA are \$1,750 million and \$295
 1260 million, respectively (unchanged)

1261 • Guideline public company information for Conglomerate as a whole indicates a range of
1262 multiples as follows (unchanged):

1263 LTM Revenue: .59X – 1.23X

1264 LTM EBITDA: 4.5X to 7.0X

1265 • Implied multiples if Conglomerate FV equals carrying value =

1266 Carrying value/LTM Revenue: $\$1,290/\$1,750 = 0.74X$

1267 Carrying value/LTM EBITDA: $\$1,290/\$295 = 4.37X$

1268 In this revised example, given the lower carrying values, the minimum premium over MVIC that
1269 would be required for Conglomerate to pass the ASC 350 Step 1 test shows a large cushion of
1270 over 30%, indicating that there is a reasonable possibility that each unit could pass the test before
1271 consideration of the MPAP. Additionally, the carrying value-implied LTM multiples are at or
1272 below the bottom end of the range of observed guideline company multiples. Therefore, the
1273 MPAP is unlikely to have any bearing on the outcome of subject impairment test and the initial
1274 analysis of the reporting unit fair values is run with minimal supporting detail for the MPAP
1275 included.

1276 The analysis of the Subject Co. fair value follows the same general process in this revised
1277 scenario as that shown in the Scenario One example. The differences in the details of the various
1278 steps in the analysis are summarized as follows:

1279 • Income Approach: In establishing the forecast for use in the cash flow analysis, the same
1280 areas of potential acquisition synergy are considered as those described in the Scenario One
1281 example. However, the objective in doing so is only to establish that the types of synergies
1282 included represent appropriate market participants' assumptions. No specific quantification
1283 of the market participants' synergies is needed as these will not be used to quantify the
1284 MPAP.

1285 • Market Approach: The guideline public company analysis is performed in the same manner
1286 as shown in the Scenario One example through the point of estimation of the Foundation
1287 Value.

1288 • MPAP Estimation: The estimation of the MPAP for application to the Foundation Value is
1289 then based only on a review of the guideline transaction premium information. The cash
1290 flow based MPAP estimation process shown in the Scenario One example is eliminated as
1291 unnecessary, pending review of the fair value results for each reporting unit relative to its
1292 respective carrying value.

1293 The results of the test under this revised scenario are shown in the table below. A fair value of
1294 \$750.0 million is concluded for the Subject Co. reporting unit, and Subject Co. passes the Step 1
1295 ASC 350 test, as follows:

| | |
|---|---------------------|
| Control Value Indication: Income Approach | \$740.0 |
| Minority, Non-Control Indication: Market Approach | \$630.0 |
| Concluded MPAP, TIC Basis | 20.0% |
| Control Value Indication: Market Approach | \$756.0 |
| Concluded Fair Value of Subject Co. | \$750.0 |
| Carrying Value: Subject Co. | \$440.0 |
| ASC 350 Pass/(Fail) | Pass \$310.0 |
| Note: All in US\$ Millions | |

1296 The cushion of \$310 million represents a wide (70%) margin over the Subject Co. carrying value.
1297 Therefore, results shown for Subject Co. clearly indicate that further, more detailed support for
1298 the MPAP is unnecessary for purposes of this analysis as the reporting unit passes the test by a
1299 margin well in excess of the 20% premium included.

1300 Regarding this more simplified analysis, the Working Group notes the following observations:

1301 • The control value concluded for the market approach in this example (\$756) is higher than
1302 that concluded in the Scenario One, more detailed, example (\$711.9).

1303 • The 20% MPAP, while within the range of market evidence from the exhibit on page 49, is
1304 lower than the average or median, reflecting consideration of the challenges regarding the
1305 transaction premium data discussed elsewhere in this paper.

1306 • If the indicated average or median transaction premium from the market evidence on page 49
1307 were simply used, the spread between the conclusion from the “detailed analysis” and the
1308 “simplified analysis” would be even greater. This suggests that the “simplified analysis”
1309 could be overstating fair value.

1310 • This provides further evidence of the need for precaution in relying exclusively on the
1311 historical transaction premium data. Use of this data should be supported conceptually by
1312 characteristics of the subject entity that would influence the extent of a reasonable MPAP
1313 such as the qualitative factors discussed in the earlier section – *Business Characteristics*
1314 *Influencing Market Participant Acquisition Premium* – to narrow the range of observed
1315 premiums from the transaction data that may be applicable for the subject entity.

1316 **Reconciliation of Market Capitalization (revised carrying value example)**

1317 The MVIC of Conglomerate as of the testing date is unchanged at \$1,867 million. The fair value
1318 conclusions for each of the reporting units have all been derived in the same manner as that
1319 described here in the Scenario Two revised carrying value example for Subject Co. and all three
1320 units are concluded to have passed the step one test. The resulting total concluded value of the
1321 Conglomerate TIC is \$2,150,000. Therefore, the premiums implied by the value conclusions are
1322 as shown in the following table.

| | |
|---|------------------|
| Concluded Fair Value of Conglomerate TIC (sum of reporting units) | \$2,150.0 |
| Test date price of Conglomerate shares | \$10.0 |
| Outstanding Conglomerate shares (millions) | 105.0 |
| Conglomerate Equity Market Capitalization | \$1,050.0 |
| Fair Value of Conglomerate Debt | \$817.0 |
| MVIC of Conglomerate | \$1,867.0 |
| MPAP Implied by Fair Value Conclusion | \$283.0 |
| MPAP Implied by Fair Value Conclusion (Equity Foundation basis) | 27.0% |
| MPAP Implied by Fair Value Conclusion (TIC Foundation basis) | 15.2% |
| Note: All in US\$ Millions | |

1323 The reconciling 15.2% TIC Foundation MPAP (27.0% on an Equity basis) is shown to be
1324 reasonable. This determination is based on the general level of premiums observed in recent
1325 transaction premiums. While this type of support would not be sufficient in a case where a
1326 premium is necessary to the support the test results, the fact that no premium is required to
1327 establish a passing result for any of the Conglomerate reporting units allows for this more
1328 efficient, less detailed approach in this case.

SUMMARY

1329 Because this VFR Advisory is intended to address best practices for the valuation of controlling
1330 interests in business enterprises under the standard of fair value for financial reporting, certain
1331 commentary is provided regarding this context.

1332 In fulfilling its mandate to provide best practices in the context of measuring fair value for
1333 financial reporting purposes, the Working Group introduced the term Market Participant
1334 Acquisition Premium, or MPAP. MPAP is defined here as the difference between (1) the *pro*
1335 *rata* fair value of the subject controlling interest and (2) *its foundation*. The Working Group
1336 believes that valuation specialists most commonly associate the *foundation* with the *pro rata* fair
1337 value of marketable, non-controlling interests in the enterprise. While this describes an MPAP
1338 Equity Foundation concept, a TIC Foundation may be more appropriate. The Working Group
1339 believes that best practices include expressing as well as applying the MPAP in the context of a
1340 TIC Foundation.

1341 The Working Group believes that MPAPs should be supported by reference to either enhanced
1342 cash flows or a lower required rate of return from the market participants' perspective. The
1343 Working Group anticipates such benefits will not in all instances exist or be reliably identifiable;
1344 in such cases resulting in either no premium or a small premium. Notwithstanding the emphasis
1345 on cash flow and risk differentials in supporting MPAPs in fair value measurement, the Working
1346 Group acknowledges the merit of analyzing historical data regarding observed premiums from
1347 closed transactions when reliable data is available.

1348 However, the Working Group cautions that exclusive reliance on observed premium data from
1349 completed transactions provides, in most cases, insufficient support for a concluded MPAP.
1350 Exclusive reliance on observed transaction premiums without careful analysis of the subject
1351 entity's relative financial performance, valuation multiples, and other metrics can result in an
1352 unreliable fair value measurement.

1353 Various business characteristics are discussed that influence an MPAP, including characteristics
1354 of the market and industry, as well as both the subject entity and market participants. The
1355 exercise of prerogatives of control by acquirers may lead to economic benefits in many areas and
1356 the valuation specialist should review the typical business characteristics likely to influence the
1357 magnitude of the benefits available to market participants. The Working Group believes that use
1358 of the framework discussed will provide an important context for review of the valuation results
1359 and will increase the relevance and reliability of the associated fair value measurement.

1360 A credible fair value measurement should include an assessment of the overall reasonableness of
1361 the measurement, including the MPAP applied or implied by the analysis. The level of rigor of
1362 analysis would depend on the importance of the MPAP to the fair value measurement. Factors -
1363 along with examples - are offered to evaluate the reasonableness of the fair value measurement of
1364 a controlling interest in a business enterprise.

EXHIBITS A AND B

EXHIBIT A

Market Participant Perspective - Controlling Interest
(in US\$ millions)

Compound Annual Growth Rate (Revenue, Through Year 5): 8.0%

| | Trailing | | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | Year 9 | Year 10 | Residual |
|-------------------------------------|------------|--------------|------------|------------|------------|------------|------------|------------|--------------------------------|------------|------------|------------|------------|
| Revenue | \$600 | | \$660 | \$719 | \$777 | \$831 | \$881 | \$925 | \$962 | \$996 | \$1,026 | \$1,057 | \$1,088 |
| <i>Revenue Growth</i> | | | 10.0% | 9.0% | 8.0% | 7.0% | 6.0% | 5.0% | 4.0% | 3.5% | 3.0% | 3.0% | 3.0% |
| Gross Profit | 360 | 60.0% | 396 | 432 | 466 | 499 | 529 | 555 | 577 | 598 | 616 | 634 | 653 |
| Operating Expenses: | | | | | | | | | | | | | |
| Research & Development | 30 | 5.0% | 33 | 36 | 39 | 42 | 44 | 46 | 48 | 50 | 51 | 53 | 54 |
| Distribution Expenses | 87 | 13.5% | 89 | 97 | 105 | 112 | 119 | 125 | 130 | 134 | 138 | 143 | 147 |
| Selling Expenses | 105 | 17.5% | 116 | 126 | 136 | 145 | 154 | 162 | 168 | 174 | 180 | 185 | 190 |
| Other General & Administrative | 45 | 7.0% | 46 | 50 | 54 | 58 | 62 | 65 | 67 | 70 | 72 | 74 | 76 |
| Total Operating Expenses | 267 | 43.0% | 284 | 309 | 334 | 357 | 379 | 398 | 413 | 428 | 441 | 455 | 467 |
| EBITDA | 93 | 17.0% | 112 | 123 | 132 | 142 | 150 | 157 | 164 | 170 | 175 | 179 | 186 |
| Depreciation & Amortization | 25 | | 25 | 26 | 29 | 32 | 35 | 38 | 40 | 43 | 45 | 47 | 49 |
| EBIT | 68 | | 87 | 97 | 103 | 110 | 115 | 119 | 124 | 127 | 130 | 132 | 137 |
| Taxes | 27 | 40.0% | 35 | 39 | 41 | 44 | 46 | 48 | 50 | 51 | 52 | 53 | 55 |
| Debt Free Net Income | 41 | | 52 | 58 | 62 | 66 | 69 | 71 | 74 | 76 | 78 | 79 | 82 |
| Incremental Working Capital | | 30.0% | 18 | 18 | 17 | 16 | 15 | 13 | 11 | 10 | 9 | 9 | 9 |
| Depreciation & Amortization | | | 25 | 26 | 29 | 32 | 35 | 38 | 40 | 43 | 45 | 47 | 49 |
| Capital Expenditures | | | 25 | 26 | 29 | 32 | 35 | 38 | 40 | 43 | 45 | 47 | 49 |
| Debt Free Cash Flow | | | 34 | 40 | 45 | 50 | 54 | 58 | 63 | 66 | 69 | 70 | 73 |
| Residual Value | | | | | | | | | | | | | 1,000 |
| Discounting Periods | | | 0.5 | 1.5 | 2.5 | 3.5 | 4.5 | 5.5 | 6.5 | 7.5 | 8.5 | 9.5 | 9.5 |
| PV Factor | 10.0% | | 0.9535 | 0.8668 | 0.7880 | 0.7164 | 0.6512 | 0.5920 | 0.5382 | 0.4893 | 0.4448 | 0.4044 | 0.4044 |
| PV DFCF | | | 33 | 35 | 35 | 36 | 35 | 34 | 34 | 32 | 31 | 28 | 404 |
| Total Invested Capital Value | 740 | | | | | | | | | | | | |
| Interest-Bearing Debt | 289 | | | | | | | | | | | | |
| Equity Value | \$451 | | | | | | | | | | | | |
| <u>Residual Value Calculation</u> | | | | | | | | | | | | | |
| | | | | | | | | | | | | | 73 |
| | | | | | | | | | 10.0% | | | | |
| | | | | | | | | | Estimated Residual Growth Rate | 3.0% | | | |
| | | | | | | | | | Residual Capitalization Rate | | 7.0% | | |
| | | | | | | | | | Residual Value | | | 1,000 | |
| MPAP (Equity) | 22.7% | | | | | | | | | | | | |
| MPAP (TIC) | 12.7% | | | | | | | | | | | | |
| <u>Relative Value Measures</u> | | | | | | | | | | | | | |
| TIC / Trailing Revenue | 1.2 | | | | | | | | | | | | |
| TIC / Trailing EBITDA | 8.0 | | | | | | | | | | | | |

