Fair Value Accounting for Entities and Intangibles: What you need to know
Presenter – David Ball, CFA

• Managing Director – Duff & Phelps
• Valuation Advisory Practice
  – Concentration in TMT Industry
  – Specialization in financial and tax reporting valuations
• Atlanta Office Leader
Duff & Phelps is the global advisor that protects, restores and maximizes value for clients in the areas of valuation, corporate finance, investigations, disputes, cyber security, compliance and regulatory matters, and other governance-related issues. We work with clients across diverse sectors, mitigating risk to assets, operations and people.
Learning Objectives

- Background on Financial Reporting Valuations and Definitions
- Intangible Asset Identification and Valuation Techniques
- Impairment Testing Framework
- Trends Impacting Fair Value Accounting
Section I

Financial Reporting Valuations
Financial Reporting Valuations
When are Fair Value estimates needed?

Business Combinations

- When a business acquisition occurs, the accounting is governed by ASC 805 – Business Combinations.
- ASC 805 requires that each asset and liability acquired in a business combination be recorded at Fair Value as of the acquisition date.

Impairment Testing

- In the post-combination period, both finite- and indefinite-lived assets are subject to impairment testing. Indefinite-lived assets are subject to impairment testing at least annually, while finite-lived assets are subject to impairment testing only upon a “triggering” event.
- ASC 350, Intangibles—Goodwill and Other
- ASC 360-10, Property, Plant, and Equipment
Financial Reporting Valuations
Who are the interested parties in this process?

- Investors & Users of Financial Statements
- Company
- Auditors / PCAOB
- SEC / Regulators
Definition of Fair Value for Financial Reporting

The price that would be received to sell an asset or paid to transfer a liability… Exit Price

Not a liquidation price or forced sale

in an orderly transaction…

Market-based View

between market participants…

Current

at the measurement date.
Market Participants

Independent of each other

Knowledgeable and sufficiently informed

Willing (not forced) to enter into a transaction

Able to enter into a transaction
Highest and Best Use (H&BU) refers to the use of an asset by market participants at the measurement date that is:

- Physically possible
- Legally permissible
- Financially feasible
- Maximizes the value of the asset (group)
Fair Value Hierarchy

Categorizes the inputs to valuation techniques and the resulting fair value measurements.

- **Level 1**: Quoted prices (unadjusted) in active markets for identical assets or liabilities
- **Level 2**: Quoted prices for similar assets in active markets (adjust Level 1 inputs for differences)
- **Level 3**: Inputs for the asset or liability that are not based on observable data
Section II

Business Combinations
Business Combinations: Key Concepts

Transaction

A transaction or event in which an acquirer obtains control over a business.

Acquisition Method

Accounted for using the Acquisition Method which requires a Purchase Price Allocation ("PPA").

Allocation

A PPA is the allocation of the purchase price to the identifiable assets and liabilities at Fair Value, any residual is goodwill.

We value the consideration (price paid for the business) and the components of the business.
What do we do with the valuation approaches?
Break Down Enterprise Value into its Components
Tangible Assets

**Inventory**
- Raw Materials
- Work in Process
- Finished Goods

**Real Property**
- Land
- Buildings
- Building Improvements
- Site Improvements
- Construction in Progress

**Personal Property**
- Machinery and Equipment
- Tools, Dies and Molds
- Lab Equipment
- Warehouse Equipment
- Furniture and Fixtures
- Office Equipment
- Computers
- Software
- Vehicles
- Leasehold Improvements
- Construction in Progress
Intangible Assets – Accounting Perspective

• **What is an intangible asset?**
  – It is *identifiable*
  – Provides control over a resource
  – Results in future economic benefits

• **In order to be separately recognizable apart from goodwill, an intangible asset needs to meet one of the following criteria**
  – Contractual / legal
  – Separable

• **There are several broad categories of intangible assets**
Intangible Assets – Broad Categories

- **Technology-Based**
  - Patents, Software, Trade Secrets, Databases, IPR&D

- **Customer-Related**
  - Customer Lists, Customer Relationships, Backlog, Contracts

- **Marketing-Related**
  - Trade Marks, Tradenames, Mastheads, Domain Names

- **Contract-Based**
  - Licensing, Franchise, Lease, Permits, Rights, Non-Competes
What is Goodwill?

Residual Amount

Goodwill acquired in a business combination is recognised as an asset and is not amortized. Instead, goodwill is subject to annual impairment tests, or more frequently, if there is an indication of impairment.
General Valuation Approaches

**Income Approach**
- Value indicated by the present value of projected cash flow attributable to the valuation subject

**Market Approach**
- Value indicated by comparison of valuation subject to identical or similar assets traded in active public markets

**Cost Approach**
- Value indicated by a summation of all costs required to reproduce or replace the valuation subject
Primary Income Approaches - Intangibles

- Relief-from-Royalty Method
- Multi-Period Excess Earnings Method (MPEEM)
- Greenfield Method
- With-and-without Method
- Premium Profits Method
Example – Purchase Price Allocation

• Company A purchased Company B for **approximately $10 billion** (Enterprise Value)
• Both companies are **US wireless industry** participants
• Company A must perform a PPA that allocates the $10 billion to the acquired assets and liabilities
• Assets / Liabilities that would be recognized on the balance sheet
  – Net working capital (e.g., cash, A/R, Inventory, A/P)
  – Personal Property (e.g., network, non-network)
  – Real Property (e.g., land, buildings)
  – Trade Name
  – Customers (e.g., post-paid and pre-paid subscribers)
  – FCC Licenses
Example – Purchase Price Allocation

Trade Name Valuation

- Relief from Royalty Method used often to value Trade Names and Trademarks
- Key assumptions:
  - Revenue projections
  - Royalty rate
  - Discount Rate

<table>
<thead>
<tr>
<th></th>
<th>FY18</th>
<th>FY19</th>
<th>FY20</th>
<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24</th>
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</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$ 5,000.0</td>
<td>$ 5,125.0</td>
<td>$ 5,253.1</td>
<td>$ 5,384.5</td>
<td>$ 5,519.1</td>
<td>$ 5,657.0</td>
<td>$ 5,798.5</td>
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<tr>
<td>Multiplied by: Royalty Rate @ 4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
<td>4%</td>
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<tr>
<td>Pre-tax Royalty Savings</td>
<td>$ 200.0</td>
<td>$ 205.0</td>
<td>$ 210.1</td>
<td>$ 215.4</td>
<td>$ 220.8</td>
<td>$ 226.3</td>
<td>$ 231.9</td>
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<tr>
<td>Less: Cash Taxes @ 27%</td>
<td>(54.0)</td>
<td>(55.4)</td>
<td>(56.7)</td>
<td>(58.2)</td>
<td>(59.6)</td>
<td>(61.1)</td>
<td>(62.6)</td>
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<tr>
<td>After-tax Royalty Savings</td>
<td>$ 146.0</td>
<td>$ 149.7</td>
<td>$ 153.4</td>
<td>$ 157.2</td>
<td>$ 161.2</td>
<td>$ 165.2</td>
<td>$ 169.3</td>
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<tr>
<td>Multiplied by: Present Value Factor @ 10%</td>
<td>0.95</td>
<td>0.87</td>
<td>0.79</td>
<td>0.72</td>
<td>0.65</td>
<td>0.54</td>
<td>0.40</td>
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<tr>
<td>Present Value of After-tax Royalty Savings</td>
<td>$ 139.2</td>
<td>$ 129.7</td>
<td>$ 120.9</td>
<td>$ 112.6</td>
<td>$ 104.9</td>
<td>$ 88.9</td>
<td>$ 68.5</td>
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</tbody>
</table>

Fair Value of the Trade Name (rounded) ($000s) $ 800.0
### Example – Purchase Price Allocation

#### Customers Valuation

- **Excess Earnings Method** used often to value Customer-related Intangibles
- **Key assumptions** include 1) Revenue and EBITDA forecasts; 2) expected churn rates; 3) value conclusions for other assets; and 4) discount rate

<table>
<thead>
<tr>
<th></th>
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<th>FY21</th>
<th>FY22</th>
<th>FY23</th>
<th>FY24</th>
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</thead>
<tbody>
<tr>
<td>Overall Revenue</td>
<td>$5,000.0</td>
<td>$5,125.0</td>
<td>$5,253.1</td>
<td>$5,384.5</td>
<td>$5,519.1</td>
<td>$5,657.0</td>
<td>$5,798.5</td>
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<tr>
<td>Multiplied by: Attrition</td>
<td>100%</td>
<td>85%</td>
<td>70%</td>
<td>55%</td>
<td>40%</td>
<td>25%</td>
<td>10%</td>
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<tr>
<td>Existing Customer Revenue</td>
<td>$5,000.0</td>
<td>$4,356.3</td>
<td>$3,677.2</td>
<td>$2,961.4</td>
<td>$2,207.6</td>
<td>$1,414.3</td>
<td>$579.8</td>
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<tr>
<td>Mutliplied by: EBITDA % @ 35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>Existing Customer EBITDA</td>
<td>$1,750.0</td>
<td>$1,524.7</td>
<td>$1,287.0</td>
<td>$1,036.5</td>
<td>$772.7</td>
<td>$495.0</td>
<td>$202.9</td>
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<tr>
<td>Less: Cash Taxes @ 27%</td>
<td>(472.5)</td>
<td>(411.7)</td>
<td>(347.5)</td>
<td>(279.9)</td>
<td>(208.6)</td>
<td>(133.6)</td>
<td>(54.8)</td>
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<tr>
<td>After-tax Profit</td>
<td>$1,277.5</td>
<td>$1,113.0</td>
<td>$939.5</td>
<td>$756.7</td>
<td>$564.0</td>
<td>$361.3</td>
<td>$148.2</td>
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<tr>
<td>Less: Return on/of PP&amp;E</td>
<td>250.0</td>
<td>217.8</td>
<td>183.9</td>
<td>148.1</td>
<td>110.4</td>
<td>70.7</td>
<td>29.0</td>
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<tr>
<td>Less: Return on Trade Name</td>
<td>150.0</td>
<td>130.7</td>
<td>110.3</td>
<td>88.8</td>
<td>66.2</td>
<td>42.4</td>
<td>17.4</td>
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<tr>
<td>Less: Return on FCC Licenses</td>
<td>300.0</td>
<td>261.4</td>
<td>220.6</td>
<td>177.7</td>
<td>132.5</td>
<td>84.9</td>
<td>34.8</td>
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<tr>
<td>Profit Attributable to Existing Customers</td>
<td>$577.5</td>
<td>$503.1</td>
<td>$424.7</td>
<td>$342.0</td>
<td>$255.0</td>
<td>$163.3</td>
<td>$67.0</td>
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<tr>
<td>Multiplied by: Present Value Factor @ 10%</td>
<td>0.95</td>
<td>0.87</td>
<td>0.79</td>
<td>0.72</td>
<td>0.65</td>
<td>0.54</td>
<td>0.40</td>
</tr>
<tr>
<td>Present Value of After-tax Royalty Savings</td>
<td>$550.6</td>
<td>$436.1</td>
<td>$334.7</td>
<td>$245.0</td>
<td>$166.1</td>
<td>$87.9</td>
<td>$27.1</td>
</tr>
</tbody>
</table>

**Fair Value of the Trade Name (rounded) ($000s)**: $1,800.0
Example – Purchase Price Allocation

FCC Licenses Valuation – Market Approach

• Market Approach is one method that is often used to value FCC Licenses

• Market Approach Benefits:
  – Market indications available from FCC Auctions and Secondary Market Transactions

• Market Approach Issues:
  – Market Indications can vary significantly and reflect many factors including
    1. type of spectrum;
    2. geography;
    3. scarcity of spectrum; and
    4. specific company needs.
  – Care must be given in determining if a market indication is appropriate to use on subject spectrum
  – Market approaches may ignore an “aggregation premium” that would be appropriate when valuing a spectrum portfolio
Example – Purchase Price Allocation
FCC Licenses Valuation – Greenfield Method

• The Greenfield Method is another technique that is often used to value FCC Licenses
• This is an Income Approach that assumes a market participant is given the asset and builds a business from scratch
• Greenfield Method Benefits:
  – Considers the value of the entire spectrum portfolio
  – Is based on expected usage of the asset
• Greenfield Method Issues:
  – Requires many assumptions, including:
    1. ramp-up period of the business;
    2. cost of initial investments;
    3. subscriber acquisition / churn patterns; and
    4. Usage of various spectrum assets and needs for future assets
  – Greenfield Method provides an aggregate value and that may require further allocation to individual licenses
Example – Purchase Price Allocation

Summary

- NWC, $500
- PP&E, $1,500
- Trade Name, $800
- Subscribers, $1,800
- FCC Licenses, $3,000
- Goodwill, $2,400

Fair Value Estimates
Section III

Impairment Testing
Impairment Testing
ASC 350 Goodwill

Goodwill is the residual amount in a business combination. Impairment testing is completed at the Reporting Unit level.

- Reporting Units exist only to test GW
- Target’s assets and GW can be allocated to different RUs; combined with existing RUs or be stand-alone
- A one step test recently replaced a more complex two step test
- Fair Value is compared to the Net Asset Value (from balance sheet)
- Optional qualitative screen, “Step 0”
- Currently amortization being considered (OK for private companies now)
Impairment Testing
ASC 350 Indefinite Lived

Created in a business combination, tested directly based on fair value. Indefinite is not necessarily eternal.

- Indefinite-lived intangibles are not amortized
- One step test - fair value is compared to book value
- Tested annually or with a triggering event
- There is an optional qualitative screen, “Step 0”
- When life becomes determinable reclassify to finite-lived asset and amortize
Impairment Testing
ASC 360-10 Finite Lived

Tests whether the carrying amount of an asset group can be recovered based on undiscounted cash flows, if not then FV.

- Assets grouped at the lowest level of identifiable cash flow, an accounting call;
- Can the carrying amount of the asset group be recovered?
- If the total (undiscounted) cash flows exceeds the carrying amount – recoverable;
- Complex rules about the projections;
- If the asset group is not recoverable then a fair value test with another set of rules is applied (step 2).
Example – Impairment Testing

Approximately 1 year after the acquisition Company A it is testing the acquisition for impairment. Company B is a separate Reporting Unit.

• **First** – Determine if there is a triggering event that would create the need to run an impairment test on definite-lived assets

• **Second** – Determine if there is a need to do a quantitative analysis on the indefinite-lived assets and goodwill

• **Third** – Perform impairment test on indefinite-lived assets
  – In this example, we would test the FCC Licenses by valuing this asset in the same way it was valued during the PPA
  – If impairment exists it would be calculated prior to the goodwill test

• **Fourth** – Perform impairment test on the goodwill
Example – Impairment Testing (Goodwill)

- In performing a Step 1 Test for Goodwill you estimate the Fair Value of the Business Enterprise and compare to the carrying value of Net Assets.
- Fair Value is most often estimated using Income and Market Approaches.
- Net Assets can be calculated by adding the Book Value of Debt and Equity.

<table>
<thead>
<tr>
<th>Weighting</th>
<th>Fair Value ($000s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Approach</td>
<td>50%</td>
</tr>
<tr>
<td>Market Comparables Approach</td>
<td>25%</td>
</tr>
<tr>
<td>Market Transaction Approach</td>
<td>25%</td>
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</tbody>
</table>

Concluded Business Enterprise Value (rounded) ($000s) $10,900.0

Carrying Value of Net Assets ($000s) $9,500.0

Indication of Impairment: NO
Section IV

New Valuation Credential & Professional Infrastructure
Overview

- **New Valuation Credential** for Financial Reporting valuations:
  
  *Certified in Entity and Intangible Valuation (CEIV)*
  
  - Valuation Professional Organizations (VPOs) issuing the CEIV credential:
    - American Society of Appraisers (ASA)
    - American Institute of Certified Public Accountants (AICPA)
    - Royal Institution of Chartered Surveyors (RICS)

- **New Performance Standards** for valuations - comprising two components:
  
  - *Mandatory Performance Framework (MPF)*
  
  - Application of the MPF


*The first phase of a broader credentialing / mandatory performance requirements process for various asset classes.*
CEIV Credential: A Two Phase Process

- Intended for valuation professionals who perform fair value measurements for financial statement reporting purposes
- Must meet rigorous qualifications as well as ongoing education and credential maintenance requirements
- Includes MPF requirements
- Agrees to be subjected to a periodic Quality Review

<table>
<thead>
<tr>
<th>VPO Phase</th>
<th>CEIV Phase</th>
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<tbody>
<tr>
<td>Hold/obtain a VPO credential (ASA, ABV, RICS), or</td>
<td>Complete VPO prerequisites</td>
</tr>
<tr>
<td>Use VPO pathway to pass a VPO-equivalent exam</td>
<td>Complete 4 online courses: on accounting standards &amp; regulatory environment, FV specialized guidance and related auditing requirements, and MPF</td>
</tr>
<tr>
<td>Qualifying exams (e.g. CFA) can be used as a substitute for the VPO exam</td>
<td>Pass a two-part CEIV exam</td>
</tr>
<tr>
<td>May be required to undertake ethics and other standards courses</td>
<td>3,000 hours of FV measurements experience in preceding 5 years</td>
</tr>
<tr>
<td></td>
<td>Continuing education, experience and compliance requirements per each VPO</td>
</tr>
</tbody>
</table>
MPF is a New Type of Standard

**Not a technical standard (not a ‘how to’)**
Both mandatory standards and voluntary guidance have been developed around technical issues in valuation.

**Not a professional standard (not a ‘who is to do’)**
VPOs have increased their focus on providing training, accreditation, technical guidance, and frameworks for professional and ethical conduct.

**It is a performance standard (how much to do)**
The MPF establishes a *minimum* threshold for a valuation professional’s scope of work and documentation.
Basic Premise of MPF

Support work with sufficient detail to provide a clear and well organized link from the data and information gathered to the final conclusion of value

- To comply, **work scope** and **documentation** should be such that an experienced **professional** must be able to:

  **Understand:**
  - The purpose, nature, extent, and results of the procedures performed
  - All approaches and methods used, and why commonly used approaches and methods were not used (if applicable)
  - Inputs, judgments, and assumptions made and why they were used

  **Determine:** who performed the work and their qualifications

  **Identify:**
  - Intended users of the valuation report
  - Sources and support for inputs, judgments, and assumptions
  - Measurement date
MPF and the Application of the MPF

Mandatory Performance Framework
Section 1: Preamble
Section 2: Valuation Engagement Guidance
Section 3: Glossary
Section 4: Authoritative and Technical Guidance

Application of the MPF
Section 1: General Valuation Guidance
Section 2: Business Valuation Guidance
Section 3: Valuation of Intangible Assets, Certain Liabilities, and Inventory Guidance

https://ceiv-credential.org/