

# VALUATION ISSUES IN ACCOUNTING

A practitioner's perspective

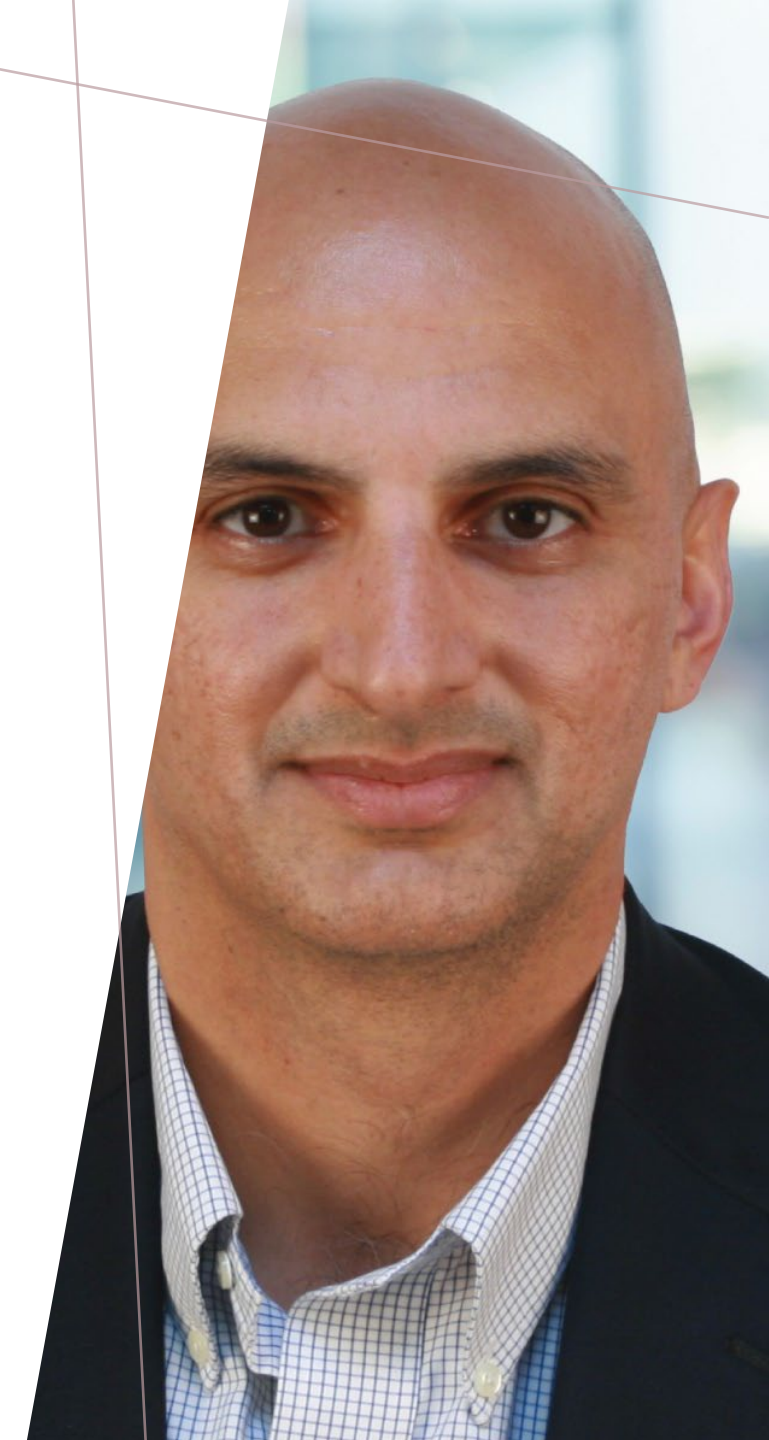
PJ Patel, CFA | Co-CEO  
Valuation Research Corporation

The logo for Valuation Research Corporation (VRC) is displayed in a large, white, serif font. The letters are bold and closely spaced, with the 'V' and 'R' being particularly prominent. The logo is positioned in the bottom right corner of the slide, overlapping the image of the skyscrapers.

VRC

# PJ PATEL, CFA, ASA

- Co-CEO VRC and chair of VRG
- VRC's client base consists of:
  - Public companies
  - Private equity firms and their portfolio companies
  - Asset managers – PE, hedge funds, BDC's, and mutual funds
  - 2023 – 1000 deals and 30k securities valued
- 1000+ deals with public companies and private equity
- PJ is a frequent presenter on valuation issues relating to ASC 805, ASC 350/360, and ASC 820
  - Instrumental in the development of best practices relating to the distributor method, inventory valuation, and deferred revenues
  - PIR on ASC 805, ASC 820
  - Participant in the FASB's goodwill roundtable
- Committees:
  - Chair – Appraisal Issues Task Force
  - Member – Appraisal Foundation Working Group
    - Practice Aid for valuing customer-related intangible assets
  - Member – American Society of Appraisers, Business Valuation Committee
  - Prior Member – Appraisal Foundation, Business Valuation Resource Panel
  - Prior Member – LES committee preparing best practices on IP valuation



# AGENDA

1. Past, present and future use of FV in accounting
2. Developments in Valuation
3. What's on the Mind of a Practitioner?
4. Case Studies
5. What Lies Ahead?



# BRIEF HISTORY OF FAIR VALUE IN ACCOUNTING

Year	Development
1850-1970	Early use of market value in accounting
1970-1990	Emergence of fair value in the era of regulative and conceptual developments
1970	<i>APB 16 Business Combination (1970)</i>
1973	APB 29 Accounting for Nonmonetary Transactions
1975	FAS12: Accounting for Marketable Securities
1990-2015	Era of fair value
1991	FAS 107: Disclosures about Fair Value of Financial Instruments
1993	FAS 115: Accounting for Certain Investments in Debt and Equity Securities
1998	FAS 133: Accounting for Derivative Instruments and Hedging Activities
2001	<i>FAS 141/142/144 issued</i>
2004	<i>FAS 123 issued</i>
2006	<i>SFAS 157 Fair Value Measurements issued by FASB</i>
2007	<i>Revised FAS141: Business Combinations released</i>
2007	FAS 159 The Fair Value Option become effective
2011	<i>ASC 820 Fair Value Measurement</i>
2016	ASC 842 - Lease Accounting
2016	ASC 326 - CECL

## Sources:

1. Alharasis, Esraa Esam, Prokofieva, Maria, Alqatamin, Rateb Mohammad and Clark, Colin (2020) Fair Value Accounting and Implications for the Auditing Profession: Historical Overview, Accounting and Finance Research, 9(3). pp. 31-52, ISSN 1927-5986
2. In pursuit of legitimacy: A history behind fair value accounting, George Omiros and Jack Lisa



# WORKING GROUP BEST PRACTICES

## Appraisal Foundation/BVRP | Top 25 issues in valuation

<https://appraisalfoundation.sharefile.com/share/view/safc7cef1f5d41c2b>

- ~~1. Contributory Assets (Including going concern and other elements of Goodwill)~~
- ~~2. Control Premium in a DCF Enterprise Valuation~~
- ~~3. "Overlapping Customers"~~
- ~~4. Economic Rents for Contributory Asset Charges~~
- ~~5. Discounts for Lack of Control or Liquidity~~
- ~~6. Asset/Earnings Prioritization Principle~~
- ~~7. Valuation of Intangible Asset Using "Current Replacement Cost"~~
- ~~8. Accounting Impact of Using Marketplace Participant Assumptions to Measure the Fair Value of an Asset that the Combined Entity does not Intend to Use or Sell~~
- ~~9. Subsequent (Day 2) Application of Marketplace Participant Assumptions to Discontinued Assets~~
- ~~10. Premiums and Discounts~~
- ~~11. Small Capitalization Premiums~~
- ~~12. EITF Topic-D108 Conclusions on the Use of the Residual Method~~
- ~~13. Use of Stratified Rates of Return for Different Classes of Assets When Using the Income Method~~
- ~~14. Non-Compete Agreements~~
- ~~15. Active Markets~~
- ~~16. Tangible Assets~~
- ~~17. Avoided Royalty Approach~~
- ~~18. Inventory~~
- ~~19. Marketplace Participant View~~
- ~~20. Cost Approach to Value Customer Relationships~~
- ~~21. Overlapping Intangibles~~
- ~~22. Unprofitable Technology~~
- ~~23. Customer Relationship Attrition~~
- ~~24. Reacquired Franchise Rights~~
- ~~25. Greenfield Valuation vs. "Excess Earnings" Approach~~

- Make valuations relevant and reliable
- Reduce diversity in practice



# WORKING GROUP BEST PRACTICES

## Appraisal Foundation valuation advisories:

- Contributory asset charges
- Customer-related assets
- Contingent consideration (earnouts)
- Market Participant Acquisition Premiums (MPAP)
- IN PROCESS:      Company-specific risk premium
- Discount rates on intangible assets

## AICPA | Best practice guides:

- IPR&D
- Stock compensation
- PE/VC guide
- Goodwill
- Business combinations

## Mandatory Performance Framework/CEIV

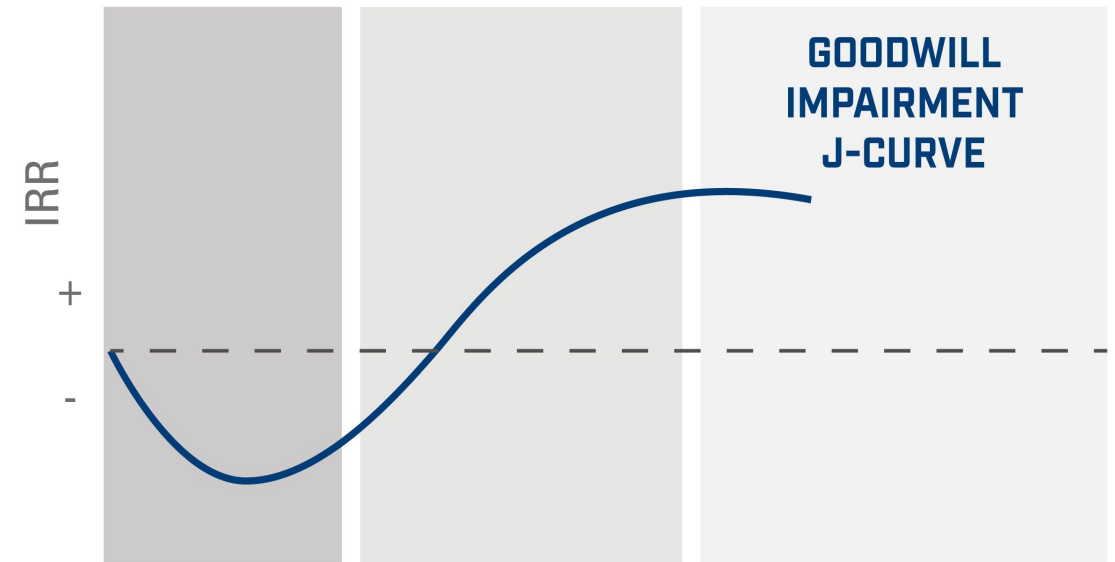
# WHAT'S ON A VALUATION PRACTITIONER'S MIND?

1. Relevance and reliability of financial statements
  - a. What do users need/want? What can preparers reasonably provide?  
Is there an overlap?
2. Are we focused on getting the income statement right or the BS right?
3. Accounting is backward-looking. Intangible assets are created in the past, booked at acquisition, and impact future earnings. Their value is based on future cash flows
4. Fair value BS is helpful but it is outside of the historical cost accrual accounting system
5. Valuing entities for Goodwill – FV of an entity is something we can easily do



# CASE STUDY 1- GOODWILL

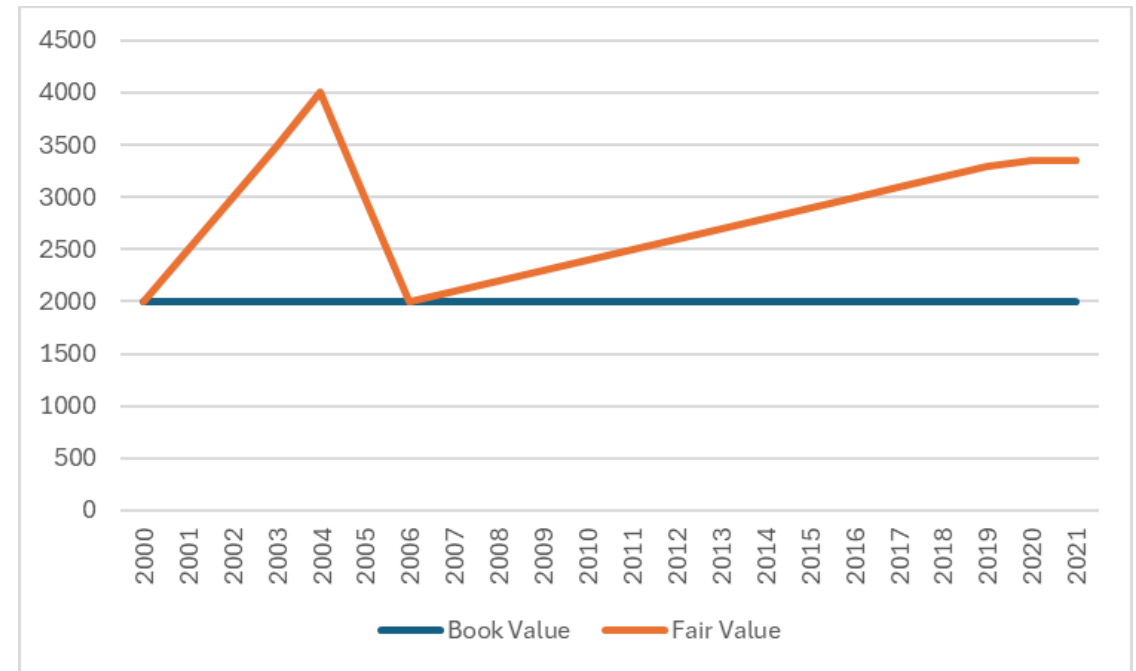
- Background
  - Involved in 2000+ deals and followed companies for impairment testing for over 20 years
- Common Complaints
  - Info is late, not meaningful
  - Biggest impairments happen during recessions
- Preparer Complaints
  - To much work, costly, not meaningful
- User Perspective
  - Want info on deals – did they work out as planned?
- What do we see?
  - FV of a business can be determined
  - Acquired company underperforms for the first 2 years and then usually outperforms from year 2.5 and beyond
  - By year 5 the target is no longer indefinable and is just part of the acquiring company
  - Impairment testing is a good measure of management's ability





# CASE STUDY 2 – INTANGIBLE ASSETS

- Common Complaints
  - Intangible assets are hard to value
  - Is the info relevant or reliable?
- What do we see?
  - FV of an intangible asset can be determined
  - Impairment testing is a good measure of management's ability
  - Derivative may be more important than absolute value



# CASE STUDY 3 – FAIR VALUE MEASUREMENTS

- Background

- Serial acquirer did 100 deals between 2009 and 2015
- Carve out from a public company in 2006
- Public in 2009, private in 2016
- Annual impairment testing, stock comp

- What do we see?

- Add discipline to the deal-making process
- Impairment testing is a good measure of management's ability to do deals and integrate them



# CASE STUDY 4

## MARK-TO-MARKET

- Background
  - Fund made investments that underperformed and wanted some internal discipline
  - Need values for NAV purposes
- What do we see?
  - Add discipline to the investment process



WHAT LIES AHEAD?



# UNNECESSARY COMPLICATIONS

1. IFRS – IAS36 value in use or FV less disposal costs
2. ASC 360 – asset groups and recoverability test
3. CECL – fair value concept without present valuing
4. Lease accounting – use of incremental borrowing rate or risk-free rate rather than the term discount rate or company's WACC

# FAIR VALUE BALANCE SHEET?

1. Intangible assets/Goodwill make up ~90% of the value of the S&P500 (17% in 1975)
2. FV is relevant but changes in FV may be even more relevant
3. What assets?
4. BS based on historical cost, fair value, hybrid, or both?



# VALUATION TECHNOLOGY

- Automated Valuation Models
- Data
- Long-term – A.I./machine learning
- Is Excel obsolete?
- What happens to valuation specialists?





# QUESTIONS?

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# APPENDIX

## Additional discussion points, time permitting

1. How did the VRC Team develop the distributor method?
2. How did the VRC Team develop the current method to value inventory?
3. Why do we apply 606 to value deferred revenue vs. determining its fair value?

