



New Financial Reporting Valuation Guidelines

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On June 10, 2008 The Appraisal Foundation released its first Discussion Draft from its Intangible Asset Working Group entitled “The Identification of Contributory Assets and the Calculation of Economic Rents.”

There is significant meaning to this document being released for several reasons. First, for quite some time there has been a desire, both in and outside of the valuation community, to improve upon the diversity in practice that currently exists. The Appraisal Foundation is seeking to tackle this critical issue by forming groups of leading practitioners to address key concerns where there is diversity. Given that there has been limited guidance in the past for practitioners, these best practices should be quite useful and lead to better fair value reporting for companies.

The first working group is covering contributory asset charges, and future topics will be covered – group two is focusing on customer-related issues. The first paper just released is a Discussion Draft that will be followed by a more detailed Exposure Draft and, later on, a final document. Feedback is being requested, and comments on the initial Discussion Draft are due on July 22, 2008. The following summarizes some key points made concerning contributory asset charges:

- “Circular”/Iterative Charges: The use of two multi-period excess earnings methods (MPEEMs) with charges that are dependent on one another (for example customers and technology for a technology company) is discouraged. This could be a controversial stipulation for some valuers. Suggested alternatives could include the following:
 - Revenue/profit split between the assets.
 - Designate one asset as secondary and use method such as relief from royalty or cost approach for the secondary asset.
 - Still use two MPEEMs but designate one asset as primary and only apply a charge to the secondary asset.
- Normalization: Charges on items such as working capital or fixed assets must be based off of normalized levels required by a market participant, which may vary from historical figures.
- Relief from Royalty Charges: Generally, if one is valuing an asset using the relief from royalty method, the charge related to that asset should be based on the royalty rate assumed as a percentage of sales.
- Debt: Rates of return used to calculate charges should consider the level of debt that would be used to finance the asset (with tangible assets typically using higher debt levels vs. intangible assets).
- Stratification: Typically rates of return for intangible assets should be similar to or higher than the company discount rate.
- Changes over time: Consideration should be given on a year-by-year basis as to what appropriate charges should be (versus applying the same charge as a % of sales throughout the projection period), as needs may change over time.

While some of the above points may not be controversial, the paper does a thorough and well-thought out job of setting a general framework for valuation professionals in doing their work. The paper also brings up many topics that were not yet agreed upon where feedback is being solicited. Some of these are very interesting and include:

- Should deferred revenue be included for a working capital charge?
- If working capital is negative, should there be no charge or a “reverse charge”/positive cash flow applied?
- For in-process research and development, should charges be applied when no revenues are being generated?
- Are iterative/circular charges acceptable?
- Do royalty rate-based charges represent a “return on and of” the asset? Why or why not?

Some of the above are very interesting issues that do not necessarily have a clear-cut answer. It will be interesting to see where the debate leads us to on this and future efforts by The Appraisal Foundation working groups in establishing best practices for financial reporting valuations.