April 28, 2017

Working Group 4- Valuation of Contingent Consideration
c/o Staci Steward
The Appraisal Foundation
1155 15th Street NW, Suite 1111
Washington, DC 20005

VFRcomments@appraisalfoundation.org
Re: First Exposure Draft- Valuation of Contingent Consideration

Dear Working Group 4 (“WG4”):
We have reviewed the contingent consideration valuation first exposure draft dated February 28, 2017 (“Exposure Draft”). We greatly appreciate the time and effort WG4 has put into compiling this draft. We have documented some comments that we hope can increase the Exposure Draft’s effectiveness and application in the field. We have structured our response in a manner such that the recipient may refer back to the Exposure Draft line number concurrently with our remarks.

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COMMENTS
Section 1.3 Motivations for Structuring Contingent Consideration
Lines 85-87 - There are numerous cases where parties to a transaction are not entirely optimistic vis-a-vis the outcome of the venture. The contingent consideration may be structured in a manner to limit further investment or allow for an unwinding of the venture should things fail to materialize.

Section 1.4 Motivation for Providing a Guide for the Valuation of Contingent Consideration

Lines 92-95 – As a technical guide, practitioners will be referring to this document as they develop procedures and other mechanical steps. We highly recommend the Valuation Advisory define terms of art for the parties to a transaction and rely on those throughout.

Section 1.5 Recommendations for Contingent Consideration Valuation Methods

Line 107 – “In the Scenario-Based Method (SBM, see section 5.3.1).” For the sake of consistency throughout the valuation industry, instead of adding another initialism, can we call this a Probability Weighted Expected Return Method (PWERM)? As support for this change, we would offer up the following: 1) This draft uses similar concepts of starting equity value, option payouts, non-linearity, etc. consistent with the discussion points raised when considering an open option modelling framework 2) the use of the term OPM appears to align with the Cheap Stock guide usage and 3) the description of the SBM as a PWERM is accurate.

Line 119 – The usage of "typically" and "most" in these lines assume a depth and breadth of study by the WG4 that includes validation against actual payouts and behavior. If such validation exercise has not yet been performed, then we would recommend limiting the usage of qualifiers like these.

Lines 122 – 123 – How does this method reconcile with the methods suggested to calculate IPR&D intangible assets? Are there down the road impairment calculation considerations of which the practitioner should be aware as it relates to the relationship between the contingent consideration value of acquired intangible assets and goodwill.

Section 3.2 Contingent Consideration Payoff Structures

Pre-line 255 – There is good consideration to be made regarding the sizes of the contingent consideration payer versus payee and the transaction parties’ various characteristics (e.g. industry, stage, geography, etc.) when selecting the most appropriate models and assumptions. Consider adding a section here describing those elements and the impact they could have on the valuation of the contingent consideration as an asset versus a liability.

Section 4.3 The Risk Associated with the Structure of Contingent Consideration
Line 540 – The following is regarding the phrase “time remaining”. Time and its application in earnouts is critical and largely unmentioned in the Exposure Draft. There are considerations related to the measurement date versus the payout date that affect the structuring of the models. Also, where the contingent consideration includes Put – Calls, there are typically “windows” of time where one party must act. Any guidance would be helpful on what term should be used in modelling CC’s where there is a time window. Also, if there are multiple steps do you simulate from N=0 to each discrete payment or from N=0 to N=1 to N=2, etc.?

Section 5.2 Key Elements of an Income Approach to Contingent Valuation

Lines 836 – 838 – Are contingent consideration values pre-tax values? If so, should a pre-tax WACC be used to arrive at risk-neutral values?

Lines 1222 – 1224 – We recommend citing ASU 2011 – 04 (May 2011), 820-10-55-5 (f), "For a liability, the nonperformance risk relating to that liability, including the reporting entity's (that is, the obligor's) own credit risk.

Section 5.3 Alternative Income Approach Techniques

Line 1242 - Any thoughts around making time or moneyness a factor in selecting a model? At some point the likelihood of payout and counter-party risk may collapse to a forward agreement. If this was the case, then valuation techniques used to value forwards would apply.

Line 1290 - Any discussion for or against using layered distributions to estimate the value of reference metric? For example, can one model revenue distribution and the separate distribution for EBITDA based on margins or something like that?

Line 1333 - If the assumption is that management's forecast is inherently biased, then are the scenario probabilities equally biased? If the projections can be adjusted to a risk-neutral amount, then should the scenario probabilities forming anything other than a lognormal distribution be adjusted back to that pattern?

Thank you in advance for your consideration of the above comments. We look forward to your response. If there are any questions regarding our response, please contact Howard Krieger at hkrieger@withum.com or at (201) 649 1152.

Regards,

WithumSmith and Brown, PC