Analyzing prospective financial information

The CEIV's impact on financial projections

Many of the national valuation practices have recently adopted, or are currently pursuing, the Certified in Entity and Intangible Valuations (CEIV) credential, its mandatory performance framework[1] (MPF), and the application of the MPF[2] (AMPF). As a result, many finance teams may observe an increase in the scope of work, level of rigor, or amount of documentation pertaining to prospective financial information (PFI) used in financial reporting valuations.

What has changed?

When performing valuations subject to the MPF, appraisers are expected to take a greater level of ownership over the PFI than was typical in the past. Valuation professionals are responsible for evaluating whether PFI provided by management is representative of expected value and properly supported. In addition, an appropriate level of professional skepticism must be applied in the review of the PFI.

Historically, PFI deficiencies have most commonly been addressed through adjustments to the discount rate. However, due to the increased documentation requirements under the MPF, appraisers may need to quantitatively support any company specific risk premiums applied. Since this can be difficult, revising the PFI may be preferable in some cases.

Assessing management's PFI

The MPF states that it is the valuation professional's responsibility to evaluate management's PFI for reasonableness. It also cites examples of factors and procedures to consider when making this assessment, which include:

— Performing mathematical and logic checks;

— Assessing management's forecasting accuracy;

— Reconciling PFI for an underlying asset of a subject entity to the entity's expected cash flows;

— Assessing the frequency in which management prepares PFI;

— Comparing the PFI to the entity's historical trends;

— Comparing the PFI to industry expectations; and

— Checking for internal consistency within the PFI.

If the PFI is determined to be reasonable, the valuation specialist is required to document how this conclusion was reached.

Documentation requirements

For valuations performed under the MPF, substantial documentation is required to support the reasonableness of the PFI. At a minimum, valuation specialists are expected to document the following in their work file, if applicable:

— The steps taken to test the PFI, as described in *Assessing Management's PFI* above, and the related results;

— Identification of the party responsible for the development of the PFI;

— The process used to develop the PFI and how it reflects a market participant's perspective;

— An explanation of the key underlying assumptions used in the PFI;

— An analysis of any evidence that contradicts management's assumptions or conclusions used in the PFI;

— The rationale for any adjustments made to the PFI; and

— Summaries of management interviews and inquiries pertaining to the PFI.

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[1] https://www.appraisers.org/docs/default-source/default-document-library/ceiv_mandatoryperformanceframework_0117.pdf?sfvrsn=538187d7_4

[2] https://www.appraisers.org/docs/default-source/default-document-library/ceiv_mandatoryperformanceframeworkapplication_0117.pdf?sfvrsn=268187d7_4

The assessment and documentation of PFI in accordance with the MPF and AMPF can also be useful to companies in responding to the impacts of the amended requirements of AS 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*, and AS 2110, *Identifying and Assessing Risks of Material Misstatement*.[3]

Impact on management

The level of documentation pertaining to PFI is expected to be more significant under the MPF than what many companies have experienced in the past. To meet these standards, valuation specialists may need to expand upon previous information requests and spend more time discussing the development and support of PFI with management. As these best practices are adopted more broadly by appraisers in their valuations, it is anticipated that many of these elements will also become more common in their review of fair value measurements.

For those companies that already have robust processes around PFI, the impact will be limited to increased time spent documenting key assumptions or providing additional background on the PFI development process. However, other companies with limited finance and FP&A teams may be challenged to sufficiently review, modify, and document the PFI in accordance with the MPF requirements. Therefore, increased reliance on valuation specialists may be required in order to navigate the process.

Given these changes, it is recommended that finance teams discuss the potential impacts on fair value measurements with their valuation provider to minimize future surprises.

[3] An overview of the amended audit requirements and considerations related to how they may impact the responsibilities of auditors and management can be found in *Understanding the Auditing Requirements for Accounting Estimates and the Use of Specialists: Considerations for Auditors and Management*, published by the Center for Audit Quality and Financial Executives International (June 2020).

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Through our industry specialization, we understand the issues, value drivers, leading practices, and trends that shape the future of a particular industry, company, or business problem.

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