Organismo Italiano di Valutazione

July 31, 2012

Sent via email to:VFRcomments@appraisalfoundation.org

Working Group 2 – Customer-Related Assets
Attn: Paula Douglas Seidel
The Appraisal Foundation
1155 15th Street NW, Suite 1111
Washington, DC 20005

RE: Comments on Discussion Draft – The Valuation of Customer-Related Assets

DearSirs/Madams,

Organismo Italiano di Valutazione ("OIV") is pleased to submit to The Appraisal Foundation ("TAF") its comments on the Discussion Draft "The Valuation of Customer-Related Assets".

OIV is the Italian valuation standard setter. OIV is a foundation established by professional associations (chartered accountants and accounting experts, financial analysts, chief administrative and financial officers), Borsa Italiana (the Italian Stock Exchange), Assirevi (the Italian association of independent auditors) and Università Bocconi. OIV intends to advance the dissemination of valuation standards and guidelines consistent with International Valuation Standards ("IVS"). OIV's valuation standards reflect the specificities and peculiarities of the Italian business landscape and its guidelines explore valuation issues related to the most controversial aspects in professional practice in greater detail than the IVSC's Technical Information Papers (TIPs). This is why OIV plays an active role in the valuation debate, such as that fostered by the TAF papers.

In Italy, all banks, insurance firms and listed companies use IAS/IFRSs. As the Discussion Draft ("DD") is intended to be consistent with both a) valuation concepts in the 2011 International Valuation Standards ("IVS") and; b) fair value guidance in IFRS 13, OIV felt that it should participate in the discussion on the document.

<u>OIV discussed the TAF's DD through an ad hoc working group. The working group thought that the DD is well-structured and well-built but excessively tilted toward non-financial companies. In fact, in OIV's experience, the valuation of Customer-Related Assets in the financial sector (banks, insurance companies, asset management firms, among others) takes on certain specific features which should be addressed in the document (e.g. unstable margins due to interest rate volatility, the</u>

way the remaining useful life of customer relationships is estimated, migration of customers from one category of services/products to another, the allocation of customers by class, etc.).
That said, our comments focus solely on the questions contained in the document.

Question 1 page 9 rows 303-305:

Discussion question regarding paragraphs 3.2.9.-3.2.11:
Are there circumstances where the customer contracts and related renewals should be recognized and measured as two separate assets?

Paragraph 3.2.9 of the DD should refer also to IFRS 3 IE27: ”A customer contract and the related customer relationship may represent two distinct intangible assets. Both the useful lives and the pattern in which the economic benefits of the assets are consumed may differ.”
OIV feels that there is no doubt that cases where customer contracts and their likely renewals are considered as a single asset are more frequent. For instance, customer relationships based on non-binding contracts do not differ, in terms of nature and risk profile, from customer relationships that are either not yet covered by contract or non-contractual. In this respect, reference should be made also to example (c) contained in IFRS 3.IE 30.[1]
However, OIV thinks that there might be cases where the renewed customer contract might be considered a different asset from the contract itself, e.g. when such renewed contract is likely to include different terms and conditions (the renewed contract might, for instance, exclude or expand the type of product/service considered, exclude or include binding commitments for the parties, etc.).
Lastly, according to OIV, it might be worthwhile to clarify the relationship between probability-adjusted post-contract expected renewals and attrition rates.

[1] “AC acquires TC in a business combination on 31 December 20X5. TC does business with its customers solely through purchase and sales orders. At 31 December 20X5, TC has a backlog of customer purchase orders from 60 per cent of its customers, all of whom are recurring customers. The other 40 per cent of TC’s customers are also recurring customers. However as of 31 December 20X%, TC has no open purchase orders or other contracts with those customers.
Regardless of whether they are cancellable or not, the purchase orders from 60 per cent of TC’s customers meet the contractual-legal criterion. Additionally, because TC has established its relationship with 60 per cent of its customers through contracts, not only the purchase orders but also TC’s customer relationships meet the contractual-legal criterion. Because TC has a practice of establishing contracts with the remaining 40 per cent of its customers, its relationship with those customers also arises through contractual rights and therefore meets the contractual-legal criterion even though TC does not have contracts with those customers at 31 December 20X5.” [emphasis added]

<u>Question 2 page 22 rows 721-725:</u>

Discussion questions regarding paragraph 5.2.18.-5.2.20:
Should the assessment of economic lives of customer relationships include consideration of post-acquisition efforts and their effect on customer buying patterns, or should very low projected attrition imply very long customer lives in all cases? In other words, should the valuation specialist consider factors other than observed or projected attrition when determining customer lives?

OIV is of the opinion that the answer to this question depends on whether the customer relationship is a PIGA (Primary Income Generating Asset). If it is not, the valuation specialist should <u>always</u> consider factors other than observed or projected attrition in determining the relevant customer life, including when attrition rates are not very low. On the other hand, if the customer relationship is a PIGA, OIV's view is that the remaining customer life will hardly be shortened by other factors.

<u>Question 3 page 23 rows 736-737:</u>

Discussion question regarding paragraph 5.2.21.:
Should migration churn be included in customer attrition calculations?

OIV thinks that migration churn should not be included in customer attrition calculations, even though there might be practical reasons (linked to company information systems) why migration churn cannot be isolated. In addition, according to OIV, migration churn involves customer location as well as, more importantly, changes in the product/service purchased by such customer. Many multi-division companies have "one stop shopping" marketing policies in place, providing the same customer base with the wide range of products and services sold by their different divisions. Customers may change their demand patterns and stop being customers/buyers of division/product X and become customers/buyers of division/product Y. In OIV's experience, this is a frequent occurrence in the financial service sector (banking/insurance).

<u>Question 4 page 33 rows 1004-1011:</u>

Discussion question regarding paragraph 5.4:
What is the most appropriate discount rate for the Without Scenario?

- *A higher discount rate than in the With Scenario*
- *The same discount rate as used in the With Scenario*
- *A lower discount rate than used in the With Scenario*

If a different discount rate is used in the With Scenario and the Without Scenario, what discount rate should be used in the Weighted Average Return on Assets ("WARA") calculation in a business combination?
OIV thinks that the appropriate discount rate for the Without Scenario is the same as that used for the With scenario. The different risks under the two scenarios should be captured entirely by the expected cash flows. Moreover, OIV feels that, in professional practice, the "With and Without" approach is more common in valuing those categories of intangibles (e.g. non-compete covenants) for which it is reasonable to assume that the discount rate (under both scenarios) is equal to the WACC.

Question 5 page 34 rows 1046-1050:

Discussion question regarding paragraph 5.5:
Should contributory asset charges be considered for all contributory assets or only those for which an income stream cannot be readily identified, such as fixed assets, net working capital, or the assembled workforce?

OIV is of the opinion that CAC should be calculated for all contributory assets.

Question 6 page 37 rows 1134-1137:

Discussion questions regarding paragraph 6.2.10:
Should the cost approach be tax-affected (in which case it would be adjusted for a TAB) or not?
If there is more than one type of key input (direct cost, indirect cost, developer's profit, and opportunity cost) reflected in the Cost Approach, does the answer differ for each different input?

In OIV's view, the choice of a tax-affected cost approach should be based on specific facts and circumstances.
In fact, according to OIV, any choice should always show internal consistency. This means that if facts and circumstances require that taxes be considered, costs should be presented on a net basis and then adjusted for a TAB. Alternatively, if facts and circumstances suggest that costs should be

expressed grossed of taxes, no consideration should even be given to a TAB. OIV considers the use of costs inclusive of taxes adjusted for a TAB to be inappropriate.
All key inputs should be treated in a consistent manner, i.e. they should all be presented net of taxes or gross of taxes, depending on the choice deemed appropriate under the circumstances.

Question 7 page 42 rows 1241-1242:

Discussion question regarding paragraph 8.1.7:
Under what circumstances should the Cost Approach be employed to value customer-related assets?

In OIV's experience, the cost approach to value customer relationships is used more frequently by:

1) Companies operating in oligopolies, featuring a stable or declining demand and high competitive pressures (e.g. the telecom industry), where the marginal cost to get a new customer is generally close to the value of the customer as calculated on the basis of an income approach or a market approach. In these sectors, managements typically place a ceiling on subscriber acquisition costs (SAC), such ceiling being the net present value of the benefits expected from new customer relationships (NPV of the marketing investment equal to zero);
2) Companies operating in consolidating industries, where new customer relationships do not generate excess earnings for the target company (given that it is a marginal company) while industry developments are too fast-paced for participants to estimate their own future economic benefits;
3) Companies where organic growth is a feasible alternative to external growth.

Question 8 page 44 rows 1305-1307:

Discussion questions regarding paragraph 9.3.1 to 9.3.6:
Which view do you feel is most appropriate?
What other views exist regarding how to adjust for deferred revenue considerations?

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OIV thinks that the four views do not provide mutually exclusive alternatives: specifically, OIV's opinion is that views A and B should lead to the same results.

That said, OIV regards view D as the most appropriate.

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We hope that this submission is helpful to you. If you have any questions regarding our comments, please do not hesitate to contact Mauro Bini – Chairman of OIV's Management Board (mauro.bini@unibocconi.it) .

Best regards,

Prof. Mauro Bini