

Fair Value for Financial Reporting



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What is Fair Value?



- SFAS 157 definition of FV differs from Fair Market Value (FMV) which valuations specialists have used for over 100 years
- FASB introduced two concepts in its definition of Fair Value
 - Exit Price
 - Market Participants
- SFAS 157 only tells you how to develop FV, not when to use it



- Definition of FMV includes “willing buyer and willing seller”
- SFAS 157 definition only focuses on the selling price, not what your client paid for it
- FASB distrusts what they call “Entity-Specific” costs or values
- So, in an auction you could pay \$30 million for a Picasso, but the FV would only be \$29 million!

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Market Participant



- Because they don't like entity-specific values, what your client paid and what he will do with the asset, FASB requires you to determine what a so-called 'market participant' would pay for the asset and use it for
- Distinguish between Strategic Buyer and a Financial Buyer
- Would use different assets in different ways in a Business Combination
- How do you know who a market participant is?

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Highest and Best Use



- Has to be determined as to how some unknown market participant would use/not use the assets, not determined by the actual buyer
- This does mean that you can value an assembled factory on an in-use premise, if other market participants would do likewise

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Levels of Value



- Level 1 = same asset with current market price --- e.g., 1,000 shares of IBM
- Level 2 = comparable asset with current market price for similar asset(s) --- e.g., GM 7% preferred stock does not trade but have a market for 6.5% and 7.8% GM preferreds
- Level 3 = everything else. We work in Level 3 world

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No Discounts or Premium



- No blockage discount allowed
- No control premium allowed
- No minority discount allowed directly, unless you can validate it as a Level 2

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FASB Definition Caused by Enron



- Enron developed its own derivatives
- Enron valued its own derivatives
- Arthur Andersen passed on Enron's values
- Values were not, and could not have been validated on a exit price basis with real market participants, i.e., Merrill, Bear Stearns, Lehman or Morgan Stanley

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Fair Value Definition Works Only for Financial Instruments



- Usually is a 'market' with 'market participants'
- Recent disruptions in financial services has caused major banks to report 'Level3' values instead of Levels 1 and 2
- Analysts dinged banks – but system works

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Intangibles and PP&E



- SFAS 157 definition of FV does not work well
 - No Market
 - No Market Participants
 - Would not sell them separately from entire business enterprise
 - In a Business Combination exit value makes no sense to value assets just acquired for a specific purpose

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FASB Loves Market Approach



- Distrusts
 - Cost Approach
 - Income Approach
- Does not want 'entity-specific' values
- Remember, Level 1 is Market Approach
- Level 3 is Cost and Income Approach

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Impairment Testing



- Must use SFAS 157 definition of FV even if values put on the Balance Sheet before SFAS 157
- Can not go back and redo
- Three impairment tests
 - PP&E and amortizable intangibles (1st)
 - Non-amortizable intangibles (2nd)
 - Goodwill (last)

Impairment Testing for PP&E



- Determine unit to be tested =
- Smallest group of assets for which cash flows can be determined
 - Can not test one item in an assembly line
- Add up future cash flows for the length of time as the longest lived asset in the group
- Do NOT discount the future cash flows
- If the sum of future cash flows is greater than book value, STOP – there is no impairment

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Determining Fair Value of Impaired PP&E Assets



- If sum of undiscounted cash flows is less than carrying value, must then determine FV of the asset(s)
- Must use SFAS 157 definition of Fair Value
- Write asset value down to the current FV
- Offset is an impairment charge to P&L
- Note: Once written down you can not restore if values subsequently go up

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Determining Fair Value of Impaired Intangibles



- Applies only to intangibles which the company is amortizing
- Same undiscounted cash flow test
- Write down to Fair Value
- Probably should use same methodology as that used when the asset was set up on the books

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Non-Amortized Intangibles



- Usually related only to trade names and licenses
- Must determine current Fair Value at least once a year in accordance with SFAS 157
- Should use same methodology as when set up on the books
- Duplicate Trade Names *may* have “defensive value”

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Testing Goodwill for Impairment



- Must be done once a year, using same methodology as before
- Phase I is to determine the FV of the 'reporting unit'
- Reporting unit = business segment, or one level below
- Must develop a Business Enterprise Value for reporting unit
- Recommend use income and market approach

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When Is Goodwill Impaired?



- Two-phases
- Phase 1 – Determine FV (SFAS 157) of Reporting Unit
 - Suggest you determine BEV through both:
 - Market Approach
 - Income Approach
 - If $FV > \text{Carrying Amount}$ then **STOP**
- Phase 2 – Only performed if $\text{Carrying Amount} > \text{Fair Value}$

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Goodwill Impairment – Phase 2



- Perform the equivalent of a full-scale allocation
- Must determine FV of all identifiable assets
- Even assets not on the books, e.g., Customer Relationships or Trade Name must be valued
- Add up FV of all identifiable assets

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Phase 2 - Continued



- The sum of all identifiable assets is subtracted from Business Enterprise Value as performed in Phase 1
- Residual ($BEV - \sum$ all identifiable assets) equals the NEW goodwill amount
- New Goodwill is subtracted from goodwill now on the books and the difference is the impairment charge

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Phase 2 - Cautions



- If BEV is way above the carrying value the client can do his own testing
- If BEV is below carrying value auditors are probably going to want an outside valuation specialist to do the work
- If BEV is very close to carrying value, say $\pm 3\%$ - 4% , then the valuation itself will be closely scrutinized by auditor

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Business Combinations SFAS 141R



- Lots of changes from SFAS 141 because of application of Board's new Fair Value definition.
- Deal expenses not capitalized – compare PP&E inbound freight and installation
- Day 2 Impairment – Oracle/PeopleSoft
- In-Process R&D capitalized
- Fair Value of liabilities is to be determined

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Exit Price and Market Participants



- Reason deal expenses can't be capitalized
- Reason duplicate customer lists and trade names must be valued even if no use to buyer - examples
- Receivables and inventories – no reserves are allowed
- Asset lives also determined by how long market participants would use

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In-Process R & D



- SFAS 2 says you expense all R&D
- When issued, FASB knew cost did not equal value
- Compare a dry hole in oil field
- Since it was assumed you couldn't really value R&D, easier simply to expense everything

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Before SFAS 141 Maximize R&D



- More R&D expensed, less goodwill to be amortized
- SEC made AICPA develop Practice Aid on valuing In-Process R&D
- Kept expenses down
- Now, with SFAS 157, Board says, “Well you do know how to value IPR&D”
- It is an asset and must be recognized

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Capitalized IPR&D



- Only valued in a business combination
- Lack of consistency between firms
- **Subsequent expenditures on the project continue to be expensed**
- Must test IPR&D for impairment each year at the then current FV
- When project ends, either capitalize or expense

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Valuing Receivables



- Not allowed to carry over the target company's reserves for receivables
- In practice, may simply put all receivables on the books at 98% - 99% of face value
- Provides opportunity for writing down, or writing off, specific receivables that are doubtful

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Valuing Inventory



- This is one area where buyers are going to have an advantage
- Can write down inventory values to Fair Value
- Surplus and obsolete inventory can be retained, but with no charge to P&L
- Currently, if companies want to write down inventories it hits P&L immediately – and have to get rid of the inventory physically

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Customer Relationships



- Who is a Customer?
- What product(s) are they currently buying?
- A single purchase order, even from a year ago, defines a “customer” – Contractual and Legal
- The theory is that the buyer of a company is looking for”
 - Products
 - Customer base
 - Employee base
- Therefore, must value customer base (relationships)

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Multi-Period Excess Earnings



- This is the standard methodology
- Originally developed in AICPA Practice Aid
- Beyond scope of this webinar to go into details
- Best reference is on Pages 162 and 180 in the new book:

“Valuation for Financial Reporting”

By Mard, Hitchner and Hyden (Wiley)

Covenant Not to Compete



- Here the definition of Fair Value helps
- Not all non-compete covenants have significant value
- Have to look at the probabilities that the seller actually would be likely to go back in business after selling to your client
- If low probability, discount should be applied
- Measure by PV of the difference between two projections:
 - With Covenant
 - Without Covenant

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Valuing Trade Names



- Two different approaches
 - Determine incremental sales/gross margin because of the trade name
 - Use the ‘Relief from Royalty’ methodology
- ‘RoyaltySource.com’ is a good data base for comparable royalty rates
- Usually applied to projected revenues for a period equal to that in overall acquisition analysis

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Valuing Software



- Despite FASB's preference for market approach, for self-developed software use a cost approach
 - Estimated number of man hours to replicate
 - Rate per hour
- Life based on facts and circumstances, but hard to support more than about 10 years

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Other Intangibles



- SFAS 141 has some 29 intangibles
- Many are irrelevant – e.g. opera score
- Have to check entire list to make sure you do not miss one. Some common ones:
 - Patents and Technology
 - Favorable/Unfavorable leases and contracts
 - Licenses and Franchise (TV, Network affiliation)
 - Internet Domain Name (URL)

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Tax Amortization Benefit



- See Page 77 of Mard and Hitchner book for explanation and how to do it
- Can not explain why applied to stock purchase where tax attributes carry forward
- Can not explain why not applied to PP&E
- Nevertheless, you must calculate for each intangible

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SFAS 159 – Fair Value Option



- Will discuss if time is available
- Used primarily by banks and financial institutions that have monetary assets and liabilities
- Result is counter-intuitive because the Fair Value of your liabilities goes down when your credit rating declines – In effect, instant income and the worse you do the greater the favorable impact!

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