Fair Value Measurements

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BRCPA A&A Day

November 6, 2008

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Emergence of Fair Value

Why the Move Towards Fair Value?

- Recent waves of mergers and acquisitions were the most active in history
- One of the accounting issues in mergers and acquisitions - “Is the financial reporting of business combinations reflecting market realities?”
- Are the financial statements in business combinations accurately reflecting the value of intangible assets acquired?

Why the Move Towards Fair Value?

Fair Value Accounting in US GAAP is required because of

- Convergence and harmonization with international accounting standards
- The redirection of the FASB to a principles-based approach as demonstrated by the Conceptual Framework Project

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Many Standards Require Fair Value Measurements

- SFAS No. 123
- SFAS No. 133
- SFAS No. 141
- SFAS No. 142
- SFAS No. 143
- SFAS No. 144
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SFAS No. 157 – Fair Value Measurements

SFAS 157 Fair Value Measurements – Effective Dates

- Note: Revised by the FASB on November 14th 2007; Effective for Fiscal Years beginning after November 15, 2007, companies will be required to implement SFAS 157 for financial assets and liabilities, as well as any other assets and liabilities that are carried at fair value on a recurring basis in financial statements.
  - Examples include derivatives, loan-servicing assets and liabilities, and some loans and debt linked to business combinations.
- The board did, however provide a one year deferral (assuming November 15, 2008) for the implementation of Statement 157 for other non-financial assets and liabilities.
  - Examples include non-financial assets and liabilities related to goodwill, business combinations, and discontinued operations.

SFAS No. 157 Learning Objectives

- What are the new Fair Value concepts in SFAS No. 157
- Understand the definition of Fair Value
- Understand the market participants concept
- Be able to distinguish between “in-use” and “exchange” valuation premises
- Be able to determine the Fair Value Hierarchy
- Understand the required disclosures under SFAS No. 157
- FSPs 157-1 and 157-2
- Recent FSP 157-3

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New Concepts in SFAS No. 157

- Statement provides a framework for Fair Value Measurements
- Changes the Definition of Fair Value
- Further elaborated on the concept of Market Participants
- Introduced Principal Market and Most Advantageous Market
- Introduced the concept of Fair Value Hierarchy
- Introduced the concept of defensive value (will discuss in Business Combinations section)

Definition of Fair Value

Fair Value is the *price* that would be received to sell an asset or paid to transfer a liability in an orderly transaction between *market participants* at the measurement date.

Definition of Fair Value

- Generally established on an asset-by-asset and a situation-by-situation basis.
- Always a control value.
- Is not associated with individual assets that include buyer’s synergies. Synergies are included as part of goodwill.
- May include tax amortization benefits.
- Neutral to selling costs.
- Only considers “market participants” in the assumptions.

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Components of the Definition of Fair Value

- Price
- Principle Market
- Market Participants

The Price

- The objective of a fair value measurement is to determine the *price* that would be received to sell the asset or paid to transfer the liability at the measurement date
- The price in the principle or most advantageous market used to measure the fair value of the asset or liability shall *not* be adjusted for transaction costs since they are not an attribute of the asset or liability
- The effect is that ‘deal costs’ are now expensed as opposed to being capitalized

Principle Market

- The market in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity for the asset or liability
- The *most advantageous* market is the market in which the price obtained maximizes the amount received

Principle Market - Example

Orange Company acquires Red Company in a Business Combination. Red has on its balance sheet an investment in common stock of Blue Company which is publicly traded on the NYSE and Toronto Exchanges as follows:

Exchange	Price	Transaction Costs	Net
NYSE	$20	$3	$17
Toronto	$19	$1	$18

What is the fair value of the common stock of Blue?

Principle Market - Answers

- $20, if the principle market is the NYSE.
- $19, if the principle market is the Toronto.
- $19, if neither NYSE nor Toronto is the principal market. (Falls to most advantageous assumption, which does consider transaction costs!)

Market Participants

- Market Participants are buyers and sellers in the principle market that are
  - Independent of the reporting entity
  - Knowledgeable of the asset or liability
  - Able to transact for the asset or liability
  - Willing and motivated to transact for the asset or liability

Market Participants

- Highest and best use must be:
  - Physically possible
  - Legally permissible
  - Financially feasible

What is the highest and best use of a service station in downtown Manhattan?

Valuation Premise Used

- *In-Use* – If the asset would provide maximum value to the market participants principally through its use in combination with other assets as a group
- *In-Exchange* – If the asset would provide maximum value to market participants principally on a stand-alone basis

Fair Value Hierarchy

- Inputs – Assumptions the market participants would use in pricing the asset or liability
- They can be
  - Observable inputs
  - Unobservable inputs

Fair Value Hierarchy

- *Level 1* – Quoted prices in active markets for identical assets or liabilities
- *Level 2* – Inputs other than quoted prices that are observable, either directly or indirectly
- *Level 3* – Unobservable inputs based on best information available in the circumstances

What inputs were used to price sub-prime securities?

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Disclosures

- For assets and liabilities measured on a recurring basis
  - FV at reporting date
  - Level used within the FV hierarchy
  - If Level 3 inputs were used, a reconciliation is required
  - Amount of total gains and losses
  - Annually, the valuation technique(s) used

FSB 157-1

- Excludes leasing transactions from the scope of SFAS 157

FSB 157-2

- Delays implementation date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually)
- Defers effective date to fiscal years beginning after November 15, 2008 and interim periods within those fiscal years

FSB 157-3

- The SEC and FASB issued a joint press release on September 30, 2008 that addresses application of FAS 157 in a market that is not active. This FSP was effective upon issuance.
- In summary, FSB 157-3 addresses:
  - How the reporting entity's own assumptions (i.e. Level 3 inputs) should be considered when measuring FV when relevant observable inputs (i.e. Level 2 inputs) do not exist.
  - How available observable inputs (i.e. Level 2) in a market that is not active should be considered when measuring FV.

Conclusion

- SFAS No. 157 provides
  - Definitions of fair value by defining the price, the principal market and market participants
  - Valuation techniques to be used
  - The fair value hierarchy
  - Required disclosures

Business Combinations

Business Combination Learning Objectives

- Be able to apply the steps to measure fair value in a business combination
- Understand what intangible assets should be recognized in a business combination
- Understand the required disclosures under SFAS No. 141
- Understand the changes under SFAS No. 141R

Steps in Measuring Fair Value

- The application of fair value measurement in a purchase price allocation in a business combination can be thought of as a series of steps.
  - Determine the purchase price
  - Determine the assets to which the purchase price is to be allocated
  - Determine the appropriate methodology and assumptions in estimating the fair value of the individual assets to be allocated to the purchase price

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What Assets are Recognized?

Contractual-Legal and Separability Criteria

- SFAS No. 141 requires that intangible assets be recognized as an asset apart from goodwill and recorded on the balance in a business combination if the intangible assets meets one of two criteria, (1) the contractual – legal criterion or (2) the separability criterion
- The asset arises from contractual or other legal rights (regardless of whether those contractual or legal rights are transferable or separable from the acquired enterprise or from other rights and obligations); or

What Assets are Recognized?

Contractual-Legal and Separability Criteria, cont.

- The asset does not arise from contractual or other legal rights but is separable (capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged, regardless of whether there is an intent to do so); or
- The asset cannot be sold, transferred, licensed, rented, or exchanged individually but can be sold, transferred, licensed, rented, or exchanged with a related contract, asset or liability.

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Examples of Intangible Assets

- Marketing-related intangible assets
  - Trademarks, tradenames
  - Service marks, collective marks, certification marks
  - Trade dress (unique color, shape, or package design)
  - Newspaper mastheads
  - Internet domain names
  - Non-competition agreements
- Customer-related intangible assets
  - Customer lists
  - Order production backlog
  - Customer contracts and related customer relationships
  - Non-contractual customer relationships

Examples of Intangible Assets

- Artistic-related intangible assets
  - Plays, operas, ballets
  - Books, magazines, newspapers, other literary works
  - Musical works such as compositions song lyrics, advertising jingles
  - Pictures, photographs
  - Video, and audiovisual material including motion pictures, music videos, television programs
- Contract-based intangible assets
  - Licensing, royalty, standstill agreements
  - Advertising, contraction, management, service, or supply contracts
  - Lease agreements
  - Construction permits

Examples of Intangible Assets

- Contract-based intangible assets (continued)
  - Franchise agreements
  - Operating and broadcast rights
  - Use rights such as drilling, water, air, mineral, timber cutting, route authorities
  - Servicing contract such as mortgage servicing contracts
  - Employment contracts
- Technology-based intangible assets
  - Patented technology
  - Computer software
  - Unpatented technology
  - Databases, including title plants
  - Trade secrets, such as secret formulas, processes, recipes

Disclosures

- Notes to the financial statements shall disclose
  - The name and a brief description of the acquired entity and the percentage of voting equity interests acquired.
    - The primary reasons for the acquisition, including a description of the factors that contributed to a purchase price that result in recognition of goodwill.
    - The period for which the results of operations of the acquired entity are included in the income statement of the combined entity.
    - The cost of the acquired entity, and if applicable, the number of shares of equity interests (such as common shares, preferred shares of equity interests) issued or issuable, the value assigned to those interests, and the basis for determining that value.

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Disclosures

- Notes to the financial statements shall disclose
  - A condensed balance sheet disclosing the amount assigned to each major asset and liability caption of the acquired entity at the acquisition date.
  - Contingent payments, options, or commitments specified in the acquisition agreement and the accounting treatment that will be followed should any such contingency occur.
  - The amount of the purchased research and development assets acquired and written off in the period and the line item in the income statement in which the amounts written off are aggregated.
  - For any purchase price allocation that has not been finalized, that fact and the reason therefore. In subsequent periods, the nature and amount of any material adjustments made to the initial allocation of the purchase price shall be disclosed.

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Changes under SFAS No. 141R

- Accounting for business combinations will be referred to as the “Acquisition Method” of accounting rather than purchase accounting
- Contingent consideration will be recognized as of the date of the acquisition (i.e. earnouts on performance targets)
- Contingent assets and liabilities will be recorded at their relative fair values (i.e. settlement of lawsuit)
- Deal costs will be expensed
- Requires consideration of ‘defensive’ value
- In process research and development would be recognized as an asset rather than expensed
- Generally effective for acquisitions made after 12/15/2008

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Impairment Testing

Impairment Testing Learning Objectives

- Understand the relationship between FAS 141 Business Combinations and the subsequent testing for impairment of assets recognized under that Statement
- Recognize the differences in testing for impairment of assets under FAS 144 opposed to 142
- Understand the two-step test for impairment of goodwill under FAS 142

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Testing for Subsequent Impairment of Fair Value

- *FASB Statement 141* describes the financial reporting of assets as of the date of a business combination (allocation of purchase price).
- *FASB Statement 142* describes the financial reporting of assets in the years following the business combination – how do goodwill and other indefinite life intangible assets continue to be treated.
- *FASB Statement 144* describes the financial reporting of assets in the years following the business combination – how do identifiable intangible assets subject to amortization continue to be treated.

Testing for Subsequent Impairment of Fair Value

The following chart describes which Statement governs what intangible asset.

	When to test	Standard for Testing
Intangible Assets subject to amortization	If impairment is indicated	SFAS No. 144
Intangible Assets with indefinite lives	Annually and if indicated	SFAS No. 142
Goodwill	Annually and if indicated	SFAS No. 142

SFAS No. 144 – Impairment Testing

- Under SFAS No. 144 long-lived assets are tested for impairment if certain events and circumstances change. Examples of other “triggering events” that may cause the long-lived asset to be tested include:
  - A significant decrease in the market price of a long-lived asset
  - A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition
  - A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator
  - Persistent negative cash flows

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SFAS No. 142 – Impairment Testing

- Under SFAS No. 142 Goodwill is tested annually for impairment or more frequently if certain events and circumstances change. Examples of these “triggering events” include:
  - A significant adverse change in legal factors or in the business climate
  - An adverse action or assessment by a regulator
  - Unanticipated competition
  - A loss of key personnel
  - A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of
  - Recognition of a goodwill impairment loss in the financial statement of a subsidiary that is a component or a reporting unit.

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SFAS No. 142 – Recognition and Measurement of an Impairment Loss

- SFAS No. 142 describes the two-step process to test for impairment of goodwill
    - The first step in testing for impairment of goodwill under SFAS No. 142 is to compare the fair value of a reporting unit to its carrying value as of a predetermined test date.
        - If the fair value is greater than the carrying value, then the goodwill is assumed not to be impaired and no further testing is necessary.
        - If the fair value of the reporting unit is less than its carrying value, then the goodwill may be impaired and a second step of the test is required.

SFAS No. 142 – Recognition and Measurement of an Impairment Loss

- Under the second step, the fair value of all of the assets are determined and allocated to the fair value of the reporting unit as of the test date.
- The residual value of the fair value of the reporting unit less the fair value of all assets tangible and intangible whether or not recorded on the balance sheet as of the testing date is the fair value of the goodwill as of the test date.

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Carrying Value versus Fair Value

- SFAS No. 142 is not specific as to what is meant by the carrying value of the reporting unit.
- Most valuation specialists believe that carrying value is the asset equivalent of invested capital, since both debt and equity holders have an interest in the cash flows of the business.

Reporting Units

- Reporting Unit is the level of reporting at which goodwill is tested for impairment. A reporting unit is an operating segment or one level below an operating segment.
- Operating Segment is a component of an enterprise that engages in business activities from which it may earn revenues an incur expenses.
- An Operating Segment is a component of the enterprise whose operating results are regularly reviewed by the enterprise’s chief operating decision maker and for which discrete financial information is available.

Auditor Responsibilities

Auditor Responsibilities Learning Objectives

- Understand the auditor's responsibility concerning the entity's process for determining fair value measurements
- Understand the standards of fieldwork related to the entity's fair value measurements and disclosures
- Understand how to test management's assumptions, models, and data
- Determine when a valuation specialist is required

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Understanding the Entity's Process

- Controls over the process used to determine fair value measurements
- The expertise and experience of persons determining fair value measurements
- The role IT plays in the process
- The types of transactions requiring fair value measurements
- The extent third parties or experts are used
- The documentation available to support management's assumptions

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Standards of Fieldwork

- Understanding the entity's process for determining fair value measurements and disclosures
- Evaluating conformity to fair value measurements and disclosures with GAAP
- Testing the entity's fair value measurements and disclosures
- Testing management's significant assumptions, the valuation model and underlying data

Testing Management's Assumptions, Model, and Data

- Are assumptions reasonable and reflective of market and industry information?
- Are fair value measurements determined using an appropriate model?
- Did management use relevant information available at the time?
- Do management's assumptions comport to reality? Past and projected?

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Testing Management's Assumptions, Model, and Data

- Perform basic tests:
  - Verifying the source of the data
  - Mathematical re-computation of inputs
  - Reviewing information for internal consistency
  - Developing independent fair value estimates

When to Use a Valuation Specialist

- If the auditor lacks the specialized skill or knowledge required in the engagement
- To gain evidential matter in performing substantive tests to evaluate material financial statement assertions related to fair values
- The use of outside exerts such as a valuation specialist is discussed in the AICPA's Statement of Auditing Standards 73 (SAS 73). SAS 73 defines a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing."

Fair Value Specialists

Consideration in Selecting a Fair Value Specialist

- Professional qualifications, including certifications, license(s), etc.
- Reputation and standing in view of peers
- Specialist’s experience in providing fair value measurement
- Specialist’s familiarity with relevant accounting pronouncements
- Independent and objective

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Who are the specialists - CPA/ABV

- The Accredited in Business Valuation (ABV) is a designation provided by the AICPA for CPAs who regularly perform valuations of businesses and business interests such as intangible assets
- CPA's who are granted the ABV credential by the AICPA meet certain required education and valuation experience levels and have passed a full-day rigorous examination
- The ABV is granted only to licensed CPAs
- The AICPA has specific standards for business valuation specialists (SSVS No. 1, effective 1/1/2008)
- Additional information about the ABV credential can be found on the AICPA's website at www.bvfls.aicpa.org

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Who are the specialists - ASA or AM

- The ASA designation is granted by the American Society of Appraisers (ASA) which is another organization that provides credentials for valuation professionals
- Business valuation specialists are credentialed by the ASA with either an Accredited Senior Appraiser "ASA" or an Accredited Member, "AM" designation
- In order to receive a designation a candidate must have either two years (AM) or five years (ASA) of business valuation experience. Additionally the valuation specialist must pass an examination and work product peer review.
- The ASA also has specific standards for business valuation specialists
- Additional information about the ASA credentials can be found at www.bvappraisers.org

CFA, CVA, IBA, and CBV

- The CFA Institute awards the Charted Financial Analyst designation to investment analysis professionals.
- Other organizations that provide business valuation credentials and standards are the National Association of Certified Valuation Analysts (NACVA) which provides a CVA designation, and the Institute of Business Appraisers (IBA) which provides an IBA designation.
- Valuation specialists in Canada can be credentialed by The Canadian Institute of Chartered Business Valuators which provides the CBV designation.

Valuation Professional Standards and Best Practices

- Professional standards are under the auspices of various credentialing organizations and The Appraisal Foundation.
- In addition to valuation credentials, the valuation specialist should have experience with the fair value measurements in financial reporting. Valuations for financial reporting have particularly unique issues, so a valuation specialist should have experience with valuations for this particular purpose.
- Best Practices are still evolving.
  - FASB's Valuation Resource Group
  - Appraisal Issues Task Force (AITF)
  - Appraisal Foundation's Best Practices Working Group
  - AICPA Fair Value Resource Panel

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Questions, Comments, Etcetera

- AICPA Toolkits – Available on AICPA Website
  - Provides illustrative guidance on audit procedures and considerations related to fair value measurements
  - Provides audit programs and checklists
  - Provides other tools which the auditor and management may find helpful in applying GAAP in fair value measurements

Thank You!

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