

# Fair Value GAAP GAAS Overview

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# Objectives of the Presentation

- Overview of Fair Value Accounting and the Increase Need for Valuations in Financial Reporting
- History of Fair Value Accounting
- Update on the latest GAAP and GAAS pronouncements, including
  - SFAS 157, *Fair Value Measurements*
  - SFAS 141 (r) *Business Combinations*
  - SFAS 159 *Fair Value Option*
  - Proposed FSP FAS142-f *Determination of the Useful Life of Intangible Assets*
- Fair Value Measurement Engagement Process



# The Trends Toward Fair Value Accounting

- The changing economic environment facing business today
  - The Information Revolution
  - Global competition
  - Wall Street “expectations”
  - Complexity of financial transactions
- Trend towards increasing regulation
  - Passage of Sarbanes Oxley Act in 2002
  - The establishment of the PCAOB
  - The focus of the SEC on transparency
- The FASB and IASB Convergence Project
- The FASB’s Conceptual Framework Project
- The implementation of Fair Value Accounting in US GAAP
  - Principles Based Accounting versus Rules Based Accounting



# The FASB and IASB Convergence Project

- The Norwalk Agreement in 2002
- “One single set of high quality, understandable and enforceable global accounting standards”
  - Essentially to bring US GAAP more in line with International Accounting Standards
  - Principles based versus Rules based Accounting
  - Increased recognition of Current (i.e. Fair Value) versus Historical Cost
- Identification of individual differences between IFRS and US GAAP
- Short-term vs. Long-term projects and timelines
  - Example is SFAS 141 ( r) *Business Combinations*



## Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks

- White Paper written November 2006
- Six Elements in the accounting profession particularly related to audits should be addressed:
  - Investor needs for information
  - Roles of various stakeholders
  - The auditing profession
  - A new business reporting model
  - Large, collusive frauds are rare
  - Information is reported and audited pursuant to globally consistent standards

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## Rule Making Bodies that Influence Accounting Standards Such as GAAP

- Financial Accounting Standards Board ( FASB)
- International Accounting Standards Board ( IASB)
- Security and Exchange Commission (SEC)
- Public Company Accounting Oversight Board ( PCAOB)
- American Institute of Certified Public Accountants (AICPA)



# SEC Recent Releases

- Release No. 33-8818, *Acceptance from Foreign Private Issuers of Financial Statements Prepared in Accordance with International Financial Reporting Standards Without Reconciliation to U.S. GAAP* ( Issued July 2, 2007)
  - November 15, 2007 SEC voted unanimously to eliminate reconciliation requirement for foreign issuers.
  - Dual reporting system
  - November 29, 2007 EU Commissioner called on the body to eliminate reconciliation requirement for U.S. GAAP issuers
- Release No. 33-8831, *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards* ( Issued August 7, 2007)
  - Comment Period recently ended
  - AICPA comment letter recommended SEC allow U.S report using IFRS



## SFAS 157 *Fair Value Measurements – Effective Dates*

- *Note: Revised by the FASB on November 14<sup>th</sup> 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 nonfinancial assets and liabilities
  - Examples include nonfinancial assets and liabilities related to goodwill, business combinations, and discontinued operations as well as some non-financial intangible assets.



## SFAS 157 *Fair Value Measurements*

- 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



## 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.

Source : SFAS 157



## Important Concepts in the Definition of Fair Value

- Price
- Principal Market or Most Advantageous 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 ( An exit price)



## Principal Market and Most Advantageous Market

- The market in which the reporting entity would sell the asset or transfer the liability with the greater 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.



## Transaction Costs

- The price in the principal 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
- Note that *transportation costs* maybe ok to include as part of fair value measurements.



# Market Participants

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



# 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:

<u>Exchange</u>	<u>Price</u>	<u>Transaction Costs</u>	<u>Net</u>
NYSE	\$20	\$3	\$17
Toronto	\$19	\$1	\$18

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



# Answers

- \$20, If the principal market is the NYSE.
- \$19, if the principal market is Toronto.
- \$19, if neither NYSE nor Toronto is the principal market. ( Falls to most advantageous assumption)



# Highest and Best Use Concept

- Use must be
  - Physically possible
  - Legally permissible
  - Financially feasible
- The use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used.



## Valuation Premise

- *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



## Example of Market Participant Assumption

	<u>Strategic</u>	<u>Financial</u>
Asset		
A ( Customer list)	\$360	\$300
B ( Technology)	260	200
C ( Trade name)	<u>30</u>	<u>100</u>
Totals	\$650	\$600

What is the fair value of Asset C- trade name?

Appendix A of SFAS 157



## Example of Fair Value of Land Under Highest and Best Use

- Reporting entity acquires land in a business combination.
- Land is currently develop for industrial use as a manufacturing facility.
- Nearby sites have been developed for high rise condominiums.
- Reporting entity determines that the site could be developed for residential use, although it intends to continue its use as a manufacturing facility.

What is the fair value of the land?



## It Depends!

- Highest and Best Use would be determined by comparing:
  - A) the fair value of the manufacturing operation, assuming in use premise – or-
  - B) the value of land vacant for residential use taking into consideration demolition costs.– Fair value is the higher of those values

Appendix A of SFAS 157



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## Example of Fair Value of IPR&D

- Reporting entity acquires IPR& D in a business combination which is does **not** intend to complete since if completed it would compete with its own internally developed project.
- The reporting entity intends to lock up the acquired project. (Defensive value)
- Fair value of the acquired IPR&D is determined based upon the highest and best use by market participants
  - Fair value would be in use if market participants would continue to develop the IPR&D project and maximize the value of a group of assets. Fair value is the price at which the IPR&D could be sold assuming use with a group of other assets.
  - Fair value would be in use, if market participants would lock up the project. Fair value would again be the price at which the IPR&D could be sold. Price may incremental increase in value to existing projects from the lock up.
  - Fair value would be in-exchange if market participants would discontinue development. ( maybe zero)

Appendix A SFAS 157



## Fair Value may not equal the Transaction Price

- Transaction is between related parties
- Transaction occurs under duress or force
- Unit of account represented by the transaction is different from that of the asset or liability
- Market in which the transaction occurs is different from the principal or most advantageous market



## Inputs to Fair Value Measurements

- 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



## SFAS 159 *The Fair Value Option*

- Relates only to certain financial instruments
- All entities can choose to measure eligible items at fair value.
- Resulting unrealized gains and losses will be reflected in earnings
- May be applied instrument by instrument
- Is irrevocable



## Eligible Items for Election Under SFAS 159

- A recognized financial asset or liability
- A firm commitment that would otherwise not be recognized and involved only financial instruments
- A written loan commitment
- The rights and obligations under an insurance contract
- The rights and obligations under a warranty



## Items Not Eligible for Election Under SFAS 159

- An investment in a subsidiary that must be consolidated
- An interest in a VIE that must be consolidated
- Various employer and plan obligations
- Financial assets and liabilities under leases
- Deposit liabilities of banks, loan associations and similar institutions
- Financial instruments that are classified as a component of shareholders' equity



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# SFAS 141r *Business Combinations*

- Under SFAS 141(R), the accounting for business combinations will be referred to as the “Acquisition Method” of accounting rather than purchase accounting. Some of the more salient proposed changes for Business Combinations under SFAS 141(R) are listed as follows:
  - Revised Definition of a Business
  - The Fair Value of the Business Combination will be measured at the fair value of the business acquired. Transaction related costs will be expensed rather than capitalized. Contingent consideration will be recognized as of the date of the acquisition.
  - Assets and liabilities that are of a contingent nature will be recorded at their relative fair values.
  - In process research and development would be recognized as an asset in a business combination rather than expensed under existing accounting treatment.



# Proposed FSP FAS 142-f

Paragraph 11 of SFAS 142 in Determining the Useful Life of an Intangible Asset proposed revision under FSP FAS 142-f:

The entity's own historical experience renewing or extending similar arrangements ( consistent with the intended use of the asset by the entity), regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of that experience, the entity shall consider the assumption that market participants would use about renewal or extensions (consistent with the highest and best use of the asset by market participants.)

# The Fair Value Measurement Engagement Process

Previously auditors relied on the work product of the valuation specialist based upon the specialist's qualifications and experience. While these are obviously still important, auditors and valuation specialists are now held to a higher standard to test the reasonableness of management's assumptions behind the valuation. One such test is to perform sensitivity analysis on management's assumptions that underlie the valuation. Additionally, auditors should understand the methods and assumptions used by valuation specialists and not just rely upon their conclusions.



# Top Ten Do's As a Valuation Specialist in Financial Reporting

1. Understand the financial reporting environment- audit evidence.
2. Read the FASB Statements themselves, including the appendices.
3. Have the appropriate credentials and experience.
4. In planning your engagement, discuss with your client, their auditor and the auditor's valuation team your approaches and methods, including major assumptions.
5. Be independent and objective.
6. Challenge and test management's assumptions.
7. Issue a draft report in a timely manner.
8. Anticipate and be prepared to answer auditor's questions.
9. Keep your client informed about specific valuation issues.
10. Prepare a detailed set of work papers supporting your conclusions.



# Top Ten Don'ts As a Valuation Specialist in Financial Reporting

1. Don't be defensive when questioned about your work product!
2. Don't just cave in to management or auditor's viewpoint. ("What do you want it to be?") Have a well reasoned supportable analysis.
3. Don't just prepare schedules without assumptions being traceable.
4. Don't use a single approach, particularly the cost approach, to estimate the value of certain intangible assets ( i.e. customer relationships) unless you have a really, really, really good reason.
5. Don't use "canned" software.
6. Don't blindly accept management's assumptions ( i.e. PFI without asking questions about those assumptions).
7. Don't assume that management's assumptions are market participant assumptions.
8. Don't assume your calculation of WACC = IRR of investment
9. Don't assume that your Excel spreadsheet foots.
10. Don't leave any "red flags"



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**Questions?**

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