

Valuation Vantage[®]

Insights and Perspectives on Leading Corporate Finance Valuation Issues[®]

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Our Valuation Practice

As a core competency and complement to its mergers & acquisitions practice, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

New SBA Loan Requirements Create Increased Need for Business Valuations

The current adverse market conditions arising from the recent subprime mortgage credit crisis has left a lasting mark on Wall Street, Americans across the country, and major international markets across the world. The crisis may still be far from over as the U.S. government is in

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SEC and FASB Issue Emergency Guidance on Fair Value

On September 30, 2008, in the wake of the current financial crisis and in an unprecedented manner, the SEC released additional guidance to help clarify Fair Value accounting practices, as previously defined by SFAS 157, *Fair Value Measurements*. The FASB followed on October 10, 2008 with FASB Staff Position 157-3 entitled, "Determining the Fair Value of a Financial Asset When the Market for that Asset is Not Active."

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Goodbye GAAP, Get Ready for IFRS

In the past few years, two main accounting issues have marked a historic change in accounting. The first is the movement to Fair Value Accounting, with which most accounting professionals are now familiar. Fair Value accounting has received plenty of press recently as valuing financial securities at potentially overly depressed prices (i.e., valuing securities in a current market versus their expected value over the long-term) has contributed to the market's downward spiral and increased volatility, magnifying the deterioration of value in the entire financial services sector.

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the early stages of executing its \$700 billion rescue package. Additional government restructuring has just begun, as various regulators review and revise the details of their rules and regulations.

The U.S. Small Business Administration (SBA), has recently revised some of its regulations with the issuance of SOP (standard operating procedure) 50 10(5). This particular SOP discusses 7(a) and 504 loan processing, as well as necessary qualifications to become and remain a 7(a) lender or Certified Development Company.

The completely new revisions regarding SOP 50 10(5) were completed on March 20, 2008, with a delayed effective date to allow the possibility of additional updates and reworking. This allowed various parties impacted by SOP 50 10(5) to address any major concerns and/or issues. For three months following the March issuance date, the SBA reviewed and discussed the numerous questions and comments it received, which ultimately resulted in two critical changes:

1. Beginning August 1, 2008, when business acquisition loans (also known as “change of ownership loans” by the SBA) are greater than \$350,000 or if there is a close relationship between the buyer and seller, the lender must obtain an independent business valuation from a qualified source.
2. According to SOP 50 10(5), a “qualified source” is an individual who regularly receives compensation for business valuations and is accredited by a recognized organization. The SOP goes on to list some recognized certifications, which include: 1) Accredited Senior Appraiser (ASA); 2) Certified Business Appraiser (CBA); 3) Accredited in Business Valuation (ABV); and 4) Certified Valuation Analyst (CVA). Another key stipulation is that the lender may not use a business valuation provided by the seller or lender.

There are a few underlying factors as to why the SBA enacted these new regulations. As stated in SOP 50 10(5), “An accurate business valuation is required because the change in ownership will result in new debt unrelated to business operations and create ‘blue sky’ or goodwill. A business valuation assists the lender and the buyer in making the determination that the seller’s asking price is supported by historic operations.”

The new restrictions also will help provide lenders a better estimate regarding the level of risk associated with a particular investment. This in turn will help lenders in their decision-making process and decrease the likelihood of default by small business owners. ♦



“SEC and FASB Issue...” continued from p. 1

As a recap, under SFAS 157, Fair Value is measured with a preference towards observable market inputs, as opposed to unobservable assumptions. SFAS 157 introduces a Fair Value hierarchy that prioritizes the inputs to the valuation techniques used to measure Fair Value, as summarized below:

- Level 1 Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 Inputs include quoted prices for similar assets or liabilities in active markets.
- Level 3 Inputs are unobservable and are developed based upon the best information available under the circumstances, which might include a company’s own data; such inputs should reflect the assumptions from the perspective of an active market participant. This level is intended for use with situations in which there is little, or no market activity for the asset or liability at the measurement date.



With the significant decreases in market activity for collateralize mortgage obligation and other types of mortgage backed securities, as companies recorded the value of the assets at Fair Value based on current market values of similar priced assets, market values tanked. This raised the issue of: When is level 3 data more relevant than level 2 data? When is market-based data not relevant?

Fundamentally, the concept of Fair Value assumes an orderly market between willing market participants. The SEC defines an orderly transaction as one that “involves market participants that are willing to transact and allows for adequate exposure to the market;” the assessment clearly requires judgment.

Likewise, market data from thinly traded or inactive markets may not be indicative of Fair Value. The liquidity of the underlying market for the security must be assessed (see our Summer 2008 edition of Valuation Vantage where we analyzed when thinly-traded stocks can be indicative of Fair Value). Accordingly, when inactive or disorderly markets exist, quoted market prices may not be the most representative of Fair Value. The data may provide assumptions that are useful in measuring Fair Value, but the market information should not be determinative of Fair Value.

The SEC provided specific guidance in determining whether an investment decline can be considered an “other-than-temporary” impairment. Specific factors to consider include:

- The length of time and the extent to which the market value has been less than cost.
- The financial condition and near-term prospects, including any specific events, such as changes in technology that impair the earnings potential of the investment or the discontinuance of a business that may affect the future earnings potential.
- The intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.

Due to the significant level of judgment involved, the SEC requires additional disclosures to clarify the Fair Value assumptions involved in determining values. Stay tuned, the evolution and underlying debate of Fair Value will continue. ♦

“Goodbye GAAP, Get Ready...” continued from p. 1

The second accounting issue of historic proportion is the movement to international accounting standards. The globalization of business and capital markets has created the need for a uniform set of international financial reporting standards. The process began several decades ago, but has been more formally adopted with the creation of the International Financial Reporting Standards (IFRS) by the International Accounting Standards Board (IASB). There has been a push in recent years, specifically by the SEC, for one set of global financial reporting standards and a convergence of U.S. Generally Accepted Accounting Principles (GAAP) and IFRS. More than 12,000 companies in almost a hundred different countries have adopted IFRS.

The worldwide popularity and acceptance of IFRS has a current practical impact on M&A transactions, where international buyers often require the financial statements of U.S. companies to be recasted in accordance with IFRS in order to understand the accounting impact of the potential acquisition.

History and Timetable

One of the initial milestones of GAAP’s convergence with IFRS was a meeting between the IASB and FASB in November 2002 in Norwalk, Connecticut. At that meeting, the Norwalk Agreement was established with the goal of eliminating differences between GAAP and IFRS in order to achieve uniform, high quality, and global financial reporting standards. Just recently in 2008, the SEC issued its proposed roadmap that includes requisite milestones for the continued acceptance and eventual transition to IFRS.

Other countries also are moving toward IFRS. In 2011, Canadian and Indian companies plan to begin using IFRS and Japan plans to eliminate any of its accounting differences with IFRS. By 2013, large U.S. public companies expect to convert to IFRS, at which time all capital markets would be operating under one set of global accounting standards.

Key Differences

It is important to note the differences between GAAP and IFRS, as some significant differences still exist.

Below are a few highlights, as noted recently by the AICPA:

- IFRS does not permit last-in-first-out as an inventory costing method.
- IFRS uses a single-step method for impairment write-downs rather than the two-step method used in U.S. GAAP, making write-downs more likely.
- IFRS has a different probability threshold and measurement objective for contingencies.
- IFRS does not permit curing debt covenant violations after year-end.
- IFRS guidance regarding revenue recognition is less extensive than GAAP and contains relatively little industry-specific instruction.
- The greatest fundamental difference between GAAP and IFRS is that GAAP provides specific rules and guidance, whereas IFRS is more principle-based, thus potentially allowing for less consistency in financial reporting.

Impact on Valuation

GAAP has already transitioned to a Fair Value accounting model. As a matter of fact, much of the impetus behind issuing SFAS 141R, and its predecessor SFAS 141, was FASB’s convergence to IFRS. However, several differences still exist. For example the definition of a reporting unit for goodwill impairment testing is different. IFRS also includes a one-step goodwill impairment test and provides for the opportunity to reverse write-downs. Differences also exist in the valuation of share-based payments and the treatment of internal R&D costs.

In the next several years, the convergence to IFRS will continue and it is likely that everyone around the globe will eventually be using the same set of financial reporting standards. Finance and accounting professionals in the United States who have been using GAAP their entire careers will have to learn a new set of financial reporting standards. The hope is that the “principles” will not be dramatically different from the current accounting foundation; however, there will still be a major adjustment for all involved to become knowledgeable and able to adopt and apply the new set of standards. ♦

Spotlight on Court Cases



Holman v. Commissioner **May 27, 2008**

In this case, the Court significantly decreased the discount for lack of control used for a family limited partnership (FLP) which gifted Dell stock in 1999, 2000, and 2001. The FLP's "lack of professional management" also factored into the Court's conclusion. The Court ruled that the discount for lack of control was too large, especially for the Dell stock gifted in 2001. Also, the Court ruled that the transfer of the Dell stock to the limited partnership one week before the 1999 gift does not constitute an indirect gift of shares since the step transaction doctrine (see *Santa Monica Pictures, LLC v. Commissioner*, T.C. Memo. 2005-104) requires that the formation of the partnership and the gifting occur on the same day for the gift to be considered as indirect. The Court ruled that the gifts of Dell stock in 2000 and 2001 are considered direct gifts. The result is that the discounts for lack of control and marketability can still be applied. However, with regards to Section 2703(a) of the Internal Revenue Code, paragraph 9.3 of section 2703(a) does not apply to the gifts since the gifts did not meet the requirement of a bona fide business arrangement. As a result, restrictions on the rights of a limited partner could be disregarded in calculating the appropriate discounts and the value of the gifts was adjusted upwards.

Fisher v. U.S. **August 6, 2008**

The issue of the case centered around whether a zero cost-basis should be used for the initial value of stock ownership rights granted in Sun Life Assurance Company (Sun Life) to the plaintiff that had experienced demutualization (the conversion of an insurance company with participating policyholders into a public-traded stock company). The Court ruled that using the open transaction doctrine, demutualization has some cost basis since there were several demutualizations in past years according to Sun Life's actuarial report from September 1999. Also, the Court found that "the evidence supports plaintiff's claim that the ownership rights did have value, albeit one that was not derivable."

This case provides additional support for the use of the open transaction doctrine, which can be applicable when it is not possible to estimate the value of either of the assets exchanged. As detailed in *United States v. Davis*, when only one of the assets has an unascertainable value, it is presumed to be of the same worth as the property for which it was exchanged. The IRS concedes that it bore the burden of showing that the open transaction doctrine applied and that the values of the properties exchanged were not ascertainable at the time of the exchange (recited from *Davis v. Commissioner*).

Mirowski v. Commissioner **March 26, 2008**

In this case, the IRS contended that the federal estate taxes paid on gifts to Mirowski Family Ventures, LLC (MFV), an FLP belonging to the estate of Anna Mirowski, were too low. The IRS's main argument was that the FLP was formed shortly before her death. However, the Court ruled that "there was an implied agreement that she retain an interest or a right described in section 2036(a)(1) with respect to the 16 percent interest in MFV that she gave to her daughters' trusts." The Court also found that "that Ms. Mirowski received an interest in MFV proportionate to the value of the assets that she transferred to it on September 1, 5, 6, and 7, 2001. On that record, [the Court] also [found] that Ms. Mirowski's capital account was properly credited with the assets that she transferred to it on September 1, 5, 6, and 7, 2001, and that, in the event of a liquidation and dissolution of MFV, Ms. Mirowski had the right to a distribution of property from MFV in accordance with her capital account." In addition, the Court found that the transfer of some of Ms. Mirowski's interests to the FLP "were bona fide sales for adequate and full consideration in money or money's worth under section 2036(a)." Also, the Court found no specific authority was given to Ms. Mirowski in the operating agreement of MFV. The authority she had as a majority holder of MFV under the operating agreement "did not include the authority to determine the timing and the amount of distributions from MFV where that agreement 'otherwise provided.'" As a result, the Court ruled that the federal estate taxes paid on the gifts given by MFV were appropriate. ♦

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New Seminar: Best Practices in Fair Value Accounting for Financial Reporting

The McLean Group is conducting a new seminar that discusses best practices in Fair Value accounting for Financial Reporting. Senior Managing Director Andy Smith, who was recognized as one of the “Top CPAs” in the Washington, DC area by SmartCEO Magazine, will present the seminar and cover such topics as:

- Fair Value and SFAS 157
- Business Combinations under SFAS 141R (vs. SFAS 141)
- SFAS 142 and 144 Impairment Testing Tips
- Allocating Equity Value Between Preferred and Common Equity
- SFAS 123R Fair Value Considerations

Register: Visit www.mcleanllc.com/seminarscalendar.htm or contact Eric Gins at (703) 827-0998 or egins@mcleanllc.com.

When: December 3, 2008, 8 a.m. - 10 a.m.

Location: Tysons Corner Marriott, 8028 Leesburg Pike, Vienna, VA 22182

Cost: \$45

Recent Valuation Engagements

