

# Valuation Vantage<sup>®</sup>

Insights and Perspectives on Leading Corporate Finance Valuation Issues<sup>®</sup>

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## The McLean Group's Valuation Practice

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

## Congratulations on the Acquisition, but the Accounting Analysis May be Far From Over

*ASC 805, Business Combinations and its Impact on Post-Close Acquisition Accounting*

The parties involved have signed off on the terms and conditions, the stock or asset purchase agreement has been finalized, the consideration has been wired and the closing dinner is done. It appears management is finally nearing the end of the transaction process. The most challenging aspects of the transaction appear to be in the past and it's time to realize those synergies. However, there is one more accounting-related hurdle to overcome: Accounting Standards Codification (ASC) 805, Business Combinations. The Financial Standards Accounting Board's (FASB's) Statement No. 141(R), Business Combinations, now known as ASC 805, introduces the acquisition method of accounting and outlines the requirements for allocating the purchase price as well as valuing acquired intangible assets. Given the dynamic nature of accounting standards and present day deal environments, post-transaction acquisition accounting has become more complex. With management typically focused on due diligence, negotiation and closing, it's also important to consider

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## FASB Changes Goodwill Testing Impairment Guidance

On August 10, 2011, the Financial Accounting Standards Board ("FASB") approved changes to the accounting standard that simplifies how an entity tests for goodwill impairment. An entity will not be required to test for impairment if, after a qualitative assessment, it determines that it is more likely than not (more than 50% likely) that the fair value of a reporting unit is greater than its carrying amount. The new guidance will be added to ASC 350 as paragraphs 350-20-35-3A through 350-20-35-35-3G and is being referred to as "Step 0" analysis.

Conversely, if it is more likely than not (more than 50% likely) that the fair value of a reporting unit is less than its carrying amount, then the two-step goodwill impairment test will need to be performed. It should be noted that a Step 0 assessment is not required and a company may proceed directly to a Step 1 of the goodwill impairment test, if desired.

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## “Congratulations on...” continued from p. 1

what implications the transaction structure will have on post-acquisition accounting, the audit review process, and earnings. Valuing contingent consideration and intangible assets can be particularly difficult and are discussed in more detail below.

### Contingent Consideration

One of the key contributing factors that has made application of ASC 805 more complex is the necessary recognition and measurement (as well as re-measurement for subsequent reporting periods) of contingent consideration (or “earnouts”). Earnouts are one of the most common transaction-related contingencies and calls for the seller to receive additional consideration if certain revenue, profitability, and/or operational milestones are met. Earnouts can play a pivotal role in not only helping close a transaction by bridging the perceived gap in value between involved parties, but also by incentivizing management to ensure that operations continue running smoothly post-closing.

The structure of an earnout can have a profound impact on estimating the Fair Value for purposes of ASC 805, especially in terms of selecting the correct valuation methodology. With earnouts continuing to play a role in acquisitions, their underlying payout structures have become more complicated and, therefore, more difficult to model. Some common earnout structures and accepted valuation methodologies used by specialists to value them include:

- Earnout payments based on a multiple of revenue or profitability, such as EBITDA, that do not include tiers, caps, and/or milestones are typically valued using a **probability-weighted scenario analysis** based on management’s projections.
- Earnout payments dependent upon a multiple of revenue or profitability that include tiers, caps, and/or milestones are commonly valued using a **Monte Carlo simulation**, which take into account the underlying earnout variables, their volatility, and correlation, if any.
- Earnout payments tied to an operational milestone or event, such as a contract win or pharmaceutical drug approval, usually rely on **industry or company-specific experience or metrics** to estimate the Fair Value of the earnout.

Estimating the Fair Value of an earnout for purposes of arriving at the purchase price represents only the first step of accounting for contingent consideration. As an earnout calls for the potential future payment of additional consideration to the sellers, it is recorded as a liability at its estimated Fair Value on the acquirer’s opening balance sheet. Thus, it is necessary to re-measure the contingency at the end of each subsequent reporting period until the contingent liability has been settled. Any subsequent

decrease in the balance of the contingent liability results in a gain being booked on the acquirer’s income statement, while any subsequent increase in the contingent liability results in a loss on the income statement.

### Valuation of Intangible Assets

As a result of a business combination, ASC 805 requires the valuation and recording of acquired intangible assets. There are many instances where more than one intangible asset plays a critical, driving role in operations, as well as, the transaction. In these instances, it becomes more difficult to estimate the separate values of each intangible asset. For example, an acquired entity’s existing customers and developed technology are both essential to generating revenue and profits. Based on the evaluation of facts, it may appear necessary to employ dual income-based approaches, including the application of two multi-period excess earnings methods (MPEEMs). However, recent guidance suggests that two MPEEMs should be avoided, further complicating the valuation process.

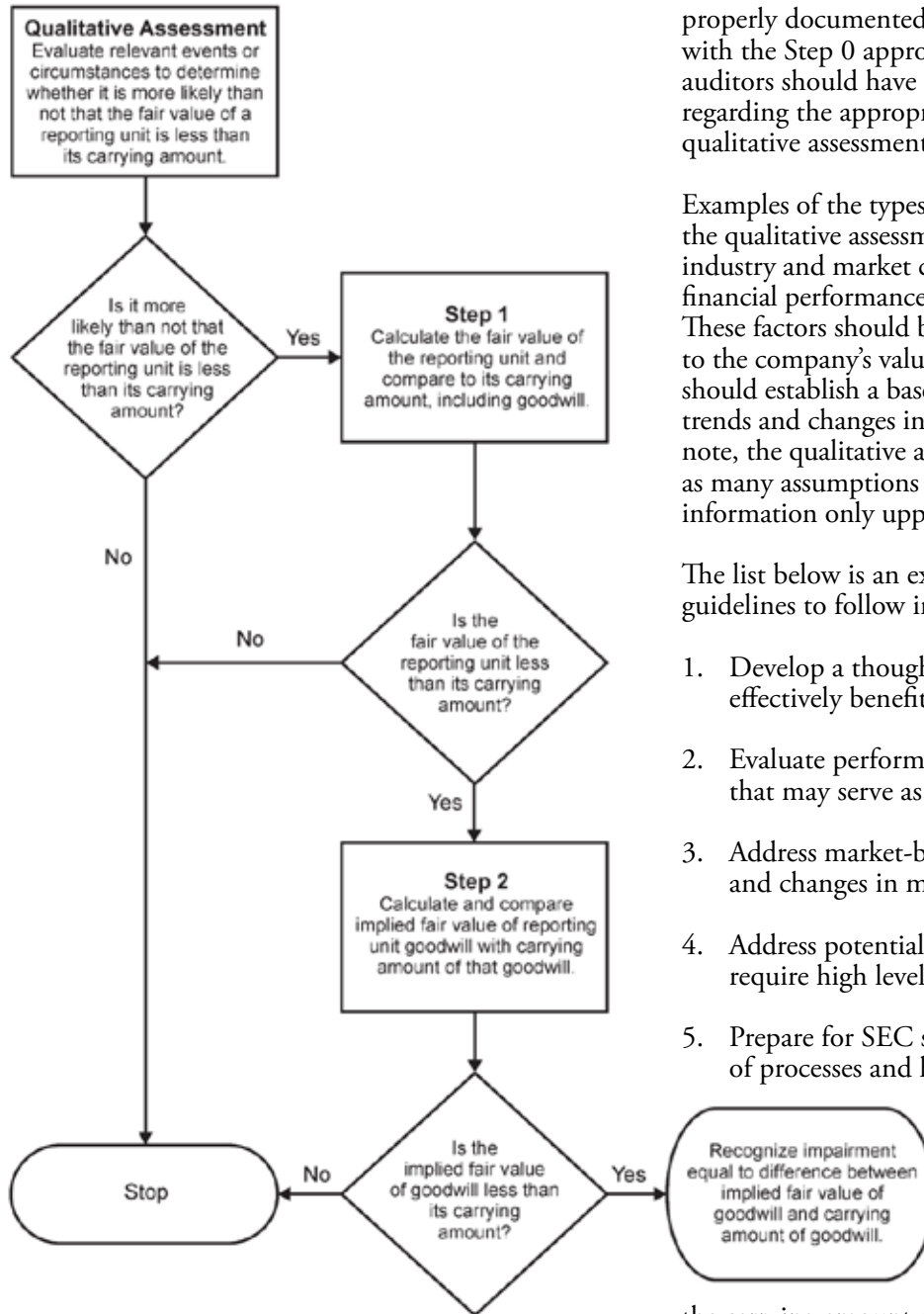
The Appraisal Foundation, a non-profit educational organization dedicated to the advancement of professional valuation and authorized by the US Congress as a source of appraisal standards and appraiser qualifications, issued best practices for The Identification of Contributory Assets and Calculation of Economic Rents in May 2010. This document addresses the complications associated with valuing two primary intangible assets, including the application of two MPEEM approaches. The MPEEM is an income-based methodology that arrives at an intangible asset’s estimated Fair Value by present valuing its projected free cash flows after taking into account contributory assets, such as working capital and fixed assets. Part of the Appraisal Foundation’s guidance calls for the avoidance of relying on two MPEEMs, such as the Hierarchy and Cross Charge methods. To avoid using two MPEEMs, the document suggests relying on an alternative valuation methodology to value one of the two intangible assets, such as:

- Cost-to-Recreate
- Revenue Splitting
- Relief from Royalty
- Combined Valuation

### Post-Transaction Impact

Once management has successfully closed on their target company and negotiations have come to a close, one of the last things they probably want to take part in is a difficult or lengthy audit review process. Engaging a qualified valuation specialist who is well versed and experienced in valuing contingent consideration, as well as a wide range of intangible assets, can drastically reduce the time spent during audit review, particularly in terms of vetting the underlying valuation methodologies and assumptions. This will allow management to remain focused on achieving post-close synergies. ♦

“FASB Changes...” continued from p. 1



properly documented. Also, to mitigate concerns or risks with the Step 0 approach, the company, preparers and auditors should have a discussion early in the process regarding the appropriate factors and metrics to utilize in the qualitative assessment.

Examples of the types of factors that should be considered in the qualitative assessment include macroeconomic conditions, industry and market considerations, cost factors, overall financial performance, and other entity-specific factors. These factors should be weighed in relation to the significance to the company’s value and reporting unit. Also, a company should establish a baseline metric to compare against the trends and changes in the market. It is most important to note, the qualitative assessment must be well documented as many assumptions used in the analysis are based on information only upper level management can provide.

The list below is an example of possible documentation guidelines to follow in performing a Step 0 analysis:

1. Develop a thoughtful process and control structure to effectively benefit from the Step 0 analysis.
2. Evaluate performance since the last fair value analysis that may serve as a baseline metric.
3. Address market-based metrics—especially market trends and changes in market multiples.
4. Address potential multiple reporting unit issues that may require high level reasonableness tests.
5. Prepare for SEC scrutiny by focusing on the disclosure of processes and having high-quality documentation.

The new guidance contains several other changes, including changes to the examples of events and circumstances to be evaluated in determining whether goodwill impairment exists when

the carrying amount of a reporting unit is zero or negative in ASC 350-20-35-8A. Also, the ability to carry forward a prior year fair value of a reporting unit analysis has been eliminated, which was previously allowed in ASC 350-20-35-29.

In addition, the new guidance, under ASC 350-20-50-3, will not require the disclosure of significant unobservable inputs under Level 3 of the fair value hierarchy for fair value measurements related to the financial accounting and reporting for goodwill after its recognition in a business combination.

The final Accounting Standards Update (“ASU”), ASU 2011-08, was issued on September 15, 2011. This update will become effective for annual and interim goodwill impairment tests that take place for fiscal years starting after December 15, 2011. Early adoption of this standard is permitted. ♦

The FASB’s intent of the recently issued guidance was to simplify and reduce the associated costs of performing annual goodwill impairment testing. However, there is a fair amount of uncertainty surrounding the documentation requirements and related costs of performing the qualitative assessment. A qualitative assessment is very subjective and difficult to audit.

Therefore, to efficiently and effectively maximize the benefit of the Step 0 analysis, a company should develop a well-reasoned and thoughtful approach to the qualitative assessment. The recommended approach would incorporate accounting, valuation and auditing standards that are

# Spotlight on Court Cases

## *Palmerino v. Palmerino*

2011 WL 1450359 (Mass. App. Ct.) (April 15, 2011) (unpub.)

The subject of this Massachusetts court case is whether or not an income-based methodology is the sole methodology to rely on for business valuations. In this particular case, a couple that recently filed for divorce disputed the value of the husband's one-third interest in a closely-held business that was founded by his father. Using a net asset approach, a joint expert valued the husband's interest at \$557,000 after applying a 20% discount for lack of control and 20% lack of marketability.

While at trial, the joint expert reversed his application of discounts based on the 2007 Bernier v. Bernier ruling, which dismissed the use of discounts in certain circumstances. Therefore, the joint expert's valuation of the husband's share in the business increased from \$557,000 to approximately \$870,000. Based on these proceedings, the husband was granted a rebuttal for which he hired a secondary expert to value his share in the business.

The rebuttal expert applied an income-based methodology, as opposed to the joint expert's use of the net asset valuation method. Moreover, the income-based methodology was applied on the premise that it is the most accurate and accepted measure of valuing an ongoing business. Based on the income-based methodology and without applying marketability and control discounts, the rebuttal expert determined the value of the husband's share in the business to be approximately \$534,000.

Although income-based approaches, such as the capitalization of earnings, primarily are used to value businesses, the court ignored the rebuttal expert's value and ruled in favor of the net asset approach that was applied by the joint expert. Thus, the Fair Value of the husband's share was approximately \$870,000. While the particular facts and circumstances of this case were all factored into its decision, the court predominately based its ruling on two factors. First, the court determined the original valuation conducted by the joint expert to be reasonable and within the range of evidence at trial. Second, income-based approaches in divorce cases can "often be speculative and therefore a dubious basis" for valuing a business. Hence, as determined by this Massachusetts court, the income-based methodology may be preferred, but it is not the only method for valuing a business. ♦



## Practice Highlights



In August 2011, Brian Sullivan, Managing Director of The McLean Group’s Silicon Valley office, and Andy Smith, Principal of The McLean Group and head of The McLean Valuation Services Group, met with accounting firms in the San Francisco and Silicon Valley areas to present “Best Practices in Fair Value Accounting.”

Leveraging broad experience in business valuation, Andy Smith, authored *An Insider’s Guide to Business Valuation*. The handbook provides board members and executives with a quick reference guide for conducting their business valuations and includes a useful appendix of important questions business owners and fiduciaries should ask when reviewing business valuation reports.



Andy Smith was interviewed on Federal News Radio’s Blueprint for Wealth hosted by Wayne M. Zell of Odin, Feldman & Pittleman, P.C. The show features weekly guests who discuss their business and entrepreneurial secrets and topics including wealth and estate planning, business planning, and tax issues related to small businesses.

## The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers and acquisitions (M&A), corporate finance, market intelligence and business valuation services with bankers in more than 30 US offices. Its affiliate, The McLean Valuation Services Group, performs business valuation services for transaction, financial reporting and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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