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Fair Value Primer for Audit Committees

From The McLean Group

By Andy Smith

With the many challenges facing board of directors, especially audit committee members, one of the more recent skill sets is a needed fluency in fair value. This issue is actually quite historic as in the last twenty plus years, U.S. GAAP has drastically moved from a cost basis balance sheet to one based on fair value. Everything from current assets to fixed assets to even goodwill, intangible assets, and liabilities, should be valued at fair value.

As defined by U.S. GAAP, fair value represents "the amount at which an asset (or liability) can be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale." [1]

Other prevalent standards of value include:

- *Fair Market Value* is a standard well-established by federal statute and case law, and is typically used for tax purposes. It is commonly defined as the cash price at which property would change hands between a hypothetical willing buyer and a hypothetical willing seller, neither being under a compulsion to buy or sell, and both having reasonable knowledge of relevant facts.[2]

- Investment Value is the specific value to a particular investor (or class of investors) based on individual investment analysis and expectations.[3]

From the seat of an audit committee member looking at potential or recent acquisitions, there are three main instances when fair value issues arise:

1. **Purchase Price Allocations**

Under SAS 141 (which is planned to be revised slightly in 2006, stay tuned), acquisitions are accounted for under the purchase method of accounting. In general, when a business is purchased, the acquired current assets, fixed assets, and identifiable intangible assets are recorded at fair value and the remaining difference is allocated to goodwill. The goodwill is not amortized.

The first step in a purchase price allocation is to determine the purchase price, which can be easy if it is a 100% cash acquisition, but if non-cash consideration or contingent consideration is involved, it can be much more difficult. Next, intangible

assets are recognized as separate, stand-alone assets when they can be separately identified and if it arises from contractual or other legal rights, or if not contractual, only if it is capable of being transferred, licensed, rented or exchanged. An assembled workforce is not separately recognized, but it is typically analyzed and valued as part of other calculations.

There are five main types of identifiable intangible assets for U.S. GAAP purposes:

- **Marketing-related** (trademarks, trade names, internet domain names, etc.);
- **Customer-related** (customer contracts, customer relationships, customer lists, etc.);
- **Artistic** (books, plays, magazines, pictures, video material, etc.);
- **Contract-based** (licensing agreements, royalty agreements, franchise rights, etc.); and
- **Technology-based** (patents, computer software, trade secrets, etc.).

In any valuation, especially one of intangible assets, the practical level of precision is often not exacting. On one hand, if the intangible asset is overstated, the accompanying amortization will also be high. On the other hand, if it is low, the exposure to goodwill impairment is greater.

Important questions for Audit Committee members to ask include: Did we identify all intangible assets that an active market participant may value? Which valuation methodologies did management apply? Are the identified and valued intangible assets consistent with the perspectives that originally drove the deal? Also, more companies are performing the purchase price allocation early in the M&A process, in order to perform more of a top down sanity check to valuation to help identify what the company is actually buying.

2. **Goodwill Impairment Testing**

Goodwill is no longer amortized, but subject to specific impairment testing under SFAS 142. In general, goodwill is tested on a reporting unit basis and a two-step test is performed. First, if the fair value of a reporting unit is less than its carrying value, than its goodwill may be impaired. Second, in such instances, all of the intangible assets would be re-valued and a new residual goodwill balance would be determined, the difference in goodwill balances is the impairment.

Goodwill should be formally tested for impairment on an annual basis (more frequently if significant risks exist).

Testing goodwill for impairment applies to all companies, whether public or private, which have goodwill balances. Goodwill impairment testing should be performed annually, but may be performed at any time during the year. For consistency, the

FASB recommends the test to be performed at the same time each year. Different reporting units may be tested at different times during the year, regardless of the fiscal year of the parent company.

The determination of the fair value of a reporting unit can be carried forward from one year to the next if all of the following criteria have been met:

- The reporting unit's assets and liabilities have not changed significantly;
- The recent fair value determination exceeded the reporting unit's carrying amount by a substantial margin; and
- Based on an analysis of the current situation, the likelihood that a current fair value determination would be less than the carrying amount would be remote.

In situations where the fair value of a reporting unit may be reduced below its carrying amount, impairment tests should be performed between annual tests, such situations include:

- A significant adverse change in the business climate;
- Unanticipated competition or loss of key personnel; and
- An expectation that a significant portion of a reporting unit would be sold.

Important questions for Audit Committee members to ask include: When did we test goodwill last? How often do we test it? How close are we to being impaired, that is, at what value does the company have to be for it to be impaired? How are we valuing the company, which methodologies are being used?

3. **Fairness Opinions**

In practice, fairness opinions have been typically used by public companies when they make significant acquisitions and in situations when potential related party conflicts exist. However, regardless of the type of company (public or private), the underlying issue is did the managers of the company exercise their prudent judgment and professional care in spending company assets?

Board members and executive offices have a fiduciary duty to the corporation and its shareholders. In general, fiduciaries have a duty of care and a duty of loyalty to the corporation. This includes the safeguarding of assets and in essence, that the assets are used (and spent) accordingly. Fiduciaries also have an obligation to ensure "fair dealing" and "fair price". Fair dealing is more from a procedural standpoint and fair price is more from a financial point of view.

Fairness opinions are used during material mergers and acquisitions, management buy-outs, recapitalizations, related party transactions, private placements, corporate restructurings, and to comply with loan covenants.

Fairness opinions are letters or other presentations to the board that analyzes a potential, material transaction. The opinion is not just about mitigating risk for the board, but also serves to summarize the transaction and its motives, aid in decision making, and generally enhance the communication revolving around a transaction (to make everyone, from the board to shareholders, educated on the potential transaction).

Obtaining a fairness opinion is an important process, and the value of it is often in the process itself. Drafts should be circulated to board members. The board should play an active role in vetting and analyzing a fairness opinion, not just accepting the report at face value. Final opinions should be dated as of the date of vote by the shareholders or as of closing, often depending on the facts and circumstances of the transaction and legal counsel.

Important questions for Audit Committee members to ask include: Any and all questions – more the better. From personal experience, I have spent days with board members vetting and analyzing every sentence and calculation in a fairness opinion. Board members can't ask enough questions. The Q&A period can be valuable to learn more about the transactions, value drivers, public companies, and valuation methodologies. The more questions the better; the only poor question is the one not asked. Another issue that audit committee members should consider is: does the opinion need to be provided by someone who is clearly independent?

[1]See Appendix F of SFAS 142. The definition of fair value varies depending on the context in which it is applied. For example, a fair value standard of value is often used in dissenting shareholder and shareholder oppression cases and its definition is implied in various state statutes and case law. fair value in dissenting shareholder and shareholder oppression cases has a different meaning than it does in SFAS 142 purposes.

[2]See IRS Revenue Ruling 59-60.

[3]See International Glossary of Business Valuation Terms, American Society of Appraisers.

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