

FAIR VALUE

THE RISE OF THE MARKET PARTICIPANT AND FAIR VALUE ACCOUNTING

Changes made by SFAS 157 and SFAS 141R will have a dramatic effect on how financial accounting is conducted, forcing business valuation specialists to alter current practice methods.

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The discussion on how to best report (and value) a company's assets and liabilities on its financial statements is not a new topic. Over the years, whether from guidance by regulatory authorities or industry practice, financial professionals have employed a wide variety of methods and techniques to reflect a company's financial position. However, in recent years, this topic has been hotly debated, as recent and proposed changes to current practice make a clear break from past methods.

Most notably, in an effort to improve consistency and comparability, the Financial Accounting Standards Board (FASB) and its international counterpart, the International Accounting Standards Board (IASB), are broadening fair value accounting and placing greater weight on market participants in determining value. In September 2006, the FASB released SFAS 157, *Fair Value Measurement*, which provides a framework for measuring fair value and applies across all of GAAP. In June 2005, the FASB released an exposure draft of a revised version of SFAS 141, *Business Combinations* (SFAS 141R) that outlined new guidelines for accounting for business combinations. SFAS 157 is effective for fiscal years beginning after 11/15/07; SFAS 141R, although not anticipated to be in final form until later this year, is expected to be effective for reporting periods beginning on or after 1/1/09.

There has been intense reaction to these changes, ranging from great praise to severe criticism, with most agreeing that there will be a dramatic impact on how financial accounting is conducted. The changes may force key stakeholders, including business valuation specialists, to alter current methods of practice, whether they relate to financing reporting, an acquisition or merger, or general business operations. This article discusses how SFAS 157 and SFAS 141R will change current practice, explores several viewpoints from stakeholders affected by these changes, and examines the implications they may have for the business community, particularly business valuation specialists.

Fair Value as the New Reporting Standard

Since its release in the Fall 2006, SFAS 157 has been a hot topic of discussion for accountants, corporate executives, and valuation specialists. The statement affects more than 40 existing accounting standards, including those used to value stock options (SFAS 123), derivatives (SFAS 133), and financial assets and liabilities (SFAS 159). It seeks to

increase consistency and comparability in fair value measurements. It defines fair value and establishes a framework for measuring fair value according to GAAP. Specifically, it states that fair value is the exchange price that occurs in an orderly transaction between market participants to sell the asset or transfer the liability in the principal or most advantageous market for the asset or liability. The definition focuses on the price in a hypothetical transaction that would be received to sell the asset or paid to transfer the liability (e.g., the exit price) and not the price that would be paid to acquire or received to assume the liability (e.g., the entry price).

Of particular note in SFAS 157 is that fair value is a market-based and not an entity-specific measurement. The standard states that fair value measurements should be based on the assumptions market participants would use in pricing the asset or liability, and further provides guidance of how best to determine the appropriate assumptions that a market participant would use. It establishes a hierarchy that differentiates between assumptions based on observable market participant data and, when little market data is available, assumptions based on management's best understanding of market participants using the best available information at the time. As part of these assumptions, a measurement of fair value must account for all risks and other factors, even those difficult to quantify, that would be considered by a market participant in pricing the asset.

Changes to Acquisition Accounting

Many of the aims of SFAS 141R can be traced to recent efforts by the Board to further the integration of fair value measurements into the balance sheet. To realize this aim, the FASB introduced SFAS 141R as a series of changes to the current practice of business combination accounting that collectively may affect a substantial portion of financial statement users and preparers. As the draft is currently proposed, not being aware of the changes and their implications may prove costly for those affected. A few of the proposed statement's changes that will affect the accounting and business valuation communities will be highlighted, namely fair value vs. cost at acquisition, changes to the post-acquisition balance sheet, and intangible asset valuations.

As reflected by SFAS 157 and current exposure drafts, the FASB has determined that measuring assets and liabilities at fair value is more useful to users of financial statements than using historical costs. The Board has not only broadened the scope of fair value reporting but also drafted guidance to bring consistency to its measurement. As first formalized by SFAS 141, a historical cost-based foundation has guided reporting for business combinations. However, SFAS 141R departs from that standard, of which three changes related to fair value accounting will be noted. These changes will require the acquiror to:

- (1) Expense rather than capitalize acquisition-related expenses.
- (2) Measure and recognize contingent consideration at fair value in the purchase price.
- (3) Value total consideration paid as of the closing date instead of the announcement date.

In addition to relying on fair value more regularly, the proposed statement does not stop at valuing a business combination at deal consummation, but would include significant changes to the post-acquisition balance sheet, including:

- (1) SFAS 141R would require that contingent assets and liabilities that arise from contractual rights or obligations be recognized at their fair values as of the

acquisition date. For acquired contingencies, this will supersede the current standard governing assets and liabilities, SFAS 5, *Accounting for Contingencies*, which precludes the recognition of either in the financial statements until it is likely to occur and its value is reasonably estimable.

(2) Companies will no longer be able to expense acquired in-process research and development (IPR&D), but instead will capitalize it as an indefinite-lived intangible asset subject to impairment testing until the completion or abandonment of the project. When the project is completed, the acquiror will have to make a separate determination of the asset's useful life.

(3) Unless they meet the requirements of SFAS 146, *Accounting for Costs Associated With Exit or Disposal Activities*, and arise from events separate from the business combination itself, restructuring expenses would be expensed at the date they are incurred (and not accrued at the time of the acquisition). The FASB, through the proposed statement, has declared that a business combination does not constitute an assumption of a restructuring liability.

Lastly, the FASB affirms that identifiable intangible assets that can be measured with sufficient reliability should be recognized separately from goodwill and measured at current exchange value (using market participant assumptions) rather than at an entity-specific value. The Board has stated that the final statement will give additional guidance on how to handle situations in which the acquiror does not intend to use an intangible asset for any, or for only a part, of its economic useful life.

Reactions and Debate

Due to the nature of many of the changes relating to fair value accounting and SFAS 141R, great debate was sparked among key stakeholders, which has led to an outpouring of opinions and comment letters, both in support and in opposition. First, as it relates to fair value accounting, proponents argue that it gives users of financial statements a far clearer picture of the economic state of a company. Dissenters, on the other hand, state that fair value may be too difficult to predict reasonably, particularly for a private company or unique asset, and disputes could arise over the very definition of certain assets and liabilities. Even if an estimate is made, they argue, raw historical data will be replaced by accounting estimates, which may be based on insufficient information and introduce bias into the process. Of greater significance, a reliance on fair value may distort a company's approach to deal-making and its capital structure.

Many were opposed to changes in SFAS 141R related to the exclusion of acquisition-related expenses from the purchase price, contending that these costs are an essential component of business acquisitions and that immediately expensing them would inappropriately reduce current period earnings. Consequently, this would overestimate an investment's returns, even though the economic impact of the source of those expenses would continue over time. Others argue that not expensing these costs would create inconsistencies in the treatment of similar assets on a company's books that were not acquired in a business combination. Supporters of the change maintain that the acquisition costs provide no future value to the acquiring company, and therefore should not be recognized as an asset. Others observed that not capitalizing these costs in goodwill will provide an additional cushion against future impairment should the acquired entity not perform as planned—a cushion management will be happy to have should the need arise.

As it relates to the balance sheet and as mentioned above, some argue that the changes and proposed changes would, in fact, create greater discrepancy for preparers. As an example, inconsistencies could be created between how contingent assets and liabilities,

as well as IPR&D, are treated, depending on whether or not they are acquired as part of a business combination or developed in-house. Two otherwise identical companies, one recently acquired and the other not, would recognize identical contingencies or IPR&D differently, thus making comparisons of those companies by investors more difficult. As it may relate to an acquisition, critics state that there is a higher likelihood of an immediate write-off of intangible assets if company management decides not to use a particular asset, even if that asset may be useful from the perspective of a market participant. Defenders of fair value and SFAS 141R state that such concerns may be misplaced, as a write-off may not be required if the overall transaction strengthens the market position of the acquirer and increases the value of the other acquired intangible assets.

Another point of disagreement is the recognition of contingent consideration. Discussion revolves around the ability or inability to measure the consideration reliably in a manner that would prove valuable to financial statement users. Many do not believe that the fair value of such future payments can be estimated with any reasonable certainty or confidence, especially considering that the event on which the payment is contingent was so uncertain as to prevent the two sides of the deal to agree on an amount in the first place. Others, however, agree with the inclusion of the consideration at fair value, arguing that fair value can be reasonably estimated given accurate and relevant data provided by management. Further, they state, in most cases the contingent consideration is already reflected in the final acquisition value of the entity, in the form of a lower purchase price.

Implications

Few in the business community argue that the wide discussion and debate surrounding fair value accounting and business combination accounting will be short-lived. Some stakeholders are not stopping there and are pushing for further changes, stating that all financial decision-making should be based on fair value. Yet, there is concern that the FASB and regulatory agencies are pushing ahead too quickly, without sufficient input from parties who claim that the practicality of implementing these changes may not be cost-beneficial.

Whatever the outcome of these and future changes may be, preparers and users of financial statements will see a difference. Managers' roles will be expanded and further complicated when assimilating information for purposes of financial reporting and making decisions related to an acquisition. Investors, in turn, are likely to exert greater pressure on managers to defend their actions and improve the transparency of the information provided.

For business valuation specialists, the impact is no less significant. Appraisers should possess a firm comprehension of these standards when preparing and issuing valuation opinions in accordance with the most relevant guidance. With such knowledge, valuation specialists have the opportunity to broaden their existing practices and serve their clients in new and meaningful ways, as the need for their skills is expected to increase sharply as a result of these accounting changes. However, valuation specialists should expect to face increased scrutiny from regulatory bodies and company auditors when assessing the reasonableness of their conclusions because these conclusions will now be more frequently relied on by management and industry practitioners.

The rise of fair value and market-based measurement, in which fair value is based on the assumptions that market participants, and not the reporting entity, would use in pricing an asset or liability, is a significant event in the business community. Although still in their early phases, changes are already being seen and will be much more widely felt

once SFAS 157 becomes effective in November and SFAS 141R is finalized later this year. Whether supporting or condemning these changes, all stakeholders need to be aware of and understand their implications for financial reporting and decision-making purposes. A lack of comprehension or poor execution in the application of these changes could lead to needless headaches and, ultimately, undesired financial results.

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