

## **Fair Value, Part Two (aka The Other Shoe)**

New accounting rules related to fair value in 2008 were blamed for everything from the credit freeze to the stock market collapse to Tom Brady's knee injury. The second phase of these rules, effective in 2009, affects how companies account for items such as mergers and acquisitions, goodwill, and impaired real estate.

The first phase of the rules, effective in 2008, related to financial assets and liabilities – stocks and bonds, derivatives such as interest rate swaps, and the like. These rules required that such items, which are typically reported in the financial statements at their fair value, be valued based on what market participants would value them at. It was no longer acceptable for a company to use its own internal model to value an item, without considering what data might be available in the marketplace regarding the value others might place on it.

This year, the rules apply to nonfinancial assets and liabilities. These are typically items that are only reported at fair value in certain circumstances. For example:

- In a merger or acquisition, the assets and liabilities of the acquired company – financial and nonfinancial – are initially measured at their fair value.
- If a current or prior merger involved the recognition of goodwill, management is required to assess the goodwill each year to determine if it is impaired, and thus must be written down. This impairment analysis is done by comparing the fair value of the company (or of the portion of the company to which the goodwill relates) to its book value.
- If a company has reason to believe its real estate or other long-lived assets may be impaired (for example, because they have become damaged, or because they are used to make products that are no longer generating positive cash flow for the company), management is again required to perform an analysis to determine if it is actually impaired, and thus must be written down. If certain conditions are met, this analysis also involves the determination of the fair value of the asset in comparison to its book value.

It has been common practice in the past to employ internal models to perform the fair value analyses required in these situations. However, the new rules, contained in the Financial Accounting Standards Board's Accounting Standards Codification (see separate article), Topic 820, require that you consider how other potential buyers and sellers of these types of assets would value them.

One significant element contained in Topic 820 is the change in focus from entry price to exit price. Think of entry price as the price paid by you to purchase an asset. Exit price is how much you could recoup by re-selling the same asset in the principal (or most advantageous) market. Since most nonfinancial assets and liabilities do not have an active market or exchange to determine value, different approaches are utilized to provide an estimate of the value. These approaches are the cost approach, the market approach, and the income approach.

The asset (or cost) approach estimates value by evaluating what it would cost to recreate the assembly of assets for the company. In practice, this approach is most relevant for holding companies. For operating companies, it is difficult to estimate the intangible value (workforce in place, branding, etc.) without applying one or more of the following approaches.

The market approach looks to transactions of shares in public companies that are similar to the subject company. Multiples are derived from the public companies and compared to the subject company to provide an estimate of value. The market approach also can involve evaluating sales of private companies in the same or similar industry and comparing those ratios and metrics to the subject company. This approach is analogous to determining the sales price of a house by using comparable sales. As with pricing a house, there is as much art as science involved in selecting the appropriate comparables to be used in the analysis.

The income approach measures the future benefits of the assets to the owner. A benefit stream, usually some form of cash flow, is determined and then discounted back to a present value. This approach takes into consideration the time value of money, a dollar today is more valuable than a dollar tomorrow, and the potential to earn a return on an investment, which is the common motivation for owning a business. The estimate of value is a function of the future benefits divided by the risk inherent in achieving that level of performance.

In today's economy, we have seen many companies estimating that future cash flow will be reduced. The cost of borrowing money has also increased. These two factors have a compound effect on the value of companies, causing rapid declines in value. This drop in value may lead to a determination that goodwill has been impaired, requiring the intangible value of the company to be written down.

If your company is in this situation, this may be an ideal time to address estate planning. Since the lifetime gifting exclusions are based on dollars, a greater portion of the overall value may be able to be transferred.

*Have questions? Please contact Tracy Harding ([tharding@bdmp.com](mailto:tharding@bdmp.com)) for more information.*