

Lemons to Lemonade: *Squeezing Value from Mandatory Valuation Engagements*

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ADAMS
CAPITAL
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VALUATION
SERVICES



David P. Adams III

- ◆ Founded Adams Capital, Inc. in 1996
- ◆ M.B.A. Georgia State University
- ◆ B.S.M.E. Georgia Institute of Technology
- ◆ Professional accreditations: CPA, ABV, ASA
- ◆ Over 20 years of testimony experience

David G. Moser

- ◆ Director of Business Valuation
- ◆ B.S. Civil Engineering, Milwaukee Institute of Technology
- ◆ Professional accreditation: ASA
- ◆ Over 40 years of business valuation experience

- ◆ Independent, third party valuation firm
- ◆ We solve problems where valuation matters
 - Accounting compliance
 - Tax compliance
 - Transaction advisory services
 - Dispute resolution
- ◆ Experience with over 3,000 transactions



FAIR MARKET VALUE

If appraisers know what everything is worth, why aren't they all gazillionaires?

The Appraisers' Full Employment Act

- ◆ Purchase Price Allocation (ASC 805)
- ◆ Goodwill Impairment Testing (ASC 350)
- ◆ Stock Option Expensing (ASC 718)
- ◆ Hedging Instruments (ASC 815)
- ◆ Impairment or Disposal of Long-Lived Assets (ASC 360)
- ◆ Estate and Gift Taxes
- ◆ C to S Corporate Conversions
- ◆ Fairness Opinions
- ◆ Collateral Assessment
- ◆ ESOP Updates

The Bottom Line

- ◆ You wouldn't hire an appraisal firm for 90% of these assignments unless required to
- ◆ There is (or ought to be) hidden nuggets of valuable business intelligence contained in the valuation report



MANDATORY VALUATIONS

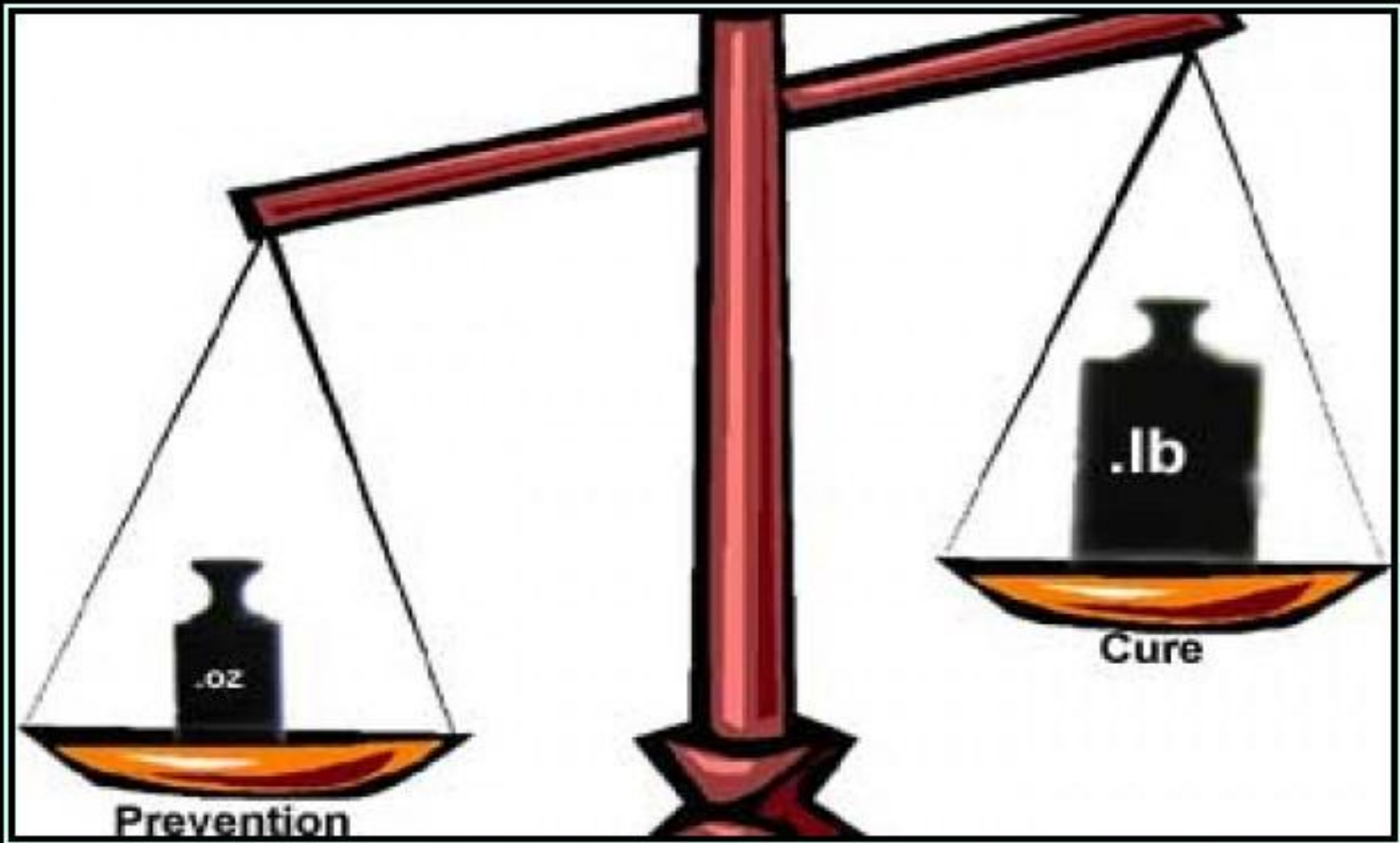
They're for your own good.

Assumptions

- ◆ The company's business thinking is value-driven
- ◆ Departments and business units talk to each other and culture encourages sharing of information
- ◆ You feel as though an appraisal is almost a FASB-imposed tax

Putting “Value” Back in Valuations

- ◆ Good appraisals contain useful information and analysis
 - Intangible asset value
 - Market intelligence
 - Financial market intelligence
- ◆ Appraisers can be consulted in advance of key transactions to enable audit and tax planning



PREVENTION

Sure I can prevent disaster with a little effort now,
but doing nothing is so much easier

General Advice

- ◆ Read the report carefully and make sure you understand the entire report
- ◆ Ask questions
- ◆ Ask for an oral walkthrough
- ◆ Understand origin of key assumptions
- ◆ How much of value composition is under your control vs. a market response?
- ◆ Consider getting appraiser involved preemptively

FAIR VALUE ACCOUNTING VALUATIONS

Summary

- ◆ **ASC 820 defines *fair value*** as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”
- ◆ **The standard does not require fair values** to be used in any situations not already covered by GAAP that existed when it was issued.
- ◆ **The “Fair Value Hierarchy” is the central component** of ASC 820. The board identifies an order of preference (Level 1, Level 2 or Level 3 *inputs*) that management must apply in estimating the fair values of assets or liabilities.
- ◆ **The standard establishes disclosure requirements** that reveal to financial statement users how the fair value estimates were produced because varying degrees of precision result from using different kinds of inputs.
- ◆ **ASC 820 is effective** for annual statements for fiscal years beginning after Nov. 15, 2007, and for interim reports prepared in that initial fiscal year

- ◆ *The fair value of an asset... is the amount at which that asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale.*
- ◆ Physical Assets
- ◆ Intangible Assets
 - Marketing-related
 - Customer-related
 - Artistic-related
 - Contract-based
 - Technology-based



ASC 805 Nuggets

- ◆ Marketing-related
 - Set licensing agreement fee structures and royalty rates
 - Provide data for future acquisitions
 - Set benchmarks for marketing return on investment (ROI)
- ◆ Customer-related
 - Order backlog can be used for credit financing
- ◆ Artistic-related intangible assets
 - Set licensing agreement fee structures and royalty rates. Can also guide potential litigation strategy
- ◆ Contract-based
 - Set buy-out thresholds, set litigation policy
- ◆ Technology-related
 - Set licensing agreement fee structures and royalty rates
 - Provide data for future acquisitions
 - Set benchmarks for marketing return on investment (ROI)
 - Estimate damages in litigation scenarios

- ◆ Engage your appraiser before you conclude an acquisition to understand what the allocation of purchase price to assets and goodwill is likely to be
 - Understand the likely goodwill allocation beforehand
 - Identify key risk factors that might lead to an impairment in the near future
 - “Free” due diligence

- ◆ Goodwill must be tested for impairment annually or when an indicator of impairment exists at the reporting unit level
 - Determine which reporting units contain more value, and which assets contribute more value to the reporting unit
 - Can value-generating activities of more valuable units be replicated?
 - Understand why goodwill is impaired – what deviated from the plan?
 - Is source of impairment localized or systematic?
 - Early updates can provide impairment warnings



GOODWILL

I can't use it, I can't sell it, I can't borrow against it, and it doesn't even cost any real money. But I need to pay \$20K a year to measure it.

- ◆ Requires expensing employee stock options at fair market value on date of issue
- ◆ Particularly challenging for complex capital structures
- ◆ AICPA has detailed guidelines for the appropriate value treatment of employee stock options of privately held companies
- ◆ Generally can be repurposed for IRS Code 409A compliance



STOCK OPTIONS

What do you mean, you'd rather just take the cash?

- ◆ Periodic valuation of the Company is a useful market signal to management and shareholders
 - Value drivers even more important – *how can the company be worth more?*
- ◆ Value allocation to common shares is also a helpful market signal
- ◆ Expense of options can and should be known before options are granted
- ◆ Valuation of warrants should also be helpful

- ◆ Covers hedging instruments that respond to
 - Changes in the value of the hedged asset (fair value hedge)
 - Changes in the exchange rates involved in currency hedges
 - Changes in cash flows associated with financial hedges, such as swaps, options



DERIVATIVES MODELS

My financial adviser says these hedges are a good investment.

ASC 815 Nuggets

- ◆ Understand if changes in value are temporary or long-term
- ◆ Understand full extent of downside risk
- ◆ Test risk management policies in a simulation
- ◆ Before changing hedging policy, determine whether policy will meet the Hedge Effectiveness criteria for hedge accounting

◆ Covers

- Assets to be held for continued use
- Assets to be sold
- Assets to be disposed of in a manner other than sale



ASSET DISPOSAL

We're preparing for an orderly disposition of certain, non-core assets.

ASC 360 Nuggets

- ◆ Valuation should give a good idea of what the sale price should be
- ◆ Analysis should contain information regarding how to make the asset worth more
 - Ask!
- ◆ If a fairness opinion is required, ASC 360 valuation should make the work easier and cheaper
- ◆ Can help optimize insurance

TRANSACTION, TAX AND REGULATORY VALUATIONS

Definition of Fair Market Value

From IRS Revenue Ruling 59-60:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of **relevant facts**.

Value: What Someone is Willing to Pay?

- ◆ Who is “someone” and what are their circumstances?
 - Free to decide to buy/sell or not to buy/sell?
 - Is the asset made available to many buyers?
 - Could the buyer flip the asset at the same price quickly?
 - What was the second highest bid?
 - Is the buyer knowledgeable and privy to all relevant facts?
 - Were the terms of sale all cash?
 - Are non-financial drivers at work?

Does Value Equal Price?



Google Inc.
GOOG



Estate and Gift Taxes

- ◆ Appraisals for other purposes may be helpful for estate planning/estate tax compliance
 - Repurposing not allowed
 - Use different assumptions and different standard of value
- ◆ For large positions
- ◆ Lots of attention paid to restricted stock holdings

Fairness Opinions

- ◆ Because of liability and SEC accountability, the highest standard of value
 - SEC mainly looking to make sure non-controlling shareholders are not oppressed
- ◆ Lay the groundwork beforehand
- ◆ Can be used to optimize deal structuring from a shareholder value standpoint
- ◆ Even if deal doesn't go through, repurposing is straightforward



FAIRNESS OPINION

Don't make me come out there and show you what I mean by "fair".

C to S Corporate Conversions

- ◆ Appraisals for other purposes may be helpful for C to S conversion
 - Repurposing not allowed
 - Use different assumptions and different standard of value
- ◆ Information can be useful when planning for sale
- ◆ Can be a starting point for other valuation needs

Collateral Assessment

- ◆ Can reveal alternative financing options
 - Sale/leaseback
- ◆ Can help optimize insurance
- ◆ Can be used for write-downs
- ◆ Can be used to build a case for new equipment purchases



COLLATERAL

Your good name is your collateral. Oh, and your kneecaps too.

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Employee Stock Ownership Plans

- ◆ Fall under ERISA jurisdiction
- ◆ Annual updates required
- ◆ Can be an outstanding planning and management measurement tool
 - Cite sources of value
 - How can company value be increased?

Reducing Fees

- Ask for a fixed fee
- Have clear data, especially financial data
- Have electronic data
- Don't wait till the last minute
- Use the same firm but keep it competitive
- Dangle the prospect of future business
- Negotiate update fees up-front and try to bundle prices



Summary Thoughts

- ◆ There's value in mandatory valuation reports
 - Read the report thoroughly
 - Pay particular attention to assumptions
 - Ask questions
 - See if market and economic research might be useful
- ◆ You're missing many value-adding opportunities if you wait until the audit process to start an appraisal process

Thanks!
Questions or
Comments?

