

Auditor's Approach to Fair Value

Presentation to LCPA-New Orleans
Chapter

January 25, 2005

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Fair Is Fair

Major accounting standards in which fair value plays a prominent role for initial recognition or ongoing valuation.

- FAS 115-Valuing equity and debt investments (Mark to market) 1993
- FAS 123-Stock-option accounting 2004 revised
- FAS 133-Hedging derivatives 1998
- FAS 141-Business combinations 2001
- FAS 142-Purchased intangibles 2001
- FAS 143-Asset retirement obligations 2001
- Interpretation 45 (affects FAS 5, 57, and 107)-Guarantees 2002

Fair Value vs Historical Cost

- Relevance vs. Reliability
- Comparability vs. Consistency

Fair Value Arguments

- Improves comparability
- Provides information about benefits expected from assets and burdens imposed by liabilities under current economic conditions.
- Reflects effect on entity performance of management's decisions to continue to hold assets or owe liabilities, as well as decisions to acquire or sell assets and to incur or settle liabilities.
- Reports gains and losses from price changes when they occur.
- Easily reflects the effects of most risk-management strategies.

Historical Cost Arguments

- Fair value Impairs comparability
- Fair value requires current market prices to determine reported amounts, which may require estimation and can lead to reliability problems.
Provides information about benefits expected from assets and burdens imposed by liabilities under the economic conditions *when they were acquired or incurred*.
- Reflects effect on entity performance only of decisions to acquire or sell assets or to incur or settle liabilities. Ignores effects of decisions to continue to hold or to owe.
- Reports gains and losses from price changes only when they are realized by sale or settlement, even though sale or settlement is not the event that caused the gain or loss.
- Reported amounts can be computed based on internally available information about prices in past transactions, without reference to outside market data.

Fair Value

The amount at which an asset (or liability) could be exchanged in a current transaction between unrelated, knowledgeable and willing parties.

Fair Value vs. Fair Market Value

- FASB believes that the measurement objectives are essentially the same.
- FMV has a large body of interpretive case law developed in the context of tax regs. This does not apply in the context of financial reporting

Overview

- Statement on Auditing Standards (SAS) No. 101 *Auditing Fair Value Measurements and Disclosures*
- Statement on Auditing Standards (SAS) No. 73 *Using the Work of a Specialist*
- FASB Exposure Draft on Fair Value Measurements, issued June 23, 2004
- Statement of Financial Accounting Standards (FAS) No. 123 (revised) *Share-Based Payment—FAS 123r*
- FASB Interpretation (FIN) No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FIN 45
- Statement of Financial Accounting Standards (FAS) No. 141 *Business Combinations*
FAS 141
- Statement of Financial Accounting Standards (FAS) No. 142 *Goodwill and Other Intangible Assets* FAS 142
- Statement of Financial Accounting Standards (FAS) No. 143 *Accounting for Asset Retirement Obligations* FAS 143

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

1. Obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.
2. Evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP.
3. Evaluate managements intent and ability to carry out specific courses of action where relevant to the use of fair value measurements and disclosures, the related requirements involving presentation and disclosures, and how changes in fair values are reported in financial statements. The auditor also should evaluate management's ability to carry out those courses of action.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

4. Evaluate whether the entity's method of measurement is appropriate (this requirement applies when there are no observable market prices and the entity estimates fair value using a valuation method).
5. Evaluate whether the entity's fair value measurements are applied consistently.
6. Consider whether to engage a specialist and use the work of that specialist as evidential matter in performing tests to evaluate material financial statement assertions.
7. Determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Under SAS 101 the auditor's tests involve

- Testing management's significant assumptions, the valuation model, and the underlying data;
- Developing independent fair value measurements for corroborative purposes; and
- Examine subsequent events that confirm or disconfirm the estimate.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

When testing management's assumptions auditors should evaluate whether:

- Management's assumptions are reasonable and reflect, or are not inconsistent with, market information;
- The fair value measurement was determined using an appropriate model, if applicable; and
- Management used relevant information that was reasonably available at the time.

These tests apply even when the fair value estimate is made by a valuation specialist.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Understanding the Fair Value Measurement Process

- Controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role that information technology has in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from nonroutine or unusual transactions).

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Understanding the Fair Value Measurement Process

- The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. SAS No. 70, *Service Organizations* applies.
- The significant management assumptions used in determining fair value.
- The documentation supporting management's assumptions.
- The process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Understanding the Fair Value Measurement Process

- The process used to monitor changes in management's assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness, and reliability of the data used in valuation models.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Understanding the Fair Value Measurement Process

- The nature, extent and timing of audit procedures will increase as the requirements for fair value measurements become more complex
- As fair value determinations involve subjective judgments by management, this may affect the nature of controls that are capable of being implemented, including management override of controls

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Are fair value measurements in conformity with GAAP?

- Auditor should rely on knowledge of the business and the industry
- This is particularly true when dealing with the valuation of complex financial instruments or intangible assets that may require company or industry specific knowledge.
 - FCC Licenses
 - Healthcare Certificates of Need
 - Core Deposits of Financial Institutions
 - Trade Secrets

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Are fair value measurements in conformity with GAAP?

- Management's intent and ability to carry out specific courses of action insofar as it is relevant to fair value measurements
 - Discounted Cash Flow Model
 - Lattice, Monte Carlo or other form of probabilistic derivatives pricing model
- Auditors should also assess the following:
 - Management's history of carrying out its stated intentions with respect to assets or liabilities.
 - Reviewing written plans and other documentation, including, where applicable, budgets, minutes, and other such items.
 - Management's stated reasons for choosing a particular course of action.
 - Management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Are fair value measurements in conformity with GAAP?

- When there are no observable market prices and the entity estimates fair value using a valuation method, auditors should consider:
 - Management has sufficiently evaluated and appropriately applied the criteria, if any, provided by GAAP to support the selected method.
 - The valuation method is appropriate in the circumstances given the nature of the item being valued.
 - The valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.
- Auditors should also consider whether an entity's method for determining fair value is applied consistently and whether changes in the environment and circumstances warrant a change in valuation method.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Are fair value measurements in conformity with GAAP?

Auditors should also consider subsequent events and transactions that may provide evidence of fair value as of the balance sheet date

- Transactions in marketable securities
- Transactions in intangible assets
- Merger or acquisition transactions
- Transactions in the entity's stock, options, debt or derivative securities
- Transactions in restricted securities

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Are fair value measurements in conformity with GAAP?

Other Considerations

- Valuation date versus balance sheet date—If working from an appraisal that differs from the balance sheet date, has there been a material change in the fair value since the date of the appraisal?
- Assets pledged as collateral—Auditors should obtain evidence regarding the existence, value, rights, and access to or transferability of such collateral, whether liens have been filed, and whether appropriate disclosures about the collateral have been made
- Inspection of the asset—For example, are there any restrictions on a security that would restrict its marketability?

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Testing Independent Fair Value Estimates for Corroborative Purposes

- The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement.
 - Test option pricing using an option pricing model with differing input assumptions
 - Test discounted cash flow models using differing input assumptions

Statement on Auditing Standards (SAS) No. 101 *Auditing Fair Value Measurements and Disclosures*

Engaging a Valuation Specialist (SAS 73)

- A specialist is a person with a special skill or knowledge in a particular field other than accounting or auditing.
- The specialist may be either engaged by the client or by the auditor, or employed by the audit firm* or the client.

* Sarbanes-Oxley Act prohibits a public company's audit firm from providing valuation services for financial disclosures.

Statement on Auditing Standards (SAS) No. 101

Auditing Fair Value Measurements and Disclosures

Evaluating the Qualifications of a Specialist (SAS 73)

- The professional certification, license, or other recognition of competence in the specialist's field, as appropriate
 - Accredited Senior Appraiser (ASA)
 - Chartered Financial Analyst (CFA)
 - Accredited in Business Valuation (ABV)
 - Others
- The reputation and standing in the views of the specialist's peers and others familiar with the specialist's capability or performance
- The specialist's experience in the type of work under consideration

Statement on Auditing Standards (SAS) No. 101 *Auditing Fair Value Measurements and Disclosures*

Evaluating the Relationship between the Client and Specialist (SAS 73)

- Auditor must assess circumstances that would impair the objectivity of the specialist
 - Can the client directly or indirectly control the specialist?
 - Is the client related to the specialist by way of employment, ownership, contractual right or family relationship?
- A specialist does not need to be independent of the client, only objective

Statement on Auditing Standards (SAS) No. 101 *Auditing Fair Value Measurements and Disclosures*

Evaluating the Reliability of the Source Data Used by the Specialist (SAS 73)

- Make inquiries of the specialist to determine whether the specialist is satisfied as to the accuracy of the source data
- Identify and conduct tests of the data transmitted
- Consider the relevance and reliability of the data provided to the specialist

Statement on Auditing Standards (SAS) No. 101 *Auditing Fair Value Measurements and Disclosures*

Communication with the Audit Committee (SAS 61)

SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), requires auditors to determine that certain matters related to the conduct of an audit are communicated to audit committees. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Proposed Statement of Financial Accounting Standards-Fair Value Measurements-Exposure Draft June 23, 2004

FASB's exposure draft, "Fair Value Measurements," aims to set up a framework for measuring fair value that would apply broadly to financial and non-financial assets and liabilities. The guidance would boost "the consistency, comparability, and reliability" available in its current measurements

Timing

- September 7, 2004-Comment period closed
- November 10, 2004-The Board decided to proceed with its plans to issue a final Statement to provide needed guidance for applying the fair value measurement requirements of existing pronouncements.
- Effective Date-Fiscal years beginning after June 15, 2005 and interim periods

Specific Issues

1. Definition of fair value
2. Valuation techniques
3. Active Markets
4. Valuation Premise
5. Fair value hierarchy
6. Level 1 Reference market
7. Pricing in Active Dealer Markets
8. Measurement of Blocks
9. Level 3 Estimates
10. Restricted Securities
11. Disclosure and Effective Date

Fair Value Hierarchy

- Level 1-Market inputs that reflect quoted prices in active markets for identical assets and liabilities
- Level 2-Quoted prices for similar assets or liabilities in active markets, adjusted as appropriate for differences
- Level 3-Multiple valuation techniques consistent with the market, income and cost approaches. May require the use of significant entity inputs derived from an entity's own internal estimates and assumptions.

Disclosure

Recurring-

- Fair value amount at end of period
- How fair value was determined
- Effect of the remeasurement on earnings

Nonrecurring

- Reason for the remeasurement
- Other disclosures same as recurring

FAS 123r—Fair Value Issues

- Equity compensation grants are to be measured at fair value on the grant date
- Service or performance based restrictions placed on the equity instrument prior to the vesting date are not to be considered in the fair value
- Restrictions placed on the equity instrument after the vesting date are to be considered in the fair value

FAS 123r *Share-Based Payment*

Grants of Stock

- The fair value should not include the impact of vesting restrictions placed on the stock or any other restrictions placed on the stock prior to vesting
- The fair value can take into account the impact of post-vesting restrictions

FAS 123r *Share-Based Payment*

Grants of Options

- Observable market prices of identical or similar equity instruments
- Option Pricing Models
 - Closed Form Models (for example Black-Scholes)
 - Lattice Models (for example Binomial) which should be used as a tool to estimate the options' expected term

FAS 123r *Share-Based Payment*

- Option Pricing Models
 - Classify by how employees are expected to exercise their options
 - Expected Life Based
 - Black-Scholes, Cox-Ross-Rubinstein Binomial
 - Exercise Factor Based
 - Hull-White, other forms of models that utilize a suboptimal exercise factor as an input assumption

FAS 123r *Share-Based Payment*

Expected Life Based

- What are the input assumptions necessary to use the model?
 - Stock Price
 - Exercise Price
 - Risk-Free Rate
 - Dividend Yield
 - Expected Term
 - Expected Volatility
- How does the model assume that options are exercised?
 - The model assumes that options are only exercised when they are in-the-money or above water at the end of their term.

FAS 123r *Share-Based Payment*

- These assumptions are easy to estimate and require only minimal judgment:
 - Stock Price: Based on a consistently applied technique (e.g. market price at end of day of grant)
 - Exercise Price: Set by the company
 - Risk-Free Rate: Equal to the zero coupon U.S. Treasury (if in the U.S.) security yield with a term equivalent to the option's expected term
 - Dividend Yield: The estimate should include consideration of historical dividend policy and consideration of how the future may differ from the past.

FAS 123r *Share-Based Payment*

- These assumptions require a bit more analysis and a significant amount of judgment:
 - Expected Volatility
 - Expected Term

FAS 123r *Share-Based Payment*

- Expected Term
 - Definition: Expected term is the period of time that the option is expected to be outstanding
 - Factors to consider in estimating input value: The estimate should include consideration of historical exercise patterns adjusted for future expectations. May also consider using a more sophisticated Exercise Factor based model to impute an expected term

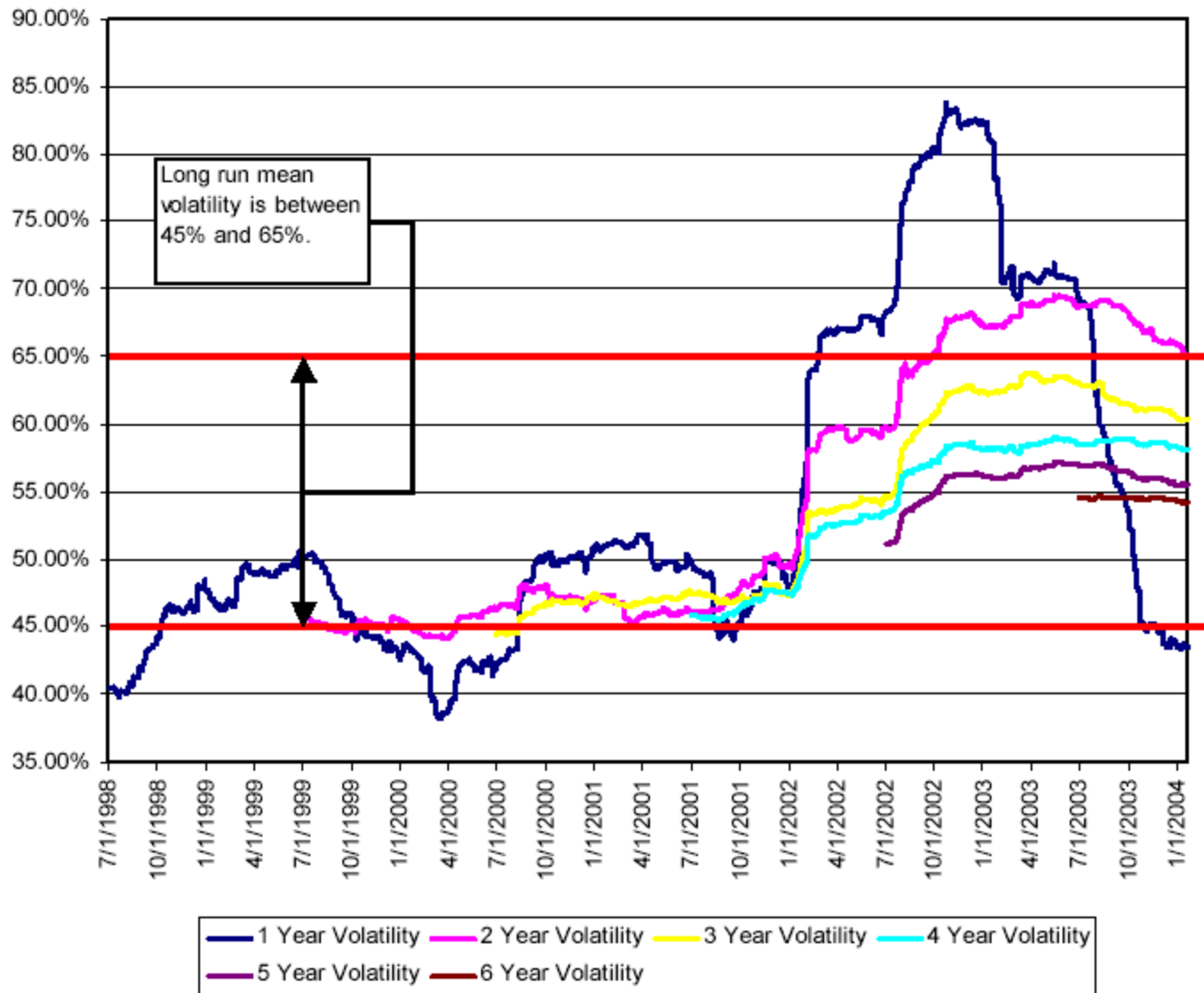
FAS 123r *Share-Based Payment*

- Expected Volatility—Factors to consider
 - Historical Volatility
 - Implied Volatility
 - Expected Volatility for the industry or peer group
 - The term structure of volatility
 - The length of time the entity's shares have been traded
 - Factors or situations that might cause expected volatility to differ from historical volatility
 - A tender offer or acquisition announcement
 - A spinoff
 - A change in the economic substance of the business

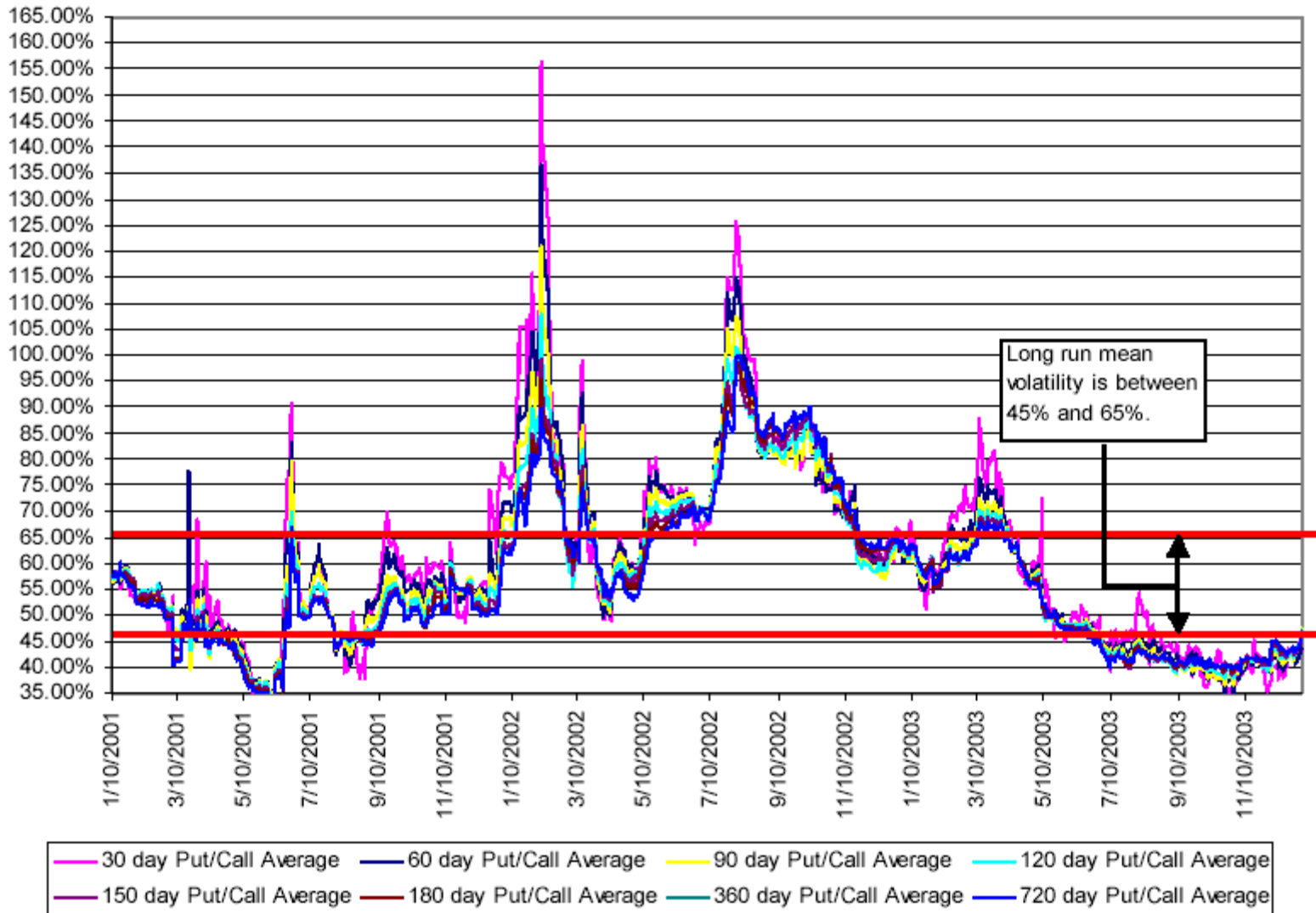
FAS 123r *Share-Based Payment*

- Expected Volatility (part 2)
 - Another factor to consider in estimating input value:
Privately-Held Companies
 - Select a group of publicly-traded companies that are similar and have historical, or implied volatility information
 - If no good individual publicly-traded company proxies exist, then use the historical volatility of an applicable industry index

Historical Volatility Analysis



Implied Volatility Analysis At-the-Money Options



FAS 123r *Share-Based Payment*

Exercise Factor Based

- What are the input assumptions necessary to use the model?
 - Stock Price
 - Exercise Price
 - Risk-Free Rate
 - Dividend Yield
 - Contractual Term
 - Term to Vest
 - Suboptimal Exercise Factor
 - Expected Volatility

How does the model assume that options are exercised?

- The model assumes that options are exercised when the stock price reaches a certain multiple (equal to the suboptimal exercise factor) of the exercise price.

FAS 123r *Share-Based Payment*

- Contractual Term

- Definition: Equal to the amount of time between the grant date and the final expiration date of the option as stated in the option contract.
- Factors to consider in estimating input value: This input assumption is stated in a contractual agreement and is easily obtained from the company's records.

FAS 123r *Share-Based Payment*

- Term to Vest
 - Definition: Equal to the amount of time between the grant date and the vest date.
 - Factors to consider in estimating input value: If the option vests over an explicit service period, then the vesting term is equal to the stated vesting term. If the option vests based on a performance condition, then the term must be estimated based on expectations of when the performance condition will be met.

FAS 123r *Share-Based Payment*

- Expected Term—Factors to consider
 - The preferred method is to value the options with an exercise ratio binomial model (or something similar) and then plug that binomial value into a Black-Scholes model along with the other five input assumptions and solve for “expected term.”
 - If sufficient information is not available about exercise behavior or post-vesting termination, then an entity is allowed to use Black-Scholes, but must develop a reasonable basis for its expected term assumption based on industry averages or other studies.

FAS 123r *Share-Based Payment*

- Expected Term—Factors to consider (part 2)
 - When using an Exercise Ratio Binomial model other factors to consider about employees exercise and post-vesting termination behavior follow:
 - Exercise Ratio: The ratio of stock price to option exercise price (stock price \div exercise price).
 - Forfeiture Rate: The rate at which employees forfeit their options after they are vested but before they expire
 - Expected volatility
 - Blackout periods or other arrangements that allow for automatic exercise during blackout periods
 - Perform a reality check by comparing the result with industry averages or a group of public peers

FIN 45 Summary

- This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees that it has issued.
- It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee.
- This Interpretation does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. This Interpretation also incorporates, without change, the guidance in FASB Interpretation No. 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which is being superseded.

FIN 45 Does Not Apply to the Following:

- a. Product warranties
- b. Guarantees that are accounted for as derivatives.
- c. Guarantees that represent contingent consideration in a business combination
- d. Guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability)
- e. An original lessee's guarantee of lease payments when that lessee remains secondarily liable in conjunction with being relieved from being primary obligor (that is, the principal debtor under a lease restructuring).
- f. Guarantees issued between either parents and their subsidiaries or corporations under common control
- g. A parent's guarantee of a subsidiary's debt to a third party, and a subsidiary's guarantee of the debt owed to a third party by either its parent or another subsidiary of that parent
- h. However, the guarantees described in (a) –(g) above are subject to the disclosure requirements of this Interpretation

Obligations Due Under a Guarantee

- The guarantor undertakes an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur (the noncontingent aspect)
- The guarantor undertakes a contingent obligation to make future payments if those triggering events or conditions occur (the contingent aspect)

FIN 45 - Fair Value Issue

- Measurement of Initial Liability Associated with the issuance of a guarantee.
- In the absence of observable transactions for identical or similar guarantees, expected present value measurement techniques as set forth in FASB Concepts Statement No 7, *Using Cash Flow Information and Present Value in Accounting Measurements*, will likely provide the best estimate of fair value. Concepts Statement 7 states in its glossary that “*expected present value* refers to the sum of the probability-weighted present values in a range of estimated cash flows, all discounted using the same interest rate convention.”

Why are guarantees valuable?

Guarantees have value to the extent they allow the borrower to obtain a lower interest rate than they would be able to obtain without the guarantee.

Valuation of a Guarantee

- Perform a credit rating of the guarantor to determine its cost of borrowing
- Perform a credit rating of the borrower to determine its cost of borrowing
- Discount the interest savings back to the present at the guarantor's cost of borrowing
- Estimate what portion of the interest savings would constitute an appropriate guarantee fee

Valuation of a Guarantee

Financial guarantors typically charge a guarantee premium between 50% and 66 2/3% of the present value of the interest rate savings.

Exception for Initial Obligation

- In the event that, at the inception of the guarantee, the guarantor is required to recognize a liability under Statement 5 for the related contingent loss, the liability to be initially recognized for that shall be the greater of (a) the amount that satisfies the fair value objective or (b) the contingent liability amount required to be recognized at inception of the guarantee of Statement 5. For many guarantors, it would be unusual for the contingent liability amount under (b) above to exceed the amount that satisfies the fair value objective under (a) above at the inception of the guarantee.

FAS 141-- Fair Value Issue

Business Combinations

The fair value of certain identifiable intangible assets must be recognized apart from goodwill and included in purchase price allocation disclosures.

FAS 142 -- Fair Value Issue

Goodwill impairment

FAS 142 requires firms to perform a market test at least annually to determine if goodwill from acquisitions has been impaired.

FAS 141 & 142

Business Combination

- An entity acquires net assets that constitute a business
- An entity acquires controlling equity interests of one or more entities
- One or more entities are merged or become subsidiaries (not already under common control)
- One entity transfers net assets or its owners transfer their equity interests to another
- All companies transfer their equity interests to a new entity “roll-up”

FAS 141 & 142

Not a Business Combination

- Joint venture
- Acquisition of equity interests of minority shareholders of a subsidiary
- Transfers of net assets or exchanges of shares between entities under common control

FAS 141 & 142

Identifying the Acquirer

- Relative voting rights
- Largest minority voting interest
- Board of Directors
- Senior management
- Public company price premium

FAS 141 & 142

Acquired Intangible Assets

Recognize Separately if:

- Obtained through contractual or other legal rights
- Can be sold, transferred, licensed, rented or exchanged

FAS 141 & 142

Finite vs. Indefinite life

An acquired intangible asset (other than goodwill) with an indefinite useful economic life should not be amortized (regardless of whether it has an observable market) until its life is determined to be finite

Separable intangible assets that have finite lives will continue to be amortized over their useful lives (subject to FASB 121 Accounting for the impairment of long-lived assets)

FAS 141 & 142

Reporting Unit

- SFAS 131, Disclosures about Segments of an Enterprise and Related Information-Operating Segment is a component of a business that earns revenue and incurs expenses, whose operating results are regularly reviewed by the chief operating decision maker to assess performance and allocate resources and for which discrete financial information is available.
- If all components of an operating segment are economically similar or if no discrete component level financial information exists, the reporting unit is the operating segment.

FAS 141 & 142

2 Step Impairment Test

1. Compare estimated fair value of each reporting unit to the carrying amount of the unit. If $FV < \text{Carrying amount}$, then Step 2.
2. Allocate reporting unit's estimated fair value at the valuation date to assets and liabilities (including goodwill). If fair value of goodwill is $< \text{Carrying amount}$, then report impairment loss.

FAS 141 & 142

Classification of Loss

- Impairment loss recognized at initial adoption of 142 is recorded as a cumulative effect of a change in accounting principle
- Thereafter, impairment expenses are an operating expense

FAS 141 & 142

Ongoing requirements

- Set up amortization schedule for identifiable intangible assets with determinable lives
- Monitor reorganizations and business disposals for their effect on goodwill impairment
- Retain documentation

FAS 141 & 142

Frequency of Impairment Testing

- At least annually (Anytime in the year, different reporting units can be assessed at different times of the year)
- If an event occurs or circumstances change that more-likely-than-not reduce the fair value of the reporting unit below its carrying value or reduce the fair value of an indefinite lived intangible asset below its book value.

FAS 141 & 142

Examples of Impairment Events

- Change in legal factors
- Change in business climate
- Adverse action by a regulator
- Unanticipated competition
- Loss of key personnel

FAS 141 & 142

Overall Effect on Company

- Offsetting of unrecorded goodwill against impaired goodwill within a reporting unit is appropriate
- Not allowed to net an impairment in one reporting unit against increases in fair value in other reporting units
- Any subsequent reversal of a previously recognized impairment loss is prohibited

Disclosure-141

- Name and description of acquired company(ies) and % of voting share acquired
- Reason for the acquisition
- Condensed balance sheet showing amounts assigned to each major asset and liability
- Amount assigned to amortizable intangible assets and amortization period
- Total goodwill and amount that is expected to be tax deductible

(Above list does not include all factors)

Disclosure-142

- Amortizable assets-Carrying amount, accumulated amortization, amortization expense, estimated amortization expense for the next five fiscal years
- Goodwill-amount of goodwill acquired, amount of impairment loss recognized
- Impairment loss-Description of the asset and facts and circumstances leading to impairment, amount of the loss and method for determining fair value

FAS 141 & 142

Valuation

- Overview of Common Intangible Assets that Often Need to be Recognized Separately from Goodwill
- Valuation of a Reporting Unit's Enterprise Value
- Allocation of the Reporting Unit's Enterprise Value to Assets

Intangible Assets

Statement 141 defines intangible assets as assets (not including financial instruments) that lack physical substance.

FAS 141 & 142

Goodwill versus Other Intangibles

- The intangible asset acquired arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the the acquired entity or from other rights and obligations.
- If the intangible asset does not arise from contractual or other legal rights, it should be recognized as an asset apart from goodwill only if it is separable; that is, it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged.

FAS 141 & 142

Intangible Assets

- Marketing
- Customer
- Artistic
- Contract
- Technology

Approaches to Estimating Fair Value

- **Market Approach:** Estimates an asset's value by analyzing the characteristics of recent sales of comparable assets
- **Income Approach:** Estimates an asset's value by determining the future cash flows to which the owner of the asset is entitled. This cash flow stream is discounted to the present by a rate that considers the time value of money and the uncertainty inherent in the asset.
- **Asset/Cost Approach:** Estimates an asset's value by determining the cost of replacing the asset with a comparable asset.

Which Value Approaches for Which Intangible Assets? *

	Primary	Secondary	Weak
Patents and Technology	Income	Market	Cost/Asset
Trademarks and Brands	Income	Market	Cost/Asset
Copyrights	Income	Market	Cost/Asset
Information Software	Cost/Asset	Market	Income
Product Software	Income	Market	Cost/Asset
Distribution Networks	Cost/Asset	Income	Market
Core Deposits	Income	Market	Cost/Asset
Franchise Rights	Income	Market	Cost/Asset
Corporate Practices and Procedures	Cost/Asset	Income	Market

* Circumstances may exist where credible answers may be derived contrary to the method preferences used.

Source: Valuation of Intellectual Property and Intangible Assets,
Second Edition.

Statement of Financial Accounting Standards (FAS) No. 143
Accounting for Asset Retirement Obligations
(AROs)

Addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs.

FAS 143 – Fair Value Issue

- Initial Recognition--Asset retirement obligations should be recognized at fair value in the period in which they are incurred
- Subsequent Recognition—Period to period changes in the liability are to be recorded to reflect (a) the passage of time and (b) revisions to the timing or amount of cash flows

Statement of Financial Accounting Standards (FAS) No. 143
Accounting for Asset Retirement Obligations
(*AROs*)

- Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurement, if available.
- It is highly unlikely that there will be any quoted prices for AROs
 - Use an expected cash flow approach

Statement of Financial Accounting Standards (FAS) No. 143
Accounting for Asset Retirement Obligations
(*AROs*)

Expected Cash Flow Approach

- Use multiple cash flow scenarios to reflect the range of possible outcomes
- Each cash flow scenario will have an associated probability assessment
- The discount rate is equivalent to a credit adjusted risk-free rate
- That is, the borrowing rate of the entity, given its credit standing and a term that coincides with the expected timing of the cash flows

Statement of Financial Accounting Standards (FAS) No. 143 *Accounting for Asset Retirement Obligations* (*AROs*)

Expected Cash Flow Approach

- The cash flows should consider the following:
 - The costs that a third party would incur in performing the tasks necessary to retire the asset
 - Other amounts that a third party would include in determining the price of settlement, including, for example, inflation, overhead, equipment charges, profit margin, and advances in technology
 - The extent to which the amount of a third party's costs or the timing of its costs would vary under different future scenarios and the relative probabilities of those scenarios
 - The price that a third party would demand and could expect to receive for bearing the uncertainties and unforeseeable circumstances inherent in the obligation

Other Fair Value Issues

- Statement of Financial Accounting Standards (FAS) No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* FAS 144
- Statement of Financial Accounting Standards (FAS) No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* FAS 146

Conclusion

