

# Viewpoint on Value



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# Can goodwill hold up in a bad economy?

The recession isn't affecting just public finance firms and automakers. Across the board, demand is down, costs are up and credit is tight. Privately owned companies cannot escape the effects of a slowed economy, either. Among those effects is the possibility of impaired values.

## A new standard?

Along with their publicly traded counterparts, private business owners need to consider the possibility that goodwill and other indefinite-lived intangible assets — as well as long-lived assets — may have declined in value. Impaired values might require corrective action to conform with Generally Accepted Accounting Principles (GAAP).

Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements*, has helped focus the spotlight on impairment testing. Effective in 2009, the new standard clarifies that fair value is an exit price determined by “market participants.” It prohibits companies from considering entity-specific synergies when estimating fair value.

These rule changes also could inadvertently cause impairment write-offs, as companies re-evaluate earlier goodwill assessments.

## What is goodwill?

Any discussion of impairment requires some background. When a business merges with or acquires another entity, SFAS 141(R), *Business Combinations*, requires the acquirer to allocate the purchase price among the assets acquired and liabilities assumed, based on their fair values. If the purchase price is higher than the combined fair value of the acquired business's identifiable net assets, the excess value is labeled as goodwill.

Goodwill is then allocated among the reporting units (or operating segments) that it benefits. Many small private companies consist of a single reporting unit. But large conglomerates may be composed of numerous reporting units.

Purchase price allocations require valuation expertise. Before lumping excess value into goodwill, acquirers must identify or value other identifiable intangible assets, such



## Make purchase price allocations a priority

Effective for deals closing in fiscal years beginning after Dec. 15, 2008, Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 141(R), *Business Combinations*, should be a forethought, not an afterthought. Like it or not, a company involved in a merger or acquisition must comply with SFAS 141(R) if its financial statements are to conform to Generally Accepted Accounting Principles (GAAP).

SFAS 141(R) changes the rules for purchase price allocations. For example, the revised rule requires companies to capitalize in-process research and development (IPR&D) costs as an indefinite-lived intangible asset. Once developed, IPR&D is assigned a value and a useful life over which to amortize its value. Additionally, SFAS 141(R) requires companies to record contingent assets and liabilities — including earnouts — on the acquisition date.

Proactive companies forecast how a transaction will affect their financial statements *before* the deal closes. Preacquisition valuations and purchase price allocations provide an extra level of merger-and-acquisition due diligence. They answer the question: “Does this purchase price make sense?” In fact, some acquirers revise deal terms — or walk away from a deal — after analyzing its probable effect on earnings.

Accounting for business combinations is more challenging than ever and requires outside appraisal expertise.

as trademarks, customer lists, copyrights, leases, patents or franchise agreements. An intangible asset is recognized apart from goodwill if it arises from contractual or legal rights — or if it can be sold, transferred, licensed, rented or exchanged.

Some intangible assets are assigned useful lives over which they are amortized. Other intangibles, such as goodwill, brand names and trademarks, may continue to provide value indefinitely.

### How to test for impairment

In lieu of annual amortization write-offs, SFAS 142, *Goodwill and Other Intangible Assets*, requires companies to annually test goodwill and other indefinite-lived intangibles for impairment. More frequent impairment tests might be necessary if other triggering events — such as the loss of a key person, unanticipated competition, business reorganization or adverse regulatory actions — occur during the year.

Impairment testing is a two-step process:

1. An appraiser compares each reporting unit’s fair value to its carrying value, which is the amount that shows up as the book value of equity if the reporting unit has a balance sheet. If the whole reporting unit’s fair value exceeds its carrying value, no impairment has occurred and testing stops.
2. If the carrying value exceeds the reporting unit’s fair value, the appraiser estimates the “implied” value of goodwill. SFAS 142 states that goodwill cannot be measured directly. So, to arrive at the implied value of goodwill, the appraiser allocates the reporting unit’s fair

value to its identifiable assets and liabilities (including any “home-grown” intangible assets that aren’t currently reported on the reporting unit’s balance sheet). Any amount left over equals the implied value of goodwill.

Step 2 is similar to a purchase price allocation under SFAS 141(R), except that appraisers use the reporting unit’s fair value in lieu of the purchase price. This hypothetical value allocation is just for impairment testing purposes. It doesn’t change the carrying value of any other asset or liability on the balance sheet.

If the purchase price is higher than the combined fair value of the acquired business’s identifiable net assets, the excess value is labeled as goodwill.

To the extent that the carrying value of goodwill exceeds its implied value, impairment has occurred. A company cannot recoup impairment losses or increase the value of an impaired asset in subsequent accounting periods. On the balance sheet, impairment is permanent.

In addition, a company must complete impairment testing on other assets — including its indefinite-lived intangibles and long-lived tangibles — *before* quantifying goodwill impairment.

## When assets are impaired

When impairment occurs, the company must decrease the asset's carrying value on the balance sheet and reduce its earnings by the same amount. Impairment charges are a separate line item on the income statement that can have real-world consequences.

For example, some companies reporting impairment losses may be in technical default on their loans. This situation might require owners to renegotiate loan terms or find a new lender. Impairment charges also raise a red flag to investors.

## Who can help?

Few companies employ internal accounting staff with the requisite training and time to handle impairment testing. And most auditors won't perform valuation services for their audit clients for fear of violating their independence standards. Instead, valuation professionals are often called in to handle these complex assignments. Because experienced valuers are familiar with current standards and methodologies, they can add objective credibility to the process for auditors. ●

# Ready, set, go

## How to ensure your valuation goes as planned

**B**efore contacting a business valuation professional, jot down some notes to ensure that you convey your expectations clearly. Miscommunication and ambiguity early in the valuation process can be frustrating and costly later on.

### Prepare the way

Here are some issues to consider before you pick up the phone — or to discuss with a prospective valuator before you proceed:

**Business basics.** A short description of what the subject company does can help the valuator prepare for initial meetings with management. Helpful information typically includes the business name, entity type (for example, partnership or C corporation), size (in terms of annual sales or total assets), industry classification code, and Web address.

**Standard of value.** Most assignments call for fair market value, which is the price at which property would change hands in a hypothetical transaction involving informed buyers and sellers not under duress to buy or sell. But some assignments call for a different standard of value.

For example, a company that's contemplating acquiring a competitor might be more interested in "strategic value," which is the value to a particular investor, including buyer-specific synergies.

In court, a judge may disregard an expert opinion that measures an inappropriate standard of value.

**Basis of value.** There are two bases of value that typically apply to private business interests:

1. Controlling, and
2. Minority (nonmarketable).

Valuators consider the basis of value when selecting valuation methodology and applying valuation discounts.

There are gray areas when defining the appropriate basis of value. To illustrate, suppose a business is split equally between two partners. While each owner has some control, stalemates could impair decision-making. On the other hand, a 2% owner might possess some elements of control if the remaining shares are divvied up equally between two 49% owners.

**Purpose.** Valuations are valid as of a specific date and for a specific purpose. A business owner shouldn't reuse a valuation prepared for, say, gift tax purposes, later — unless the appraiser specifically approves it.

The appraisal purpose dictates which valuation techniques the appraiser uses. For example, some family courts prefer the excess earnings method to the discounted cash flow method. Or a divorce



case might require the appraiser to separately value professional and entity goodwill for equitable distribution of the marital estate.

## Reports and services

It's important to define the valuation parameters as well as any other services that might be required. For instance, you need to consider:

**Report type.** An oral presentation may suffice in some situations, such as preliminary settlement talks or merger-and-acquisition consulting. But most assignments call for more formality. Written reports can be as short as a two-page letter or as detailed as a bound report with multiple exhibits.

The appropriate format is a function of the client's preferences and the valuation purpose. For example, the U.S. Tax Court typically substitutes an appraiser's oral direct testimony with his or her written report. So, detailed written reports are usually necessary for tax-related valuations.

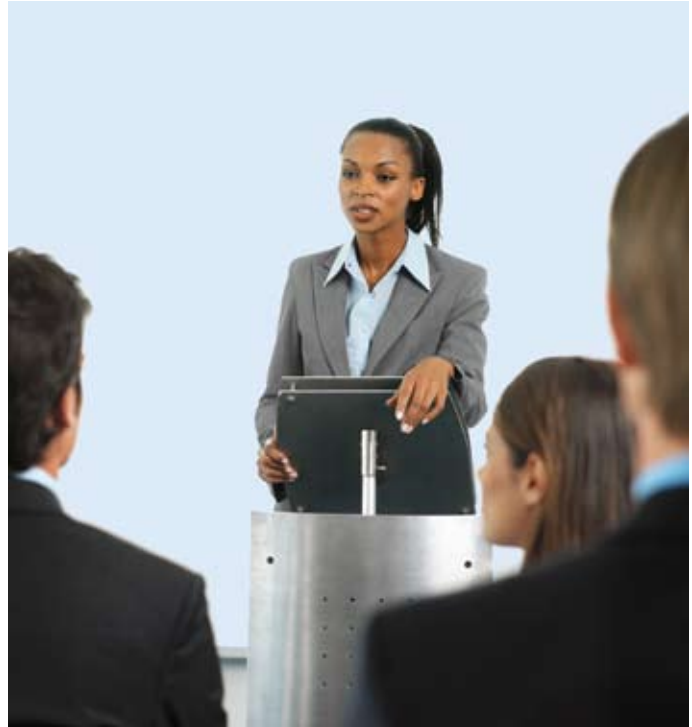
**Ancillary services.** In some situations, financial expertise beyond appraisal is needed. For example, an oppressed minority shareholder who suspects the controlling owners are understating profits or hiding assets to minimize business value might need forensic accounting expertise. Or an acquisitive business might need its valuator to help with its purchase price allocation and other postacquisition accounting issues.

## In court, a judge may disregard an expert opinion that measures an inappropriate standard of value.

Anticipate any ancillary services you might require so that you can work with your appraiser from the outset to determine which services he or she will handle.

**Time frame.** Advance notice of meetings, depositions and trial dates can minimize scheduling conflicts. It's often helpful to compile a timeline for completing major milestones in the valuation process. For the appraiser, these milestones might include:

- Receiving completed questionnaires and data requests,
- Touring plant facilities,



- Interviewing management,
- Drafting preliminary reports, and
- Presenting appraisal conclusions to clients.

If you delay in providing information to your valuator about impending deadlines, he or she may not have enough time to gather and analyze data or to write and review the report.

**Engagement letter.** A valuator normally summarizes the project's details in an engagement letter, which serves as a legal contract between the client and the appraiser. In essence, this letter establishes an understanding as to the valuator's duties, scope and responsibilities. An engagement letter also enumerates appraisal costs, retainers and late fees, if applicable.

Sometimes the assignment's scope or the definition of value changes. For example, you may later decide to add ancillary services or to upgrade from an oral presentation to a detailed written report. When expectations change, your valuator probably will require you to sign a revised engagement letter or an addendum to the original contract.

## Better safe than sorry

It's always better to be safe than sorry. After you've ironed out the details and communicated the essential information concerning the assignment, it's time for the appraiser to start work. Following these steps will ensure the process ends well. ●

# Bridging the gap between public and private firms

Transactions of public company shares can sometimes represent good benchmarks for appraisers valuing a private business. Yet many privately held business owners wonder: How can valuers compare small businesses with large, publicly traded corporations? These two types of businesses differ significantly both in terms of operating characteristics and market dynamics. But experienced valuation professionals understand the differences — and how to account for them with the requisite adjustments.

## The gap

Owning a small business is much different than owning a share of public company stock. For example, private businesses typically provide employment for the owners and their family members. Many prepare just one set of accounting records for tax purposes, with the primary objective of minimizing taxable income. Private businesses usually sell when the owner retires, and most transactions require owners to sign short-term consulting agreements and noncompete contracts.

In contrast, most public companies are professionally managed, with many layers of management. If an owner dies, a public entity's operations are rarely disrupted. In addition to providing audited financial statements that conform to Generally Accepted Accounting Principles (GAAP), public companies strive to maximize reported earnings to satisfy investors. Public mergers and acquisitions typically occur for strategic purposes, not to serve the owners' personal needs.

## Building the bridge

If public and private companies are so different, why use public company data in valuing private businesses? Public market data provides objective evidence of what investors are willing to pay in arm's-length transactions. In fact, Internal Revenue Code Section 2031(b) states that valuers should first consider "stocks listed on an exchange" when valuing private businesses. And courts embrace the use of public market data to value private businesses.

So appraisers might use public market data in the following ways, depending on the valuation's purpose and the valuation approach chosen:

**Income approach.** Valuers typically base discount and capitalization rates on rates of return culled from public



markets. After comparing and contrasting public and private investor expectations, a valuator adjusts the public stock returns for small-stock, industry-specific and company-specific risks.

**Market approach.** Valuers can derive pricing multiples from comparable public stocks or from mergers and acquisitions involving similar publicly traded companies. Public transaction data is voluminous and detailed, but finding meaningful comparables in the sea of data can be difficult.

Because many public firms are too large and diversified to compare with private companies, comparisons with public stock transactions usually work best when an appraiser is valuing large private companies. When data is applicable, the appraiser subjectively adjusts the average or median pricing multiples to account for the differences between the public transaction data and the subject company.

Even if the appraiser doesn't use the market approach, transactions involving public companies can serve as useful checks for other value indicators.

**Determining valuation discounts.** Valuers often use restricted stock and pre-initial public offering (IPO) studies to help quantify marketability discounts. A control premium study, which compares publicly traded stock

prices with acquisition premiums paid for controlling interests in publicly traded companies, can be the basis for a minority interest discount.

When quantifying valuation discounts, valuers study the public company characteristics analyzed in the empirical data and note how they differ from those of the subject company. From there, valuers adjust for differences, such as financial performance, leverage and size.

## Crossing safely

This article merely scratches the surface of this complex topic. No two businesses are the same. Valuation professionals are trained to use public market data as a resource in valuing even the smallest private firms. But they also know how to spot and account for the myriad differences with well-thought-out, supportable adjustments, so that your valuation can safely cross the bridge between public and private firms. ●

# Joint appraisal: The power of one

Traditionally each party to a transaction or lawsuit hires its own expert to value the business. But when the parties come together and agree to hire a single expert, they can save money and time. More important, a joint appraisal facilitates information sharing, which streamlines the valuation process and minimizes divergent opinions that can result from incomplete access to financial data.

## Opportunities

Joint appraisal can be especially beneficial in divorce cases, where one (or both) parties lack financial resources or access to financial data. In fact, some jurisdictions mandate the use of a joint appraiser when the marital estate includes a privately held business interest. Joint appraisal also can be key to collaborative divorces, where the parties agree to settle out of court through a series of joint meetings.

Shareholder disputes, buyouts, and mergers and acquisitions are other situations in which joint appraisal can be beneficial.

## Pitfalls

Joint appraisers aren't appropriate for every situation. Distrust, dishonesty and personal drama can get in the way of objective analysis, discovery and open communication, which are required for effective joint appraiser use.

When such negative conditions exist, appraisers get frustrated. Both sides may wind up dissatisfied with the opinion.

## Checklist of considerations

Other considerations when using a joint appraiser include:

- **Scope.** In addition to a business valuation, parties might request specific due diligence, forensic or forecasting procedures. Generally, the parties split joint expert fees. But one party might agree to pay extra for the ancillary services, if they cannot agree on the scope of the joint assignment.
- **Communication.** Typically, joint appraisers communicate openly with all parties. For example, appraisers usually compile and distribute notes following meetings, particularly if one party is absent.
- **Report format.** One factor that affects the appraisal is the preferred reporting format. Because both sides usually split the fees in a joint appraisal, it's important to decide up front how the appraiser will communicate his or her opinion. Preliminary settlement talks and purchase negotiations usually are less formal than litigation, so oral presentations or abbreviated letter reports may suffice.

## The right expert for you

Joint appraisal is a specific process that presents numerous benefits, as well as some potential pitfalls. Effectively managing a joint appraisal assignment requires finesse to engender trust and satisfaction on both sides.