Forensic Accounting, Business Valuation and Consulting

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Subsequent Events Revisited

Donald P. Wisehart, ASA, CPA/ABV/CFF, CVA, MST

The reality of subsequent events hit hard on my last valuation (litigation). In reviewing this issue, I realized that it might be informative to revisit this very subject in this short article. I believe we're constantly facing this issue of subsequent events even if we're not fully aware that it is an issue!

As we have all learned, we appraisers use only that relevant information that is "known or knowable" at the valuation date. Shannon Pratt points out in a March 2002, that "reasonably foreseeable" should be added to "known or knowable". Thus today, we think of known, knowable or reasonably foreseeable. To this end, "known, knowable or reasonable foreseeable" has been supported by various business valuation standards in our industry, revenue ruling 59-60, and a host of valuation treatises. Unfortunately, this is not necessary the view of our courts throughout this land. In their article in The CPA Journal, September 1, 1995, entitled "Impact of Post-Mortem Events on Estate Tax Valuations", Ted D. Englebrecht and John J. Masselli, authors, point out that "several recent court cases have indicated a potential willingness of the courts to relax the restrictions on the use of post-mortem facts and circumstances in valuation cases. This article is now 18 years old!

So why do we appraisers differ with those judges? The answer to this question is contained in a superb article published by The Value Examiner, May/June 2006, written by Michael J. Mard, CPA/ASA, ABV, Christopher Mercer, ASA, CFA, and LuAnne Tanner, entitled "Subsequent Events Must Be Considered". The article states: "Courts make their decisions at the trial date and are *obligated* to consider *all* the evidence duly admitted and made known *at or before* the hearing or trial. (Emphasis added) The obligation on the appraiser/expert is not *whether* to consider the subsequent information, but *how* to consider the subsequent information. And the "how to" is a function of the environment, namely the Court of Equity."

So what, as appraiser, do we do? For starters, we must do a better job in our interviews with management to detail the subsequent event and the environment in between. In the tax court case *The Estate of Helen M. Noble v. Commissioner*, T.C. Memo. 2005-2, January 6, 2005, the court stated,

> *"When a subsequent event such as third sale before us is used to set the fair market value of property as of an earlier date, adjustments should be made to the sales price to account for the passage of time as well as to reflect any change in the setting from the date of valuation to the date of sale. (citing Estate of Scanlan[1]) These adjustments are necessary to reflect happenings between the two dates which would affect later sales price vis-à-vis a hypothetical sale on the earlier date of valuation. These happenings include (1) Inflation, (2) changes in the relevant industry and the expectations for that industry, (3) changes in business component results, (4) changes in technology, macroeconomics, or*

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Subsequent Events Revisited (Continued from page 1)

> *state law, and (5) the occurrence or nonoccurrence of any event which a hypothetical reasonable buyer or hypothetical reasonable seller would conclude what affect the selling price of the property subject to the valuation."*

In closing, there seems to be a trend, as Mard, Mercer and Anderson point out, to "address subsequent events in a formal section of the appraisal report called "Subsequent Events". This section would then describe the event and its effect on the matter being valued". ~~

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Endnote:

1. Estate of Scanlan v. Commissioner, T.C. Memo. 1996-331.

Standards for Private Firm Goodwill Accounting

Michael A. Crain, CPA/ABV, ASA, CFA, CFE

FASB's overseer, the Financial Accounting Foundation (FAF), has a regular process of periodically reviewing important accounting standards previously issued by FASB and GASB.[1] FAF conducts a review several years after a new standard has been issued to assess its effectiveness and identify practice problems, and provides this feedback to FASB. FAF collects data from stakeholders in financial reporting such as preparers, auditors, and investors. It uses surveys as a key method for collecting such data.[2] Since these stakeholders often have conflicting interests,[3] FAF weighs stakeholder comments and makes its own judgment on what to report and not report about the effectiveness and problems of an accounting standard.

On May 22, 2013, FAF published its review report on SFAS 141R, the standard for business combinations accounting, issued by FASB in 2007.[4] This standard is now codified in FASB's ASC section 805. The report gives 141R positive and negative comments, derived from 313 survey responses from stakeholders. Responses came from financial statement preparers (30%), accounting practitioners (42%), users (20%), and academics (8%).

One complaint that stakeholders have is the high costs of complying with the standard. In practice, SFAS 141 works with SFAS 157, another accounting standard that tells accountants how to determine fair values. Preparers and auditors of financial statements incur high costs in hiring external valuation specialists to comply with the complexity of these accounting standards. The report notes that smaller preparers may face higher costs for such valuation expertise.

Stakeholders have told FAF about particular implementation problems with 141R: (i) fair value measurements of acquired assets and liabilities assumed in applying SFAS 157, (ii) fair value measurements of contingent consideration in business combinations, such as potential earn out payments to a seller, and (iii) determining whether a particular transaction is a business combination or asset purchase.

These kinds of comments tend to come from preparers and auditors of financial statements as practice problems. In contrast, investors use such financial information to make their decisions whether to invest, sell their investment, and so on. For this group of stakeholders, more information is better, and costs for financial statement preparation and auditing are not their concern.

FAF reports that 141R has resolved some of the practical issues with the purchase method when accounting for business combinations. But they also note important practice issues still exist.

On May 30, 2013, FASB published its written response to FAF on the review.[5] It diplomatically acknowledged many of the report comments and says it will work to address them, making accounting standards for business combinations better. FASB acknowledges particular practice problems of SFAS 157: (i) difficulty with fair value measurements of hard-to-value assets and liabilities, including contingent consideration and certain intangible assets, (ii) unanticipated complexities with valuation models for certain kinds of assets and liabilities, and (iii) high costs and complexity in compliance that often requires hiring external valuation specialists.

In July 2013, FASB issued a proposed change to the goodwill accounting standard for private firms.[6] If adopted, private firms, which tend to be small- and medium-sized enterprises (SMEs), can reduce their costs when accounting for goodwill. Private firms,

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Announcements:

Valuation for Financial Reporting

Fair Value Measurement in Business Combinations, Early Stage Entities, Financial Instruments and Advanced Topics, 4th Edition

by Mark Edwards, James R. Hitchner and Michael J. Mard

Educates preparers, auditors and valuation practitioners and litigators with methodologies for identifying and valuing intangible assets and goodwill. The Book also presents fair value elements for early stage entities and financial instruments.

- Provides specific guidance for determining Fair Value in a Business Combination, including Acquisition Method, Classifying or Designating Assets and Liabilities, Research and Development Assets, and Goodwill.
- Provides guidance for determining Fair Value for Financial Instruments, including option contracts such as derivatives (forwards, swaps) and asset-backed securities such as collateralized debt obligations.
- Gives clear guidance and ASC 815-40-15 financial reporting compliance.
- Presents advanced topics in fair value including:
  - Measurement of brand value;
  - Measurement of intangible assets in ad valorem matters; and
  - Analyzing the developmental and reporting standards of all major valuation groups.

Includes a Wiley web site with checklists!

Published 2014 by John Wiley & Sons, Inc.

- Mike Crain will be teaching corporate finance to global MBA students for the Manchester Business School, University of Manchester (UK).
- Mike Crain has been invited to speak in November at the American Institute of CPAs annual Forensic and Valuation Services Conference on advanced issues for discounted cash flow models.
- Mike Mard will be speaking in October at the Florida Southern College on Business Succession Planning – Valuing the Closely Held Business.

their accountants, and others have been critical of the complexities and costs of current U.S. GAAP for goodwill accounting, documented in SFAS 142[7] and now ASC section 350.[8]

This proposal is based on a report from FASB's Private Company Council (PCC) that addresses input from private firm stakeholders who have said the benefits of goodwill accounting do not justify the related costs. The changes would be available for entities recognizing goodwill in a business combination except for publicly traded firms and non-for-profit entities. The proposal would simplify the accounting requirements for private firms with goodwill recorded on their balance sheets compared to current accounting standards.

Current U.S. GAAP requires firms with goodwill to (i) report goodwill acquired in a business combination at the *reporting unit* level and (ii) test for impairment of such goodwill at least annually or more often in certain circumstances. Firms may use a shorter qualitative analysis as a first impairment test to assess whether a reporting unit's fair value may be less than its carrying value. If this qualitative test is not used, then firms alternatively use step one of a two-step quantitative test documented in ASC 350. If the qualitative test or step one of the quantitative test indicate a firm's carrying value may exceed its fair value, then step two of the quantitative test is needed. This test is complex and costly. It requires the application of a hypothetical purchase price allocation to determine the fair values of the reporting unit's identifiable intangible assets and

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residual goodwill following the accounting requirements of ASC 805.

FASB's proposed change allows private firms to amortize goodwill acquired in a business combination on a straight-line basis over the useful life of the related main long-lived asset up to 10 years. Impairment testing standards are modified from current U.S. GAAP, requiring testing only when a triggering event occurs indicating the entity's fair value may be below its carrying value. Another proposed change requires impairment testing at the entity level rather than the reporting unit level. Any loss from impairment is the difference between an entity's carrying value of goodwill and its fair value. The proposal effectively eliminates the costly Step 2 goodwill impairment test and keeps the simpler Step 1 test.

This proposal is FASB's recommended change to ease the burden of goodwill accounting for private firms. AICPA has a competing accounting framework for private firms that it published in June 2013.[9] Multiple accounting standards for private firms will add to the complexity of preparing and using financial statements. AICPA's guideline for goodwill treatment after initial recognition is simply amortizing the initial value over the same period used for federal income tax purposes or 15 years (section 13.60). It does not require any goodwill impairment tests unlike current U.S. GAAP and the FASB proposal for private firms.

Confusion is likely for financial statement preparers and users. As things stand now, private firms will choose goodwill treatment among (i) current U.S. GAAP, (ii) FASB's proposed elective guidelines, or (iii) AICPA's reporting framework for SMEs. Then financial statement users such as lenders and investors will sort out which way the financial statements were prepared, assuming they are sophisticated enough to know about such things. ~~

Endnotes:

1. http://tinyurl.com/kk8w4xc.
2. http://tinyurl.com/n45fu9a.
3. For instance, investors want more financial information for decision-making and preparers are worried about the costs of creating such information.
4. http://tinyurl.com/multodl.
5. http://tinyurl.com/kzfebyh.
6. http://tinyurl.com/ldqycep.
7. http://tinyurl.com/ksa4r2l.
8. http://tinyurl.com/m9lk63v.
9. http://tinyurl.com/ls893rx.

The New Guide on the Valuation of Privately-Held-Company Equity Securities

Donald P. Wisehart, ASA, CPA/ABV/CFF, CVA, MST

Outline of the New Guide:

A. Introduction:
   a. Brief outline of what is included in guide
   b. Defines scope
   c. Brief description of contemporaneous versus retrospective discussed later in Chapter 11.

B. Chapter 1 - (no title):
   a. Basic fair value concepts
   b. Detailed cross-referencing FASB ASC 718 (Compensation-stock compensation, 505 (Share-based payments to nonemployees), and 820 (Fair value measurements) to the conduct of the valuation.

C. Chapter 2 - Stages of Enterprise Development: (formerly Chapter 4)
   a. Similar to but expanded over former practice aid

D. Chapter 3 – Factors to Be Considered in Performing a Valuation: (formerly Chapter 5)
   a. Similar to but expanded over former practice aid
   b. Table 3-1 expanded (formerly table on page 19)

E. Chapter 4 - (no title): (formerly Chapter 6)
   a. Similar to but expanded over former practice aid
   b. Discussion of a discount for lack of marketability (DLOM) excluded (see new Chapter 7)[1]

F. Chapter 5 - Valuation of Equity Securities in Simple Capital Structures
   a. New subject dealing with a single class of stock

G. Chapter 6 – Valuation of Equity Securities in Complex Capital Structures (formerly Chapter 10)
   a. Similar to but expanded over former practice aid

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b. Table 6-1 updated (formerly table on page 56)
c. Table 6-2 same

H. Chapter 7 – Control and Marketability (new)
   a. New chapter and scope
   b. Endorses the protective put option method (Chaffee Model) in determining the DLOM over
      i. Longstaff option model (considered a unreasonable method)
      ii. Quantitative Marketability Discount Model (more appropriate for simple capital structures)
   c. Does not endorse the restricted stock and IPO studies

I. Chapter 8 – Inferring Value from Transactions in a Private Company's Securities
   a. Provides a framework for evaluating private and secondary market transactions

J. Chapter 9 – Relationship between Fair Value Stages and Stages of Enterprise Development (formerly Chapter 8)
   a. Similar to but expanded over former practice aid

K. Chapter 10 – Valuation Implications of a Planned Initial Public Offering (formerly Chapter 9)
   a. Expands former practice aid
   b. Appendix A, "The IPO Process" supplements this chapter

L. Chapter 11 – Reliability of the Valuation (formerly Chapter 7)
   a. Similar to but expanded over former practice aid
   b. Detailed discussion of the distinction between *contemporaneous and retrospective* valuations

M. Chapter 12 – Common Valuation Questions (new)
   a. Situational questions concerning the value of debt
   b. Situational questions dealing with changes in values of debt and/or enterprise
   c. Situational questions pertaining to complex capital structures
   d. Question dealing with discount rates used in P-WERM
   e. Question dealing with volatility in early stage companies
   f. Situational questions dealing with control and marketability
   g. Questions dealing with post-valuation (subsequent) events
   h. Questions dealing with the "shelf lives" of valuations

N. Chapter 13 – Elements and Attributes of the Valuation Report (formerly Chapter 11)
   a. Similar to but expanded over former practice aid
   b. Adds recommendation to follow SSVS1
   c. Outlines SSVS1

O. Chapter 14 – Accounting and Disclosures
   a. Updated to incorporate the Accounting Standards Codification
   b. Updates sample disclosure paragraphs

P. Appendix A – The IPO Process (formerly Chapter 9)
   a. A supplement to Chapter 10 of new guide
   b. Similar to but expanded over former practice aid

Q. Appendix B – Venture Capital Rate of Return
   a. Replaces the returns that were previously reported in Chapter 10 of the former practice aid

R. Appendix C – Criteria for the Selection of a Valuation Specialist (formerly Appendix B)
   a. Similar to but expanded somewhat over former practice aid

S. Appendix D – Table of Responsibilities of Management and the External Valuator (formerly Appendix C)
   a. Similar to but expanded over former practice aid
   b. Table Updated from former table (page 85 of former practice aid)

T. Appendix E – Table of Capitalization Multiples (formerly Appendix D)
   a. Similar to but expanded over former practice aid

U. Appendix F – Derivation of Weighted Average Cost of Capital
   a. Similar to but expanded over former practice aid
   b. The term "beta" in the former practice aid is exchanged for the term "relevered beta"; however, the definition remains unchanged

V. Appendix G – Real Options (formerly Appendix E)
   a. *Significantly* expanded

W. Appendix H – Rights Associated With Preferred Stock
   a. Similar to but expanded over former practice aid

X. Appendix I – Illustration of Methods for Valuing Equity Securities
   a. *Significantly* expanded
   b. More examples with more detail

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The New Guide (Continued from page 5)

Y. Appendix J – Illustrative Document Request to Be Sent to Enterprise to Be Valued
   a. Same as former practice aid

Z. Appendix K – Illustrative List of Assumptions and Limiting Conditions of a Valuation Report
   a. *Significantly* expanded

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Endnote:

1. Where the old practice aid (¶ 57) indicates that DLOM is outside the scope, the new guide adds Chapter 7, thus including DLOM (as well as control discounts/premiums) in its scope.

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