

“Business Combinations and Goodwill: What is the Latest with Fair Value?”

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- I. The History of Fair Value Accounting and why it has become so prominent.
 - a. The changing economic environment
 - i. Information revolution
 - ii. Global competition
 - iii. Wall Street “expectations”
 - iv. Complexity of financial transactions
 - v. The current economic crisis
 - b. The trend towards increasing regulation of the accounting profession
 - i. Sarbanes Oxley Act in 2002
 - ii. The establishment of the PCAOB
 - iii. The focus from the SEC on transparency
 - c. The FASB and the IASB convergence project
 - i. “One single set of high quality, understandable and enforceable global accounting standards.”
 - ii. Termed the “Norwalk Agreement”
 - 1. Short term and long term projects and timelines
 - 2. First joint statements were SFAS 141 (R) *Business Combinations* and SFAS 160 *Consolidations*.
 - 3. Principles based accounting versus rules based accounting
 - d. Vision from the CEOs of the International Audit Networks
 - i. White Paper written in November 2006
 - 1. Six elements need to be addressed
 - a. Investors need better information

- i. Intangible assets
 - b. There are additional stakeholders
 - i. Employees, creditors, suppliers, etc.
 - c. The auditing profession needs to adapt
 - i. A single global auditing standards
 - d. New business reporting model
 - i. Real time audits and financial reporting
 - e. Large collusive frauds are rare
 - f. Information is reported and audited pursuant to globally consistent standards.
- e. SEC recent releases
 - i. Release to eliminate the reconciliation requirement
 - ii. Concept release to allow U.S. firms report using IFRS

II. SFAS 157 *Fair Value Measurements*

- a. Fair value is, “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.”
- b. The exit price
- c. Principal Market and Most Advantageous Market
- d. Transactions Costs
- e. Market participants
- f. Valuation Premise
- g. Highest and Best Use
- h. Defensive Value
- i. Fair Value Hierarchy
 - i. *Level 1* – Quoted prices in active markets for identical assets or liabilities
 - ii. *Level 2* – Inputs other than quoted prices that are observable, either directly or indirectly

- iii. *Level 3* – Unobservable inputs based on best information available in the circumstances
 - j. Fair value of Liabilities Acquired in a Business Combination
 - i. FSP FAS 157-c

- III. How Fair Value Accounting may or may not have impacted the credit crisis
 - a. “Accounting Rules require banks to value many assets at something close to very low fire-sale price rather than the hold – to –maturity price”
 - i. Ben Bernanke testimony to the Senate Banking Committee, September 23, 2008.
 - b. SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting, For Immediate Release, 2008-234 September 30, 2008
 - i. Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?
 - ii. Can transactions in an inactive market affect fair value measurements?
 - c. Joint Statement of the Center for Audit Quality, the Council of Institutional Investors and the CFA Institute Opposing Suspension of Mark-to-Market Accounting
 The Center for Audit Quality, Council of Institutional Investors and the CFA Institute – representing the nation’s public company auditors, institutional investors and chartered financial analysts – are united in opposing any suspension of “mark-to-market” or “fair value” accounting.
- D. FSP FAS 157-3 *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*
 - i. Fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. (An exit price). Determining fair value in a dislocated market

depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.

- ii. ...the use of the reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available.
- iii. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but are not necessarily determinative if an active market does not exist for the financial assets.
- iv. Amends Statement 157 for paragraphs A32A-A32F for an example that illustrates these concepts

- e. SEC Study on Mark to Market Accounting
- f. New FASB Project to Improve Measurement and Disclosure of Fair Value Estimates (February 18, 2009)
- g. Proposed FSP 157-e Comments to end April 1, 2009

IV. Issues in implementing fair value measurements, particularly in business combinations.

- a. Best practices in value in financial reporting as identified by the AITF, the AICPA and the Appraisal Foundation.
- b. Possible changes in fair value measurements as introduced by the Valuation Resource Group of the FASB.
- c. SFAS 141 (r) *Business Combinations*
 - i. Acquisition Method
 - ii. New definition of a business
 - iii. Contingent consideration is measured at fair value
 - iv. Transaction costs are now expensed
 - v. In process research and development is capitalized
 - vi. Same identification criteria for intangible assets as previous statement.
 - vii. Measurement date is date of change of control
 - viii. 100% of fair value on the acquirer's balance sheet

- V. How fair value accounting may influence purchase price negotiations in future transactions.
- a. Change in definition of a business means more transactions fall under SFAS 141 r.
 - b. More consideration provided for defensive assets
 - c. Transaction costs will impact income statements earlier
 - d. New definition of business may cause company's to reconsider reporting units under SFAS 142
 - e. "Negative goodwill" is treated as a gain on the income statement
 - f. More cash in transactions

VI. Conclusions and Questions