

# Alert

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## Is Fair Value the Tail Wagging the Dog?

Now more than ever, CFOs and controllers, and their boards of directors, are dealing with fair value issues. As a valuation firm, it had been rare for us to meet with the boards of public companies – other than when we are delivering a fairness opinion or solvency opinion. But recently, we have been front and center with the controller and CFO in discussing issues of fair value – namely, impairment.

This last year-end reporting cycle has seen a huge spike in impairment charges. And the sometimes massive hits to book values that are being taken have more than caught the eye of the board – they have been forced, by the magnitude of the charges, to review and understand the hows and whys of the write-downs. Usually these have been taken because of FAS 142 goodwill reviews, and occasionally by FAS 144 (long-lived asset) reviews. The reasons for the charges are many, and the discussions commonly revolve around the following questions:

- Is this charge because our share price is down?
- Did we pay too much for that deal we just did?
- Why is our auditor asking about the “implied control premium?”

### SHARE PRICE DOWN

The SEC and auditors are focusing attention on the value of a public company's stock. With share prices down, and not just temporarily – which can mean for more than two or three months – companies are being forced to consider that as one indicator of impairment. Comparing a company's market cap with the carrying value of its shareholder equity may reveal a likely impairment charge. The SEC has made it clear that share price declines cannot be overlooked. Thus, more reliance is being placed on the “market” as an indicator of impairment than ever before.



### DID WE OVERPAY?

Other common questions are: “If we are writing off all the goodwill on the deal we did in 2007, does that mean we were wrong about doing the deal? Is that unit not working out?” And the answer is often, “no, that business is performing well, it's just that the market is not paying the same as it was

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### VRC NEWS

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*“...the newest hot topic is the ‘control premium’ implied in the fair value of a company versus the value indicated by its public shares.”*

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paying at the acquisition date.” If the market comps are all now pointing to paying six times EBITDA, or 1.2 times revenue, instead of the ten times EBITDA and two times revenue it was paying in the sector two years ago, then your acquisition may be meeting plan, and yet the fair value of the unit will be down on a current fair value basis.

### IMPLIED CONTROL PREMIUM

Perhaps the newest hot topic is the “control premium” implied in the fair value of a company versus the value indicated by its public shares. This is the (sometimes considerable) gap that one can see when one adds up the fair values of all reporting units in a FAS 142 review, and compares this total to the value derived from the company’s market capitalization. A year or two ago, we would often see a fair-value-of-the-parts equal less than the value implied by market cap. Now, we have often seen a fair-value-of-the-parts equal more than the value seen from the market. For instance, we may value one reporting unit at 100, another at 150, and a third at 20, for an aggregate fair value (FV) of 270. We may also see the value of the company derived by the market value equals 200. Thus, the FV of the company is above the market value – and in this example, the implied control premium is 35%, as the FV is above 200 by 70. The SEC (and therefore the auditor) is looking for support for this implied control premium. Is there a basis for determining that the control premium is reasonable – that is, empirical market data to support the 35%? As valuation professionals, we have supported the implied control premium that occurs (when the data supports it, of course).

### IS THE TAIL WAGGING THE DOG?

CFOs, controllers and boards are questioning these fair value reviews, and the impairment charges that can be required by a stock price fall. “Is it fair that because the values/prices of our peer group have fallen, our own assets need be marked down?” Or, to paraphrase a common refrain: “... under fair value, there’s nothing right on the left side of my balance sheet, and nothing left on the right side!”

We will leave it to the comments from the SEC when they concluded that fair value is, and should be, a valuable component of financial reporting: “... most investors, and many others, agree that fair value is a meaningful and transparent measure of an investment for financial reporting purposes. Financial reporting is intended to meet the needs of investors.”

### RELY ON OUR EXPERIENCE

VRC regularly assists clients with SFAS 142 and 144 reviews, including underlying tangible and intangible assets. For more information contact your VRC representative or Raymond Weisner at 212-983-3370. **VR**

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Boston	617.342.7366
Chicago	312.957.7500
Cincinnati	513.579.9100
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