



OUR NEW DLOM STUDY—AN UPDATE

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See inside for case summaries on *Astleford, Bergquist, Holman, Mirowski and Gross*

Management Planning, Inc. (“MPI”) has been valuing privately held securities since 1939 and since the mid-1980s has relied on its proprietary restricted stock study to substantiate marketability discounts. Prior to our new initiative, our study included 259 private placement transactions that took place between 1980 and 2000. The median and average discounts of 24.8% and 27.4%, respectively, became the starting point for determining discounts for lack of marketability (“DLOM”).

Recent developments in Tax Court and our desire to provide the highest quality opinions to our clients have caused us take a fresh look at DLOM and its derivation. We approached the issue with an open mind and a desire to gain clarity into how the DLOM has varied over time. Specifically, we wanted more current information, we wanted to determine what factors actually influence marketability, and we wanted to better understand the effect of lapsing restrictions on discounts. We were also interested to know how marketability differed between investment holding entities and operating entities.

First, we identified as the explorable universe every private placement of publicly traded stock included in the Thomson Financial Database from 2000 to 2007. Our study started with data on over 2,000 transactions. After eliminating transactions that were either duplicates or for which there was insufficient information, we

settled on 1,600 transactions. For these 1,600 companies, the average discount was 14.6%. For roughly 100 companies whose privately placed stock was registered, the



average discount was 9.5%. For the roughly 200 companies whose stock was unregistered (and as far as we know, never registered), the average discount was 18.7%. The remaining 1,300 companies had either registration rights, had agreed to register, or were later registered. It must be remembered that all of the transactions in this study occurred after 1997 when the holding period for Rule 144 was reduced from two years to one year. For comparative purposes, the average discount for 240 unregistered transactions in the 1980 to 1997 period (in the original MPI study) was 28.8%.

THE TRUE FEAR OF IMPAIRMENT

By Joseph C. Hassan, CFA, ASA

Earlier this month, the National Bureau of Economic Research issued a press release stating that the U.S. is definitively in a recession¹. Lackluster economic activity has spread across almost all industries, sectors, and markets. Economists and politicians are dominating the headlines with indications that we should expect conditions to get worse before an ensuing recovery. Accordingly, almost every company with reported goodwill on its balance sheet is contemplating whether or not it may face goodwill impairment.

Goodwill impairment charges are typically associated with a number of negative events. For example, executive managers fret over the reaction of investors to goodwill impairment charges. In the public markets, managers have concerns about the perception of an impairment charge and the prospect of an accompanying sell-off in the stock price. In the private sector, managers must address the concerns of larger shareholders and, in some cases, family members. Another concern for managers is how the



company's bank will react. Executives ponder various scenarios: Will my goodwill impairment charge trigger a covenant default? Will it increase my cost of borrowing? Will additional funding be available if needed? Finally, when taking an impairment charge, many executives wonder if the charge highlights their mistakes. Did we pay too much for that acquisition? Could the net loss last year have been prevented?

While the focus is typically on some or all of the aforementioned negative events, the real problem is a lack of understanding regarding the complexities associated with a goodwill impairment appraisal. These complexities

highlight the need to hire a knowledgeable and competent professional to help guide and manage the appraisal process. As a prelude to understanding the need to establish a highly structured and disciplined appraisal process, some background on the mechanics of the impairment test is required.

The Financial Accounting Standard Board's Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets (FAS 142), provides guidance for determining whether certain intangible assets and goodwill are impaired. FAS 142, issued in June 2001, made significant changes to the accounting treatment of goodwill. Prior to FAS 142, the treatment of goodwill followed APB Opinion 17, issued in 1970, which called for goodwill recorded from an acquisition to be amortized over a period not to exceed 40 years. FAS 142, on the other hand, provides that the goodwill of a reporting unit is not amortized. Rather, goodwill is tested for impairment on an annual basis, and between annual tests if events or circumstances change to an extent that may indicate impairment.

Goodwill of a reporting unit is tested for impairment at the reporting unit level. A reporting unit could be a company's operating segment as defined under FAS 131, or a component of a reportable operating segment as defined in paragraph 30 of FAS 142. A two-step impairment test is used to identify potential goodwill impairment and to measure the amount of goodwill impairment to be recognized, if any.

The first step, used to identify potential goodwill impairment, compares the fair value of a reporting unit with its carrying value, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not impaired; thus, the second step of the impairment test is unnecessary.

However, if the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test is necessary to measure the amount of impairment loss. In the second step, the implied fair value of goodwill is compared to the carrying amount of goodwill. If the carrying amount of reporting unit goodwill exceeds the implied fair value of goodwill, an impairment loss is recognized in the amount equal to that excess.

Under the second step of an impairment test, the implied

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¹ Source: Internet (<http://www.dev.nber.org/cycles/dec2008.html>).

RECENT VALUATION CASE SUMMARIES

By John H. Hardwick, Jr., Esq.

Astleford v. Commissioner, T.C. Memo. 2008-128. Filed May 5, 2008

This gift tax case involved the valuation of limited partnership interests in a family real estate partnership, one of the assets of which was a 50% general partnership interest in a partnership owning Minnesota farmland. The 50% interest was noncontrolling since each 50% general partner could not act alone.

The IRS has often argued that valuation discounts at levels below the top tier or “parent” entity are not appropriate. Here the Court allowed lack of control and marketability discounts at both levels, noting that the farmland partnership was only 16% of overall net asset value and one of fifteen real estate investments. Concluded combined discounts were 30% for the general partnership interest and roughly 35% for the limited partnership interest.

COMMENT: Judge Swift’s list of favorable multi-tiered discount Tax Court cases is handy:

Estate of Piper v. Comm’r., 72 T.C. 1062 (1979).

Janda v. Comm’r., T.C. Memo. 2001-24.

Gow v. Comm’r., T.C. Memo. 2000-93, affd. 19 Fed. Appx. 90 (4th Cir. 2001).

Gallum v. Comm’r., T.C. Memo. 1974-284.

Bergquist v. Commissioner, 131 T.C. No. 2. Filed July 22, 2008.

A group of anesthesiologists gave stock in their professional service corporation (UA) to a newly formed tax-exempt medical professional service corporation (OHSUMG). Four months later the anesthesiologists transferred their individual practices to OHSUMG when a planned consolidation with other medical practice groups was completed. UA was viewed as an operating entity when the gifts were made so it was valued as a going concern rather than on a liquidation basis. These actions were pursuant to a plan devised by their accountant which enabled “huge windfall” charitable deductions for income tax purposes.

Subsequent events must be considered by an appraiser if they were reasonably foreseeable on the valuation date. After reviewing the facts, the Court decided consolidation

was “imminent” when the gifts were made, thereby rejecting a going concern valuation approach, and directed its attention to UA’s value as an asset-based entity holding cash and accounts receivable. It accepted IRS discounts of 35% minority interest and 45% lack of marketability.



The Court agreed with the IRS that the anesthesiologists had acted in bad faith and, accordingly, misstatement of value penalties should be imposed.

COMMENT: It is interesting to compare discount for lack of marketability results here with those in other important cases where restricted stock studies were also used to support the discount:

<i>Bergquist</i>	45%
<i>Peracchio</i>	25%
<i>Lappo</i>	24%
<i>McCord</i>	20%

Holman v. Commissioner, 130 T.C. No. 12. Filed May 28, 2008.

In a reviewed opinion in a case involving gifts of limited partnership interests within a few days after the partnership was formed and funded, the Tax Court rejected IRS “indirect gift” and “step transaction” arguments but said transfer restrictions in the partnership agreement should be ignored for valuation purposes, relying on Code Section 2703. In doing so, we believe the Court did not follow hypothetical willing buyer-willing seller standard precedent (see *Morrissey* and *Simplot* cases) when it speculated that a partner who wanted out would be accommodated. We understand many in the legal community view this as reversible error.

MPI was the taxpayer’s valuation expert. Our combined valuation discount of 44% (14% minority interest and 35%

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Recent Valuation Case Summaries, Continued

lack of marketability) for the 1999 gifts was reduced to 22% (11% and 12.5%).

Under Section 2703 a restriction on transfer is disregarded unless (1) it is a bona fide business arrangement, (2) it is not a device to transfer property to the family for less than adequate consideration and (3) its terms are comparable to similar arrangements between persons in an arm's length transaction. The Court did not rule on the third requirement because it decided the transfer restrictions in the partnership agreement failed to meet the first two. It saw no "bona fide business purpose" where the primary reason for the partnership was preservation of family wealth. As for the second requirement's "device" test, the Court stated:

"...given the significant minority interest and marketability discounts from an LP unit's proportional share of the partnership's NAV that each expert would apply in valuing the gifts, it would appear to be in the economic interest of both any limited partner not under the economic necessity to do so but wishing to make an impermissible assignment of LP units and the remaining partners to strike a deal at some price between the discounted value of the unit and the dollar value of the units' proportional share of the partnership's NAV. The wishing-to-assign partner would get more than she would get in the admittedly 'thin' market for private transactions, and the dollar value of each remaining partner's share of the partnership's NAV would increase."

COMMENT: There is considerable discussion in the opinion about the discount for lack of marketability, its components and restricted stock studies, but the bottom line is the application of Section 2703 and its huge impact on the Court's valuation conclusions. Indeed, even the IRS appraiser was at a 35% combined discount (11% and 27%) if the restrictions were taken into account.

Estate of Mirowski v. Commissioner, T.C. Memo. 2008-74. Filed March 26, 2008.

Anna Mirowski formed and funded a Maryland LLC with 90% of her assets, made gifts of 16% noncontrolling interests to her three daughters' trusts, keeping a 52% majority interest as general manager, and then died. All of

this occurred over a two week period. Are these facts bad enough for Code Sections 2036 and 2038 to apply? Here are some of the reasons why Judge Chiechi rejected IRS arguments that the LLC's assets should be added back to the gross estate:

Mrs. Mirowski's eight month illness was treatable and her death was unexpected. The entire process of finalizing LLC arrangements took a little over a year.

Among the "legitimate and significant" nontax purposes for creating the LLC were joint management of family assets, single pooling of assets to allow for more investment opportunities, and enabling children and eventually grandchildren to share family assets equally.

The LLC was found to be a "valid functioning business operation"

Mrs. Mirowski retained sufficient assets (\$7.5 million) to live on after her transfers to the LLC. An \$11.8 million gift tax bill would have been paid from a combination of

several sources, including personal assets, future 52% LLC distributions, and /or borrowing against same.

The LLC was found to be a "valid functioning business operation" that had to manage matters relating to patents and a license agreement for an implantable defibrillator (the "ICD", invented by Mrs. Mirowski's deceased husband) as well as a \$62 million securities portfolio.

IRS arguments under 2036(a)(1), 2036 (a)(2) and 2038(a)(1) (retention and control of enjoyment) failed because a close reading of the LLC agreement showed that Mrs. Mirowski did not really have the authority to decide timing and amounts of distributions despite her majority interest. Furthermore, Maryland law imposed upon her fiduciary duties to other LLC members.

Gross v. Commissioner, T.C. Memo. 2008-221. Filed September 29, 2008.

After discussions and agreement with her two daughters

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Recent Valuation Case Summaries, Continued

about the need for a family limited partnership for investment management purposes, Bianca Gross filed a certificate of limited partnership with the State of New York on July 15, 1998. Transfers of marketable securities and nominal cash to a partnership account over the next few months were completed by December 4, 1998. One December 15, 1998 Ms. Gross and her daughters signed the partnership agreement and Ms. Gross made 22.25% gifts of limited partnership interests to each daughter. A 35% combined valuation discount was applied in valuing the gifts.

The IRS argued that indirect gifts of marketable securities had been made because the partnership was not formed until the agreement was signed, which was after the transfers.

Judge Halpern ruled in favor of Ms. Gross. The filing of a certificate of limited partnership is conclusive evidence of the formation of the partnership under New York law. Furthermore, New York law permits formation of a general partnership where limited partnership formation requirements fail if the conduct of the parties suggests a partnership arrangement. The judge reviewed the facts and found nothing inconsistent with a limited or general partnership's formation on July 15.

COMMENT: MPI was valuation expert for Ms. Gross. Our combined discount was approximately 41%. A combined discount of 35% was stipulated by the IRS and Ms. Gross.

WITH SHARES TANKING, THINK ABOUT GIFTING

By Arden Dale of the *Wall Street Journal*, November 11, 2008

NOTE: As Stephen Roberts discussed in his article, "Valuations in Times of Uncertainty" in the September 2008 issue of Perspectives, the current economic climate offers unique gifting opportunities to stockholders of closely held operating companies and other asset holders. The conditions which prompted his discussion are clearly not disappearing anytime soon. The Applicable Federal Rates for family transfer techniques such as GRATs and Intentionally Defective Trusts remain historically low. We are not alone in recognizing this silver lining—the Wall Street Journal published this piece by Arden Dale on November 11, 2008, explaining the advantages of gifting in the current economy. Keep in mind, however, that considering the perpetual flux of today's market, as well as increased regulatory and auditor scrutiny, a reliable valuation is an integral part of any gifting strategy. Please feel free to contact us if we can be of assistance in meeting your valuation needs. You'll find contact information on the back page of this newsletter.

The classic tax strategy of giving away stock to family members packs more punch right now.

Donors can give twice as much for their money in some cases because prices are so low. And people who get a gift have a chance to build wealth by holding it until the market recovers.

Take the example of shares now worth \$6 that would have sold for \$12 in April: A parent can give 2,000 of them to a

child now without having to pay a gift tax, compared with 1,000 shares in April.

"It's the best time so far in a long while for this," said Joan Crain, senior director of wealth management strategies at BNY Mellon Wealth Management in Fort Lauderdale, Fla.



Many wealth advisers expect Congress to reform the gift- and estate-tax system permanently next year, possibly making it more expensive and harder to give. Tax experts say this is another reason to give now.

Individuals can give an unlimited number of \$12,000 gifts this year without paying gift tax (\$24,000 for couples). The ceilings rise to \$13,000 and \$26,000 in 2009.

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With Shares Tanking, Think About Gifting, Continued

Gift tax is paid on what the stock is worth at the time the gift is made.

Separate from the \$12,000 gifts, each individual can give away up to \$1 million free of gift tax during a lifetime. This may be a good time to use up some of that lifetime exemption, according to Ms. Crain. To do that, the donor makes a gift over the \$12,000 limit; the amount above the limit eats into the lifetime exclusion. For example, a donor who gives \$45,000 in a single gift to an individual would deduct \$33,000 from his \$1 million exclusion.



One doesn't have to report gifts of up to \$12,000 to the Internal Revenue Service. Good records are critical, however, in case of an audit. Gifts over the \$12,000 limit must be reported on a gift-tax return (Form 709) filed along with the income-tax return. Spouses must file a gift-tax return if one of them makes a gift over \$12,000, to show the IRS they have agreed to split the gift. If they make a gift of up to \$24,000 out of a joint account, however, they don't need to file Form 709.

Stock is probably the easiest asset to give. Real estate, for example, usually involves transferring partial interests, which can get messy, and may even raise other issues like transfer taxes and property-tax assessments, according to Don Weigandt, wealth adviser at J.P. Morgan Private Bank in Los Angeles.

With stock, the donor simply transfers shares to the recipient, usually through a broker or wealth adviser. The transfer isn't considered a sale of the security, so capital gains aren't an issue until the person who receives the stock decides to sell it.

"If the person doesn't sell, there are no capital gains implications at all," said Mr. Weigandt. The reason is that gifts aren't considered to be income, he added.

"You can also gift shares of mutual funds the same way, by contacting your wealth manager or mutual-fund companies," said Ms. Crain of BNY Mellon.

The donor's cost basis in the shares goes to the recipient, with one exception. In the case of a gift big enough to generate the gift tax, a portion of the tax is factored into the new cost basis.

The recipient also takes the same holding period for the shares as the donor had. So if the person giving the stock held it for 36 months, the recipient is also considered to have held it that long.

When choosing stocks to give right now, pick ones that look like they have a good opportunity to recover. Shares of financial and health-care firms, and large-cap, blue-chip stocks all deserve a look, but there are bargains across the board, according to tax advisers. High-grade muni bonds also hold promise.

For people who receive a gift now, the idea is to be patient. One may have to wait three, four or five years to get the most out of it.

Despite the logic of giving now, many people simply don't feel generous when faced with a shrunken portfolio. Financial advisers say they are struggling with some wealthy clients to persuade them to make even their usual annual gifts to relatives.

"People feel poorer, so psychologically there's been a hurdle there," said Ms. Crain. Some of that is changing, she added, as people start to realize the "end of the world isn't coming."

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FINANCIAL REPORTING UPDATE: SUMMARY OF TOPICS PRESENTED AT 2008 NATIONAL ASA/AICPA BV CONFERENCE

By David A. Gaynor, II, ASA, CBA

The 2008 National ASA/AICPA Business Valuation Conference kicked off with a presentation by Robert H. Herz, Chairman of the Financial Accounting Standards Board. Mr. Herz provided an overview of recent and current FASB projects relating to fair value and valuations including:

- Fair value measurement guidance
- Business combinations
- Conceptual framework
- Financial statement presentation

While fair value financial reporting continues to take significant heat in the marketplace, Mr. Herz emphasized that fair value accounting is clearly superior when compared to the prior historical cost model, which failed to convey relevant information to investors. Mr. Herz commented that fair value “tells you where you are now” and noted that he believes in “reporting the truth.” He noted that fair value results in greater comparability, it is basic to economic theory and the reality of the markets, it is a better basis for investment decisions and it is more understandable. Finally, fair value has been confirmed as appropriate by numerous third party investor organizations, including the ASA and the CFA Institute.

Fair Value Panel

Up next on the docket was a fair value panel comprised of representatives from each of the “Big 4” accounting firms. The panel was asked a series of questions pertaining to current fair value issues.

Topic #1: Is fair value to blame? This discussion addressed whether or not fair value is to blame for the current financial crisis. As Joseph Hassan wrote in the September 2008 issue of *Perspectives*, many have been criticizing fair value accounting, particularly among Level III inputs. Level III inputs are unobservable inputs (i.e., information not gleaned from market data such as market prices). Instead, valuation analysts need to gather and review the best information available in order to fully vet inputs. The response from the panel regarding whether or not fair value is to blame was a resounding “no.” The panel relied upon the usual arguments in favor of fair value reporting, including increased transparency, the generation of the most relevant information for investors, and so forth. Perhaps the strongest point, however, was that as a society, we should examine the root cause of the current market turmoil (such as lax lending requirements and greed) as opposed to reactively blaming the turmoil on fair value reporting.

Topic #2: Audit Review. Those of us who prepare fair value analyses for financial reporting purposes know that audit review can be painful. Well, we may want to brace ourselves, as the expectation is that audit reviews will be even more difficult in the coming months. In this regard, the panelists urged the audience to be mindful of the fact that liability for the valuation firm is generally limited. Notwithstanding the efforts of valuation firms, the financial statements are ultimately management’s responsibility, a factor which substantially reduces the liability for valuation firms. The audit firms, on the other hand, have the responsibility of assessing an unqualified opinion with regard to the validity of the financial statements; this is the essence of the audit. In this regard, audit firms are increasingly concerned about associated liabilities and this factor alone will make audit review more difficult as we linger in challenging economic times. In fact, one of the panelists commented that his firm billed over one million hours last year attributable to valuation review, a number which is likely to increase.

Topic #3: FAS 157 Fair Valuations. Several important points were conveyed on this topic. First, the panelists commented on the increased volume associated with FAS 157 portfolio company valuations for private equity firms.



A second point revolved around the theoretical mismatch that currently exists between values determined via the income approach versus those determined via the market approach. It is possible that the market is exhibiting irrational behavior on the downside, thus making values determined using the market approach less useful. This contrasts with the valuations prepared during the dot.com bubble, a time when market approach valuations exhibited upside irrational behavior. It is the job of the analyst to discern why differences in value exist between different approaches, and either reconcile, weight accordingly, or otherwise discard certain

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Financial Reporting Update, Continued

approaches.

Another point concerned the vetting of projections. The panelists have seen too many analyses where analysts simply accept management's projections without question. There might be a material projected increase in sales. There could be a significant projected change in margins. Or the income statement projections may not be possible to achieve while maintaining a sound financial position. No matter what the assumptions are, it is the job of the analyst to thoroughly vet the projections. The panelists noted that this is a sensitive topic in audit review. Projections need to be reviewed, researched, and analyzed. The assumptions should be thoroughly questioned to ensure that the projection scenario is as realistic as possible.

A fourth point discussed was the issue of expertising. Expertising means allowing the subject company to name the valuation firm in a public filing. It is akin to an indication that the appraisal firm (and not management) is responsible for the valuation. The concept of expertising carries negative connotations and/or repercussions for all parties involved. First, management teams should know their values and how they were derived. They should be experts on the valuation conclusions, relying on guidance from outside appraisal firms. Expertising puts the ball in the court of the valuator. From the valuator's standpoint, allowing your firm to be expertised exponentially increases the risk of litigation.

Contributory Asset Charges ("CACs") Working Group Update

This presentation provided an update on the status of the Appraisal Issues Task Force ("AITF") and The Appraisal Foundation's ("TAF") first Working Group. The TAF is a non-profit educational organization founded by 8 national appraisal organizations in 1987 to foster professionalism in valuation by promoting professional appraisal standards and appraiser qualifications. TAF is authorized by the U.S. Congress as the source of appraisal standards and appraiser qualifications.

The AITF, in which MPI actively participates, is a voluntary group of professional appraisers who wish to improve the practice of valuation. It provides a forum for the discussion of issues related to valuation for financial reporting purposes and helps establish and interpret existing rules. Further, the AITF works with the FASB and the SEC to evaluate proposals and recommend methodologies, assumptions and approaches. In February 2006, the AITF, through a sub-committee, issued a draft document titled "*Illustrative Valuation Issues*," identifying a "Top 25" list of issues related to the valuation of assets.

In 2006, TAF met with the FASB and volunteered to sponsor the creation of Best Practice Working Groups to address best practices for the valuation of assets and liabilities for financial

reporting purposes. The aforementioned AITF "Top 25" list is typically used as a guide in establishing topics/issues for the Working Groups to address. The goal of the first Working Group is to issue a best practices document to assist in decreasing the diversity in practice with respect to CACs.

On June 10, 2008, the working group issued a Discussion Draft for comments. In it, three key issues were addressed and alternative viewpoints and/or valuation assumptions were presented. These key issues were: i) the identification of contributory assets (also known as capital charges or economic rents) which are a requisite consideration in applying the Multi-Period Excess Earnings Method ("MPEEM") to estimate the fair value of an intangible asset; ii) valuation methodologies/assumptions such as appropriate working capital levels and the application of CACs within the MPEEM; and iii) the stratification of discount rates by asset or asset categories due to the lack of publicly available data. Of the largely positive responses received, a majority of the comments supported

one of the alternative views suggested.

An Exposure Draft was expected to be issued by the end of 2008, with a final publication in early 2009. The next working group will address the valuation of customer relationships.

The panelists have seen too many analysts simply accept management's projections without question

Discounted Cash Flow Analysis

Perhaps the star of the annual business valuation conference was Aswath Damodaran, professor of finance at Columbia University. Damodaran gave a lively presentation entitled "*Dante Meets DCF*," questioning ten elements and assumptions of discounted cash flow (DCF) analyses. The ten assumptions questioned by Damodaran are as follows:

1. Current year numbers
2. Cash flow
3. Taxes
4. Growth
5. Discount rate
6. Growth rate revisited
7. Debt ratio revisited
8. Garnishes
9. Per-share value
10. I-bankers inferno

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The True Fear of Impairment, Continued

fair value of goodwill is determined in the same manner as the amount of goodwill recognized in a business combination is determined. That is, pursuant to the guidance provided under FAS 141, an entity allocates the fair value of the reporting unit to all of the assets and liabilities of that unit as if the reporting unit had been acquired in a business combination. The fair value of the reporting unit, as determined in Step One, is assumed to be the price paid to acquire the reporting unit for the Step Two analysis. The excess of the fair value of the reporting unit, if any, over the amounts assigned to its assets and liabilities is the implied fair value of goodwill.

Turning back to management of the appraisal process, one can easily surmise that the goodwill impairment test can be a lengthy proposition. The Step One analysis under FAS 142 can, in some cases, take several weeks. If Step Two is required, more complicated cases can span two to three months. A good valuation team will work diligently with management and their CPA firm to manage the goodwill impairment test process from start to finish, avoiding potential costly delays with regard to the preparation of financial statements.

Separately, there are a number of uncertainties related to the valuation of businesses and intangible assets that must be considered during both Step One and Step Two of the impairment test. Select issues that must be addressed follow below:

- Which valuation approaches should I use and why? Should I use more than one valuation approach?
- Should my valuation approach include a premium for control?
- Should my valuation approach include a discount for lack of marketability?
- Under market approach techniques, how do I select multiples, royalty rates, or other benchmarks without bias?
- Under income based techniques, what is the appropriate discount rate to use for my company? Moreover, how do I support the selection of the discount rate?
- If I've used more than one approach, how do I weight the approaches to develop a final value?
- Should the value be based upon a taxable or nontaxable transaction set of assumptions (i.e., asset

deal, stock deal, etc.)?

- Do I use certain assumptions for Step Two only, or must the assumptions apply to both Step One and Step Two?
- If I get to Step Two of the impairment test, which intangible assets need to be separately valued? How should I value the intangible assets?
- Is my analysis thoroughly supported by the underlying assumptions?

These valuation issues are enough to cause angst among even the most valuation-savvy financial managers. A competent valuation team will be equipped to address these issues in an efficient manner, enabling executive managers to focus more of their time on managing their business. Moreover, hiring a knowledgeable valuation firm can help managers avoid mismanagement of the appraisal process through the application of inappropriate valuation techniques.

Finally, the uncertain economy has increasingly highlighted mismanagement of the impairment process for other reasons, as well. Although on the one hand, executive managers are concerned over the previously mentioned ramifications associated with a goodwill impairment charge, these same managers are also concerned about the potential liability if economic conditions quickly deteriorate. Take, for example, the situation where impairment is not indicated under a Step One goodwill impairment test prepared as of a contemporaneous date. Market conditions subsequently deteriorate, and quickly. Since impairment tests rely heavily on forecasts and other prospective financial information provided by management, how will investors and regulatory bodies react if management takes consecutive significant impairment charges? Similarly, how will investors and regulatory bodies react if there is one very large impairment charge? Should the impairment have been identified earlier? An independent valuation firm can help by objectively questioning and vetting the prospective



The True Fear of Impairment, Continued

financial information used in the course of the goodwill impairment test, resulting in the most thorough analysis possible as of any given date.

In conclusion, for many reasons, it is both logical and necessary for financial managers to engage third party independent valuation firms to help guide them the

Financial Reporting Update, Continued

A full review of Damodoran's presentation is beyond the scope of this article. However, Damodoran's presentations are typically made available to the public on his website. In light of the aforementioned comments regarding "vetting the projections," as well as the common use of DCF techniques for valuing intangible assets for financial reporting purposes, viewing the Damodoran presentation in its entirety is strongly recommended.

Valuation of In-Process Research and Development ("IPR&D")

This presentation centered on an informative discussion regarding the need to "refresh" the AICPA *Practice Aid: Assets Acquired in a Business Combination to be Used in Research & Development Activities* (the "IPR&D Practice Aid") due to the issuance of FAS 157¹. The IPR&D Practice Aid was originally issued in December 2001, followed by a later update to reflect the issuance of FAS 141/142. According to the presenter, the IPR&D Practice Aid sets forth a conservative view regarding the valuation of IPR&D. It continues to be widely used as a reference not only for the valuation of IPR&D, but also for the valuations of other intangible assets.

Some of the needed changes in the IPR&D Practice Aid include: i) adjustments to the definition of fair value to reflect such principles as market participants, exit value, principal market vs. most advantageous market, fair value hierarchy, and highest and best use, to name a few; ii) revision of the definition of research and development assets acquired; and iii) the addition of language surrounding auditing requirements as they pertain to acquired IPR&D estimates.

Surviving the Audit

Over the course of two breakout sessions, representatives from the Big 4 offered their views and tips for surviving the audit review process. In general, and as mentioned earlier, the level of review has escalated and is expected to continue to escalate as audit firms are increasingly concerned about liability. In addition, the number of comments from the Public Company Accounting Oversight Board ("PCAOB") pertaining to valuation has increased in recent years. Approximately 30% of all current PCAOB comments are related to fair value issues

goodwill impairment test process. MPI has a seventy-year track record of preparing quality valuation work, and significant experience preparing both Step One and Step Two analyses under FAS 142. Please contact us if we may be of assistance.

(and this is prior to FAS 157 becoming effective).

One recommendation is to involve the auditors (both the audit manager and the appropriate valuation personnel) early. This process is one that is commonly implemented by MPI. The goal is to have everyone on the same page regarding the assets to be valued, contemplated valuation techniques, and the process in general, with a view to avoiding unexpected delays to finalization for the end client.

The aforementioned point is particularly significant now, given the increasing amount of FAS 142 goodwill impairment work and the associated fast turnaround times. The timeline for impairment tests is typically less than 90 days (and often much shorter), including both the step one enterprise level test and the step two allocation and determination phase, if necessary. Given the need for fast turnaround times, it is imperative that valuation professionals get the process right from the beginning.

The speakers also outlined common points of contention during audit review. An abbreviated list follows:

- Use of market participant assumptions
- Vetting the projections
- IPR&D
- Determination of discount rates
- Reconciliation of WACC, IRR, and WARA
- Intangible asset lifing

Conclusion

We are in precarious economic times. Fair valuation issues are at the forefront of current debate. The audit review process has become more difficult, while techniques utilized in valuing identifiable intangible assets are in a state of flux. Because of this, it is more important than ever that you engage an experienced outside valuation firm, knowledgeable of current fair valuation issues, to help guide you through the process. Please contact us with any questions or if we may be of service.

¹ FAS 157 centers on an updated definition of fair value, effective for non-financial assets and liabilities for fiscal years beginning after November 15, 2008.

Our New DLOM Study, Continued

Simply extrapolating from the aforementioned downward trend in Rule 144, private placement discounts would ignore the structural and legal evolution of Rule 144 stock and misapply these “current” market indications to the stock of closely held companies, a trap that has found its way into recent Tax Court opinions and expert reports. This is not to say, however, that recent transactions should be ignored. On the contrary, by employing sophisticated sta-



tistical techniques, MPI has created a method to control for various influences (such as the aforementioned holding period reductions) while at same time enriching the analysis through incorporation of security-specific information.

MULTIPLE REGRESSION ANALYSIS

Once the exhaustive universe of transactions was established, we assembled a variety of data, including transactional details such as the transaction date, the stock price of the company on the transaction date, the private placement price, the status of registration and/or registration rights, the block size, holding period regime, etc. We also gathered a range of company-specific data including, but not limited to: market capitalization, historical stock price volatility, operating performance metrics and measures of financial strength. Since we believe overall market events affect the private placement discounts required by investors, we compiled relevant data on broad financial market conditions including those relating to the equity and credit markets.

Our study tested numerous model specifications including transformations of independent and dependent variables. Ultimately, we settled on a parsimonious model that not only incorporates a manageable universe of relevant and statistically significant independent variables but also one that explains a significantly higher proportion of the overall variation in restricted stock discounts than previous regression-based DLOM models.

As a result of the statistical techniques employed, we can now not only build the bridge between the private placement discounts observed over the various Rule 144 restriction periods, but also establish yet another strong foundation for quantifying unique discounts for lack of marketability for our operating and investment holding company clients by incorporating client-specific information and contemporaneous market condition data.

NEXT STEPS

Our new restricted stock study has consumed thousands of man hours and represents an achievement of which we are quite proud (and protective). We have a little more data gathering to do in order to finish incorporating the original MPI study data. We will then submit our work for a rigorous review by researchers at a top academic institution. By the first quarter of 2009, we anticipate that we will use our regression model in determining DLOMs on client assignments.

Finally, we are considering our alternatives regarding the publication of this study. We are considering a variety of options ranging from maintaining our study as a proprietary product to a publication of the entire study in a peer-reviewed journal.



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