# ASA Fair Value Conference – SEC Update

*May 7, 2009*

*Evan Sussholz*
*Professional Accounting Fellow - Valuation Specialist*
*Office of the Chief Accountant*

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# *SEC Staff and Valuations*

# *The SEC Staff and Valuations: Division of Corporation Finance*

- Committed to taking valuation issues seriously
- Look for / ask questions to inquire:
  - Valuation is in compliance with GAAP
  - Overall fair value conclusions and related key assumptions make sense based upon facts and circumstances
  - Appropriate valuation methodologies applied
  - Sufficient disclosures for investors to make investment decisions
- May seek advice from OCA as necessary
- Common Responses to Valuation Queries
  - "What my peers are doing"
  - "Use of methodology in other filings"

# *The SEC Staff and Valuations: Office of the Chief Accountant*

### ***Registrant Consultations (Pre-filing)***

- Different from the “comment letter” process
- Valuation consultation issues may include:
  - Appropriate methodologies
  - Valuation factors to consider
  - Relevant financial reporting guidance to consider
  - Overall reasonableness of numbers given facts and circumstances
- Discuss issues and try to resolve with auditors first before seeking consultation with OCA

# *The SEC Staff and Valuations: Office of the Chief Accountant*

## *Registrant Consultations (cont'd)*

- Guidance for resolving 'pre-filing' questions is posted on the SEC's website

  *www.sec.gov/info/accountants/ocasubguidance.htm*

- Companies should provide OCA with a written submission (commonly referred to as a "pre-filing" submission)
  - Auditor participation
  - Audit committee participation

# *Fair Value Accounting and Current Economic Crisis*

# The Fair Value Debate

***Some believe fair value accounting…***

- Destabilizes our financial markets
- Inappropriately requires investment write-downs
- Unnecessarily requires financial institutions to raise additional capital

***Others believe fair value accounting…***

- Serves to enhance transparency
- Strengthens investor confidence in our financial markets
- Serves the needs of investors

***The Emergency Economic Stabilization Act of 2008 mandated that the Commission staff study mark-to-market accounting and its effects***

# *Fair Value Study - Focus*

1. The effects of fair value accounting standards on financial institutions' balance sheets;
2. The impacts of fair value accounting on bank failures in 2008;
3. The impact of fair value accounting standards on the quality of financial information available to investors;
4. The process used by the Financial Accounting Standards Board (FASB) in developing accounting standards;
5. Alternative accounting standards to those provided in FASB Statement No 157; and
6. The advisability and feasibility of modifications to fair value accounting standards.

***The 90-day study's report was delivered to Congress on December 30, 2008***

# *Fair Value Study – Findings*

1. Investors generally believe fair value accounting increases financial reporting transparency and facilitates better investment decision-making;
2. Fair value did not appear to play a meaningful role in the bank failures that occurred in 2008;
3. Bank failures in 2008 appeared to be the result of growing probable credit losses, concerns about asset quality, and in certain cases, eroding lender and investor confidence; and
4. Fair value and mark-to-market accounting have been in place for years and their abrupt removal would erode investor confidence in financial statements.

***"Suspending FAS 157 would only revert practice to inconsistent and sometimes conflicting guidance"***

# *Fair Value Study– Recommendations*

- Development of additional guidance and other tools for determining fair value in illiquid or inactive markets
- Enhancement of existing fair value accounting disclosure and presentation requirements
- Educational efforts to reinforce the need for management judgment in the determination of fair value estimates
- Examination by the FASB of both the impact of liquidity in the measurement of fair value and potential improvements to the impairment accounting models
- Assessment by the FASB of whether the incorporation of credit risk in the measurement of liabilities provides useful information to investors

***"Improve, do not suspend, fair value accounting standards"***

# *FASB Actions In Response to Recommendations*

- FSP FAS 157-4 -*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*
- FSP FAS 107-1 and APB 28-1 - *Interim Disclosures about Fair Value of Financial Instruments*
- FSP FAS 115-2 and FAS 124-2 - *Recognition and Presentation of Other-Than-Temporary Impairments*
- Other Ongoing Projects:
  - FAS 157—Applying Fair Value to Interests in Alternative Investments
  - FAS 157—Improving Disclosures about Fair Value Measurements

# *Fair Value Accounting and Valuation Specialists*

## ***Expanding Role of the Valuation Specialist***

- Perform valuations for financial reporting purposes considering relevant accounting guidance (SFAS 157, SFAS 123r, IAS 39, etc)
- Review valuations performed by management and other valuation specialists (AU 336 and AU 328)
- Participate in the development of accounting standards and application guidance (Valuation Resource Group, IASB Expert Advisory Panel, Comment Letters to Standard Setters)
- Develop valuation best practice documents and valuation standards for financial reporting.
- Educate preparers and users of financial statements on how to perform and interpret fair value estimates

# *Observations / Hot Topics*

# *Control Premiums*

## ***Overview***

- The selection of a control premium requires a great deal of judgment
- The Staff does not have “bright line” tests that we use in determining the reasonableness of a control premium
- Registrants should carefully analyze the facts and circumstances of their particular situation when determining an appropriate control premium.
- The Staff may ask a registrant to support the propriety of a selected control premium (or other reasons why market capitalization does not reflect fair value)
- The amount of supporting evidence supporting a judgment would likely be expected to increase as any control premium increases.

# *Control Premiums*

## *Observations*

- Lack of supporting analysis on selected control premium
  - Developed based on broad historical averages and other anecdotal information
  - Inadequate responses include:
    - “Based on our experience”
    - “We relied upon reasonable judgment”
    - “Represents a price that we would be willing to sell the entity”
- **Lack of support for “reasonable period” when calculating market capitalization**
  - Analysis of significant historical company events
  - Analysis of company, industry, and broader market trading behavior

# *Control Premiums*

## *Observations*

- Lack of appropriate financial statement disclosures on valuation methodology and significant assumptions
  - Misleading statements regarding reconciliation to market capitalization
  - Few details regarding significant assumptions, sensitivity, and risk

# *Discount Rates / WACC*

## *Current Market Environment*

- Additional analysis should be performed when selecting:
  - Equity risk premiums
  - Debt to equity ratios
  - Cost of debt
  - Beta

## *Observations*

- Equity risk premiums
  - No adjustment to reflect impact of current risk bias
- Debt to equity ratios / Cost of debt
  - Utilizing book value of debt to determine D/E ratio, but using market implied yield for cost of debt
  - Calculating a “normalized” capital structure
- Lack of consistency

# *Multi-Period Excess Earnings Method*

## ***Observations / Common Errors***

- Allocation of operating expenses
  - New customer marketing expenses
  - R&D expenses
  - Fixed cost structure
- Including interest expense
- Excluding amortization tax benefit
- Company specific vs. market participant contributory asset charges
- Reconciliation of individual asset cash flows to overall business enterprise cash flows

# *Valuation of Restricted Stock*

- SFAS 141R requires stock issued as consideration paid in a business combination to be measured at fair value
- The calculation of the fair value of restricted stock should follow the guidance in paragraphs A28 – A30 of SFAS 157 , which generally requires that:
  - Restrictions that are considered to be an <u>attribute of the security</u> and would transfer to market participants should be considered when estimating the fair value of the security
  - Restrictions that are considered to be <u>unique to the holder</u> and would not transfer to market participants should not be considered when estimating the fair value of the security
- An example of a restriction unique to the security would be Rule 144 or similar rules of the SEC
- An example of a restriction unique to the holder of a security would be an agreement with a selling shareholder that prohibits the sale of stock received for a specified period of time.

# Limited Scope Engagements

### *Observations*

- Valuation engagement is limited to certain valuations approaches
  - Statement 157, paragraph 19 and FSP 157-4 indicates that multiple valuation techniques maybe appropriate when valuing reporting units and inactive assets
  - May ignore relevant information that market participants would consider in pricing an asset or entity
- Valuation engagement is limited to certain assets or procedures
  - May result in inappropriate assumptions and inputs being utilized in valuation analysis (i.e. contributory asset charges, discount rates, etc.)
  - Reporting entity management not be qualified to perform remaining tasks (i.e. discount rate reconciliation, valuation adjustments, etc.)

# Conclusion

Questions and Answers