# *Valuations in Financial Reporting*

*May 9, 2007*

*Cheryl Tjon-Hing*
*Valuation Specialist*
*Office of the Chief Accountant*

# Disclaimer

As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. The comments herein express the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the Staff

# SEC STAFF AND VALUATIONS

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

- Committed to taking valuation issues seriously
- Look for / ask questions to ensure:
  - 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
  - There are sufficient disclosures for investors to make their investment decisions
- May seek advice from OCA as deemed 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
  - Review overall reasonability of numbers given facts and circumstances
- ***Do request that issues be discussed and tried to be resolved 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-clearance" submission)
  - Auditor participation
  - Audit committee participation

# *SEC STAFF COMMENTS, OBSERVATIONS & AREAS of CONCERN*

# *Expertization Issues*

- Written consent of Experts (Rule 436)
  - Filed as exhibit to 1933 Act filings
  - States that the named expert consents to any quotation/summarization of the expert report and/or reference as an expert in the filing
- Registrant needs to obtain Written Consent:
  - Any reference to the use of an expert (e.g. valuation consultant) in 1933 Act filing
    - Any portion of the expert's report/opinion is quoted/summarized
    - If it is stated that any information in the filing has been reviewed/passed upon by a person whom the registrant relies upon as an expert

# *Expertization Issues*

- SEC Executive Compensation Disclosure
  - Effective for:
    - Fiscals ending after 12/15/2006
    - 8Ks filed after 11/07/2006
  - Corporate Governance Disclosure 407 (e)(3):

    "the company will be required to describe its processes and procedures for the consideration and determination of executive and director compensation including:….<u>any role of compensation consultants</u> in determining or recommending the amount or form of executive and director compensation, <u>*identifying such consultants*</u>…."
  - 407 Application Q&A – no consent required

*www.sec.gov/divisions/corpfin/guidance/execcomp407intep.htm*

# *Employee Stock Option Valuation Issues*

### *Market Based Option Valuations*

- SEC staff has only commented on the design of ESOARS, subject to some adjustments on forfeiture considerations
  - No different from the logic behind other option pricing models - Law of One Price ("LOOP")
    - BSOP – European call value = value of a levered position in the underlying stock
- Have *not* commented on the following:
  - An appropriate market pricing mechanism;
  - Credible information plan

(see August 31, 2005 letter from OEA to OCA)

# Employee Stock Option Valuation Issues

## *Analytical Approaches - Valuation Models*

- Limitations of Black Scholes vs. attributes of target award

## *Expected Term - Simplified Method*

- At this time, still expected to sunset at December 31, 2007 (as stated in SAB 107)

# *Employee Stock Option Valuation Issues*

### *Discounts/Premia*

- Reference to studies not appropriate as primary support for discounts/premiums applied

### *Tax Issues*

- Not consider tax implications to employees
  - Value to employee consideration and not to the issuer of the award

# *Equity Value Allocation Issues*

- Valuation methodology used must be consistent with target share attributes as well as facts and circumstances surrounding the valuation
- Current method issues
  - In the majority of situations, the Staff believes the use of the current method is likely inappropriate in any IPO reporting period
  - May be appropriate for:
    - Companies where liquidation is imminent
    - Early stage development companies

# *Valuation Specialists Providing Accounting Advice*

- Statement of Auditing Standards 50/97, "Reports on the Application of Accounting Principles"
  - SAS 50, para 5: "Reporting Accountants" should have adequate technical training and proficiency

- Opinions of Value re: Goodwill
  - Factors to consider may include the following:
    - Deferred tax and effective tax rate considerations
    - Allowance analysis
    - Tangible asset valuations

# Other Reporting Issues

- Level of assurance provided by an independent valuation specialist
  - Calculations/analysis of value considered inappropriate as primary support
  - Estimates of value – varying levels of diligence
- Engagement caveats in Valuation Specialist reports
  - Auditors should understand the implications of any scope limitations adjust their work accordingly
    - Only certain assets were considered by the specialist
    - Limited access to confidential information

# *Specific SFAS 141/Intangible Asset Valuation Issues*

- High levels of goodwill still being observed
- Customer Relationships - "Primary asset" considerations
- Tax amortization benefit issues
  - Generally, where asset resides
  - If not deductible for tax purposes
- Selected valuation methodology applied needs to be consistent
  - For purchase price allocation and impairment test purposes (where asset is tested on a stand-alone basis)

# *SFAS 141/Intangible Asset Valuation Issues*

- Grouping of assets into a single model
  - Netting of Individual “Negative”/ Positive Values of a Class of Assets

    Factors to Consider:

    - SFAS 141, para. A17
      - Complementary assets can be recognized as a single asset apart from goodwill if the group of assets have similar useful lives
    - All or none purchase?

# SFAS 141/Intangible Asset Valuation Issues

- *Grouping Issues (cont'd)*
  - *Why "grouping of assets" into a single model is relevant:*

***No such thing as a negative valued asset (unless obligation is a true liability)***

**Example 1:**

| | **Fair Value** |
|---|---|
| Asset A | 200 |
| Asset B | (100) |

| | **Grouped Model** | **Ungrouped Models** |
|---|---|---|
| Asset A | 200 | 200 |
| Asset B | (100) | - |
| Recorded FV | **100** | **200** |

***Tax Amortization Benefit only applied to Assets***

**Example 2:**

| | **DCF Value** |
|---|---|
| Contract Asset A | 200 |
| Contract Liability B | (100) |

| | **Grouped Model** | **Ungrouped Models** | |
|---|---|---|---|
| Asset A | 200 | 200 | |
| Liability B | (100) | - | (100) |
| DCF | 100 | 200 | (100) |
| TAB | 25 | 50 | - |
| | | 250 | (100) |
| Fair Value | **125** | | **150** |

# *Contributory Asset Charge (CAC) Issues*

***Multi-period Excess Earnings Method (MEEM) on MEEM CACs - caution:***

- "Royalty stream" generated is often excluded from the valuation of the charging asset
  - Similar concepts as:
    - Migration technique in IPR&D Practice Aid
    - Relief from royalty method
- If using an ROA or Gross Lease Method, as asset lives increase, most likely will result in unreasonable results or insolvable models for both assets
  - Eg. Business Entity with only 2 assets and asset 2 contributes to asset 1

# Contributory Asset Charges (CAC) Issues

**Return on Assets Method**

***(Assume only CAC is the one noted below and taxes are NIL)***

| **Entity Business Plan** | | **Year 1** | **Year 2** | **Year 3** | **Year 4** | **Year 5** | **Year 6** | **Residual Years** |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | | 4,000 | 4,200 | 4,400 | 4,600 | 4,800 | 5,000 | |
| Net Operating Cash Flow | | 1,500 | 1,600 | 1,700 | 1,800 | 1,900 | 2,000 | 33,333 |
| **Enterprise Value** | | **26,317** | | | | | | |
| **Asset 1** | | | | | | | | |
| Cash Flow before CAC | | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 1,000 | 10,000 |
| CAC - Asset 2 | | (1,789) | (1,908) | (2,027) | (2,147) | (2,266) | (2,385) | (39,751) |
| **Cash flow to be discounted** | | **(789)** | **(908)** | **(1,027)** | **(1,147)** | **(1,266)** | **(1,385)** | **(29,751)** |
| Discount Rate | 10% | 0.9091 | 0.8264 | 0.7513 | 0.6830 | 0.6209 | 0.5645 | 0.5645 |
| | | (717) | (750) | (772) | (783) | (786) | (782) | (16,793) |
| **Fair Value** | | **(21,384)** | | | | | | |
| **Asset 2** | | | | | | | | |
| Cash Flow before CAC charge | | 500 | 600 | 700 | 800 | 900 | 1,000 | 23,333 |
| CAC Income | | 1,789 | 1,908 | 2,027 | 2,147 | 2,266 | 2,385 | 39,751 |
| **Cash flow to be discounted** | | **2,289** | **2,508** | **2,727** | **2,947** | **3,166** | **3,385** | **63,084** |
| Discount Rate | 10% | 0.9091 | 0.8264 | 0.7513 | 0.6830 | 0.6209 | 0.5645 | 0.5645 |
| | | 2,081 | 2,073 | 2,049 | 2,013 | 1,966 | 1,911 | 35,609 |
| **Fair Value** | **B** | **47,701** | | | | | | |
| Annual CAC | **B x 10%** | 4,770.07 | | | | | | |
| CAC as a % of Revenue | | 119.3% | | | | | | |

*1,500* Business Plan

# *Contributory Asset Charges (CAC) Issues*

***Cash flow projections often need to be adjusted for "return of" portion of CAC but are not***

- When comparable royalty rates not available, 2 main methods to determine CAC:

| ***Return on Asset Method*** | ***Gross Lease Method*** |
| --- | --- |
| Return on and Return of the asset are *calculated separately* | Return on and Return of the asset are *calculated together* |

# Contributory Asset Charges (CAC) Issues

**Return on Asset Method**

Charge of the asset is reflected
by depreciation and amortization
Charge on the asset is
reflected by Return on Assets

Return on charge for wasting
assets may need to be
factored into the projections

**Gross Lease Method**

Lease charge reflects both
a return on and
of charge of the asset

Return on charge for wasting
charge needs to be backed
out of the projections

# *Contributory Asset Charges (CAC) Issues*

***Other***

- Royalty/Licensing rates and CACs
- Capital intensive industries/large capex projected
- CAC cause value result to be negative
- Reported asset number selected from a valuation range

# Conclusion

Questions and Answers