FINANCIAL REPORTING VALUATIONS

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In the United States, companies prepare financial statements in accordance with Generally Accepted Accounting Principles (GAAP), which often drive the need for business valuations related to financial reporting.

Financial reporting valuations are based on the principle of fair value, "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."[1] This definition means that fair value is a market-based measurement, not an entity-specific measurement. Fair value should be determined based on the assumptions market participants would use to price the asset or liability.

There are several scenarios that tend to necessitate financial reporting valuations, including purchase price allocations, stock-based compensation, goodwill impairment testing, and other fair value measurements. This post will explain each situation and answer common questions so you can navigate the financial reporting valuation process with confidence.

A purchase price allocation is required for financial report and certain tax accounting purposes.

PURCHASE PRICE ALLOCATION

Purchase price allocation is the process of allocating the purchase price of a company in a change of control transaction to the different assets that were acquired. It is required for financial reporting and certain tax accounting purposes. As a very simplified example, if an owner purchased a company for $5 million, the purchase price allocation might determine that $3 million of that purchase price should be allocated to tangible assets such as cash, accounts receivable, or machinery and equipment while the remaining $2 million should be allocated to the intangible assets of the business.

Tangible assets — such as cash on hand, accounts receivable, product inventory, and equipment — typically can be valued in a relatively straightforward manner based on the book value of those assets. In certain circumstances, such as if the fair value of machinery and equipment is materially different than its book value, a fixed asset appraisal should be performed. For example, when machinery and equipment have been fully depreciated but are still in use, the net book value is $0, but the fair value of the assets should be greater than $0 because those assets are still being utilized.

Intangible assets include trademarks, customer relationships, and computer software a

1 According to Accounting Standards Codification 820 (ASC 820)

company has developed. Not surprisingly, intangible assets tend to be more difficult to value, and often owners don't consider them as separate assets. The kind of intangible assets that need to be identified depends in large part on the industry, and they generally fall into one of five categories: marketing-related, customer-related, artistic-related, contract-based, and technology-based. The chart below lists several examples of each type of intangible asset.

Identifiable Intangible Assets for Purchase Price Allocations	
Asset Type	**Common Intangible Assets**
Marketing-related	Trademarks and trade names Service marks Internet domain names
Customer-related	Backlog Customer contracts Customer relationships
Artistic-related	Books, magazines, and other literary works Musical works Pictures and photographs Video and audiovisual material
Contract-based	Licensing agreements Lease agreements (above or below market rates) Franchise agreements Mortgage servicing contracts Use rights (drilling, water, mineral, etc.)
Technology-based	Computer software Patented technology Trade secrets (formulas, processes, recipes, etc.)

One of the ways that purchasers can classify the intangible assets in a transaction is by thinking about why they purchased a specific company. The answer to that question (the company's patents, technology such as developed software, or the target company's presence in a specific market) will typically be a good indication of the most valuable intangible assets in that transaction, although there may be others a buyer did not consider.

Auditors are required to thoroughly evaluate purchase price allocations. That makes it especially important to choose an experienced valuation firm that will carefully document assumptions and methodologies to give the auditor the information needed to efficiently review the analysis.

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CONSIDERATION PAID

Another component to purchase price allocations is the determination of the consideration paid for the business. While it might seem this should be straightforward, the determination of the consideration (amount paid) in a transaction can be more complex. Two primary components of purchase consideration which are not so straightforward are rollover equity and earnouts.

Rollover equity, often a component of the total consideration depends on the value of the combined business. For example, imagine a merger in which the buyer gives the seller of a business a 40% equity interest in the combined company. There is no defined currency amount for the consideration, but a complete business valuation of the combined company must be performed to determine the fair value of the 40% equity interest which is the consideration.

Earnouts can also be simple or complex with multiple time periods and reliance on future performance targets for the business. An earnout might depend on revenue or earnings several years after the transaction, which represents a significant unknown as of the transaction closing date. Earnouts impact purchase price allocation with a higher value for the intangible assets.

STOCK-BASED COMPENSATION

The fair value of stock-based compensation is often determined to satisfy both tax (409A) and financial reporting (ASC 718) requirements. ASC 718 offers GAAP guidance about stock compensation expense).

Stock-based compensation is expensed based on the fair value of the granted options or equity (like shares of common stock given to employees in lieu of cash compensation). These structures are seen commonly in technology companies, which often pay employees partially in stock or stock options. Tax regulations (409A) state that the strike price of an option has to be at or above the fair market value of the underlying security (common stock in most cases) to qualify as deferred compensation. If stock options don't qualify as deferred compensation, the employee would owe tax immediately on option grants even though they didn't receive cash, which is an undesirable outcome for everyone involved.

In 409A or ASC 718 valuations for companies with multiple equity classes (such as preferred equity), a more in-depth analysis is required. The valuation needs to account for different levels of seniority, rights, and preferences between the various equity classes as well as other existing options or warrants. In many cases, a stock-based compensation valuation for 409A and ASC 718 will require two components: (1) a valuation of the company as a whole and (2) the allocation of the total company value to each equity class. Choosing a firm that fails to take these complexities into account will typically be a frustrating mistake with a few pitfalls — either resulting in excessive stock-based compensation expense which deflates earnings or being required to re-do the process before receiving approval from the company's auditors.

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GOODWILL IMPAIRMENT TESTING

Private company accounting alternative elections allow companies to amortize goodwill over 10 years, eliminating the need for annual goodwill impairment testing. However, impairment testing can still be required if there is a triggering event or evidence of a significant goodwill impairment. The COVID-19 pandemic could potentially be a triggering event, although it depends on the industry and the particular company because some behavior shifts have been detrimental to some but beneficial to others. ASC 350 guidance considers:

- Macroeconomic conditions (e.g., as deterioration in general economic conditions, significant fluctuations in foreign exchange rates, or the inability to access capital)
- Industry and market considerations (e.g., deterioration in the environment in which the company operates or a significant regulatory or political development)
- Cost factors (e.g., increases in the cost of raw materials or the cost of labor)
- Decreasing overall financial performance
- Other relevant entity-specific events (e.g., changes in management or key personnel)
- For public companies, a sustained decrease in share price

For private companies amortizing goodwill, an impairment test may still be needed if any of the above considerations suggest the fair value of an entity or a reporting unit is below its carrying amount (book value). For companies testing goodwill impairment annually, the triggering events above may result in the need to perform an impairment test at an interim date.

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OTHER FAIR VALUE MEASUREMENTS

There are some circumstances in which a fair value measurement is needed that doesn't fall into the category of goodwill impairment testing, stock-based compensation, or purchase price allocations. We categorize these circumstances generally as "Fair Value Measurements." These circumstances are varied but generally represent assets or liabilities that need to be recorded at fair value on a company's balance sheet.

Private equity funds need to value the interests in their portfolio companies. While many private equity firms perform this analysis internally or carry interests at cost, some investors are increasingly looking for independent, third-party valuations of the fund's equity interests. Specialized warrants issued by a public company need to be recorded at fair value quarterly. Often these warrants are complex with terms beyond "plain vanilla" options such as changing strike prices depending on various trading price averages. Depending on the specific terms of the warrants, a simple or more complex approach may be needed. Adams Capital uses custom Monte Carlo or real options analysis to determine the fair value of unique assets or liabilities.

CONCLUSION

In the increasingly complex regulatory environment, well-documented independent financial reporting valuations are vital. The level of scrutiny from auditors continues to increase as they receive pressure from their regulators to more thoroughly evaluate and question fair value conclusions. Comprehensive documentation and knowledge of audit requirements help create a seamless experience for company management which allows you to focus on running your business instead of investing time in valuation exercises.

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Adams Capital offers a no-cost initial telephone consultation to provide a sounding board to anyone potentially in need of a fair value measurement. Whether you need purchase price allocation, stock-based compensation, goodwill impairment testing, or another fair value measurement, you can rely on us to ensure compliance and allow you to spend more time on your business.

Please email us at tara@adamscapital.com or call us directly at 770-432-0308 to schedule a consultation or to learn more.