

### Key Concepts in Fair Value Accounting

After three years of planning and endless discussion, the Fair Value standards from the Financial Accounting Standards Board (FASB) have now gone into effect, applying to all corporations for fiscal years beginning December 16, 2006 and beyond. No one can afford to underestimate the “sea change” these standards represent; and everyone, from business appraisers to auditors to corporate attorneys, needs a good working knowledge of the key concepts of fair value.

#### Working Definition

FASB’s first working draft of *Fair Value Measurements* (FVM)(2004) defined fair value “as the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated, willing parties.” Further deliberations prompted the board to clarify the exchange price in the context of a purchaser’s exit strategy or objective. The revised, working draft of the FVM (2005) defines fair value as:

*...the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability*

The revisions helped clarify the following key components:

- 1. Estimated Versus Actual Price.** Fair value pricing is an estimate rather than an actual price on the measurement (effective valuation) date. The estimate arises from a hypothetical determination of what the price would be in a marketplace transaction on the measurement date, regardless of the entity’s actual intent and/or ability to complete the transaction.
- 2. Marketplace Participants.** Fair value is a market-based rather than an entity-specific measure. The FVM incorporates and expands on the marketplace concept by presuming that all participants are: (a) unrelated—each acting independently; (b) knowledgeable—with a reasonable level of understanding of all relevant factors and information, including what is available publicly and through due diligence; (c) able to transact in the reference market for the asset or liability, with the legal and financial ability to do so; and (d) willing—that is, are motivated but not compelled to transact in the reference market.

- 3. Reference Market** is the “most advantageous market” in which an entity would transact for the asset or liability, as seen from the entity’s perspective. As the ultimate goal of most entities is to maximize profits or net assets, the most advantageous market is also the one that maximizes the price to be received in the sale of the asset.

#### Fair Value Hierarchy Focuses on Inputs

FASB’s stated goal has been to provide fair value without damaging basic accounting principles. The issue is not fair value versus historical cost, or whether companies should focus on assets and liabilities, but how management (or their valuation specialists) prepares estimates of value. To accomplish this objective, the FVM establishes a “fair value hierarchy” which ranks the inputs to valuation techniques; the ranking provides a framework for assessing the relative reliability of the estimate, with the highest ranking (Level 1) going to market inputs, and the lowest (Level 5) to internally derived, entity inputs. Generally speaking, the fair value hierarchy recognizes that the more market inputs—the more reliable the estimate:

**Level 1:** These inputs rely on observable market data, which represent quoted prices in active markets for identical assets or liabilities (“as is”), where that information is available.

**Level 2:** Where quoted prices for identical assets/liabilities are not available, these inputs require the use of quoted prices on similar assets/liabilities, adjusted to capture the differences between the subject asset (or liability) and the comparable. These differences must be objectively determinable.

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**Level 3:** These include market inputs that are directly observable, other than quoted prices.

**Level 4:** These are unobservable market inputs, but may be corroborated or correlated through other market data.

**Level 5:** These inputs are developed entirely by management, based on the reporting entity's own data. They are adjusted to exclude factors specific to the reporting entity if a market participant would exclude those factors.

### Two Final Points

Finally, fair value standards assume a premise of value that refers to the location and condition of the assets that are being valued. The appropriate premise—whether “in use” or “in exchange”—should be the one that maximizes the highest and best use of the asset. The new standards also accept the market, income, and cost approaches to valuation—the most commonly utilized methods, thus helping further to “standardize” the framework for fair value estimates.

## New Focus on Fair Value Accounting: What to Expect From Your Valuation Specialist

The new “fair value” accounting standards are applicable for all corporations effective for fiscal years beginning December 16, 2006 and beyond, according to the latest “Proposed Statement of Accounting Standards (SAS)—*Fair Value Measurements*” (Working Draft), published by the Financial Accounting Standards Board (FASB). This working draft applies broadly to financial assets and non-financial assets and liabilities that the U.S. Generally Accepted Accounting Principles (GAAP) require to be measured at fair value.

This also leaves FASB working with the following definition:

Fair value is the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability. (Working Draft, paragraph 5)

### Increased Federal Oversight

The era of fair value for financial reporting is effectively here. Companies can expect heightened scrutiny of their fair value estimates from the Securities and Exchange Commission (SEC) and other federal regulators. In fact, the SEC has recently hired valuation specialists to provide in-house expertise to assess companies' fair value estimates, and to focus on such areas as:

- Stock option expense determination
- Calculation and allocation of purchase price
- Identification of acquired intangible assets
- Application of valuation methodology
- Selection of life or indefinite life
- Impairment analyses
- Liability valuation methodology

Based on comment letters posted to its Web site ([www.sec.gov](http://www.sec.gov)), the SEC appears to be reviewing the appropriateness of fair value calculations, their reasonableness, and, just as important, their underlying assumptions.

### Ultimately, it's Management's Responsibility

Federal regulators aren't the only concern: Independent auditors are also turning their focus to fair value assessments. For example, in 2003, the Auditing Standards Board issued its “Statement of Auditing Standards (SAS) 101, *Auditing Fair Value Measurements and Disclosures*.” According to these guidelines, auditors may review:

1. *Management Assumptions.* In addition to management assertions and assumptions, auditors will review their models and methods; and whether managers used relevant and reliable information to construct their fair value estimates. They may interview management, and—where applicable—outside valuation firms.
2. *Market Information and Marketplace Participants.* Valuation methods must incorporate information that marketplace participants would use, whenever market information is available. Auditors may also review subsequent events and transactions, those which occur after the balance sheet date but before completion of audit fieldwork.
3. *Reasonable Basis.* Auditors must evaluate whether management assumptions were reasonable, and/or consistent with market information. They may compare the methods and assumptions used in the preceding accounting period.
4. *Valuation Specialist.* Auditors will review who prepared the fair value estimates, their specific experience and expertise, and the appropriateness of using their work for the intended purpose.

If the auditors determine that the fair value estimates lack sufficient documentation, are inconsistent with management assertions, or do not reflect the assumptions of a marketplace participant, they may perform additional audits.

Whether companies prepare internal valuations or hire outside specialists to meet their financial reporting obligations, fair value measurement is ultimately management's responsibility. Section 302 of Sarbanes-Oxley places the responsibility squarely on the chief executive and financial officers of public

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companies to personally certify the accuracy of financial statements and disclosures in the company's periodic reports. Management must also certify that in all material aspects, the statements fairly present the company's operations and financial condition.

### **What to Expect from Valuation Specialists**

Having an experienced, reputable valuation specialist on management's "fair value team" can be critical. These specialists should be well-versed in valuations of the type and purpose that management requires, and should provide objective support and reasoned rationales for their fair value estimates. Most importantly, they should prepare independent, well-documented and well-supported valuations that follow accepted valuation practices and relevant accounting standards. To comply with all current regulations, valuation specialists should:

- Test or challenge management-provided assertions and assumptions;
- Be able to present the data relied upon in estimating fair value and to explain why any other available data was excluded from the analysis;
- Be mindful of whether the current valuation is consistent with other valuations and within the valuation study itself;
- Be ready to explain any material inconsistencies in the current fair value study as compared to past studies or studies prepared for different purposes;
- Be prepared to explain and support their analyses to the satisfaction of the client, the client's auditor, and the auditor's valuation specialist;
- Include facts and circumstances supporting fair value measurements from a valuation perspective, not from an accounting vantage; and,
- Provide a detailed written report explaining the derivation of all fair value estimates, including assumptions and methods applied as well as any limitations applicable to the study or the estimates themselves.

Management shouldn't rely on valuation specialists to assess the accounting implications of their fair value conclusions. The valuation specialist should be familiar with accounting rules and guidance, but should not offer accounting advice.

In sum, as fair value accounting becomes more prevalent, regulators are becoming more exacting in assessing fair value measurements, and are holding management and their valuation team to higher standards. As this trend continues, management—their auditors and attorneys—need to stay well-versed in the complexities of fair value analysis, including knowing what to expect (and not expect) from their valuation specialists.

## ***Lottery Winner Convinces Court to Buy Discounted Present Value of Annuity***

***Davis v. United States, 2005 U.S. Dist. LEXIS 34372 (December 19, 2005)***

What are the odds that a lottery winner can persuade a federal court that the present value of his right to receive future lottery payments warrants a discount for lack of marketability?

### **Present Value vs. 'Fair Market Value'**

The New Hampshire lottery winner had died before receiving the last ten of his annual payments of \$209,000. By referring to IRS annuity tables, his estate valued his right to these payments at about \$1.6 million, and then discounted it for lack of marketability by half, or to roughly \$800,000.

The IRS challenged the discount, claiming that the "present value" contained in the annuity tables was controlling; and moreover, that this value was equivalent to fair market value for estate tax purposes. Federal tax regulations specifically provide that in estate valuations, "the fair market value of annuities . . . is their present value" as determined by the tables.

The estate agreed that the right to receive annual lottery payments constituted an "annuity" within the meaning of applicable provisions of the tax code (IRC §§ 2039 and 7520(a)), as well as estate tax regulations (§ 20.7520-3(b)(1)(i)(A)). The estate also agreed on the general rule "that the annuity must be valued by reference to IRC annuity tables," unless it could show that the result would be so "unrealistic or unreasonable" that an alternative valuation should apply.

"The estate's claim appears to be this," the Court observed: "a well-informed buyer would be willing to pay substantially less for an identical annuity that he or she could not sell or assign than that same buyer would be willing to pay for an identical annuity that could be sold or assigned." And more critically, the estate claimed that the IRC tables fail to take into account the diminished market value of a non-transferable annuity.

### **Issue Extends to All Non-Marketable Annuities**

The federal courts are divided on the narrow legal question of how to value a non-transferable right to receive lottery winnings in the form of guaranteed, annual payments. The Davis court reviewed the precedent—and then extended the divide by considering the valuation of all non-marketable annuities.

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The problem, according to the Court, is that the IRC annuity tables consider only two factors: time and a discount interest rate. Consequently, they provide only a present valuation—which for a marketable annuity is “roughly equivalent to its ‘fair market value.’” The tables also provide “a cost-effective, efficient, and, generally speaking, reliable means by which to calculate an annuity’s fair market value.”

More importantly, the annuity tables’ many attributes fall into doubt when dealing with non-assignable annuities, as “by virtue of their structure and assumptions,” the tables fail to consider that “a hypothetical buyer would naturally be willing to pay less for a non-marketable annuity than . . . a marketable one,” which he or she could convert immediately into a lump sum for reinvestment or “any number of uses.”

“The right to transfer is one of the most essential sticks in the bundle of rights that are commonly characterized as property,” the Court declared, citing precedent from the Ninth Circuit, which has joined the Second Circuit on this issue (and disagreed with the Fifth Circuit’s finding that no discounts apply). “It is axiomatic that if an asset’s marketability is restricted, it is less valuable than an identical marketable asset.”

#### **Estate Still Needs to Prove Alternate Valuation**

Having determined that the IRC annuity tables: (1) do not account for lack of marketability; and

(2) that the fair market value of a non-marketable annuity is some degree less than its present value; and (3) that the IRC tables are not necessarily an accurate measure of fair market value—the Court next determined whether the estate had carried its burden to prove, as a matter of law, that an alternate valuation must be used. “*It has not.*”

At this juncture, all the Court could conclude was that the “present value” of the non-marketable annuity was likely to be higher than its “fair market value.” Use of the IRC tables might be inappropriate—but they might not, depending on the case, warrant the conclusion that the IRC tables produce an “unrealistic and unreasonable” value. That is factual matter that the parties must resolve at hearing (this case came on their cross motions for summary judgment).

In its conclusion, the Court explained that its determination turned on *defining the interest as an annuity*, instead of a “right to receive defined cash payments of a defined period,” for which a present value can readily (and accurately) be expressed, as in the cases of reducing an individual’s lifetime earnings to a lump sum, present value. “A ‘marketability’ factor simply has no place in that kind of calculation,” the Court said, giving a nod to the jurisdictions that have declined to discount the present value of annual lottery payments, and perhaps a nudge to the IRS to review its definitions of the same.

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