Jim Hitchner's Valuation Products and Services

VPS Q&A

A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

ISSUE 10 - FEBRUARY 2009

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TIME PERIODS FOR THE INCOME AND MARKET APPROACHES

Question 1: When applying both the capitalization of cash flow (CCF) method of the income approach and the guideline public company method (GPCM) of the market approach, is it appropriate to use different time periods? For instance, using a CCF method utilizing a five-year average benefit stream and using the GPCM using the most recent latest twelve-month (LTM) benefit stream?

Answer 1: Assuming that you agree that both valuation methods are appropriate, I believe that most valuation analysts would initially consider multiple periods for both the CCF method and the GPCM. If both time periods, i.e., most recent LTM and five-year average, are reasonable, then both benefit streams can be used in both valuation methods (sometimes with different levels of reliance). If you believe that the LTM benefit stream is representatative of future performance and not a five-year average, then the LTM benefit stream should be used in both methods-- vice versa for a five-year average.

Also, when computing valuation multiples for the guideline public companies over a five-year period, the numerator, e.g., price of stock, should be as of the valuation date, but is divided by the five-year average benefit stream, e.g., five-year average of prior after-tax earnings. Do not average five years of valuation multiples, only five years of the benefit stream.

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RELIANCE ON OTHER APPRAISALS PRIOR TO VALUATION DATE

Question 2: I hope this question is not too basic. I would like to know if there is a window for the date that outside appraisals can be used without updating. For example, if I have an appraisal for real estate that uses comparables that cover the period of a year or more before the real estate appraisal date of July 1, 2008, can I use that appraisal in a valuation dated November 1, 2008, which is four months after the date of the appraisal? Thanks for your input.

Answer 2: Your question is not too basic. In this situation, which is common, I believe the answer lies in disclosure and risk management. You are not the real estate appraiser. You can only decide to rely upon the real estate appraised values. I would state this in the engagement letter and the report, and I would also suggest a representation letter where the client states that the appraised real estate values are still valid as of the later valuation date. I would also ask the client to get a letter from the real estate appraiser stating that the values are good for the later date. Many real estate appraisers will sign such a letter after they do some work to feel comfortable that nothing has changed between the two valuation dates.

Now we have to talk about business valuation standards. In the AICPA Statement on Standards for Valuation Services No. 1 (SSVS), there are sections and paragraphs on **Establishing an Understanding With the Client, Scope Restrictions or Limitations and Using the Work of Specialists in the Engagement to Estimate Value.**

Establishing an Understanding With the Client

"17. The understanding with the client reduces the possibility that either the valuation analyst or the client may misinterpret the needs or expectations of the other party. The understanding should include, at a minimum, the nature, purpose, and objective of the valuation engagement, the client's responsibilities, the valuation analyst's responsibilities, the applicable assumptions and limiting conditions, the type of report to be issued, and the standard of value to be used."

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Scope Restrictions or Limitations

"19. A restriction or limitation on the scope of the valuation analyst's work, or the data available for analysis, may be present and known to the valuation analyst at the outset of the valuation engagement or may arise during the course of a valuation engagement. Such a restriction or limitation should be disclosed in the valuation report (paragraphs 52(m), 68(e), and 71(n))."

Using the Work of Specialists in the Engagement to Estimate Value

"20. In performing an engagement to estimate value, the valuation analyst may rely on the work of a third party specialist (for example, a real estate or equipment appraiser). The valuation analyst should note in the assumptions and limiting conditions the level of responsibility, if any, being assumed by the valuation analyst for the work of the third party specialist. At the option of the valuation analyst, the written report of the third party specialist may be included in the valuation analyst's report."

Whether you call it an understanding with the client or a scope limitation, I would make it clear that you are relying on the appraised values and that you do not have an opinion about whether the appraised values are correct.

In this example you could use language something like the following: "An independent appraisal prepared by Val Dude, MAI, Dude Appraisal Co., Inc. and provided by management, indicated that the fair market value of the property was $_,___,___ as of July 1, 2008. Mr. Dude and Management indicated that the value of the property was not materially different as of the date of this valuation, November 1, 2008. We relied on the value of [real estate] as provided to us by the appraiser and management without independent analysis or verification, and we have no opinion as to the appraised real estate values."

In the Uniform Standards of Professional Appraisal Practice (USPAP) there is also some language that deals with the issue of reliance on other expert's work. In the most recent USPAP 2008 - 2009 edition, **Standards Rule** 10-3, pp. U-76 and U-77 states:

"In an assignment that includes real property or personal property assignment results not developed by the business and/or intangible asset appraiser(s), any business and/or intangible asset appraiser(s) who signs a certification accepts full responsibility for the business and/or intangible asset elements of the certification, for the business and/or intangible asset assignment results, and for the business and/or intangible asset contents of the appraisal report. When a signing appraiser(s) has relied on work done by appraisers and others who do not sign the certification, the signing appraiser is responsible for the decision to rely on their work.

The signing appraiser(s) is required to have a reasonable basis for believing that those individuals performing the work are competent. The signing appraiser(s) also must have no reason to doubt that the work of those individuals is credible."

USPAP Advisory Opinion 31 (AO31) **Assignments Involving More than One Appraiser,** p. A-108 states: "for assignments involving multiple disciplines (e.g., real property appraisal and personal property appraisal), an appraiser could sign a certification accepting responsibility only for the elements of the certification, assignment results and report contents applicable to the appraiser's discipline."

Remember that Advisory Opinions do "...not establish new standards or interpret existing standards. Advisory Opinions are issued to illustrate the applicability of appraisal standards in specific situations and to offer advice from the ASB for the resolution of appraisal issues and problems." (p. A-107)

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GOODWILL IMPAIRMENT STEP ONE: TESTING AND DEBT

Question 3: **I have been wrestling with a question regarding the appropriate amount of market participant considerations in goodwill impairment test work. Here is a scenario that has come up more than once. A company is purchased and significant debt financing is part of the deal structure such that at the end of the first year, when SFAS 142 kicks in and goodwill must be tested for impairment, the capital structure of the company is much different from an industry capital structure.**

When performing a DCF and applying the market participant (considering the industry capital structure) weighted average cost of capital (WACC) to the debt-free cash flow projections of the company to arrive at the value of invested capital, should you really then subtract the Company's actual debt to arrive at the fair value of equity? Or, alternatively, should you also consider the market participant assumptions in the debt amount and therefore adjust the debt subtracted from invested capital to be consistent with the capital structure used in the WACC?

In practice, I have typically seen actual debt subtracted; however, in theory it seems to me to be a disconnect in assumptions...market participant capital structure in WACC but then company-specific debt in cash flow analysis/equity value determination? If you have a moment to give me your thoughts, it would be greatly appreciated. Thank you in advance.

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Answer 3: I use a market participant WACC to determine the fair value of invested capital. I then perform the Step One impairment test by comparing that answer to the carrying amount of invested capital. One generally does not perform the Step One test at the equity level for this reason, among others. In fact, some practitioners add back to the fair value of invested capital the fair value of the non-debt liabilities (appropriate if there's a material difference from carrying amount) and perform the test at the "total right side" level, also equal to total assets. SFAS 142 is not specific about at what level you compare fair value and carrying amount (equity, invested capital, etc).

Answer by: Steve Hyden, CPA/ABV, ASA, The Financial Valuation Group (Tampa), coauthor of Valuation for Financial Reporting, Fair Value Measurements and Reporting, Intangible Assets, Goodwill and Impairment, 2nd edition, 2007, Wiley. shyden@fvginternational.com

[***Editors Note:*** For an excellent article on this topic, see *Financial Valuation and Litigation Expert* journal, Issue 17, February/March 2009, "SFAS 142 Impairment Testing: Lack of Definition Creates Confusion"by Jeff D. Balcombe, CPA/ABV, CFA, ASA, Keith F. Konen, CFA and J.R. Radcliffe, Business Valuation Advisors, LLC, Dallas, TX. The following is a quote: "Given the potential for flawed results as illustrated above, we believe that goodwill impairment testing should be conducted in the context of the reporting units total assets or invested capital, instead of its equity."]