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Carrying Amount Conundrum
SFAS 142 Update

Intercompany Debt Allocations. In performing valuation analyses for step one impairment testing under SFAS 142, the determination of the appropriate carrying amount of the reporting unit can often be less straightforward than anticipated. The carrying amount of a reporting unit is presumably the net of the carrying values of the assets (including goodwill) and liabilities assigned to the reporting unit. Paragraph 32 of SFAS 142 addresses the assignment of assets acquired and liabilities assumed to reporting units.

"For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of the acquisition date if both of the following criteria are met:

a. The asset will be employed in or the liability relates to the operations of a reporting unit.

b. The asset or liability will be considered in determining the fair value of the reporting unit.

... these issues raise a warning to auditors, valuation professinals and corporate finance professionals that even the "simple" step one analysis may be fraught with unexpected complexity ...

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the above criteria are met. Examples of corporate items that may meet these criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets."

Extending this advice to allocating existing assets and liabilities to reporting units, two primary conclusions can be drawn:

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Fairness Opinions
When and Why

We are often called upon to provide fairness opinions in transactions as part of our transaction advisory services. The purpose of a fairness opinion is to assist directors in making decisions concerning the transaction and to protect decision makers from claims that those decision makers violated the business judgment rule. The business judgment rule requires that the board exercises due care in the process of reaching its decision, that the board acts independently and objectively in reaching its decision, that the decision was made in good faith, and that there was no abuse of discretion in making the decision.

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Maximizing the Value of the Closely Held Company

07/18/02 Alliance of M&A Advisors
Chicago, IL

08/22/02 Texas Association of Business Brokers
San Antonio, TX

11/11/02 International Business Brokers Assn.
Los Angeles, CA

Tax Boot Camp for the M&A Professional

06/11/02 International Business Brokers Assn.
New Orleans, LA

Advanced M&A Tax Strategies and Deal Structures

11/12/02 International Business Brokers Assn.
Los Angeles, CA

Succession Planning: Exit Strategies for the Privately Held Company

06/10/02 International Business Brokers Assn.
New Orleans, LA

11/07/02 American Institute of CPAs
Souix Falls, SD

12/05/02 American Institute of CPAs
Jackson, MS

Quantifying Personal Goodwill

06/14/02 International Business Brokers Assn.
New Orleans, LA

08/23/02 Texas Association of Business Brokers
San Antonio, TX

Descriptions of the courses offered by Darrell Arne can be found on our website

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1. Tangible (and recognized identifiable intangible) operating assets and liabilities should be allocated to the reporting units for which the assets operate, and the liabilities are incurred.

2. Financial assets and liabilities should be allocated in a manner consistent with the valuation assumptions made regarding the reporting unit.

Application of the first conclusion is straightforward. Implementation of the second conclusion is complicated by the tendency of large multi-unit companies to maintain complex systems of intercompany receivables and payables. To the extent intercompany funding items allocate the actual financing structure of the consolidated entity to the reporting units, it appears to be appropriate to rely on the intercompany liabilities and assets in determining both fair value and the carrying amount comparison. However, to the degree intercompany items are not representative of the actual consolidated capital structure (thereby creating a large net "corporate" receivable from, or payable to, the reporting units), it is appropriate to eliminate the "excess" intercompany balances from the carrying amount determination of the reporting units.

The following principles are consistent with the FASB's guidance in SFAS 142:

1. Analyze the earning power of the reporting units on an operating basis (EBIT), ignoring financing concerns.

2. Allocate 100% (no more or less) of the actual debt outstanding to the reporting units on some logical basis (the relative amount of intercompany debt assigned to the unit may be such a basis). Subtract the implied interest expense from the ongoing EBIT estimate to derive ongoing pretax, and net, income.

   Alternatively, value may be estimated on the basis of some relevant total capital multiple, from which the allocated amount of actual debt outstanding would be subtracted to determine fair value.

3. Determine the carrying amount of the reporting unit on the same basis as actual debt outstanding was allocated to estimate the fair value of the reporting units.

4. Confirm that the combined net earning power of the reporting units equals that of the consolidated entity, and that the combined carrying values of the reporting units equals consolidated book value. In general, the net "corporate" carrying amount should be minimal.

Regardless of how carrying value is ultimately derived, the estimation of fair value must be consistent with all assets and liabilities, both operating and financial, allocated to the reporting unit

In the end, the determination of the carrying amount is an accounting, rather than a valuation, concern. Regardless of how carrying value is ultimately derived, the estimation of fair value must be consistent with all assets and liabilities, both operating and financial, allocated to the reporting unit. A valuation expert should not perform a fair value opinion without a thorough, documented understanding of the assets and liabilities assigned to the reporting unit.

Negative Carrying Amount. There is a concern about the possibility of negative carrying amounts for report-

ing units and these concerns can be divided into two distinct issues:

1. Is the notion of a negative carrying amount consistent with the purpose of the goodwill impairment test? In other words, is it possible for a reporting unit to really have a negative carrying amount?

2. Is the fair value of a reporting unit necessarily non-negative? If so, it would appear that the goodwill of a reporting unit with negative carrying amount could never be impaired (under step one of the impairment test).

With regard to the first issue, we note that the purpose of step one of the impairment test, at the simplest level, is to determine whether the business acquired via a prior deal is worth more or less today (fair value) than what was actually paid (carrying amount). Since business combinations are generally consummated at positive prices, it would appear that carrying amount should never be negative. However, at least two potential real-life scenarios may complicate this assumption. First, as has been discussed at length, reporting units may consist of multiple business acquisitions, as well as "organically" grown operations. This robs our initial conclusion of at least a portion of its logical clarity. Second, operating losses (presumably larger than any expected) subsequent to the acquisition may cause the company to finance the reporting unit's operations with additional liabilities sufficient to overwhelm the initial equity investment, causing the reporting unit's carrying amount to indeed be negative.

To address the second issue, some adhere to the concept that the value of common equity is non-negative, regardless of the relative (im)balance of

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Fairness Opinions

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There are no hard and fast rules concerning when fairness opinions are required, but they are desirable in a variety of circumstances, the most common being a merger or sale of the company. In these transactions, a fairness opinion is considered a necessary step in the due diligence process of the seller.

For most transactions, a number of alternatives exist to the proposed transaction, and certain groups of stakeholders may believe that one or more of those alternatives is preferable to the proposed transaction. Deals that might be in the best interest of all the stakeholders might be delayed or killed by dissenting shareholders, and a fairness opinion can help avoid some of the misunderstandings that might give rise to unpleasant stakeholder relations during a critical time. Fairness opinions can also help to avoid disagreements in situations where there is a perception that corporate insiders might enrich themselves at the expense of the minority shareholders due to the structure of a transaction.

... when insiders or other affiliated parties are involved in the transaction, a fairness opinion can go a long way toward avoiding disagreements among the stakeholders and between the stakeholders and the board

In a sale or merger transaction where a number of competing offers representing different exchange rates, different ratios of cash-to-stock, or different credit quality in terms of debt are received, a fairness opinion is usually obtained. The fairness opinion letter will typically interpret and compare the competing bids and explain why one alternative is preferable to the others. If a company has recently experienced poor financial performance, a fairness opinion will typically explore the idea of waiting to sell the company at a later date (after a turnaround) rather than selling at what might be perceived as a low valuation.

Unsolicited and/or hostile offers often give rise to fairness concerns, as surprised minority shareholders may perceive that their concerns were not addressed in the process. If the board of directors lacks unanimity in such a situation, it is almost certain that some stakeholders will be dissatisfied with the transaction. When the consideration offered is other than cash, and particularly when the consideration offered is an interest in a closely held company, the financial advisor must investigate not only the interest being sold, but the interest received in return.

In addition to concerns surrounding the total consideration paid in a transaction, issues of fairness can arise concerning the distribution of the consideration. For example, if different classes of stock exist, certain stakeholders may disagree as to the relative value of those classes of stock. Shareholders may also take issue with the noncompete or employment agreements received by managers, or with any other perceived differential treatment of insiders. Regardless of the reason for the fairness opinion on a sale or merger transaction, the opinion serves to memorialize the degree of effort expended by the board in order to reach its decision regarding the adequacy of the consid-

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Fairness Opinions

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eration received in the transaction and the fairness of the transaction to the stakeholders.

Even when an outright sale or merger is not being considered, fairness opinions are commonly sought on other significant corporate transactions. These include the sale of subsidiary businesses or lines of business, recapitalizations, stock repurchase programs, squeeze-out transactions, spinoffs, and other material corporate events. Particularly when insiders or other affiliated parties are involved in the transaction, a fairness opinion can go a long way toward avoiding disagreements among the stakeholders and between the stakeholders and the board. Please call us if we can be of assistance. ◆

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Carrying Amount Conundrum

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assets and liabilities. This position is frequently supported by noting that common equity is analogous to a call option on the company's operations. Therefore, regardless of the current degree of moneyness (excess of enterprise value over liabilities), the common equity can be worth no less than zero, since the common shareholders retain the right to walk away from the company's liabilities. In the case of reporting units which represent only a portion of the company's total operations, this assumption may not be appropriate, however. In other words, the company may not be able to walk away from the liabilities assigned to the subject reporting unit without a direct negative impact on the company's other operations.

There may be, then, situations in which one or more of a company's reporting units may have a negative fair value. Such a situation may often correlate with a negative carrying amount, thereby mitigating the potentially asymmetrical case in which a reporting unit's fair value is negative due to poor operating performance, yet goodwill is necessarily unimpaired since a non-negative fair value would obviously pass step one of the goodwill impairment test.

The complexities related to carrying amount determinations discussed in this article may reflect certain scenarios not fully contemplated by the FASB in the new Standards. It is, after all, difficult to foresee every possibility beforehand. At a minimum, these issues raise a warning to auditors, valuation professionals and corporate finance professionals that even the "simple" step one analysis may be fraught with unexpected complexity that requires solid analysis and concise explanation. Please call us if we can be of assistance. ◆

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