The McLean Group
Investment Bankers to the Middle Market

VALUATION UPDATE

Insights & Perspectives on Leading Corporate Finance Valuation Issues Fall 2006

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SFAS 157 DEFINES FAIR VALUE

A MARKET PERSPECTIVE AND MARKET PREFERENCE TO MEASURING FAIR VALUE

Introduction

Before SFAS 157, generally accepted accounting principles (GAAP) used the term fair value in approximately 67 accounting pronouncements, with no uniform definition or guidance to measure fair value. SFAS 157 establishes a consistent definition for fair value as well as a framework in which to measure the fair value of assets and liabilities in accordance with GAAP.

"Fair value is 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."

Market Perspective

Fair value is measured from the perspective of active market participants and should

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FIDUCIARY DUTIES AND TRANSACTION FAIRNESS

Fiduciaries of businesses have faced an evolving legal environment. Although a detailed job description of a fiduciary would be quite long, as established by the Delaware courts, a fiduciary has a triad of primary fiduciary duties:

- Duty of care;
- Duty of loyalty; and
- Duty of good faith.

The duty of care addresses a fiduciary's duty to act in a diligent manner after taking into account reasonable facts and circumstances that a prudent decision-maker would consider.

The duty of loyalty addresses unfaithfulness and self-dealing. Fiduciaries have an inherent duty to be independent in their decision-making and ensure that they are not putting their personal financial benefit above that of their shareholders or other constituents to whom they owe their fiduciary duty.

The duty of good faith is closely linked to the business judgment rule, where fiduciaries are expected to act in an informed basis, in good faith, and in the honest belief that the action taken is in the best interest of the entity and its constituents.

Concept of Fairness

The Delaware Supreme Court has stated that "fairness" (in a transactional context) consists of two perspectives:

- Fair price
- Fair dealing

As established by the courts, the issue of fairness should be looked at in its entirety, not necessarily bi-furcated between fair dealing and fair price. Fair price addresses all of the economic aspects of a transaction. Fair dealing focuses on the procedural matters relating to the timing and manner in which a transaction was initiated, structured, negotiated, and disclosed to the directors, and how approvals were obtained (Weinberger v. UOP, Inc., 457 A.2d at 711).

Fairness Opinions

To make a conclusion regarding the fairness of a transaction and the role of the associated fiduciaries, the fundamental question that must be asked is: how did the director(s) at hand address his/her fiduciary duties with regard to the fairness of a transaction?

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When to Test Goodwill for Impairment

Testing goodwill for impairment applies to all companies, whether public or private, which have goodwill balances – principally arising from merger and acquisition transactions. Goodwill impairment testing should be performed annually, but may be performed at any time during the year. For consistency, the FASB recommends the test should be performed at the same time each year. Different reporting units may be tested at different times during the year, regardless of the fiscal year of the parent company.

When Can Prior Year Tests Be Carried Forward?

The determination of the fair value of a reporting unit can be carried forward from one year to the next if all of the following criteria have been met:

- The reporting unit's assets and liabilities have not changed significantly.
- The recent fair value determination exceeded the reporting unit's carrying amount by a substantial margin.
- Based on an analysis of the current situation, the likelihood that a current fair value determination would be less than the carrying amount would be remote.

Should Impairment Tests Be Performed Between Annual Tests?

In situations where the fair value of a reporting unit may be reduced below its carrying amount, impairment tests should be performed between annual tests, such situations include:

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Fiduciary Duties and Transaction Fairness (Continued)

...an effective fairness opinion can enhance communication and analysis of a proposed transaction and provide additional comfort over its fairness.

One way in which related parties and boards of directors discharge their fiduciary duties is to consult with independent, qualified third parties. Often times a fairness opinion is obtained to document such an analysis. In general, fairness opinions serve three main purposes:

- Aiding fiduciaries in the decision-making process;
- Mitigating fiduciaries' risk; and
- Enhancing communication regarding a proposed transaction.

Fairness opinions provide an independent analysis of the financial terms of a transaction. They are commonly used by fiduciaries in related party transaction, restructurings, asset sales and merger and acquisition transactions. Related party transactions and public companies have particularly high exposure.

The fairness opinion process is more detailed than a formal business valuation. The process analyzes the value of the consideration that is given up and received in a proposed transaction. It considers the financial implications of a transaction on the various affected parties to the transaction. A specific point estimate of value is not determined, but rather the proposed exchange consideration is tested to determine if it falls within a reasonable range, from a financial point of view.

Independence

Independence can also be a significant issue in regards to fairness opinions. The NASD is also focused on this issue and has proposed Ri;e 2290 to address potential conflicts of interest and independence issues related to fairness opinions.

In all, an effective fairness opinion can enhance communication and analysis of a proposed transaction and provide additional comfort over its fairness.

[1]Weinberger v. UOP, Inc. (426 A.2d 1333 (del. Ch. 1981)

[2]Clements and Wisler, The Standard & Poor's Guide to Fairness Opinions: *A User's Guide for Fiduciaries.* 2005.

SFAS 157 Defines Fair Value

A Market Perspective and Market Preference to Measuring Fair Value (Continued)

therefore be based on the assumptions that market participants would use when pricing the asset or liability and not the assumptions of a specific entity.

Market participants are buyers and sellers in the principal (or most advantageous) market for the asset. Market participants are assumed to be independent (not related parties), knowledgeable about the asset or liability, able to transact for the asset or liability, and willing to transact (motivated, but not otherwise compelled).

Fair value measures the assets in its principal market, which is the market with the greatest volume and activity for the asset or liability. In absence of such a market, the most advantageous market for the asset or liability should be used. The measurement of fair value is the price, in an orderly transaction, that would be received to sell the asset or paid to transfer the liability at the measurement date, which should then reflect an exit price.

Market Preference

Fair value is measured with a preference towards observable market inputs, as opposed to unobservable assumptions. SFAS 157 introduces a fair value hierarchy that prioritizes the inputs to the valuation techniques used to measure fair value.

- <u>Level 1 Inputs</u> are quoted prices in active markets for identical assets or liabilities.
- <u>Level 2 Inputs</u> include:
  - Quoted prices for similar assets or liabilities in active markets;
  - Quoted prices for identical assets of liabilities in markets that are not active;
  - Observable inputs other than quoted prices, such as interest rates and yield curves; and
  - Inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- <u>Level 3 Inputs</u> are unobservable and are developed based upon the best information available under the circumstances, which might include the reporting entity's own data. Unobservable inputs should reflect the reporting entity's assumptions about the market participants. This level is intended for use with situations in which there is little, or no market activity for the asset or liability at the measurement date.

Disclosure Requirements

SFAS 157 requires the reporting entity to disclose the following information for each major category of assets and liabilities:

- Fair value measurements at the reporting date;
- The level of fair value hierarchy in which the fair value measurements fall;
- For non-recurring assets and liabilities measured, a description of inputs and information that was used to develop such inputs is required for fair value measurements using significant unobservable inputs;
- Fair value measurements performed on a recurring basis with significant unobservable inputs will require a reconciliation of beginning and ending balances, total gains and losses, and transfers in and/or out; and
- For annual periods only, the valuation techniques used to measure fair value and a discussion of changes in valuation techniques, if any, during the period. For non-recurring fair value measurements, entities are also required to disclose and discuss any changes in the valuation techniques used to measure similar assets or liabilities in prior periods.

SFAS 157 is effective in November 2007, but early adoption is encouraged. The Appendices to the statement provide implementation guidance, examples, and other background information.

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When to Test Goodwill for Impairment (Continued)

- A significant adverse change in the business climate.
- Unanticipated competition or loss of key personnel.
- An expectation that a significant portion of a reporting unit would be sold.

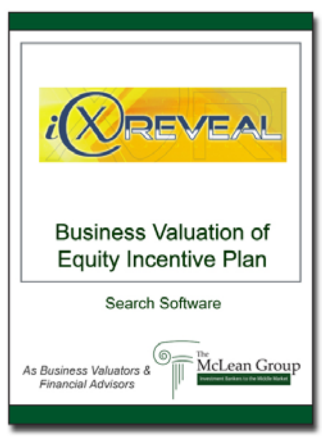
What if Other Impairment Tests Need to be Performed?

If another asset or asset group is also subject to impairment testing (for example, SFAS 144 impairment testing), the impairment testing for goodwill should be performed after the testing of the other asset or asset group.

Business Valuation Practice News

- In the July 2006 issue of SmartCEO magazine, Andy Smith was recognized as one of the Top CPA's in the Washington DC Area. SmartCEO Magazine selected the Top 50 CPA's after canvassing the magazine's readership, the Greater Washington Society of Certified Public Accountants, fellow CPAs, clients, and others.
- Dennis Roberts will be teaching the National Association of Certified Valuation Analysts' "M&A Workshop" (a four-day intensive course on mergers and acquisitions) in Providence, Rhode Island and San Diego, California this fall.
- John Jacob, AVA, completed the CFA Level One Exam.
- The McLean Group welcomes Whitney Weiss, the newest member to the firm's valuation team.

Selected McLean Group Engagements



About the McLean Group

The McLean Group is a middle-market investment bank providing merger and acquisition, business valuation, capital formation, executive advisory and litigation support services. Its focus is on serving middle-market businesses generating between $5 million and $300 million in revenues. The firm has a widespread practice with particular expertise in the IT services, technology, telecommunications, government contracting, staffing, and travel and hospitality sectors. McLean Securities is a registered broker dealer with the NASD.