The McLean Group
INVESTMENT BANKING

Valuation Vantage©

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Insights and perspectives on leading corporate finance valuation issues.

Inside This Issue

Goodwill Accounting Changes for Private Companies

On November 25, 2013, the FASB endorsed the Private Company Council's ("PCC's") proposal to provide private companies with an alternative approach to goodwill accounting, which is comprised of the following:

1. A private company can amortize goodwill over the useful life of the primary asset acquired in a business combination, not to exceed 10 years.

continued

"Goodwill Accounting Changes for Private Companies" continued

2. Goodwill should be tested for impairment only when a triggering event occurs that may reduce the Fair Value of an entity below its carrying amount.

3. Step 2 of the goodwill impairment test, which requires the application of a hypothetical purchase price allocation to calculate the goodwill impairment amount, is eliminated. Instead, the goodwill impairment amount represents the excess of the entity's carrying amount over its Fair Value. Also, the goodwill impairment would be performed at the entity level rather than the reporting unit level. However, the goodwill would not be reduced below zero.

The final standards will be effective December 15, 2014 and early adoption is allowed. The formal amendment to the Accounting Standards Codification related to this proposal is expected to be issued in December 2013.

In issuing the proposal, the PCC noted that some respondents voiced concern about private companies being able to transition to public company accounting standards, if the intent of certain private companies is to eventually go public. For example, if a private company decided to go public, it would be subject to public companies' goodwill accounting requirements. Some respondents also were concerned about the proposed alternative's impact on public companies that have a significant investment in private companies.

Private companies must carefully consider whether it makes sense to choose the alternative approach to goodwill accounting. ◆

New AICPA Guide Regarding Goodwill Impairment Testing

In November 2013, the AICPA Impairment Task Force released a new practice guide "Testing Goodwill for Impairment – Accounting and Valuation Guide." The guide's main takeaways include:

1. Annual Testing Date – No more than 12 months should elapse between goodwill impairment tests.

2. Carrying Amount – There should be consistency for goodwill impairment testing regarding whether the carrying amount for the reporting unit is calculated on an enterprise value or equity value basis.

3. Qualitative Assessments – The potential cost of performing a Step 0 assessment for a reporting unit should be weighed against performing a Step 1 assessment (formal business valuation), especially if it seems that the reporting unit's Fair Value is barely above its carrying amount.

The Step 0 test or qualitative assessment is often more than a simple memo as many of the same methods used when performing a Step 1 test also are used when performing a Step 0 test.

The following are steps and best practices that the AICPA Impairment Task Force recommends when performing qualitative assessments:

1. Identify inputs and assumptions that most affect Fair Value, which involves analyzing the inputs and assumptions that were used in the last quantitative assessment performed for the reporting unit, whether this is the prior Step 1 goodwill impairment test or some other prior Fair Value analysis for the reporting unit.

2. Identify relevant events and circumstances during the testing period (in addition to examples in ASC 350-20-35-3C), such as:

    a. Market reaction to new products or services;

    b. Technological obsolescence issues and risks;

    c. Significant legal developments;

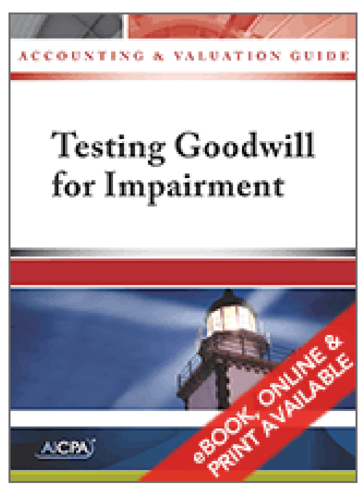
    d. Changes in key customers or employees;

    e. Changes to the strategy or business plan; and

    f. Expectation of a change in the risk factors or risk environment that influence assumptions used to calculate a reporting unit's Fair Value such as discount rates or market multiples.

3. Weigh relevant events and circumstances. For example, if the analysis reveals more negative evidence than positive evidence, it would be harder to conclude that further goodwill impairment testing can be avoided.

The release of the AICPA's new guide further clarifies the process for companies to test goodwill. ◆



DCF Undermines Fairness Opinion

Koehler v. NetSpend Holdings Inc., Delaware Chancery Court, Civil Action No. 8373-VCG (May 21, 2013)

Background

In this case, the Plaintiff, a stockholder in NetSpend Holdings, Inc. ("NetSpend," the "Company," or the "Defendant") requested a preliminary injunction to prevent NetSpend from being acquired by Total System Services, Inc. ("TSYS"). The Plaintiff did not believe that TSYS' purchase price to acquire NetSpend was appropriate for several reasons:

1) Lack of a sufficient auction of the Company;

2) Negotiation with only one potential purchaser;

3) Reliance on a weak fairness opinion;

4) Agreement to forgo a post-agreement market check; and

5) Agreement to a don't-ask-don't-waive provision.

Focus on Fairness

The Plaintiff alleged that NetSpend's board of directors relied on a poor fairness opinion in approving the acquisition of the Company by TSYS. Although the Court ruled that the price offered by TSYS was fair, the Court found that the fairness opinion was weak and did not provide an effective price check for the amount offered by TSYS. In particular, the bottom range of the discounted cash flow ("DCF") analysis was 20% higher than TSYS' offer price. The fairness opinion was not consistent with the underlying valuation analyses and the results of the different valuation approaches were not reconciled.

The Court's Conclusion

The Plaintiff's motion for a preliminary injunction was denied by the Delaware Chancery Court since the Court found that granting the injunction would possibly keep all NetSpend shareholders from receiving a premium on their shares. Also, the Court noted that there were no other potential bidders during the sales process.

Best Practices

Although the Plaintiff was not successful in obtaining an injunction, the errors in the fairness opinion commissioned by NetSpend's board, particularly with regards to the DCF conclusion, make it critical that fairness opinions are properly prepared in accordance with accepted valuation standards. In addition, it highlights the importance of properly documenting a business' sale process. ◆

PCAOB Releases Report on its Inspection of Public Company Audits

The Public Company Accounting Oversight Board ("PCAOB"), recently released its "Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies." The PCAOB, which was established in 2002 as a result of the Sarbanes Oxley Act ("SOX"), inspects registered public accounting firms for compliance with SOX. Inspections are conducted annually for firms that provide audit reports for more than 100 public companies and triennially for firms that provide audit reports for less than 100 public companies.

Based on these inspections, the PCAOB has noted several audit areas with common deficiencies, including audits of Fair Value measurements. In addition, the report noted several areas of common deficiencies in audits of business combinations and impairment testing of intangible and long-lived assets.

As noted in the PCAOB's report, "PCAOB standards require that the auditor test management's Fair Value measurements and disclosures based on his or her assessment of the risk of material misstatement and consider using the work of a specialist in performing audit procedures related to Fair Value . . . Substantive tests of Fair Value measurements may involve:

(a) testing management's significant assumptions, the valuation model, and the underlying data;

(b) developing independent Fair Value estimates for corroborative purposes; or

(c) reviewing subsequent events and transactions."

The report highlighted that firms failing to gather sufficient audit evidence to determine the reasonableness of significant assumptions or sufficiently test assumptions used in Fair Value estimates are the primary reasons audit deficiencies are occurring.

Audits of business combinations and impairment testing of intangible and long-lived assets noted specific deficiencies including firms failing to:

(a) test the value of the purchase price or consideration given in the business combination;

(b) evaluate whether all of the tangible and intangible assets acquired and all of the liabilities assumed have been identified and allocated an appropriate portion of the purchase price;

(c) evaluate the reasonableness of estimated useful lives and appropriateness of the methods applied to acquire intangible assets; and

(d) evaluate the issuer's accounting for reverse merger transactions.

The audit deficiencies noted in these areas occurred mostly because firms failed to sufficiently test underlying assumptions or gather sufficient evidence to support the reasonableness of assumptions used in an analysis.

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"PCAOB Releases Report on its Inspection of Public Company Audits" continued

The PCAOB's findings are significant because valuation work is being subjected to increased scrutiny by audit firms as they attempt to improve audit procedures related to Fair Value measurements and reduce audit deficiencies. In the end, this means additional time and fees for clients, auditors and valuation specialists.

The following is a short list of situations where an increased level of documentation may be warranted in a valuation report:

- The forecast is decreasing, and the company is not meeting profitability goals, but the valuation report indicates that there is no goodwill impairment.
- There is a large disparity between a company's market capitalization and book value.
- A recent sale of company stock is disregarded for purposes of estimating a company's Fair Value.
- A valuation of common stock is based on only one valuation methodology, rather than multiple valuation methodologies.
- Customer-based or technology-based intangible assets do not represent a significant amount of the total purchase price.

To be more proactive, clients and valuation specialists can work together to help auditors gather information necessary for their audit work.

The following are some helpful tips:

- Planning meetings – Get everyone on board with the approach and vet potential issues before completing the valuation analysis.
- More documentation – Spend additional time documenting key assumptions, methodologies used, such as discussing the company's historical performance as compared to projections.
- Sensitivity analysis – It often is helpful for auditors to see an analysis that demonstrates how much a change in a key assumption may or may not impact the overall valuation.

In being more proactive, clients and valuation specialists can help ensure that audit firms are more comfortable with the underlying assumptions in Fair Value estimates for purposes of complying with GAAP and meeting SOX standards. ◆

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The McLean Group

Headquartered in the Washington, DC metropolitan region, The McLean Group provides M&A, business valuation and strategic consulting services to middle market businesses.

Practice Highlights

On September 19, 2013, The McLean Valuation Services Group's Andy Smith, Ryan Berry and Elisabeth Wayman spoke on an "Allocating Value between Equity Classes" panel at The Virginia Society of CPAs' 14th Annual Business Valuation, Fraud & Litigation Services Conference in Richmond, VA. The program discussed the applicability and key assumptions of different equity allocation methodologies, and included a detailed review of practical examples of option pricing and probability-weighted expected return case studies.

On October 22, 2013, The McLean Valuation Services Group's principal Andy Smith, presented "Best Practices in Fair Value Accounting" at The Eighth Annual George Mason University Tax & Accounting Conference in Falls Church, VA.

In October 2013, Andy Smith was selected a Virginia Super CPA in the Business Valuation/Litigation category by *Virginia Business* magazine and the Virginia Society of Certified Public Accountants.

The McLean Valuation Services Group

As a core competency and complement to our M&A practice, The McLean Valuation Services Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes. The McLean Valuation Services Group has the requisite experience and credentials to support litigation proceedings, including quantifying economic damages and valuing business interests.