

Fair Value Accounting Issues for the Global Treasurer

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Topics of Discussion

- Introduction and importance for Treasurers
- Growth of Fair Value Standards
- Impairment Boondoggles
- Valuation Basics
- Business Combinations and valuation
- Documentation
- International Considerations
- Summary

Introduction

Introduction

- There is a transition taking place in the accounting model
- Financial Disclosure has been moving from Historical Accounting of Assets and Liabilities to Fair Value Accounting bringing a whole new set of issues to high level corporate financial professionals

Which is Better?

- Relevant Fair value

Or

- Reliable Historical Cost

For Corporate Treasurers

- The information that auditors and valuation consultants will use in determining value will come from corporate management.
- Therefore, it will be necessary for corporate management to develop, document, and justify the information.

Strategic Role of Treasury

- **Enhancement of enterprise value**
- **The internal process of cash forecasting**
- **Proactive in investing and risk management**

Growth of Fair Value

Fair Value Standards (U.S)

- FAS 115- Equity Investments
- FAS 123r-Stock Options
- FAS 133- Hedging Derivatives
- FAS 141- Business Combinations
- FAS 142- Intangibles
- FAS 143- Asset Retirement
- FAS 144- Accounting for Impairment
- FAS 146- Exit or Disposal Costs
- FAS 150- Accounting for Certain Financial Instruments
- FAS 153- Exchanges of Non-Monetary Assets
- FAS Interpretation 45- Guarantees

Fair Value-International

- IFRS 3- Business Combinations
- IFRS 5- Non-Current Assets
- IAS 39- Derivatives
- IAS 19- Pensions
- IAS 36- Impairment

Intangible Assets

- Patents
- Copyrights
- Trademarks and Trade Names
- Proprietary Processes/Products
Technology
- In-Process Research and Development
- Know-How
- Software
- Customer Relationships

Company Embarrassments

Impairments

- AOL- 54.2 billion in 2001
- JDS Uniphase- 50 billion
- AT&T- 11.4 billion in 3rd 2004
- Viacom- 18 billion
- T-mobile- 16 billion in 2002

Valuation Basics

Valuation Approaches

- **Cost approach**
 - ◆ Based on substitution
- **Market approach**
 - ◆ Based on comparables or similarity
- **Income approach**
 - ◆ Based on economic income

Elements of Fair Value

- Estimate of future cash flows
- Variations in timing and amount
- Price for cash flow uncertainty
- Time value of money
- Specific company or market issues
- Creditworthiness (for liabilities)

(From FASB Fair Value ED Appendix A)

Inputs of Computation

- Projected Revenue from Asset
- Projected Direct Costs
- Projected Indirect Costs
- Taxes

Cash Flow Considerations

- Market Size
- Growth Rates
- Competition
- Developments

Probable Life Determinants

- **Legal Life**
 - ◆ Patents, tradename, copyrights
- **Contract Life**
 - ◆ Lease, franchise agreements, customer contracts
- **Functional and technological life**
 - ◆ Change in technology
- **Economic Life**
 - ◆ Period in which the asset generates a positive cash flow
- **Analytical Life**
 - ◆ Historical turnover trends of customers

Discount Rate Risk

- An economic cycle where interest rates are increasing pose the greatest risk.
- An impairment adjustment could be triggered simply by changes in interest rates (increasing rates result in a smaller present value).

Discount Rate-Continued

- Increasing interest rates generally exist in growing economies, suggesting that future cash flows of an asset may cancel out any discount rate loss.
- Future cash flows and asset life need to also be reconsidered.

Valuations can be effected by:

- **External economic factors**
(General economic conditions)
- **Specific external factors**
(Company competition)
- **Internal factors**
(Company costs)

Internal Factors

- Assembled Workforce
- Operating Margins
- Working Capital Requirements
- Capital Expenditures
- Synergies

External Issues

- National Economic Conditions
- Consumer Spending
- Inflation
- Productivity
- Financial Markets
- Interest rates
- Unemployment Levels
- Industry Characteristics and Trends
- Level of Regulation

Valuation Consequences

- Can effect balance sheet and income statement ratios which can have a negative impact upon:
 - ★ Earnings
 - ★ Credit ratings
 - ★ Cost of capital
 - ★ Investor confidence
 - ★ Bank relationships
 - ★ Salaries and bonuses

Data Concerns

- Volatility
- Quality of data
- Inaccurate assumptions
- Manipulation of variables
- Management or consulting bias
- General economic trends

Present Value of Liabilities

- Fair value accounting also applies to liabilities
- Liabilities are to be valued at a price which other entities would be willing to hold these liabilities as an asset

Factors in determining liability values

- Entity's credit standing (credit rating). Risk of default
- Timing of cash flow
- Collateral
- Other terms

Business Combinations

- Accounting and valuations of business combinations are driven by FAS 141 and IAS 39
- Elimination of Pooling of Interest
- Proposal that M&A Costs must be expensed in the current year
- (But for Japan which still allows Pooling)

Documentation

Documentation Examples for Copyrights

- List of all copyrights
- Remaining legal life
- Economic life
- Economic trends
- Contractual terms
- Customer patterns
- Overlap with other intangible assets
- Ongoing copyright costs
- Company strategic plans and related costs
- Indirect administrative costs

Documentation Examples for Technology Intangibles

- Age of intangible
- Growth or decline of technology
- Existing Competition and market share/market potential/market barriers
- Profitability
- Costs associated with intangible
- Economic conditions
- Effects of any legal or regulatory policy

Documentation for Software

- Actual costs to develop
- Costs to recreate
- Historical revenue
- Internal development which may increase or decrease life
- Direct and indirect expenses
- External factors
 - ◆ Competition
 - ◆ New technology
 - ◆ Economy

Documentation for Licensed Products

- Length of license (any renewal options?)
- Termination provisions
- Minimum royalty rates
- Size of territory
- Market and growth rates
- Competition
- Support
- Experience (technical and managerial)
- Financial health

Documentation of Customer Accounts

- Historical customer history
- Rate of customer growth
- Rate of customer attrition
- Costs of maintaining and developing customers

International Issues

International Concerns

- Country specific valuation risks
 - ◆ Currency risks
 - ◆ Country risks
 - ◆ Legal and regulatory
 - ◆ Foreign competition

(These all effect the expected cash flow and appropriate discount rate)

Valuation Issues in Transitional and Developing Countries

- **Country Issues**
 - ◆ Legal Environment
 - ◆ Enforcement
 - ◆ Cultural

- **Intellectual Property is most at risk (pirating) such as:**
 - ◆ Copyrights
 - ◆ Trademarks
 - ◆ Patents

- **Specific Industries**
 - ◆ Software
 - ◆ Music
 - ◆ Publishing
 - ◆ Pharmaceutical

Monitoring Changes in Transitional and Developing Countries

- Expected cash flows can change when:
 - ◆ Change in Country Laws
 - ◆ Volatility swings of economy
 - ◆ Enforcement changes
 - ★ Police
 - ★ Judicial

Factors which have an adverse effect on valuations

- Actual cash flow fail to match original expectations

Factors

- Earlier than expected decline in revenue
- Increased competition
- Increased production costs
- Legal obstacles
- Increased interest rates
- Tax changes
- Excess capacity
- Errors in original cash flow expectations
- Declining market growth
- National disasters/corporate accidents

Conclusions

- Documentation of cash flow assumptions will drive the valuation and asset preservation process
- The Treasury Professional must be familiar with and be able to document and support the components used in establishing company values
- Failure to actively and materially participate in this process will risk compromising the value of the Treasury Professional and allows the less informed auditor and consultant to establish their own assumptions