

# Business Valuation Notes

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## Valuation Protocol ...

### ACCOUNTING RULES CHILL VC PARTNERS

By issuing new accounting rules for valuing individual portfolio securities, the Financial Accounting Standards Board has chilled the venture capital community. In the past, venture funds have typically relied on internal committees for appraising holdings, according to Carl E. Kaplan, a retired partner at Fulbright & Jaworski L.L.P. He believes those committees should now be abolished.

Minnesota Business Valuation Group President Randall Schostag said, "This is just the beginning of a growing awareness by fund managers that informal practices for pricing portfolios are no longer acceptable."

"The tasks now required to value each portfolio company will be beyond the practical ability of a Committee to perform," Kaplan wrote in an article July 15, 2008. "Without the correct process, a GAAP accounting opinion will not be obtained. Valuation 'mistakes' could conceivably also give rise to Committee liability," Kaplan

warned.

Investors who put money into businesses rely on accurate accounting, presented according to generally accepted accounting principles, and attested to by accountants who apply generally accepted auditing standards (GAAS). If a fund is unable to obtain an unqualified audit opinion from a CPA, a few investors may be precluded from investing due to fiduciary limitations, and most investors would be much more cautious about investing.

*Business Valuation Notes* has previously published the changing accounting and valuation rules and the likely effect those changes would have on funds with multiple security holdings. Kaplan's comments allude to one such change: when the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) adopted the Statement for Financial Accounting Standard (SFAS) 157 which took effect November 15, 2007.

Appraisers, accountants, and chief

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## Adding more Footnotes ....

### DERIVATIVES REQUIRE NEW DISCLOSURE

Beginning after November 15, 2008, the Financial Accounting Standards Board (FASB) will require amended *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*. Minnesota Business Valuation Group thinks it's important to understand derivatives because a lot of the current financial and stock market problems stem from Credit Default Swap (CDS) derivatives.

MBVG President Randall Schostag said, "The new disclosures should make the use and potential overuse of derivatives more transparent to analysts. It's likely this kind of disclosure would have been helpful before the melt down of Lehman Brothers, Merrill Lynch, and American International Group. But anticipate even more regulatory oversight."

The amendment is contained in FASB 161 released March 19, 2008, and effective after mid November.

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# DERIVATIVES

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It enhances and expands derivative disclosures of FASB Statement 133, *Accounting for Derivative Instruments and Hedging Activities*. To the extent that the FASB gives more information to an analyst, it will ease valuation of individual company risks and could have made overall economic risk more apparent leading to the losses from mortgage backed securities which analysts thought were covered by credit default swaps.

Robert Kemp, CPA, Professor at the University of Virginia, in March observed that more disclosure is always better for financial analysis. MBVG agrees. "FASB 161 is a significant improvement in the way derivatives are disclosed," Kemp wrote.

"The new FASB attempts to supplement previous FASB's by making management disclose intent and logic in their derivative positions and related risk management."

PriceWaterHouse Coopers Structured Finance Group added in June that the new FASB will also require entities to show how derivatives and related hedge items affect an entity's financial position, financial performance, and cash flows.

A credit swap derivative is like insurance on a bond or other security. Funds holding such securities may

elect to purchase CDS to protect them against possible default. The buyer pays periodic premiums or payments to a credit protection seller. If the security does default, the seller either takes the bonds or other securities and pays the buyer face value, regardless of the present trading price, or pays the buyer a cash settlement to make the buyer whole.

CDS is like an insurance policy, Schostag said. Its use has exploded in the past few years by institutions holding debt securities, enabling the portfolio managers to [insure](#) against default of the debt instrument.

According to the British Bankers Association, the CDS market expanded from just \$180 billion in 1996 to \$20 trillion a decade later. Money and Markets editor Mike Larson (<http://www.moneyandmarkets.com>) says that amount was about \$57.9 trillion at the end of 2007, citing the Bank for International Settlements.

While having characteristics of an insurance policy, the CDS market is not regulated. There is no requirement to actually hold any asset or suffer a loss, so a credit default swap can also be used for speculative purposes.



**Larson**

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## DOES FAIR VALUE PRODUCE INSTABILITY

In a July 2008 article by Peter J. Wallison (American Enterprise Institute for Public Policy Research, *Fair Value Accounting: A Critique*), the author contends fair value accounting has been the principal cause of an unprecedented decline in asset values and an unprecedented rise in instability among financial institutions. Wallison believes this is because Fair Value accentuates procyclicality which tends to cause asset bubbles and exacerbate the effects of their collapse.

MBVG President Randall Schostag said he expects the volatile financial markets and the collapse of Wall Street investment banks and insurers is likely to fuel more debate about how to value securities and assess risk.

Certified appraisers recognize the importance of marking securities to market, Schostag said, but fair value seems to only use that which is really a market approach method. Besides the market approach, appraisers also value from an income approach and an asset-based approach, he said.

Values obtained by using three approaches are likely to be very different, according to Schostag. "During the reconciliation process of reexamining the outcomes of all three approaches, the analyst will decide if one or more measures are out of line and should either not be weighted or weighted less," Schostag said.

# Accounting Rules

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financial officers in companies which are now audited must use Fair Value as defined by the standard for unqualified audits. SFAS 157 prescribes minimum procedures to conduct valuations before an unqualified opinion can be achieved.

Kaplan said, "The recent adoption of FAS 157 mandates valuation methodologies and valuation standards which



**Schostag**

differ, and in some cases, conflict with existing practice." Kaplan said that "... all [venture funds] involved knew and accepted ... [that even though] GAAP standards always called for 'fair value' valuations ... the difficulties in valuing the illiquid securities held in venture capital portfolios [would be eased] immeasurably by a guideline approach."

Such "guidelines" were developed by the National Venture Capital Association and other national and international groups concerned with private equity portfolios. Kaplan writes that for illiquid securities, SFAS 157 now requires "...analysis which utilizes methodologies and instruments requiring significant management judgment or estimation to determine fair value..." and that it does not allow for an "easy" guideline technique, such as these funds have used in the past.

Schostag said, "What Kaplan is saying is what the accounting rule mak-

ers wanted in order to maintain public user confidence in audits. Valuing privately held securities by funds has been very informal, and the methods funds have used were inconsistent with procedures used by certified valuation professionals or by the courts.

"FASB wants to assure that for financial audits, the statement user is confident that when security values are presented, the auditor has tested those values using accepted procedures.

"The funds continue to have the choice of not obtaining a financial audit," Schostag said. "But if an audit is necessary, then the auditor must insist on attestable valuations for the values to be credible."

In a two-part series of articles for the National Association of Certified Valuation Analysts (NACVA) *Value Examiner* (March / April and May / June issues), Schostag summarized the history of portfolio valuation procedures and the impact of recent changes in industry and regulatory requirements. (Copies of those articles are available by request or at <http://www.BusValGroup.com> for download.)

On October 10, 2008, Schostag will present at the national annual meeting of the Financial Management Association (FMA) "Portfolio Valuation Creates Opportunities and Problems, Portfolio Valuation Using Automation", and on October 8, 2008, he will participate in a corporate roundtable for the FMA Practitioners Demand Driven Academic Research Initiative (PDDARI) where he will

focus on "Discounted Cash Flow: Testing Model Reasonableness."

The FMA meeting will be in Dallas (Grapevine), Texas. The FMA was established in 1970 and has become a global leader in developing and disseminating knowledge about financial decision making. FMA's members include academicians and practitioners across the world. Schostag said that Kaplan's remarks about venture capital committees mirror broad concerns which are rising in both the academic and practitioner communities.

The problem for funds in valuing portfolio holdings stems partly from the time-consuming and expensive process involved in appraising private securities, investments which are not publicly traded, and for which public quotations are not available, Schostag said. But, he explained, that is only a part of the problem, "... because many professionals are also critical of valuing securities by simply 'marking to market' the prices."

In the NACVA articles, Schostag enumerated that SFAS 157 rules may complicate valuing securities because the recommended way reinforces the mark to market method. Rather than just marking to market, Schostag believes it would be more effective to mark to model, a process which may at least partly replicate what professional appraisers now do, but on a more cost effective and timely basis.

# DERIVATIVES

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“Investors started buying CDS on companies with worsening credit – expecting those contracts to rise in value,” Larson wrote, “and selling CDS on companies with improving credit – expecting to record a gain as those contracts declined in value.”

The problem, according to Larson, is that an increasing number of CDS were being bought and sold by hedge funds and other thinly capitalized companies. “After all, what good is insurance if the company standing behind it can’t make good on claims?” Larson asks.

Besides offering more transparency for CDS, CFO.com reporter David M. Katz, March 28, 2008, wrote that Enron’s balance sheet – before its demise – included customer deposits as an asset and liability when they were, in fact, oil contract derivatives. Charles Mulford, a professor of accounting at Georgia Tech and director of GT Financial Reporting & Analysis Lab, wrote in *Creative Cash Flow Reporting and Analysis*, that labeling those contracts as customer deposits enabled Enron to portray what was really a loan as operating cash flow.

SFAS 161 will not change the accounting for derivatives, Schostag said. But with the added disclosure, we expect the reporting to be more transparent and understandable in financial statements.



## OLSEN-THIELEN CORPORATE OFFICES MOVE TO NEW LOCATION

**Remains a St. Paul, Minnesota Company**

MBVG Chairman and Olsen Thielen President Ken Vohs has announced that the Olsen Thielen & Co. offices have moved to a new location after more than 37 years in Little Canada. “We’re very excited about our new facilities and pleased that our



**Vohs**

growth has required it,” Vohs said.

Olsen Thielen & Co., Ltd. is the parent company of the Minnesota Business Valuation Group, LLC. OT is a major, regional CPA firm with headquarters in St. Paul and a satellite office in Edina, Minnesota. In addition to MBVG, another subsidiary, Olsen Thielen Technologies, was also relocated to the same new offices.

MBVG, OT, and OTT are now located at 2675 Long Lake Road, St. Paul, Minnesota 55113-1117. OT continues to also maintain a Minneapolis, Minnesota

office in the Flagship Corporate Center at 775 Prairie Center Drive, Suite 480, Minneapolis, 55344-7314. The St. Paul office main number has changed to 651.483.4521 although MBVG can still be reached at the same telephone number: 612.240.0309.

The new offices are just off County Road C, on the West side of Highway 35W, near the Rosedale shopping mall. The location offers continued visibility and access from a major highway. The reopening of Highway 35W with new bridge gives clients an easy, short drive.

The offices consist of 36,000 square feet of space; OT has a first option to add another 10,000 adjacent square feet to accommodate expected future growth.

Contact us about our open house and exciting new programs.

# Minnesota Business Valuation Group

## Professional Business Appraisals

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#### **BUSINESS VALUATION**

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

#### **BUSINESS ASSET VALUATION**

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,  
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,  
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

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**WE WILL CONNECT OUR COMPUTER.**

**PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.**