

Business Valuation Notes

Minnesota Business Valuation Group - 2675 Long Lake Road, St. Paul, Minnesota 55113-1117

Telephone 800 303 2889 or 612 240 0309 Fax 612 677 3881 www.BusValGroup.Com

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SEC Roundtable ...

MARK-TO-MARKET UNDER FIRE

On October 29 and again on November 21 the Securities and Exchange Commission (SEC) hosted roundtable discussions on mark-to-market (MTM) accounting, giving proponents and detractors of the accounting method a forum to discuss their differences. The recently enacted Emergency Economic Stabilization Act requires the SEC to conduct a study on MTM accounting and report its findings to Congress by January 2.

“Mark-to-market has become a focus of national legislators who have considered the way by which accountants are required to report portfolio security values to improperly appraise the values, giving values which are too high during market tops and too low during market slides,” according to Randall Schostag, President of the Minnesota Business Valuation Group. “Although the current debate has centered on the valua-

tion of debt securities, the debate is about how accountants should be applying its fair value measurement for companies with security holdings.

“Besides the debt holdings of banks, investment banks, and similar financing entities, this discussion about properly measuring fair value also impacts firms which own equity securities.”

Business Valuation Notes has published several articles relating to the Statement of Financial Accounting Standard (SFAS) 157 which defines fair value and how it is to be measured, noting that it clearly requires an emphasis on using MTM as the method of valuation, substantially dismissing the importance of using other methods to assess value, such as discounted cash flow.

In the March / April and the May / June issues of the *Value Examiner*, a national publication of

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VALUING DISTRESSED COMPANIES

At a time when public securities markets are displaying wide fluctuations and most public companies have dropped by large amounts, analysts expect to see more private firms which may be facing financial stress.

In a recent interview with two analysts of the Minnesota Business Valuation Group, they indicated that this financial stress may be seen in various valuations, ranging from fair market values for gift and estate valuations to fair values reflected in goodwill impairment tests, acquisitions, consolidations, and litigation.

Randall Schostag, MBVG President, said that MBVG was recently on the sell side of a merger / acquisition where the transaction “vanished overnight” as funding sources “dried up.”

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DISTRESSED

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“The banking source of funds suddenly reduced the percentage of the acquisition which it was willing to fund and at the same time increased the interest rate it would charge for the amount it would finance,” Schostag said.

As a result, the buyer wanted to have the seller either reduce the selling price and / or carry paper back as part of the sale or both. Those new terms effectively killed the deal.”

MBVG Senior Valuation Analyst Laurel Sorensen said that she expects the wild market swings and loss of appetite by many lenders to translate into “a decline in merger and acquisition transactions with a corresponding decline in SFAS 141 work.”

SFAS 141 is the standard required by accountants for generally accepted auditing reporting when doing purchase price allocations following purchases. Sorensen said she expects that there may also be more impairment of goodwill after year end for SFAS 142.

“Besides the effect of marking-to-market which is likely to

mean lower value,” Sorensen observed that expected “future growth is likely to slow and may even turn negative short term, thus affecting discounted future cash flows.”

Elsewhere in this issue of *Business Valuation Notes* we discuss how the SEC is addressing mark-to-market accounting requirements in “Mark-to-Market Under Fire.”

MBVG Analyst Joel Grundmeier said, “We’ve been warned that in past recessions there was an increase in company valuations which may be in or near bankruptcy. For normal valuations, there are usually a limited number of parties interested in the valuation, whereas for distressed valuations, we’ve been alerted that there are more interested parties, many with different interests and motivations.”

Schostag noted that data-gathering can be even more time consuming and expensive when the analysts must evaluate distressed companies.

Historical financial statements are not likely to reflect or be helpful in projecting the near or intermediate term of those companies, Schostag said. “Projections are going to be much more dependent on the

limitations due to weakened balance sheets and tight lending.”

Sorensen said, “Even when times are good, management often believe that we are picky when asking operating questions pertinent to business planning. In this environment when small mistakes can have an even larger effect, we’re probably going to be asking even more questions.”

Sorensen said that in addition to the careful work she is known for in ‘normalizing’ financial statements, there are going to be even more questions about inventory, accounts receivable collection, loan terms, and personal guarantees on loans. An issue which must be ascertained early,” she said, “is determining if the valuation should be as a going concern or a valuation in liquidation. If in liquidation, we really have to consider how long that may take, and if it would proceed as an orderly sale over time or if it would be an auction.”

Grundmeier, who is also a tax specialist, also stressed the importance of appraising the value of any net operating loss carryforwards, assuming a going concern premise of value.

MTM

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the National Association of Certified Valuation Analysts (NACVA), Schostag authored articles tracing the history of MTM, why it has played such an important role in accounting, and why it fails to provide a reasonable way to measure value.



Schostag

With the adoption of SFAS 157 this year, the MTM model for valuing securities became even more entrenched in financial reporting.

Since the ‘melt down’ of several financial institutions in September / October, critics of SFAS 157 pointed to what has been called the procyclical outputs of using this form of valuation, noting that many financial institutions seemed to be under water as a consequence of being forced to mark to market, but that the current pricing does not reflect true value.

Reportedly there were some at the November 21 meeting who proposed that regulatory accounting principles should be adjusted to back out procyclical effects, which would likely not address the concern with anything other than an exception.

“In established valuation,”

Schostag said, “the analyst must consider not only MTM, but should also consider other approaches. As certified appraisers we are required to consider the market approach – MTM – but also consider the income approach, such as estimated discounted cash flow, and the asset-based approach. MTM is only one leg of a three-legged framework.”

Certain assets, some of which are held by credit unions, are required to be measured using the MTM accounting technique, the critics note. This essentially requires those assets to be valued at the price they could be sold for today on the open market.

Those opposed to the use of MTM argue that a financial institution's intention to hold assets for the long term should be a factor in valuing them. Those in favor of the accounting technique argue that allowing a bank's management to value assets will only lower investor confidence.

The study which has been required by Congress is to include the effects of MTM accounting on a financial institution's balance sheet. The act also authorizes the SEC to suspend application of MTM.

SEC Chairman Christopher Cox, in his opening remarks at the latest roundtable, said, “Already, the input that we’ve received...in

response to our request for public comments has indicated that at a minimum there are areas where FV accounting could be improved.” He observed that the current way of valuing assets for impairment can be difficult to apply, and may provide questionable utility, and that especially in inactive or illiquid markets, additional work is necessary to insure the reasonable application of the standards.

Schostag said that he considers the way the roundtable resolves the issue of MTM will be important for all public companies, but especially for those smaller public companies which are not actively traded and for privately-held companies which are now encouraged to use MTM from publicly traded firms.

“The discussion still centers on debt securities,” Schostag said. “But many of the hedge funds hold privately-held securities which are being adversely affected by the same rules, and which are now under heavy pressure from investors who are running to the exits for redemption as a consequence of how SFAS 157 favors MTM.

“The rules as they now stand are being felt down to the corporate level for companies with subsidiaries and which issue options.”

Minnesota Business Valuation Group

Professional Business Appraisals

Minnesota Business Valuation Group, LLC

A subsidiary of

OLSEN THIELEN & CO., LTD.

Toll Free: 1 800 303 2889

Ph: 612 240 0309 Fax: 612 677 3881

Email: RSchostag@BusValGroup.Com

[Http://www.BusValGroup.com](http://www.BusValGroup.com)

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.**

OUR FORMAT IS POWER POINT - BASED.

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY
INSTRUMENT.**

WE WILL CONNECT OUR COMPUTER.

PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.