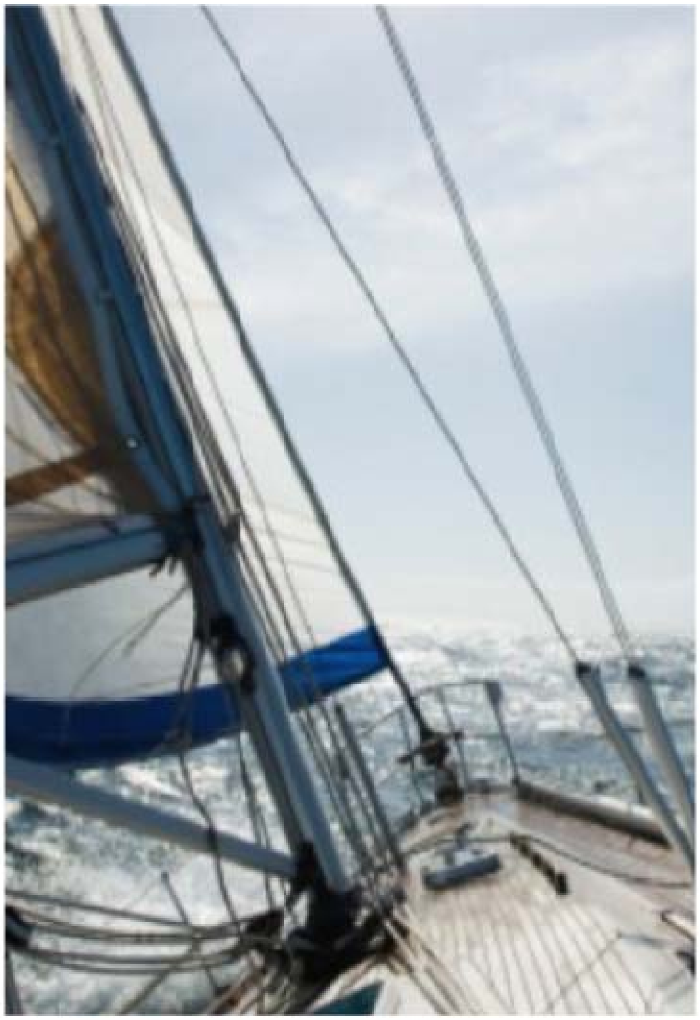
Valuations

DSE Newsletter



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Winter 2008

DOTY SCOTT ENTERPRISES, INC.

Determining Fair Value in Volatile Markets

FASB Update to FAS 157

There are significant issues related to fair valuing securities under volatile market conditions. Recent market conditions have become volatile, distressed, and illiquid. The Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") have taken positive steps to address serious concerns that application of "fair-value" or "mark-to-market" accounting is artificially depressing corporate balance sheets due to the necessity of using steeply declining market prices to value financial assets. In September and October of 2008, the accounting staffs of the SEC and FASB issued statements and letters to clarify the application of FAS 157 in today's turbulent credit environment.

Fair Value Requirements

FAS 157 became effective for companies filing after November 15, 2007. The statement defined fair value and established a framework for measuring fair value and expanded disclosures about fair value measurements. The statement put an emphasis on using market quotes for assets and liabilities, where available. Now that many companies are preparing to file their year-end financials, implementing the fair value requirements under the current market conditions have again raised issues regarding the fair value of the assets or liabilities versus the quoted market price.

FASB 157-3

On Oct 10th, 2008, the Financial Accounting Standards Board finalized its new Staff Position FASB 157-3 on "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active". Their purpose was to bring additional clarity to how fair market value ("FMV") should be determined in illiquid markets. FAS 157-3 addresses the following primary issues:

- How the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when determining fair value when relevant observable inputs do not exist;
- How available observable inputs in a market that is not active or distressed should be considered when measuring fair value; and

Determining Fair Value in Volatile Markets (continued)

- How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.

Additional key points of clarification and guidance provided in FAS 157-3 include:

- When there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same—the price that would be received by the holder of the financial asset in an orderly transaction that is not a forced liquidation or distressed sale. Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. If prices in an inactive market do not reflect current prices for the same or similar assets, then adjustments may be needed to arrive at fair value.
- In determining fair value for a financial asset, use of a company's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. In some cases, it is appropriate for an entity to determine that observable inputs require adjustment based on unobservable data. Regardless of the valuation technique used, however, an entity must be sure to include appropriate risk adjustments that market participants would make for liquidity risks and nonperformance.
- Broker quotes or pricing service quotes may be appropriate inputs when measuring fair value in a market that is not active, but they are not necessarily determinative. In weighing a broker quote as an input to a fair value measurement, less reliance should be placed on quotes that are not reflective of actual market transactions. The nature of the quote (e.g., whether the quote is an indicative price or a binding offer) should also be considered.

Inactive or Distressed Markets

The FASB provided some general guidelines to determining whether the markets of specific assets or liabilities are inactive or distressed and thus their fair value should be reviewed. They concluded that this determination requires judgment. Factors that should be included in this judgment include:

- Changes in the size of the bid-ask spread
- Volume, number of observable transactions
- Date of most recent transactions
- Volatility in prices over time or between market makers

Therefore, a reporting firm needs to evaluate the bid-ask spread, the number of bidders, and the timing and volatility of the markets in which their assets or liabilities trade. Even for assets or liabilities that are traded in an established market, a reporting firm can no longer just accept the latest trade price as determinative indicator of fair value.

Determining Fair Value in Volatile Markets (continued)

Expected Cash Flows and Discount Rates

If market data is insufficient to fair value specific assets and liabilities, then the reporting firm typically uses other acceptable methods of valuation as outlined under FAS 157. Many of these are discounted cash flow models. The FASB staff indicates that the reporting entity may exercise their own judgment in how to model the expected cash flows and discount rates. "In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available." The FASB guidance sounds simple enough.

The guidance is unclear on whether these are a reporting firm's own proprietary assumption on the expected future behavior or a consensus which market participants would agree is the current expectation for future performance. The distinction between the use of proprietary assumptions versus market consensus assumptions is very significant not only in the determination of the asset's FMV, but also in the comfort level that interested parties, both internal and external to the reporting firm, will have in such FMV.

Broker Quotes need Questioning

Apparently FASB does seem to endorse the use of third-party broker quotes, but only if in the judgment of the reporting firm an active market does not exist for the financial asset. "Broker (or pricing service) quotes may be appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset… However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker." The use of management estimates that incorporate current market participants expectations of future cash flows and factor in appropriate risk premiums may be a better input into fair value than insufficient, non-binding broker quotes.

Updated MD&A Requirements

In an effort to promote accurate and transparent disclosure to investors, the SEC distributed letters in March 2008 to certain reporting companies suggesting information that they should consider including in the Management's Discussion and Analysis ("MD&A") sections of their quarterly reports regarding assets and liabilities that were not being valued using observable market data. With economic conditions continuing to deteriorate, the SEC sent another letter to CFOs of public companies in September

2008 setting forth additional considerations for disclosure when valuing certain assets using measures other than market prices. The letter says executives should "continue to evaluate whether they could provide clearer and more transparent disclosure regarding their fair value measurements."

The SEC is prodding companies to provide clear and full disclosure to justify their value measurements when economic conditions require that they value their securities using Level 3 inputs. They stated that the following additional considerations may be relevant to the reporting contained in public companies' MD&A disclosures:

- The significant judgments made in classifying a particular financial instrument in the fair value hierarchy;
- An explanation of how credit risk is incorporated and considered in the valuation of assets and liabilities;
- Disclosure of gains or losses on financial instruments that a company is required to carry at fair value and an explanation of:
    - how the company's credit risk affected the valuation of derivative liabilities and the resulting gain or loss that was included in earnings related to changes in that credit risk;
    - how counterparty credit risk affected the valuation of derivative assets and the resulting gain or loss that was included in earnings relating to changes in that credit risk;
    - how deterioration of the counterparty's credit combined with an inability to collect on a derivative asset would impact ensuing financial statements;
- Discussing the implications of items the company has elected to carry at fair value in the same section as the similar discussion pertaining to items that the company is required to carry at fair value;
- The criteria used to determine whether the market is inactive or active for a given financial instrument;
- Which financial instruments are affected by the inactivity, how the lack of liquidity impacts the valuation technique used, and how the company used illiquidity when determining fair value of those financial instruments; and
- The extent to which, and how, information is obtained and used from brokers or pricing services in developing fair value measurements.

Conclusion

There are a number of new requirements that reporting companies must incorporate into their fair value process. These new requirements are effective immediately. The primary issues that reporting firms must consider are:

- Determining whether quoted prices are acceptable for valuing specific assets or liabilities or whether the quoted prices are from inactive or distressed markets and must be adjusted. This requires an analysis of the markets before utilizing market data.
- The use of alternative valuation techniques when quoted market prices are not available or are from inactive or distressed markets and incorporation of appropriate assumptions into those valuation techniques.
- Expanding disclosure for assets or liabilities that are accounted for at fair value regarding the evaluation of the markets, broker quotes, and/or the significant assumptions factored into the valuation technique and a sensitivity analysis of these assumptions.

The fair value and the disclosures required for FAS 157 rely on the judgment of the reporting firm. Valuation experts can provide their estimate of fair value and provide fully transparent assumption disclosures and sensitivity analysis.

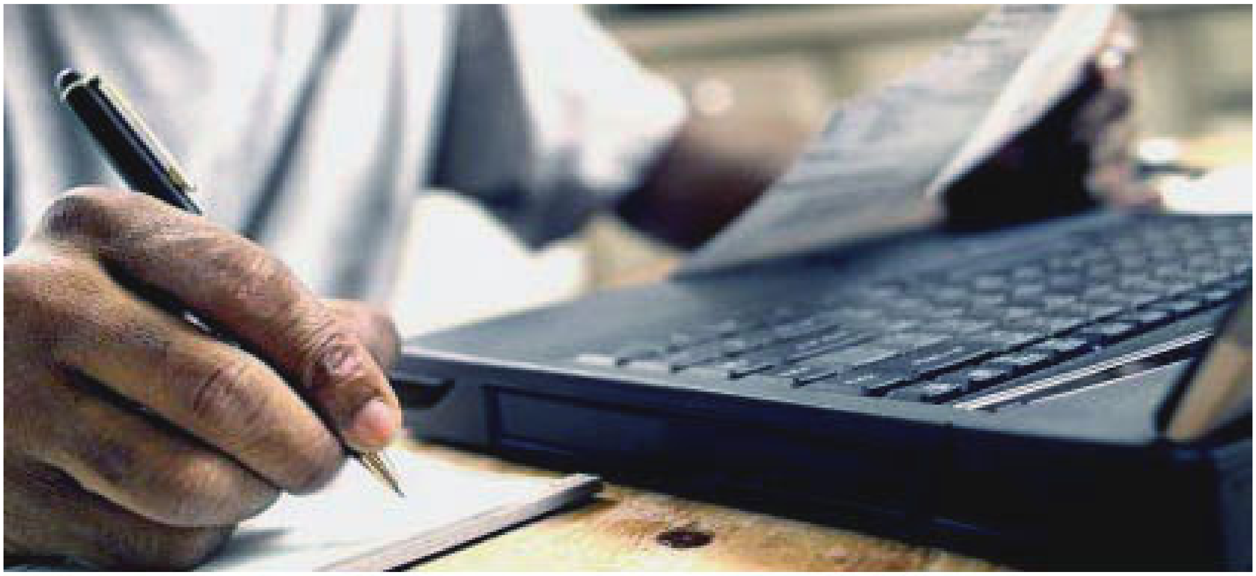
Derivative Treatment for Reset Provisions

Determining Whether an Instrument is Indexed to an Entity's Own Stock

EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock" provides guidance for determining whether an instrument is indexed to an entity's own stock and thus scoped out of derivative treatment. One of the outcomes of this pronouncement is that equity linked instruments with reset provisions are not scoped out of derivative treatment. This is a common provision in many warrants and convertible debt instruments whereby the exercise price of the instrument is reset upon a subsequent event in which lower priced securities are offered by the issuing entity. The reset may be a full ratchet reset or a dilutive reset. These instruments do not have a fixed settlement provision regardless of the probability of such reset event or whether it is within the entity's control. These instruments as well as other instruments will need to be re-evaluated for derivative treatment.

EITF 07-5

Emerging Issues Task Force Issue No. 07-5 applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative as defined in paragraphs 6-9 of FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of FAS 133. EITF 07-5 also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6-9 of FAS 133, for purposes of determining whether the instrument is



Derivative Treatment for Reset Provisions (continued)

within the scope of Issue 00-19. EITF 07-5 does not apply to share-based payment awards within the scope of FAS 123(R) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement.

Instruments (including but not limited to) at issue are as follows:

- Option contracts containing contingent termination provisions that base the settlement amount on variables, such as interest rates, dividends, or stock volatility.
- A conversion option that increases the number of shares to be issued upon conversion if a change in control or subsequent stock issuance occurs.
- A forward contract to deliver a fixed number of shares at fair value, with a contingent ceiling or floor for the settlement amount as a result of a change in the entity’s operations.
- A warrant to buy shares whose price resets if the company sells shares at a lower price to another investor.

In order to be accounted for as equity instruments, rather than as assets and liabilities, derivative contracts on a company’s own stock must be both indexed solely to the company’s stock and settleable in shares. The Task Force reached a consensus that entities should apply a two step approach for determining whether an instrument or embedded feature is indexed to an entity's own stock:

- First evaluate the instrument's contingent exercise provisions, if any
- Second evaluate the instrument's settlement provisions

A contingent exercise provision could include the timing of the ability to exercise the instrument or provisions that extend the length of time the instrument is exercisable. The financial instrument being evaluated fails the first step if the exercise contingency is based on an observable market or an observable index (unless it is the market or index for the issuer’s stock). A market index such as the Dow Jones or S&P 500 would preclude the instrument from being indexed to an entity’s own stock. If the contingent exercise provision is based on sales revenue or net income of the issuer, it would not be precluded from being indexed to the entity’s own stock.

EITF 07-5 states “an instrument (or embedded feature) would be considered indexed to an entity’s own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity’s shares and a fixed monetary amount or fixed amount of a debt instrument issued by the entity.” In other words, the changes in the settlement amount should mirror the changes in the fair value of the entity's stock (they should be correlated). The strike price or the number of shares would not have to be fixed to be considered indexed to an entity's own stock. However, an instrument would not be considered indexed to an entity's own stock if the variables that could affect the settlement amount were not inputs to the fair value of a fixed-for-fixed forward or option on equity shares. These variables could include stock price, strike price, term, dividends, interest rates, volatility, etc.

The Task Force concluded that the following equity-linked instruments or embedded features would not be considered indexed to an entity's own stock:

- An equity-linked instrument or embedded feature with terms that reduce the strike price of the instrument when the entity subsequently issues (a) its own shares for an amount that is less than the exercise price of the instrument or (b) a new equity-linked instrument with a lower strike price
- An equity-linked financial instrument or embedded feature that has a strike price denominated in a currency other than the issuer's functional currency
- A market-based employee stock option valuation instrument

If a previously bifurcated embedded conversion option in a convertible debt instrument, no longer meets the criteria for bifurcation under FAS 133 after the adoption of this EITF, the amount of the liability already recorded should be reclassified to equity. Any debt discount associated with the instrument should continue to be amortized. EITF 07-5 is effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. It should be applied to outstanding instruments as of the beginning of the fiscal year in which it is adopted. Any adjustment would be recognized in the opening balance of retained earnings.

Conclusion

FASB has issued this guidance to assist reporting firms in evaluating whether specific instruments are indexed to their own stock and scoped out of derivative treatment under FAS 133. An entity should evaluate all of its outstanding instruments that are indexed to their own stock to evaluate the contingent exercise provisions and the settlement provisions to determine whether they will continue to be treated as equity instruments or rather as assets or liabilities. A careful analysis of the specific terms of each instrument is required at this time, especially all instruments that have reset provisions.

PHIL SCOTT, CFA

PRINCIPAL

Twenty years of financial, valuation, corporate advisory, merger and acquisition and restructuring experience. Mr. Scott is a Chartered Financial Analyst designee. Mr. Scott has also served as the CFO for SurgiCare, Inc., PSX, Inc. and The Camden Group and has led these companies through successful restructuring and equity sales. Mr. Scott has also served as Vice President of Development for Health Care Partners, Ltd. and Heritage Provider Network, Inc., completing numerous acquisitions. He has an MBA (Summa Cum Laude) from the University of San Diego and a BS Degree in Chemical Engineering from California Institute of Technology.

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