

Be Proactive in Tackling Fair Value Accounting

By Will Andronico

The shift toward mandating fair value assessments will present major challenges for many companies. A partner in a Boston-area accounting firm argues that businesses need to determine if they have adequate resources for dealing with the issue in-house.

For internal financial departments, conforming to generally accepted accounting principles (GAAP) is enough of a challenge without additional factors like fair value complicating the process. But like it or not, that's exactly what has happened: fair value has become such a presence that it is now virtually intertwined with GAAP. In fact, more than 50 pronouncements and interpretations under GAAP reference fair value, and minor swings in valuation assumptions can have a material effect on the numbers.

This infiltration is so complete that the Financial Accounting Standards Board (FASB) stepped in to address any confusion and to reinforce the idea that fair value is here to stay. FASB issued SFAS 157, Fair Value Measurements, in September 2006 (partially effective in 2008 for calendar year reporters), which established a framework for measuring fair value, expanded relevant disclosures and formally defined "fair value" to enhance consistency and comparability. The official definition now reads: "...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

All cleared up, right?

For most businesses, not even close. Finance departments have to apply this definition or retain a fair value specialist to get through their accounting under GAAP (also worth noting, this should not be confused with the "fair market value" used for tax and other purposes; while similar, the results can be quite different).

So where is this convergence of fair value and GAAP? As noted, it crops up in many places, and during the normal course of accounting it has become common to get entangled in areas such as:

❑ **Stock-Based Compensation:** Under the newest compensation accounting rules for stock options, before the fair value of the stock options can be determined, the fair value of the company's stock is required. In a private company, this isn't so simple, especially when equity rounds have resulted in preferred stock alphabet soup. Once the underlying company stock value is determined, the stock options themselves must be valued in order to record the compensation expense, which can be accomplished using the Black-Scholes or lattice option pricing models.

❑ **Purchase Price Allocations:** If a company has been acquired or makes an acquisition, the purchase price must be allocated to individual assets, including intangible assets and goodwill, based on their relative fair values. However, if the purchase price includes non-cash consideration, the value of that consideration needs to be determined first so that the total purchase price from which to allocate can be pinned down. With respect to goodwill, at least annually, the book value has to be assessed for impairment (by "reporting unit," of course) -- and that can involve having to revalue the company or a portion of the company.

❑ **Warrants:** No question, if the word warrant comes into the picture as part of any transaction, along with all of those excruciating bifurcation considerations, valuing the warrant to record the transaction will be a must. If the warrant happens to be on redeemable preferred stock instead of common stock, the quicksand just got deeper: it may have to be further marked to market.

❑ **Don't even get me started on derivatives.**

The solution, like many in this environment of tight regulation and corporate transparency, is to view this area as a process. Fair value is so finely integrated with accounting that as regulatory filings are made, audits conducted, or M&A transaction activity considered, it is critical that the

right information be passed to the right party at the right time. For public companies, Sarbanes-Oxley assumes that a



company has all the requisite resources and controls in place over financial reporting to get the numbers right, regardless of whether fair value is involved or not.

As with other specialized areas, like Sarbanes-Oxley implementation, actuarial calculations and certain IT functions, the opportunity exists to outsource some of this work. But that does not mean it should automatically be passed to the nearest provider. Management has to take responsibility for its numbers, regardless of whether or not it outsources components like fair value assessments. Therefore, it should evaluate carefully and pursue the most effective and reliable option. Financial leaders should measure both the existing capabilities of in-house resources and the level of effort for those resources to become specialists, and weigh the use of those resources against outsourcing those functions.

For larger companies, this may reveal that resources are best devoted to educating, redeploying or retaining new in-house valuation talent. However, for many smaller public companies and most private companies, while fair value plays a significant role in accounting, it does not reach a level of requiring full-time credentialed fair value specialists in house.

Even with skilled experts on board, the process of stopping, outsourcing, restarting, finalizing and auditing can still be inefficient if the “process” mentality is lost. The key is to create a standard fair value outsourcing process to lay out all expectations and avoid duplication and delay.

The in-house liaison and any outside resource should work together to prepare a specific annual schedule that lays out the timelines for when information and deliverables will flow in each direction. Also, determining ahead of time the specifics surrounding what such information should and will contain will prevent bottlenecks caused by the “back and forth” process. Ample time for the accounting department

to review and apply calculations should be worked into all timelines.

And lest we forget, the auditor will undoubtedly be part of the process. The fair value operation should map out the timing of submissions to the auditors for their feedback. If auditors can plan ahead for their review, the audit will run more smoothly – especially where the fair value auditors are in a remote office.

For situations where fair value comes into play only upon new transactions, a standard interaction process should be established between the two parties. The more the outside resource understands deadlines and is equipped to respond in a timely manner, the more effective the process will be. It is safe to say, then, that fair value is a part of the GAAP process, and as the integrated nature of these two areas is likely in its infancy, dealing with it proactively is the best line of attack. Using a thoughtful approach with skilled partners will give a leg up on saving costs, time and countless headaches.



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