CLAIRENTADVISORS
VALUATION AND TRANSACTION SPECIALISTS

Fair Value – Theory and Practice

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Agenda

- **Increasing SEC and PCAOB Scrutiny on Fair Value Issues**
- **Background – When Does Fair Value Come Into Play?**
- **Audit Process Related to Fair Value Reporting**
- **Fair Value Definition**
- **Case Studies**
  - **Business Combinations – Data Center Software / Hardware Company**
  - **Goodwill Impairment – Marketing Services Company**
- ***Appendices:***
  - *Speaker Background / Contact Information*
  - *Wall Street Journal Articles*

Increasing SEC and PCAOB Scrutiny on Fair Value Issues[1]

- PCAOB inspection reports released in the last two years found a **threefold increase** in valuation-related audit problems

- Summary PCAOB findings (from 2012 PCAOB reports):
  - 123 audit deficiencies related to **fair value estimates and asset impairments** in 2010 – making asset valuation the most common audit problem
  - Out of 234 audit deficiencies cited in the agency's 2010 inspection reports of the Big Four, it found **92 fair value deficiencies** and **31 asset impairment-related deficiencies**
    - Compares to 21 fair value deficiencies and 17 impairment-related deficiencies in 2009

- Tightening requirements = greater documentation needed
  - "Auditors are going to be asking a lot more questions about how values were determined … The work is exponential."

[1] See Appendix 1 for two Wall Street Journal Articles which provide further perspective on recent PCAOB findings.

Background – When Fair Value Comes Into Play

Event	Financial Reporting Standard(s)
▪ **Acquisition of a company**	▪ ASC 805, *Business Combinations* (formerly SFAS 141R)
▪ **Testing of goodwill and/or indefinite-lived intangible assets for possible impairment**	▪ ASC 350, *Goodwill and Other Intangible Assets* (formerly SFAS 142)
▪ **Testing of long-lived assets (e.g., intangible assets or fixed assets) for possible impairment based on a triggering event**	▪ ASC 360, *Accounting for the Impairment or Disposal of Long-Lived Assets* (formerly SFAS 144) ▪ Also guidance in ASC 350-30-35
▪ **Issuance of stock options to employees**	▪ ASC 718, *Compensation – Stock Compensation* (formerly SFAS 123R)
▪ **Marking to market required for certain assets and/or liabilities**	▪ ASC 820, *Fair Value Measurements and Disclosures* (formerly SFAS 157)

Audit Process Related to Fair Value

- 3rd party / independent valuation provider or Company management prepares a fair value analysis
- Audit review team (including both valuation and accounting/audit team members) reviews the fair value analysis
  - Valuation-specific and accounting/audit-specific questions
- Typical review process –> the audit review team:
  - Reviews analysis to identify key assumptions, assess reasonableness of methodologies, check calculations, etc.
  - Prepares a list of questions for valuation provider and management to address; responses typically prepared in writing.
  - Document responses to questions and whether items were resolved satisfactorily.
  - Workpaper documentation on other procedures performed (e.g., shadow calculations for items not satisfactorily resolved).

Audit Process Related to Fair Value (continued)

- **Challenges Faced By Accounting/Audit and Valuation Review Teams**
  - Reviewers must balance scope and depth of review with audit materiality considerations
  - Review timing
  - Challenges with reviewing internal analyses prepared by management
  - Issues not satisfactorily resolved
    - “Shadow calculations”
    - Research and identification of supporting market and other data

Audit Process Related to Fair Value (continued)
Best Practice Suggestions

Collaboration and consensus among **management, auditors** (both accounting/audit and valuation teams), **and external valuation specialists** is key

- Key when a valuation has unusual or atypical considerations; also when certain specific circumstances exist (e.g., contingent consideration related to an acquisition)
- Firm and reviewer-specific considerations and preferences
- Consensus between local audit team vs. "National" standards group
- Well reasoned approaches + high quality documentation needed

Engage in planning discussions as early as possible

☞ *Example: Marketing Services Company*

Fair Value Definition

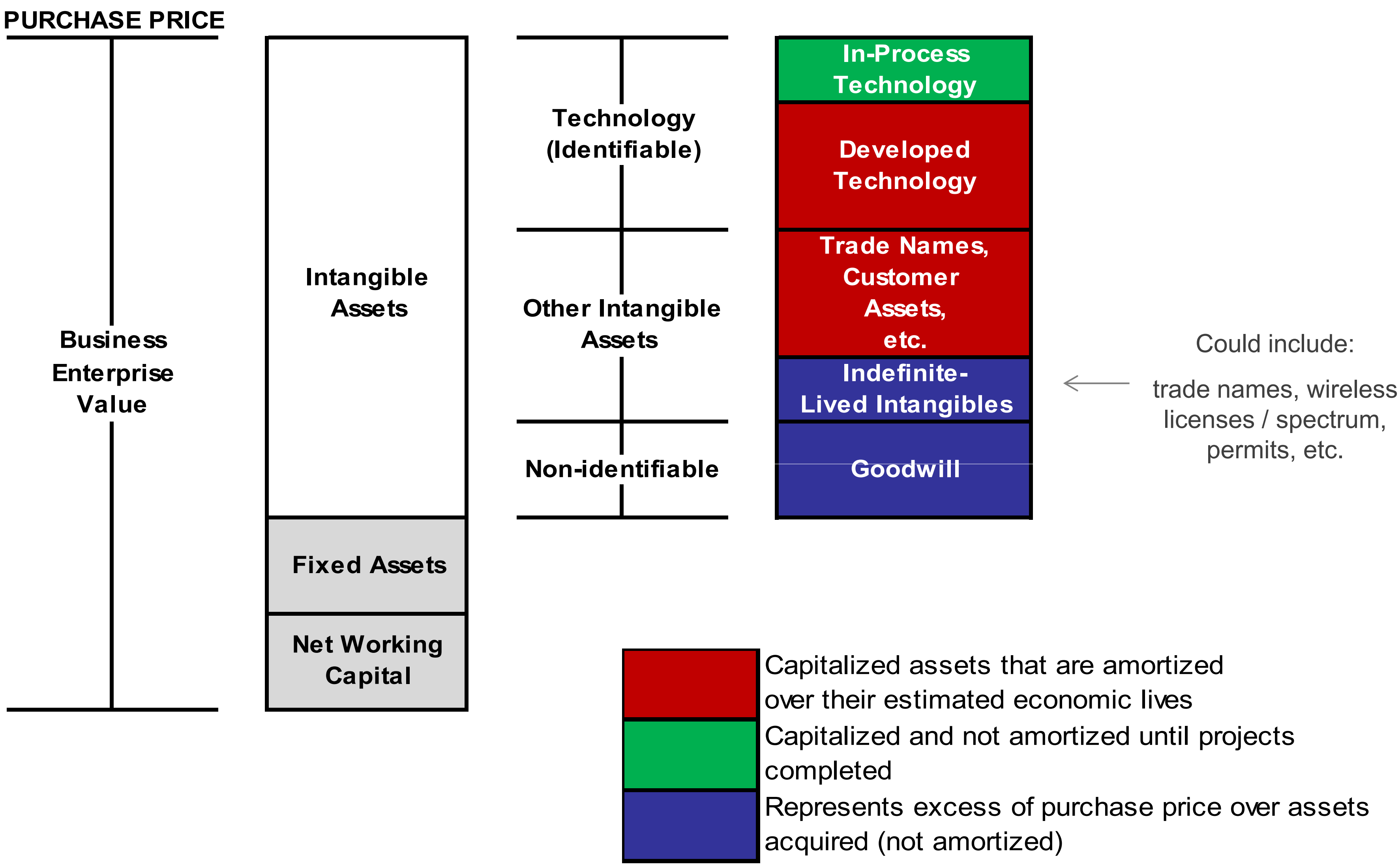
- **ASC 820 Fair Value Definition**
  - ***"Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."***
- ***Orderly Transaction***
  - Assumes **exposure to the market** for a period prior to the measurement date to allow for usual and customary marketing activities related to a transaction
  - Occurs in the **principal or most advantageous market** from the seller's perspective; *highest and best use*

- ***Market Participant Considerations***
  - Market participants are:
    - Independent of the reporting entity
    - Knowledgeable
    - Able to transact
    - Willing to transact (motivated; not forced)
  - Reporting entity does not need to identify specific market participants; it should identify characteristics that distinguish market participants generally
  - Both strategic and financial market participants should be considered

- Not necessarily the value specific to the reporting entity
  - Include market participant synergies; exclude entity-specific synergies only available to a specific buyer

> ☞ *Example:*
> *Wireless services company – definition of market participants in impairment analysis of spectrum licenses*

Case Study: Business Combinations (ASC 805)
Overview of Purchase Price Allocation Principles



Case Study – Business Combinations (ASC 805) – *Overview of Purchase Price Allocation Principles*

Analyze Transaction

- Obtain a thorough understanding of the transaction
  - Terms of the agreement
  - Total transaction value
  - Intentions of the acquirer -- potential synergies, risks, and challenges
- Identify intangible assets to be valued
- Understand goodwill elements

Compile Relevant Data

- Develop company-specific data request / discussion topics list
- Conduct management interviews
- Perform industry, technical, and other research

Analyze Data Received

- Draw conclusions from a thorough analysis of:
  - Company and product data
  - Technology, market, competitive, and other data
  - Financial data (historical data and forecasts)
  - Similar company / market participant data

Value Business Enterprise

- Customize valuation models
- Develop global assumptions and related support (revenue, expenses, other cash flow; discount rate selection)
- Assess preliminary results -- indicated value should be consistent with deal value
- *If needed, determine fair value of purchase price (including contingent consideration; private company stock if applicable)*
- *Reconcile with business enterprise value above*

Value Intangible Assets

- *Develop understanding of "story" and key qualitative factors related to identified intangible assets*
- Develop valuation approaches and models
  - Attempt to develop more than one approach for each asset, as applicable
- Develop assumptions and associated support
- Assess preliminary results

Other Documentation

- *Document intangible asset categories considered but ultimately not valued*
- *Document understanding of goodwill*
  - *Consider both qualitative and quantitative factors*

Reconcile Preliminary Results / Overall Reasonableness Checks

- *Compare asset values to the total transaction value and purchase price premium*
- *Examine asset values in relation to each other -- do relative values make sense considering the acquiring company's intentions, public disclosure on the deal, etc.?*
- *Examine weighted average return related to assets*
- *Elicit feedback from management*
- *Examine assumptions for reasonableness*
- *Analysis of purchase price allocations -- intangible asset value % / goodwill % related to transactions involving similar entities*

Work with audit team

Case Study: Business Combinations (ASC 805)
Overview of Purchase Price Allocation Principles (cont.)

Business Enterprise Model

Starting economics for acquired assets

Key assumptions and support for:
- Revenue growth
- Margins
- Discount rate
etc.

Assumptions feed into intangible asset models

Intangible Asset Models

Technology

Customers

Other

Asset-specific assumptions

Enterprise Value - Ties to purchase price

Purchase Price

Upfront payment + **fair value of of non-cash consideration + earn-outs / contingent payments**

Incorporate understanding of "THE STORY" behind company / assets

Typically Recognized Intangible Assets

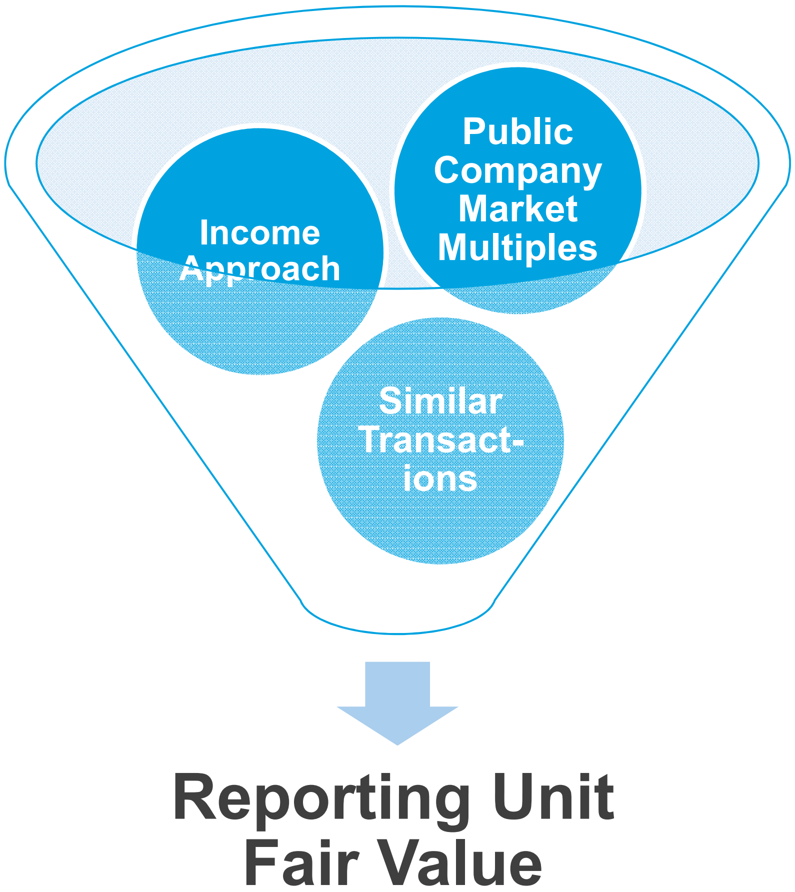
Technology-Based Intangible Assets - Patented Technology - Unpatented Technology (*Developed Technology*) - In-Process Research and Development - Databases	**Customer-Related Intangible Assets** - Backlog - Customer Contracts - Customer Relationships (Non-Contractual) - Customer Lists
Marketing-Related Intangible Assets - Trademarks, Trade Names - Trade Dress (Unique Color, Shape, Package Design) - Internet Domain Names - Non-Competition Agreements	**Contract-Based Intangible Assets** - Licensing, Royalty Agreements - Franchise Agreements - Operating and Broadcast Rights

Artistic-Related Intangible Assets
- Pictures, Photographs
- Video and Audiovisual Material (Motion Pictures, TV Programs)
- Musical Works (Compositions, Song Lyrics)

Case Study: Business Combinations (ASC 805)

Acquirer	▪ **Private hardware company, >$1 billion in revenue**
Target	▪ **Data center software / hardware company**
Intangible Assets Identified and Valued	▪ Developed technology ▪ Customer relationships ▪ Trade name (transition strategy)
Project Challenges	▪ Aggressive / optimistic management forecast and market participant considerations
Audit Review – Anticipated Valuation-Team-Specific Questions	▪ Overall results – identified intangible assets vs. goodwill (as % of purchase price premium) ▪ Intangible assets considered but not valued ▪ Qualitative support – what does goodwill represent? ▪ Selection of methodologies – evolving discussion of preferred approaches among valuation providers when both technology and customer assets need to be valued ▪ Technology – existence of IPR&D? ▪ Discount rate build-up and reasonableness; rates of return utilized to value intangible assets
Audit Review – Anticipated Accounting/Audit Team-Specific Questions	▪ Sources of forecast assumptions; achievability of forecast ▪ "Auditable" assumptions related to intangible asset valuations - Developed technology – lifecycle; royalty rates - Customer relationships – historical pattern of repeat business by largest customers; historical attrition

Case Study: Goodwill Impairment (ASC 350)
High Level Overview -- Approach



- Compare Fair Value to Carrying Value
- If Fair Value < Carrying Value, proceed to Step 2 (similar to a purchase price allocation to calculate implied goodwill)

Case Study: Goodwill Impairment (ASC 350)

Company	▪ **Publicly traded marketing technology and services company**
Project Background	▪ Company restructured its reporting units – increasing the number from 5 to 9 ▪ Fair values of RUs required for impairment testing purposes as well as for reallocating goodwill among the new RUs (based on relative fair values) ▪ Project involved supporting management who prepared certain internal analyses (discounted cash flow calculations for each RU) ▪ Our work involved: - Reviewing management's DCFs; discount rate development and supporting calculations - Developing indications related to market approaches – including consideration of both public company and transaction multiples - Consolidating and evaluating reporting unit conclusions - Evaluating overall results (sum of reporting unit fair values vs. overall Company market capitalization) - Assisting with documentation development and audit review discussions
Project Challenges	▪ Conflicting feedback from audit team (local team vs. national team input) regarding the allocation of goodwill ▪ Initial odd results for one reporting unit (non-core operations, but provided critical support services) ▪ Troubled reporting unit and unique considerations ▪ Evaluating reasonableness of key assumptions for all reporting units – relative discount rates, market multiples, etc.

Case Study: Goodwill Impairment (ASC 350) (continued)

Company	▪ **Publicly traded marketing technology and services company**
Audit Review Questions (from both Valuation and Accounting/Audit Teams)	▪ Sources of forecast assumptions; comparison to prior year assumptions ▪ Management's reasons underlying perspective on forecast achievability – specifics driving revenue growth and operating margin improvements – "story behind the numbers" ▪ Support related to key assumptions - Long-term growth rate - Selected market multiples *Sample review questions for selected RUs* ➢ *"The implied 2012 and 2013 fair value EBITDA multiples are at or near the low end of the range of EBITDA multiples for the comparable companies. Please discuss."* ➢ *"We note the fair value indication from the DCF analysis is less than carrying value. Please discuss in greater detail and please provide additional support for the multiple selection in the market approach analysis."*

Q & A

Speaker Background / Contact Information

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Current Responsibilities

Josette Ferrer is the founder and a Managing Director of Clairent Advisors. Since 1993, Josette has been assisting clients with the valuation of closely held businesses and business interests, intangible assets, intellectual property, stock options, debt instruments, capital equipment / fixed assets, and other assets.

Experience

Prior to founding Clairent Advisors in 2010, Josette was the U.S. Practice Leader of Marsh's Valuation Services Group (formerly Kroll's Valuation Services Practice). Her career includes serving as the Managing Director in charge of the San Francisco Valuation Services Group of WTAS, Inc. ("WTAS"), a former subsidiary of HSBC Group. At WTAS, Josette's responsibilities included developing and overseeing all technical, operational, marketing functions for the SF valuation team. Prior to WTAS, Josette was a director with Huron Consulting Group and a senior manager at Arthur Andersen LLP.

While Josette has extensive experience serving clients in many industries, areas of specialty include telecommunications, high technology, service companies, consumer products, manufacturing, and financial services. Her clients have ranged from small, emerging businesses to Fortune 500 companies. Josette has been a guest speaker for a wide variety of forums, including Financial Executives International (“FEI”), the Institute of Management Accountants (“IMA”), the Practicing Law Institute (“PLI”), the San Francisco Bar Association, Santa Clara University, BIOCOM, and various venture capital roundtables, and has also published an article related to the valuation of intellectual property for the PLI.

Education and Affiliations

- B.S. in Business Administration, University of California, Berkeley
- Member, Fair Value Forum
- Board Member, SF Chapter, Financial Executives International
- Corporate Affiliate, Finance Scholars Group
- Member, ProVisors

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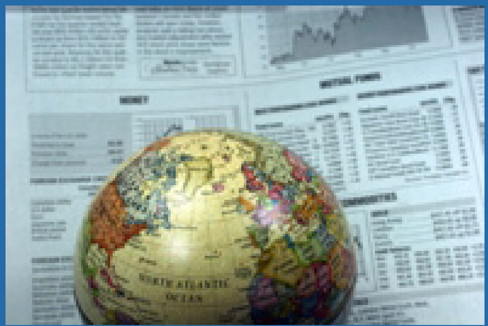

Appendix: Wall Street Journal Articles