

Determining goodwill value in a harsh M&A climate

What a difference a year makes.

Last February, many companies were coming off of record years and merger and acquisition activity was at a peak. All of that buying and selling frenzy has resulted in a hangover on the balance sheets of many companies

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as buyers are evaluating the "goodwill value" of their purchased companies on their financial statements.

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In its simplest terms, goodwill is the intangible value of a business and is calculated as the difference between the purchase price and the net book value of the business purchased. Accounting standards require that goodwill be evaluated annually for impairment; if the value is determined to be impaired, the company must write down the value to its current fair value. With acquisition pricing peaking in recent years it is expected that many acquirers will find themselves faced with charges against income this year for goodwill impairment.

The question that now has to be addressed for these businesses is how to determine fair value. In 2007 new accounting standards were issued establishing a framework for measuring fair value. Some companies have been using this fair value accounting, or mark-to-market pricing, because it was thought to provide a better indication of actual earnings and financial strength. The clear challenge that these companies face today will be how to accurately assess the fair value of previous and current year's acquisitions.

For mergers and acquisitions occurring in fiscal years beginning after Dec. 15, 2008, all business combinations must be recorded at fair value under the new fair value accounting standards. This is a change from previous guidance, which provided for different definitions of fair value to be used when recording a business combination transaction.

The new fair value standards focus on the price a seller would sell for (an exit price) as opposed to the price a buyer would pay to acquire an asset (an entry price). In addition, the fair

value accounting standards provide for three levels of input to be considered when determining fair value: "Level 1 inputs" are observable inputs such as quoted stock prices in open markets. This works great when you are valuing shares of a publicly traded company, but this level of input is not relevant for most closely held business transactions.

Somewhat less reliable are "Level 2 inputs" into fair value, which would include quoted prices for similar assets in active markets, or quoted prices for the exact same asset in an inactive market.

Real estate appraisals could be an example of Level 2 input. However, if you don't have either Level 1 or Level 2 input measures to draw upon, then fair value is determined by "Level 3 inputs" which are inputs that are typically based upon past history of the reporting entity, estimated future events, and forecasts.

Non-public companies usually depend upon "Level 3 input" when trying to value intangible assets such as goodwill. This typically means that value is dependant upon future esti-

mates and assumptions of business activity. This is a daunting task in this current economy as it is extremely difficult, for many companies to see beyond their next quarter. In addition, current events typically weigh heavily on these assumptions and lead to lower valuations.

From an M&A standpoint, determining the value of goodwill today is very much like navigating uncharted territory. The value of transactions completed during the last few years will be heavily scrutinized, and many companies will take charges for impairment losses. New mergers and acquisitions will undoubtedly require substantially more due diligence.

Presently, management, CPAs, consultants, investors and bankers have their work cut out for them, as the hosts of unknowns in determining value has never been greater, yet the pressure to do it accurately has never involved more risk.

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