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GBQ Goelzer Valuation Services

VALUATION observations

Fair Value Checklist for Audit Season

By Brian D. Bornino, CPA/ABV, CFA and Kelly C. Noll, CFA

As the New Year begins, many companies and their auditors are gearing up to comply with fair value requirements in the context of annual audits. As auditors, investors, and other financial statement users increasingly scrutinize and focus on fair value measurements, below is a checklist to ensure that your company addresses all key financial reporting requirements related to fair value measurements during its upcoming audit:

√ **Identify and Address Issues Early in the Process.** Fair value measurements can be complex and often require significant time to complete and audit. Even for qualified valuation professionals, it is common for a valuation report to take 30 to 60 days or longer to complete… not to mention the time needed by the company and the auditor to review it. Therefore, it is critical to identify any issue involving fair value early in the audit process (ideally, before the audit even starts) to ensure that the desired audit timeline is achievable.

√ **Goodwill Impairment Testing.** If your company has goodwill or other indefinite-lived intangible assets on its balance sheet, those assets must be tested for impairment. The mandatory level of due diligence surrounding impairment testing has increased dramatically in recent years, so the company-prepared, "back-of-the-napkin" valuation analysis is not going to cut it. Be prepared to perform a full and comprehensive valuation analysis for impairment testing (see the *Use Appropriate Valuation Methodologies* and *Support and Document All Key Assumptions* paragraphs below).

√ **Business Combinations.** If your company acquired another company during the past year, the purchase price must be recorded based on the fair values of all acquired assets and liabilities. Although many companies in the past combined all intangible value into "goodwill", ASC 350 requires that intangible assets such as customer relationships (whether contractual or not), technology (whether patented or not), trade names, and non-compete agreements be separately identified, valued, and recorded on the balance

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Fair Value Checklist for Audit Season (continued)

sheet separate and apart from goodwill. Also, the company must verify that the purchase price was equal to fair value, or else an immediate gain or loss is recorded.

√ **Stock-Based Compensation.** All stock-based compensation (i.e., stock, stock options, phantom stock, stock appreciation rights, etc.) must be recorded based on the fair value of the stock as of the grant date. As such, a valuation of this stock is required for each date that stock-based compensation was issued.

√ **Use Appropriate Valuation Methodologies.** Current valuation theory includes consideration of three commonly accepted approaches to value: a market approach, an income approach, and an asset approach. Although we often see companies relying on a single valuation method, it is definitely preferable to value most profitable, operating companies using both a market approach (i.e., multiples based on comparable transactions or publicly traded companies) and an income approach (i.e., discounted cash flow analysis).

Auditors, investors, and other financial statement users are increasingly focusing on, and scrutinizing, fair value measurements.

√ **Support and Document All Key Assumptions.** While there is some "art" in valuing a business or intangible asset, there is ample "science" involved as well. Documenting all key company assumptions (e.g., growth rates, profit margins, working capital requirements) and valuation assumptions (e.g., cost of capital, guideline companies selected, pricing multiples utilized) will be paramount when auditors are reviewing valuation analyses. The typical deliverable from a high quality valuation practice is a thorough, comprehensive written report that explains the basis of all key assumptions and valuation approaches. Auditors are increasingly requiring this level of documentation from clients that choose to perform valuations internally.

√ **Reconciling This Year's Valuation Conclusions with Prior Valuations.** After conducting a valuation analysis, one should always "step back" and ask whether the conclusion makes intuitive sense. Since fair value measurements are often annual requirements, companies can compare fair value estimates from year to year to ensure that the increase or decrease in value is reasonable based on the company's performance, outlook, and operating trends, as well as changes in economic and industry conditions.

√ **Seek Advice.** The valuation of companies, stock, and intangible assets

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can be extremely complex. Auditors have increased the level of rigor with which they audit fair value measurements in recent years, and investors and other financial statement users are increasingly focusing on, and scrutinizing, fair value measurements. While some larger companies may have finance departments with valuation capabilities, experience, and expertise, most companies do not. Also, independence rules prevent the firm that provides your audit from performing fair value calculations, or providing significant assistance in that regard. As such, companies should consider outsourcing valuation requirements to qualified valuation professionals.

GBQ is among the most active valuation practices in the Midwest, completing over 200 valuation assignments annually. We are frequently involved in fair value measurement for financial reporting purposes and we would welcome the opportunity to discuss your situation in confidence.

ABOUT US

GBQ Consulting specializes in Business Valuation, Mergers and Acquisitions, and Dispute Advisory and Forensic Services. Our Business Valuation group is one of the largest and most experienced in the Midwest. Professionals at our offices in Columbus (OH) and Indianapolis (IN) provide valuation services in the following contexts:

- Transaction Support & Opinions
- ESOP Valuation & Consulting
- Succession & Wealth Planning
- Financial Reporting
- Corporate Planning & Assistance
- Expert Opinions & Disputes

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