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Edited by
James P. Catty

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International Financial Reporting Standards

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CONTENTS

FOREWORD

Relationships, Dependency, and Reliability[1]

LIU PING

CHINA

Today's expanding global business environment demands that all professionals responsible for financial information have to work together and rely on each other. Accountants, auditors and appraisers (valuators) must ensure that stakeholders in an entity—management, shareholders, creditors, and regulators—receive reliable, up-to-date financial information, enabling them to make the right decisions in fulfilling their duties and responsibilities. Errors in incorrectly recording, valuing, and auditing data at any stage will lead to wrong, possibly even damaging results. With the expansion of International Financial Reporting Standards (IFRS) throughout the world, the roles of the accountants and auditors are becoming harmonized, with appraisers supplying the basis for many conclusions. Now is the era of the appraiser; this book is a start.

To generate profits and run efficiently, management has to know in detail the costs involved in producing, selling, and distributing the entity's various goods and services. In addition, it has to ascertain that there is enough cash available for capital expenditures, for working funds, and to pay shareholders the dividends that ensure continuing investment. Finally, such information, both financial and operational, allows management to demonstrate to regulators that the entity is in full compliance with all laws and regulations.

Shareholders need such material to decide whether to buy or sell securities, to establish trading prices and, in particular, as a measure for portfolio performance and stability. Today investors have many choices; to make wise and advantageous decisions, they need reliable financial information.

Lenders and creditors, including banks and suppliers, use such know-how when deciding to make new loans, extend existing ones, or enhance lines of credit, and also to gauge a firm's ability to pay its bills and properly service both its short- and long-term debt. It is also of importance to vendors, who rely on it to grant trade credit and enter into long-term contracts.

Last, but not least, regulators insist on reliable financial information as part of their duty to protect the public trust. To supply this accurately requires the combined talents of the three separate sets of interrelated professionals: accountants, auditors, and valuators, each of whom relies on data from both the others. Their interaction is illustrated by Exhibit F.1.

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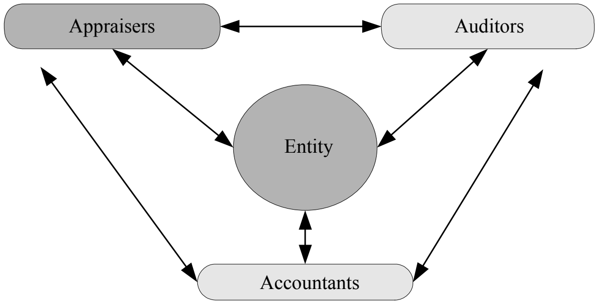
[1] *Based on a speech in Beijing to the International Network of Auditors & Accountants (INAA) in May 2007.*

Exhibit F.1



Accountants deal mostly with the present, recording on a daily basis the activities of every entity involved. Auditors, who are also accountants, deal with the past, confirming that the accounts they had been given present "fairly" the results of preceding activities, while appraisers, among whom I have the honor to serve, look to the future, calculating what someone will pay now for benefits that are yet to come.

Based on information and data from the entity's accountant and advice from its auditors, we perform our services and reach our conclusions. Those may encompass numerous steps, including determining: the fair value of the whole firm; an individual division, subsidiary, or department; specific financial, physical, or intangible assets; or a potential acquisition target.

Valuing individual assets, especially intellectual property, is essential to the impairment tests, which since 2003 have been required by IFRS at least once a year. To conduct such an engagement properly, valuators must be able to rely on accurate financial information, continuously and freely provided as required by management through its accounting staff. The quality of any valuation is adversely affected by inaccurate or inadequate inputs. Valuators then deliver to the accountant and management their conclusions to be incorporated into the entity's records for confirmation by the auditors. Similarly, the auditors have to rely on the professional efforts of both the accountant and the valuator.

The close business ties between eastern and western economies and global financial interaction over the past decades have led Africa, Asia, and Australia to adopt IFRS and its related fair value accounting. This in turn caused all valuators to become much more aware of approaches, methods, and techniques developed in North America and Europe. With contributors from six continents, this book offers a thorough grounding in all of those approaches.

PREFACE

JAMES P. CATTY

UNITED KINGDOM

For some years, the world has experienced accelerating globalization that has exceeded any commercial interchanges of previous centuries by an order of magnitude. Common sense dictates that such networks require an equally universal approach to accurately valuing interrelated holdings, following the same worldwide accounting principles; this is under way, as, by 2011, approximately 150 countries will have adopted International Financial Reporting Standards (IFRS). This book offers thorough assistance in such an undertaking, creating a unified language and giving advice concerning relevant methodologies.

While there are many national valuation textbooks, mainly in the United States, there are no international ones. To fill this void, our book is a collaboration of over 30 participants from 14 countries; it was written during an unprecedented downturn in the world economy and sets out best practices in many segments of valuation, for good times and bad. The concept is also to assist readers to react quickly to the *new normal* when it arrives.

When, as chairman of the International Association of Consultants, Valuators and Analysts (IACVA), I signed the contract with John Wiley & Sons, Inc., in October 2008, the world stock markets had been in virtual free fall for a month; I thank Wiley for its courage in taking on this project. After that, values continued to decline, in the United States a further 33%, before, in early March 2009, staging a remarkable resurrection. Now most indexes are back to or above their October levels, as massive, stimulative government policies are taking effect.

This has been the greatest turmoil in the markets since I first became involved in valuations more than 50 years ago. During the long period of Goldilocks economies, which lasted until 2007, risk premiums for virtually every feasible asset were low, reflecting comparatively limited recent losses. In 2008, a combination of repricing of risk, and fears that the financial world, as we knew it, was coming to an end changed everything and gave rise to the continuing worldwide crisis.

Recent Bubbles

Most investors profited from 1995 to 2007; that was a period of asset bubbles in many stock markets, most commodities (oil, copper, nickel, iron ore) and real estate; unfortunately, nearly everyone lost in the subsequent multiple collapses. Worldwide share and commodity value declined, following the huge decreases in home prices in many countries, principally: Australia, Britain, Spain, and the United States. The result was the greatest destruction of fortunes since the Dirty Thirties. According to some commentators, over one-third of worldwide wealth vanished in the last 12 months. Each bubble had four phases.

Stealth. "Smart funds" get in quickly, quietly, and cautiously; asset prices gradually increase, but the general population remains unaware.

Awareness. Price increases get attention; there is some profit taking, but selling is short-lived, as investors treat the dips as opportunities to buy more.

Mania. Masses peg relevant investments, first Internet shares, then real estate, as "the opportunity of a lifetime"; phrases like "prices can only go up" are passed around as indisputable facts but turn out later to be nasty viruses. More unsophisticated money pours in, as "smart funds" begin to unwind their position.

Blow-off. The absence of fresh capital lowers prices, but many late-to-the-party players insist that the wreck can be salvaged. They get evermore adamant about their "buy" recommendations as prices drop. That stubbornness creates a brief pause before the final nosedive.

The New Normal

It has become increasingly clear that the current situation is fundamentally different from all other recessions since World War II. Virtually every country is experiencing not merely another manifestation of the business cycle but a profound restructuring of its economic order. For some organizations, near-term survival is their only possible motivation, resulting in not merely cutting fat but also flesh. Others are peering through the fog of uncertainty, thinking about how to position themselves once things return to normal.

What is the *new normal* going to look like? It is unlikely that it will resemble any of the "before" situations; rather it will be shaped by several powerful forces, of which two—less borrowing and more government impact—will be dominant. A return to tighter regulation and the inclusion of activities such as derivatives that were under consideration long before the downturn began can also be expected.

It is important to realize that past avalanches of borrowings for virtually any purpose and the related underpricing of risks had two sources. The first was financial innovations that apparently reduced risks and added value to the economy. The second was a credit bubble, led by U.S. borrowers, fueled by misaligned incentives, irresponsible risk taking, lax oversight, and fraud. Where the former ends and the latter begins is hard to discern, but it is clear that the future will involve significantly lower leverage and higher prices for risks than we had all come to expect during the years of euphoria. Only entities that boost returns on equity the old-fashioned way, namely through productivity gains, will be rewarded.

Another feature will be expanded government activities. In the 1930s, during the Great Depression, participants in various economic sectors of most countries redefined their roles in the financial system; in the 1980s and 1990s, many such restructurings were unwound in the name of deregulation.

All signs point to an equally significant regulatory restructuring, with governments around the world laying down the ground rules in all financial sectors, including those that were once only lightly, if at all, regulated. They and other bodies, such as the International Accounting Standards Board (IASB), will demand new levels of transparency and disclosure and get involved in decisions that were once the sole prerogative of corporate boards, including executive compensation.

Some forces arise directly from the financial crisis, but others, which already existed, have been strengthened. For example, it was clear before the crisis began that U.S. consumption, which depends on income gains, could not continue to be the locomotive for global growth. For over 40 years, U.S. disposable income has been boosted by a series of one-time factors, such as the expanded entry of women into the workforce, increases in college graduates, the ability to refinance homes, and easy credit for all sorts of purposes; those have now played themselves out.

Peak spending of the baby boomers helped boost consumption in the 1980s and 1990s. Now aging, they are beginning to live on retirement savings that were insufficient in the first place, even before a great deal of housing and stock market wealth evaporated. As a result, the world's economic center of gravity will continue its westward movement toward Asia. Fortunately, likely ongoing technological innovation and increasing human knowledge will tend to offset the declining value of aging auto plants.

Valuators who want to succeed in the *new normal* must focus on that which is changing and what remains basically the same for their clients, businesses, and industry. The resulting environment, while very different from the past, will give major opportunities to those who are prepared.

Scope

This publication is divided into two sections written by a combination of academics and practitioners. The first 13 chapters deal with subjects that have to be considered by all valuators on every assignment. The remaining chapters deal with particular areas that may or may not be of immediate significance but which, at some time or other, will become important.

As shown by their biographies, our contributors are all highly qualified, with most practitioners having taught professional development classes, many in several countries. They all realize that readers need comprehensible material that gets to the bottom of things and eliminates extraneous information.

The potential audience is everyone—managers, accountants, investors, bankers, teachers, and students—who is involved professionally with finance. Principle-based standards cannot, by their nature, give detailed guidance about how fair value is to be determined. This book fills numerous gaps so that all involved have greater understandings of value conclusions.

Theme

Accountants deal with activities in the past; managements deal with the reality of the present; valuators deal with expectations of the future. Value reflects the recognition and pricing of all the risks involved. Neither accountants nor managers are trained to quantify those; valuators are.

The world is drowning in data; by some estimates, corporate digital material in 2010 will amount to one zettabyte (21 zeros). To put values on the entities involved, such data will have to be compressed and summarized into useful information and the nuggets of actionable gold extracted from the mounds of informational ore. In addition, gold must be separated from any pyrite. Our objective is to help all readers in identifying and extracting that gold.

Fortunately, none of the contributors found it necessary to follow Raymond Chandler's perfect literary advice:

> *When in doubt have a man come through the door with a gun in his hand.*

May that never happen to any of us.

Good reading.

Jim Catty
Klosterneuburg, Lower Austria and Toronto, Canada,
August 2009

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To write a book is a complicated endeavor. Having gone that route before, I know the importance of partners, contributors, and associates

Therefore, I would first like to thank my partners in IACVA—Bob Brackett, Richard Claywell, Bill Hanlin, and Terry Isom of the United States; Susan Yi of China; and Lionel Newton of Canada—for their continued support and encouragement.

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Last, but not least, I thank my wife, Dita Vadron, who edited the final texts in her third language, English, and our assistant, Hellen Cumber, who kept me on schedule and applied strict control over numerous versions of individual chapters.

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From 1987 to 2001, Richard held management positions in major dealers in derivatives. They include director, global head of Emerging Markets Fixed Income Trading, ABN AMRO Incorporated; managing director, Equity Trading, Nomura Securities International; principal, Fixed Income Derivative Products, Morgan Stanley Dean Witter; and managing director, vice president, Derivative Products, Bankers Trust Company, United States. Richard obtained his MBA at Columbia University, United States (1986), and has published articles including "Canadian Wheat Board Performance Benchmarking" and "Reform of the Canadian Wheat Board: A 'Made in Canada' Approach to Marketing Grain" (Western Centre for Economic Research, University of Alberta, 2007 and 2008), and "A Bushel Half Full: Reforming the Canadian Wheat Board" (C.D. Howe Institute, 2008).

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Byeongil is a specialist in intellectual property rights (IPR) including its related law. He spent 27 years teaching the law of patents, utility models, design patents, copyrights, and trademarks at INHA Law School in Korea. The subjects include IP information, IP valuation, patent strategy, IP transfer, and industrial security. He is combining studies in science/technology and law. He has been an engineer, jurist, IP valuer, IP transferor, and security expert. He is a vice president of the Korea Valuation Association and has published several books, including *IP Law* and *Science/Technology and Law* and 20 papers on IPR. Byeongil received his Ph.D. in intellectual property law (2005) from INHA University, South Korea; his LLM in intellectual property law (1999) from Franklin Pierce Law Center, United States, and his master's of management information system engineering (1994) from Korea Advanced Institute of Science and Technology.

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As managing editor for *International Treasurer* and FAS133.com, publications of The NeuGroup in New York City, Andrea specialized in breaking news and enterprise stories on the subjects of derivatives, foreign exchange markets, derivative accountings and issues surrounding the landmark implementation issues of Financial Accounting Standard 133. During her tenure at The NeuGroup, she worked closely with the editorial advisory board, which included senior executives at General Electric, Intel and PWC. As a reporter and editor, she has covered presidential press conferences and interviewed senators and governors.

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Terry is the team leader at Sentry, in charge of accounting and tax issues, and is integrally involved in program and transaction structuring. In December 1994, Terry authored *Asset Financing Strategies,* which addressed the issues of lease versus buy and sale lease-backs. He has been the primary author of four books on leasing: *The Handbook of Equipment Leasing* (Amembal & Isom, 1988), *Leasing for Profit* (American Management Association, 1980), *Handbook of Leasing: Techniques and Analysis* (Petrocelli Books, 1982), and *Guide to Captive Finance Company Equipment Leasing* (Amembal American Association of Equipment Lessors, 1984); he recently coauthored the two-volume *Operating Leases—The Complete Guide* (Amembal & Associates). Before his current activities, Terry was a member of the University of Utah's accounting faculty, during which time he consistently ranked among the top three instructors based on student evaluations. He taught both undergraduate courses in finance and accounting and graduate courses in managerial accounting. He currently serves as chairman of the board of NACVA and as a director of IACVA.

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Karrilyn has experience researching and valuing companies and has worked in equity research and business valuation. She has received numerous awards in business, finance, and research, including the Canadian Institute of Business Valuators First Place Research Award and the Chartered Financial Analyst First Place Research Award. She has also published several research articles and received a number of scholarships and research grants in accounting and finance. Her B. Comm. in finance and entrepreneurship is from Saint Mary's University, Halifax.

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Michael is a geologist who has spent most of his professional career (spanning 43 years) as a mining and geological consultant with major international resource consultancies and as managing director of their regional operations: from 1970 to mid-1982 for the French government's BRGM/SEREM; and from mid-1988 to 1990 for the Robertson Group plc (UK). In 1991, he founded Sydney-based Minval Associates Pty Limited (MINVAL), which specializes in mineral property audits/due diligence and valuation, and minerals industry dispute resolution solutions. While at the NSW Department of Mineral Resources and Energy (mid-1982–mid-1987), he completed his studies for his graduate diploma in public sector management and participated in corporate planning, internal management strategy reviews, and organization analysis and redesign projects. He also developed skills in dealing with government administration (at local, state, and federal levels) and the political process as well as how public interest/civil society groups use their influence. His consultancy work (1970–1982 and 1988 to date), including the time he spent as a mining analyst with stockbroker Lancaster Securities (mid-1987 to mid-1988), involved him in mineral economics, financial analysis, and resource asset/company valuation. He has published 94 technical papers and made major contributions to AusIMM's VALMIN Code since 1991 (chair, VALMIN Committee, 2000–2002); and development of AusIMM/MICA Alternate Dispute Resolution Scheme (chair, Interim Board, 2000–2003).

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Laura has been valuing businesses and business damages since 1981. She has held several leadership positions in organizations, including serving on the boards of the Associate of

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John has a varied background, including COO and CFO positions and a traditional CPA tax practice. Currently his sole-practitioner practice is limited to M&A, family and business dispute resolution, income tax controversy, and litigation support. He is an author of published articles on Med/Val™ and personal goodwill and covenants not to compete. He presents on the subjects of mediation, collaborative divorce, taxation in divorce, personal goodwill, and covenants not to compete, for national conferences of AICPA, IBA, and NLSS as well as for the State Bar of Arizona, PESI, NBI, and many other organizations.

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Ulrich obtained his Ph.D. from the University of Stuttgart (1989). He acts as a management consultant in the field of intellectual property and business valuation. He has over 15 years of experience in the field with a strong focus on valuing intellectual property rights, portfolios of them, early-stage technologies, and purchase price allocations (FAS 141/142, IFRS 3). Recent projects include valuing a portfolio of more than 100 trademarks as well as the product pipeline of a biotech company. He spends considerable time supporting strategic business decisions of clients based on advanced valuation techniques. He also assists in developing and implementing intangible asset management systems. Ulrich often speaks at national and international business valuation and intellectual property conferences. He regularly publishes articles on corporate finance and valuation topics and is editor of *Praxis der Unternehmensbewertung* (practitioner's guide to valuation).