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Valuing Hidden Liabilities

Session Description

If uncovered before a deal is consummated, hidden liabilities can either throw a wrench into a deal or allow for a more equitable price to be paid for the acquisition. This workshop will provide you with the knowledge of how hidden liabilities arise and their impact on the value of an entity.

- ✓ Overstated assets & unresolved contingencies
- ✓ Retirement obligation & unfunded pensions
- ✓ Existing or potential contingent liabilities
- ✓ Tax disputes & penalties
- ✓ Warranties, guarantees & rebates

Valuing Hidden Liabilities

Let’s start by reviewing terms…

Liabilities

Provisions

Contingent Liabilities

Contingent Assets

Legal Obligations

Constructive Obligations

What are some HIDDEN Liabilities?

Retirement Obligations

Earn-outs

Tax Disputes & Penalties

Warranties, Guaranties & Rebates

Embedded Derivatives

"To warn that the untoward may occur when the event is contingent is prudent; to caution that it is only possible for the unfavorable events to happen when they have already occurred is deceit."

Huddleson v. Herman & MacLean
650 F.2d 815 (U.S. 5th Cir. 1981)

How do hidden liabilities arise?

Litigation

Overstated Assets

Unresolved Contingencies

Retirement Obligations

How do hidden liabilities arise?

Earn-outs

Tax Disputes & Penalties

Warranties, Guarantees &

Rebates

Embedded Derivatives

What indicates a hidden liability?

Credit rating

Embedded derivatives

Such as rights to convert to equity

What is fair value?

"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"

Includes risk

Measurements without

risks adjustment

(such as non-performance)

are **NOT** Fair Value!

How is a fair value calculated?

Fair Value Hierarchy

3 levels of input

(assumptions on pricing that includes risk)

observable from market data

or subjective sources

Level 1

Quoted prices

- financial instruments
- homogeneous products, cars, trucks
- frequent trades in volume

  in major markets or exchanges

Level 2

All other prices however observable

- Interest rate & yield curves at quoted intervals
- Implied volatilities or credit spreads

Level 3

Unobservable inputs or need adaptation

- projected cash flows
- past real estate transactions in a different area
- adjust for time, size, condition and location

How are risks assessed?

Obtain Market Participant view:

Potential buyer

Trade

Financial

Congloerate

Compare with

publicly traded debt

or equity securities

of similar firms

Credit risk

differs

with term and nature

of liabilities

Payables and other current liabilities risk free

Risk decreases with security

Risk increases with with term

Greatest risk:

Junior subordinated

unsecured debt!

Equity is less risky, has upside

More factors:

Look at which legal entity owes what

Problem with holding companies

and financial vehicles

Credit Rating

Is NOT a measure of

Credit Risk

possible property tax arrears

Visit target

Talk to management

Understand the statements

Identify future changes

VERIFY EVERYTHING!

Fair Values of Liabilities

Service Company in Eastern Canada

- 2012 Revenues $81,492,000
- 2012 Pre-tax Profit $8,287,000

Government Contracts

	A	B
Share Revenue	21%	11%
Expires	2015	216
Options	3 x 1 year	3 x 1 year
	Sole Bid	Multiple Bids
Benefit	Loaned Equipment	Training Grant

Locations	Montreal Toronto Halifax	Union Non-union Union
Growth	Government Commercial	1% - 2% 2% - 3%
Warranties	No provisions, just rework	

Capital Assets	$1,053,000
Current Assets	$18,637,000
Bank Loan	$10,000,000
Other Current Liabilities	$3,762,000
Equity	$5,928,000

Intangible Assets

government contracts
commercial customer relationships

Renegotiation Risk
Lose government business

Hidden Liabilities

Employee terminations
Possible closure of locations
Replacement of loaned equipment

How does litigation affect value?

COSTS!

Arbitration or mediation

Appeals

Settlements or awards

Court, expert & legal fees

Caveats:

Quality of evidence

Credibility of facts

Result

Win

or

Lose

Financial Statements

What is Missing?

MISSTATED COSTS!

Vacation pay

Insurance

Professional fees

MISSTATED COSTS!

Interest capitalized not expensed

Items expensed not capitalized

MORE MISSTATED COSTS…

Bonuses

Rebates

Warranties

Product liability

Yet more COSTS…

Leases

Repayments

Commitments

Un-accrued

Duties

and even more COSTS!!

Bribes

Kickbacks

Deceit in advertising

Administration falsification

Insurance coverage

Not to mention

risky products

But there's more…

mitigation | economic loss | psychiatric damages | mental distress | aggravated distress | punitive damages | liability insurance

Put a value on that!

Not to mention

embedded taxes

Who wants litigation?

Shareholders

Creditors

see Downtown Eatery (1993) Ltd. v. Ontario (2002) 54 OR (3d) 161, CA

Trustees

see Margaritis (1977) 23 CBR (NS) 150 (Ont. CA)

Derivative non-performance risks?

Reduced by

Credit default swaps

Collateral or credit enhancements

Only an attribute

inseparable from the instrument

affects the Fair Value

of a financial liability

lower credit standing

=

higher discount rate

=

reduction in value

If carrying amounts = Fair Value

Own credit deterioration gives

imaginary reported gain

Own credit improvement

results in

imaginary reported loss

Provision?

IAS 37 says record it if

reliable estimates are likely

If not = contingent liability

Obligation = resource outflow

Based on a reliable estimate

Probable = more likely than not

> 50%

Recorded at estimated cost

to settle at balance sheet date

Same cost a

third party would pay

Contingent assets are disclosed only when virtual certainty of benefits

Timing issue

Liability recognition > 50% probability

Related contingent asset > 95% probability

Pay now

Profit later

Likely Outcome	Contingent Liability/Loss	Contingent Asset/Gain
Virtually Certain > 95%	Recognize	Recognize
Probable 50% - 95%	Recognize	Disclose
Possible 5% - 50%	Disclose	No disclosure required
Remote < 5%	No disclosure required	No disclosure required

Example

Manufacturing plant damaged by super storm

physical damage estimate	$3,500,000
“loss of profits” during downtime	$880,000

Insurance covers wind but not water damage
plus 90% of extra operating costs (lost profits)

- immediate payment for physical damage
- loss of profit charged as incurred
- proceeds for damage only when insurer authorizes repairs adjuster’s report
- loss of profit recognized when insurer accepts claim
- Significant delay between recording loss of $4,380,000
  and insurance receipts of $1,230,000 (physical) plus $792,000 (loss of profits)

“expected value” or

“net present value”

of the outflow

as are normal measures

Expected Value

when a large population of items is being measured

a probability is assigned to each value

and the sum of the probability weighted amounts

= the figure recognized

Net Present Value

where the effect of the time value of money

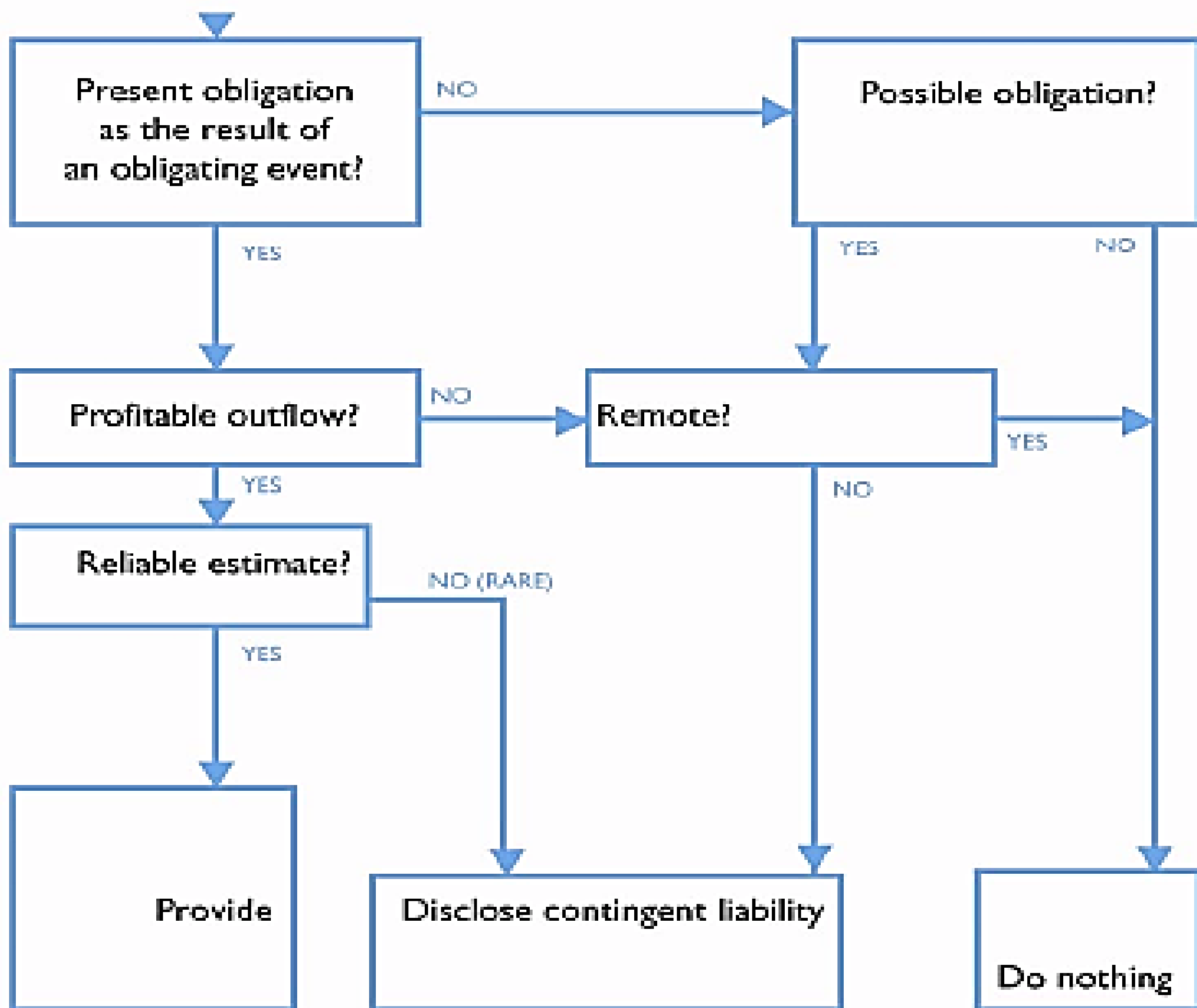
is material

mainly for long-term obligations

discount rate is pre-tax and reflects current market

assessments of the time value of money & risks

specific to the entity


Present obligation as the result of an obligating event?
NO
Possible obligation?
YES
YES
NO
Profitable outflow?
NO
Remote?
YES
YES
NO
Reliable estimate?
NO (RARE)
YES
Provide
Disclose contingent liability
Do nothing

If management planned changes to the scope or conduct of the business?

Only direct costs are recognized

and at the time

they become an obligation

Just one catch …

“Onerous Contracts”

Onerous contracts

=

Unavoidable costs

Exceed benefits

Amount recorded = net cost to exit

= the lower of:

cost to fulfil the contract

or

penalties from failure to complete

It’s Onerous…

A firm enters 10-year “take-or-pay” contract buying natural gas from Alberta for a fertilizer plant in Ontario

Total cost = $4.20/MCF

Originally purchase is 120%-140% of contract

Gas becomes available from Ohio at $3.00/MCF

It’s Onerous…

Contract has 5 years to expiry

Local pricing is based on $3.00/MCF

Cost of original gas exceeds benefits

by 10% ($1.20/MCF differential)

It’s Onerous…

Charge earnings with provision of present value

at the entity’s WACC

at differential pay (minimum) portion

of original contract during remaining life

What is required to retire an asset?

Conceptually similar general principles

But

IFRS does not have anything similar

To old CICA 3110 for

Asset Retirement Obligations (ARO)

AROs reflect

Any liability including environmental

Legal or constructive requirements

to remove and / or restore conditions

Recognized if:

Resource outflow probability > 50%

and has a reliable estimate

Under IFRS

ARO = discounted cash outflows

at current interest rate

Methodology for IFRS reporting

Discount at risk free rate

risks are accounted for

in cash flows

under various scenarios

Discount rate reflects risks

not in cash flows

Fair Value of each ARO

is recognized

in period incurred

Fair Value of ARO

= willing third party demand

to assume duties and risks

What are ARO terms?

Unit of Account

Total legal obligation on retirement

Recorded at Fair Value

when requirements meet

Valuation Premise

Not applicable to ARO as it assumes transfer to market participant

No Principle Market

AROs not actively traded

no observable data on prices

Most Advantageous Market

Where the minimal amount is paid

to transfer the ARO

Generally developed by management

What valuation method?

Consider all three approaches

Use quoted prices in active market

Expected present value

Incorporates risks in cash flows

Market Approach

Comparable public information

from recent M&A transactions

Market Approach

Valuation metrics

from publicly quoted

guideline company traders

Income Approach

Company cash flows projections

Discount rates from market participants’ data

Cost Approach

Reliable estimated amount

for remediation work

Accounting for a change in measurement

Based on model used

Reflect differences

In estimated timing

outflow of resources

discount rate

Cost Model

Increase or decrease

depreciated cost

in current period

Fair Value Model

Revaluation under IAS 40 *Investment Property*

First reduce reserve

When eliminated balance

flows through profit and loss

What are unresolved contingencies?

Example

Barrel manufacturer opened in 1870

Continuous production

In 2000's site has more value for residential

Book value	$300,000
Market value	$4,500,000
Remediation cost	$1,650,000
ARO	$?

Return of WACC on adjusted book value = no change

Market Value	$ 4,500,000
Remediation Cost	(1,650,000)
Selling Expenses (7%)	(315,000)
	2,535,000
Tax (15%)	(380,000)
Adjusted Book Value	$ 2,155,000

Decision Tree		$'000
Continuation	60%	-
Disposal	40%	$1,402,000
	($1,650,000 less $244,000 tax saving)	
Probable time		3 years
WACC	10%	
ARO		$3440,00059
	(1,402,000 x 40% x 0.712)	

Significant problems from uncertainties

Provisions recorded in Financial Statements

Contingent liabilities in Notes

Conservative accounting

"When in doubt

book the liability"

Except unresolved contingencies!

Read the Notes !!

Product warranties

Reasonably estimated costs

recorded as expense

=

Cost Approach

Similar to warranties

coupons | rebates | loyalty cards |

free rentals | prizes |

any sales incentives

Details vary

Procedures and outcomes similar

Environmental liability

Past present and future compliance

Seller usually pays to clean up

Auditors only report items in financial statements as fairly presented

But

There is no assurance cleanup is fully accounted for

Standards have trouble with future risk

Use a decision tree

What are Retirement obligations?

IAS 19 says

Net total of defined benefits in

Balance sheet

Defined benefit – assets or liabilities

Present value of obligations

Fair value of all assets

Future Actuarial losses

Past service cost not yet recognized

Retirement obligations are

discounted future payments

Rate same as expected return

Confirm reasonableness

Discount rate > Average actual 3-year pension asset ROR

=

Possible BIG Hidden Liability

Example

	$'000
Present value of obligations	(1,100)
Fair value of plan assets	(1,010)
	(90)
Unrecognized actuarial gains	50
Unrecognized actuarial losses	(110)
Unrecognized past service cost	(70)
Unrecognized liability on adoption of IAS 19	(90)
Defined Benefit Liability	(310)

In-combination

Maximum value as part of a group

Stand Alone

Maximum value as an individual unit

Highest & Best Use

physically possible

legally permissible

financially feasible

Market participant

$\neq$

willing seller or buyer

Market Participant

Independent

Knowledgeable

Reasonable understanding of transactions

Can enter into a hypothetical sale

Willing to deal, not forced

Market Participant

A key concept in Fair Value

To maintain objectivity

Fair Value ≠ most advantageous market

Principal market trumps multiple markets

Is a strategic buyer the

most logical market participant?

Valuators
can’t prove it

Auditors
can’t disprove it

Questions?