Viewpoint on Value

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Devil in the details
Creative ways to structure mergers and acquisitions

Make sure your expert is really an expert
Passing the *Daubert* test

Capital gains tax: To discount or not to discount?

Why valuators need accounting know-how

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Devil in the details

Creative ways to structure mergers and acquisitions

Private business owners seldom give business value much thought until it's time to sell or retire. They're simply too busy with daily operations to stop and ponder: "What's my business worth?"

A business valuation professional can help a seller understand what the business is currently worth based on current asset values, cash flow analysis and comparable sales. He or she also can discuss different ways to structure a deal, depending on the owner's cash flow needs, priorities and aversion to risk.

What's my asking price?

Most valuation assignments call for fair market value. In a nutshell, this standard measures what the universe of hypothetical buyers would agree to pay for a business interest. But strategic or investment value might be a more relevant standard in a merger or acquisition (M&A). Strategic value gauges how much a select group of qualified buyers might be willing to pay. Usually strategic value is higher than fair market value because acquiring the business may result in specific cost-cutting or revenue-enhancement benefits to the buyer.

If your business has been appraised in the past — say, for gift tax or divorce purposes — that value might understate the optimal asking price. Alternatively, it may overstate the asking price if, for example, the appraisal is several years old and your company was hard hit by the recession.

Setting a reasonable asking price is imperative. Aim too high, and you risk scaring away suitors. Aim too low, and you risk leaving money on the table. When establishing an asking price, consider a professional valuation that incorporates the cost, market and/or income approaches.

How can I attract buyers?

Economic turbulence and tight credit have changed the M&A landscape in recent years. In many transactions, buyers and sellers have been forced to consider creative alternatives to cash.

One of the more common solutions is seller financing. Here, a seller agrees to accept a down payment

Asset sale or stock sale?

When negotiating a merger and acquisition (M&A) transaction, buyers and sellers need to decide whether to structure it as an asset sale or a stock sale. Consider the pros and cons:

Asset sales. Buyers generally prefer to cherry-pick the most desirable assets and liabilities in an M&A. Asset sales offer a fresh start because the buyer receives a step-up in basis on the acquired assets, which lowers future tax obligations. Depreciation starts anew. And the buyer negotiates new contracts, licenses, titles and permits.

But the seller pays capital gains on assets sold in an asset sale. If the seller is a C corporation, its shareholders also will pay tax personally when the company liquidates.

Stock sales. Sellers typically like stock transfers because they're simpler and tax obligations are usually lower. But stock sales may be riskier for buyers because operations — including all debts and legal obligations — continue uninterrupted. In a stock sale, the buyer also inherits the seller's existing depreciation schedules and tax basis in the company's assets.

when the deal closes and the remainder over an installment period.

How do valuators support earnouts?

M&A parties might also consider an earnout. Generally used to mitigate the risk of achieving forecasted results, earnouts differ from installment sales. A portion of the sales price in an earnout is not only deferred, but is also *contingent* on future performance. Suppose a buyer pays $12 million for ABC Inc. at closing, plus an additional $6 million over the next three years — but *only* if ABC Inc. achieves its profit targets over the earnout period.

An earnout may require a seller's ongoing involvement in the new entity, typically as a consultant.

To support an earnout, a valuator can develop forecasts of what will be paid in the future under a variety of probable scenarios. Sensitivity analyses can help determine which assumptions create the greatest volatility in the payouts.

An earnout may require a seller's ongoing involvement in the new entity, typically as a consultant. Such an arrangement eases the transition to new management. The IRS treats consulting agreements as ordinary income for the seller, subject to FICA. The buyer then can deduct the payouts as an expense in the current period. Sellers need access to accounting information to confirm their earnout payments, and many will require CPA verification of financial results.

Alternatively, a seller may be asked to "roll over" part of existing equity into an investment in the new entity. A seller, for example, might receive 80% cash and the remaining 20% of the asking price as stock in the buyer's business. Especially popular in mergers with supply chain partners or competitors, these transactions require a valuator to appraise the expected value of the combined entity.

Why do I need an expert?

Business appraisers deal with M&A transaction data on a daily basis. This data eliminates guesswork by providing tangible market evidence to supplement an owner's gut instinct.

Moreover, no universal deal structure works for everyone. Valuators keep current on deal trends and tax laws and can help buyers and sellers negotiate mutually advantageous terms. ●

Make sure your expert is really an expert

Passing the *Daubert* test

When business valuation issues are at the heart of the matter, a qualified, experienced valuator can be a tremendous asset to an attorney. This professional can do everything from providing a well-researched and reasonable appraisal opinion, to critiquing an opposing expert's conclusions, to helping the attorney draft deposition and cross-examination questions. But courts increasingly hold expert witnesses to a higher standard — considering, among other things, the expert's education, experience and credentials.

An expert who fails the court's admissibility standards may be completely or partially excluded from testifying — putting the party that's retained the expert at a significant disadvantage. That's why attorneys need to be familiar with the guidelines for admitting expert witnesses when using a valuator in a legal context.

Understanding the *Daubert* effect

According to Federal Rule of Evidence (FRE) Rule 702, if scientific, technical or other specialized knowledge will help a judge or jury make sense of evidence or understand facts, an expert witness may testify. In 1993, a U.S. Supreme Court case, *Daubert v. Merrell Dow Pharmaceuticals Inc.*, affirmed judges' roles as gatekeepers against "junk science."

In an important distinction, rather than addressing the accuracy of an expert's opinion, *Daubert* focuses on the reliability and relevance of an expert's analyses. The *Daubert* test includes the following criteria:

Testing. Has the opinion been tested?

Peer review. Has it been reviewed by other practitioners? Has the methodology been published in professional journals?

Error rate. What is its known rate of error? Has the expert's profession established standards to control its use? If so, has the expert complied with these standards?

Acceptability. Is it generally accepted among members of the scientific community?

The Supreme Court intended courts to apply these factors with flexibility and consider the method's replicability. For instance, a new method might pass muster if another expert can replicate the expert's analyses — and if the expert can persuade the court that the method is appropriate for the case.

Because *Daubert* dealt specifically with medical testimony, the legal community initially questioned whether it applied to technical or specialized expert testimony. But in 1999, *Kumho Tire Company v. Carmichael* ended this debate, extending the scope of *Daubert* beyond scientific testimony to other academic disciplines.

Looking at the *Daubert* criteria

When assessing an expert's chances of withstanding a *Daubert* challenge, it's important to look beyond education, professional designations, industry experience and reputation for qualities that could lead to exclusion during a *Daubert* challenge. These include mathematical errors, of course.

Further, courts have disqualified experts for cherry-picking documents and data sets that supported their side's financial interests. And courts often expect a high level of due diligence concerning the company's operating history and its financial projections. For instance, a disclaimer that the valuator accepted a company's projections at face value (without assessing reasonableness) might raise a red flag during a *Daubert* hearing.

In addition, ongoing professional relationships or contingent fees may impair an expert's perceived objectivity. Reliable experts maintain independence and avoid acting as advocates for their clients. Obviously, an expert's testimony shouldn't extend beyond his or her area of expertise. Make sure to review relevant *Daubert* case law when challenging opposing experts or defending your expert.

Surviving *Daubert* challenges

Before motioning for a *Daubert* hearing, realize that the opposition will likely fire back with a similar motion. So first consider your own expert's reliability and the relevance of his or her methodology.

An objective review by a third expert to reveal both experts' mistakes and weaknesses could be helpful. In some cases, your expert's methodology may be sound, but his or her report may require minor improvements. For example, it might be a good idea to ask your expert to explain why he or she rejected alternative methods or excluded specific documents — before you launch an attack on the opposition.

Being *Daubert*-savvy

In addition to assessing an expert witness's qualifications, a *Daubert*-savvy attorney reviews the valuator's report and evaluates whether the underlying methodology conforms to academic literature and professional standards. Doing so can help the attorney identify "junk science" before it has a chance to waste resources and cause courtroom blunders. ●

Capital gains tax: To discount or not to discount?

Courts often struggle with how to interpret statutory fair value in shareholder disputes, including whether to discount business interests for built-in capital gains tax. The U.S. District Court for the Northern District of Mississippi recently granted a dollar-for-dollar reduction for this tax liability. The oppressed shareholder case demonstrates how courts may be persuaded by thorough, credible expert appraisal evidence.

Case history

In *Dawkins v. Hickman Family Corporation*, several oppressed minority owners requested a judicial dissolution and buyout of their 35.7% combined interest in a family business. The corporation and its general chairman and general manager, Perry Hickman, countered with a petition to buy out the minority interests at fair value.

Like many states, Mississippi grants courts the authority to dissolve a corporation if the shareholders prove that the directors have acted (or will act) in an illegal, oppressive or fraudulent manner. It also allows the corporation or remaining shareholders to buy out the other shareholders at fair value in lieu of dissolution. The primary issue in *Dawkins* was the fair value of the oppressed shareholders' interests.

The plot thickens

The federal district court granted the petitioning shareholders an extra 45 days to retain a property appraiser and business valuation expert. But according to the court, the plaintiffs never provided any independent appraisal evidence "other than arbitrary numbers without explanation or evidentiary support."

The defendant hired a valuation professional who valued the entire business at $225,000. Accordingly, the expert concluded that each of the four petitioning shareholders owned a 7.143% interest worth $16,071.75.

Hickman Family Corporation operates farmland that doesn't generate income. So the appraiser concluded it was akin to a real estate holding company and based his value solely on the asset-based approach. Under this methodology, fair value equals the difference between a company's assets and liabilities.

By not challenging the appraiser's methodology, the petitioning shareholders "appear to concede that this asset-based methodology is correct." The court accepted the expert's report and commended his thorough review.

Ambiguous about discounts

Under the Mississippi Business Corporation Act (MBCA), fair value specifically excludes discounts for lack of control and marketability. But MBCA is ambiguous about discounts for built-in capital gains taxes. Typically, capital gains tax is charged on the difference between the selling price of a company (or an asset) and its adjusted cost basis. For C corporations like Hickman, sales proceeds are taxed again on the personal level when the corporation distributes cash to shareholders.

Because the farmland had been purchased in the 1940s, it had less than $20,000 of tax basis and would incur significant built-in capital gains tax if sold. Citing *Dunn v. Commissioner*, the court noted that "the corporation cannot realize the fair market value of the assets without incurring this tax liability." Accordingly, a dollar-for-dollar reduction for built-in capital gains tax was upheld, even though a sale was not imminent.

Drawing conclusions

Most case law granting discounts for built-in capital gains tax has been estate tax–related. But in *Dawkins*, a dollar-for-dollar reduction for capital gains tax was permitted in a shareholder dispute. Because there have been few cases of this nature, *Dawkins* could be cited in dissenting and oppressed shareholder cases in other jurisdictions.

Dawkins also may have relevance in divorce cases. Although family courts are hesitant to rely on valuation discounts from Tax Court cases, they might be more accepting of a discount applied in a statutory fair value dispute.

Finally, this case underscores the importance of hiring a credentialed valuation professional to prepare a comprehensive valuation report. In *Dawkins*, the only valuation evidence provided at trial was from the defendant's expert. Throughout its opinion, the court applauded the appraiser's in-depth analysis. Accordingly, the judge accepted the appraiser's conclusion — lock, stock and barrel. ●

Why valuators need accounting know-how

Accounting and appraisal are interrelated disciplines. After all, financial statements are the foundation for valuing a business. So it's imperative that valuators understand accounting terminology and how to adjust for material differences in accounting methods.

Acceptable accounting methods

Private businesses use different methods of accounting depending on what works best for their financial circumstances. Take inventory as an example. A manufacturer might use the last-in, first-out (LIFO), first-in, first-out (FIFO), average cost, or specific identification method to report its inventory.

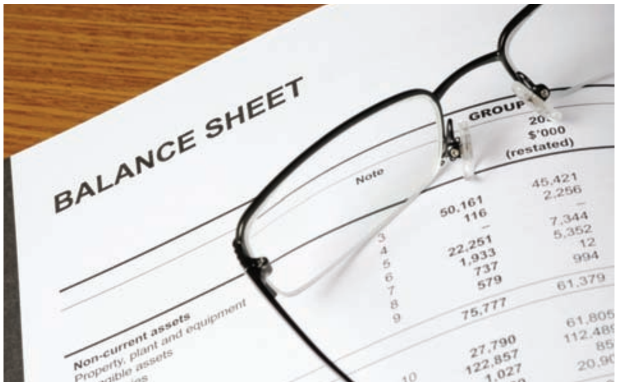
All are acceptable methods under Generally Accepted Accounting Principles (GAAP). Some privately held companies, however, don't follow GAAP and may simplify accounting with cash or tax-basis reporting.

Importance of adjustments

Balance sheet and income statement items differ depending on the accounting methods used. Therefore, valuators need to adjust a subject company's financial statements — as well as market data obtained from public and private comparables — for differences in accounting methods.

Valuation professionals most frequently make adjustments in areas such as:

- Fixed-asset depreciation,
- Revenue and expense recognition timing,
- Bad debt write-offs,
- Treatment of intangibles,
- Differences in inventory reporting methods, and
- Contingent or unrecorded liabilities.



Valuators unfamiliar with accounting may not realize the importance of these adjustments. For example, a fictional novice valuator might use a pricing multiple of 1 times the prior year's revenues to value an accounting firm. The valuator obtains this multiple from sales of comparable private firms that had used the accrual method to report revenues.

But the subject company reports revenues using the cash-basis method, meaning it reports revenues only when it collects cash, not when services are rendered. Thus, the novice appraiser's use of the prior year's cash-basis revenues likely understates the company's current value if the firm is growing. If those revenues are adjusted to accrual basis, a growing company's appraised value probably will be higher. Thus, the valuator needs to determine industry accounting norms and then adjust the subject company's financial statements to match the methods the comparables used.

Apples to oranges comparisons

As the previous example shows, failure to adjust financial statements for differences in accounting methods results in apples to oranges comparisons — and potentially erroneous value conclusions. That's why it's critical for companies to engage professional valuators with a thorough understanding of accounting methodology. ●

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.