Viewpoint on Value

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Facts and figures you need before closing
Valuators minimize stress on both sides of the deal

Key people: Hard acts to follow, hard risks to measure

5 steps to valuing a business

How excess earnings fits into an appraiser's toolkit

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Facts and figures you need before closing

Valuators minimize stress on both sides of the deal

An appraisal can be useful when you're planning to buy or sell a business. Both sides of the deal may have unrealistic expectations — and the use of a valuation professional brings some objectivity and concrete transaction data to the negotiating table.

Differentiating strategic value

An appraisal can provide meaningful insight to company insiders. It can help the seller set the asking price or evaluate whether unsolicited purchase offers seem reasonable. But valuators typically caution against sharing this information with prospective buyers, because it could leak proprietary information to competitors. Sharing appraisals could also limit how much buyers will offer and how much lenders will finance.

Most appraisal assignments call for "fair market value," which is essentially the price that well-informed buyers and sellers would agree to buy or sell the business for. In mergers and acquisitions, a more relevant standard of value is "strategic value." That's the price specific to a particular buyer or seller.

Valuing synergies

If a buyer can achieve synergies from a transaction, it may be willing to pay a premium above fair market value. Most synergies are buyer-specific.

Valuators can help both buyers and sellers put a price tag on synergies. Economies of scale are the most obvious type of synergy. Two companies, once merged, can achieve greater negotiating power with suppliers and consolidate overhead expenses.

A business combination can also increase revenues through cross-selling opportunities between the two entities. Or the combined entity may increase sales volume by reducing prices to pass along synergy-related cost savings to customers.

Some buyers will share a portion of their synergies with the seller in exchange for financing, ongoing participation from the seller or other desirable deal terms. A seller that operates in a technical niche or foreign market is in a strong negotiating position, for example.

Allocating value

Business combinations require another value-related consideration: The parties need to allocate the purchase price for book and tax purposes. These allocations start by computing a cash-equivalent purchase price if a portion of the deal is contingent on future earnings or if noncash consideration (such as stock in the combined entity) changes hands.

Next, all the tangible and intangible assets acquired and liabilities assumed must be identified. Many of a company's most valuable assets aren't on the balance sheet, unless the seller had previously purchased

them from a third party. Accounting Standards Codification (ASC) 805 provides a list of intangible assets, including patents, customer lists, trademarks, domain names and copyrights.

FASB recently issued an Accounting Standards Update that outlines amendments simplifying how private firms report goodwill.

Assigning value to working capital items is usually a matter of transferring book value from one company to the next. But other assets — such as equipment, real estate and intangibles — often require outside appraisals. What's left over after assigning value to tangible assets, identifiable intangible assets and liabilities is booked to goodwill.

Companies that follow Generally Accepted Accounting Principles (GAAP) classify goodwill as an indefinite-lived asset that's subject to impairment testing, rather than amortization. But the Financial Accounting Standards Board (FASB) recently issued an Accounting Standards Update (ASU 2014-02) that outlines amendments simplifying how private firms report goodwill.

In a nutshell, FASB now gives eligible private companies the option to amortize goodwill straight-line, over a period of 10 years (or possibly less if the company can justify a shorter useful life), and test for impairment only when a triggering event — such as the loss of a major customer or supplier — occurs.

Helping both parties succeed

Valuators can help buyers and sellers throughout the merger and acquisition process. But these assignments require a different mindset and specialized skills. Do-it-yourself valuations may result in unrealistic synergistic expectations. They also can lead to postmerger tax investigations and impairment write-offs due to inaccurate purchase price allocations. ●

What's for sale: Stock or assets?

In an asset sale, the buyer cherry-picks assets and liabilities, renegotiates contracts and loans, and applies for new licenses, titles and permits. In a stock sale, shares of stock transfer to the buyer, and the business continues to operate uninterrupted. In general, buyers prefer to buy assets, while sellers prefer to sell stock.

Buyers generally don't like to assume all of the seller's liabilities. They also want a fresh start in depreciating their purchases to reduce taxable income. In an asset sale, the buyer allocates the purchase price to equipment, buildings and other assets. Then acquired long-term assets are depreciated over their useful lives.

Conversely, if the buyer purchases stock, it assumes the seller's basis in the corporation's assets. After years of depreciation, the seller's basis in an asset may be significantly below its fair market value.

Sellers typically prefer selling stock because shareholders' proceeds are generally taxed at long-term capital gains tax rates, which are lower than ordinary income-tax rates. Sellers pay more tax on asset sales, because these proceeds are typically taxed as a combination of ordinary income and capital gains.

Asset sales also can result in double taxation for C corporation sellers. The corporation first pays tax on any gains from the asset sale. Then the corporation's shareholders pay tax (again) on their gains when the corporation is liquidated. In some cases, it's possible to defer personal-level tax by having the corporation hold and invest the sale proceeds, however.

Key people: Hard acts to follow, hard risks to measure

No one is indispensable. But filling the shoes of a founder, visionary or rainmaker that unexpectedly leaves a business is sometimes challenging. The loss of such a "key person" could disrupt day-to-day operations, alarm customers, lenders and suppliers, and drain working capital reserves.

Consider the stock price fluctuations that Apple has experienced following the death of innovator Steve Jobs in 2011. Apple possesses a well-trained, innovative workforce, a backlog of groundbreaking technology and significant capital to continue to prosper. But other businesses aren't so lucky. Some small firms take *years* to fully recover from the sudden loss of a key person.

Factors to consider

Key people provide value in different ways, depending on the roles they play in their businesses. So valuators may inquire about the key person's duties, training, experience and contribution to annual sales. Other factors valuators consider when evaluating a key person discount include:

- The nature of the business,
- Personal guarantees signed by the key person, and
- Management depth and qualifications.

Generally, companies that sell products are better able to withstand the loss of a key person than are service businesses. On the other hand, a product-based company that relies heavily on technology may be at risk if a key person possesses specialized technical knowledge.

Personal relationships are also a critical factor. If customers and suppliers deal primarily with one key person, they may decide to do business with another company if that person leaves the company. On the other hand, it's easier for a business to retain customer relationships when they're spread among several people within the company.

Replacement candidates

One of the valuator's most important tasks is to evaluate the ability of others inside the company to take over a key person's responsibilities and relationships in case of death or a departure from the business. Does existing management have the knowledge, skills and business acumen needed to fulfill the key person's duties? Does the company have a solid succession plan in place to smooth the transition?

If no one internally could take over, the valuator also needs to look at the external options. This includes estimating the cost of hiring someone with the same knowledge, skill and business acumen as the key person.

A key person life insurance policy can help the company fund a search for a replacement or weather a business interruption following the loss of a key person. So, companies with key person life insurance typically warrant a lower discount for this risk factor.

Measurement techniques

Valuators generally use one of three methods to incorporate key person discounts into their calculations:

1. Adjust future earnings to reflect the risk of losing a key person,
2. Adjust the discount or capitalization rate through the specific company risk adjustment, or
3. Discount the preliminary value by a certain percentage.

Quantifying the discount is a challenge because, unlike marketability and minority discounts, there's little empirical support for across-the-board key person discounts in business valuations.

However a valuator chooses to quantify the risk of losing a key person, it's important not to double-count factors or ignore steps the company has taken to mitigate key person risks. For example, a business might purchase disability and life insurance policies on key people to bridge the temporary cash flow shortage their departures might cause. A business can also minimize key person risks by implementing management training programs, succession plans and long-term contracts with key customers.

Rare but potentially significant

Not every business warrants a key person discount. Most have taken steps to minimize the risks of losing a key person. But sometimes — especially for small businesses with limited operating history and charismatic, innovative leaders — key person discounts are a real, and potentially significant, possibility. ●

5 steps to valuing a business

Valuators use a variety of analytical techniques and possess different qualifications. But a common denominator is the *process* that everyone uses to value a business.

1. Retention

The first step to valuing a business or an interest in a business is retaining an appraiser and agreeing on the price, deliverables and scope of the assignment. Typically, the valuator and client sign an engagement letter, which serves as a legally binding contract that helps the parties understand such parameters as the:

- Company name,
- Percentage or number of shares to appraise,
- Effective appraisal date,
- Standard of value (such as fair market value, fair value or strategic value),
- Premise of value (controlling or minority, marketable or nonmarketable),
- Basis of value (as a going concern entity, in orderly liquidation or forced liquidation), and
- Purpose of the appraisal.

For example, you might retain an appraiser to determine the fair market value of a 20% interest in ABC Company as of Dec. 31, 2013, on a minority, nonmarketable basis as a going concern entity for estate tax purposes.

Engagement letters also confirm the fees. Expect to sign a revised engagement letter or an addendum to the original contract if the scope of the project changes.

2. Document requests

The valuator will provide a list of documents that he or she will need to better

understand how the business operates. In addition to the last five years' financial statements and tax returns, the expert might request shareholder agreements, leases, marketing materials, trade association benchmarks and other relevant documents.

If an appraisal will be used in a legal proceeding, involve the valuator in the discovery phase. This is especially beneficial when you lack access to the company's financial records and premises. It's harder for a controlling shareholder to deny access if it's been mandated by the court.

Calculation engagements are appropriate only in limited circumstances and generally not used for litigation purposes.

3. Fieldwork

Next the valuator will visit the company's facilities to conduct site visits and interview management. This is an integral part of the valuation process, not to be overlooked.

The purpose of fieldwork is to see firsthand how the business operates and ask relevant questions before the appraiser crunches the numbers. This step is essential to understanding the risk factors and opportunities the business faces.

4. Report preparation

Full written reports typically start with a summary letter, followed by a more detailed description of the valuation methodology used and conclusions made. Appendices may include statements of sources used and key management representations, the appraiser's curriculum vitae, and numerical exhibits that summarize financial analytics.

A survey conducted at the AICPA Forensic & Valuation Services Conference in 2013 revealed that the average length of a business valuation report is currently about 50 pages. Participants at the recent conference also reported an increase in the demand for shorter "calculation reports." Although calculation engagements may cost less than full reports, they're appropriate only in limited circumstances and generally not used for litigation purposes.

5. Expert testimony

An expert's written report may serve as his or her direct testimony in tax court. But other courts allow experts to provide direct verbal testimony when they value a business for other purposes, such as minority shareholder disputes, economic damages claims and marital dissolutions.

Before appearing in court, most experts ask clients to pay their fees in full, excluding court time. If they don't, the expert could be perceived as a hired gun who gets paid only if the court rules in his or her client's favor.

When everyone's on the same page

When all of the parties know what to expect at each phase of a valuation project, it makes the process easier for everyone. This awareness promotes collaboration and timeliness, as well as minimizing potential surprises, misunderstandings and rework. ●

How excess earnings fits into an appraiser's toolkit

Critics of the excess earnings method call it subjective, ambiguous and outdated. IRS Revenue Ruling 68-609 recommends using it "only if there is no better basis available."

Yet the method remains a viable tool, especially when valuing small professional practices for divorce purposes. Because of its perceived simplicity, the excess earnings method can also serve as a meaningful sanity check for other methods. Here's how it works.

Start with tangibles

The first step of the excess earnings method is to value the company's net tangible assets. Book value may be a reasonable proxy for some items, but others may need to be adjusted.

For example, the book value of inventory may include obsolete or missing items. Fixed assets that have been fully depreciated may continue to provide value. And real estate recorded years earlier at historic cost may require an appraisal.

Tangible assets generate returns of 8% to 10%, according to Rev. Rul. 68-609. Valuators decide what's appropriate for the subject company, based on its perceived risk and industry guidelines, if available. Then they multiply the rate of return by the value of net tangible assets.

To illustrate: Suppose a business expects to achieve a 10% return on $2 million of net tangible assets. That's $200,000. If the company's annual earnings historically have averaged $800,000, its excess earnings from intangible assets would equal $600,000 ($800,000 normalized earnings minus $200,000 return on assets).

Impute intangible value

The next step is to value the intangibles. Rev. Rul. 68-609 recommends using a 15% to 20% return, depending on risk levels. The ruling provides no guidance about the type of earnings to use, however. Continuing with our example and assuming a 15% return, the value of intangibles would be $4 million ($600,000 divided by 15%). There's no specific empirical evidence on which to base this rate of return. Instead, valuators use professional judgment.

Add the parts to value the whole

The last step is to combine the value of tangible and intangible assets. In our example, the company's value would be $6 million ($2 million of net tangible assets plus $4 million of intangibles).

An appraiser can also calculate the overall rate of return on assets to use as a sanity check. That requires dividing the company's normalized earnings by its value. For example, $800,000 divided by $6 million equates to an overall return on assets of about 13%.

Avoid pitfalls

Like any appraisal technique, the excess earnings method is only as reliable as its underlying assumptions. A valuation professional can help you apply this method correctly and avoid potential pitfalls. ●

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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.