

Valuations Plus

SUMMER 2009

Fair value accounting – New standards require adapting to change

The times, they are a-changin'.

Economic turmoil and financial scandals dominate the headlines.

Companies continue to innovate and evolve in the face of competition, relying more and more heavily on intellectual property and ever more fluid arrangements and relationships to gain a competitive advantage.

Many do so through acquisitions.

The times, they are a-changin'.

The Financial Accounting Standards Board (FASB) continues to issue and modify Statements of Financial Accounting Standards (SFAS) in an effort to adapt financial statements for these changing circumstances.

The following are just a few examples of how those changing standards affect both buyers and sellers, and how smart owners and management teams can be prepared for them.

SFAS 141r (revised) – Statement 141 allowed pre-acquisition contingencies to be deferred until they were measurable in both amount and timing with a reasonable amount of certainty. SFAS 141r now requires a buyer to recognize assets acquired and liabilities assumed arising from contractual contingencies as of the acquisition date, measured at their acquisition-date fair values.

What this means is that all contracts with significant potential future outcomes – whether inflows (assets) or outflows (liabilities) – have to be valued as of the acquisition date. This new rule will force management teams to estimate probabilities of outcomes and consider current scenarios, whereas until even recently they might have overlooked them just to close a deal.

SFAS 157 – As fair value takes a more prominent role in accounting, and valuation specialists become a more integral part of the financial reporting

team, more attention is paid to how much of that fair value is based on facts and market pricing and how much is based on assumptions and valuation models.

Every fair value measurement is now categorized as a level 1, 2 or 3 measurement, with level 1 based purely on market data, level 2 based on a mix of market data and valuation assumptions, and level 3 based primarily on valuation assumptions and management estimates. The main assumptions have to be documented and disclosed.

SFAS 157 introduces two additional concepts: market participants and exit pricing. Valuation is now to explicitly incorporate the assumptions about value and pricing that market participants are expected to make.

Who are these market participants? Whoever is the most likely group of buyers and sellers for the particular asset or liability in question.

Exit pricing means the price or value available from selling or disposing of the acquired asset or liability, as opposed to what price may have been paid to obtain it. Why? It was deemed that the relevant measure of value was what one could get to convert the investment into cash, rather than what was paid.

For example, an acquisition that includes a hedged

Methods Measures

By CPAMerica guest columnist
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Bring your CPA to the table for mediation of cases

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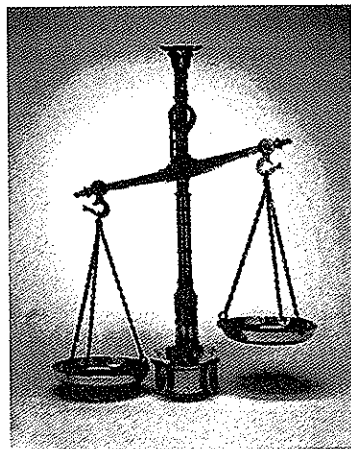
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Court rules on appraisers' ability to support their discounts

Once again, a Tax Court case boiled down to the issue of what percentage of discounts should be used for built-in capital gains taxes, lack of control and lack of marketability.

As in many cases, this one was decided by the expert who was able to support his discounts. Engaging an appraiser that effectively supports discounts can be the difference between winning in Tax Court and paying a substantial tax bill.

In *Estate of Litchfield v. Commissioner*, TC Memo 2009-21 (Jan. 29, 2009), the decedent owned minority interests in two



S corporation holding companies, LRC (43.1 percent) and LSC (22.96 percent), at her date of death on April 17, 2001. In this instance, both entities were newly formed S corporations that would pay a corporate level tax on the sale of any assets prior to 2010.

At the valuation date, LRC owned primarily farmland and marketable securities totaling \$33,174,196. Of that amount, \$28,762,306 was built-in capital gains. LRC had converted from a C corporation to an S corporation

on Jan. 1, 2000. The company was marginally profitable and management occasionally sold assets to raise cash.

LSC primarily owned marketable securities totaling \$52,824,413. Of that amount, \$38,984,799 was built-in capital gains. LSC had also converted from a C corporation to an S corporation on Jan. 1, 2000. LSC had a history of paying dividends.

The reported discounts and the judge's conclusions are summarized in the table below.

	<u>Estate's expert</u>	<u>IRS expert</u>	<u>Judge's ruling</u>
LRC			
Built-in gains taxes	17.4%	2.0%	17.4%
Lack of control	14.8%	10.0%	14.8%
Lack of marketability	36.0%	18.0%	25.0%
LRS			
Built-in gains taxes	23.6%	8.0%	23.6%
Lack of control	11.9%	5.0%	11.9%
Lack of marketability	29.7%	10.0%	20.0%

In calculating his discounts for built-in capital gains taxes, the estate's expert reviewed minutes of board meetings, reviewed the company's history of asset sales and talked with the officers and board of directors about plans for the sale of corporate assets.

The IRS expert reviewed only historical asset sales.

Judge Swift relied on the calculation of the estate's expert stating, "The estate's expert's assumptions relating to asset turnover estimates were based on more accurate data (namely, historical data, recent data and conversations with management)

than were the IRS expert's assumptions (namely, historical data and wrong assumptions as to management's plans)."

To determine the discount for lack of control, the estate's expert used closed-end funds, REITs and real estate limited partnerships (RELPs). For LRC, he considered that a 43.1 percent owner would have some ability to force liquidation and to change LRC's policies and operations but considered LRC's returns to be substantially below similar investments. For LSC, he used closed-end funds and considered that a 22.96 percent interest would have fewer rights to force liquidation or change operations.

Again, Judge Swift relied on the estate's expert. In regard to LRC, both experts calculated different discounts for the various asset classes. However, the estate's expert used a weighted average discount to account for the fact that LRC held more farmland than securities. The IRS expert took just a straight average.

For LSC, the estate's expert increased the lack of control discount because the interest would have fewer rights than the interest in LRC. The IRS expert blindly used the same rate as LRC's marketable securities.

With respect to the discounts for lack of marketability, the estate's expert primarily used restricted stock studies. He considered restrictions on transferability as well as the built-in gains and determined that these issues would result in a relatively high discount.

He also considered the profitability of the companies, along with future cash flow and liquidity of the underlying assets. The IRS expert considered restricted stock studies, as well as private placement sales studies, to support his discounts. He also considered specific things related to the two corporations that made them different from the underlying data. LSC's historical dividend policy was also considered.

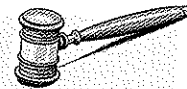
Judge Swift never discussed the IRS expert's methodology. With regard to the estate's expert, he felt that the conclusions for his discounts for lack of marketability were high, especially when combined with what he considered to be "high" discounts for lack of control. He also believed that the estate's expert used some outdated data relating to the restricted stock studies.

Finally, this same expert had valued the shares in LSC in 2000 and "appropriately discounted for lack of marketability by 21.4 percent."

In this instance, the estate's expert was able to support his built-in capital gains discount and his discount for lack of control. Although Judge Swift did not fully accept his discount for lack of marketability, it was adjusted downward only slightly.

Prior to trial, the IRS was alleging a \$6,223,176 federal estate tax deficiency. By hiring an expert who could support his discount, the estate was able to drastically reduce the proposed tax bill. ■

CASE by CASE



By CPAmerica valuations consultant
Linda Trugman, CPA/ABV, MCBA, ASA, MBA,
with Gregory Flicek, CPA/ABV, CVA

Bring your CPA to the table for mediation of cases

Mediation increasingly is becoming part of the legal landscape.

Court systems – some more than others – use mediation to reduce docket load and make breakthroughs in deadlocked cases. Parties on their own increasingly use mediation to resolve divorce, business, employment, contract and other conflicts.

Mediation, unlike litigation, has the potential not only to resolve disputes but to address underlying issues that create conflict.

“Transformational mediation,” for example, can help individuals and organizations that will continue to have ongoing contact, such as neighbors, divorcing parents, or employers and employees, find common ground and work cooperatively in the future.

Mediation, unlike litigation, has the potential not only to resolve disputes but to address underlying issues that create conflict.

However, in most cases, even those where transformation attitudes and achieving mutual understanding are important goals, money often matters.

In many cases, financial issues may be the stumbling block that prevents the mediation from being successful. In some cases, financial issues may be the only thing that matters to the parties. This is where a CPA can be helpful, since finance is the CPA's area of expertise.

CPAs can assist attorneys representing clients in cases or conflicts that are being mediated in a several ways. First, the CPA can assess conflicts and proposed solutions in terms of the financial impact. While attorneys are accustomed to recognizing (and pointing out to clients) the potential dollars at stake, CPAs may provide perspectives that only an accountant can provide. And many CPAs are qualified mediators themselves.

For example, if asset A is worth \$10,000 and asset B is worth \$10,000, on its face the assets would seem to be of equal value. However, suppose asset A is an asset that likely will depreciate, such as a car, and asset B is an asset that

likely will increase in value, such as stock or real estate. A CPA can calculate the likely relative value of the assets three years from now, providing a perspective on value from an accountant's point of view.

Similarly, an accountant can advise about, and calculate, the tax consequences of proposed solutions to conflict. Taking again the example of assets A and B that appear to be of equal value, if sale of A will result in taxable gain and sale of B will result in deductible loss, the assets are not equal in value when you take into account the tax consequences of converting the asset to cash.

CPAs know there are three parties to every transaction – the seller, the buyer and Uncle Sam. Therefore, CPAs also may be able to spot creative solutions to problems that draw upon tax knowledge. Take these examples in the divorce field with which family law attorneys will be familiar.

Assume wife and husband are divorcing and wife seeks money from husband. If she receives that money in the form of property or child support, the transfer is not a taxable event. If she receives alimony, however, that is deductible by the husband and treated as income to the wife.

Depending upon the parties' respective taxable incomes, it could be advantageous for both parties for the husband to pay alimony in lieu of something else that might be due, such as child support or division of property. Similarly, though wife has custody of the children and is entitled to the dependency exemption for them, depending upon incomes it may be advantageous for both parties for the husband to pay a little extra to the wife in exchange for the right to claim the exemptions.

What applies in divorce disputes applies even more strongly in business disputes. Information is power. Having the financial and tax perspective of the CPA available when mediating a solution to conflict provides an attorney with more information to broker a compromise that best serves his or her client.

WORDS on WORTH

By CPAAmerica guest columnist
Michael Wilson, J.D.



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Fair value accounting *continued from front*

position, such as a futures or a forward contract to lock in a delivery price, might be measured as either a level 1 or level 2 measurement, depending on whether active market prices existed for the derivative instruments or a comparison had to be made to some other market prices.

In that same acquisition, intellectual property that is unique to the company would be measured (valued) as a

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level 3 measurement, based primarily on management's estimates of the benefits and characteristics of the acquired asset.

Ultimately, SFAS 157 and SFAS 141r may or may not add any more precision,

certainty or clarity, but they do create more robust valuation and reporting requirements. The hope is that the tradeoff is an increased visibility "under the hood" so that users of financial statements can better understand the costs and value impacts of an increasingly important component of

the balance sheet – intangible and hard to value assets.

Much as equipment and machinery are the main productive assets of the manufacturing economy, it is these intangible assets that are so important to companies competing in today's economy.

At first blush, these new FASB pronouncements may be seen as doing nothing more than adding to the accounting burden of acquisitions that is already quite heavy and expensive. The increased use of fair value measurements will undoubtedly increase the fees of valuation specialists and the portion of auditor time spent in reviewing those specialists' work and verifying that the footnotes and disclosures are properly presented.

However, smart buyers will turn this use of resources into a pre-acquisition tool to help in acquisition due diligence.

Increased understanding and documentation of a target's management estimates and critical business issues will help uncover true synergies while identifying earlier the impact of contingencies that could be either deal killers or wind-falls that completely change the dynamics and ROI of deals. In fact, many sophisticated buyers already do. ■

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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