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Viewpoint on Value

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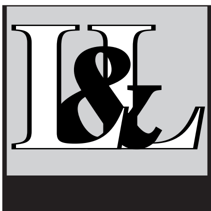

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SFAS Nos. 141 and 142: Up close and personal

For many industries, hard assets and historic costs have become antiquated metrics of financial health. Instead, today's analysts and investors want more information on intangible assets and market values.

The Financial Accounting Standards Board (FASB) has slowly begun to remedy the gap between what generally accepted accounting principles (GAAP) financial statements offer and what analysts and investors want. As a result, the FASB has passed several new standards — including Statement of Financial Accounting Standards (SFAS) Nos. 141 and 142 — that require business valuation and intangible asset expertise.

Understanding SFAS No. 141

SFAS No. 141 (*Business Combinations*) eliminated the option of recording mergers and acquisitions with the pooling-of-interest method. Instead, companies that merge with or acquire another company after June 2001 must use the purchase method, which entails allocating the purchase price to the entity's tangible and intangible assets based on their respective fair values. (See "Calculating fair value" below.)

As a result of SFAS No. 141, companies that merge with or acquire another company must give investors and analysts a better idea of their intangible assets' market values.

Purchase price allocations under SFAS No. 141 are also more complex than in the past. Now companies must differentiate goodwill from other identifiable intangible assets, such as software, noncompete agreements, customer lists and brand names.

Getting to know SFAS No. 142

In the years after a merger or an acquisition, SFAS No. 142 (*Goodwill and Other Intangible Assets*) kicks in. Formerly a dumping ground for intangible value, goodwill is no longer amortizable under SFAS No. 142. But other identifiable intangibles continue to be amortized over their useful lives.

In lieu of amortization, companies must periodically estimate the fair value of goodwill and other intangible assets. If an intangible asset's fair value has fallen below its book value, the company may need to reduce the amount shown on its balance sheet and lower its earnings to reflect the impairment. SFAS No. 142 also calls for enhanced footnote disclosures on intangible asset impairment.

Clarifying confusion

Issued in 2001, SFAS Nos. 141 and 142 continue to raise questions and concerns from financial professionals and require ongoing clarification from the FASB. These valuation assignments differ in many ways from traditional business valuation engagements.

CALCULATING FAIR VALUE

Most traditional valuation assignments call for an estimate of "fair market value." But this term is not synonymous with "fair value," the standard of value required under SFAS Nos. 141 and 142.

For instance, as defined by accounting literature, fair value is always calculated on a controlling basis. Unlike fair market value, fair value is also net of selling costs and should include any tax amortization benefits.

In addition, when estimating fair value, valuators consider only market participants — as opposed to the entire universe of hypothetical buyers.

Here are some reasons that SFAS Nos. 141 and 142 confound financial professionals:

Determining the appropriate purchase price. The first step in allocating a purchase price under SFAS No. 141 is estimating the cash equivalent price paid in a business combination, including any cash payments and liabilities incurred. But when a transaction involves payments other than cash, this seemingly simple step becomes complicated.

For instance, valuators may find it more difficult to determine a reasonable purchase price for deals that involve contingent payments or exchanges of private company stock. Furthermore, a seller under duress may accept a discounted price. In this case, the purchase price may be significantly less than the combined fair value of the entity's assets.

Using the appropriate valuation method. The FASB has established a three-tiered hierarchy of valuation techniques to help valuators estimate fair value:

Level 1. The active market to which a company has immediate access.

Level 2. Quoted prices for similar assets traded on an active market.

Level 3. Other valuation techniques, such as the market, income and cost approaches.

As evidenced by this hierarchy, the FASB endorses the guideline-public-company method for determining fair value.

Timing impairment tests. At a minimum, SFAS No. 142 requires companies to annually assess goodwill and other intangible asset impairment. But after a company has established a reporting unit's fair value, it needn't be recomputed in the future if:

- The reporting unit's components remain unchanged,
- When originally measured, the reporting unit's fair value significantly exceeded its book value, and
- No evidence exists that the reporting unit's fair value has diminished over the year.

On the other hand, some situations may require more frequent tests for impairment. For example, an interim impairment test may be necessary if the company loses a key person, a competitor introduces an innovative new product or a public company's market capitalization drops substantially below its net book value.

Choosing the right valuation professional

When selecting valuation professionals for their SFAS Nos. 141 and 142 compliance needs, clients should inquire about the experts' experience with allocating purchase prices, testing for impairment and valuing intangible assets.

Not only can experienced valuators prevent misleading financial reports, but their superior accuracy and efficiency also cost companies less money in the long run. ▮

Private vs. public companies

The New York Stock Exchange and other public markets provide readily available, objective pricing information. Therefore, valuators routinely rely on public stock market data when valuing private businesses.

Are they comparable?

For instance, the guideline-public-company method bases a private company's value on the stock prices of similar public companies. Alternatively, when employing a discounted-cash-flow analysis, a valuator uses public stock returns as the foundation for a private company's cost of capital.

Comparisons between public and private entities often have limitations and may require subjective adjustments to bridge the gap.

Keep in mind that the use of public stock market data generally results in a minority, marketable value. When using public market data to estimate a controlling interest in a private company, the

VALUATIONS ARE NOT JUST FOR PRIVATE BUSINESSES

Finding a stock price for a public company may seem like a no-brainer — just open the *Wall Street Journal* or visit Morningstar's Web site and, voila, you've got it.

But public companies (and their investors) occasionally require valuation advice, too. Here are some common reasons valuators are hired to appraise public companies:

Mergers and acquisitions. Although a public company's price per share is easily attainable, the entire company's value often exceeds its market capitalization. For instance, a strategic buyer may be willing to pay a premium to gain market share or to achieve synergies.

Bankruptcy filings. Financially distressed companies often use valuation experts during the bankruptcy process. Valuators can assess turnaround plans or identify potential spin-offs. And if a creditor claims that a public company made a fraudulent conveyance, the board may hire a valuator to provide a solvency opinion.

Fairness opinions. In light of recent accounting scandals, many boards obtain a fairness opinion before embarking on large (or controversial) transactions. A fairness opinion helps the board demonstrate that directors acted on an informed basis, in good faith, in a manner consistent with the investors' best interests, and without fraud or self-dealing.

Accounting compliance. The Financial Accounting Standards Board (FASB) sometimes requires public companies to use valuators when preparing their financial statements. For instance, public companies (as well as private companies) need appraisers to value acquired intangible assets (under Statement No. 141, *Business Combinations*) and to test for goodwill impairment (under Statement No. 142, *Goodwill and Other Intangible Assets*).

In accordance with the Sarbanes-Oxley Act and stricter AICPA independence rules, public companies must now hire an outside valuation firm — independent of their audit firm — to perform these valuation services.

valuator should consider other subjective adjustments, such as control premiums and (possibly) illiquidity/marketability discounts.

Sources of discrepancy

Although numerous exceptions exist, as a general rule, public companies trade at higher price multiples (or, conversely, pay investors lower percentage returns) than their private counterparts.

One primary reason for this discrepancy can be summed up in a single word: risk. Private companies are riskier than public companies for several reasons. Public companies generally have greater resources, more professional management, more stringent regulatory oversight and more diversified product offerings than private companies. Public markets also provide greater liquidity — or opportunities to trade securities issued by the company — which investors desire.

Another reason for the multiple discrepancy relates to management's objective in reporting income. When private companies record profits, management's primary objective is often to minimize income taxes. Conversely, public companies maximize their reported earnings per share to please analysts and investors. This philosophical dichotomy naturally deflates private company price multiples.

Possible strategies

Nearly every valuation relies on public market data to some extent. Although public market data is a key part of valuation science, valuators and attorneys need to understand its limitations.

Valuators can bridge the gap between private and public company values in several ways. For example, they can consider adjusting income streams and price multiples to ensure that their analyses compare apples to apples.

Valuators may also need to apply valuation discounts or consider supplementing their analyses with other sources of information, such as industry rules of thumb or private transaction databases.

Tax Court resolves valuators' irreconcilable differences

A "startling" difference between two "deficient and unpersuasive" valuation opinions recently forced the Tax Court to perform independent calculations to reach a compromise.

Facts of the case

At the time of her death in May 1998, Josephine T. Thompson owned a 20.57% interest in Thomas Publishing Co., Inc. (TPC). Best known for publishing the Thomas Register of American Manufacturers, New York-based TPC held "an effective monopoly in the United States on business-to-business industrial and manufacturing print publications."

From 1993 to 1997, TPC's average revenues and net income were approximately $201 million and $13.5 million, respectively. The company also held approximately $98.7 million in cash and short-term investments in 1998. Although prosperous, TPC faced one major "wild card" in 1998: the Internet and technology-related issues.

Expert opinions

The parties disputed the fair market value of the decedent's 20.57% interest in TPC:

Petitioner's expert opinion. To obtain "a more favorable valuation," the estate hired a lawyer to prepare a valuation report. With the help of an accountant, the lawyer valued the decedent's interest at approximately $1.75 million (or $3.59 per share).

These experts relied exclusively on the income-capitalization method and applied a 40% minority interest discount and a 45% marketability discount.

Respondent's expert opinion. The IRS's expert used the guideline-public-company and discounted-cash-flow methods. After substantially revising his original report, he estimated that the decedent's interest was worth approximately $32.4 million (or $66.45 per share).

The respondent's expert felt that a minority interest discount was inappropriate, because it was already embedded into the valuator's underlying methodology. But he agreed to a 30% marketability discount. The IRS also alleged that the estate should pay an accuracy-related tax penalty in excess of $7 million under Internal Revenue Code Section 6662(a).

Tax Court weighs in

The Tax Court openly criticized both experts' qualifications and analyses. The court opinion claimed that the petitioner's "inexperienced, accommodating and biased" expert downplayed the company's historic profitability, misstated financial data and was overly pessimistic in estimating the Internet's probable impact on TPC's future.

In addition, the court criticized the lawyer's aggressive, unsupported valuation discounts and 30.5% capitalization rate, which included a 12% Internet and management premium.

The court also attacked the IRS expert's "sterile" valuation approaches. It disputed the valuator's 11 guideline companies, which were selected solely on broad industry classification factors. The court also condemned the respondent's expert's numerous mathematical errors and the "questionable and inadequately explained adjustments" in his discounted cash flow analysis.

The end result

Rather than choose either expert's calculations carte blanche, the court performed its own independent calculations. Using the petitioner's income-capitalization method as a starting point, the court valued the decedent's interest at approximately $13.5 million (or $27.75 per share). This estimate included a $68 million add-back for nonoperating assets, a 15% minority interest discount and a 30% marketability discount.

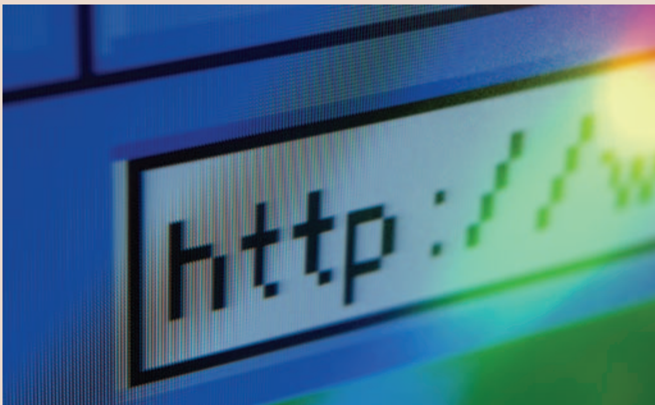
Finally, because the case involved several difficult judgment calls, the court refused the IRS request to impose an accuracy-related tax penalty on the estate. ▮

Dot-com accounting tricks

High-technology companies (commonly referred to as "dot-coms") are among the most difficult types of businesses to value. Few have established track records, and even fewer can boast a profit.

Pinpointing meaningful industry price multiples is challenging, to say the least. Price-to-revenues multiples have fluctuated wildly from the height of dot-com fervor in the late 1990s to their collective demise at the turn of the century.

To add insult to injury, dot-com financial statements are susceptible to distinctive accounting shenanigans. Valuators and attorneys should understand potential financial statement scams to ensure reliable appraisals for their high-tech clients.



4 accounting tricks

This list, while not all-inclusive, identifies four dot-com accounting conventions that may skew a valuator's conclusion:

1. Inflated revenues. Because many high-tech ventures are unprofitable, the industry focuses on price-to-revenues rather than price-to-earnings multiples. With revenues emphasized over profits, dot-coms have a distinct incentive to overstate sales, because inflated revenues artificially boost a high-tech company's stock price.

Because they don't alter profits, such scams may seem like a matter of semantics. But when an industry focuses on revenues, revenue scams can mislead investors.

2. Advertising fees paid in-kind. Dot-coms often derive a portion of their revenues from advertising fees. Many high-tech ventures, however, barter online banner ads on their sites in exchange for offline advertising or another type of good or service.

When companies report bartered advertising fees as revenues, the accounting technique can mislead investors and analysts.

Without a viable cash transaction, the market value of advertising is left to management's discretion. Dot-coms seeking to boost their stock price have an incentive to overstate the value of their bartered advertising fees.

3. Investment gains reported as operating income. More established high-tech companies are also susceptible to questionable accounting practices. For instance, some successful technology companies invest in smaller technology startups hoping to reap a capital gains bounty.

As a rule, companies report investment income outside of their operating income, because it doesn't reflect a company's ongoing ability to generate profits from core operations. But aggressive high-tech companies rationalize that these outside investments are part of their core operations and classify their one-time investment gains from the high-tech startups as operating income.

4. Stock options and EPS dilution. Cash-poor dot-coms frequently issue stock options to employees in lieu of salary to save on payroll expenses. Some stock options also provide income tax deductions in the period they are exercised.

While stock options offer several benefits to high-tech businesses, they can also mislead analysts and investors by masking the potential number of outstanding shares. Investors and analysts often rely on earnings per share (EPS) as a measure of stock performance. But when employees exercise stock options, the number of outstanding shares increases — thereby diluting the company's EPS.

The valuation upshot

Valuators need to identify how the subject company and guideline companies report revenues and expenses. Accurate appraisals require consistency

between the accounting techniques of the subject company and its comparables.

Further, before comparing the financial performance of a subject company to its comparables, a valuator should also investigate whether any companies have issued employee stock options.

A challenge

High-technology companies present valuators with numerous challenges. To achieve meaningful values for dot-com clients, attorneys should seek diligent, qualified valuators with experience in this dynamic industry.

PUTTING VISUAL AIDS TO WORK FOR YOU

In today's multimedia world, visual aids — such as charts and graphs — offer valuators a means of spicing up their presentations.

Are visual aids appropriate?

Whether to use visual aids is an important strategic decision. They not only provide a change of pace but also can simplify a complex verbal presentation. In addition, visual aids help an expert stand out when judges and jurors are faced with several divergent expert opinions.

On the other hand, visual aids add to your client's out-of-pocket expenses. They can also be a gamble. For instance, a projector blowing a fuse or opposing counsel pointing out a numeric error can diminish a visual aid's impact.

Visual aids aren't appropriate for every case. Attorneys should generally reserve them for complex cases that present several conflicting expert opinions.

Strategic considerations

When employing visual aids, the attorney and valuator should meet to identify which key points underlie the expert's conclusion. Well-thought-out visual aids will drive home these important points.

To get the highest impact from a visual aid, match the graph or chart type with its purpose. For instance, sales trends are usually best illustrated by a line or bar graph. Alternatively, a bubble or pie chart may best represent a company's relative market share or product positioning.

Repetition can help emphasize key points. Often valuators reproduce courtroom visual aids in an addendum to their written reports. Judges and jurors frequently revisit an expert's report during their deliberations, and repetitive visual memory cues can enhance an expert's verbal testimony.

When visual aids backfire

To ensure that visual aids help — not hinder — a valuator's testimony, be mindful of these common pitfalls:

Overkill. Valuators who create too many visual aids compromise their effectiveness. Astute judges and arbitrators limit the number of visual aids per expert witness, only allowing their experts to use a handful of exhibits to reinforce key points.

Distraction. The best visual aids are clean and simple. Graphs and charts should contain just enough text (via titles and legends) to explain their meaning.

Technical blunders. Before using laptops, overhead projectors or other media, do a few dry runs with your valuator. Test courtroom equipment before you use it — and *always* have a backup plan.

Mathematical errors. Finally, review the mathematical accuracy of your expert's visual materials. Recompute mathematical calculations. Compare numeric presentations to information contained in court filings and the valuator's written report. Nothing discredits an expert witness more than a sloppy mistake — particularly when blown up to life-sized proportions.

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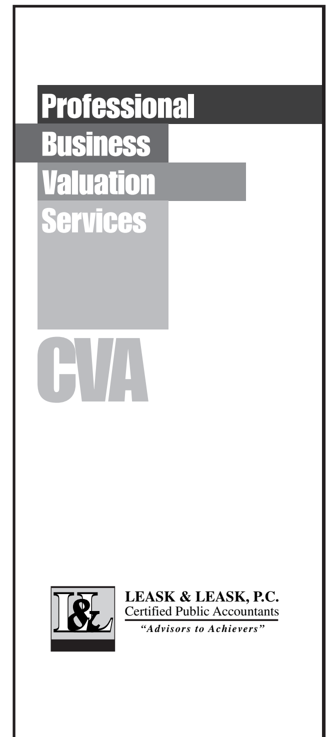
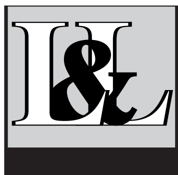
John M. Leask, II (Mac) values between 20 and 50 businesses annually for a variety of reasons. **He has done valuations to support estate and gift tax returns and has testified as an expert witness in divorce cases and shareholder disputes. Most often, Mac's valuations are done in conjunction with the purchase or sale of a business** — to assist shareholders or to set values when shareholders purchase the interest of a retiring shareholder. Recent examples of valuation engagements include a valuation done to support a pre-nuptial agreement and a valuation of a franchise business prior to purchase. Here are some more specifics about the types of engagements Mac performs:



- **Due Diligence & Assisting in the Purchase of a Business:** Mac has assisted the purchasers of businesses by determining or reviewing the offer. He is often called upon to help negotiate the purchase price and perform due diligence. These services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to the future success of the businesses.
- **Family Limited Liability Partnerships/Companies & Closely Held Businesses:** Mac is regularly called upon to value 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.
- **Expert Witness in Divorce & Shareholder Disputes**

More information about Leask & Leask's valuation services (including case studies) may be found at our firm's web site (www.leask.com).

*Contact Mac for a copy of our business valuation brochure, to schedule an individual consultation, or to discuss any other points of interest. He may be reached by phone at **(203) 384-1237, Ext. 223**, toll free at **1-888-LEASKPC (532-7572)**, by fax **(203) 384-9157**, or by e-mail: **mac@leask.com**. Be sure to visit our web site at **www.leask.com**.*



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