

Business Valuation Notes

Minnesota Business Valuation Group - 223 Little Canada Road, St. Paul, Minnesota 55117

Telephone 800 303 2889 or 612 240 0309 Fax 612 677 3881 www.BusValGroup.Com

Volume 7, Issue 10 (Copyright 2007, Minnesota Business Valuation Group, LLC) October 2007

FAIR VALUE DEFINED FOR ACCOUNTING NEW STANDARD GOING INTO EFFECT

Just when you thought you were getting an understanding of what "value" means to appraisers, another definition is about to be added. Accountants will soon have a new standard of value which has differences from those already commonly accepted. Many appraisers thought it would be deferred until later in 2008 and changed.

As interpreted by the Minnesota Business Valuation Group, LLC, the Financial Accounting Standards Board (FASB) in its October 17, 2007, Board Meeting, decided **not to defer** adoption of most of Statement of Financial Accounting Standard (SFAS) 157, Fair Value Measurements, although it had been expected to do so. Therefore, MBVG has started applying the newly defined standard of value for financial reporting. There is still a chance that there will be a deferral in implementing the new standard, but the time now set for adoption – November 15 – is rapidly approaching.

The standard pertains only for valuations used in an accounting context, such as for audited financial statements; the standard will not be used for such things as filings for the Internal Revenue Service and Department of Labor, which will continue to use a long-standing standard which has also been generally adopted for many other applications.

SFAS 157 is the accounting world's way of effectively avoiding all

of the standards already adopted by courts



Schostag

and appraisal organizations outside of the American Institute of Certified Public Accountants (AICPA), instead imposing a new way to view value. According to Randall Schostag, MBVG President, the standard has been considered by many to be confusing and seems to depart in material ways from methods and procedures which have become accepted within the wider valuation community.

In the release, FASB hedged and said that "...the Board directed the staff to evaluate other potential deferral for (1) all assets and liabilities except financial assets and liabilities and derivatives subject to the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (2) private entities, and/or (3) 'small' entities." The Board release said that those alternative deferral options will be discussed at a future meeting. This would seem to offer the chance that some provisions may still be changed before full adoption, Schostag noted. As of October 31 there have not been any additional materials from FASB regarding such alternatives.

Within the valuation community there are many "standards of value", Schostag said. There are fair market
(Continued on page 3 ... FASB 157)

Expert is Tested COURT RULES EXPERT ADMISSABLE

The United States District Court for the Western District of Texas, San Antonio Division, (Civil Action No. SA-060CA-0264 FB (NN)), recently denied a motion to exclude a valuation expert due to inadequate experience with a specific industry or his testimony because he relied on information provided by the client. The decision arose in the matter of B. J. Tidewell Industries, Inc. v. Diversified Home Products, Inc., et al., and was decided October 19, 2007.

Minnesota Business Valuation Group President Randall Schostag said in his experience as an expert (He is not a lawyer) opposing counsel attempts to impeach his testimony by first trying to show that he is insufficient as an expert and then that his work product is insufficient relative to the case. In some instances, however, opposing counsel may introduce a motion outside of the actual trial to exclude an expert. Often this consists of a request submitted to the court in an attempt to exclude evidence from the proceedings.

Such a motion may be made by a party who believes that simply the mention of the evidence could prejudice the jury against a party, even if the judge later were to instruct the jury to disregard the evidence. Most motions *in limine* in federal courts are governed by the Federal Rules of Evidence. Some others arise under the Federal Rules of Civil Procedure for failure to comply with discovery.

(Continued on page 2 ... Expert)

EXPERT

(continued from page 1)

In *Tidewell v. Diversified*, Tidewell moved to exclude the expert – Dr. Gregory Faulk – and his report and testimony.

Tidewell complained that Dr. Faulk was not uniquely qualified to testify about the valuation / economic loss of a cabinet distribution business, stating that most of Dr. Faulk's work had been related to personal injury economic losses. Tidewell also challenged the reliability of Dr. Faulk's testimony, complaining that he relied on summary spreadsheets prepared by Diversified's employees. Tidewell asserted that Dr. Faulk should have verified the authenticity of the data before ascertaining the economic loss.

The Court pointed to the Federal Rules of Evidence – 702 concluding that testimony is admissible if it will assist the trier of fact to understand the evidence or to determine a fact in issue. The court noted the testimony should be: (1) based upon sufficient facts or data, (2) the product of reliable principles and methods, and (3) able to demonstrate that the witness has applied the principles and methods reliably to the facts of the case. The Court also said that a witness may be qualified as an expert, "by knowledge, skill, experience, training, and education"

In the matter of *Tidewell v. Diversified*, the Court believed that the defendants showed their expert was qualified by knowledge, skill, experience, training, or education. In this instance the Court qualified the expert mainly on his education background and partly on his business activities. The Court indicated that, even though the expert had not previously done a valuation of a cabinet distribution business, he had the knowledge, skill, experience, training, or education to enable him to conduct such a valuation.

The Court then moved to the question of whether or not the expert's testimony was reliable. Citing Federal

Rules of Evidence – 703, the Court stated that an expert's opinion is generally admissible so long as the facts and data underlying that opinion are of a type reasonably relied on by experts in the field.

The expert had relied on the spreadsheets prepared by the company's employees, as well as financial records and interviews with company employees. Finally, he attested that the information is the type of information that experts in his field normally rely upon when performing a valuation.

The Court noted that; "although the expert did not attest that he verified the accuracy of the information he received from the company, it seems unreasonable to expect valuation experts to ascertain the accuracy of the financial information provided by their clients." As such, the Court accepted the admission of the defendant's expert.

What is the value...

DEFINE BUY-SELL PRICE & TRIGGERING EVENTS

A Wisconsin appeals court recently ruled in favor of a lower court about how a limited liability partnership was valued in a divorce, pointing out that the buy-sell agreement among participants did not specify what to do in the instance of divorce, thus enabling the lower court to make the decision about how the value was ascertained.

The case was decided in May 2007 by the Court of Appeals of Wisconsin, District Four, as an unpublished opinion (Appeal No. 2006AP3020-FT) regarding the marriage of Terry Ann Barnes v. Kent Roger Barnes. (Since it's unpublished it has no precedential value.)

MBVG analyst Joel Grundmeier said the case is a reminder of the importance of drafting thorough buy-sell agreements which consider the many "triggering" events that may occur between the parties.

"Too often we see families and

business partners who suffer the unintended consequences of badly drafted buy-sell agreements in our work," Grundmeier said. "There seems to be a tendency to take one of those agreements off the shelf and put in names without adequate attention to particular facts and circumstances of parties."

Grundmeier is a MBVG business appraiser and, as a Certified Public Accountant, is also a tax specialist with Olsen Thielen & Co., Ltd., MBVG's parent company. He said that in this case the court was to decide how to calculate the value of the husband's interest in a limited liability farm partnership with his parents.

The partnership delineated what to do in the event of a withdrawal as well as what to do in the case of liquidation. Using the calculation for withdrawal produced a higher valuation than using a calculation for dissolving the partnership. The lower court used the value obtained using withdrawal, thus providing the wife a larger settlement. The husband, on appeal, argued that the court should have used the liquidation value.

The appeals court wrote: "The main flaw in [the husband's] argument is that, while it is true there was no evidence that he was going to withdraw from the farm partnership, there was also no evidence that the partnership was going to be dissolved or liquidated. The partnership agreement quite simply did not make any provision for valuation in the event of a divorce."

In a recent presentation at the 7th Annual Minnesota CPA Business Valuation Conference, Matthew R. Crow, CFA, ASA, Mercer Capital Management, itemized seven triggering events which should be considered in all buy-sell agreements. They are: Quits, Fired, Retirement, Disability, Death, Divorce, and Bankruptcy.

Grundmeier emphasized that while he is not a lawyer, it is not uncommon for lawyers to bring appraisers into discussions when buy-sell agreements are written.

FASB 157

(Continued from page 1)

value, strategic value or investment value, and intrinsic value, for example. The new accounting name is “fair value”, though that name is already used in connection with appraisals for dissenting and oppressed shareholders. Therefore, there are now two meanings for “fair value,” according to Schostag.

FASB has said that the new standard of valuation for accountants will be fair value and will establish a framework for measuring fair value as used in generally accepted accounting principles. This statement applies under accounting pronouncements that require or permit fair value measurements, the Board having previously concluded that fair value is the relevant measurement attribute. “This statement does not require any new fair value measurements,” according to FASB. “However, for some entities, the application of this Statement will change current practice.”

FASB has observed that throughout the many accounting pronouncements over the years, and especially in recent years, guidance on fair value measurements has been dispersed and often inconsistent, making it difficult to apply to GAAP. FASB’s goal with 157 was to increase consistency and comparability and for expanded disclosure about the measurements.

James Hitchner, CPA/ABV, ASA, Managing Director, The Financial



Hitchner

Valuation Group, said at a recent business valuation conference, that the new standard uses “exit” value compared to “entry” value. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability. One of the changes in the standard is that it redefines a market participant, Hitchner said. Appraisers can no longer simply consider the time-worn “hypothetical willing buyer and hypothetical willing seller.”

Hitchner, who spoke at the 7th Annual Minnesota CPA Business

Valuation Conference, October 17 in Minneapolis, said it is important to know that the standard is seeking a value “in exchange” rather than “in use.” Schostag said that the assumption of a value in exchange creates a whole new set of considerations, if the concept is fully implemented.

“The value in exchange assumes the concept of highest and best use,” Hitchner has said, and puts much more emphasis on understanding the principal market in which the buyers are located. “The market with the greatest volume and level of activity for the asset or liability...” must be used. “If there is no principal market, an entity must determine the most advantageous market for the asset or liability.”

Schostag said that this concept could have far reaching implications in, for example, purchase price allocations, which are clearly driven for accounting applications. “A buyer may have determined a value for a particular asset, say a piece of equipment, based on its use in the business,” Schostag said. “But suddenly to comply with the new standard for purchase price allocation, the asset values may change appreciably.”

Technically, the standard requires that the entity ascertain if the asset is worth more “in use” or “in exchange.” Hitchner said that if the market participants will use the asset as part of an asset group, an in use valuation premise should be applied. But if the participants will use the asset on a stand-alone basis, an in-exchange valuation would be applied. “The use must be viewed through the prism of the market participants,” Hitchner said.

Valuation procedures, according to FASB, will use a hierarchy in determining value: Where there are observable market inputs for identical assets (or liabilities) in an active market, the inputs are considered Level 1 and are preferred. If there are other observable market inputs, they are considered Level 2 and should be used. Finally, if the analyst is unable to find observable inputs, procedures become Level 3. Level 3 includes such entity inputs as projections used for discounted cash flow analyses.

“The nomenclature sounds alarming, but the procedures already used by appraisers are consistent with this aspect of the new standard,” Schostag said. “Clearly the message here is that the market approach is favored over the income approach, something which is already important for fair market value analyses. Importantly, the standard, for those of valuing small and mid market sized private firms, becomes weighted heavily in Level 3 of the fair value hierarchy, according to Schostag. “That is because many times with small business, the quality of information about comparable companies or assets is questionable, forcing the appraiser to rely more on entity specific information, such as discounted cash flow projections.”

Another significant factor from an appraisal perspective, Schostag said, relates to blockage discounts. Hitchner noted, “Entities may not apply a blockage discount when valuing a large position in an unrestricted security...” under the new standard. Schostag said such a position would seem to fly in the face of common sense: “If there is a very large security position in a publicly traded common stock, for example,” Schostag said, “it is clear that a discount will be required in the ‘real world’ to sell the block. This seems contrary to using an ‘exit’ value that is realistic, unless a hypothetical market participant is conjured up who is going to pick up the whole block.

“MBVG will adopt the new standard as best as possible, given the uncertainties,” Schostag said. “There are likely to be more changes, interpretations, and guidance as FASB encounters real world issues with the standard.

“It’s a shame that FASB was unable to adopt more of the body of knowledge already established for valuation,” Schostag added. “The new standard will certainly be worthwhile for appraisers, but the differences, nuances really, with SFAS 157 is going to make it even more difficult for valuation users to compare appraisals conducted for different purposes and thus understand the underlying business. It’s also likely to result in more fees for appraisers.”

Minnesota Business Valuation Group

Professional Business Appraisals

Minnesota Business Valuation Group, LLC

A subsidiary of

OLSEN THIELEN & CO., LTD.

Toll Free: 1 800 303 2889

Ph: 612 240 0309 Fax: 612 677 3881

Email: RSchostag@BusValGroup.Com

[Http://www.BusValGroup.com](http://www.BusValGroup.com)

BUSINESS VALUATION

Goodwill Impairment Analysis (141/142)

Businesses

Intellectual Property

Intangible Assets

Options

Strategic Planning

ESOP

Divorce

Shareholder Oppression / Dissenting Rights

Buy/Sell Agreements

Merger / Acquisitions

Fairness Opinions /Purchase Allocation

Planning

BUSINESS ASSET VALUATION

Experts or Consultants

Sale / Purchase

Insurance

Fair Rental Rates

Financing

Ad Valorem Taxes

Condemnation

Feasibility

Purchase Price Allocation

Property Records

Fiduciary Review

Sale / Leaseback Structuring

Business Planning

**WE ARE AVAILABLE FOR PRESENTATIONS FOR ESOP IMPLEMENTATION,
MERGER & ACQUISITION CONSIDERATIONS, EXPERT TESTIMONY PREPARATION,
GENERAL BUSINESS VALUATION, AND MANY OTHER TOPICS.**

OUR FORMAT IS POWER POINT - BASED.

**WE REQUEST THAT YOU SUPPLY THE SOUND SYSTEM AND APPROPRIATE DISPLAY
INSTRUMENT.**

WE WILL CONNECT OUR COMPUTER.

PLEASE ALLOW AT LEAST 30 DAYS FOR SCHEDULING.