

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

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NEW STANDARDS FOR BUSINESS VALUATION WORK ISSUED BY AICPA

Expect more Questions from your CPA

Effective January 1, 2008, anyone who is a Certified Public Accountant or who is associated with a CPA practice which is a member of the AICPA will now be governed by new rules when preparing business valuations.

Joel Grundmeier, CPA, Minnesota Business Valuation Group analyst, said the standards must be applied if a CPA provides a full appraisal as a valuation engagement, but must also be applied for very informal valuations, such as when a client asks for a 'quick and dirty' idea of value, which are now called 'calculations'.

The new standards were set forth by the AICPA Consulting Services Executive Committee as the *Statement on Standards for Valuation Services No. 1 (SSVS No. 1)* in June 2007 and takes effect in the new year.

Minnesota Business Valuation Group, LLC President Randall Schostag said that MBVG has been slowly adopting the new standards and that its effect in documentation and reporting will be more apparent in December.

"These standards are the culmination of several years of debate within the accounting community," Schostag said. "We believe that the standards enhance the quality of valua-

tion work done and that the new standards will be good for those who need valuations done. The standards *should* ensure at least minimal quality work from those doing the work."



Schostag

SSVS No. 1 will apply to all disciplines, such as audit, tax, consulting, personal financial planning, and litigation services, for example; any CPA who performs business valuation services.

During November there were numerous seminars, newsletters, and other announcements issued by the AICPA, the National Association of Certified Valuation Analysts, and other valuation trade publications and certifying groups, according to Schostag.

"There is no reason for any Certified Public Accountant to argue that he or she has not heard about the new rules and does not comply for that reason," Schostag said.

NACVA, one of the certifying organizations for appraisers, has also been rewriting its standards to conform with the new AICPA standards. While not yet finalized and issued, NACVA's new standards in draft appear to be a restatement of the AICPA standards, but NACVA's standards are shorter in that they do not

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FASB 157 DEFINING WHAT FAIR VALUE MEANS

The Statement for Financial Accounting Standard 157 took effect November 15, 2007. Along with it, appraisers, accountants, and chief financial officers in companies which are audited must now use *Fair Value* as modified by the standard for financial reporting purposes.

"We've heard many questions about when to use SFAS 157," Randall Schostag, President, Minnesota Business Valuation Group, said. "The standard will be used only in the context of valuation for accounting purposes, such as for purchase price allocation, goodwill impairment, valuing options for audit purposes, and so forth. The standard does not apply to valuations for other purposes, such as for gift and estate valuations, shareholder disputes, divorce, and other situations where there are already defined standards to apply."

Business Valuation Notes reported in the October 2007 issue about the issuance of FASB 157, noting that many of its provisions remain unclear, especially with respect to non-financial assets.

There was a last minute discussion by the Financial Accounting Standards Board on November 14, but the accounting body decided to require compliance with SFAS 157 beginning November 15 in spite of the lingering questions. Further clarification and guidance is, therefore, likely, including possible redrafting of some sections, Schostag believes.

Standards

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go into as much 'methodology' as the AICPA version.

Lari Masten, an affiliate of the Minnesota Business Valuation Group and instructor of the new standards, said that the AICPA included much more detail about approaches, methods, and other valuation procedures in the standard because many of the accountants simply are not familiar with what constitutes a proper valuation.



Masten

Masten, MSA, CPA/ABV, CVA, is President of Masten Valuation in Denver Colorado. She was joined in co-presenting *Working Through the BV Standards Maze* in a half-day workshop November 30 in Minneapolis, Minnesota, by Mark Kucik, CPA, CVA, CM&AA, President of the Kucik Valuation Group, in Chicago, Illinois. The session was sponsored by NACVA for members.

Much of the AICPA standard reads like valuation 101 in that it includes minimal work which must be done by a CPA for providing an opinion of value. Kucik and Masten observed that many CPAs have never taken a valuation course and simply are not aware of what is required. The new standard will offer that guidance.

Richard Thorsen, CPA/ABV, CMEA, CSBA, a Minneapolis-based appraiser who has been active both as an appraiser and a CPA in the Twin Cities community and nationally, also presented the new standards November 27 at the annual Minnesota state NACVA meeting in Minneapolis.



Thorsen

Thorsen emphasized the link between SSVS No. 1 and other CPA professional standards, including the *AICPA Code of Professional Conduct*

and the Statement on Standards of Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards (AICPA Professional Standards. Vol. 2, CS sec 100)*. The existing standards are also clear with respect to competency, i.e. is the CPA capable of performing the work. This is addressed in Rule 201A, *Professional Competence, of the AICPA Code of Professional Conduct (AICPA Professional Standards, No. 2, ET. Sec 201.01)*, according to Thorsen.

Numerous publications have been sent over the last 60 days by the AICPA, by NACVA, and have been published by industry resources such as *Business Valuation Update*™, a monthly publication of Business Valuation Resources.

In addition to adoption by NACVA, early indications are that the other appraisal organizations, including the American Society of Appraisers and the Institute of Business Appraisers will also adopt most of the points set forth by the AICPA.

On a national level the Appraisal Foundation had promulgated standards known as the Uniform Standards of Professional Appraisal Practice or USPAP which arose after there were severe strains in the savings and loan industry after it was learned that most of the real estate and other tangible asset appraisals which had been used to support loans were wrong with respect to the values which they gave lenders.

Although Federal appraisals require compliance with USPAP, the certifying organizations (ASA, IBA, NACVA, AICPA) were dismayed by the politics which arose within the body and the foundation's failure to include the voices of business valuation practitioners. Only ASA, therefore, ended up requiring compliance with USPAP while the other organizations refused to require compliance with that standard. Since Federal appraisals are minimal for business valuation, they've had little effect for business valuation for not complying with USPAP.

The rise in recent years of the AICPA in the valuation profession, including the recent issuance of the new standards seems likely to finally create some cohesion among appraisers, Schos-

tag said. "CLARENCE is a group of national certifying bodies which has collaborated for several years on establishing some uniformity on valuation terms," according to Schostag. "That group, which now includes the AICPA, seems to have been elevated lately to adding standards to the list of things on which these organizations should find common ground."

An early signal about the various certifying bodies coming together is the apparent agreement about how to handle work for clients which requires less than a full appraisal. In the past there have been several terms used for such limited engagements, and often times an organization would simply deny an appraiser's ability to undertake any engagement which was less than a complete appraisal. AICPAs SVSS No. 1 has shifted that debate and now permits such limited appraisals, calling them 'Calculations'.

The new AICPA standard clarifies valuation work by separating the gathering of information and conduct of analysis as Development and the issuance of findings as Reporting. As such the standard makes it easier to ascertain what is required at each step.

For any Valuation Engagement, the Development of information must be thorough, without exceptions. In Valuation Engagements, the appraiser must apply his or her full knowledge, skill, and experience when ascertaining a value. For a Calculation Engagement, the appraiser and the client must agree in advance to certain Procedures, many of which may not be in accordance with accepted appraisal practice and, therefore, are unlikely to provide an indication of value which would be obtained if proper procedures were used for a Valuation Engagement.

"At first blush, a Valuation Calculation may sound like a big loop hole for CPAs to continue to offer 'off the cuff' pencil valuations for clients," Schostag said. "But there are substantial requirements for the CPA to fulfill: the procedures must be defined and agreed to and all underlying documentation must be prepared and saved. There is also the question of assurance that these limitations have been agreed to."

ACCOUNTING STANDARD HEIGHTENS CONCERN FOR VALUING MULTIPLE SECURITIES

Issuance of SFAS 157 coincides with increased pressure on equity portfolio managers to provide better valuations of the underlying securities in their portfolios. Various organizations are rushing in to offer guidance to the managers for portfolio compliance, but the cost is likely to be high.

Rawley Thomas, President of Life Cycle Returns and a Principal of the Minnesota Business Valuation Group has noted that there has been a consistent battle between portfolio managers 'marking securities to the market' or 'marketing securities to a model'.



Thomas

With the added guidance now issued by the Financial Accounting Standards Board, more auditors and chief financial officers of equity funds are going to be 'on the line', according to Thomas, to do a better job of ascertaining the 'real market value' of holdings.

The recent controversy over hedge funds which held securitized mortgages with variable interest rates has increased attention of both investors and regulators over how fund managers are reporting their holdings. Accounting auditors are among those caught in the middle of these debates given their role in attesting to reported values on the financial statements. Numerous funds have had large losses in what had been thought were comparatively low risk, interest-bearing securities.

"The biggest question about marking to a model in the past has been a failure of the model to provide empirical support for the values," Thomas said. "The new standard clearly differentiates between 'theory' and being able to offer empirical validation of the values.

The portfolio valuation system developed by LCRT in association with the Minnesota Business Valuation Group has stressed being able to conduct 'back testing' so that platform users are assured of the reliability of the values obtained. The back testing provides a way to determine a 'confidence level' of findings so that the auditor and outside users, including investors, are able to gain a sense of the reasonableness of findings.

Thomas, who was the 'T' in HOLT, which developed a semi automated, proprietary equity valuation system which was eventually sold to Boston Consulting Group and then to Credit Suisse, said that a significant aspect of SFAS 157 is the definition of 'levels' when using procedures for the valuation the auditor uses.

Level 1 procedures are the most accurate, according to SFAS 157, and are simply a reporting of the price at which the security has been trading in a market which should be reflective of value (not thinly traded). Level 2 procedures may use values obtained from similar securities, similar to methods now used by appraisers and called the market approach. Level 3 are all other non observable methods and procedures, such as the income approach. Both Level 1 and Level 2 use observable transactions in the market place, while Level 3 values are developed using much more subjective input, according to those familiar with the FASB, and are considered based on non observable inputs.

"At first glance the definitions of the various levels used to develop values for financial reporting seem to be of no consequence," Thomas said. "But the new standard goes on to give guidance as to what

the auditors are going to have to do for their working papers and footnotes when receiving information from these various levels."

Essentially, the portfolio manager / compliance director / auditor will be required to designate which securities are valued by which level, thus setting up 'buckets' of securities. Level 1 is not a major concern (except for blockage discounts which may be eliminated under the new standard). Level 2 will require some additional documentation since, although using observable inputs, it is indirect in obtaining value. Level 3, however, will create a huge issue for portfolio managers and auditors, requiring a great deal of documentation.

"To the extent that portfolio managers are able to reduce the number of securities in the Level 3 bucket," Thomas said, "the audit will cost less money. Let's face it: these requirements on fund managers look like they are going to be very, very expensive."

To get to Level 2 from Level 3 requires quoted prices for similar assets or liabilities in active markets, quoted prices for similar assets in inactive markets, observable data other than quoted market prices such as interest rates, yield curves, credit / default rates, etc., and / or derived information such as from correlation / regression from observable market data.

The LCRT / MBVG model for semi automated portfolio valuation is based on publicly traded information over an extended period of time and uses company specific economic information compared to pricing. The price, model obtained is then applied to the specific economic information for a company over a period of years and compared to stock pricing in those years go obtain a confidence level in the model.

BUILT- IN CAPITAL GAINS ENFORCED FOR TAX PURPOSE

In a recent appeals court ruling, the tax court value was vacated and the value of an investment holding company was remanded, ordering the tax court to use a dollar-for-dollar reduction of the entire built-in capital gains tax liability of a company.

The matter relates to the Estate of Frazier Jelke, III, deceased, versus Commissioner (United States Court of Appeals for the 11th Circuit, 2007 U.S. Appeals No. 05-15549, Tax Court No. 1 3512-03). The appeals decision was filed November 15, 2007.

At issue was whether or not the Tax Court used appropriate valuation methodology in computing the net asset value of a closely-held, investment holding company to determine the value of Jelke's interest in a closely-held, investment holding company for estate tax purposes on the date of death.

The tax court allowed the estate only a partial discount for the company's built-in capital gains tax liability, indexed to reflect present value on the date of the decedent's death. It used projections based on findings as to when the assets would likely be sold and when the tax liability would likely be incurred.

The estate held a 6.44% stock interest, or 3,000 shares, in Commercial Chemical Company; the shares were appreciated and marketable.

The Commissioner's expert witness allowed the estate only a partial \$21 million discount for the built-in capital gains tax liability. Additionally, the expert based the estimate on the present value of such a claim as to when it would occur, over a 16-year period. The contingent liability was much greater, i.e. \$51 million, according to the expert representing the estate.

The estate's position was based on the Estate of Dunn versus Commissioner, 301 F.3d 339 (5th Cir. 2002) that a 100% dollar-for-dollar discount was mandated for the entire \$51 million.

Under de novo review, as a matter of law, the court of appeals accepted the precedential authority of Dunn (at 350-55). The court acknowledged that accepting the full value without discount uses the arbitrary assumption that the holdings would be liquidated at the date of death rather than at some future point. The parties had also stipulated that in the five years prior to death there was no intent to liquidate the company. Both of the appraisers had agreed to a 20% discount for lack of control and a 35% discount for lack of marketability.

Because the estate had used \$51 million instead of \$21 million, on December 2, 2002, the IRS issued a notice of deficiency for estate tax of \$2,564,772. The Commissioner determined that the decedent's interest was worth \$9,111,000 and not \$4,588,155 as claimed by the estate.

In March 2003 the estate filed a petition contesting the deficiency. After a two-day bench trial, the tax court rejected the estate's position of a dollar-for-dollar reduction. Specifically, the tax court said a hypothetical buyer of only 6.44% would not be able to cause or force liquidation of the company. Furthermore, the company's long history of dividends and appreciation, with no immediate plans to liquidate (one trust continues until 2019), together with its low turnover of securities belied the "arbitrary assumption" of complete liquidation on the valuation date.

Determination of the likelihood of actual liquidation could be important, according to MBVG President Randall Schostag, in that it would be the only likely event which would actually result in incurring the capital gains tax.

The tax court had also differentiated the Estate of Jelke from the Estate of Dunn in that the later case was for a majority or controlling interest as compared to the Jelke case which was clearly a minority. Schostag said that this mat-

ter is important in that in most instances a controlling interest investor is generally considered to have the ability to buy and sell assets whereas a minority investor does not have that ability.

The tax court cited extensively the Tax Reform Act of 1986, Pub. L. No. 99-514, Section 631, 100 Stat. 2085. Noting that the act made dramatic tax law changes, including requiring recognition of the corporate-level gains on the distributions of appreciated property, thereby repealing what had been previously in effect, viz., the General Utilities doctrine and certain Internal Revenue Code sections (311(b), 336, and 337).

"Prior to the repeal of the General Utilities doctrine by TRA 1986, no corporate tax would have been required to be paid and no discount would have been allowed. TRA 1986 required recognition of corporate-level gains and losses on liquidating sales and on distributions of corporate property," the appeals court wrote.

The appeals court said that due to the taxpayer's inability to receive a step-up basis to fair market value on the valuation date after TRA 1986, it then became important for a taxpayer to be able to quantify his or her loss in value of the stock due to inherent capital gains tax liability in the company.

Despite this general recognition, the tax courts continued to argue against a discount for capital gains for the next 12 years until in the Estate of Davis versus Commissioner (110 T.C. 530 (1998)) the tax court noted that a hypothetical willing buyer and seller would have taken such a capital gains tax into consideration. Although it did not explicitly permit a discount for the capital gains tax, it did allow a larger discount for lack of marketability.

In another case, Estate of Eisenberg, 74 T.C.M. (CCH) 1046 (1997), the tax court again disallowed a capital gains discount, but on an appeal (155 F.3d 50, 57 (2nd Cir. 1998), the court concluded that, even though no liquidation or sale was imminent, such a requirement was unnecessary.

Subsequent cases have further eroded the IRS position and upheld (See Estate of Jameson and Estate of Welch) the capital gains discount.

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)

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