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Summer, 2002

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Why Do You Need a Business Appraiser?

(in no particular order!)

1. You are involved in estate planning and your client has an interest in a closely held business. Your client may be a successful businessman who wishes to provide for his family without incurring punitive estate or gift taxes. A competent business appraiser will work with the attorney to determine what discounts are legitimately available to values so that the appropriate structure can be created in order to achieve the client's goals.
2. Your client owns several revenue-producing properties and for estate planning and other purposes, you advise transfer of some properties to a Family Limited Partnership. Limited partnership interests therein are either sold to a generation-skipping trust or gifted. At any rate, a business appraiser will value the limited interests by applying reasoned discounts to the appraised (by a real estate appraiser) value of the underlying properties. The discounts allow the properties, over time, to pass to the ownership of the designees and minimize the tax due.
3. You represent a private business contemplating an acquisition or wishing to spin off a division. Again, a "bullet-proof" appraisal is important to have even if, for strategic reasons, management decides to hold out for a price in excess of fair market value or a strategic buyer is forced to pay more than fair market value.
4. You represent a private business with minority shareholder issues. An appraisal will save your client a good deal of grief by pointing out exactly what the potential litigant is entitled to under state law: Fair Value is a standard more or less defined by state law and is likely to produce a different result than the tax-based Fair Market Value standard.
5. The business you represent is buying a financially weak competitor. You are concerned that the seller's creditors, who are probably not going to get paid in full, will claim that adequate consideration was not received by the seller. You need a Fairness Opinion prior to closing; the opinion is designed to make it considerably more difficult to make that claim.
6. You represent a financially weakened business in need of some strategic planning. The owners need to have a candid assessment of the competitive situation, and of the various valuation-based alternatives.

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Carrying Amount Conundrum

SFAS 142 Update

Intercompany Debt Allocations. In performing valuation analyses for step one impairment testing under SFAS 142, the determination of the appropriate carrying amount of the reporting unit can often be less straightforward than anticipated. The carrying amount of a reporting unit is presumably the net of the carrying values of the assets (including goodwill) and liabilities assigned to the reporting unit. Paragraph 32 of SFAS 142 addresses the assignment of assets acquired and liabilities assumed to reporting units.

> *"For the purpose of testing goodwill for impairment, acquired assets and assumed liabilities shall be assigned to a reporting unit as of*

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7. Determination of a planned exit strategy for the owner of a closely held business. Somewhat related issues include motivating your team through phantom stock, and succession planning in all its possible forms (with your children or 3rd party management).

8. Drafting of a Buy-Sell or Shareholders' Agreement: The most useful Buy-Sell agreements are those that take the evolving value of a business into account; the very best require periodic input by a business valuation professional in such a manner as to avoid costly litigation and help realize all the shareholders' goals.

9. Determination of value for business interruption insurance coverage and appropriateness of coverage generally.

10. Support planned giving involving interests in closely held businesses.

11. Employees Stock Ownership Plans ("ESOPs"). There are hard tax reasons, as well as practical ones, to sell the family business to an ESOP. Besides creating liquidity for the owners, an ESOP could actually eliminate all built-in capital gains for the seller under specific circumstances. Besides, if your employees truly are responsible for the success of the business, why not sell it to them? An ESOP can also motivate key people if it creates the right culture. How about an ESOP through an S corporation which would put the business at a significant tax advantage?

12. Your client, a C corporation wishes to elect to be taxed as a sub-chapter S corporation. At that point, its value must be established so as to avoid costly problems with the IRS at a later date.

13. Your client is purchasing a business rich in intangible assets, which could include a high-tech venture or a professional corporation. In order to allocate as much as possible to faster-to-depreciate asset categories, you retain a business appraiser to value those intangible assets: intellectual property, patents, computer software, "masks," in-process research and development, etc. See also item # 18 below for relevant new accounting standard.

14. Certain types of businesses such a law partnerships are difficult to value, but we have the knowledge to do it credibly.

15. Litigation support involves providing the financial and valuation perspective to a lawsuit in order to make it more effective. We work with attorneys and make sure your action stays focused and works towards your financial goals.

16. You are a family law practitioner and your client or the opposing party to the action own(s) a closely held business or a professional practice. This could includes options and other complex assets. You need a specialist to determine, in a credible manner, what the value is based on the law. The appraisal needs to withstand the scrutiny of the opposing side and its expert, and more importantly needs to convince the judge or jury.

17. When complex valuation issues are at stake in a lawsuit, it pays to have a business valuation professional make sure they are understood by all parties: you need a business valuation expert witness.

18. If the financial statements of your business are audited, generally accepted accounting principles now require that intangibles be accounted for and periodically tested in a specific manner. Accounting firms now generally advise their clients to support the accounting treatment of an acquisition, of the periodic testing and of an event leading to impairment of goodwill, by an independent third-party appraisal.

19. Employee Stock Options in both public and private companies require focused valuation services. Ask us to advise you about your specific circumstances.

20. Professional corporations present valuation challenges in divorce or buy/sell situations since few financial statements are generally available beyond personal tax records. Further, professional corporations are complex businesses with both a personal and an entity goodwill. We can help.

21. Estates often own secured or unsecured promissory notes. A business appraiser will value these assets with appropriate analytical, empirical and factual support so as to minimize the risk of a costly IRS audit.

22. Family Limited Partnerships and Family LLC's are emerging as the vehicle of choice, when properly structured and valued, to tranfer, over time, portfolios of real estate or securities to your clients' families *and* minimize the still very much alive transfer taxes.

23. Fractional interests in real property are also subject to discounts in estate or gift situations, if you can document the discounts in a reasoned manner consistent with the latest in business valuation as well as relevant tax case law.

There are several other situations where you should suggest hiring a Business Valuation professional in order to make sure you and your client have the best advice. We have the middle-market and the valuation experience; we have the credentials and take the time to do it right. Call us at 203-325-2703 or visit our website at www.NYNJCTbizval.com. ◆

Carrying Amount Conundrum

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the acquisition date if both of the following criteria are met:

a. The asset will be employed in or the liability relates to the operations of a reporting unit.

b. The asset or liability will be considered in determining the fair value of the reporting unit.

Assets or liabilities that an entity considers part of its corporate assets or liabilities shall also be assigned to a reporting unit if both of the above criteria are met. Examples of corporate items that may meet these criteria and therefore would be assigned to a reporting unit are environmental liabilities that relate to an existing operating facility of the reporting unit and a pension obligation that would be included in the determination of the fair value of the reporting unit. This provision applies to assets acquired and liabilities assumed in a business combination and to those acquired or assumed individually or with a group of other assets."

Extending this advice to allocating existing assets and liabilities to reporting units, two primary conclusions can be drawn:

1. Tangible (and recognized identifiable intangible) operating assets and liabilities should be allocated to the reporting units for which the assets operate, and the liabilities are incurred.
2. Financial assets and liabilities should be allocated in a manner consistent with the valuation assumptions made regarding the reporting unit.

Application of the first conclusion is straightforward. Implementation of the second conclusion is complicated by the tendency of large multi-unit companies to maintain complex systems of intercompany receivables and payables. To the extent intercompany funding items allocate the actual financing structure of the consolidated entity to the reporting units, it appears to be appropriate to rely on the intercompany liabilities and assets in determining both fair value and the carrying amount comparison. However, to the degree intercompany items are not representative of the actual consolidated capital structure (thereby creating a large net "corporate" receivable from, or payable to, the reporting units), it is appropriate to eliminate the "excess" intercompany balances from the carrying amount determination of the reporting units.

... these issues raise a warning to auditors, valuation professinals and corporate finance professionals that even the "simple" step one analysis may be fraught with unexpected complexity ...

The following principles are consistent with the FASB's guidance in SFAS 142:

1. Analyze the earning power of the reporting units on an operating basis (EBIT), ignoring financing concerns.
2. Allocate 100% (no more or less) of the actual debt outstanding to the reporting units on some logical basis (the relative amount of intercompany debt assigned to the unit may be such a basis). Subtract the implied interest expense from the ongoing EBIT estimate to derive ongoing pretax, and net, income. Alternatively, value may be estimated on the basis of some relevant total capital multiple, from which the allocated amount of actual debt outstanding would be subtracted to determine fair value.
3. Determine the carrying amount of the reporting unit on the same basis as actual debt outstanding was allocated to estimate the fair value of the reporting units.
4. Confirm that the combined net earning power of the reporting units equals that of the consolidated entity, and that the combined carrying values of the reporting units equals consolidated book value. In general, the net "corporate" carrying amount should be minimal.

In the end, the determination of the carrying amount is an accounting, rather than a valuation, concern. Regardless of how carrying value is ultimately derived, the estimation of fair value must be consistent with all assets and liabilities, both operating and financial, allocated to the reporting unit. A valuation expert should not perform a fair value opinion without a thorough, documented understanding of the assets and liabilities assigned to the reporting unit.

Negative Carrying Amount. There is a concern about the possibility of negative carrying amounts for reporting units and these concerns can be divided into two distinct issues:

1. Is the notion of a negative carrying amount consistent with the purpose of the goodwill impairment test? In other words, is it possible for a reporting unit to really have a negative carrying amount?
2. Is the fair value of a reporting unit necessarily non-negative? If so, it would appear that the goodwill of a reporting unit with negative carrying amount could never be impaired (under step one of the impairment test).

With regard to the first issue, we note that the purpose of step one of the impairment test, at the simplest level, is

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to determine whether the business acquired via a prior deal is worth more or less today (fair value) than what was actually paid (carrying amount). Since business combinations are generally consummated at positive prices, it would appear that carrying amount should never be negative. However, at least two potential real-life scenarios may complicate this assumption. First, as has been discussed at length, reporting units may consist of multiple business acquisitions, as well as "organically" grown operations. This robs our initial conclusion of at least a portion of its logical clarity. Second, operating losses (presumably larger than any expected) subsequent to the acquisition may cause the company to finance the reporting unit's operations with additional liabilities sufficient to overwhelm the initial equity investment, causing the reporting unit's carrying amount to indeed be negative.

To address the second issue, some adhere to the concept that the value of common equity is non-negative, regardless of the relative (im)balance of assets and liabilities. This position is frequently supported by noting that common equity is analogous to a call option on the company's operations. Therefore, regardless of the current degree of moneyness (excess of enterprise value over liabilities), the common equity can be worth no less than zero, since the common shareholders retain the right to walk away from the company's liabilities. In the case of reporting units which represent only a portion of the company's total operations, this assumption may not be appropriate, however. In other words, the company may not be able to walk away from the liabilities assigned to the subject reporting unit without a direct negative impact on the company's other operations.

Regardless of how carrying value is ultimately derived, the estimation of fair value must be consistent with all assets and liabilities, both operating and financial, allocated to the reporting unit

There may be, then, situations in which one or more of a company's reporting units may have a negative fair value. Such a situation may often correlate with a negative carrying amount, thereby mitigating the potentially asymmetrical case in which a reporting unit's fair value is negative due to poor operating performance, yet goodwill is necessarily unimpaired since a non-negative fair value would obviously pass step one of the goodwill impairment test.

The complexities related to carrying amount determinations discussed in this article may reflect certain scenarios not fully contemplated by the FASB in the new Standards. It is, after all, difficult to foresee every possibility beforehand. At a minimum, these issues raise a warning to auditors, valuation professionals and corporate finance professionals that even the "simple" step one analysis may be fraught with unexpected complexity that requires solid analysis and concise explanation. Please call us if we can be of assistance. ◆

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