

# The Expert

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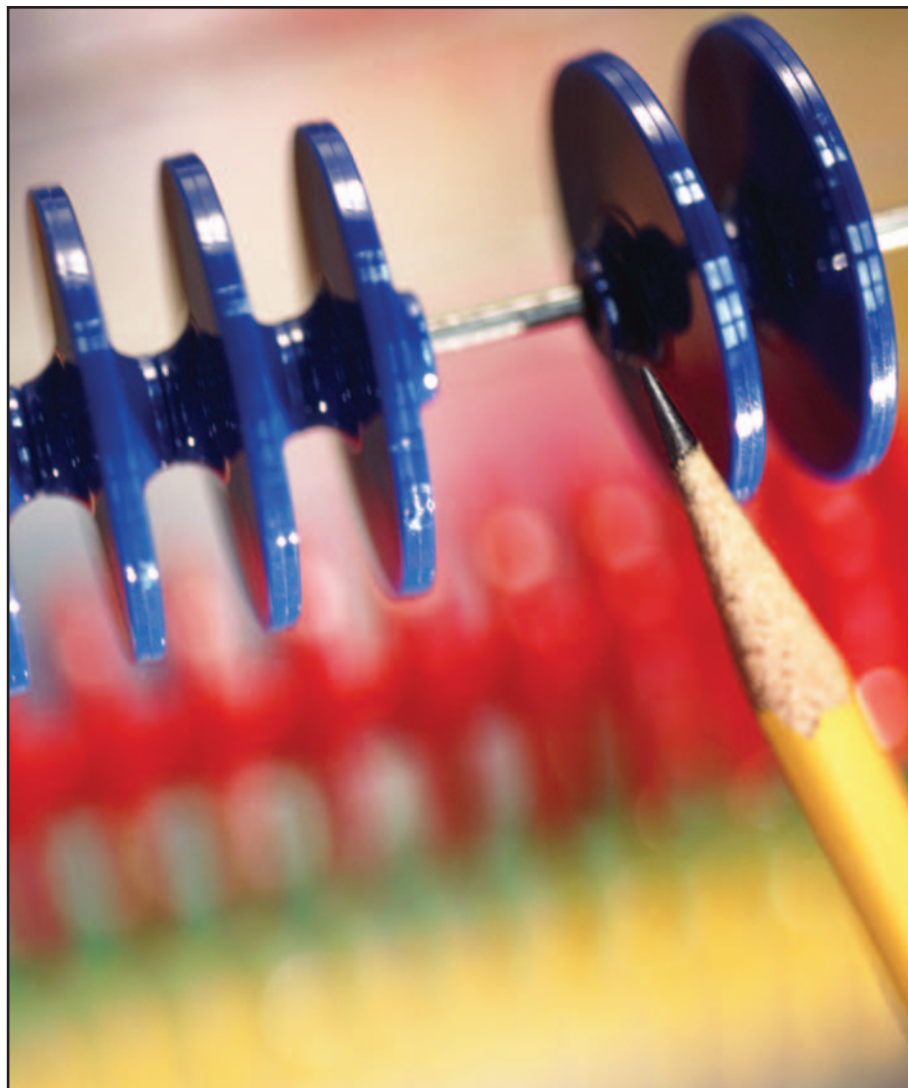
## The market approach remains a valuation touchstone

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## Find me the money!

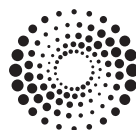
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# As easy as 1, 2, 3

M&A goes smoother with a financial expert on your side

**M**erger and acquisition (M&A) transactions can be daunting endeavors for both buyers and sellers. That's why putting a financial expert proficient in valuation methods on your side, whichever side it may be, can help reduce guesswork and give you a better shot at a winning deal.

## Stage 1: Predeal assistance

Financial experts are able to assist sellers in the early stages of an ownership transfer in many ways. For starters, he or she can help you establish realistic expectations about value based on comparable business sales and, thereby, assist you in setting a reasonable asking price.

An expert can create an informal prospectus to distribute to qualified buyers. Or, if you're gifting interests to your heirs, a formal appraisal can be used in conjunction with a gift tax return. Perhaps a fairness opinion would help support a management buyout in such cases.

On the flip side, buyers tend to undervalue a business. When you're considering expanding

through M&A, an expert can provide an objective estimate of what the business and its underlying assets are worth — so you make a reasonable offer without overpaying.

You can also turn to a financial expert for help in identifying assets and liabilities that aren't on the balance sheet, such as:

- Customer lists,
- Brand names,
- Goodwill,
- Undisclosed pending litigation, and
- Contingent tax liabilities.

Other due diligence hot spots include inventory and receivables verification; assignability of leases, loans and franchise agreements; revenue recognition policies; employee retention; normalization adjustments; and related-party transactions.

## Stage 2: Just before closing

How the M&A deal is structured is critical. Why? Because it affects how the balance sheet looks in

the future, how much risk the new business is exposed to and how much the new business will owe in taxes.

Experts know which terms are effective in reaching objectives of buyers or sellers. For example, earnouts are especially popular in an uncertain economy, because the seller retains some risk. If sales don't pan out as expected, the seller



## Operating a “sale ready” business

Smart business owners always operate as if they’re planning to sell — because they never know when someone will come along with an irresistible offer or when tragedy might strike.

So what does it mean to operate “sale ready”? It means preparing reliable, transparent financial statements that comply with Generally Accepted Accounting Principles (GAAP). It means hiring a CPA to audit your books, creating formal plans and budgets, and implementing a strong system of internal controls. It means engaging a qualified appraiser for regular business valuations.

When potential buyers must make financial statement adjustments to get a clearer idea of what’s for sale, it makes them uneasy and may decrease your selling price. These include adjustments for nonrecurring one-time expenses, related-party transactions, unreported cash receipts, or below- (or above-) market owners’ compensation. Fixed assets should be well maintained and replaced if necessary.

Decentralized management structures appeal to potential buyers, too. Train the next generation of managers, and establish contingency plans. Life insurance policies are also an important part of surviving the untimely loss of a key person.

will receive lower earnout payments. To minimize their risk, many sellers stay on as consultants to ease management transitions and help the business meet its short-term goals.

The parties also must agree on whether to transfer specific assets or stock in the business, and financial experts can contribute insights on which way to go. Asset sales are like a fresh start; after a new entity acquires the specific assets and liabilities, new contracts, licenses, titles and permits are required.

Acquired assets are reported at fair market value, and the buyer receives a step-up in basis, which lowers future capital gains tax and starts depreciation anew. The seller, however, must pay capital gains on the assets sold and, if the seller is a C corporation, again when winding down the business.

When stock (rather than assets) changes hands, business operations continue uninterrupted. Stock sales are generally less messy, because assets stay at book value and existing depreciation schedules

apply. But stock sales carry additional risks: The new buyer inherits all of the seller’s liabilities — including undisclosed and contingent obligations.

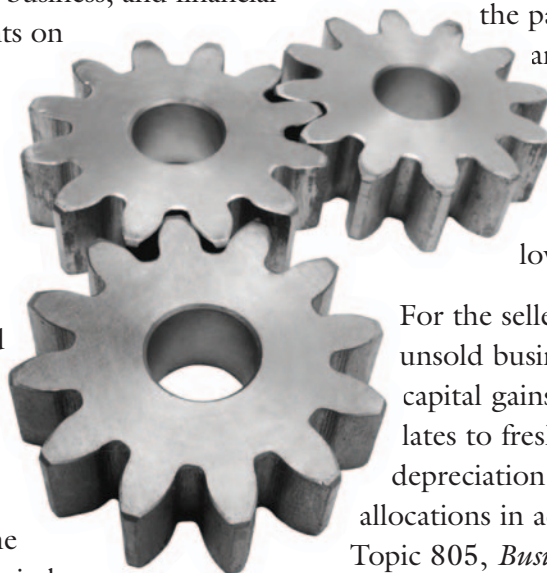
### Stage 3: After the dust settles

After the deal closes, a financial expert can help the parties handle their postdeal tax and accounting issues, including postclosing purchase price adjustments. In-house accounting personnel are often unfamiliar with how to account for changes following an M&A transaction.

For the seller, this means winding down any unsold business operations and handling capital gains tax issues. For the buyer, it translates to fresh-start accounting, including new depreciation schedules and purchase price allocations in accordance with FASB Codification Topic 805, *Business Combinations* (formerly Statement No. 141R).

### A little easier

As a private business owner, you may find that an M&A transaction is the most important and difficult challenge you’ll ever face. Why leave anything to chance? Add a valuation-savvy financial expert to your team to make life at least a little easier. ♦



# The market approach remains a valuation touchstone

Under the market approach, appraisers use guideline companies to help them estimate the value of a private business. With so many companies in circulation, this approach has become a long-standing valuation touchstone.

## Picking a category

Two primary valuation methods are categorized under the market approach. First, there's the guideline public company method. Under this method, appraisers identify companies whose stock (or partnership interests) is actively traded in the public markets, such as the AMEX or NYSE. Then they calculate key financial variables, using the stock price and a variety of pricing multiples such as price-to-revenue, price-to-net income and price-to-book.

*The availability of transaction data is a key determinant of whether an appraiser uses the market approach.*

Financial variables may be calculated for a variety of time periods, such as next year's forecasted performance, the preceding 12 months, or an average of the last five years. The appropriate pricing multiple depends on case specifics and is a matter of the appraiser's professional judgment.

The subject company's fair market value equals the pricing multiple times the subject company's financial variable (for example, revenues, net income or book value). Because the guideline public company method is based on individual stock prices, under certain circumstances it generates a minority, marketable basis of value.

The second categorized approach is the guideline merger and acquisition (M&A) method. For guideline transactions under this method, appraisers analyze sales of entire public or private businesses. So this technique typically generates a controlling, marketable basis of value.

Because private businesses aren't required to disclose sales to the SEC, finding out their details can be difficult. Fortunately, appraisers have access to several proprietary databases (such as Pratt's Stats, Done Deals, BIZCOMPS and the IBA Market Database) that can identify and analyze private deals.

Once they've identified a relevant sample of potential guideline transactions, appraisers calculate pricing multiples relative to key financial variables. Fair market value is a function of the pricing multiple and the subject company's financial metric (say, last year's revenues or book value).

## Pulling the trigger

The availability of transaction data is a key determinant of whether an appraiser uses the market approach. Pure players (companies that focus on a single target market or offer a limited menu of products) may be hard to come by in the public markets — especially in industries dominated by conglomerates. And some industries lack a meaningful sample of M&A transactions, particularly those involving small niche participants.

In general, the guideline public company method makes more sense if the subject company is large enough to consider going public and when valuing a minority interest in a going concern business. Using this method to value a controlling interest may require subjective adjustments for control.

Conversely, the guideline M&A method is generally more appropriate when valuing controlling



financial statements of the subject company or the guideline companies to ensure accurate comparisons.

For example, nonrecurring items and discontinued operations may need to be eliminated. Or, for comparative purposes, appraisers may need to rectify accounting inconsistencies, say, for depreciation or inventory methods. Ideally, appraisers make these adjustments before selecting guideline companies and computing pricing multiples.

interests. But, with proper adjustments and analyses, it can be used to value minority interests.

Other disadvantages of the guideline M&A method are that transaction databases provide limited information about guideline companies, details provided are unverified, and the sales price may include buyer-specific synergies and undisclosed terms (such as installment sales, employment contracts and noncompete agreements).

### Avoiding mistakes

One common valuation mistake that may occur under the market approach is failing to adjust the

Inconsistent terminology may also lead to problems. Slight differences in the ways databases or appraisers define terms such as “cash flow” or “earnings” can trigger significant valuation differences. It’s imperative to understand how each database defines variables as well as what’s included (or excluded) in the selling price.

### Putting in the work

As long as there are companies to compare, there will be the market approach. The trick is putting in the work to ensure a comparison is accurate and defensible. ♦

## Tax Court covers much ground in IRS dispute

Some cases that go before the U.S. Tax Court are more dynamic than others. In *Estate of Gallagher*, the court addressed a couple of areas of dispute: the propriety of tax affecting and the guideline public company valuation method.

### Proposed adjustment

At her death, Louise Gallagher owned a 15% minority interest in Paxton Media Group LLC (PMG), a publisher that had elected to be taxed as an S corporation. Gallagher’s estate valued the

interest at about \$35 million, relying on a valuation by PMG’s president. The IRS, on the other hand, valued the interest at \$49.5 million.

After the estate received the agency’s notice of proposed adjustment, it obtained an independent appraisal valuing the interest at about \$26.6 million. The IRS then issued a notice of deficiency, confirming the \$49.5 million value. The estate sought a redetermination of deficiency.

The estate and the IRS each retained new experts before trial. The estate’s expert relied on an

income approach, applying certain adjustments and a 30% discount for lack of marketability (DLOM), ultimately estimating the value of the interest at \$28.2 million. The IRS expert used a market and income approach, with a 17% discount for lack of control under the income approach and a 31% DLOM under both approaches. He estimated the final value at about \$41 million.

*The selection of appropriate comparable companies is of paramount importance to the guideline company method.*

### Taking on tax affecting

Both experts used the discounted cash flow method, an income-based approach that measures a company's value by the present value of future income it expects to realize for its owners' benefit. The estate's expert, however, tax affected the income, assuming a 39% income tax rate. (The process of tax affecting reduces a business's projected future income by deducting hypothetical corporate income taxes on that income.)

He also assumed a 40% marginal tax rate when calculating the appropriate discount rate to calculate present value. The IRS expert disregarded shareholder-level taxes when projecting the cash flows and calculating the discount rate.

The Tax Court noted that, because most data used for stock valuation comes from publicly traded C corporations, appraisers sometimes tax affect an S corporation's earnings to reflect its S status. But the estate's expert failed to argue why the earnings and discount rate

should be tax affected, so the court "declined to do so."

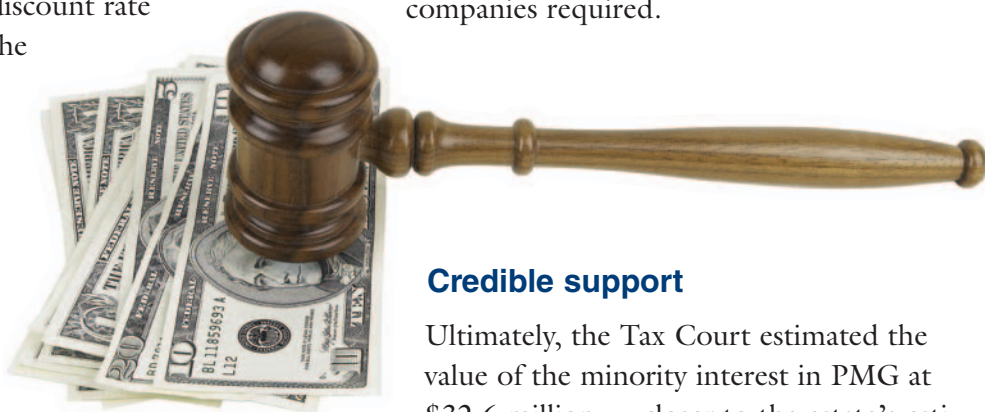
The court instead cited its previous holding in *Gross v. Commissioner*: The principal benefit enjoyed by S corporation shareholders is the reduction in their total tax burden. Having heard no argument for ignoring this benefit, the Tax Court stated that it wouldn't impose an "unjustified fictitious corporate tax burden" on future earnings.

### Guidance on guideline companies

The court also considered whether the guideline public company approach, which estimates a company's value by comparing it to similar public companies, was appropriate here. The IRS expert relied on the approach when valuing the interest.

The Tax Court explained that the selection of appropriate comparable companies is of paramount importance to the guideline company method. The IRS expert used four newspaper publishing companies similar in size to PMG.

But the court held that the companies weren't sufficiently comparable to warrant using the guideline company method. It found that, though the guideline companies chosen were similar to PMG, their differences from PMG prevented a reliable comparison. The greater the differences, the greater the number of comparable companies required.



### Credible support

Ultimately, the Tax Court estimated the value of the minority interest in PMG at \$32.6 million — closer to the estate's estimated value than the one calculated by the IRS. Its decision emphasizes the importance of retaining a qualified valuation expert who can credibly support his or her conclusions. ♦

# Find me the money!

## Asset tracing can uncover fraud

**W**ith the economy in turmoil, your clients may be more at risk of suffering occupational fraud than ever. Fraud experts can help companies detect such wrongdoings — and potentially recover their funds — by identifying and tracing misappropriated cash assets via the point of payment.

### Fictitious billing

The Association of Certified Fraud Examiners estimates that fictitious billing schemes (such as an employee submitting inflated invoices or invoices for fictitious goods or services) carry a median loss of \$128,000.

To uncover such schemes, an expert will pore over cash receipt and disbursement journals, ledger accounts, purchase orders, invoices, canceled checks, and electronic payment data. Red flags for inflated invoices include notations for “extra” or “special” charges with no additional explanation or mention of related goods or services; variances between the invoice amount and actual payment; and unusually high charges.

Where fictitious billing is suspected, fraud experts pay special attention to accounts with no tangible deliverables, such as those for consultants, commissions and advertising. Electronic bank statements can also expose unknown and possibly fictitious payees and suspect transactions.

Fraud experts also look for multiple vendors with the same mailing address, as well as vendors whose address matches up with that of an employee. Post office boxes and consecutive invoice numbers (suggesting a lack of other customers) warrant attention, too.

Canceled checks often provide experts with valuable information. For instance, it’s uncommon for legitimate businesses to actually cash their checks instead of depositing them. They don’t typically

endorse checks to third parties, either. A fraud examiner can search for any connections between the vendor or third party and your employees.

Finally, checks are generally stamped with the name of the endorser and, if deposited, the financial institution of deposit. That information can be critical in determining a fraudster’s identity.

### Ghost employees

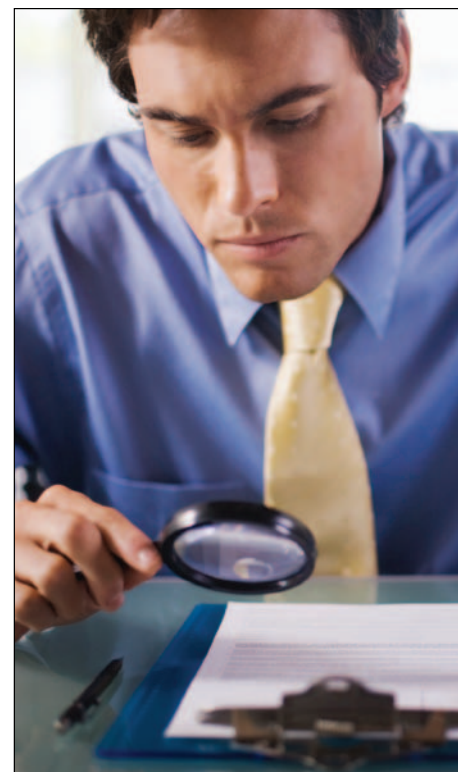
Experts can also use asset tracing to tie nonexistent (or “ghost”) employees who receive paychecks to current or former employees. To work their way back to the culprit, they’ll examine items such as:

- ◆ Payroll lists,
- ◆ Current and former employee lists (with start and termination dates and Social Security numbers),
- ◆ Authorized deductions,
- ◆ Withholding forms,
- ◆ Personnel files, and
- ◆ Employment applications.

The data gleaned from these sources can provide links not otherwise discernible.

### Blink of an eye

Regardless of the exact type of fraud, documentation is the cornerstone of any asset-tracing investigation. Missing documents, discrepancies and other anomalies will demand a fraud expert’s additional attention. And time is of the essence: These days, misappropriated monies can move across the globe — possibly to unreachable jurisdictions — in the blink of an eye. ◆



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