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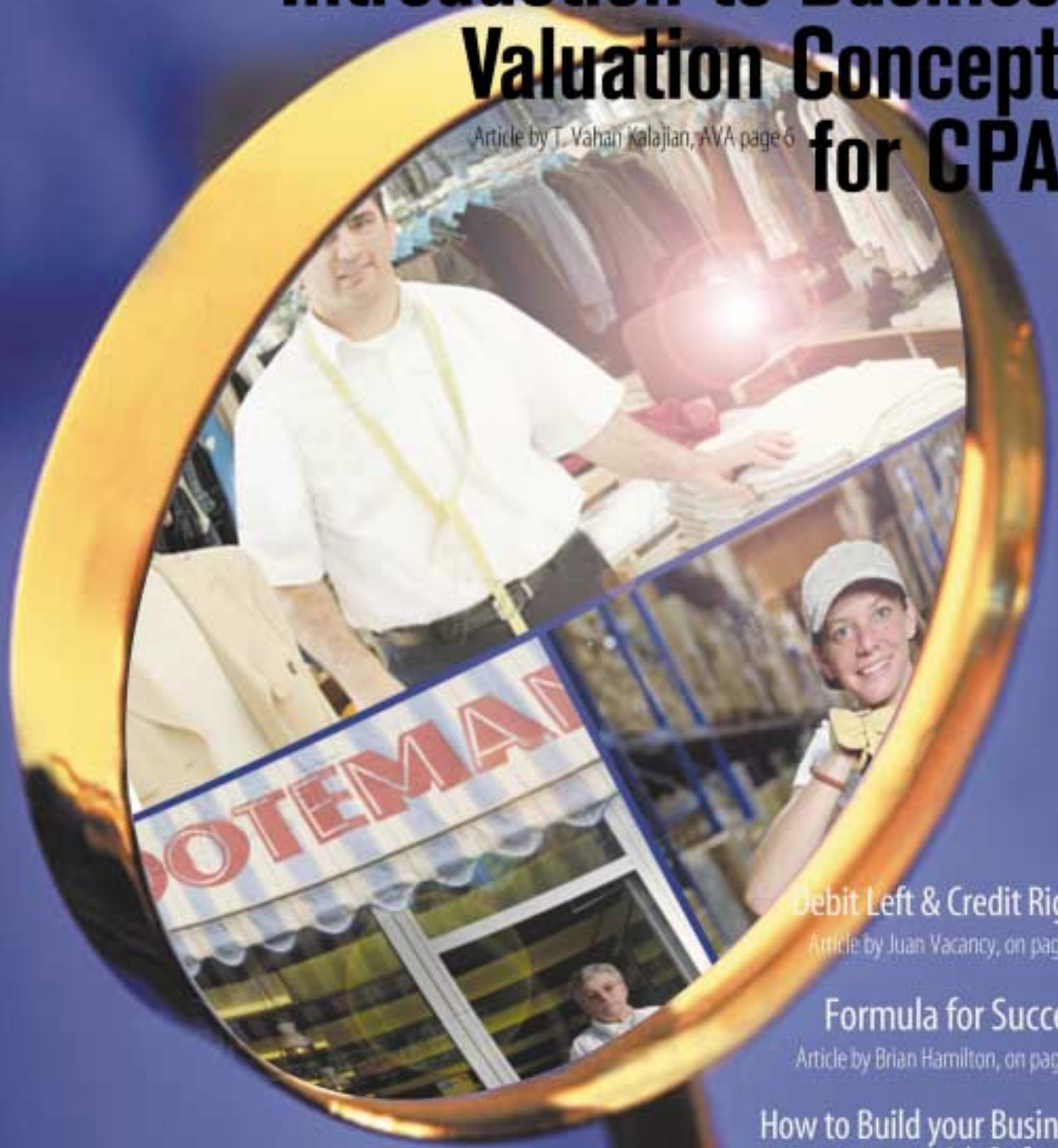
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The Premier Resource for the Independent California CPA

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President's Message

By: Harold L. Shively, CPA, President

When I began my message that appeared in the Summer edition of this magazine I prefaced my remarks that "This is going to be a landmark year for S.C.A." Indeed this will be a great year for the only organization in California that represents the small C.P.A. practitioner.

I had the opportunity to be a part of the first meeting of our new Central Coast Chapter in October. We have an enthusiastic core of members who have worked hard to develop the chapter. If you are interested in receiving information about the Central Coast Chapter, please contact the SCA Executive Office.

I am also excited about our plans to improve our already outstanding website. We have begun planning a new website which will improve navigation and add features, without losing any of the useful features and functionality of our current website. We envision a more interactive website which will allow our members to join, pay dues and request a CE report online. In addition, a member's only site will be added allowing members access to legislative information, the Ledger Sheet and much more. Downloadable .pdf files will be stored in an easy-to-access area of the site.

The new website will include a forum that will greatly enhance the most important benefit of S.C.A. membership, that of networking. Instead of networking with our circle of acquaintances, SCA will host a Discussion Forum, which will provide a means of posting either questions or comments, to which other members can easily respond. I have seen this type of forum work very well, allowing for an almost conversational resolution to problems and questions.

...this will be a great year for the only organization in California that represents the small C.P.A. practitioner.

Your Board of Directors, Technology Committee and Executive Office are working very hard to make the new S.C.A. website a reality as soon as possible.

We are always interested in hearing from our members. If you have a suggestion for the website, or a new member benefit you would like to see SCA offer, please contact the SCA Executive Office at:

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Introduction to Business Valuation Concepts for CPAs

This article is intended to provide CPAs a conceptual introduction to business valuation. Business valuation is a broad and technically challenging discipline. This article is designed to present several key concepts with the perspective of CPAs in mind.

How To Facilitate the Study of a New Field

In gaining understanding of any new field, it is very helpful to first identify its fundamental postulate. Once known, the postulate becomes the stable orientation point around which subsequent information and inevitable complexities can be aligned and understood. For example, theoretical mathematician Luca Pacioli developed a perfect model which serves as the framework for all western accounting today. Once the accounting student understands Pacioli's postulate about his arbitrary construct of equal and opposite debits and credits,¹ all accounting transactions can be reduced to these two factors in a balanced mathematical equation.

The Significance of Revenue Ruling 59-60

One of the earliest expositions on business valuation was published in 1959 by the Internal Revenue Service in Revenue Ruling 59-60,² which continues to offer clarity to business appraisers. Perhaps the most frequently quoted section lists the eight factors that must be considered in a full valuation report. These eight factors are central to the valuation process:

- (a) The nature of the business and the history of the enterprise from its inception.
- (b) The economic outlook in general and the condition and outlook of the specific industry in particular.
- (c) The book value of the stock and financial condition of the business.
- (d) The earning capacity of the company.
- (e) The dividend-paying capacity.
- (f) Whether or not the enterprise has goodwill or other intangible value.
- (g) Sales of the stock and the size of the block of stock to be valued.
- (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.³

CPAs should consider this the first reference on business valuation they read.

Continued on next page

The Fundamental Postulate of Business Valuation

It is from Rev. Rul. 59-60 that a workable fundamental postulate emerges:

Valuation is, in essence, a prophesy as to the future,⁴ thus for an operating going concern, value is based upon the risk-adjusted present value of the expected future benefit stream.⁵

Indeed, discounts, premiums and further calculations, assumptions and limiting conditions must be considered in arriving at the value conclusion. However, the basis of business valuation is conceptually grounded on the above postulate.

Principles of Valuation

The foundation of business valuation theory is governed by three fundamental principles:

1. Principle of Alternatives - Each party to the transaction has alternatives to fulfilling the transaction, for what price and with whom.⁶
2. Principle of Substitution - Substitution acknowledges how parties to a transaction will behave regarding alternative choices among comparable properties when prices vary. A prudent investor will not pay more for one investment than another equally desirable substitute. Derived from investment theory, an investor will choose the higher return between two choices of equivalent risk.⁷
3. Principle of Future Benefits - Valuation is based on the future outlook of the business in the form of capital appreciation or dividends, or both, all distributed in the form of cash flow. Investors do not buy historical earnings, but history is relevant in assessing achievability of projections and assessing the risk associated with realizing future economic benefits.⁸



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How the Body of Knowledge Is Organized

Valuation methodology is organized into a hierarchy of three basic levels:

1. Approaches,
2. Methods, and
3. Procedures.



Figure 1 - Interdependency of Valuation Approaches
Source: Provident Valuation Professionals, Inc.

Three Valuation Approaches

The Approach defines the general course of action in which an indication of value is to be developed. There are three Approaches: Asset (or Cost), Income and Market. All three must be considered to conform to the guidelines of Rev. Rul 59-60. An inappropriate Approach may be rejected if justified by the appraiser.

All three approaches are dependent upon one another. The diagram in Figure 1 illustrates their interdependence. For example, a method under the Income Approach is dependent on the market to develop its discount and capitalization rates. A method under the Asset Approach capitalizes excess income, which depends on the market for capitalization rates. Certain methods under the Market Approach must consider revenue and income variables to calibrate its guideline companies for appropriate comparison purposes.

For operating businesses, Rev. Rul. 59-60 suggests the Income Approach is most appropriate. For holding companies or start-ups, where assets are the basis of value, Rev. Rul. 59-60 suggests the Asset Approach.⁹ There are no hard and fast rules in business valuation like those that provide guidance and comfort in public accounting. Indeed, Rev. Rul. 59-60 says:

A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate influence.¹⁰

Valuation Methods

Under the Approaches, each has their Methods for computing a value indication. A Method is a way an Approach can be implemented. The use of all Methods within an Approach is not required, but in some cases, many appraisers choose multiple Methods for deriving indications of value, then synthesize these indications into a conclusion of value.

Valuation Procedures

A Procedure is a technique implementing a Method. The choice of the Method and Procedure is based on the application of the appropriate theory and methodology and the judgment of the appraiser given the facts and circumstances of each case.

Valuation Premises

Overlaid amongst the Approaches and Methods is the concept of Premise, which is defined as “an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation.”¹¹ The Premise, along with other variables, determines the procedures used to calculate the value.

Many valuation authorities recognize three common Premises:

1. Value as a going concern,
2. Value as an orderly disposition,
3. Value as a forced liquidation.¹²

Another less common premise states:

1. Value as an Assemblage of Assets. This is used primarily when operations have not commenced, and going concern, disposition or liquidation are not appropriate premises of value.¹³

Premise becomes especially significant when the Income and Market Approaches yield little or no value when the company historically has weak profits or continued expected losses. Then, the presumption of a going concern Premise is tested against a liquidation Premise, which may yield a higher calculation of value. If both premises yield a negative value, then the appraiser must look to the possibility that the company has little or no value.

This nuance introduces another implicit assumption in business valuation: the concept of the highest value and best use, borrowed from a well-established principle in real property appraisals. This concept is included in the professional appraisal standards of leading appraisal organizations.¹⁴ Thus, it is wise for the appraiser to refrain from stipulating the valuation premise before commencing the valuation engagement.

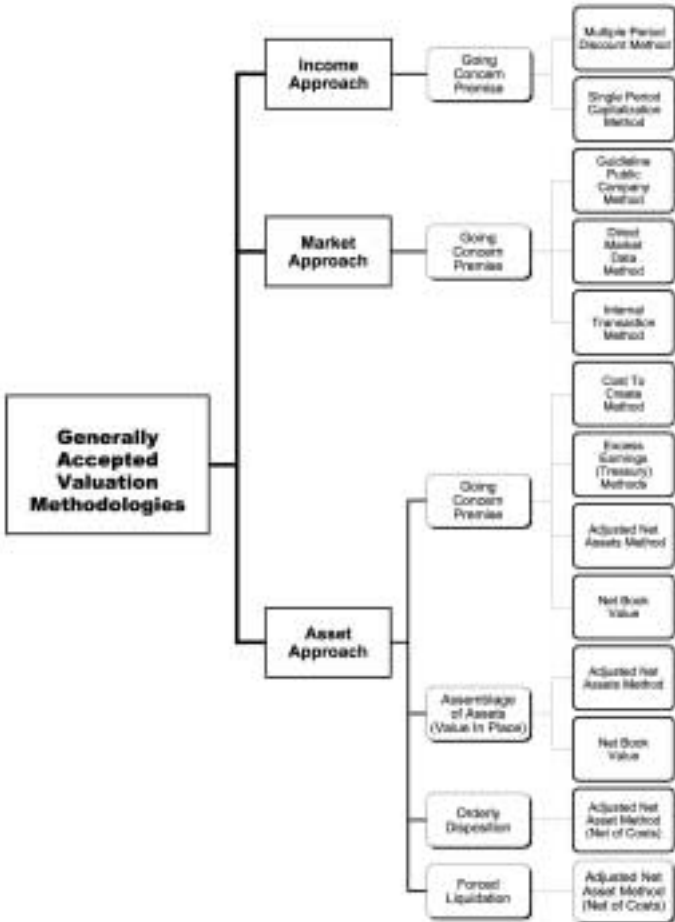


Figure 2 shows the basic organization of valuation methodology. Procedures are not included to avoid over complicating the diagram.

The Capitalization of Excess Earnings Method is a hybrid of the Income and Asset Approaches. Some authorities assign this Method to the Asset Approach, while others assign it to the Income Approach. Valuation is an integrated discipline. Most Methods rely on the interaction of more than one Approach.

Some Methods are mutually exclusive to others. For example, within the Income Approach, the appraiser may select the Capitalization of a Single Period Method, or the Discounted (Multi-Period) Cash Flow Method. There are guidelines as to which is appropriate. However, it would be a gross technical error to use both of these Methods within the Income Approach.

Standard of Value

The same asset can have different values to different investors. This variable is addressed by defining the value attributes. The definition (or standard) of value answers the



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Figure 2 - Organization of Valuation Approaches and Methods
Source: Provident Valuation Professionals, Inc.

question, "Value to whom?" A competitor, a spouse, a disinterested investor?

The most common standards of value are:

- Fair Market Value**
- Investment Value**
- Intrinsic Value**
- Fair Value**

Choosing the standard of value has a significant impact on the value conclusion, as each will require different procedures, yielding different value indications, all based on the same set of facts. Using the wrong definition of value would likely result in the wrong value conclusion. The standard of value should not be determined by the appraiser and should be disclosed as such in the engagement letter.

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Fair Market Value

Most common standard of value is Fair Market Value. The most commonly cited authoritative definition is:

... the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.¹⁵

Investment Value

Investment value is “the value to a particular investor based on individual investment requirements and expectations.”¹⁶ For example, if an independent neighborhood nursery would sell to anyone, the buyer is hypothetical and fair market value would be the most appropriate standard of value. Conversely, if the nursery sells to a national chain that wishes to enter the local market, certain special benefits through expectations of synergy inure to the national chain, thus increasing the value to the chain over the value to an independent buyer.

Intrinsic Value

Intrinsic value, involves a rigorous analysis of the company’s “fundamentals,” typically in the context of security analysis in determining the theoretical value of an equity without consideration of a hypothetical or specific investor. Thus, if a stock’s market value is below an analyst’s conclusion of intrinsic value, the stock would be considered a “buy.” Conversely, the stock would be a “sell.”¹⁷

Fair Value

The fair value standard has multiple meanings depending on the context and the jurisdiction involved. For example, in an accounting context, the standard is defined by FASB 141 as:

The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than a forced or liquidation sale.¹⁸

In a marital dissolution context, the standard is usually defined by each jurisdiction, usually ignoring marketability or minority interest discounts. In other cases, fair value is defined nearly identically to fair market value. Thus, fair value must be carefully understood by the appraiser in the context and purpose with which the valuation assignment is concerned.

A Subtle but Common Error in Using Fair Market Value

Fair market value is riddled with subtle but critical implications. For example, the implications of a hypothetical buyer and seller are lost in some appraisal reports for valuing a small business in contemplation of sale. It is unlikely that the owner will sell a small business to anyone but a buyer who is familiar with its operation, thus violating the hypothetical nature of the participants which the Fair Market Value standard requires.

Nonetheless, about 40% of demonstration reports for small business valuations submitted to a credentialing organization’s quality review committee ignored this nuance. Thus, the value conclusion was understated because these appraisers used the inappropriate fair market value standard.¹⁹ The more appropriate standard for a small business, especially a labor intensive “main street” business in contemplation of a sale would be investment value, where neither the seller nor buyer is hypothetical. Depending on the synergies involved, the value conclusion using investment value can be as much as 20% higher than using fair market value.

The Valuation Date

The valuation date is the “specific point in time as of which the valuator’s opinion applies (also referred to as the ‘Effective Date’ or ‘Appraisal Date’).”²⁰ The valuation date for business appraisal has significant implications beyond the concept used in public accounting. For example, for audited or reviewed financial statements, accounting standards require significant subsequent events to be disclosed, while valuation methodology generally requires these events to be ignored.


Numerous cases of valuation disasters surround the issue of valuation date, either because understandings were not documented in engagement letters, or because misunderstandings were discovered during litigation. Entire cases are lost on the inadmissibility of the expert’s appraisal report because of erroneous valuation dates. Do not accept the notion that valuation dates are “close enough for government work.”

Eligibility of Data

One subtle factor sometimes gets overlooked regarding the valuation date and the hypothetical investor. Remember, Rev. Rul. 59-60 endows the hypothetical investor with the presumption of prudence in performing reasonable due diligence. The appraiser, attempting to reconstruct this hypothetical transaction, simulates the probable actions of the investor by a similar degree of due diligence.

Further, the reconstruction of the hypothetical event cannot consider subsequent events that are not reasonably foreseeable by the investor at the valuation date. Thus, when conducting economic and industry research or using

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Debit Left & Credit Right

By: Juan Vacancy

**CPA: You know I'm not as stupid as I look.
Client: I certainly hope not.**

From recent headlines:

"Martha goes to jail for lying"



Granted the Martha soap opera is not an accounting scandal directly. However, Martha Stewart sold some ImClone stock after she allegedly got inside information. As a consequence of lying, Martha is now a resident of a Grey Bar Hotel. Fittingly, the Alderson Federal Prison Camp in West Virginia has a cutesy name: Camp Cupcake. Be sure to order your set of matching dishtowels from the Sears/Kmart near you.

The point that I would make is that the vast majority of CPAs, protected by faithful observance of the code of professional conduct, will not ever suffer Martha's fate. Ethically, CPAs are not permitted to lie – not even if it is to the Internal Revenue Service. Lying is not permitted under either the AICPA Standards of Tax Practice or the U.S. Treasury Department's new Circular 230. We all know the drill. If the IRS agent asks the question, the CPA must provide a truthful answer. If "the question" is not asked, we are not required to answer. During an IRS audit, we all hope that the agent will keep busy on routine matters and expend his or her time budget – before asking "the question".

"Audit misses \$250 million in overstated revenue"

According to Times Wire Services, the Los Angeles-based TV Guide publisher, Gemstar and its auditor, KPMG, each paid \$10 million fines to the SEC without admitting or denying charges related to significant revenue overstatements for the years 1999 to 2002.

"Audit Fees Double"

According to a syndicated article by Bloomberg News service, the Sarbanes-Oxley Act of 2002 has doubled the audit fees paid by major corporations. Under section 404, audit firms are prohibited from auditing the internal control systems that their consultants provided to the client. While one firm is auditing the corporate financial statements, another firm is auditing for material weaknesses in internal control. Corporate executives point out that the new law has created only a slightly better environment for the investing public. However "it's a tremendous hit to our bottom line" and "it's a windfall for the accounting firms" complain corporate executives. In determining what constitutes a material weakness, "you're somewhat at the mercy of the auditor's opinion."

Hans and his client Howie

Over the years, I had many partners and colleagues – some were exceptional professionals and some were just average. Some of my colleagues would have made very worthy partners. Hans was the great story teller. At lunch, Hans would put Sweet'N Low in his beer – because he did not like the taste of American beer. Hans would often recount humorous tales about the trials and tribulations of his entrepreneur client and retired fertilizer sales executive, Ol' Howie Pharz from Mississippi. Lest I think that Ol' Howie was a made-up character, Hans announced that his friend from Mississippi had an appointment with him that very afternoon. It

Continued on next page

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seemed that whenever Ol' Howie got himself into a pickle with IRS, Hans would go to the rescue – all without having to lie. Sure enough, Ol' Howie came in to see Hans about the status of his IRS audit. Hans announces to Howie that his tax return had been accepted as filed. Very smugly, Hans adds you know I'm not as stupid as I look. Not to be out done, Ol' Howie retorts I certainly hope not. Years later, Hans tells me that Ol' Howie had gone to see his maker. He died I asked? Pronouncing quite solemnly, I hope so, they buried him. Hans loved to have the last word and wait for the laugh. For me, the toughest choice was going back to work in the afternoon – or investing in another beer or two. It seems that Hans studied lots of Laurel & Hardy films during his university days at USC. ❖

Confidential Letters to Editor Juan

Rather than to get on one of my soapboxes, I think that it is about time that I answered some of my mail.

"BG", a Southern California reader. "I was catching-up on some delinquent reading when I looked at a complementary issue of The Successful California Accountant. Your column is a breath of fresh air flowing into a very stuffy place inhabited by [self] glorified bean counters. In the Spring, 2004 outing, you discussed your disenchantment with the AICPA. I am disgusted with AICPA and with CPA-ship in general.... Although I hold [another state] CPA certificate, I have voluntarily not attempted to become licensed. I am employed in the accounting field, and I stay quite current with my CPE, although I have not done the ethics hours. The big boys cause all the trouble and make us little guys take ethics! Imagine that! I would apply for SCA membership except that I would have to become a "real" accountant and become known to the rest of the bunch. I'm not ready to re-assume that role just yet. Oh, and in my circles, that \$3000 would be better invested in Miller [rather than Budweiser]. Keep up the good work and don't forget to Bearandgrinnit."

JV: Muchas gracias, Señor!

"PB", another Southern California reader says that C.P.A. stands for "Can't Prove Anything."

JV: Si, es verdad, Señor! Que es \$250 millones en pesos?

"SY", a Nevada reader is attempting to pin me down on my alumni affiliation.

JV: No, Señor! I was not a partner in that international CPA firm with radio station call letters. ❖

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About The Author

Juan Vacancy

When I started with this magazine assignment, I told the readership that I am writing under a Nom de Debit so that I can freely express myself about the embarrassments to our profession that, in recent years, we have unfortunately become accustomed to reading in the business pages. For my nom-style, I have selected a moniker that cannot be found in the "License Lookup" section of the CBA website.

I have been in the accounting profession a fair number of years (more than 20 but less than 30). I have had a variety of experience and have achieved most of my career goals in public and private accounting. From my college days to the present, the only aspiration that has escaped me is that of being a Big 8 partner in that big city office. That Big 8 phrase itself dates me. I have been with all sizes of public accounting firms including my own two-partner firm. I will not name names except to say that I was never with the firm formerly known as Arthur Andersen.

Commentary is fair game – let me know what you think. (Juan@gosca.com)

Formula for Success



By: Brian Hamilton

By nature, finance professionals get so caught up in the details of preparing financial statements that we are at risk of forgetting “the big picture”—what do the numbers mean and how do we use them to make better decisions? When it comes to serving our clients to the best of our abilities, our greatest challenge is identifying the “key performance indicators (KPIs)” that will ensure successful operation. A key performance indicator is a leverage point—a fulcrum that drives other less important metrics. For example, in the construction industry, we know that if a business can control direct labor dollars and direct material expenses, it is likely to have strong gross margins, which will yield strong net margins, which, in turn, will yield strong liquidity. To recognize the factors that drive business success, we need to “know” the business in question inside and out. How do we achieve such understanding? Increased client contact is key, which means meeting with the client more often than at “tax time.” After all, your clients are relying on your domain knowledge and expertise to help them reach their goals. Your first step in analyzing your client’s potential for success is to consider two metrics common to almost any business, namely net operating margin (net margin) and the growth of assets or liabilities against growth of profits. In terms of net margin, the number is calculated as net profit before interest, taxes, depreciation and amortization (EBITDA), divided by sales. Essentially, the ratio tells us how many cents of profit the company is earning on each dollar of sale it generates from operations. There are several reasons why this ratio is important. First, the net margin clearly shows us how successful managers are in watching costs against sales. Second, the net operating income margin gives managers great insight into how they can grow a company. Typically, companies are most efficient (make the most money) when they operate at different sales levels (or relevant ranges). For example, pharmaceutical companies need a high level of sales to be profitable. Consequently, the manager’s job is to drive high sales during the earlier stages of growth. Interestingly, bakeries tend to lose or gain efficiency as they grow. From \$0 to \$1 million in sales,

To recognize the factors that drive business success, we need to “know” the business in question inside and out.

the average net operating profit margin of retail bakeries is 4.4 percent (according to the Robert Morris Associates 2001 survey). Companies between \$1 million and \$5 million in sales earn a net margin of 7.8 percent. However, once the companies grow to more than \$10 million in sales, the average net margin falls to 6 percent, and once they grow to more than \$25 million in sales, the net margin average drops to 3.8 percent. This tells astute managers that they need to plan expenditures accordingly as they grow their business within these sales (or operating) ranges. By reviewing the net margin, we can gain a general picture of the sales level at which the company will be most efficient, within certain industry categories. Finally, and most importantly, there is no better long-term indicator of cash flow than the operating income margin of a company. While it is true that balance-sheet transactions have a major effect on short-term cash flow, the net operating margin indicates how much money the company generates from operating from its core activities.

The growth of assets or liabilities against growth of profits/sales series of metrics is a little more difficult to calculate. As finance professionals, we need to remember that managers only have a few resources at their disposal—assets, people and debt. These resources can only generate two positive events: helping a company increase either sales or profits. It is therefore vital to carefully watch how asset and debt levels are changing in conjunction with sales and profit changes. Many times, neither finance nor non-finance professionals monitor the relationship between these items until it is too late. For example, a direct relationship exists between assets and return on assets (ROA) and return on equity (ROE). In order to calculate this, you need to divide the percentage growth in profits by the percentage change in the resource (either assets or debt). This will show how a change in the denominator (the bad thing) may drive a change in the numerator (the good thing). The method can be applied to

Continued on next page

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monthly, quarterly, yearly or even multiple yearly data. For example, Company X has a net profit before taxes of \$100 in 2002. Its total asset base is \$1,000. During 2003, net profits grow to \$125, a 25-percent increase. During 2003, its asset base grows to \$1,100, a 10-percent increase. By dividing the increase in net profits (25 percent) by the increase in assets (10 percent), we see that, for every dollar we invested in assets, we returned \$2.50 in net profits. The point is to track how management decisions on using resources affect profits over time. This type of analysis can be used with any resource available to managers, whether fixed assets, inventory or people. Be wary of one thing, however: Sometimes the change in profits is the result of something that did not happen in the denominator; the two factors are not necessarily related. Basically, you need to watch for both false positives and false negatives in using this tool. Nevertheless, this technique is an easy way to detect disturbing trends, where the company acquisition of debt and/or assets is outstripping its growth in net profits. As finance professionals, we need to guide managers in making better decisions. This technique can be used as a way to catch early negative trends before they result in poor overall economic performance. ❖



About The Author

Brian Hamilton

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By: Kevin Lawrence, Business Coach

How to Build Your Business with R



Your business is a lot like a big wooden barrel in an old farmyard full of other barrels. Your barrel holds all of your customers. The other barrels belong to your competition. When a customer leaves, for whatever reason, think of this as your barrel of business leaking - part of its content is being drained.

What's important to understand, if you want to build and sustain your business, is how you can prevent this from occurring. Why spend countless hours of time, heaps of money and plenty of precious energy marketing your business, if new clients just slip out through holes after you siphon them into your barrel?

There are two ways you can make your barrel's level rise and not sink:

1. Put a hose in the barrel, in order to supply a constant stream of fresh, new customers. This is known as client acquisition.
2. Plug the cracks in your barrel before customers begin slipping through. This is called client retention or repeat business, and it can easily lead to referrals. Better customer service and stronger relationships with clients are maintained by businesses whose barrels stay leak-free.

Let's look at the first method: Adding a hose or constant stream of new customers to keep your barrel's level from dropping. It's very expensive to build your business this way, and many medium to smaller sized companies cannot afford the advertising budgets or additional skilled salespeople necessary to be successful using this approach. As you know, you can eat up all your profits so quickly with even one brief marketing campaign.

And, that's why it's been said that it's five times as expensive to bring in a new customer as it is to keep an existing one happy. It's also ten times more fun and fulfilling to take care of an existing client than it is to look for a new one: How much do you enjoy searching for clients?

The other way you can increase the level of your barrel is by plugging its holes. Certain business' growth systems create a protective layer of film within their barrel. As a result, the barrel is insulated and its cracks are sealed. Once these cracks are filled, price sensitivity amongst customers tends to decline and competitors are left unable to penetrate your barrel in their pursuit of new clientele. Furthermore, a wonderful thing happens when you plug all the leaks you possibly can: Your barrel starts to self-generate.

When customers are cared for and feel positive about dealing with you, they will invite their friends, relatives, neighbors, co-workers and others to come join them in your barrel. This form of self-generation is called referrals - my favourite way of building businesses! What's beautiful is that it's effortless, it works, and it's really simple: Treat all your existing clients, contacts, suppliers, prospects and peers the right way - the way they expect to be treated - and they will bring you success in the form of repeat business, loyalty and new customers. If you are friendly and sincere with your clients and take pride in doing the best job possible, and if you experience happiness because you have made other people happy, then you have truly added value to your customers' experience. They will reward you for this, because it truly is the little things that separate successful people from the rest.

Continued on next page

Referrals & Repeat Business

We design systems to help our clients properly insulate their barrels. An effective strategy for building your business with repeat and referred clients should contain:

1. A description of your "ultimate customer": You get what you focus upon and if you don't focus - well, you get the picture. We all know there are certain people and particular business types we would rather deal with.
2. A description of your ideal strategic alliances (people or businesses that you can share business with) and a strategy for meeting and building mutually beneficial relationships with these people.
3. Plan to C.A.R.E. for your clients:
Continuously stay in contact with them throughout the year
Appreciate your clients and their ongoing business
Remind them of all the services you provide and that you do value their referrals
Educate your clients on different areas of tax and finance that they can benefit from
4. A detailed outline of the step-by-step process you will rely upon in order to effectively convert potential and new customers into lifelong supporters and referrers.
5. A referral reward plan to show your appreciation to those who give you referrals in order to encourage them to send you even more customers in the future.
6. A plan to build and maintain your customer database so as to ensure that it is current and effective.
7. A list of your personal and business goals for the next 1 to 5 years.
8. A time management strategy: How do you intend to spend your time each week, reactively or pro-actively? If you're reactive, you'll get other people's "stuff" done, but wonder what happened to your day. On the other hand, if you're pro-active, you'll set goals, prioritize activities, stick with your plan, and look back upon your day with satisfaction and tangible results.
9. A Year Planning Chart (YPC) that ties all activities outlined above together on one sheet, so that, at a glance, you can see everything you need to do as well as how far you have come and have to go to reach your goals.
10. Your celebration plan: How will you reward yourself and your staff once you reap the benefits of following your plans and charted activities?

Our referral system can work for you in any way you like - your imagination is all that limits its potential. But remember, any successful plan has to be pre-defined and recorded, otherwise human nature will take over and nothing will happen. ❖

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About The Author

Kevin Lawrence

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Introduction to **Business Valuation Concepts** for CPAs

Continued from page 10

comparative industry financial data, the appraiser must be certain that the data is not published after the valuation date, lest it be disqualified as ineligible for use in the valuation analysis under the hypothetical buyer standard of Rev. Rul. 59-60.

For example, if the valuation date is December 31st, the appraiser may be tempted to use fourth quarter economic information for assessing economic conditions. However, the fourth quarter economic reports are not usually published before the following April. Thus, if the appraiser matches the December 31st valuation date with the fourth quarter economic research, it would be ineligible for inclusion in the report. Perhaps the most current economic data available at the valuation date would be the third quarter, perhaps published in late December, which would be eligible at the valuation date, December 31st.

Controversy continues over the validity of using the December 31st financial statements based on the same line of reasoning. However, protagonists for ineligibility offer two justifications: the financial statement data could have reasonably been made available by December 31st, as most of the transactions could have been accessible in rough form, and the general idea is to avoid a “slippery slope,” where the possibility of subsequent information would enter into the analysis by gradual increments. This is still a controversial area, but the basic limitations should be followed when possible. The general standard on eligibility of data is whether the information “would have been known on the valuation date by a reasonably informed person.”²¹

The Valuation Purpose

The Purpose of the valuation is clearly another variable which sets the direction and defines many of the processes which will be used to perform the appraisal. The same subject company with the same valuation date will be valued differently depending on the Purpose.

For example, if the Purpose is to value a non-marketable minority interest for estate tax purposes, the valuation procedures are specific to that Purpose, yielding a specific result. Then, there are regulatory requirements that influence the valuation process. The valuations of ESOPs are generally more involved because of additional requirements imposed by the Department of Labor.

Because the purpose has a dominant impact on the valuation process and the valuation result, a single valuation cannot serve more than one Purpose.

Recasting the Financial Statements

Though rarely done in public accounting, recasting the historical financials must be considered in business valuation. If the historical financials are prepared on OCBOA, they must first be recast to GAAP, tax adjusted, using the corporation’s effective tax rate.²²

If appropriate, the GAAP-adjusted historical trend income statements are adjusted for excess, discretionary, non-operating, personal, non-recurring or understated expenses. This process is called “normalizing” the financials. The normalization adjustments are tax-adjusted, as were the GAAP adjustments. Then the balance sheet at the valuation date is normalized for excess, deficient, non-operating or unrecorded assets and liabilities, both tangible and intangible. Working capital is assessed for adequacy, sometimes using the familiar “Bardahl” formula, and adjusted as necessary.

If the equity interest being valued is a controlling interest and has the legal authority to hypothetically implement the adjustments, then normalization adjustments are appropriate. In some cases, a minority interest may have the authority to impose limited changes, such as in a suppressed stockholder action. Only those normalization adjustments, which are legally possible, should be included in the appraiser’s analysis. The result is a normalized controlling interest net income stream. Care must be taken to avoid double counting the controlling interest characteristic by mismatching the capitalization rate or later applying a control premium, for example.

It is from these normalized financial statements that the projections are used for converting the normalized net income into net cash flow, after which the result is either capitalized in the single period method or discounted in a multi-period method under the Income Approach. It would be a gross technical error to ignore the normalization process altogether.²³

Connectivity in the Assessment of Risk

If the basic procedures have been properly followed, the math checked, the calculations checked for matching variables, a problem in many appraisal reports is the weak connection between the research and the support for the risk-affected judgmental decisions. The author refers to this characteristic as “connectivity.”

For example, once the economic studies have been performed, does that section of the report conclude in a risk assessment for the subject company? Once the industry research has been performed, does the appraiser conclude in an assessment of the risk the industry imposes on the subject company? After the appraiser drudges through pages of analysis on the financial statements, shows comparative trends and exhaustive comparisons of ratio analysis, does the report conclude in an assessment of these findings as to risk of the company and a basis for projecting growth in the cash flow stream?

Much analysis and careful research are usually present in many reports, but sometimes these sections appear to be cut and paste exercises, either from internet research sources, “canned” analyses prepared by appraisal organizations or sections endlessly copied from previously prepared appraisal reports. This connectivity provides the support required to render the conclusion credible.

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Conclusion

CPAs should not be dismayed by the seeming lack of precision in the appraisal profession. It is not a science of sums certain, as is the accounting profession. After all, the value conclusion depends on the judgment of the appraiser in the selection of key variables through a series of "decision gates" along an unbroken supportable line of reasoning, finally arriving at the destination of an estimate of value. The process is tempered by common sense and guided by a convergence of a body of generally accepted valuation methodology and theory.

Thus, the field is both art and science, dynamically invoking its presence with other professional financial disciplines. Savvy CPAs are informing their clients about the demise of the "Rule of Thumb" mentality, the dangers of substandard internet valuation mills, and the emergence of the professional appraisal community. This article is to provide a better understanding of the valuation process, the variables and judgments involved in determining business value, and a general guideline for CPAs to calibrate the quality of valuation reports as an expansion of their role to the clients they serve. ❖

REFERENCES

- ¹ In bookkeeping, these terms have opposite meaning, relating to entries made on the left and right respectively. However, the author's research suggests these two terms are derived from Latin words having a similar meaning. Compare **Debit** < Debt < debitum (thing) owed, neuter part participle of debere to owe, *The World Book Dictionary*, The Scott Fetter Company (New York: 1979) 535; **Credit**, from Latin creditum a loan < credere trust, entrust, lend (money), *The World Book Dictionary*, 487.
- ² Internal Revenue Service, *Revenue Ruling 59-60*, 1959-1 C.B. 237
- ³ *Revenue Ruling 59-60*, Sec. 4. Factors to Consider, paragraph .01
- ⁴ *Revenue Ruling 59-60*, Sec. 3. Approach to Valuation, paragraph .03
- ⁵ *Revenue Ruling 59-60*, Sec. 5. Weight to Be Accorded Various Factors, paragraph (a).
- ⁶ Gary R. Trugman, *Understanding Business Valuation*, 2nd Ed. (New York: American Institute of Certified Public Accountants, 2002) 55.
- ⁷ Trugman, 56.
- ⁸ Trugman, 56.
- ⁹ *Revenue Ruling 59-60*, Sec. 5. Weight to Be Accorded Various Factors, paragraph (a)
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- ¹¹ *International Glossary of Business Valuation Terms* (American Institute of Certified Public Accountants, et al, 2001)
- ¹² James R. Hitchner, *Financial Valuation Application and Models* (Wiley, 2003) 6.



T. Vahan Kalajian

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¹³ Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, Fourth Edition (New York: McGraw-Hill, 2000) 33.

¹⁴ The Institute of Business Appraisers, Inc., *Business Appraisal Standards*, §5.3(j)(ix)

¹⁵ *Revenue Ruling 59-60*, Sec. 2. Background and Definitions, paragraph .02

¹⁶ *International Glossary of Business Valuation Terms*

¹⁷ Pratt, 31.

¹⁸ Hitchner, 755.

¹⁹ Rand M. Curtis, CBA, ASA, "Improving Your Appraisal Reports Some Constructive Suggestions," *Business Appraisal Practice* (The Institute of Business Appraisers, Inc., Premiere Issue Winter 1999) 42.

²⁰ *International Glossary of Business Valuation Terms*

²¹ The Institute of Business Appraisers, Inc., *Business Appraisal Standards*, §1.20

²² The author believes adjustments for pass-throughs should be tax-affected using the effective rate as if the entity was a C corporation. The valuation community is generally divided on this controversial issue, especially in light of the Gross decision (Walter L. Gross, Jr. et us., et al. v. Commissioner, T.C. Memo 1999-254 (July 29, 1999)).

²³ The author has seen instances where the normalization process has been incorrectly substituted by valuation "mill" operators as the weighted average income of the prior three years, calling this process "normalization."

Starting a Business

Choosing the Right Business Entity

By: Bill Staley



Should a new business incorporate? The key question is whether the business is likely to generate claims against the business owner. Tax issues are secondary.

But no business entity will protect the owner from liability for the owner's wrongful actions.

To decide whether to incorporate, first identify the liabilities that are reasonably likely in this business. It will help to discuss this with a liability insurance agent who is familiar with this line of business.

There are several ways that a business owner can be exposed to "strict liability," which can be imposed even if the owner does nothing wrong. Both the employer and the employee are liable for claims that are caused by the employee's actions in the course of employment. Partners in general partnerships (and general partners in limited partnerships) are liable for all claims against the partnership. Generally, everyone in the chain of distribution of a defective product shares liability for an injury caused by the defect. Also, all record owners of contaminated real property share the duty to remediate the property.

If a liability insurance policy covers a claim, the insurer will pay for attorneys to settle or litigate the claim, and will pay the covered claim, subject to deductible and coverage limits.

Is the liability exposure minimal? If so, the owners can avoid complexity. If not, can likely claims be covered by insurance? Are the premiums and deductibles manageable? Are the coverage limits high enough? If the answers are "Yes," then keep it simple. For one business owner, a "sole proprietorship" can be used and no business entity is necessary. For more than one owner, a "general partnership" is the least complex form.

If adequate liability insurance is not available or affordable, the owner should consider incorporating. A "limited liability company" ("LLC") is ideal for many businesses. It provides protection from liability for the owners (if it is organized and operated properly) and avoids the tax problems of corporations. But it is subject to a California tax (up to \$11,700) on its total receipts that applies even in years in which it has a net loss.

Before there were LLCs, a "limited partnership" with a corporation as the general partner was a common structure. Now this structure is most useful in states that tax LLCs like corporations.

Businesses that are licensed under the California Business and Professions Code (which include most licensed businesses) cannot use a limited liability company. Partnerships of accountants, attorneys and architects can use registered limited liability partnerships ("LLPs") to limit the liabilities of partners.

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What if the business needs to incorporate but can't use an LLC or an LLP? The last resort is a corporation. There are two kinds for tax purposes. If it will probably be sold for much more than the owners invested in it and all of the shareholders are eligible to hold shares of an "S corporation," that type of corporation will provide limited liability and avoid a double tax.

If the business will offer its shares to the public or the owners never expect to sell it for much more than they invest in it, a "C corporation" will serve the business owners' purposes.

S corporations that fail to meet eligibility rules become C corporations. This is one of several reasons why the LLC is preferred over the S corporation. ❖

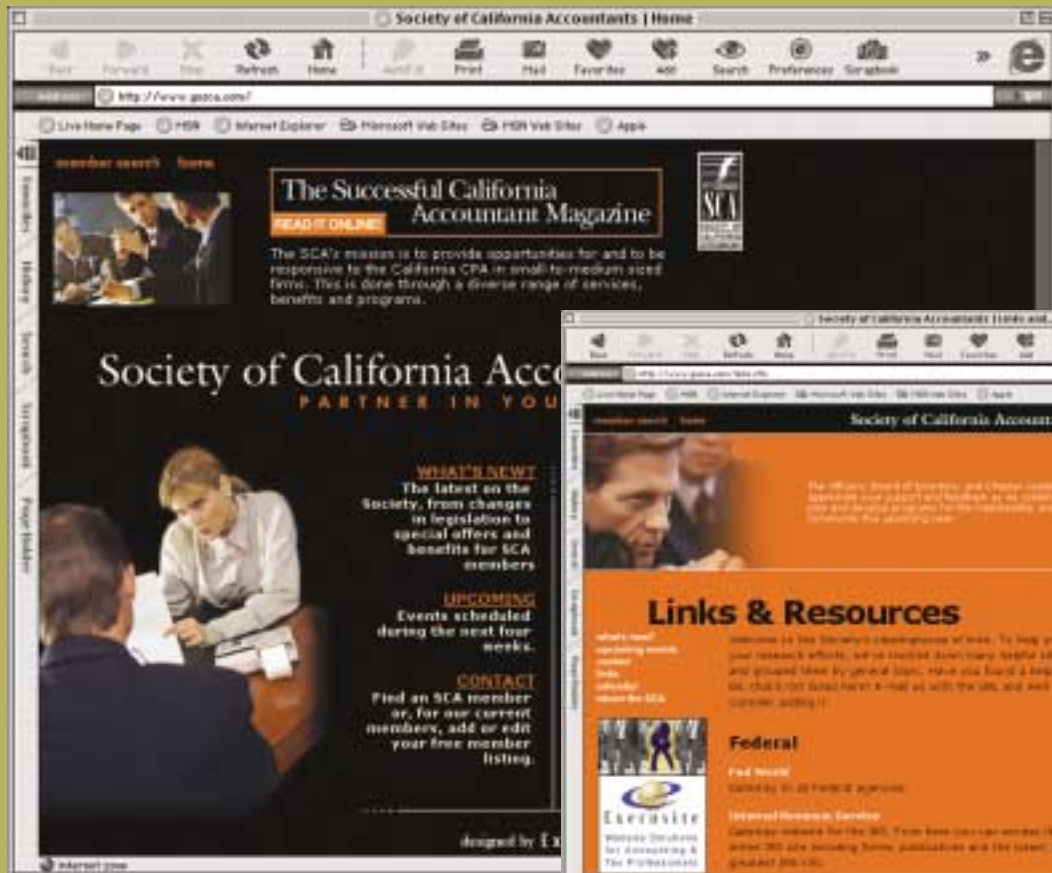


About The Author

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Bill Staley (818 936-3490 www.staley.com) practices tax, business and nonprofit law in Woodland Hills. He is a frequent speaker on choice of entity and other business tax topics and is a past chair of the Taxation Section of the Los Angeles County Bar Association.

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