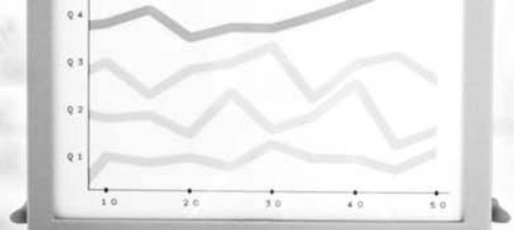

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VALUATION Trends

Trugman Valuation Associates, Inc.

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What CPAs and Attorneys Should Know About the New AICPA Valuation Standards

After six years of drafts, debates, and deliberations, this past summer—in June 2007, the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (the Statement). The Statement applies to any AICPA member, regardless of technical discipline, who performs an engagement to estimate the value of a business, business ownership interest, security, or intangible asset. The Statement identifies these members as "valuation analysts."

Valuation analysts must comply with the Statement whenever they perform a valuation engagement involving a conclusion of value or a calculated value. The only exceptions are: (1) when the valuation is part of an attest engagement; (2) when a client or third party has provided a subject value, and the analyst does not apply any independent analysis; (3) engagements to determine economic damages (unless inclusive of an estimation of value); and (4) jurisdictional exceptions for governmental, judicial, or accounting authorities. The Statement is effective for all applicable engagements after January 1, 2008, but earlier adoption is encouraged.

Parties who rely on valuation reports—including attorneys, bankers, and transaction principals—will now be able to define alternative levels of valuation services and reports. They will benefit from increased transparency, consistency, and reliability of valuation reports. What follows are the key points regarding the effect and application of the new Standard:

1. Competency. The Statement requires the analyst to possess a level of knowledge sufficient to identify, gather, and analyze valuation data; consider and apply appropriate valuation approaches and methods; and use professional judgment.

2. Objectivity. "Objectivity is a state of mind." The Statement defines objectivity as imposing the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest."

3. Independence. If the valuation analyst also performs an attest engagement, then the analyst must meet the requirements of Rule 101 of the AICPA Professional Standards ("Independence") and Rule 102 ("Integrity and Objectivity").

4. Types of engagements. The Statement permits: (i) a valuation engagement, expressed as a conclusion of value, with applied methods and approaches selected by the analyst; and (ii) a calculation engagement, for which the analyst and client agree on the methods and extent of procedures, resulting in a calculated value.

5. Factors to consider. In a valuation engagement, the Statement lists eight factors:

- i. the nature of the subject interest, including financial and non-financial data; and type of ownership interest
- ii. the scope of the valuation engagement
- iii. the valuation date
- iv. the intended use of the valuation
- v. the applicable standard of value
- vi. the applicable premise of value
- vii. any assumptions and limiting conditions
- viii. any applicable governmental regulations or other professional standards

6. Valuation approaches and methods. In a business or security valuation, the valuation analyst should consider: the income, market, and asset-based approaches. The income, market and cost approaches apply to an intangible asset valuation.

7. Rules of thumb. The Statement permits rules of thumb and/or industry benchmarks as reasonableness

Continued to next page...

IN THIS ISSUE

checks but discourages their use as the only method to value a subject interest.

8. Valuation adjustments. The analyst should consider whether valuation adjustments should be made; e.g., price premiums or price discounts (lack of control and/or marketability).

9. Conclusion. In determining the conclusion of value, the analyst should: (i) assess the reliability of results under different valuation approaches and methods using the information gathered in the valuation engagement; (ii) correlate and reconcile the results gathered from the different valuation approaches and methods; and (iii) determine whether the conclusion of value should reflect (a) the result of one valuation approach and method or (b) a combination of results.

10. Subsequent events. In most cases, the analyst should consider only those events existing prior to and at the valuation date. Should a "subsequent event" (after the valuation date but before the report is issued) impact value, the analyst should consider only those events "known or knowable" at the valuation date.

11. Documentation. The Statement requires the valuation analyst to apply professional judgment to determine the type, quantity, and content of documentation. These may include information gathered and analyzed to understand value, assumptions and limiting conditions, restrictions on scope, etc.

12. Calculation engagement. At a minimum, the analyst should consider: (i) the client; (ii) the subject interest; (iii) the degree of ownership control and marketability; (iv) the purpose and intended use of the calculated value; (v) the intended users; (vi) the valuation date; (vii) the applicable premise and standard of value; (viii) the sources of information used; (ix) the agreed-upon valuation approaches and methods; and (x) any subsequent events.

13. Valuation report. The Statement defines a valuation report as a "written or oral communication to the client about the conclusion of value or the calculated value of the subject interest." Exceptions include reports for "controversy" proceedings, unless the analyst forms a conclusion of value or calculated value. The report should identify any use restrictions.

14. Written reports. For a valuation engagement, the Statement permits a "detailed" report and a "summary" report; the distinction is the level of reporting detail. The detailed report should enable intended users to understand the information, reasoning, and analyses underlying the conclusion of value and should include these sections:

- i. Letter of transmittal
- ii. Table of contents
- iii. Introduction, including an overall description of the valuation engagement
- iv. Sources of information
- v. Analysis of the subject entity and related non-financial information
- vi. Financial statement/information analysis
- vii. Valuation approaches and methods considered
- viii. Valuation approaches and methods used, identifying each method used and the reason(s) for their use, including rules of thumb
- ix. Valuation adjustments (if any)
- x. Non-operating assets, non-operating liabilities, and excess or deficient operating assets
- xi. Representation of the valuation analyst, including eight specific statements
- xii. Reconciliation of estimates and conclusion of value, including specific disclosures
- xiii. Professional qualifications of the valuation analyst
- xiv. Appendices and exhibits, including examples, assumptions, and limiting conditions

The summary report provides an abridged version of a detailed report and does not require the same level of detail. At a minimum, it should include the subject interest, the valuation date, the purpose of the valuation, and the premise and standard of value.

For a calculation report, the analyst should identify: (i) any hypothetical conditions used in the calculation agreement (including the basis for their use); (ii) any assumptions and limiting conditions of the engagement; (iii) how a specialist's work was used; (iv) any application of the jurisdictional exception; (v) any subsequent events (in certain circumstances); and (vi) the calculated value.

Lastly, an oral report may be used in a valuation engagement or in a calculation engagement. The valuation analyst should document in working

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papers the substance of the oral report that was communicated to the client.

Our valuation reports are in compliance with these standards. We will be happy to answer any questions you have about them.

Court Outlines Key Factors In Calculating Lost Profits For Un-established Business

Parlour Enter., Inc. v. The Kirin Group, 2007 Cal App. LEXIS 504 (April 6, 2007)

For over 20 years, from the mid-1960s to the mid-1980s, there were nearly 150 Farrell's Ice Cream Parlours across the country. By the mid-nineties, however, only one California location remained open. A company (the Kirin Group), whose CEO used to work at a Farrell's as a teenager, purchased the trade name, and in 2000 the company made a sub-franchise deal with the Parlour Enterprises.

By 2003, the agreement had unraveled. Parlour had opened only one franchise, with plans to open up to seven additional stores. In suing the Kirin Group for breach of contract, business interference, and other claims, Parlour asserted lost profits and lost franchise fees based on its expert's analysis of all eight locations. It won a jury award of over $6 million, based largely on management's financial projections, with support from market and industry data. An appeal examined the extent to which expert evidence established damages for the early-stage company with "reasonable certainty."

Problems with projections

At trial, Parlour's expert admitted that he didn't know who had prepared the projections, only that they'd been done at the behest of management, who were "experienced in these sorts of businesses." Subsequent testimony indicated that the projections came from investment proformas; they were based not on actual operations but on the principals' five-year assumptions and estimates. Although the two principals did have extensive experience in the restaurant business, neither provided specific qualifications regarding his ability to predict the finances of the franchise operations. (This could suggest that the gap lay in the evidence rather than in expertise. That is, if the principals had laid a proper foundation, their projections might have proved more credible.)

But the principals also failed to derive the projections from the single store in operation or any other "actual number" that would be a reliable indicator of future income, expenses, or profits of a franchise," according to the Court. In fact, management admitted they had "backed into" the numbers, based on what they knew they had to accomplish financially. As the projections were not based on facts "substantially similar" to the lost business opportunity, the Court found they failed to provide sufficient evidence to support the damages.

Farrell's is no Friendly's

Parlour's expert tried to buttress the projections with industry analysis. He considered market data from a "couple of dozen ice cream parlors," as well as data from Friendly's, the publicly traded restaurant chain he claimed was "relatively similar to the Farrell's concept," as its menu included food as well as iced desserts.

Friendly's operated over 300 outlets nationwide, however, and its addition of food to the menu "does not make them sufficiently similar to Farrell's for purposes of proving lost profits," the Court said. The expert's "cursory" description of Friendly's business model also didn't help establish comparability sufficient to provide an adequate model for Farrell's lost profits.

As for data from Farrell's existing operations, "all [the expert] did was speak to Parlour's principals about that restaurants' revenues, expenses, and profits." There was no evidence regarding what those numbers were or how they impacted the expert's calculations. In the end, the Court found the market and industry data unreliable.

Lost franchise fees also lost credibility

Parlour's expert calculated lost franchise fees by including a percentage of the total gross revenue estimated for all eight locations (even though only one was operational) and a $35,000 one-time fee for each of the seven proposed locations.

But as the gross revenue figures were based on the same "unreliable" management projections, the Court disregarded this element. The franchise fees were unrecoverable, largely because the majority of locations were still in the proposal stages--far too speculative to serve as a basis for lost profits, while the development of the remaining one or two locations depended on sub-agreements with other entities, which would have been liable for the related fees.

The Court did leave Parlour's claim for nearly

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$203,000 in lost development costs, which were supported by "concrete" evidence of bank and other expense records. But given the substantial problems with proof of the lost profits claims, the Court threw out over $6 million of the original jury award—surely a bitter end to what could have been a sweet deal.

'Splitting the Difference' Is Not an Acceptable Valuation Method in Divorce

Augoshe v. Lehman, 2007 Fla. App. LEXIS 6367 (April 27, 2007)

In an attempt to reach fair and equitable solutions, divorce courts will often "split the difference" between the parties' disparate business appraisals. If the court makes an adequate record, including competent evidence to support its ultimate value conclusion, the "midpoint" determination may withstand reconsideration and/or subsequent appeal.

But in this case, the trial court made no such record in deciding the value of a Florida motel, purchased by the parties during a short (three-year) marriage. At trial, the wife's expert had presented two valuations, one based on the comparable sales approach ($4.40 million) and another based on the income approach ($4.31 million). The only evidence of value offered by the husband was the $2,842,858 purchase price for the motel.

Court cites Solomon

The trial court concluded the motel was worth $3,576,429, and the husband appealed. On review, the appeals court was unable to find "any competent evidence to support this finding," other than that the value was the "exact midpoint" between the purchase price and the income approach valuation by the wife's expert. Citing the Florida case of Solomon v. Solomon (which is hard to resist repeating, simply for the irony of the name), the appeals court found that "simply splitting the difference" between two divergent appraisals was an "improper method of valuation," and it remanded the case for further findings.

Another 'Bad Facts' FLP Falls to Established Criteria of Section 2036(a)

Erickson v. Comm'r, 2007 Tax Ct. Memo LEXIS 108 (April 30, 2007)

This is the latest in yet another "bad facts" case that was captured by the broad reach of Internal Revenue Code § 2036(a)(1). The daughter of a widow suffering from late-stage Alzheimer's enlisted the help of an attorney to form a family limited partnership (FLP), primarily with real estate assets and securities worth over $2 million. A second daughter joined the first as a general and limited partner.

However, it wasn't until a couple of days before their mother died (at age eighty-two) that the daughters completed the funding for the FLP and the gifting of partnerships interests to other family members. None of the partners had separate legal counsel—and it was doubtful the daughters (or the mother) fully understood the arrangement.

A mere 'asset container'

Given these facts, the Tax Court swiftly concluded that § 2036(a)(1) applied. The Court also found that the "bona fide sale" exception did not apply, as there was no credible evidence the FLP had any substantial, nontax business or investment purpose. In fact, the FLP served as "just a vehicle for changing the form of the investment in the assets, a mere asset container." Accordingly, the Court included the FLP's assets in the decedent's taxable estate.

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