The McLean Group
INVESTMENT BANKING

Valuation Vantage©

Insights and Perspectives on Leading Corporate Finance Valuation Issues© Fall 2009

Inside This Issue

- Determining Reporting Units for Goodwill Impairment Testing
- Converting to an S Corporation - New Laws and Tax Implications
- Valuator's Cheat Sheet to the New GAAP Codification
- Spotlight on Court Cases
- Recent Valuation Engagements

The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Valuation Service Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting, and tax purposes.

Determining Reporting Units for Goodwill Impairment Testing

U.S. GAAP requires goodwill impairment testing to be performed at the "reporting unit" level. As a result, a company's management team, valuation practitioners, and auditors need to know how many reporting units are within a company and which reporting units hold goodwill.

Accounting Standards Code ("ASC") 350-20-20 defines a reporting unit as an operating segment, or a segment that is one level below an operating segment (also referred to as a component). An operating segment is defined by ASC 280-10-50 as a component of an enterprise that earns revenue and incurs expenses, of which discrete financial information is available.

Management regularly reviews the operating results of a component to determine the allocation

Continued on p.2

Converting to an S Corporation – New Laws and Tax Implications

For many business owners, converting from a C corporation to an S corporation can provide substantial tax savings. Previously, if owners converted from a C corporation to an S corporation, any built-in gains were taxable over a ten year period. Recently, the law has temporarily changed and reduced the recognition period from ten years to seven years.

Owners of a C corporation are often taxed twice: the corporation pays tax and the owners pay tax again when dividends are distributed. A similar double taxation can occur when a business is sold.

Continued on p.2

Valuator's Cheat Sheet for the New GAAP Codification

Effective July 1, 2009, the Financial Accounting Standards Board ("FASB") rolled out a new classification and organization of its accounting standards, called the Accounting Standards Codification ("ASC"). The new codification will change U.S. GAAP by removing the current four-level U.S. GAAP hierarchy and replacing it with two levels: authoritative and non-authoritative. The codification will become the single source of authoritative U.S. accounting and reporting standards.

Continued on p.2

"Goodwill Impairment..." continued from p. 1

of resources among an enterprise's various segments. This task is performed by a chief operating decision maker. Generally, an operating segment also has a segment manager who maintains regular contact with the chief operating decision maker to discuss operating activities, financial results, forecasts, and plans for the segment.

Goodwill impairment testing is not intended to be performed on an acquisition by acquisition basis. For example, the existence of separate legal entities is not relevant. When trying to determine whether or not a specific acquisition is a reporting unit, it is also helpful to analyze qualitative factors. For example, management should consider if the acquisition has its own accounting systems and ledgers and if it has a separate formal budget. Management should also consider the level that the acquisition has been integrated into the company and how the market perceives the business.

After an acquisition, management decides if the acquired entity should remain as a separate reporting unit. Many companies decide to have one reporting unit. The advantage to this is that while one acquired company may be underperforming, another acquired company may be exceeding expectations. Thus, the goodwill that may be impaired from one acquisition could be covered by the other acquisition.

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"Converting to an S..." continued from p. 1

Conversely, profits and gains from S corporations are passed directly to their shareholders for tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and pay tax at their individual income tax rates. S corporations avoid double taxation on corporate income while maintaining limited liability from creditors.

To become an S corporation, a company must meet the following criteria:

- Be a domestic corporation;
- Have only allowable shareholders, which can include individuals and certain trust, and estates, but may not include partnerships, corporations or non-resident alien shareholders;
- Have no more than 100 shareholders;
- Have one class of stock; and
- Not be an ineligible corporation (certain financial institutions, insurance companies, and domestic international sales corporations are ineligible).

One of the drawbacks of converting to an S corporation is the built-in gain tax. The built-in gain tax is a tax on the fair market value of the assets in excess of the tax basis as of the effective date of S corporation, and is only due if these gains are realized within ten years after a company converts. A formal business valuation is often required to establish the fair market value as of the effective date of the S corporation.

A major change to this rule comes from the American Recovery and Reinvestment Act ("ARRA"). Since February 2009, the ARRA has temporarily shortened the ten-year period to seven years for 2009 and 2010. In general, this applies to companies that were sold in 2009 and 2010 and were converted to an S corporation at least seven years prior. Some S corporations may be able to minimize their taxes if they are sold in 2009 or 2010. Business valuations are often required at the time a company converts to an S corporation. Management should consult its tax advisors and legal counsel. ◆

"Valuator's Cheat Sheet..." continued from p. 1

Although the new system will be frustrating for many, the codification will facilitate accounting research. As opposed to researching accounting issues in various places and never being quite sure if you have reviewed each applicable EITF, the codification will make research easier and more complete. All relevant accounting guidance is linked and referenced in one place.

We have highlighted the ASC references to the primary valuation-related accounting standards below:

	SFAS	ASC
Stock Options	SFAS 123R	ASC 718
Purchase Price Allocations	SFAS 141R	ASC 805
Goodwill Impairment Test	SFAS 142	ASC 350
Intangible Asset Impairment	SFAS 144	ASC 360
Fair Value Measurements	SFAS 157	ASC 820

Many professionals have spent a career learning the various accounting references that will shortly be extinct. The new GAAP references present an opportunity for younger valuators and accountants to become fluent with the new references before their older colleagues. All practitioners and analysts need to be fluent in the ASC in order to properly interpret financial statements and research accounting issues. ◆

Spotlight on Court Cases

Courts Exclude an Otherwise Qualified Expert's Testimony

MDG International v. Australian Gold Inc., 2009 WL 1916728 (S.D.Ind.)(June 29, 2009)

This court case is a prime example of how an otherwise "supremely qualified" expert and his valuation report fail to meet the requirements of the Federal Rules of Evidence "FRE" and a Daubert challenge ("Daubert") for reliability and admissibility at trial.

The plaintiff was the exclusive distributor of the defendant's tanning products in select territories. The plaintiff claimed the termination of their business agreement due to failed quotas was unjust. To value the business as well as its expected profits, the plaintiff retained a professor of accounting and chair of an accredited MBA program. The defendant's counsel dismissed the expert, claiming "numerous deficiencies" in his valuation report, and filed for summary judgment. The defendant's counsel pushed to exclude the expert and his valuation under Daubert and Rule 702 FRE.

Despite the valuation professor's extensive experience in valuing large public companies, he had no previous experience valuing closely-held private companies. The defendant challenged the professor's opinion claiming he failed to independently verify data that was hand-selected by the plaintiff, ignored specific clauses in the contract, excluded reasonable business expenses, and used unreasonable markups on sales.

The court found "numerous other deficiencies," which included calculation errors and omission of sales from an entire territory of the plaintiff's business. The court also insinuated that he failed the first element of the Daubert test: he lacked necessary "knowledge, skill, experience, training or education" to testify the value of a closely-held private company. In light of these facts, the court could not "conclude with any confidence that he qualifies as an expert in the area." ◆

Trial Court's Minority Discount in 50% Interest Rejected

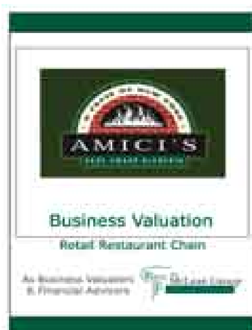
Marriage of Williams, 2009 WL 2597950 (Mont.) (Aug. 25, 2009)

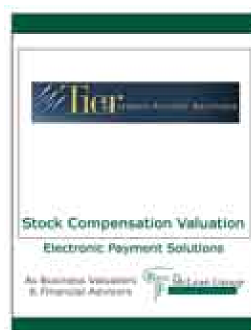
A recent trial court ruling was overturned by the Montana Supreme Court because the plaintiff did not adequately justify a 35% minority discount for a 50% interest in a going concern. A father and son (the respondent) equally owned a trucking company, filed as an S-corporation. In addition to the trucking business, the company owned a real estate holding company that invested in five plots of land and two airplane hangars. The two owners equally shared the management responsibilities of the day-to-day operations and finances.

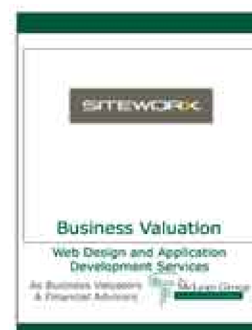
At the divorce trial, the respondent argued that due to his previous misuse of the company's finances, his father terminated his ability to make financial decisions on behalf of the company. Subsequently, the divorce court ruled that the respondent "lacked enough control to operate the business without the concurrence of his dad," and implied that his 50% non-controlling interest in the family business "is not saleable at face value." Furthermore, the court ruled that the respondent could not "require or force the S-corporation to pay out the income on which he is taxed, and to date, the company has paid very little to its owners." The child support awarded in the divorce court excluded the respondent's "passive, taxable but not received" earnings, and reduced his income to $100,000 per year, despite historical levels ranging from $200,000 to $300,000.

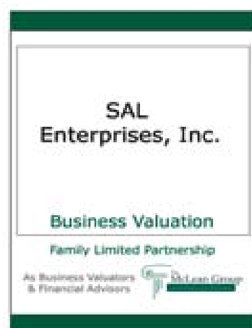
The Montana Supreme Court ruled that a discount for a minority interest is appropriate when the minority shareholder "has no ability to control salaries, dividends, profit distributions, and day-to-day corporate operations." However, the court found the respondent to have had adequate control over the company's finances and operations, and that his alleged lack of control occurred only after his father took away his power. Prior to relinquishing his financial control, the respondent used the company's finances for personal use and to pay down the company's debt, thus increasing his personal net worth. The court remanded the case, instructing the trial court to determine the child support based on the respondent's tax returns, the company's financial statements, and other relevant information. ◆

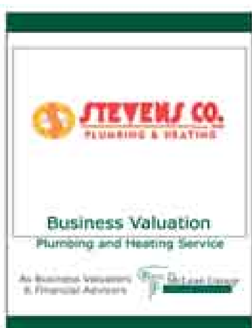
Recent Valuation Engagements











The McLean Valuation Services Group Offices

The McLean Group is a national middle market investment bank providing mergers & acquisitions (M&A), capital formation, market intelligence, business valuation, litigation support and exit planning services in over 25 offices in the U.S. and Canada. The McLean Valuation Services Group performs business valuation services for transaction, financial reporting, and tax purposes. The McLean Valuation Services Group has dedicated business valuation offices in the following locations:

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