THE McLEAN GROUP

VALUATION UPDATE

Spring 2006

Insights & Perspectives on Leading Corporate Finance Valuation Issues

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VALUATION ISSUES FOR AUDIT COMMITTEES

TOP 3 VALUATION ISSUES & THE QUESTIONS BOARD MEMBERS SHOULD BE ASKING

With the many challenges facing boards of directors, especially audit committee members, one of the more recent skill sets is a needed fluency in fair value. This issue is actually quite historic – in the last 20+ years, US GAAP has drastically moved from a cost basis balance sheet to one based on fair value. Everything from current assets to fixed assets to even goodwill intangible assets, and liabilities, should be valued at fair value.

1. Fairness Opinions

In practice, fairness opinions have been typically used by public companies when they make significant acquisitions and in situations when potential related party conflicts exist. However, regardless of the type of company (public or private), the underlying issue is did the managers of the company exercise their prudent judgment and professional care in spending company assets?

Board members and executive offices have a fiduciary duty to the corporation and its shareholders. In general, fiduciaries have a duty of care and a duty of loyalty to the corporation. This includes the safeguarding of assets and in essence, that the assets are used (and spent) accordingly. Fiduciaries also have an obligation to ensure “fair dealing” and “fair price”. Fair dealing is more from a procedural standpoint and fair price is more from a financial point of view. *(continued page 3)*

VALUATION ISSUES FOR BUY/SELL AGREEMENTS

Overview

Buy/sell agreements are commonly used by closely held businesses to provide a plan for the transfer, valuation, and payment of a shareholder’s interest in a business.

A buy/sell agreement should not be drafted solely to protect against an unforeseen death of a shareholder, but also to create security for other events, such as:

- Divorce
- Disability
- Bankruptcy
- Retirement
- Termination of employment
- Personal liquidity needs

Most attorneys strongly recommend such agreements be drafted during the business creation process. Buy/sell agreements should, of course, be periodically reviewed and modified as necessary during the growth and evolution of a business.

Types of Buy/Sell Agreements

There are three main types of buy/sell agreements used by closely-held businesses:

- Entity Purchase Agreements specify that the company will buy the shares of the departing (or deceased) shareholder from the shareholder or his/her estate.
- Cross-Purchase Agreements specify that one or more of the other shareholders may purchase the departing shareholder’s shares.
- Hybrid Agreements are essentially the best of both worlds. These agreements let the current shareholders “wait and see” what the best course of action may be, depending upon the condition of the company, financial constraints of the remaining shareholders, tax considerations, and liquidity preferences.

Valuation Provisions

The valuation provision of a buy/sell agreement is often the most important and significant section of the agreement. In general, there are three primary valuation methods that can be utilized in a buy/sell agreement:.

- Professional Valuation – A company may engage a valuation professional to perform a valuation on an annual basis if an event occurs that triggers the buy/sell agreement. A professional valuation should consider asset-based, market-based, and income-based methods and select the most appropriate method in determining a valuation of the company.
- Formula Approach – The shareholders, with advice from their financial advisors, may define a set formula to establish value for the shares. In creating a formula, it is important to identify and focus on the primary value drivers of the company.

For example, a revenue-based formula that specifies the value of a company being worth 1.5 times revenues does not consider earnings and may not be applicable if the company is losing money and has a significant working capital deficit. *(continued page 2)*

Purchase Price Allocations

For Government Contractors

The accounting standard for business combinations (SFAS 141) and acquisitions is accounted for under the purchase method of accounting. In general, when a business is purchased, the acquired current assets, fixed assets, and identifiable intangible assets are recorded at fair value and the remaining difference is allocated to goodwill. The goodwill is not amortized.

Purchase price allocations for government contractors have many unique attributes. We have studied over 53 acquisitions of government contractors and published an accounting analysis of purchase price allocations for government contractors.

Overview of the Purchase Price Allocation Process

The first step in a purchase price allocation is to determine the purchase price, which can be easy if it is a 100% cash acquisition, but if non-cash consideration or contingent consideration is involved, it can be much more difficult.

Next, intangible assets are recognized as separate, stand-alone assets when they can be separately identified and if it arises from contractual or other legal rights, or if not contractual, only if it is capable of being transferred, licensed, rented or exchanged. An assembled workforce is not separately recognized, but it is typically analyzed and valued as part of other calculations.

There are five main types of identifiable intangible assets for US GAAP purposes:

- Marketing-related (trademarks, trade names, internet domain names, etc.);
- Customer-related (customer contracts, customer relationships, customer lists, etc.);
- Artistic (books, plays, magazines, pictures, video material, etc.);
- Contract-based (licensing agreements, royalty agreements, franchise rights, etc.); and
- Technology-based (patents, computer software, trade secrets, etc.).

Specific Purchase Price Allocation Issues for Government Contractors

Non-contractual Customer Relationships – This is always a tough one, but US GAAP does provide useful guidance: in accordance with EITF-02-17, Recognition of Customer Relationship Intangible Assets Acquired in a Business Combination, all funded and unfunded contract amounts should be analyzed, as this is the expected revenue stream from the underlying contracts and customer relationships.

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Valuation Issues For Buy / Sell Agreements (continued)

A business valuation for a buy/sell agreement can also help identify the value drivers of a business and help the shareholders focus their efforts towards their common goal of maximizing the company's value. Business valuation should be viewed as an essential strategic planning tool.

- Formula with Contingency – A formula can be established to set the value of the company, but in the case of a significant development in the company, such as the winning of a patent, significant revenue growth, or an acquisition, then the need for a professional valuation would be triggered. This protects the departing shareholder if a significant event occurs and the shareholders have not updated the formula in their buy/sell agreement in a timely manner.

If a formula is used, it is critical to define its components. Extra details and illustrative examples are helpful. Even some of the more common terms such as: revenues, book value, cash flow, and taxes should be defined. In addition, it is very important to define the standard of value that should be applied. The terms book value, fair market value, and fair value are terms of art for business valuation professionals and need to be defined accordingly.

Also, be sure to specify which financial period the valuation will be based on (e.g., the previous fiscal year, the prior twelve months starting from the previous quarter, etc.). Problems may arise if the valuation date is the exact date of death or other significant event. It may not be feasible for some businesses to produce a set of proper financial statements in the middle of the month.

Once a valuation is determined, the actual transaction value of the shares may be adjusted depending upon the situation. For illustrative purposes, payments might be made in accordance with the following example percentages:

- Death = 100%
- Disability = 85%

Summary

Buy/Sell agreements are critical for closely held businesses. It is important to structure them to protect the departing shareholder as well as the remaining investors. The agreement should be tailored to meet the specific needs and terms unique to the situation. The valuation provision should be carefully reviewed to ensure fairness. A sound agreement will minimize the time and expense involved in liquidating and transferring the shares.

Valuation Issues for Audit committees

Top 3 valuation Issues & The Questions Board Members Should be Asking (continued)

Fairness opinions are used during material mergers and acquisitions, management buy-outs, recapitalizations, related party transactions, private placements, corporate restructurings, and to comply with loan covenants.

Fairness opinions are letters or other presentations to the board that analyze a potential, material transaction. The opinion is not just about mitigating risk for the board, but also serves to summarize the transaction and its motives, aid in decision making, and generally enhance the communication revolving around a transaction (to make everyone, from the board to the shareholders, educated on the potential transaction).

Obtaining a fairness opinion is an important process, and the value of it is often in the process itself. Drafts should be circulated to board members. The board should play an active role in vetting and analyzing a fairness opinion, not just accepting the report at face value. Final opinions should be dated as of the date of vote by the shareholders or as of closing, often depending on the facts and circumstances of the transaction and legal counsel.

2. Goodwill Impairment Testing

Goodwill is no longer amortized, but subject to specific impairment testing under SFAS 142. In general, goodwill is tested on a reporting unit basis and a two-step test is performed. First, if the fair value of a reporting unit is less than its carrying value, than its goodwill may be impaired. Second, in such instances, all of the intangible assets would be re-valued and a new residual goodwill balance would be determined, the difference in goodwill balances is the impairment.

Goodwill should be formally tested for impairment on an annual basis (more frequently if significant risks exist).

Testing goodwill for impairment applies to all companies, whether public or private, which have goodwill balances. Goodwill impairment testing should be performed annually, but may be performed at any time during the year. For consistency, the FASB recommends the test should be performed at the same time each year. Different reporting units may be tested at different times during the year, regardless of the fiscal year of the parent company.

The determination of the fair value of a reporting unit can be carried forward from one year to the next if all of the following criteria have been met:

- The reporting unit's assets and liabilities have not changed significantly;
- The recent fair value determination exceeded the reporting unit's carrying amount by a substantial margin; and
- Based on an analysis of the current situation, the likelihood that a current fair value determination would be less than the carrying amount would be remote.

In situations where the fair value of a reporting unit may be reduced below its carrying amount, impairment tests should be performed between annual tests, such situations include:

- A significant adverse change in the business climate;
- Unanticipated competition or loss of key personnel; and
- An expectation that a significant portion of a reporting unit would be sold.

Important questions for Audit Committee members to ask include: When was the last time we tested goodwill? How often do we test it? How close are we to being impaired, that is, at what value does the company have to be for it to be impaired? How are we valuing the company and which methodologies are being used?

3. Purchase Price Allocations

Under SAS 141 (which is planned to be revised in 2006, stay tuned), acquisitions are accounted for under the purchase method of accounting.

In general, when a business is purchased, the acquired current assets, fixed assets, and identifiable intangible assets are recorded at fair value and the remaining difference is allocated to goodwill. The goodwill is not amortized.

The first step in a purchase price allocation is to determine the purchase price, which can be easy if it is a 100% cash acquisition, but if non-cash consideration or contingent consideration is involved, it can be much more difficult. Next, intangible assets are recognized as separate, stand-alone assets when they can be separately identified and if it arises from contractual or other legal rights, or if not contractual, only if it is capable of being transferred, licensed, rented or exchanged. An assembled workforce is not separately recognized, but it is typically analyzed and valued as part of other calculations.

Are the identified and valued intangible assets consistent with the perspectives that originally drove the deal?

Important questions for the Audit Committee members to ask include: Any and all questions –the more the better. From personal experience, I have spent days with board members vetting and analyzing every sentence and calculation in a fairness opinion. Board members can't ask enough questions. The Q&A period can be valuable to learn more about the transactions, value drivers, comparable public companies, and valuation methodologies. The more questions the better; the only poor question is the one not asked. Another issue that audit committee members should consider is: does the opinion need to be provided by someone who is clearly independent?

US GAAP Spotlight

- Release date of SFAS 141-R is postponed, expected release date is Q12007 effective for 2008.
- Exposure draft on mergers and acquisitions for non-profit organizations and Fair Value Measurements are expected to be released this summer.

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BUSINESS VALUATION PRACTICE NEWS

- Dennis Roberts is serving on the National Association of Certified Valuation Analyst's Executive Committee
- Andy Smith is serving on the AITF Task Force, which advises the SEC and FASB on valuation issues
- John Jacob has been awarded the AVA Credential

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PURCHASE PRICE ALLOCATIONS

FOR GOVERNMENT CONTRACTORS (CONTINUED)

Additional non-contractual relationships should be captured in the analysis of the company's proposals and pipeline.

Non-compete Agreements – Non-compete agreements are explicitly identified as an intangible asset subject to separate identification and valuation. A non-compete provision is a typical term of an M&A transaction. However, valuing them can get quite complicated because the value of the business with and without competition should be analyzed (two separate business valuations). If the executive subject to the non-compete is 85 years old and plans to retire to Florida after the transaction, does the non-compete have value? It is important to take into account the probability of competition, as well as the potential impact to cash flows. What if the non-compete agreement is for two years and the company's cash flows for the next three years are covered by existing, long-term contracts, is there a material affect to the cash flows of the business under the terms of the non-compete agreement?

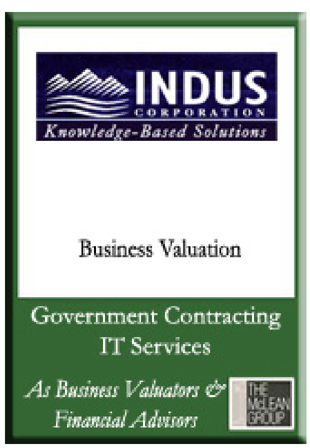
Developed Technology – We commonly hear that the acquired company was an IT service provider. But, upon talking to people outside the accounting department, proprietary software tools and other know-how usually exists and should be analyzed. It is important to get a thorough understanding of the business to make sure all identified intangibles have been accounted for.

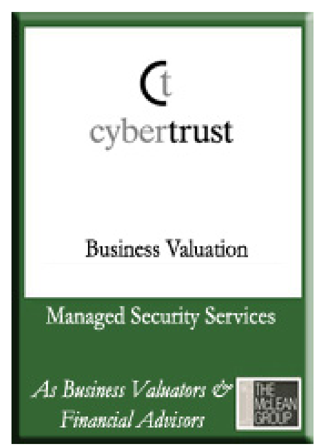
In-Process Research & Development (IPR&D) - If there is developed technology, there may also be IPR&D. IPR&D can be separately recognized if the projects have characteristics of control, expected economic benefit, and the Fair Value can be estimated with reasonable reliability. An acquiring company's interest in IPR&D is controllable by the combined enterprise if it can obtain benefit from the asset and control others' access to the asset. Acquired IPR&D has economic benefit when the acquiring company can demonstrate that the assets will be used for post-combination IPR&D activities and that the IPR&D is measurable.

Stay Tuned

Purchase price allocations will be changed with the release of SFAS 141R, stay tuned for more details.

SELECTED McLEAN GROUP ENGAGEMENTS





ABOUT THE McLEAN GROUP

The McLean Group is a middle-market investment bank providing merger and acquisition, business valuation, capital formation, executive advisory and litigation support services. Its focus is on serving middle-market businesses generating between $5 million and $300 million in revenues. The firm has a widespread practice with particular expertise in the IT services, technology, telecommunications, government contracting, staffing, and travel and hospitality sectors. Registered broker dealer.