

Value Added

Insights and Updates on Business Valuation

About Value Added

Volume II, Issue I

Copyright 2004

January, 2004

This newsletter is available both in hardcopy and by e-mail. Please feel free to forward this to your clients and associates.

To have your name removed from our list, please send an e-mail with your name to: unsubscribe@axiomvaluation.com.

Power Points

(Recent Speaking Engagements, Press Releases, and Publications by Our Staff)

• MassMutual

Affiliation

MassMutual Financial Group joins list of satisfied Axiom affiliates—web Release (January 2004)

• Current Trends In Valuation

A presentation by Stan Feldman to the 7th Annual M&A Advisors Conference in New York (December, 2003)

• Business Valuation

Axiom-written chapter in *The Team Approach to Tax, Financial & Estate Planning*, Lance Wallach, editor, AICPA Publication (December 2003)

• Launch of Free Industry Search Engine

Axiom is lead sponsor of new, free industry search engine, www.naicscod.com—press release (December 8, 2003)

Check the What's New and Valuation Library at www.axiomvaluation.com for links to most of these citations.

Risks of Advising Outside Your Expertise

Despite complexity and specialization required to offer competent valuation and transactional advice to business owners, many financial professionals provide this advice despite the absence of the requisite experience and training. Unfortunately, the results are often disastrous for everyone involved in the transaction.

Axiom was recently engaged to advise a business owner who sold a profitable company to a direct competitor. Throughout the transaction process, the business owner relied nearly exclusively on his long-term CPA for advice. The CPA, who had no valuation training and limited experience with transactions, served as the key advisor on the valuation computation for the firm and offered extensive strategic advice on the deal. As part of the advisory services, the CPA did two things that ultimately haunted all parties to the deal:

1. The CPA advised the seller that he was not entitled to any of the synergies the buyer would enjoy as a result of merging its number one competitor into its operation (e.g. pricing power in the market by eliminating competitor, increase leverage in negotiating with vendors); and
2. In addition to counseling the seller, the CPA also performed an audit on behalf of the buyer, which all parties relied upon in calculating earnings for valuation purposes.

As a result of the CPA's advice, the

seller did not attempt to value the business in such a way as to receive any of the synergistic benefits of the deal. Although the seller certainly could not have expected to receive 100% of those synergies, a competent valuation professional would have counseled the seller to negotiate to receive some of that value. To add insult to injury, not only did the seller not receive appropriate value for his business, he ultimately was forced to pay back 20% of the multi-million dollar sales price. This occurred because the buyer sued the seller for misrepresenting its earnings through the audit performed by the CPA, allegedly because the audit was not GAAP compliant. As icing on the cake, the seller also was ordered to pay the buyers attorneys' fees for the arbitration. Axiom is now advising the business owner in his professional malpractice lawsuit against the CPA and his firm.

Everyone lost in this situation. The seller did not receive fair value for a firm he spent his professional life building. The buyer felt, and was adjudicated to have been, wronged by the seller through the improper work of the CPA. And, the CPA is now being sued for professional negligence. This was hardly the result the parties envisioned at the outset of negotiations and it never would have happened but for a simple fact: the CPA was afraid to tell his client that he lacked the requisite experience in

the transactional realm. As a result, he gave erroneous advice and put himself in an impossibly conflicted position by advising both sides of the transaction.

Several important lessons emerge from this case:

1. Know Your Expertise – Practice only in areas where your education, training and experience render you qualified. Advisors who step outside their skill sets risk hurting clients and put their own livelihoods in jeopardy.
2. Stand Strong – Be able to spot conflicts of interest or areas where you lack expertise and tell the client that you cannot carry out the engagement.
3. Facilitate the Acquisition of Expertise – Although you may not be able to carry out a particular assignment, you can still be the key member of your client's team. Put your client in contact with experts in the relevant fields. Clients will appreciate that you practice in areas where you provide real expertise and will value your ability to introduce them to the best advisors for any situation.

Advisors, who bring not only their expertise in particular areas but also the right specialists for other aspects of the client situation, will best serve their clients, while greatly mitigating malpractice risk. (See below for more on teaming)

Axiom Chapter in New AICPA Book

The American Institute of Certified Public Accountants recently published a new book, *The Team Approach to Tax, Financial & Estate Planning*, edited by Lance Wallach. Axiom's principals contributed Chapter 7 on Business Valuation. This chapter and the book overall provide practical advice for CPAs on

partnering with other experts to provide the best planning advice for the CPA's clients. Axiom's chapter focused on the need for, and the advisor benefits associated with, undertaking a valuation when doing any financial planning for a business owner. Given the complexity associated with financial planning for

business owners, partnering with experts in fields such as valuation, taxation and finance is essential to providing clients with the level of service they require.

For more information on the book, or to purchase a copy, visit www.cpa2biz.com.

Hot Links

(Websites of Interest to CPAs and
Other Professional Advisors)

encycogov.com

Free encyclopedia of corporate gov-
ernance issues

accountingmalpractice.com

Free and fee-based information and
advice on fraud and malpractice
issues facing accountants

Axiom Valuation's Services

Business Value Estimates

Certified Business Valuations

FAS 141 (Purchase Price Allocation) & FAS 142 (Goodwill Impairment)

Litigation Support & Expert Testimony (Valuation/ Economic Damages)

Axiom Valuation's Senior Staff

Dr. Stan Feldman
Chairman

Roger Winsby
President

Matt O'Connor
Vice President

Pat Mansfield
Vice President

www.axiomvaluation.com

800-477-VALU

600 Suffolk Street, 4th Floor
Lowell, MA 01854

Expert, Defensible & Cost Effective Valuation Services

Tax Minimization. Or Is It Value Minimization?

Tax season is upon us and business owners and their CPAs are huddling to review 2003's tax liabilities and to formulate tax strategy for 2004. The central goal of many of these strategies will be tax minimization for the new year. Conventional wisdom tells us that limiting tax exposure is sound advice for every business owner. Like all general rules, however, conventional wisdom is not correct for every owner.

Incorporating strategies to legally minimize tax liability is sound advice for businesses during both their start-up phase and for much of their operating existence. However, when the time is approaching for the business to be transitioned, the tax strategy is one of the most important business issues that needs to be re-evaluated.

To minimize tax liability, the owner is also limiting reported earnings. Limiting earnings is problematic because earnings drive the value that a buyer is willing to pay for a firm and play a significant role in a buyer's

ability to finance a deal.

Owners seeking to exit a firm at its maximum value must make the transition from a tax minimization strategy to one stressing value maximization. This strategy shift will likely lead to an increase in valuation that will far outweigh any increased tax liability.

This strategy shift cannot occur overnight. Owners must have time to alter their tax strategies gradually while also making other operational changes that they know will increase earnings, but which they have often put off because of the implementation challenges these changes entail.

By encouraging owners to take a hard look at tax strategies in conjunction with operational changes three to five years before a planned transition, you can perform a valuable service by assuring that clients maximize the values of their businesses as they move into the next phase of their lives.

Creating IRS Friendly Family Limited Partnerships

The IRS is always on the look out for family limited partnerships that have no business purpose. Recently there have been several court cases involving FLPs that have made investors very nervous that the IRS will conclude that their FLPs are mere tax shams. Financial planners and lawyers are naturally concerned that many of the FLPs they helped create may not pass muster with the new IRS guidelines. Additionally, these financial advisors are wondering whether tighter IRS scrutiny will question, and eventually overturn the large discounts that valuation advisors often apply when valuing the shares of an FLP or an LLC set up as an FLP.

FLP structure includes, a general partner, usually a parent, and limited partners, typically children. The assets that typically make up the partnership include real estate, public stocks and bonds, and ownership shares in closely-held corporations. The FLP effectively issues two types of shares- control shares owned by the general partner and shares owned by the limited partners. Even though the general partner may only own 1% of the total shares outstanding, the general partner's the per share value is greater than the per share value of any limited partner because the general partner has control over income distributions and how the assets of the FLP are deployed. Limited partner shares can be further discounted for lack of liquidity. In total, these discounts can amount to as much high as 40% of the value of the underlying assets of the FLP. To reduce the risk of IRS challenge, keep the following in mind:

1. Consider having someone other than the investor, like an adult child, serve as the general partner;
2. Make sure the purpose of the FLP is clearly stated and that it is a business purpose;
3. Be sure that a paper trail demonstrates that the general partner is managing the FLP consistent with its stated purpose and that all corporate formalities are maintained;
4. Do not intermingle personal assets or purposes of the general partner with FLP;
5. Have an appraisal of any gifted FLP shares carried out by a qualified valuation professional and be sure that the discounts applied to the limited partnership interests are consistent with accepted academic research. A study by a consulting firm establishing the size of the discount for lack of control and lack of liquidity is insufficient.

Axiom Sponsors NAICSCode.com

Axiom Valuation is the lead sponsor of a new, **free** Internet search engine, www.NAICSCode.com, the most comprehensive resource for NAICS, the North American Industry Classification System. This website serves as an important resource for accountants, business owners, library professionals, and anyone needing to identify the appropriate NAICS code, SIC code, or the IRS Business Activity Code (based on the 2002 NAICS system) for a U.S. business.

The Business Activity Code is a required line on a business tax return, yet 30% of tax returns we review have the wrong code. Assigning the wrong code raises the risk of an IRS audit – an occurrence CPAs and business owners want to avoid!

AccountingMalpractice.com and U.S. Financial Advisors, LLC, have joined Axiom in sponsoring this free resource, reflecting our common focus on providing important content and services to CPAs.