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VALUATION ISSUES™

Klaris, Thomson & Schroeder, Inc. **2002-1**

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FASB Statements 141 & 142

by Philip M. Reynolds, CPA, CVA

In June of 2001, the Financial Accounting Standards Board ("FASB") issued new standards relating to the accounting for business combinations. The new rules, which had been under consideration since 1996, make two important changes. The first change is that Statement Number 141, which supersedes Accounting Principles Board ("APB") Opinion Number 16, disallows the use of the pooling-of-interests method of accounting for business combinations, and requires instead the use of the purchase method. FASB felt that this change was necessary for several reasons.

Under APB Opinion Number 16, whenever twelve specific criteria were met, the pooling-of-interest method was required. If even one of those twelve criteria were not met, the purchase method was required. The overriding theme of the twelve criteria is continuity of ownership. If all twelve of the criteria were met, this indicated that there was a continuity of ownership, that the owners of the separate businesses were pooling their interests in their separate companies, and so the pooling-of-interests method was required. If even one of the twelve criteria were not met, this indicated a lack of continuity of ownership. In this case, the owners of the separate businesses were not pooling their interests in their separate companies, but rather, one of the companies was purchasing the other, and so the purchase method was required. As a result, similar transactions were often recorded using different accounting methods which produced very different results in the post-merger financial statements. The new standards are intended to make similar business combinations more comparable.

"Since intangible assets are increasingly important, FASB felt that they should be recognized."

Second, the purchase method recognizes all of the intangible assets acquired in a business combination, while the pooling method recognizes only the pre-existing intangible assets. Since intangible assets are increasingly important, FASB felt that they should be recognized. The new standards are intended to give a more complete recognition to intangible assets.

Third, differences between the pooling and the purchase methods were affecting competition in the mergers and acquisitions arena. By mandating the use of a single method of accounting in all business combinations, the accounting treatment under the new standards should become more neutral, neither encouraging nor discouraging business combinations, but simply providing impartial information about them.

Finally, although combining companies often strove to meet the twelve criteria necessary to qualify the transaction as a pooling-of-interests, FASB is of the opinion that nearly all business combinations are acquisitions, and, like other asset acquisitions, should be reported based on the values exchanged. The purchase method records business combinations based on the values exchanged. This allows financial statement users to better analyze post-transaction results.

The second important change which resulted under the new standards is that Statement Number 142, which supersedes APB Opinion Number 17, disallows amortization of goodwill, and requires instead the use of an annual impairment test. FASB felt that this change was necessary for several reasons.

Since intangible assets are increasingly important, better information about them was required. Also, users

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FASB 141 & 142
(Cont.)

of financial statements did not consider amortization of goodwill to provide useful information.

Under APB Opinion Number 17, all intangible assets were assumed to deteriorate with the passage of time, and so they were required to be amortized over their useful lives in order to properly calculate net income. The maximum life over which intangible assets could be amortized was forty years.

Under the new standards, intangible assets are not assumed to deteriorate with the passage of time. Identifiable intangible assets with finite lives will continue to be amortized over their useful lives, but with no arbitrary maximum life. Non-identifiable intangible assets with indefinite lives, such as recorded goodwill which arises from a business combination, will no longer be amortized. Instead, goodwill will be allocated at the date of acquisition to one or more business reporting units, and tested at least annually thereafter for impairment. The test will be performed by determining the fair value of the business reporting unit as a whole, calculating the value of the recognized net assets other than the goodwill, and determining the fair value of the goodwill as the difference between the two. Fair value is defined as the amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. If the appraised value of the goodwill exceeds its book value, no action is required. However, if the appraised value of the goodwill is less than its book value, then the book value of the goodwill must be reduced to its appraised value, and the loss from impairment of the goodwill must be presented as a separate line-item in the operating section of the income statement.

"The new rules were quite controversial when they were proposed, and were modified several times before they were issued."

The new rules were quite controversial when they were proposed, and were modified several times before they were issued. Critics contended that the elimination of the pooling-of-interests method would cause a decrease in the number of mergers. Merging companies prefer to use the pooling method rather than the purchase method because it makes their reported post-merger financial results look better. Under the purchase method, the recorded value of acquired assets are based on the values exchanged, and these are often higher than the pre-combination values. This led to higher depreciation charges as a result of the higher recorded values of the fixed assets, higher amortization charges as a result of higher recorded values of the fixed assets, higher amortization charges as a result of the amortization of goodwill, higher stockholders' equity as a result of the higher reported asset values, and lower reported net income. The lower reported net income and higher reported stockholders' equity led to lower reported return on investment.

Under the pooling method, since the business owners are merely joining their interests, there is no purchase of assets. This means that asset values do not need to be restated, goodwill does not need to be recorded, stockholders' equity does not need to be increased, and future reported net income is higher because it is not burdened with higher depreciation and amortization charges. The higher reported net income and lower reported stockholders' equity lead to a higher reported return on investment under the pooling method. The change from the amortization of goodwill to an impairment test, and the elimination of maximum lives for intangible assets may have been designed to make the elimination of the pooling method more palatable for those who were opposed to the change.

Klaris, Thomson & Schroeder, Inc., (KTS) is a multi-disciplined appraisal firm with capabilities in financial analysis, as well as in the valuation of entities and their assets including real estate, machinery and equipment intangible assets and goodwill. In addition, KTS has performed goodwill impairment tests (step 1 and step 2) for many of its clients.

Philip M. Reynolds, CPA, CVA is a Senior Valuation Consultant with **KTS, Inc.**, *in the Maryland office. (302) 283-1505*
e-mail: preynolds@ktsvaluation.com

Estate of Helen Bolton Jameson
T.C. Memo 1999-43
Vacated and Recommended for Further Proceedings By The 5th Circuit on Appeal
October 17, 2001

By John A. Thomson, ASA, MAI

Key Issue: Built-in Capital Gains Consideration

In this issue we will give our original thoughts on why this case was vacated.

Judge Gale in his tax court ruling "Crafted His Own Valuation" per the 5th Circuit on valuing a 98 percent interest in Johnco, Inc.

Because neither the taxpayer's experts or the IRS expert provided creditable analysis, Judge Gale started with the net asset value approach (as the company Johnco, Inc. was an asset holding company, primarily timber property and other real estate). He then proceeded to develop his own built-in capital gains allowance, quoting the Davis case. However, his method of developing the built-in capital gains allowance was completely different than

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Estate of Helen Bolton Jameson (Cont.)

the method used in Davis, and for this reason we believe his decision was vacated.

Judge Gale without the help of creditable expert analysis on built in capital gains, starts with net asset value, then develops his discount (allowance for built in capital gains) by assuming a certain growth rate on the timber and deducting a 34 percent capital gain tax from the expected revenue (cash flow) over a 9-year period.

We note that had Judge Gale used the same method and analysis KTS used in the Davis case he would have concluded the same answer (approximately a 13 percent discount as part of a marketability discount). It is unfortunate he was provided no help by the experts on this issue. In fact, on page 40 of the opinion, he appears to label the IRS expert as an advocate.

We will discuss this in more detail in our next issue.

Estate of Elma Middletown Dailey

T.C. Memo 2001-263
40 Percent Interest-Marketable Securities
October 3, 2001

By John A. Thomson, ASA, MAI

This case involved a family limited partnership holding marketable securities. There were two dates of value, December 8, 1992 relative to certain gifts of limited partnership interests (45 and 15 percent), and January 10, 1997 relative to a 40 percent limited partner interest the decedent held at death. The parties stipulated to the underlying asset value of $1,267,619 and $1,047,603, respectively. The parties disagreed as to the discount applicable to the subject interest. As of the respective dates, the Partnership held only three (3) separate marketable securities; however, as of the first date, one common stock (Exxon), represented 95 percent of the total asset value and as of the second date it represented 98 percent of the total asset value.

The estate took a 40 percent discount on the gift tax return and on the estate return. The taxpayer's expert opined that a 40 percent discount (including lack of marketability and lack of control) was appropriate. The IRS's expert (respondent's expert) opined that a 15.72 percent discount was appropriate for December 8, 1992 and that a 13.51 percent discount was appropriate for January 10, 1997. The court concluded that a 40 percent discount should be applied based on the facts and circumstances submitted and the testimony of the two expert.

Many readers would stop here and proclaim that 40 percent is the new standard discount for limited partnership interests holding marketable securities. However, we would suggest a more careful reading of the entire case, especially as to what was said about the IRS's (respondent) "Expert." We quote from the case:

> **"Many readers would stop here and proclaim that 40 percent is the new standard discount for limited partnership interests holding marketable securities."**

"Respondent's expert, on the other hand, relied in part on an unpublished study that he co-authored and, in a revised report submitted at trial, increased the marketability discount purportedly substantiated by his unpublished study from 12.5 percent to the 14.1 percent. Respondent's experts opined that an aggregate discount of 15.72 percent on December 8, 1992 and 13.51 percent on January 10, 1997, should be applied. At trial, respondent's expert testified that he could not recall reviewing the agreement and, although he believed that unrealized capital gains are "an important source of discount," he did not review the documents to determine if the FLP had any such gains. Respondent's expert's testimony was contradictory, unsupported by the data, and inapplicable to the facts."

One must wonder why this "expert" was retained by the IRS. When an appraiser does not review all the data and does not use reasonable judgement which is well supported, to advocate a value, whether it be for the IRS or the taxpayer, they perform a disservice to their client and to the profession. According to the court, the IRS's expert did not even read the Partnership Agreement (WOW). As appraisers we are not supposed to be advocates (actually we are not allowed to be advocates if we are accredited) and just because the attorney for one side or the other side is an advocate for his client, as he should be, an appraiser must not get caught up in the advocacy even if it means taking a pass on the assignment.

Judge Foley goes on to say in his opinion that while neither expert was extraordinary, petitioners' expert provided a more convincing and thorough analysis than respondent's expert.

Relative to the reference to built-in capital gains on the Exxon stock, I would suggest it may not be meaningful in the context of this case considering the IRS's expert's, testimony. Also, we are reminded that the built-in capital gains case "Davis" involved a "C" corporation where there was double taxation, not a partnership.

John A. Thomson, ASA, MAI *is a Managing Director with* **KTS, Inc.**, *in the Los Angeles Regional office, a Senior Member of the American Society of Appraisers (ASA) and a Member of the Appraisal Institute (MAI). (562) 597-0821 e-mail: jthomson@ktsvaluation.com*

KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

8/8/01	Presentation—IRS - LMSB Engineering CPE Session, St. Louis, MO.—"Common Errors, Misconceptions, and Fallacies of Business Valuation"
9/24/01	Presentation—Pinellas County Estate Planning Council—"Overview of Strangi and Knight Cases"
10/26/01	Presentation—20th Annual Advanced Business Valuation Conference, Seattle, Washington
11/01/01	Presentation—Manatee County Estate Planning Council—"Valuation Concepts From the Davis Case"
11/14/01	Presentation—Business Valuation Roundtable, St. Louis, Missouri, "Identification and Valuation of Intangible Assets"
1/15/02	Presentation—Waterloo Rotary Club, Waterloo, Illinois—"Business Valuation"

KTS RECENT ENGAGEMENTS

* Valuation of subsidiary of publicly traded company - high tech electronics manufacturer - for goodwill impairment testing under FASB.
* Valuation of large medical supply company for potential joint venture purposes.
* Valuation of a Midwest grocery chain for recapitalization and conversion of stock.
* Valuation of automobile dealerships for dissolution of marriage.
* Valuation of the common stock of a closely-held internet solutions company for litigation support purposes.

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Valuation Issues

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Quarterly Quote:

"A problem well stated is a problem half solved."

-Charles F. Kettering