NOVEMBER / DECEMBER 2017

ADVOCATE'S EDGE

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3 approaches to valuing a business

Business valuation professionals typically apply three different approaches when valuing a business — the cost, market and income approaches — ultimately relying on one or two depending on the type of case and other factors. It's vital that attorneys and clients who rely on business valuations understand the basics of each approach.

1. Cost approach

The cost (or asset-based) approach derives value from the combined fair market value (FMV) of the business's net assets. This technique usually produces a "control level" value, meaning the value to an owner with the power to sell or liquidate the company's assets. For that reason, a discount for lack of control (DLOC) may be appropriate when using the cost approach to value a minority interest. This approach is particularly useful when valuing holding companies, asset-intensive companies and distressed entities that aren't worth more than their net tangible value.

The cost approach includes the book value and adjusted net asset methods. The former calculates value using the data in the company's books. Its flaws include the failure to account for unrecorded intangibles and its reliance on historical costs, rather than current FMV. The adjusted net asset method converts book values to FMV and accounts for all intangibles and liabilities (recorded and unrecorded).

2. Market approach

The market approach bases the value of the subject business on sales of comparable businesses or business interests. It's especially useful when valuing public companies (or private companies large enough to consider going public) because data on comparable public businesses is readily available.

Under this approach, the expert identifies recent, arm's length transactions involving similar public or private businesses and then develops pricing multiples. Several different methods are available, including the:

Guideline public company method. This technique considers the market price of comparable (or "guideline") public company stocks. A pricing multiple is developed by dividing the comparable stock's price by an economic variable (for example, net income or operating cash flow).

Merger and acquisition (M&A) method. Here, the expert calculates pricing multiples based on real-world transactions

Excess earnings method blends the cost and income approaches

The excess earnings method derives value from the sum of 1) adjusted net assets, and 2) capitalized "excess" earnings. The second component represents the extra earnings that the company has been able to achieve beyond the return that comparable businesses earn on a similar set of net assets.

Essentially, this method equates capitalized excess earnings with the value of the business's goodwill. It's calculated using a technique similar to the capitalization of earnings method (see main article) — that is, excess earnings are divided by an appropriate capitalization rate.

This method was originally developed to compensate distilleries and breweries for loss of business value during the Prohibition era. However, to date, there's no reliable source of market data to support comparable returns on net assets or capitalization rates for excess earnings. So, experts generally refrain from using it as a sole method of valuation, unless a particular court has shown a preference for this technique. In addition, IRS Revenue Ruling 68-609 suggests that the excess earnings method be used only if there are no other appropriate methods.

involving entire comparable companies or operating units that have been sold. These pricing multiples are then applied to the subject company's economic variables (for example, net income or operating cash flow).

Under the market approach, the level of value that's derived depends on whether the subject company's economic variables have been adjusted for discretionary items (such as expenses paid to related parties). If the expert makes discretionary adjustments available to only controlling shareholders, it may preclude the application of a control premium. If not, the preliminary value may contain an implicit DLOC.

3. Income approach

When reliable market data is hard to find, the business valuation expert may turn to the income approach. This approach converts future expected economic benefits — generally, cash flow — into a present value. Because this approach bases value on the business's ability to generate future economic benefits, it's generally best suited for established, profitable businesses.

The capitalization of earnings method capitalizes estimated future economic benefits using an appropriate rate of return. The expert considers adjustments for such items as discretionary expenses (for example, for above- or below-market owner's compensation), nonrecurring revenue and expenses, unusual tax issues or accounting methods, and differences in capital structure. This method is most appropriate for companies with stable earnings or cash flow.

The discounted cash flow (DCF) method also falls under the income approach. In addition to the factors considered in the capitalization of earnings method, the expert accounts for projected cash flows over a discrete period (say, three or five years) and a terminal value at the end of the discrete period. All future cash flows (including the terminal value) are then discounted to present value using a discount rate instead of a capitalization rate.

As with the market approach, the income approach can generate a control- or minority-level value, depending on whether discretionary adjustments are made to the future economic benefits.

Important decision

No universal formula exists for all businesses. Therefore, it's essential for experts to explain why they chose a specific method (or methods) over all the possible options. ■

’Tis the season for donations

How not-for-profits can detect and prevent common fraud schemes

Charities and other not-for-profit organizations typically receive most of their donations at year end. Although fraud is generally *less* common among not-for-profits than at for-profit businesses, it’s critical for these organizations to be on the lookout for fraud during the busy season. Here are examples of fraud schemes that are most common to not-for-profit organizations, along with some ideas to help beef up internal controls to prevent fraud.

Identify vulnerabilities

Many not-for-profits are staffed by people who believe strongly in their missions, which contributes to a culture of trust. Unfortunately, such trust makes nonprofits vulnerable to certain types of fraud. For example, if managers don’t supervise staffers who accept cash donations, it provides an opportunity for them to skim (keep a donation for themselves without recording its existence in the books). Skimming is even more likely to occur if a not-for-profit doesn’t perform background checks on new employees and volunteers who’ll be handling money.

> During crowded, chaotic fundraisers, not-for-profits should generally discourage supporters from making cash payments.

However, skimming isn’t the most common type of fraud scheme in the not-for-profit sector. According to the *2016 Report to the Nations on Occupational Fraud and Abuse* published by the Association of Certified Fraud Examiners, religious, charitable and social services entities are most likely to fall prey to corruption schemes — where a staffer abuses his or her influence to gain direct or indirect economic benefit, such as a bribe or a contract for a for-profit business that he or she invests in.

Other top schemes among not-for-profits include check tampering, phony expense reimbursement claims and billing schemes. For example, nonprofit staffers might invent and submit invoices on behalf of fictitious vendors or collude with actual vendors who are willing to submit false or inflated invoices.

Reinforce internal controls

Preventing such crimes begins with strong internal controls. Even small nonprofits that consider their employees and volunteers “family” need to establish and follow procedures that limit access to funds. Dishonest staffers who are paid modest salaries or who volunteer may justify their wrongdoing because they would earn more if they provided the same services to a for-profit business.

Possibly the most important internal control to prevent insider fraud is segregation of duties. To reduce opportunities for any one person to steal, multiple employees should be involved in processing payables. For example, every incoming invoice should be reviewed by the staffer who instigated it to confirm the amount and that the goods or services were received, and a different employee should be responsible for writing the check. For large expenditures, not-for-profits should require the approval of more than one person.

Similar guidelines apply to receivables. The staffer who deposits checks shouldn't also open the monthly bank statement. And the employee who opens mailed donations needs to be different from the person who makes bookkeeping entries and deposits checks.

And don't forget to protect electronic records that include financial data on donors, vendors, employees and others. Staff members should be given access only to the information and programs required for their job responsibilities. All sensitive information should be password-protected, and users should be required to change their passwords periodically.

Many nonprofits depend on money raised during a big annual gala or other special event at year end. During crowded, chaotic fundraisers, not-for-profits should generally discourage supporters from making cash payments. Instead, they can presell or preregister event participants to limit access to cash on the day of the event. If cash is accepted at the door, not-for-profits should try to assign cash-related duties to paid employees or board members, rather than unsupervised volunteers.

Consult a forensic accountant

A fraud incident can ruin a not-for-profit organization's reputation, so it's important to have strong internal controls in place to prevent fraud from happening in the first place. But internal controls can never be 100% fraud-proof. We understand how fraud happens in this unique sector and can help not-for-profits reinforce internal controls, as well as investigate suspicious behavior. ■

Are settlement proceeds taxable?

The federal tax code specifically excludes damages received for personal physical injuries or physical illness from taxable gross income. But settlements don't always explicitly provide the reason for a damages award. A recent U.S. Tax Court decision illustrates the important role the language in a settlement agreement plays when it comes to tax matters.

Ready, set, settle

The taxpayer worked for a federal government agency from 1974 until she retired in 2009. About six weeks before her retirement date, the taxpayer filed a complaint against her employer with the U.S. Equal Employment Opportunity Commission. She initially alleged discrimination and a hostile work environment on the bases of age and physical disability. She later expanded the bases of her complaint to include constructive discharge.

In April 2011, the taxpayer and her former employer entered into a settlement agreement. She agreed to withdraw her complaint, and the federal agency agreed to pay her a lump sum of $40,000.

The agency reported the payment to the IRS as nonemployee compensation for 2011, but the taxpayer didn't report the payment on her 2011 tax return. In 2015, the IRS sent her a notice of deficiency for almost $10,000, based on her failure to report the payment in her taxable gross income. She turned to the U.S. Tax Court for relief.

Nature of claims determines tax treatment

When determining whether damages received under a settlement agreement are excludable from taxable gross income, courts consider the nature of the claim. They look first to the settlement agreement for indications of its purpose.

When the agreement doesn't expressly state the purpose, courts look to other evidence indicating the payer's intent in making the payment. Such evidence includes — but isn't limited to — the amount paid, the factual circumstances that led to the settlement and the plaintiff's allegations in the complaint.

In the case at hand, the agreement between the taxpayer and her former employer didn't provide any insight into whether the payment, or any part of it, was made on account of personal physical injuries or physical illness. And the taxpayer failed to introduce any credible, objective evidence that the payment was made in lieu of damages for personal physical injuries or physical illness.

The Tax Court concluded that the damages paid under the settlement agreement were for the resolution and withdrawal of the taxpayer's constructive discharge and discrimination claims. Therefore, it ruled that the settlement payment was includable in her 2011 taxable gross income.

Don't forget the employer's tax liability

Damages excludable from gross income generally aren't subject to payroll taxes. But, to the extent a settlement payment represents back- or front-pay, the IRS will consider that payment to be taxable wages. The agency also contends that dismissal pay, severance pay and other payments for involuntary termination of employment are wages for federal employment tax purposes.

The label the parties place on settlement payments doesn't necessarily control the payroll tax treatment of payments. An employer's statement that the payment was made merely to settle a case won't satisfy the IRS that the money doesn't represent taxable wages. Generally, if the agreement doesn't specifically allocate the payment, the status of the payment is determined by looking at the employee's claims and the surrounding facts and circumstances.

Words matter

The language in a settlement agreement can have significant income and payroll tax repercussions for both parties. A financial expert may be able to help you draft settlement agreements to minimize unfavorable tax consequences. ■

Knowing when to consider subsequent events in business valuations

The value of a business interest is valid "as of" a specific date (also known as the "effective" date). This is a critical cutoff point, because events that occur after that date generally aren't taken into account. However, there are some important exceptions based on whether information is *foreseeable* or provide an *indication* of fair market value.

Foreseeability factor

Under the AICPA's Statement on Standards for Valuation Services (SSVS) No. 1, a business valuation expert generally should consider only circumstances existing on the effective date. However, under SSVS No. 1, the question of whether the valuation should take into account subsequent events ultimately turns on the *foreseeability* of those events on the effective date.

> The *Jung* case differentiates subsequent events that *affect* fair market value from those that provide an *indication* of fair market value.

The U.S. Tax Court also has generally focused on whether the events were foreseeable as of the valuation date. For example, in *Estate of Noble v. Commissioner*, the court held that the postdeath sale of the stock offered the best indication of its fair market value. It explained that "an event occurring after a valuation date … is not necessarily irrelevant to a determination of fair market value as of that earlier date."

The court held that subsequent events could affect the value on the effective date if they were

reasonably foreseeable by the hypothetical buyer or seller as of that date. For example, if a large customer contract expires three months after the valuation date and renewal negotiations were going poorly on the effective date, the valuation expert might adjust a business's revenue and profit, discount rate or pricing multiple.

Furthermore, in another case, *Estate of Jung v. Commissioner*, the U.S. Tax Court ruled that unforeseeable events can prove probative if relevant to establishing the amount a hypothetical buyer would have paid a hypothetical seller. According to the court, this category of subsequent events includes evidence of "actual sales prices received for property after the date, so long as the sale occurred within a reasonable time … and no intervening events drastically changed the value of the property." This ruling differentiates subsequent events that *affect* fair market value from those that provide an *indication* of fair market value.

Never say never

Rules — especially "general rules" — are made to be broken. While subsequent events usually won't factor into a valuation, attorneys shouldn't be surprised if they do. ■

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