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### CPAs Differ by More than 50% on Fair Value of Firm

**Peterson v. Jackson, 2011 WL 14519606 (Utah App.) (April 14, 2011)**

When three shareholders in a CPA firm couldn't agree on a buyout price for a departing partner, they sought judicial dissolution and appraisal under the applicable statutory scheme (Utah). At trial, the partnership's expert used the market, income, and asset approaches to reach a range of value from \$581,000 to \$713,000 for the entire firm, but then rejected all but the asset approach to value the shareholder's 37.6% interest at just over \$224,000.

In contrast, the departing shareholder's expert assigned zero weight to the asset approach and under a combined capitalization of cash flow and market approach, reached a total value in excess of \$1.26 million. After adding a pro-rata portion of undistributed cash and declining to deduct the value of personal goodwill (due to a non-compete), he valued the departing shareholder's interest at \$505,000. The trial court also heard evidence that one of the partners had bought into the practice in 2001 at a multiple of 90% of gross sales—which, when applied to the departing partner's shares, would have yielded a value of nearly \$518,000.

Given the more than 50% difference between the two sides, the trial court was tempted to take a "Solomon approach and split the difference." Rather than "picking a number out of thin air," however, the court credited the departing shareholder's expert, including his opinion on goodwill, and criticized the firm's expert for relying solely on the asset approach without any evidence of liquidation. He also valued the company in the hands of a specific owner rather than a "fair value concept in which the ownership interest is valued as if it were placed on

the open market for sale," the trial court said. Using the 2001 buy-in price as an additional "guidepost," it found the firm's fair value was \$1.26 million, excluding any undistributed cash, yielding roughly \$459,000 for the departing partner.

On appeal, the appellate court confirmed that the departing partner's expert provided the more reliable estimate of value while the company's expert "strayed from the clear guidance" of fair value precedent. The trial court was also correct to exclude any personal

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goodwill from its valuation, the appellate court said, with emphasis, because the non-compete effectively "converted personal goodwill, if any, to enterprise goodwill." Finally, although the departing partner's expert reduced the cash in his income approach to avoid double-counting an award of

the undistributed cash reserves, he did not offer an

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alternate calculation of value that included reserves—which were substantial (\$138,000) but not clearly outside of the firm’s historic practice. The trial court’s unwillingness to recalculate the expert’s income approach “was not error,” the appellate court found, and affirmed its fair value determination in all respects.

## How Synergies & Other ‘Non-Stock’ Benefits May Impact M&A Values

Two courts approach synergies from opposite sides of the financial spectrum—the Delaware Chancery Court after a successful asset sale and a federal district court after an acquisition ended in bankruptcy. Both decisions ask essentially the same question: did the company experts adequately factor the value of synergies in their appraisals?

In *re* Cencom Cable Income Partners, LP, 2011 WL 2178825 (Del. Ch.)(June 3, 2011) concerned an investment partnership that owned nine cable TV systems in diverse parts of the country. When the partnership expired, the general partners (GPs) purchased the assets according to the stipulated appraisal process, by which they selected an independent appraiser and the American Arbitration Association selected a second. The two appraisers valued systems individually to reach a total value of \$201 million. In addition, the underwriter retained a third appraisal at \$210 million.

The GPs set the purchase price at \$211 million and attached all three appraisals to a disclosure statement. Sixty percent of the limited partners approved the sale, but the dissenters sued the GPs in the Delaware Court of Chancery, claiming the defendants breached their fiduciary duties by “driving the valuation process to an appraisal of the cable systems individually without properly including the synergistic benefits resulting from an aggregation of the business entities.” In particular, their expert posited a 3% to 5% savings attributable to the collective synergies, which would have led to a significantly higher value for the systems.

On review, the court found no evidence that the GPs manipulated the appraisal process or that their selected appraisers were anything but experienced and independent. Moreover, the plaintiff’s expert had less experience in the cable industry and was unable to explain how he calculated the alleged savings due to synergies. He also failed to account for the systems’ lack of geographic

diversity and that their financial statements already reflected most of the benefits that the centrally managed systems reaped from economies of scale. Based on this and the “bulk” of credible evidence that the company’s appraisers captured the synergistic benefits that were already “baked into” the financial statements, the court dismissed the complaint.

In the first phase of *In re* Global Technovations, Inc., 2011 WL 1297356 (E.D. Mich.)(March 31, 2011), the bankruptcy court found that the debtor became insolvent after acquiring the American division of a Japanese automotive technology company, in large part because the parent seller had overstated the subsidiary’s earnings by \$2 million. After it avoided the sale as a fraudulent conveyance, the seller appealed, claiming the bankruptcy court’s insolvency determination ignored the “pre-transaction” projections of synergies such as new business, exclusive distribution rights, access to trademarks and technology, and maintaining a stock exchange listing.

The federal district court disagreed. In particular, it noted that bankruptcy court specifically found that in this case, since the subsidiary was worth only 53% of the debtor’s cash payment, “the value of all the benefits to [the debtor] becomes critical and demonstrates

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### Recent changes to the SEC’s Division of Corp Financial Reporting Manual include:

- 3330.3 Combining entities with different fiscal year ends—changed “Form S-4” to “Form 8-K or registration statement.”
- 4110.7 Recently acquired subsidiary guarantor financial statements—audit and auditor requirements.
- 4310.6 Clarification of “newly public” companies and their S-K 308 reporting requirements.
- 12220.1c Updating financial statements in a reverse recapitalization Form 8-K filed by a shell company.
- 12240.4 Change in fiscal year as a result of a reverse acquisition—transition report chart updated.

*Note that the listing above does not include all recent changes. Changes to the Financial Reporting Manual can be found at: <http://www.sec.gov/divisions/corpfm/cffinancialreportingmanual.shtml>*

why bankruptcy courts [must] examine all aspects of the transaction and carefully measure the value of all benefits and burdens to the debtor, direct or indirect.” The bankruptcy court acknowledged some value in the debtor avoiding a delisting on the stock exchange. Other than that, it found that the net value of any non-stock benefits was zero, not only because acquisition led to the debtor’s collapse, but also because any non-stock benefits were “highly speculative and in fact . . . unachievable.”

In making this finding, the bankruptcy court did not impermissibly rely on hindsight, the appellate court held, but correctly assessed reasonably equivalent value at the time of the transfer. Based on the entire record, it dismissed the appeal.

## Economic Outlook

Consensus Economics, Inc., publisher of Consensus Forecasts - USA, reports that the consensus of U.S. forecasters believes real GDP will increase at a seasonally adjusted annual rate of 3.2% in the third quarter of 2011 and 3.3% in the fourth quarter. Every month, Consensus Economics surveys a panel of 28 prominent

U.S. economic and financial forecasters (the “forecasters”) for their predictions on a range of variables including future growth, inflation, current account and budget balances, and interest rates.

The forecasters expect GDP to grow 2.5% in 2011, 3.1% in 2012, and 3.3% in 2013. In the long term, they report that real GDP will grow by an average annual rate of 2.5% between 2017 and 2021.

The forecasters believe unemployment will average 8.8% in the third quarter of 2011 and 8.7% in the fourth. They believe unemployment will average 8.8% for all of 2011 and 8.3% for 2012.

The forecasters believe the 3-Month Treasury Bill rate will be 0.1% at the end of the third quarter of 2011 and 0.2% at the end of the fourth. They believe the rate will be 1.5% at the end of 2012. They forecast that the 10-

Year Treasury Bond yield will be 3.4% and 3.7% at the end of the third and fourth quarter of 2011, respectively. They believe the 10-Year Treasury Bond yield will rise to 4.2% at the end of 2012.

They also believe consumer prices will rise at a rate of 2.2% and 1.9% in the third and fourth quarter, respectively. They expect consumer prices to increase 3.0% in 2011 and 2.1% in 2012. They expect producer prices to increase at a rate of 1.3% in the third quarter and 1.4% in the fourth. The forecasters anticipate producer prices will rise 6.0% in 2011 and 1.8% in 2012.

The forecasters in the survey believe real disposable personal income will increase at a seasonally adjusted annual rate of 2.3% in the third quarter of 2011, before increasing at a rate of 2.9% in the fourth quarter. They believe real disposable personal income will increase 1.7% in 2011 and 2.1% in 2012.

They forecast personal consumption will increase at a rate of 3.0% and 3.1% in the third and fourth quarter of 2011, respectively. They expect personal consumption to increase 2.7% in 2011 and 2012.

The forecasters expect industrial production to increase at a rate of 5.1% in the third quarter of 2011 and 4.5% in the fourth. They forecast industrial production will increase 4.5% in 2011 and 4.0% in 2012.

Nominal pre-tax corporate profits will be 7.7% and 5.9% in 2011 and 2012, respectively, according to the forecasters.

## FASB issues amendments to simplify goodwill impairment test and provide fair value convergence between U.S. GAAP and IFRS

The Financial Accounting Standards Board issued amendments in an Accounting Standards Update that address goodwill impairment. ASU No. 2011-08, Intangibles-Goodwill and Other (Topic 350): Testing Goodwill for Impairment, which was released in September 2011, now gives companies the option of doing a qualitative assessment first to determine whether it is more likely than not that its fair value is less than its carrying amount. Although the update is meant to simplify the impairment test, some concerns have been raised on how auditors will audit a qualitative assessment included in a fair value topic.

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  - Unemployment will average 8.8% in the third quarter
  - Nominal pre-tax corporate profits will be 7.7% in 2011 and 5.9% in 2012
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The Financial Accounting Standards Board also released ASU No. 2011-04, Fair Value Measurement (Topic 820), in May 2011. Although the update does not require additional fair value measurements, it does provide additional explanations on how to measure fair value in order to achieve common fair value measurements and disclosure requirements for U.S. GAAP and IFRS.

Full Accounting Standards Updates are located at <http://www.fasb.org>.

## Size Premium Driving Middle Market M&A Activity

Data published in GF Data's Second Quarter 2011 Report reveal unprecedented differentials in the valuations and debt multiples between small and large transactions, according to a recent GF Data press release. The gap "indicates the resurgence of an even more severely bifurcated market that is less

accommodating to smaller transactions," the GF Data sources add. "The size premium also extends to, and to some extent is caused by, disparities in debt availability to larger and smaller businesses," says B. Graeme Frazier IV, Principal and Co-Founder of GF Data. "While this is not apparent in the overall data, when you look at Total Debt/EBITDA multiples for deals in the \$10-25 million TEV range, they are on par with 2010 levels in the high two's, [and] yet for larger deals, Total Debt/EBITDA went from an average of 2.8x in 2010 to 3.9x in the first half of 2011."

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