

# *The* Expert

WINTER 2012

---

## **Do rules of thumb have a place in today's appraisals?**

**Know your context  
when it comes to  
lost profits calculations**

FLPs on trial  
**IRS argues for taxability  
of transferred assets**

**Go phish: Piecing  
together e-mail fraud**

---



# Do rules of thumb have a place in today's appraisals?

**R**ules of thumb are mathematical formulas designed to gauge value. For example, the selling price of a medical practice should equal 20% to 60% of its accounts receivable. Or a golf course should sell for its green fees multiplied by four.

Some business brokers, company owners and trade associations may propagate these rules of thumb as convenient yardsticks for estimating a company's value. And, in today's weak economy, a cash-strapped business owner might be tempted to use one to establish an asking price, buy out a shareholder or file a gift tax return. The question is: Do such rules of thumb have a place in today's business appraisals?

## John's dilemma

Before you answer, consider the following fictitious scenario: John, the owner of a manufacturing company, wants to expand his shop by

buying a smaller competitor. He's heard a rumor that manufacturers sell for five times EBITDA — a commonly used acronym for “earnings before interest, taxes, depreciation and amortization.” EBITDA multiples are widespread and intuitively appealing, because they purportedly estimate cash available for owners' distributions.

John has identified two acquisition candidates that are identical in every way, except Plant X has newer, better maintained equipment. The two companies' respective net cash flows differ as follows:

- ◆ Plant X has \$1 million in EBITDA and an annual required capital investment of \$250,000, for a net free cash flow of \$750,000.
- ◆ Plant Y has \$1 million in EBITDA but an annual required capital investment of only \$100,000, for a net free cash flow of \$900,000.



Which plant should John buy? Based solely on the industry rule of thumb, both businesses are worth \$5 million (\$1 million times five). But, clearly, Plant X has kept up with its capital expenditures and, therefore, is a more attractive purchase.

## Overlooked differences

Our preceding example is oversimplified; businesses usually differ in myriad ways. For instance, a company might have superior financial performance, key people or concentration risks, nonoperating assets, quasibusiness expenses, or excessive debt compared with its competitors.

## Not to be confused with the market approach

Real-life business transactions of similar companies can provide significant insight into a subject company's value. But using oversimplified rules of thumb (see main article) differs from applying the market approach to value a business.

Here, the appraiser analyzes the specific details of comparable transactions and attempts to find a statistically relevant relationship between selling price (or stock price) and financial metrics — such as revenues, cash flow and pretax earnings.

Analytical legwork is the primary difference between rules of thumb and the market approach. When using the latter, an appraiser tears apart each individual guideline transaction, establishing comparability and adjusting for atypical performance and deal terms. Also unlike rules of thumb, the market approach is a widely accepted valuation method that, if properly applied, can withstand scrutiny in the boardroom and in court.

Rules of thumb tend to overlook these differences, leading to erroneous conclusions. Over time, rules of thumb also may become outdated as an industry matures or its M&A activity heats up — or slows down, as is common today in industries such as construction and retail.

Even a common source of industry guidelines, *Handbook of Small Business Valuation Formulas and Rules of Thumb*, states:

There is no single formula that will work for every business. Formula multipliers offer ease of calculation, but they also obscure details. This can be misleading. Net revenue multipliers are particularly troublesome because they are blind to the business's expenses and profit history. It is easy to see how two businesses in any given industry group might have the same annual net revenue, yet show very different cash flows. A proper valuation will go beyond formulas and include a full financial analysis whenever possible.

In some industries, there may be several rules of thumb — some based on revenues, others based on earnings — that generate conflicting value estimates or a broad range of value. Where do you go from there?

### Sanity check

Although they generate divergent or conflicting results, rules of thumb may have a small place in the valuation paradigm. They can be conversation

starters by providing rough market comparisons based on informal market data. Also, their ease of use may pique the interest of laypeople and get them thinking about a formal appraisal.

Rather than turn a blind eye, many appraisers keep a watchful one on relevant rules of thumb. Then they reconcile the results of their cost, market and income approaches against the range of values obtained from industry rules of thumb.

*Over time, rules of thumb may become outdated as an industry matures or its M&A activity heats up or slows down, as is common today in industries such as construction and retail.*

Frequently, an appraiser's value estimate won't coincide with the preliminary value indicated by a rule of thumb. So he or she will summarize probable reasons for the discrepancy in the written appraisal report.

### Interesting perspectives

In a nutshell, rules of thumb offer interesting perspectives on many industries and can serve as a "sanity check" for more formal, empirical analyses. Therefore, though they should never be used as a sole valuation method, these formulas do have a place in today's business appraisals. ♦

# Know your context when it comes to lost profits calculations

No business owner likes to think about lost profits — under any circumstances. But if an executive and his or her attorney head to court to litigate a given injury, they should bear in mind that the lost profits calculation used by their financial expert will depend on the context of their case.

## Different circumstances

Lost profits calculations in litigation typically consider a finite period of time — the term of a contract, the useful life of a product or the amount of time required for the plaintiff to reasonably mitigate losses — that will pass before a business can recover from the injury. The undiscounted lost profits represent the difference between the lost net revenue and the expenses saved for that period.

If the company is unable to recover, however, a full-blown business valuation will be required. Here an expert must determine the value of the lost profits for the business’s entire expected lifespan “but for” the injury. However, the risks faced by a business over its entire expected infinite lifespan are different from those risks faced during a finite period of lost profits.

## Risks, risks ... everywhere

Discount (or interest) rates are used to calculate “discount factors.” The projected loss for each applicable period is multiplied by the discount factor to determine the discounted loss, or present value.

Discount rates must accurately reflect the expected risks the particular business would face in the absence of the injury. Relevant risks might include the general business environment (such as economic conditions and government regulation) and the company’s market (such as barriers to entry, market size, strength of the competition and evolving buyer preferences).

The expert will also look at financial issues (for example, illiquidity and excessive debt) and the company’s product line (such as dependence on key suppliers, obsolescence and limited production capacity). Management depth and dependence on key employees may be important issues as well in evaluating risks. Ultimately, the chosen discount rate will reflect the risk associated with the probability of achieving the projected lost profits.



According to a reference guide on damages appearing in the Federal Judicial Center’s *Reference Manual on Scientific Evidence*, an “ordinary interest rate” (also known as a nominal interest rate) should be used to discount future losses projected in escalated terms adjusted for inflation. To discount future losses projected in constant dollars, a “real interest rate,” which deducts the assumed rate of future inflation from the ordinary interest rate, should be applied. In general, “[d]iscount calculations should use a reasonable interest rate drawn from current data at the time of trial,” such as a bond market rate.

## Discount rate methods

Depending on the subject of their calculations, damages experts may use one of several methods to arrive at the discount rate. One option is a “safe” (or risk-free) rate, which is the starting point for determining an appropriate discount rate. It can be derived from a Treasury Bond or Treasury Bill rate.

Another option is the build-up method, which considers several factors to assess expected inherent risk exceeding the safe rate. An expert might start with the Treasury rate and build from there,

using stock market benchmarks as well as risks inherent to the subject company.

Also, the Capital Asset Pricing Model (named by the aforementioned reference guide) may be used “to calculate [a] risk-adjusted discount rate” by considering such factors as “the historical average risk premium for the stock market.”

## Not simple

Calculating lost profits is not a simple task. That’s why it’s critical to work closely with your expert to establish the proper context for his or her work. ♦

FLPs on trial

# IRS argues for taxability of transferred assets

Last year, the IRS continued to challenge family limited partnerships (FLPs) on a variety of grounds. In *Estate of Turner*, the agency argued that assets transferred to an FLP should be included in the transferor’s taxable gross estate. And the Tax Court’s ruling highlights how FLPs that are poorly structured and operated may be vulnerable to this attack.

## Contributing assets

In 2002, Clyde Turner and his wife formed an FLP. The provisions of the partnership agreement came from a standard form their attorney used for such agreements.

About eight months later, the Turners contributed assets (mostly cash and marketable shares in banks) worth about \$8.7 million. They subsequently gifted limited partnership interests to their children and grandchildren. After Mr. Turner’s death in 2004,

the IRS challenged the estate’s characterization of the FLP assets as outside of the taxable estate.

*A transferor retains the enjoyment of property if an express or implied agreement exists at the time of the transfer that states the transferor will retain the property’s present economic benefits.*

Under Internal Revenue Code Section 2036(a)(1), property transferred by a decedent during his or her life is nonetheless included in the gross estate at fair market value (FMV) if the decedent retains “the possession or enjoyment of, or the right to the income from, the property.” But an exception is granted for bona fide sales for adequate and full consideration.

## Parsing the exception

To constitute a bona fide sale, the transfer must serve a legitimate business or other nontax purpose. The Tax Court dismissed the nine reasons listed in the partnership agreement because they came from a standard form and didn't necessarily reflect the Turners' actual reasons.

It also rejected the estate's other purported reasons, including the consolidation of assets for management purposes. The court acknowledged that this could be a legitimate and significant nontax purpose but found it wasn't in this case. The Turner FLP was a "mere asset container" holding passive investments that didn't require active management.

The court cited additional factors that indicated the transfers weren't bona fide sales. For example, Mr. Turner commingled personal and partnership funds when he used FLP funds to make personal gifts to two grandsons, to pay premiums on life insurance policies for the benefit of his children and grandchildren, and to pay legal fees relating to his and his wife's estate planning.



- ◆ Commingling of personal and FLP assets,
- ◆ Disproportionate distributions to the transferor,
- ◆ Use of FLP funds for personal expenses, and
- ◆ Testamentary characteristics of the arrangement.

Under the FLP agreement, the Turners were paid \$2,000 per month as a management fee. The court found this unreasonable in light of evidence that no management services were provided. The fee, it noted, indicated that the FLP was a taxable investment account from which withdrawals could be made.

Further, the Tax Court found that nearly all of the facts pointed to an implied agreement that Mr. Turner would continue to possess and enjoy the transferred assets. Among other factors, he transferred most of his assets; both Turners took distributions at will and used funds for personal purposes; and Mr. Turner took disproportionate distributions. The court also determined that the FLP's purpose was primarily testamentary (related to their will).

## Retaining enjoyment

As the Tax Court explained, a transferor retains the enjoyment of property if an express or implied agreement exists at the time of the transfer that states the transferor will retain the property's present economic benefits. Factors indicating that the decedent retained benefits include:

- ◆ A transfer of most of the decedent's assets,
- ◆ Continued use of transferred property,

## Booting the boilerplate

Typically, an IRS challenge of an FLP will fail because of the bona fide sale exception. In this case, the Tax Court noted three potentially qualifying purposes: 1) consolidated asset management, 2) resolution of family disputes and 3) asset protection. Unfortunately, the Turners' boilerplate form took none of these reasons into account. ◆

# Go phish: Piecing together e-mail fraud

**T**he FBI reports that fraudsters are increasingly using technology to target the financial accounts of businesses, resulting in substantial monetary losses. A fraud expert can decipher how your victimized clients were duped.

## Reeling in victims

Cyberfraudsters often target executives or accounting or HR personnel, inducing them to download malicious software (malware) that steals their personal information and log-in authorization. The perpetrator can then use these credentials to divert money from business accounts or nab proprietary data such as customer lists.

Such schemes are commonly referred to as “phishing.” To reel in victims, a cyberfraudster sends an e-mail posing as a legitimate entity, say a bank or government agency. Duped recipients inadvertently download the malware by opening an attachment, clicking on a link or accepting a fake friend request on a social networking site. Variations include “smishing” (baiting a victim with fraudulent text messages) and “vishing” (baiting over the phone or voice over IP [VoIP]).

More targeted “spear phishing” schemes are also spreading rapidly. Here the e-mails appear to come from co-workers, friends or family members. For example, you receive a message from an associate saying he’s been mugged in London and needs money immediately.

The FBI warns that no business is safe. While cyberfraudsters once concentrated on large corporations, they’ve expanded to include municipalities, smaller businesses and nonprofits.



## Catching phishers

Fraud experts will search a company’s system for unsolicited e-mails sent to staff that appear to be from a legitimate business and employ some scare tactic that prompts the employee to open the message and respond with account information. As examples, the FBI cites e-mails from:

- ◆ UPS (with a message like “There has been a problem with your shipment ...”),
- ◆ Financial institutions (“There is a problem with your account ...”), or
- ◆ Courts (“You have been served a subpoena ...”).

A phishing e-mail might also appear to provide information regarding current events such as natural disasters, major sporting events or celebrity news.

A fraud expert will examine hardware and software, too. Changes in a computer’s performance — for instance, a loss of speed, unexpected rebooting, or new or unexpected icons or toolbars — can indicate the presence of malware.

Fraud experts can also help a client detect fraud by scrutinizing accounts. It may even be possible to trace the path of stolen funds after they leave a business account.

## Patching the holes

Of course, the ideal approach to any type of fraud is to stop it before it occurs. A comprehensive fraud risk assessment, including an examination of technological risks, can help your client identify and patch the holes in their defenses. ◆