

Valuation Vantage[®]

Insights and Perspectives on Leading Corporate Finance Valuation Issues[®]

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Inside This Issue

- The M&A Impact of SFAS 141R
- Best Practices for Goodwill Impairment Testing
- Improvements to be Made to Fair Value Accounting Standards
- Spotlight on Court Cases
- New Valuation Offices Open
- Book Release: *Mergers and Acquisitions: An Insider's Guide to the Purchase and Sale of Middle Market Business Interests*
- Recent Valuation Engagements

The McLean Group's Valuation Practice

As a core competency and complement to its mergers & acquisitions (M&A) practice, The McLean Group provides business valuation services, including intangible asset and financial security valuations for a variety of transaction, financial reporting and tax purposes.

The M&A Impact of SFAS 141R

The McLean Group's Andy Smith, (Partner and Senior Managing Director) and Ryan Berry (Associate Director), recently co-authored an article "The M&A Impact of SFAS No. 141R" published in *Strategic Finance's* November 2008 edition. The article highlights the following:

The revised accounting rules enact several changes that will impact not only the structure of M&A transactions, but also the accounting for transactions, including:

- **Transaction Costs:** Under 141R, transaction costs will be expensed as opposed to being part of the purchase price.

Continued on p. 2

Best Practices for Goodwill Testing

As a quick refresher, SFAS 142 states "Goodwill and Other Assets" require the periodic testing of goodwill. Goodwill impairment testing is a two step process. Best practices and other tips include:

- **Overview to the 2 Step Test:**

Step 1

- Determine Carrying Amount of Reporting Units
- Determine Fair Value of Reporting Units

Step 2 (if Carrying Amount is greater than Fair Value)

- Determine Fair Value of net assets (including identifiable intangible assets) and compare the resulting implied Fair Value of goodwill to its Carrying Amount

Continued on p. 3

Improvements to be Made to Fair Value Accounting Standards

Congress recently released a report required under the Emergency Economic Stabilization Act of 2008. Although Congress was considering a suspension of the fair value accounting standards, the SEC office reported that an improvement in fair value accounting standards is more appropriate.

Continued on p. 2

“The M&A Impact ...” continued from p. 1

- **Valuation of Earn-outs:** The purchase price will take into account the fair value of any contingent considerations, such as earn-outs. The acquirer in the transaction must estimate the fair value of the earn-out. Any further changes to the estimation will be accounted for in the income statement.
- **Restructuring Costs:** Any expected restructuring or other costs will be expensed and recognized separately as post-combination expenses when incurred.
- **Research and Development:** In-process research and development was previously expensed at the time of acquisition. Under 141R, R&D will be recorded as an intangible asset and classified as indefinite-lived until completion or abandonment.
- **Timing:** Transactions are to be valued on the date the transaction closes as opposed to the announcement date. This will add pressure on companies to close transactions quickly.
- **Restructuring Costs:** Any expected restructuring or other costs will be expensed and recognized separately as post-combination expenses when incurred.
- **Gains from Bargain Purchases:** “Negative Goodwill” is to be counted as an immediate gain on the income statement of the acquiring company.
- **International Applicability:** The new SFAS No. 141R was written in light of US GAAP’s convergence with International Accounting Standards. This will allow a global set of standards to be accepted across the accounting world, and will ensure that it will be easier to do work with and between the US and other international companies.

Good deals will always get done, but the art of the deal continues to evolve. With the transition to fair value accounting,



additional details in the underlying fair value estimates will be required during the initial planning phase of transactions. The accounting changes under SFAS No. 141R will affect not only the financial reporting of M&A transactions, but also the way in which management analyzes potential transactions and plans for due diligence. ♦

“Improvements to be Made...” continued from p. 1

The 211 page report discusses the impact the new accounting standards have had on the balance sheets of an institution as well as the impact it has on the information that is provided to its investors. The report found that fair value accounting did not seem to play a major role in the multiple bank failures that occurred in 2008, but rather, such things as decreasing confidence of the customer and asset quality were the major factors. Additionally, the report analyzed how fair value accounting affected investors and the information they receive. It noted that investors believe that fair value accounting allows for better reporting and overall decision-making. Most analysts and pundits agree that fair value accounting did not necessarily cause the recent financial crisis, but it has served to help magnify it.

Former SEC Chairman Christopher Cox stated that the study “... is the culmination of several months of extensive analysis, public roundtables and consultations with investors groups, accounting firms, banks, insurance companies, think tanks, and academics. It will be a useful source of information and guidance not only to policy makers in Congress but also to the independent standard-setters as they continue their work on these important issues...”

Recommendations made to improve fair value accounting standards include further developing available guidance and tools to improve the presentations that reveal the effects fair value accounting has on reporting on financial statements. The SEC and FASB have continued to issue interpretative guidance on the issues, specifically in regards to situations where market prices aren’t available in inactive markets. ♦



“Best Practices for Goodwill...” continued from p. 1

- **Don't wait until year-end:** SFAS 142 requires an annual impairment test, but a company can choose the date. The valuation date does not have to be the end of the fiscal year. Many companies select the end of the third quarter to test goodwill so that they can resolve it during interim audit testing and before year-end accounting pressures mount.
- **Prior Year Reports:** SFAS 142 specifically states that prior year valuations can be carried forward under the following circumstances:
 - The reporting unit's assets and liabilities have not changed significantly;
 - The recent Fair Value determination exceeded the reporting unit's Carrying Amount by a substantial margin; and
 - Based on an analysis of the current situation, the likelihood that a current Fair Value determination would be less than the Carrying Amount is remote.
- **Interim Test May Be Required:** Although goodwill impairment testing should formally be completed on an annual basis, interim testing is required if there is:
 - A significant adverse change in the business climate;
 - An unanticipated competition or loss of key personnel; or
 - An expectation that a significant portion of a reporting unit would be sold.
- **Reporting Units:** Remember that goodwill impairment testing is performed at the reporting unit level, not the legal subsidiary and not on a specific acquisition by acquisition basis. Assigning a recent acquisition to a reporting unit can be a strategic decision for CFOs (refer to SFAS 131 for guidance for the definition of a reporting unit).
- **Net Operating Losses:** Remember that the impact of any NOLs should be considered (see EITF 02-13). SFAS 142 assumes the Fair Value of the reporting unit as if it were sold to a hypothetical market participant. Any NOLs, other tax advantages, or other financial adjustments should be reflective of the value that a hypothetical market participant would receive if it acquired the reporting unit.

Many clients are experiencing goodwill impairment issues, and the Fair Value of reporting units should be reviewed on a regular basis. Given the current market changes, many recent acquisitions that occurred over the past several years may now be less valuable. ♦



The McLean Group Completes Its Annual Accounting Analysis of Purchase Price Allocations for Government Contracting M&A Transactions

The firm's study surveys the accounting disclosure of 130 acquisitions of government contractors. The study includes specific details regarding the types of intangible assets that are valued as well as benchmarks for the percentage of the purchase price that are recognized as goodwill versus identified intangible assets. Amortization periods are also summarized. For a copy of the white paper, please e-mail Andy Smith at asmith@mcleanllc.com.

Spotlight on Court Cases



Estate of Thelma & Michael Hurford v. Commission

December 11, 2008

This case examined the effectiveness of family limited partnerships (FLPs) as an estate planning tool. The case focuses on the estate of Michael Hurford, which upon his death was managed by his widow, Thelma Hurford. During the re-shifting of the estate, Mrs. Hurford passed away from cancer, and her children were left to take over the re-shifted estate, hoping to take away as much money as possible after taxes. After hearing this case, the court made the following list of suggestions to assess the non-tax purpose of a purported FLP, including:

- Adherence to partnership formalities;
- The taxpayer's dependence on distributions;
- Whether the taxpayer commingled personal funds with partnership funds;
- The taxpayer's old age or poor health when forming the FLP; and
- Whether the FLP functioned as a business enterprise or otherwise engaged in any meaningful economic activity.

Considering the entities in this case, the court found that they existed only to satisfy the Hurfords' "drive for a discount." ♦



Progressive Child Care Systems, Inc. v. Kids 'R' Kids

November 6, 2008

Progressive Child Care Systems, Inc. (franchisee) and Kids 'R' Kids (franchisor) entered into a 25 year contractual agreement. However, after approximately three years both parties cited breach of contract and Kids 'R' Kids sought claims for lost profits including past-due and future royalties owed by Progressive Child Care Systems, Inc.. This case resulted from the appeal filed by Progressive Child Care citing that the first case awarding Kids 'R' Kids \$1.38 million was excessive. To evaluate the total amount of lost profits, an expert evaluated the following:

- Enrollment records;
- Cash receipts;
- Account deposits;
- Check registers;
- Income tax returns (for five years prior to breach);
- Weekly revenue reports;
- Sign-in sheets;
- Tuition and income spreadsheets; and
- Monthly royalty summaries.

The expert calculated the lost profits through the end of the 25 year contract term and awarded Kids 'R' Kids \$1,000 less than the original case. ♦



The McLean Group

Opens Two New Business Valuation Offices

Austin, Texas



The McLean Group's new Austin, Texas office, managed by Shari Overstreet, CPA/ABV, CVA, CM&AA, will focus on providing business owners and stakeholders with business valuation, and mergers and acquisitions (M&A) services.

Ms. Overstreet remarks that, "I am excited to bring both a national

business valuation and middle market investment bank to the Austin area." As a local in the area, Mrs. Overstreet believes that, "A national business valuation and middle market investment banking firm is needed in the dynamic and flourishing Austin business community, especially one that deals with the increasing technicalities associated with business valuations, and merger and acquisition deals."

Additionally she feels that, "The McLean Group has continually demonstrated leadership and professionalism in both the business valuation, and mergers and acquisitions banking professions on the national front. These attributes will be paramount in the establishment of the Austin office."

Shari Overstreet is a Managing Director in The McLean Group's Austin office. She has more than 25 years of financial, accounting, business valuation, and M&A experience, all in the Austin area. Ms. Overstreet began her career in public accounting where she worked for a regional and then a national firm in both the audit and tax divisions. She then held financial and operational leadership roles in a variety of Austin-based companies. She performs business valuations for many companies in the Austin area, many of which are technology based.

Sacramento, California



The McLean Valuation Services Group, LLP new Granite Bay office, managed by Neil Paschall, CPA/ABV, CVA, CFFA, and will focus on providing corporate valuation analysis for financial reporting, equity incentive plans, general business valuation, litigation consulting, and transaction opinions. In addition to valuation service, The McLean Group's Granite Bay office has been open for three years

with a focus on merger and acquisition (M&A) transactions.

Mr. Paschall remarks that, "I am pleased to add the nationally recognized expertise of McLean Valuation Services Group to our service offerings in the northern California market." As a local in the area, Mr. Paschall believes that, "There is a need for a strong business valuation group in the Northern California area to meet the growing needs for fair value reporting, dispute resolution, distressed business management, emerging business compensations issues, and transaction opinions."

Neil Paschall is a Managing Director of The McLean Group's Sacramento office. His career spans over 30 years, including experience in public accounting with a Big Four firm, serving as a Corporate Financial Executive for a Fortune 500 company where he was responsible for acquisition due diligence and valuation, and serving as a business valuation and investment banking firm's CEO. Mr. Paschall is a renowned speaker and author on acquisition due diligence, corporate valuation and transaction analysis, enhancing business value, and mergers & acquisitions (M&A).

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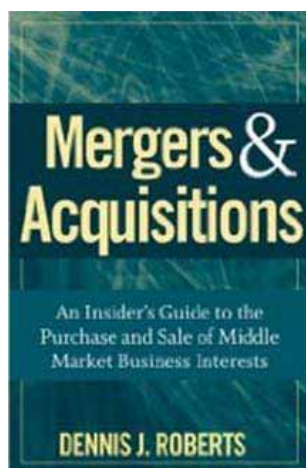
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*Formerly practicing CPA

Release of New Book: *Mergers & Acquisitions: An Insider's Guide to the Purchase and Sale of Middle Market Business*



The McLean Group's Chairman, Dennis Roberts, has authored a new book. The book was designed not only for owners and managers of middle market businesses but as a training text for middle market M&A investment bankers and advisors. It discusses the art and science of middle market M&A as well as the all-important psychology and behind-the-scenes negotiations pursued with a particular emphasis on obtaining the absolute highest value when selling a business. Subjects addressed include valuation, taxation, negotiations, M&A conventions, among many others from the buy-side and sell-side perspectives.

This serious but occasionally irreverent book tells it like it is, including anecdotes to provide a "feel" for what really goes on in middle market transactions. The author, a former practicing CPA and a business valuation expert, is a veteran M&A investment banker with years of real life experience. He also is a widely-acclaimed instructor in the M&A field and a nationally-respected practitioner who has trained thousands of investment bankers. No comparable book on the market today provides this degree of comprehensive and invaluable insight.

Available now at amazon.com.

Recent Valuation Engagements

