



INSIGHTS ON

# VALUATION

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## Doom and Gloom: Opportunity to Gift

The economy is in the worst recession we have had in decades, and business owners are struggling to survive. We have not yet seen the worst. More mortgage foreclosures and layoffs are expected, and there will be businesses that fail over the next several months. The economy is not expected to start its recovery until 2010. Small business owners are fighting to keep their companies afloat, fending off losses, maintaining liquidity, and keeping their lending lines open.

Falling sales and profits, tight cash flow, a sour economy and limited credit availability all mean that business values are also down. Wall Street values are off nearly 50% from their high, and so might be the value of your small business. While Wall Street is known for its excessive highs and excessive lows, with attentive management and constant vigilance, a small business can retain its stability and sustainability. The market value of your company will be restored in the not too distant future.

The struggle has been so consuming that many business owners have forgotten to look for the opportunities created by this calamity. One such opportunity is the ability to make gifts of a greater

percentage of the ownership of your company without increasing your estate and gift tax cost. Each person has a \$1 million limit on the amount of gifts he or she can make before incurring a federal gift tax. If that value represented 10% of your company in 2008, it may represent a significantly greater percent today.

For example, let's say your company was worth \$10 million before the economy went down, and now it is worth just \$5 million. You can transfer 20% of your company equity now, instead of just 10%, without incurring a tax. And a few years from now, that transfer will once again be worth \$2 million, and possibly more.

This two-for-one advantage is scalable. Even small gifts below the annual present interest exclusion (\$13,000 for 2009) can benefit. So consider making gifts of business interests now to take maximum advantage of the recession. This window of opportunity will not last.

Please call us to discuss what the current state of economic affairs may mean for the value of your business, and your ability to make gifts to your children in a tax-free and/or tax-efficient manner.

# Calculation Engagement

The business valuation industry has grown significantly over the last decade. The increasing demand pulled many CPAs into the valuation profession. In fact, NACVA was formed in response to the CPA community seeking licensing and peer review by a national governing body. Thousands of CPAs and professionals sought the CVA and AVA credential(s) knowing professional regulation and standards were good for the industry. Recently the AICPA, the national CPA governing body, issued Statement on Standards for Valuation Services (SSVS) “to improve the consistency and quality of practice among AICPA members performing business valuations.”

This statement establishes standards to be followed by CPAs providing valuation services. SSVS states: “There are two types of engagements to estimate value—a valuation engagement and a calculation engagement. The valuation engagement results in a conclusion of value. The **calculation engagement** results in a **calculated value**.”

The purpose of this article is to define and discuss the “calculation engagement”. The SSVS defines calculation engagement as: “An engagement to estimate value wherein the valuation analyst and the client agree on the specific valuation approaches and valuation methods that the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform to estimate the value of the subject interest. A calculation engagement

generally does not include all of the valuation procedures required for a valuation engagement. If a valuation engagement had been performed, the results might have been different. The valuation analyst expresses the results of the calculation engagement as a calculated value, which may be either a single amount or a range.”

Clients will typically request a calculation engagement when a reliable estimate can meet their business purpose for the valuation. The business purpose might be consideration of estate or gift tax planning strategies or consideration of the sale of a business. Both scenarios should begin with an estimate of the subject interest value. A calculated value will require less time and cost than a conclusion of value. Thus providing the client with the level of service needed at that point in time.

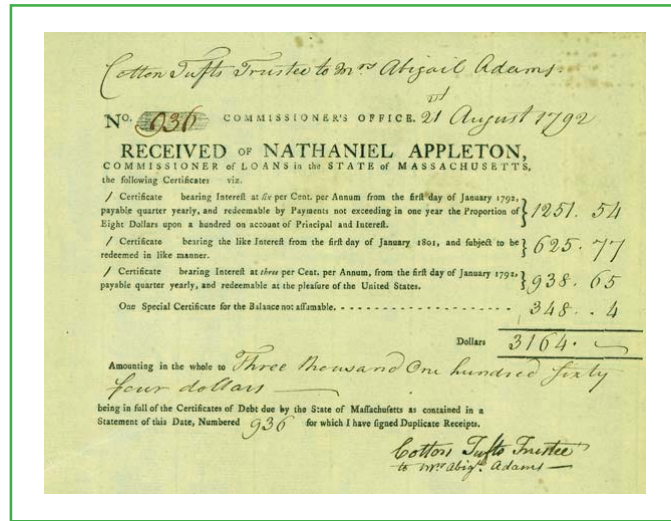
Per SSVS “valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest (these procedures will

be more limited than those of a valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement.”

A calculation engagement is much less costly than a valuation engagement because it does not require a written report. The client and the analyst can agree on the extent of procedures and the format by which the results will be communicated. The analyst is not required to explain all the considerations and calculations performed. It is particularly suited to circumstances where there is no tax return or court filing requirement. Call us to discuss your need and the level of reporting appropriate to it. When the stock of a business is valued using the income approach, whether by the single-period capitalized cash flow method or the multi-period discounted cash flow method, the valuation analyst focuses on three fundamental factors to determine value. Those

County	Average Property Taxes	Average Home Value	Taxes as % of Home Value	National Rank*
Alameda County	\$2,912	\$98,700	2.9%	1
Alameda County	\$2,838	\$98,700	2.9%	2
Alameda County	\$2,807	\$120,400	2.8%	3
Alameda County	\$2,768	\$108,900	2.8%	4
Alameda County	\$2,899	\$115,900	2.8%	5
Alameda County	\$2,895	\$115,900	2.8%	6
Alameda County	\$2,256	\$93,200	2.5%	7
Alameda County	\$1,880	\$76,400	2.4%	8
Alameda County	\$145,300	\$76,400	2.4%	9
Alameda County		\$76,400	2.4%	10
Alameda County		\$76,400	2.4%	11
Alameda County		\$76,400	2.4%	12
Alameda County		\$76,400	2.4%	13
Alameda County		\$76,400	2.4%	14
Alameda County		\$76,400	2.4%	15
Alameda County		\$76,400	2.4%	16

factors are the amounts of expected annual cash flows, the rate at which those cash flows are expected to grow over time, and the risk of actually achieving those cash flows as reflected in the discount rate. These value drivers apply whether a cost of equity discount rate or a weighted average discount rate is being developed.



## Discount Rates in Times of Uncertainty

For small businesses, the discount rate is usually established by use of what is known as the “build-up method,” whereby the analyst begins with a risk-free rate, commonly the 20-year Treasury bond rate, and then builds on that by adding an equity risk premium, an industry premium, a size premium and a specific company risk premium. From this built-up discount rate, the analyst will subtract the long-term expected growth rate in cash flow to arrive at a capitalization rate.

Since the early fall of 2008, all three value drivers have been influenced by the economic meltdown, but the most severely affected has been the discount rate, causing valuation analysts to reassess their traditional methods of deriving estimates and data for the build-up method. For example, some of the issues and problems that analysts have to deal with are as follows:

- U.S. Treasury bond yields are likely at a temporarily low point, resulting in low estimates of the discount rate just when the

economic climate contains more, not less, uncertainty and risk. Therefore, analysts should ignore the low “spot” yield on 20-year Treasury bonds at December 31, 2008 and instead opt for either a longer-term historical average yield or use a “forward” rate on such bonds.

- The expected equity risk premium, the rate of return on a diverse portfolio of common stocks in excess of the rate of return on Treasury bonds, has increased as stock market values have broadly declined. Therefore, analysts who have been using lower equity risk premiums because of perceived changes in the market over the past decade will have to revert to higher, historical premiums.

- Current debt to equity ratios are probably not sustainable in the long-term for many companies and therefore analysts need to consider estimating the discount rate with an expectation of changing capital structures.

- Because income subject to income taxes is and will continue to be less than zero for many companies,

analysts cannot automatically use an after-tax cost of debt capital (i.e., multiply the interest rate by one minus the income tax rate) in calculating an appropriate weighted average discount rate.

- Analysts need to pay special attention to the specific company risk factor that will be included in the built-up discount rate being developed, as each subject company will respond differently to current economic conditions.

- Analysts must always test the resulting discount rate estimates for reasonableness and not simply apply data or formulas by rote.

Estimating a discount rate is always the most difficult part of a valuation assignment, and today’s economic environment has only made this exercise more challenging.



*If you have any questions,  
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