



CA NEWS BRIEF

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- ASA Issues New Guidelines for the Valuation of Partial Interests
- Court Rules SSVS-1 Is Not Binding
- Tax Court Disagrees With IRS on Cost of Capital
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WILL THE SUPREME COURT RENDER THOUSANDS OF SOFTWARE PATENTS INVALID?

Bilski and Warsaw v. Kappos, 545 F.3rd 943, 88 U.S.P.Q.2d 1385. On April 10, 1997 Bernard L. Bilski and Rand Warsaw filed a patent application for a method of hedging risks in business methods. The patent examiner rejected the application on the grounds that the invention was not implemented on a specific apparatus and was merely designed to manipulate an abstract idea and solve a mathematical problem without any limitations to a practical application. Bilski and Warsaw appealed to the Board of Patents and Interferences which affirmed the rejection, but on different grounds. The Board held that the examiner erred by relying on a technological arts test because case law does not support such a test. Further the Board held that the requirement of a specific apparatus was also erroneous because claims not reciting a specific apparatus may still be directed to patent-eligible subject matter. The applicants appealed to the Federal Circuit which upheld the rejection. The majority opinion characterized the issue as whether the claimed method is a patent-eligible "process", as the patent statute uses that term.

The Supreme Court heard arguments November 9, 2009 and is expected to issue a ruling in June 2010. At risk are the thousands of software patents that have already been issued. If the Supreme Court upholds the Patent and Trademark Office's rejection, then those previously issued software patents could be held invalid. The resulting loss of value could be astronomical. Whether you are an attorney specializing in intellectual property or a business owner with software patents, stay tuned to learn the final ruling.

ASA ISSUES NEW GUIDELINES FOR VALUING PARTIAL INTERESTS

The American Society of Appraisers has updated its Business Valuation Standards to include a new Procedural Guideline: PG-2 Valuation of Partial Ownership Interests. PG-2 provides a mechanism to respond to USPAP's SR 9-4(d) in terms of analyzing the effect on value, if any, of the extent to which the interest appraised contains elements of ownership control and is marketable and/or liquid. It is not binding. The ASA, listed some of the factors which may be related to partial interests:

- Provisions in the organizational and governance documents that affect the rights, restrictions, marketability and liquidity of the subject interest
- Applicable laws and regulations
- Existing ownership structure and configuration
- Access to, availability of, and reliability of information regarding the underlying asset or entity
- The relevant pool of potential buyers, if any

PARTIAL INTERESTS (CONT'D)

- Market data on transactions in similar markets, if any
- Expected holding period for an investment in the subject interest
- Expected economic benefits associated with the subject interest
- Required return for investing in the subject interest
- Ownership-level tax effects, if any
- Prior transactions in the subject interest, entity or asset

Whether requiring a valuation of a 100% controlling interest or a partial ownership, be sure that your appraiser is fully qualified and current on all valuation guidelines. Please feel free to call us if you have any questions.

COURT RULES SSVS-1 IS NOT BINDING

Experts should be knowledgeable of relevant court cases as well as valuation standards.

The AICPA released *Statement on Standards for Valuation Services No. 1 (SSVS No. 1): Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* with the purpose of improving the consistency and quality of practice among AICPA members who provide valuation services.

During the divorce of Mr. and Mrs. Devries (California) the court appointed a forensic accountant who used the excess earnings and capitalization of earnings approach to value the husband's construction business. These approaches determined that there was no goodwill value however, the expert used three months of past gross profits to determine a goodwill value of \$100,000 which the court added to a \$750,000 asset value. The husband appealed, claiming that the expert's use of a 'three month rule of thumb' violated Standard 39 of SSVS-1, which provides that rules of thumb "should generally not be used as the only method to estimate the value of the subject interest."

In re Marriage of Devries, 2009 WL 4264309 (Nov. 30 2009), the California Court of Appeals disagreed. As in many states, the California courts recognize that AICPA, NACVA, ASA, IBA and other professional organizations are appropriate sources of valuation standards, but they also have large bodies of case law which have traditionally held that valuation is flexible and is contingent on the facts and circumstances of each case. The court held that "the AICPA guidelines are instructive but not dispositive on the issue," and relied on prior precedent to confirm the lower court's decision.

While valuation experts are required to uphold the standards of their respective professional organizations (NACVA, IBA, ASA, AICPA), they must also be cognizant of case law. If you have any questions, please feel free to call us.

TAX COURT DISAGREES WITH IRS ON COST OF CAPITAL

Veritas is in the business of developing, manufacturing, marketing, and selling advanced storage management software products. In the mid to late 1990's Veritas expanded its business through corporate acquisitions and the formation of foreign subsidiaries. In 1997, Veritas acquired and merged with OpenVision Technologies, Inc. In 1999, Veritas acquired Seagate Software Network and Storage Management Group, Inc. As a result of these acquisitions, Veritas became

TAX COURT (CONT'D)

the largest storage software company in the industry. In 2005, Veritas was purchased by Symantec Corp. and became one of Symantec's wholly owned subsidiaries. In 1999, Veritas entered into an agreement with its Irish subsidiary, whereby Veritas assigned all of its existing European sales agreements to the Irish subsidiary. In return, Veritas received a lump sum payment and was to receive future royalty payments based on the value of the Intangible Assets used to fulfill the sales agreements.

The IRS took exception to the valuations used by Veritas. The IRS used two different experts to determine the values of the intangible assets, yet only one of the experts was called to testify (the second). After hearing testimony and reviewing the evidence presented by both sides, the presiding judge found the testimony presented by the IRS' expert was "unsupported, unreliable, and thoroughly unconvincing." The judge found that the expert used the wrong beta, the wrong equity risk premium, the wrong risk-free rate, and the wrong growth rate in calculating the cost of capital. For the full-text of the Tax Court opinion, refer to *Veritas Software Corp. v. Comm'r*, s009 WL 4723602 (Dec. 10, 2009).

If you have any questions about intangible asset valuation, please call.

Valuation experts need proper training and experience.

VALUE BEFORE AND AFTER A RECESSION

The country's leading economic experts tell us that we are on the road to recovery from the worst economic downturn since the Great Depression. However, that road is long and filled with many potential potholes. Markets are down, unemployment is extremely high and sales are pretty much down throughout the country. Your company's sales and earnings have probably been adversely affected, as well. That means that the value of your company is not as high as it was before the recession. As a business owner, what steps can I take to increase the value of my company?

Sales. Look at your competition. Have they cut back on sales staff? If so, then it may be a good time for you to be proactive and work on increasing your market share. It will be important to maintain existing customers as well as add new ones.

Cash Flow. If you don't have enough cash, you won't make it. There are three areas you will need to concentrate on to properly manage your cash flow:

Accounts Receivable. Your customers will tend to slow down their payments. This means that either you or a key employee needs to watch receivables on a daily basis. This can get real tricky. You will want to contact customers without alienating them. It might be a good idea to start lower on the totem pole and call your customer's accounts payable clerk before contacting top management.

Inventory. You should carefully evaluate your inventory levels. You can improve your cash flow by reducing the amount of inventory to the minimum amounts required for maintaining sales. Do you have any old or obsolescent inventory? Sell it.

Expenses. Evaluate expenses to determine which are 'absolutely necessary' and which are 'nice to have'. Cut back on those not absolutely necessary until your business turns

Increase your Company's value by concentrating on the most important areas.

VALUE (CONT'D)

around.

Customer Service. Do not let your level of customer service decrease. You must maintain, and in some cases increase, your customer service in order to keep existing customers. Customer service will also help you add new customers.

Systems. Your company has a number of systems in place for: sales, operations, and delivery. Take the time to evaluate and improve on the critical systems in place. In some cases, you may not have a system. Develop one.

Capital Expenditures. A lot of business owners, during a recession, will decrease the amount they spend on adding new equipment. Instead, they will employ short term, temporary fixes. While these short term fixes may improve your immediate cash flow, they could end up costing you more down the road. Be sure to carefully evaluate the repair vs. new purchase requirement.

If you need assistance in evaluating any areas of your company, in order to improve your cash flow, please give us a call.

CA APPRAISER HIGHLIGHTS

SELECTING AN APPRAISER & UNDERSTANDING THE VALUATION PROCESS

Selecting an Appraiser. Look in the Yellow Pages or search the Internet and you will probably find numerous business appraisers listed in your area. How do you select the best one for your situation? The following list includes the questions that are, generally, the most important when talking to your potential appraiser:

- What credentials do you hold? (ASA, CBA, AIBA)
- Do you perform business valuations on a full-time basis?
- What experience do you have appraising (your type of business)?
- How many business valuations does your firm perform annually?
- Are your appraisers members of, or credentialed by, the ASA, NACVA, IBA?
- Will you provide references?
- What data sources do you have access to?
- Do you have litigation support experience? How much?
- Have you performed valuations for any governmental institutions?
- Do you charge by the hour or do you charge a flat rate?
- **Understanding the Process.** Each assignment will require its own steps, depending on the details. Generally, the appraisal process consists of the following steps:
 - **Define the Assignment.** The appraiser needs to identify: the business and ownership interest being valued; the effective date; the standard of value; and, the purpose and intended use of the valuation. This will determine the scope of work (limited or complete). This step usually takes place during a face to face meeting.
 - **Gather Information.** Generally, the appraiser will be obtaining and analyzing the necessary information. Typically, the appraiser will need tax returns (5 years), financial statements (5 years and interim to date),

*Ask the right questions
and understand what
comes next.*

SELECTING AN APPRAISER (CONT'D)

asset depreciation schedules, loan documents, lease documents, corporate documents, partnership/shareholder agreements, property documentation, and other documentation deemed necessary for the specific engagement.

- **On-Site Visit.** The on-site visit may take place at the same time as the meeting defining the assignment. The visit provides the appraiser with an opportunity to understand how the business operates. The visit will also provide the appraiser with a clearer understanding of how the financial statements are generated. In addition, the appraiser will be contacting the appropriate personnel to help explain operating results, trends and unusual circumstances.
- **First Draft.** After obtaining all the documentation and explanations from management, needed for the valuation, the appraiser will commence work on the actual report.
- **Client Review.** The appraiser should afford the client the opportunity to review the Company write-up as well as the adjusted financial statements to ensure that major errors have not been committed. At this time, the appraiser usually discusses any changes he has made to the financial statements.
- **Final Report.** Once the appraiser has completed the valuation report, it is customary for the appraiser to meet with the client (and his advisors, if appropriate) to explain the procedures used to determine value. Once concluded, the appraiser will present the client with his copies of the report.

The steps outlined above are general in nature and may be changed, depending on the nature and scope of the engagement or the nature of the business being valued. However, these steps should give a business owner a general idea of what expect when getting his business valued.

If you should have any questions, or if you need an appraisal, please feel free to call and discuss your situation.

*Know what is involved
in a business valuation.*

BUSINESS APPRAISAL PROVIDES SURPRISING BENEFIT

One of the reasons business owners obtain appraisals is to determine the value of ownership interests when merging partnerships. Just recently, Ken Harbin of CA was retained to perform appraisals of two related partnerships. The owner was actually planning his exit strategy. Mr. "M" owned 100% of Partnership A, a company involved in manufacturing oil and gas field pipe screens, float valves, and MWD parts. Mr. "M" also owned 70% of Partnership B, an ISO 9001:2000 certified machine shop. Mr. "M" wanted to determine the fair market value of both partnerships in order to convert his partner's 30% interest in the machine shop to the appropriate interest in the newly formed, merged company. The owner's intent was to have his partner concentrate his efforts on improving the performance of the new company rather than just the machine shop. This would allow the owner to gradually phase out of the day to day operations of both partnerships.

Both companies owned a significant number of specialized machinery: various lathes, CNC welding/cutting machines, compressors, cranes, presses, etc. In order to determine an accurate FMV, Russell Knapp of CA also performed a machinery & equipment appraisal, which was incorporated in the business appraisal report.

SURPRISE BENEFIT (CONT'D)

During the course of the M&E appraisal process, it was discovered that numerous pieces of expensive equipment had been duplicated on both partnerships' asset lists. In addition, both companies were carrying equipment on their books that no longer existed. This meant that each partnership had been overpaying its ad valorem taxes for a number of years. Business appraisals provide a number of benefits to business owners. Some benefits are not always obvious when the appraisal process starts.

If you, or one of your clients, require appraisal services, please feel free to call.

MACHINERY & EQUIPMENT APPRAISAL OF AN AUTOMOBILE DEALERSHIP

A machinery & equipment appraisal, like other appraisal projects, requires careful attention to the details of inventory. An accurate and complete inventory of all assets of machinery and equipment, as well as office furniture and fixtures, automation and IT assets, and any other ancillary assets that may bear on the total asset value of what is generally called Machinery & Equipment Appraisal is absolutely required.

The creation of a complete asset inventory can be a time consuming process, but is essential to accuracy and ethical completeness. Recently Russell Knapp of Certified Appraisers, Inc. was given the assignment to appraise the machinery, equipment, furniture, fixtures, IT support equipment (including computers, printers, servers, calculators and the like), and including even signage and sales lot lighting of an automobile dealership in a southern state. Our assignment did not include real estate or structures.

In this case we notified the client that additional time would be required to complete the inventory listing and the project was approved under those conditions. While such an appraisal assignment can be tedious, it is of utmost importance to personally examine and record each and every asset of the inventory. A photographic depiction of a representative selection of the assets is also included in all Certified Appraisers, Inc. reports. In this project the inventory asset list exceeded six hundred fifty items. Each item is individually appraised to determine the total Fair Market Value of all machinery & equipment.

Two of the three approaches to appraisal (Cost, Market and Income) were utilized to complete this appraisal project. It is important to note that the Income Approach requires the appraiser to assign a portion of the income of a given business to each major piece of equipment and its ancillary support equipment. This approach requires detailed financial data on the client, which is frequently not available for purposes of Fair Market Value appraisal. In fact, an income approach more closely resembles a Business Valuation than a Machinery & Equipment appraisal. Thus, the appraiser used the depreciated cost and market approaches in the assignment under discussion.

Certified Appraisers, Inc. provides appraisal services throughout the United States as well as other countries. All types of appraisal services are offered, excepting residential real estate. Qualified personnel are on staff to promptly respond to our clients' needs, wherever they might be. We can be reached at telephone (713) 680-3290 or facsimile (713) 680-9915, website location www.certifiedappraisers.com.