

DECOSIMO

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DECOSIMO ADVISORY REVIEW

Five Things You Need to
Know about Contingent
Consideration

Step Zero: New
Qualitative Assessment
Allowed for Assessing
Goodwill

Built-In Gains Tax:
Advantageous Tax
Opportunity Available for
Asset Sales by Year End

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DECOSIMO **ADVISORY** REVIEW

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Five Things You Need to Know About Contingent Consideration

Shannon Farr, CPA•ABV•CFF - Valuation Manager

The Financial Accounting Standards Board issued a revision of Statement of Financial Accounting Standards No. 141, Business Combinations, now codified within Accounting Standards Codification Topic 805, Business Combinations (ASC 805), in December 2007. After a relative drought in merger and acquisition activity in 2008 and 2009, business combinations are now on the rise. Acquisitive companies will need to be familiar with the new provisions in ASC 805, which contained significant changes in accounting for acquisitions. Likely, the most significant change is the new treatment of contingent consideration which is outlined below:

1. What is “contingent consideration?”

Contingent consideration is an obligation of the acquirer to transfer additional assets or equity interest to the sellers of a target if specified events occur or conditions are met. Contingent consideration is commonly referred to as “earnouts.”

Business combination deals may also contain “clawback” provisions that may reduce future payments to the sellers or call for a reimbursement from the sellers. These provisions are also covered by guidance in ASC 805.

2. When is it recorded?

Under the new guidance, the fair value of the contingent consideration is recorded as a liability (when additional assets will be transferred) or within equity (when additional equity interest will be transferred) at the acquisition date. This is a major departure from previous guidance, under which any post-transaction earnout payments were accounted for if and when the related conditions were met. The fair value of the contingent consideration directly increases the purchase price to be allocated.

3. How is the value determined?

The mechanics of determining the fair value of contingent consideration are as varied as the terms outlined in deals and can be complex. In other

Continued on page 6 »

Advisor Spotlight: **Frank Lamanna, Jr.**



Frank Lamanna, Jr., an assurance principal in Decosimo's Memphis office, also serves as a Director with Decosimo Corporate Finance, LLC, a broker/dealer member FINRA, SIPC. Frank provides audit and management advisory services to businesses, partnerships and not-for-profits, as well as 401(k) and profit-sharing plans. In addition to providing assurance services, Frank has spent much of his 17-year career providing corporate buy-side and sell-side transaction advisory services. He has been involved with numerous due diligence engagements for software, wholesale distribution, telephone systems companies and a minor league baseball team.

Frank is a member of the American Institute of Certified Public Accountants, the Alabama Society of Certified Public Accountants and the Tennessee Society of Certified Public Accountants and is actively involved with the Tennessee Chapter of the Association for Corporate Growth. In 2001, he was named to the Memphis Business Journal's 40 Under 40 list. He is a 2006 graduate of the Leadership Academy's Masters program.

A Memphis native, Frank is very involved in the Memphis community. He is past Chair and current member of the board of directors of the Boys & Girls Clubs of Greater Memphis. He is also the current Chair of the board of directors of the Alliance for Nonprofit Excellence and serves as a member of the finance committees for Chickasaw Country Club and the St. Agnes Academy/St. Dominic School. An avid outdoorsman, Frank is a board member of the Minnendosa Duck Club, a fundraising organization supporting the activities of Delta Waterfowl. He also enjoys playing golf and tennis, as well as any activity with his two boys.

He has previously served as a member of MpactMemphis! and the Grand Krewe of Ptolemy, where he was a board member and treasurer. He is a founding member of the Memphis chapter of the Spring Hill College Alumni Association, where he has served as president. Frank was also a past president and treasurer for the board of directors of Hands On Memphis, Inc.

Frank received a bachelor of science degree in accountancy from Spring Hill College in Mobile, Alabama.

Five Things You Need to Know About Contingent Consideration

» *Continued from page 4*

words, the valuation model must be tailored to fit the specified conditions of the business combination. For example, the value of a linear earnout (the seller will be paid 3 times earnings of a future period) is calculated under a significantly different model than a non-linear earnout (the seller will be paid 3 times earnings of a future period only if the earnings exceed a specified milestone).

In general terms, two methods are used to value contingent consideration: discounted expected cash flow models and option pricing models.

In one commonly used form of the discounted cash flow method, management, often with the assistance of an outside valuation expert, assesses the cash flows associated with one or more potential outcomes (i.e., situations where the earnout is paid in full, situations where the earnout is not paid at all and situations where a portion of the earnout is paid) along with the relative likelihood of each of those potential outcomes. The cash flows associated with the potential outcomes are discounted to the present, and the relative probabilities of the outcomes are applied to determine the value of the earnout.

The determination of the appropriate discount rate may include consideration of the risk-free rate, the deal's internal rate of return, rates of return available on similar investments, the acquirer's cost of borrowing, or other factors appropriate to the specific earnout analyzed.

Option pricing models may be used when the earnout structure is similar to an option instrument. These analyses can be quite complex.

4. What happens next?

Contingent consideration recorded as a liability is remeasured at each reporting date, with any adjustments to fair value recorded within earnings, until the contingency is resolved.

Contingent consideration recorded in equity is not remeasured.

5. What does this mean to me?

Earnouts have historically been used as a relatively low-cost way for buyers and sellers to reflect differing views of the risk of future performance. We have been involved in a number of deals that may never have closed but for

the existence of an earnout that bridged the gap between the negotiating positions of the parties. Under the new rules, it has become important to be aware of the potential financial statement impact of the earnout, both at the closing date and for the duration of the earnout agreement.

The fair value of the earnout will be included in the consideration paid to the seller, so it will have an impact on the initial purchase price allocation. In addition, as the expected cash flows associated with the earnout and the probability of realizing those cash flows change over time, the change in fair value of the earnout will affect earnings in each period.

At Decosimo Advisory Services (DAS), our experts can help you during the negotiation phase of the deal to structure an earnout that will facilitate fair value analysis, both at the closing date and over time. If you have already negotiated an earnout, we can help you comply with the new accounting requirements with purchase price allocation services, determination of the fair value of contingent consideration at closing, and remeasurement of the fair value of contingent consideration over time.

The Decosimo CPA firm and its valuation division, DAS, provides due diligence and valuation services to the merger and acquisition communities, specifically providing services to private equity groups. We have provided these services for over 30 years, over a wide range of industries, and on total transactions exceeding \$20 billion. DAS has a full staff of experienced professionals dedicated to providing valuation services and possessing the top valuation credentials. A representative list of recent due diligence and valuation assignments can be found on our website at www.decosimo.com/advisoryengagements. ■

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Advantageous Tax Opportunity Available for Asset Sales by Year End

J. Andrew Lipscomb, CPA•ABV, ASA - Valuation Manager

Additional tax liability generally results for S corporation shareholders when appreciated assets are sold within 10 years of a C corporation's S election or some types of acquisitions. Commonly referred to as the "built-in gains tax," gains realized during the 10-year holding period are taxed at 35%, instead of the 15% capital gains tax rate. In addition, the gains are subject to two levels of taxation, a result not normally encountered in an S corporation.

For the remainder of 2011, the normal 10-year holding period is reduced to five years, creating an opportunity for S corporations to divest appreciated assets held for at least five years with more favorable tax consequences.

In general, when an S corporation sells assets, the gain or loss passes through to the shareholders and is taxed at capital gain rates (currently 15%) if the asset was a capital asset to the corporation. However, there is an exception: §1374 of the Internal Revenue Code imposes a tax commonly called the built-in gains tax. The following is a basic summary of how this tax works:

- A potential built-in gain tax liability can be created in two ways. The more common occurs when a corporation elects Subchapter S status, having previously operated as a C corporation. The other arises when an S corporation acquires an asset from a C corporation and carries over the C corporation's basis (for example, in a merger). In the former case, the "starting date" is the date of the S election; in the latter, the date on which the assets were acquired.
- At the starting date, a maximum liability for each asset is established as the amount of gain that would result from selling that asset at its fair market value on that date. In addition, an overall maximum is established as the net gain across all assets (including those for which a fair-market-value sale would be at a loss). Note that goodwill (which, for tax purposes, includes all intangible assets that are not explicitly treated separately) is an asset (a capital asset) for this purpose, even if it has not been recorded on the books. Therefore, it is critical to determine values of all assets—tangible and intangible—at the time the S election or acquisition is made.

- If such an asset is sold within a certain period of time, normally 10 years, after the starting date, there is a taxable gain equal to the lowest of three amounts: the potential gain on that asset, the remaining amount of the overall maximum gain, and the gain actually realized. This gain is taxed at 35%. (If there is additional gain beyond that amount, that part of the gain is passed through to the shareholders under the normal S-corporation rules.) In addition to the tax paid at the corporate level, the gain (net of the tax) is passed through to the shareholders where they again pay tax on the gain.

Recently, the “certain period of time,” referred to above, has been changing. For most S corporations (those that report on a calendar-year basis)--in 2011 only--the period is five years, measured to the day from the starting date. Thus, assets whose built-in gain period began between 2003 and 2006 (inclusive), or in 2002 after the start of the year, may be sold without built-in gains tax, provided the sale is made in 2011. At the start of 2012, the period reverts to its usual length of 10 years, so those assets will again be subject to the built-in gains tax.

The situation is slightly more complex for S corporations using a fiscal year:

- The “window” for the five-year rule does not open until the corporation begins a fiscal year in 2011. In the 2010 fiscal year, the period is seven years, measured as taxable years. Thus, to avoid the tax on a sale before the start of the 2011–2012 fiscal year, the S election had to be made in 2003 or before, or the asset had to have been acquired before the start of fiscal 2004–2005.
- Similarly, the window does not close until a fiscal year begins in 2012. Thus, even assets acquired in early 2007 may be eligible, if sold between the five-year anniversary date and the end of the 2011–2012 fiscal year.

Through the Decosimo CPA firm’s relationship with Decosimo Corporate Finance, LLC, member FINRA/SIPC, our professionals have the expertise and experience to assist with buy-side and sell-side transactions, including the analysis of complex tax implications such as the build-in gains tax. The firm recently celebrated its 40th anniversary of providing exceptional service to our clients. Please visit www.decosimo.com/transactionadvisory for more information about our transaction advisory services. ■

Incentive Stock Plans and Business Valuation

Tom Decosimo, CPA•ABV, ASA - Principal

Mike Costello, CPA•ABV•CFF, CFE, ASA - Principal

Many of our clients struggle with the question of how to compensate and appropriately incentivize key employees. One solution relied on by the compensation committees of many public companies is to grant equity securities, such as shares of stock or stock options, to key employees. This strategy aligns the economic interests of owners and managers, because the employees benefit from an increase in the value of the underlying enterprise.

While the granting of equity securities to incentivize managers is a practical solution in a publicly traded company, the vast majority of businesses are not publicly traded. The nonmarketable minority interests of privately held businesses present a number of complications when used as incentive securities. For example, options of a Subchapter S corporation may be treated by the IRS as a second class of stock, causing the S election to be lost. Further, securities of any pass-through entity (such as an S corporation, partnership, or LLC) issued to incentivize employees may complicate the tax situation of both the employee and the employer.

For these and other reasons, when we help our clients design and implement a stock incentive plan, we often advise them not to issue ownership interests in the underlying business, but rather to create a Stock Incentive Plan (SIP). SIPs reward key executives and employees for building value of the company over time, and they require that the company be appraised on a periodic basis. A focus on building the value of the company obviously helps both owners and managers. A well thought out SIP rewards managers for increasing the value of the owner's investment without the tax, governance, and other issues associated with issuing equity securities outside the current ownership group.

Three key variables in such plans are the number of incentive units involved, the baseline value, and the date of payment. The baseline value is the minimum value that the company's equity must have for any payment to be made. When the payment date comes, the baseline is subtracted from the value at that date, and the difference is multiplied by the number of units to determine the amount to be paid.

These plans are known by a number of names, most commonly phantom stock plans or stock appreciation right plans. Typically, a phantom stock plan involves the

payment of bonuses based either on the value of the company or on the change in value over time. These bonuses are typically paid at predetermined dates, and they are treated for income tax purposes just like any other bonus; the employer deducts the amount of the bonus and the recipient is taxed at ordinary income rates.

A stock appreciation right is similar, but it is typically structured as a payment equal to the increase in the value of a certain number of shares of the company's stock over a period of time. Stock appreciation rights (SAR) plans provide payouts similar to call options, and plans vary widely in terms of when the SARs can be exercised. From the point of view of the recipient of a stock appreciation right, a value just short of the baseline is no better than a severe drop in value. This creates two key drawbacks:

- It encourages managers to run the risk of major losses in the hope of large gains.
- It does not reward a manager who limits the loss in value from difficult external conditions, while over-rewarding improvements that are from outside the company in good times.

The baseline and the number of units can be set in many different ways to customize the particular incentives that the company wishes to set before its management. In addition, the timing of awards may vary. Some plans call for annual payments, others allow the recipient to choose when to receive payment, and others are triggered only by a change of control.

This flexibility is both a key advantage and a major challenge of these plans. Many decisions need to be made about who participates, how many units will be granted, vesting and forfeiture, funding of payments, rights to interim distributions, and rights to participate in corporate governance (if any).

In addition, decisions must be made about valuation. Is the valuation to be prepared on a controlling interest basis or a minority interest basis? Should the appraiser consider a discount for lack of marketability? Should the valuation consider the dilutive impact of the plan itself? If the company owns nonoperating assets, should they be included? To measure the amount of value that has been created (or diminished as the case may be), a valuation must be conducted as of the date of grant (if that value is to be used in setting the baseline) and at each payment date. While valuation procedures and methods may change over time, it is important that the periodic valuations are not inappropriately inconsistent in their basic assumptions regarding standard of value, level of value, and similar defining elements of the appraisal.

Step Zero: New Qualitative Assessment Allowed for Assessing Goodwill Impairment

Shannon Farr, CPA-ABV, Valuation Manager

The Financial Accounting Standards Board (FASB) recently approved new guidance that would permit an entity to first assess qualitative factors to determine whether the two-step impairment test procedures currently prescribed are necessary to be performed.

Accounting Standards Update No. 2011-08, published by the FASB this September, contains a list of qualitative factors such as the following for management to consider prior to the performance of the two-step impairment test:

- Macroeconomic conditions: a deterioration in general economic conditions, limitations on accessing capital or fluctuations in foreign exchange rates;
- Industry conditions: a deterioration in the market in which an entity operates, increased competition, a decline in market-dependent multiples or metrics, or a regulatory or political development;
- Cost factors: increases in raw materials, labor, or other significant costs;
- Overall financial performance: negative or declining cash flows;
- Entity-specific events: changes in management or key personnel, changes in strategy, contemplation of bankruptcy or litigation issues, among others.

If qualitative assessment indicates that it is more likely than not that the fair value of a reporting unit is less than its carrying amount, the entity is required to proceed to Step 1 of the goodwill impairment test, which identifies potential impairment by comparing the fair values of each of the reporting units to its carrying value. If the carrying value of a reporting unit exceeds its fair value, Step 2 of the goodwill impairment testing process is used to measure and recognize any impairment.

Although the new guidance is effective for annual and interim goodwill impairment testing for fiscal periods beginning after December 15, 2011, early adoption is permitted.

As with any significant update to accounting standards, management is encouraged to coordinate the implementation of this new guidance with the external auditors.

As one of the region's leading providers of audit and assurance services, the

Decosimo CPA firm's valuation division, DAS, can assist you in your fair value for financial reporting needs. DAS has a full staff of professionals dedicated to providing valuation services and possessing the top valuation credentials who are available to assist your firm in documenting the assessment of the prescribed qualitative factors. DAS routinely provides fair value for financial reporting services including impairment testing, purchase price allocations, and valuation of stock-based compensation. Contact one of our valuation professionals for more information. ■

Speakers Bureau

November 11, 2011

11:05 AM - 12:45 PM

FAIR VALUE IN HEALTHCARE ENTITIES FINANCIAL REPORTING

Shannon Farr

Georgia Chapter Healthcare Financial Management Association Savannah, GA

November 11, 2011

9:10 AM - 10:50 AM

SUCCESSFUL FINANCIAL TESTIMONY STRATEGIES IN HEALTHCARE LITIGATION - FROM AN EXPERT WITNESS PERSPECTIVE

Mike Costello

Georgia Chapter Healthcare Financial Management Association Savannah, GA

November 16, 2011

12:00 PM - 1:00 PM

VALUATION OF PHYSICIAN PRACTICES IN DIVORCE

Mike Costello

Memphis Bar Association Memphis, TN

November 17, 2011

4:00 PM - 5:00 PM

SUCCESSFUL FINANCIAL TESTIMONY STRATEGIES IN HEALTHCARE LITIGATION - FROM AN EXPERT WITNESS PERSPECTIVE

Mike Costello

Alabama Chapter Healthcare Financial Management Association Birmingham, AL

November 30, 2011

12:00 PM - 1:00 PM

UNDERSTANDING & CALCULATING LOST PROFITS DAMAGES

Mike Costello and Sharon Hamrick

Memphis Bar Association Memphis, TN

Engagement Spotlight: DAS Professional Testifies in U.S. Tax Court

This past year, **Tom Decosimo**, supported by the valuation professionals at Decosimo Advisory Services (DAS), gave testimony in U.S. Tax Court in Washington, DC. The Tax Court is the primary court hearing disputes under Federal tax law at the initial trial level.

As the main authority on matters of tax law, including those in which the value of a business is a point under dispute, the U.S. Tax Court requires testimony from business valuation practitioners with experience in the field, in addition to a thorough understanding of business appraisal standards and the Internal Revenue Code.

In the case at hand, DAS professionals were required to value a privately held business with operations in approximately 30 states as of three different dates and to review reports issued by other appraisers at two of those dates. Preparation for the testimony took place over three years prior to the testimony.

Our review so clarified the valuation issue that existed at one of the three dates that the IRS abandoned the claims related to that valuation date. Specifically, the IRS asserted that when the company issued options on some of its stock, the options were “in the money”—that is, that they gave a right to buy stock for less than its fair market value—when granted. This was important because, if true, it would have meant that the company’s S-corporation (pass-through) status was invalid retroactive to the date of the transaction, and our client would have faced major back tax bills.

We were able to demonstrate that the IRS was relying on a report prepared for a different purpose, and that for the matter at hand, the value needed to be corrected to take an intervening event into account. In addition, that report contained errors and biased judgments; after correcting those issues, we showed that the options were in fact out of the money, a conclusion that the IRS accepted before trial.

The other main issue was a simple issue of the value of a stock-based payment to an employee that was being taxed. In this part, both sides agreed on the as-if-freely-tradable value on the date of the transfer; the difference was in the amount by which the value should be reduced to account for lack of marketability.

We were asked to rebut a report that applied an average discount based on the result of a number of restricted stock studies. Because the interest in question was very different from the typical restricted stock in those studies in terms of risk (as measured by size, profitability, and other attributes), potential for interim cash flows, and expected holding period, we testified that the average discount of those studies was not appropriate. We advocated for a discount consistent with the discounts observed on a subset of restricted stocks with investment characteristics similar to the subject interest. We also testified that the report's adjustments to the average were in conflict with the reasoning the report gave for those adjustments.

Our road to testifying in U.S. Tax Court began over 15 years ago when our firm committed the necessary resources to have a team of valuation professionals that could undertake a job as large and complex as the one in which we were involved. We brought to bear, as we do in all our valuation work, deep knowledge and experience not only in business valuation but expertise in taxation, audit and accounting principles, litigation support, financial reporting, debt and equity finance, mergers and acquisitions and investment banking.

We hope that when you need valuation and litigation support services you will consider calling Decosimo Advisory Services. ■

Incentive Stock Plans and Business Valuation

» *Continued from page 11*

To avoid inconsistency, we work with our clients to help owners and management understand the principles of valuation. We stress the three major inputs of valuation—the money you make, the risk you take, and the capital you stake. Prior to the preparation of a periodic valuation, we meet with concerned parties to review the approaches, methods, and inputs. We find that when everyone understands these critical inputs and how changing them can affect value, owners and management work together to ensure the valuation will be of high quality.

We are passionate about the valuation process and the benefits of incentive stock plans. Please contact us at 800.782.8382. ■

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