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Preparing for Trial Testimony

As accountants, we're sometimes asked to provide either fact testimony or expert opinion testimony at trials. The purpose of such testimony is to assist the finder of fact (the jury or judge) in reaching a decision. We're not there to advocate or sell one position over another; that's the role of the attorneys representing the opposing parties. Understanding this differentiation is critical to the success of the process.

Trial testimony comes in two forms: **direct testimony**, when the attorney who retained you will ask you questions, and **cross examination**, when opposing counsel will ask you questions.

If you've been retained as an expert witness, it's assumed that you've developed opinions related to your findings and have documented those findings in a report filed with the court. Here's how a common way of organizing direct testimony.

Qualifications: Name, address, educational background, employment history, professional accomplishments and any particular experience or training that may be relevant to the case at hand.

Information Considered: Here you're trying to convey to the jury the information you examined that allowed you

to reach your opinions. Examples include the complaint, discovery, income tax returns, bank documents, production record, the other side's expert report, depositions, interviews, corporate minutes, life care plans, or any other relevant documents.

Opinions: These should be presented in a logical order. Also, if the opinions include damages, both the major components of damages and total damages should be presented. It's important to let the jury know early on what the projected damages are.

Bases for Opinions: Here is where you tell the jury how you arrived at your opinions. How you convey this information is a matter of professional judgment. Report exhibits are often helpful. Define what you want to convey, communicate that information, and finish. Remember, this is a one act play for listeners who don't know what's going to be presented. Information has to be simple and administered in digestible doses. ■



PERSPECTIVES ON VALUE

A SEMIANNUAL NEWSLETTER ADDRESSING FORENSIC AND VALUATION ANALYSIS

FALL 2010

Mergers, Acquisitions, and Healthy Skepticism

Healthy skepticism in business dealings and decisions is something many simply did not practice well in the boom years of 2000 through 2007. The euphoria of the bull market and the run-up in real estate values was too much to resist; our retirement plans, business values, and bottom line profits grew relentlessly, almost in spite of ourselves. Unfortunately, many who were caught up in this euphoria made investments in new businesses that have now come back to haunt them in today's crushing economic environment.

Many of the past decade's small business acquisitions have failed miserably, leaving buyers in financial turmoil and sellers getting their businesses back. While the economy certainly played a role in the demise of many businesses, the much bigger issues are the prices and terms upon which businesses were acquired.

It's unlikely that any of us could have foreseen the building storm and eventual collapse of our financial and credit markets.

However, a business valuation tempered with a healthy dose of skepticism would likely have given both buyers and sellers reason to pause and consider the implications of selling a business at a price that could not be sustained in slower economic times.

The problem of overpaying is not just an issue for buyers of businesses. Sellers have certain legal and financial obligations that may survive the sale of the business. Seller representations are often called into question when financial results fail to meet buyers' expectations created during the selling process; this can lead to litigation. Sellers who finance part or all of the sale assume significant financial risks as well as the potential for protracted litigation should the buyer fail to

meet the terms of the financing. In addition, some tax matters that were presumably transferred to the buyer may find their way back to the seller.

Clients are, of course, excited about acquiring their new venture and are often caught up in the entrepreneurial spirit. Sellers are excited to convert their illiquid assets into cash and move on with their lives. Healthy skepticism practiced by all participants in the merger or acquisition process serves everyone well and helps to ensure that potential risks are evaluated and properly considered before closing the deal. ■



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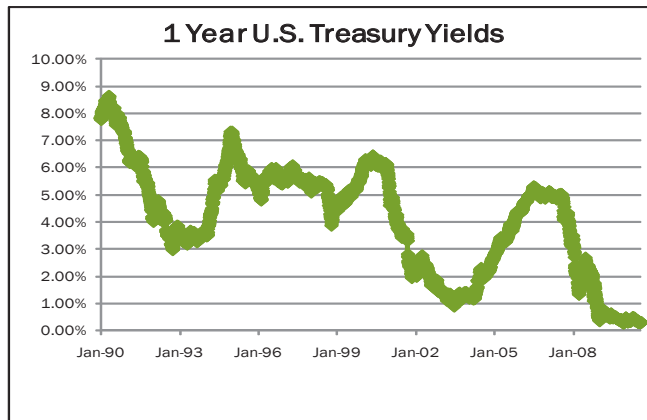
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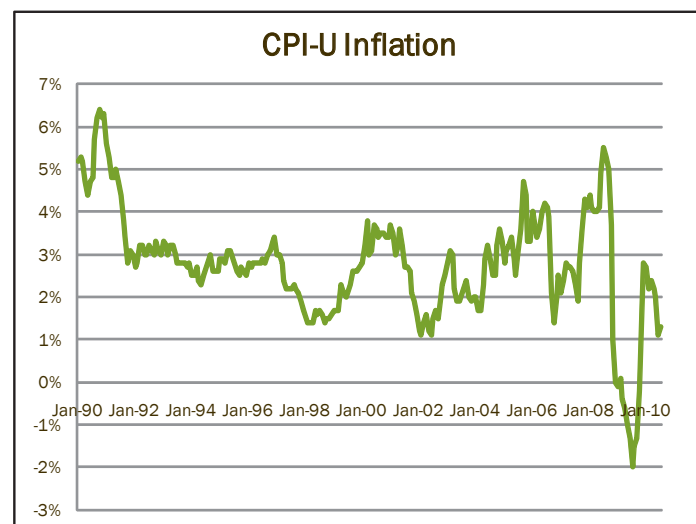
Present Value Computations: When Will the Roller Coaster Ride Be Over?

In May 2008, *Montana Lawyer* published "Present Value Computations in a Troubled Economy: Increased Damages?" Written shortly after the financial crisis of 2007-2010 began, the article explained that low interest rates and higher than normal inflation have challenged the ways in which economists and CPAs think about the future value of money. Since the time this article was published, some economic forces have changed while others have not. For this reason, we need to revisit the topic.

There are two components to calculating the present value of economic damages or other cash flows. The first is the **yield on risk free securities**. The most common measure of risk free securities is the yield on mixed term U.S. Treasury Bills. According to the National Bureau of Economic Research, the most recent recession began in December 2007. From January 1990 to November 2007, the yield on one-year U.S. Treasury Bills steadily declined. The average yield during this period was 4.5%. Since the start of the current financial crisis, the yield has continued a deep decline, falling from 3.15% to 0.29%.



Inflation is the second component. The generally accepted measure of inflation is the Consumer Price Index–Urban (CPI–U). The CPI–U produces monthly data on the changes in prices paid by urban consumers for a representative basket of goods and services. For present value computations, the index is used to calculate the percent change in price over the previous year. From 1992 to 2001, CPI–U inflation ranged between 2% and 4%. During that same period, the yield on short term U.S. Treasury Bills ranged from 3% to 7%. The difference between inflation (measured by percent change) and the yield on risk free securities is the net discount rate. From 1992 to 2001, the unadjusted net discount had an average value of 2.28%, with a standard deviation of 1.20%. It ranged from zero to 4.55%. The stability of the net discount rate during this time period contributed to the widely accepted idea that for long term present value computations, the net discount rate should not be less than 2%.



Since 2001, net discount rates have been highly volatile. From 2002 to 2009, the unadjusted net discount rate has averaged .12%, with a standard deviation of 1.54%. It has ranged from -3.22% to 3.61%. What does this mean for economic damages?

The question at the heart of this issue is, "How much money is needed today to pay for a future expense?" For example, if the defendant is found liable for economic damages of \$100,000 that would have occurred in one payment five years in the future, how much money is needed for the defendant to meet that liability?

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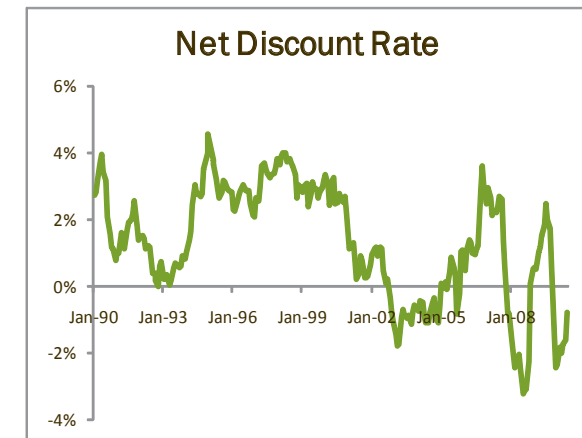
Present Value Computations: When Will the Roller Coaster Ride Be Over? (Cont'd)

Calculations for this question are shown below:

Net Discount Rate	0.0%	2.0%	-2.0%
Discount Factor	1.0000	0.9057	1.1063
Economic Damages	\$100,000	\$90,573	\$110,629

With a zero net discount rate, the economic forces of inflation and interest rates neutralize each other. When the yield on risk free securities is higher than inflation, it takes less money today to fund a future expense. When the opposite is true, it takes more money.

All things being equal, the continued pressure on the net discount rate will produce larger dollar damages for the same cash flow. Given the length of time considered, this increase may be significant. Economists and CPAs still use a net discount of (or close to) 2%. The argument is that these are abnormal times and that the unadjusted net discount rate will return to normal in the long run. This poses a question: If unadjusted net discount rates do not return to normal, at what point do we begin rethinking the future value of money? If we continue to wait for the long run, it could be a while. It was John Maynard Keynes who once said, "We're all dead in the long run."



Business Valuations: Understanding the Math

The most common method of valuing a small business is the "income approach." Under this approach, the valuator develops an estimate of the future economic benefit (generally cash flow) expected to be received by the investor and capitalizes that economic benefit at an expected rate of return, given the risk characteristics of the investment. See Example 1 for an illustration of how this works.

Mathematically, as the investor's expected rate of return (i.e., the capitalization rate) increases, the lower the investment value becomes, given the same annual cash flow. While owners generally have the ability to control and impact the annual cash flow generated by their business interest, they do not have the ability to significantly impact an investor's required rate of return. The market and returns on alternative investment opportunities significantly impact the value of your business, despite the fact that you may have shown the same profits or cash flows from the business for the past several years. As shown in Example 2, a modest 5 percent increase in the capitalization rate results in a nearly 17 percent decrease in the value of the business.

Annual Cash Flow from the Investment / Capitalization Rate = Estimated Value of Investment

Income Approach:

Example 1: \$100,000 / 25.0% = \$400,000

Example 2: \$100,000 / 30.0% = \$333,333