

VALUATION NEWSLETTER

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BUSINESS VALUATIONS:

Family Limited Partnerships (FLP):

An accepted method of estate planning is to set up an FLP. The process involves transferring assets, usually real estate or securities, to a limited partnership and subsequently gifting partnership minority interests to the next generation. The question becomes how to place a market value on those non-marketable minority interests.

Revenue Ruling 50-60 states that in valuing unlisted securities, the valuator should make reference to securities in a similar line of business. Our reference point is the secondary market for the billions of dollars of partnership interests that were sold in the 1980's; most of these were real estate companies. Note, this is not a public market as we know it. In fact, the trading volume is only about \$50 million per year and it takes an average of 45 days for the seller to collect on a sale. The net asset value of the partnership interest is published; and the selling price is, on average, 27% less than such net asset value. Debt, yield and industry data is also published. This provides a critical bench mark in helping valuers determine fair market value of interests in FLP's.

We also use data on publicly traded closed end funds and real estate investment trusts in helping us determine the fair market value of FLP's. The discount evidenced from these sources is the minority discount and not the marketability discount.

DAMAGE DETERMINATION:

Damages Determination Cases: Discount Rates

In a damage case, there is the an alleged wrongful act (called "egregious event") which causes a financial injury, such as a patent infringement. The injury causes a business to lose future cash flow. A financial expert is appointed to prepare projections of expected cash flows in the future and discount that back to the present using a discount factor in order to measure the loss. In this article, we shall focus on the discount rate.

Most importantly, we must understand the enormous impact of discount rates on the amount of damages. The higher the discount rate, the lower the damages. The discount rates that may be applied ranges from 5% to 25%. An example is a business that has a ten year expected annual cash flow of \$100,000 per year. The present value of that cash flow would be \$357,000 using a 25% discount rate and \$772,000 using a 5% discount rate. The low end rate is derived from risk-free investments, such as Treasury Bonds. The high end rates is adjusted for risk – the business may fail, competition may become intense, etc.. More specifically, the damage award should provide a fund, when properly invested, that the injured party can draw upon over time to replace the *lost income or profits*.

FORENSIC ACCOUNTING:

Bookkeeper Fraud:

As the economy contracts, company owners reduce their work force and combine responsibilities. This often leads to the elimination of critical duties in the accounting department. This was the case in one company that lead to one the largest fraud scandal on record. The bookkeeper, using a very popular software package, (i) prepared checks payable to himself, (ii) used the signature stamp to sign the check; (iii) subsequently deleted the transaction; (iv) destroyed the check when it was returned by the bank; and (iv) balanced the books by replacing the deleted check with a fictitious check for the same amount. This fraud lasted several years and aggregated to a loss of \$7 million.

A few easy control measures can used to prevent this type of fraud:

1. The owner receives the unopened bank statement, opens the bank statement and examines the contents.
2. Signature stamps should be avoided and the duties of check signing and check preparation should be separated.



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