

Valuations Plus

CPA objectivity important when valuing a business

As cliché as it may sound, one of the pillars of the accounting profession is integrity.

The role of the accountant is so crucial for the successful operations of a business that CPAs have always been looked to with respect for their ability to advise business owners on a myriad of topics. It has long been established that the CPA must meet certain standards of independence, objectivity and integrity when performing attest services.

Similarly, certain standards are called into play when a CPA performs a business valuation.

When working with a client on a business valuation, the CPA assumes one of the following roles: an adviser who is compensated to determine a value that – within the constricts of sound valuation theory – is most advantageous to the client or, alternatively, one who is compensated to perform an objective valuation of a company.

The CPA should be very clear to communicate which of these very different roles he or she is being paid to take on and document it in an engagement letter. This possibility of being an advocate versus being neutral requires knowledge and a commitment to remaining independent.

The foundation in accounting literature for the concept that a CPA performing a business valuation is objective can be found in the American Institute of Certified Public Accountant's (AICPA) Code of Professional Conduct, Rule 102 – Integrity and Objectivity:

"In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others."

This hallmark for CPA conduct is amplified by even newer literature, namely the AICPA Statement on Standards for Valuation Services No. 1, which states:

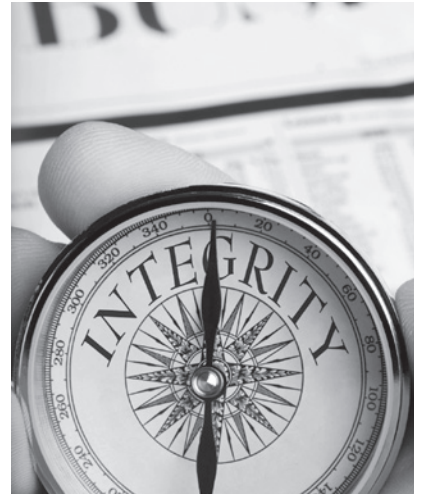
"... The principle of objectivity imposes the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest. If necessary, where a potential conflict of interest may exist, a valuation analyst should make the disclosures and obtain consent as required under Interpretation No. 102-2."

Consider the impact the work of a CPA has in preparing a business valuation when it comes to a divorce engagement.

The value determined by the valuation analyst will be used to establish equitable distribution between the spouses. Not only will the value of the business be factored into asset allocation and division, but some of the procedures performed for the valuation may also serve in determining the true income of the business-owning spouse. This has very significant consequences because it is a basis on which alimony is determined.

Clearly, it is the objectivity and integrity of the CPA that attorneys seek when hiring a valuation analyst. Even more, these qualities

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On the surface, a recent Tax Court case appears unremarkable, but it involved application of the Internal Revenue Code to a rather unusual set of facts.

In 1962, Adelina Van immigrated to the United States from China, as a single mother with her four children. In the 1970s, Van struck up a romantic relationship with a gentleman who purchased a home for her that became the subject of her estate's tax issue.

In 1997, Adelina Van gifted title to her residence to her daughter and three granddaughters. Van continued to live in the house rent free until her death in 2000. The estate excluded the value of the residence, and the IRS disagreed.

The IRS viewed the situation as a classic gift with a retained life interest of the type that includes the property in the estate under §2036(a). But the estate had a different view of the situation.

To understand the estate's position, the story must begin at the beginning.



and deeded the house to herself as trustee. In 1999, she transferred the house from herself as trustee to her daughter and three granddaughters. All of these transfers were executed without consideration.

When Van died in 2000, the estate reported the value of the house on the estate tax return and then deducted the value, explicitly noting the estate's belief

The court was persuaded that Van's intention to occupy the home, and the fact that she occupied it until her death, invalidated the resulting trust argument.

Court must unravel complicated real estate transfers

Van and her children moved into the home, rent free, in 1973. Her significant other retained title to the house. Although he apparently did not reside in the home, the gentleman paid all the expenses associated with purchasing and maintaining the home.

By 1988, Van's daughter Norma had married James Hu. The Hus expressed interest in purchasing Van's home from her friend.

The owner was willing to sell the house to Van rather than to the Hus. The friend and Van agreed on a sale with a cash downpayment and a secured promissory note. The Hus provided Van with all of the cash necessary for both the downpayment plus principal and interest payments on the note.

In 1989, Van took title to the house and immediately reconveyed title to herself and her two granddaughters as joint tenants. Then without telling the Hus, Van had the grandchildren reconvey the title back to her in 1994.

In 1997, Van created a revocable trust

that Van had no ownership in the house.

The estate's position was that the Hus had provided the purchase money and that title had passed to Mrs. Hu and her three daughters before Van's death.

The estate took the position that any evidence showing Van as the owner of the house simply reflected the fact that Van was acting as agent for the Hus in dealing with the seller of the house. The court was not convinced.

Looking at the entire scenario, the court concluded that the Hus had made a gift to Van of the cash she used to purchase the house for herself. Van later transferred the house for less than adequate consideration as a gift to her daughter and granddaughters.

Because Van continued to enjoy rent-free occupancy of the house until her death, that gift was a transfer with retention of possession or enjoyment for life. So the value of the house was included in Van's estate under §2036(a).

The court also rejected the estate's argument that the initial purchase of the

house caused the creation of a "resulting trust" under California law. The court described the resulting trust doctrine as follows: "[It] arises in favor of the payor of the purchase price of the property where the purchase price, or part thereof, is paid by one person and title is taken in the name of another."

In this case, the court was persuaded that Van's intention to occupy the home, and the fact that she occupied it until her death, invalidated the resulting trust argument. Van held title to the house for her own benefit, not for the benefit of the Hus.

Although it did not change the outcome of the case, the estate prevailed on one aspect. The court ruled that the way the estate disclosed the existence of the house on its return, and the level of cooperation the estate gave to the IRS during its examination of the return, effectively shifted the burden of proof from the estate to the IRS.

Estate of Adelina C. Van. et. al. v. Commissioner (T.C. Memo 2011-22, Jan. 27, 2011 – Michael Redemske, CPA

How to manage clients' goodwill during a sale

The time has come. You've decided to sell your business.

You know that a great deal of your business's value comes from your existing client base. The potential buyer, whoever he may be, may not want your building, your processes or your company name, but he will want the revenue stream that your customers generate.

This should be a serious consideration during the search for a potential buyer and throughout the transition. You'll maximize your company's value if you can demonstrate that your clients are loyal and will likely remain so.

To increase the chances that your clients will stay, here are a few things they will want to know:



1. What will change? Clients hate surprises. Most people can deal with change if they know what to expect. Too often, businesses pretend that everything will stay exactly the same, when, in fact, they know it won't.

It's important when you select a buyer that you consider the things that need to stay the same for your clients to stay in the fold. If your clients buy from you primarily because of personal service, that should be a serious consideration in selecting the new owner. If the new owner's model is automation instead of personal service, your clients aren't likely to stick around for long. They may migrate to a new model over time, but the change in ownership gives them permission to look elsewhere. A change in service philosophy will reinforce the desirability of looking,

It's important when you select a buyer that you consider the things that need to stay the same for your clients to stay in the fold.

2. What will stay the same? Many advisers will tell you to focus on this section when you talk with your clients about the change. This is important because it tends to comfort clients, especially if they feel that you've been honest with them about the things that WILL change.

How long will you continue to be present? Will the people they've been used to dealing with stay with the new entity? Will phone numbers and e-mail addresses be the same? What about credit policies and billing practices? It is often to your buyer's benefit to keep as much the same as possible, at least until the transition is successfully completed and clients get used to the new particulars.

Well-planned, gradual changes will certainly occur over time, and your clients can embrace those – so long as they don't happen all at once.

3. Why is the transition being made? Research tells us that people will accept a request or decision more readily if they know why it was made. Certainly, those customers who have close relationships with you will want to know what is driving the decision. You have to determine how much or how little you're willing to share. It's always best to tell the truth.

For example, perhaps you've decided to sell because you have been running thin on capital and you don't know how long you'll be able to keep things going. That might be more information than you want to share, but you could also say that you know the company will be in a better competitive position with the buyer that you've found, and you want to see the company do well for many years to come. You decide what you want to share, and be consistent. Your clients will likely feel better about your decision if they are given a reason for it.

4. What is the time frame? When to tell clients is always a dilemma.

It is customary to say nothing until the deal is done. It is often in the buyer's and seller's best interests to minimize the number of people involved in the process.

Once the deal has been made, it's important to inform your clients as soon as possible. Have a

plan in place for how long you will remain with the new entity. How long will their current salespeople handle their accounts? Think about all the touch points that affect your

clients, and try to give them a timeline so they will be in the loop as changes occur.

As with most changes, communication is key. Your transition plan should include a detailed communication plan. You want your clients to feel good about the changes.

Communicate the benefits that will make this good for your clients. Be honest with them. You've built up goodwill over all the years you've been in business – don't compromise it now. – *Denise Altman, MBA, CPA, CPBA*

CPA objectivity *continued from front*

must be beyond reproach when considering the fact that often the CPA is an expert who may be called upon to testify at trial or even to assist in mediating the case between all parties.

The same standards of independence and objectivity apply in the purchase or sale of a business, valuation for estate planning and gifting, the buy-in or buy-out of a business owner and many other scenarios. Certainly there are parts of any business valuation that require the valuation analyst's judgment, and one CPA may differ with another in one of these areas. However, this does not negate the need for an independent analysis.

While the CPA adviser may discuss negotiation strategies with clients, this does not eliminate the need for independence.

Independence is discussed in terms of "fact" and "appearance." While the "facts" of independence violations are delineated in accounting literature, the "appearance" violations are occasionally subject to debate.

For example, what if a CPA performs write-up work for a company and prepares the owner and spouse's income tax return. When the couple divorces, should the CPA perform the valuation?

On the one hand, the valuation analyst could make his role clear to the attorneys and disclose it in an engagement letter and subsequent report. But is that sufficient?

On the other hand, how does the CPA defend himself from potential charges that he intended to keep the business owner as a client in the future (with the write-up work, of course) and that this fact did not influence the work product?

Another factor to consider is that of self-review. A CPA in the above situation would effectively be reviewing his own write-up work as he prepares the business valuation. While he may claim to be independent with respect to each party, it is very difficult to be perceived as "intellectually honest" when reviewing one's own work.

Further, if the valuation analyst later testifies to a valuation report that found issues with the write-up work, the credibility of the entire firm may become an issue.

While CPAs often try to be a one-stop shop for all their clients' needs, considering the absolute need for independence and objectivity when performing a business valuation, they may need to consider passing the valuation work to others outside the firm in certain situations. – *Anthony Talerico, Jr., MBA, CPA*

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The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the information contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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