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# EXPERT

AICPA Newsletter for Providers of Business Valuation & Litigation Services

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### Responsibilities for Litigation Services

An exposure draft of a *Proposed Statement on Responsibilities for Litigation Services No. 1* has been issued by the Statement on Responsibilities Task Force of the Litigation and Dispute Resolution Subcommittee. The proposed SOR would define the scope of litigation services and provide a comparative analysis of standards and responsibilities. The task force drafted the proposed SOR to provide additional guidance to practitioners on existing professional standards affecting litigation services engagements. The proposed SOR addresses the AICPA Code of Professional Conduct, the AICPA Statement on Standards for Consulting Services, and the federal Rules of Evidence and includes appendices covering the application of professional standards and conflicts of interest.

Comments on the exposure draft are due January 31, 2002. To obtain a copy, visit: [www.aicpa.org/members/div/ptp/litvscs.htm](http://www.aicpa.org/members/div/ptp/litvscs.htm).



## ASSESSING UNSYSTEMATIC RISK: PART IV—INDUSTRY ANALYSIS

Warren D. Miller, MBA, CPA/ABV, CMA

*Previous articles in this series provided an overview of unsystematic risk and a detailed discussion of macroenvironmental analysis. This installment continues the discussion of the next level of risk: the industry.*

The preceding article in this series dealt with certain aspects of market structure as it relates to industry analysis. This piece completes the subject that, in our reports and memoranda, we call *Industry Dynamics*. That term better conveys the truth that, in free markets, industries and organizations are in a constant and dynamic state of change.

To summarize where we've been: Risk assessment is key in valuing any company. The smaller the company, the more important risk assessment is. Despite the seeming simplicity of small-company appraisals, most are complex assignments because risk is usually oozing from most pores of the company's internal and external environments.

The unsystematic risk framework posited in this series comes from three levels: macroenvironment, industry, and company. All too often, the greatest source of risk to a company is itself.

Because there are few data related to unsystematic risk, most CPAs are uneasy in assessing and quantifying it. This series aims to give them a framework for such risk assessment and the

tools with which to use the framework.

At the risk of repeating myself, let me add that an important benefit of doing this type of analysis is the depth by which it enhances the appraiser's understanding of *how the business works*. We continue to be amazed at the reports we read that reflect beyond any doubt the appraiser's failure to understand the business: How it competes (vs. how it *should* compete), what its value drivers are, how it creates wealth, the sustainability of its wealth-creating mechanism, and so on.

These are not "no-brainer" issues that can be run through a spreadsheet. They're complex, and they require analysis. Invariably, most of the analysis is qualitative.

Not surprisingly, industry analysis is also qualitative.<sup>1</sup> There are hard data—market share, demand cycles, and the like. But so much of the data depend on how the industry is defined. For most of us valuing smaller companies, the industry is defined in terms of strategic groups, in a local or regional context. Quite often, the structures of those industries are very different from their national counterparts. That is why industry data gathered nationwide by Ibbotson and by the Bureau of the Census can (or should) seldom be used in valuations. The usual case is

<sup>1</sup> For the purposes of this article, the terms *industry* and *strategic group* are used interchangeably. That is because the techniques of industry analysis apply perfectly to the analysis of a strategic group.

that local and regional competitive arenas are more concentrated than national ones. That leads to differences in competitive behavior—and profitability.

An individual company can—with foresight, understanding of itself and its competitors, and a little luck—slowly shape industry (or strategic group) forces in its favor. It takes time and perseverance. But it can be done.<sup>2</sup> The effect is to have others playing by the rule-maker's rules. Imitators will never do it as well as the rule-maker. They'll always be playing catch-up. That is why innovation, not imitation, is the only viable long-term strategy.

## INDUSTRIAL ORGANIZATION

The tools of industry analysis come from a field of economics called *industrial organization*, or IO. Unlike traditional microeconomics with its assumptions about profit maximization, rationality, perfect information, and so on, IO is real-world economics. Its fundamental premise is that, within an industry, there is a relationship between market structure, competitive conduct, and performance. This structure-conduct-performance model, as it's called, is extraordinarily useful for appraisers because it helps us make inferences about the future.<sup>3</sup> And, as we all

know, valuation is all about the future.

Three aspects of IO set it apart from traditional microeconomics. The first is the unit of analysis—the industry (vs. the individual firm). The second is its reliance on empirical data, rather than on theory whose credibility is undermined by assumptions (profit maximization, complete rationality, perfect knowledge, and so on) that don't reflect everyday reality. The third is its explicit recognition that conduct affects outcomes; in traditional microeconomics, performance is preordained, determined by marginal cost analysis. In short, IO recognizes what other branches of economics deny: Behavior (read *strategy*) matters.

Industrial organization matters to valuation professionals because the original field of study of Michael Porter, originator of the famed “Five Forces Framework,” is IO. The seminal contribution to how we think about industry analysis is his *Competitive Strategy: How to Analyze Industries and Competitors*.<sup>4</sup> For a quick synopsis of his five-forces framework, see “How Competitive Forces Shape Strategy.”<sup>5</sup> The Porter Framework, as it's come to be known, consists of (1) the threat of new entrants, (2) the bargaining power of suppliers, (3)

the bargaining power of customers, (4) rivalry between industry incumbents, and (5) the threat of substitute products or services. Let's examine each of these.

### FORCE #1: THREAT OF NEW ENTRANTS

In a free society, industries come and (sometimes) go. Whatever happened to slide rules, hula hoops, CB radio, and buggy whips?

Companies come and go too. Forty-five of the 50 largest companies in America in 1909 either are no longer with us or are no longer in the top 50.<sup>6</sup> This is the essence of capitalism. Economist Joseph Schumpeter called it *creative destruction*. So any group of incumbents in an industry or strategic group must always contend with the prospect of new entrants. Revenue Ruling 59-60 is likewise explicit on this point:

*Prospective competition which has not been a factor in prior years should be given careful attention. (Sec. 4.02(b))*

To enter an industry, one must usually clear one or more barriers to entry. The more numerous and more difficult these are, the “higher” they are said to be. As we would expect, industries with higher entry barriers have fewer competitors. Those with lower ones have many. It stands to reason that, the higher the

<sup>2</sup> More on this in a later article in this series on unsystematic risk assessment at the company level.

<sup>3</sup> *Industrial Market Structure and Economic Performance* by Scherer and Ross, which is out of print. Recommended in-print tomes on IO include *Modern Industrial Organization* by Dennis W. Carlton & Jerry M. Perloff, *Applied Industrial Economics* by Louis Philips (Ed.), London: Cambridge University Press, 1998; *Market Microstructure: Intermediaries and the Theory of the Firm* by Daniel F. Spulber, New York: Cambridge University Press, 1999.

<sup>4</sup> This 1980 classic came out in a (slightly) revised edition in 1998 with a new introduction from Porter. The examples, while dated, are relevant and illustrative.

<sup>5</sup> *Harvard Business Review*, May-June 1979, pp. 137-143. Here's the link for a fee based download: [http://www.hbsp.harvard.edu/hbsp/prod\\_detail.asp?79208](http://www.hbsp.harvard.edu/hbsp/prod_detail.asp?79208).

<sup>6</sup> The five: International Paper, GE, Du Pont, Sears, Kodak. See *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*, Cambridge, Mass.: MIT Press, 1962, p. 5.

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barriers, the more profitable should be the industry. Not an individual company per se, but the industry. That is usually, but not always, the case.

In public accounting, for instance, barriers to entry include a four-year degree with at least 120 semester hours of credit (soon to be 150 hours in many states), good character, and passing the uniform CPA exam. In some states, two years of indentured servitude in auditing is required; in other states, industry experience can be substituted. And in a few states, the experience requirement can be waived if 30 semester hours of accounting and business law are on one's college transcript.

It should be intuitive that, as entry barriers are raised, fewer are likely to enter. Yet, for all the professionally defensible reasons surrounding the adoption of the 150-hour rule to become a CPA, it should surprise no one that the number of accounting majors has fallen. This is Economics 101: What's the opportunity cost of staying in school for an extra year vs. hitting the job market with a four-year 120-hour degree? Even a 22-year-old can figure it out. More important, so can the check-writers keeping the 22-year-old afloat.

What constitutes a particular barrier to entry varies with one's economic perspective. Outside the "Chicago School," for instance, which concedes the existence of few barriers, the following barriers are widely recognized:

*Capital requirements*—Some industries require huge amounts of capital to enter. These are often capital-intensive lines of business such as exploring for oil and gas. But consumer products such as breakfast cereal, where an oligopoly governs, also require lots of money for entry. Unlike capital-intensive industries, however, much of the money a new breakfast-cereal entrant would have to spend would be for advertising. Unlike a new widget-manufacturing

machine, advertising is a sunk cost with no residual value. Risk is higher, and the cost of capital is too. So it goes in most arenas where advertising plays a dominant role.

*Differentiation*—The essence of differentiation is *perceived uniqueness*. The beauty of differentiation is that uniqueness can come from almost any source. The double-barreled challenge of differentiation is that uniqueness should add value the customer is willing to pay for—but the gap between the differentiator's product or service and that of the market leader should not be so great as to lose customers.

Successful differentiators abound: Dell, Chubb Insurance, Lexus, Ralph Lauren, Cole-Haan, Four Seasons Hotels, Estee Lauder, Steinway, Hewlett-Packard handheld calculators, American Express Platinum, and Tiffany's. They differ in different ways, but quality, durability, and service tend to head the list. In this era of short product life cycles, product features seldom offer the advantage they held in years past.

*Economies of scale*—Scale economies refer to decreasing costs per unit of output *within a time period*. These economies can arise from mass production, from purchasing, and from advertising, to name just a few sources. As with product features, scale economies tend to offer false feelings of security in fast-changing markets.

*Switching costs*—These are costs that a customer incurs in shifting loyalty from one supplier to another. These days, switching costs are often tied to investments in new learning, as, for instance, the costs a company would incur in shifting from the Corel Office Suite to Microsoft Office. Or changing from MAC OS to Windows. Less obvious switching costs are frequent-flyer programs for a road warrior who moves and must change his or her primary airline.

*Access to distribution channels*—This access shows up in such arenas as ready-to-eat breakfast cereals, films

made for entertainment, airports that are hubs for certain airlines, and travel agents' software (Sabre vs. PARS). With the advent of the Internet, distribution channels don't hold the power they once did.

*Cost disadvantages independent of scale*—These disadvantages arise from an incumbent having a proprietary product or process, and advantageous location, or exclusive access to vital supplies of raw materials. Some years ago, we valued a tobacco store in a city where one player had more than 85 percent of the cigar market. Because cigars were in short supply, her long tenure in the industry gave her clout with suppliers that newer competitors could not match. They often had to go to her store to buy products for resale in their own stores.

*Government policy*—Government policy began its decline as a barrier to entry in 1978 with the deregulation of the airline industry. Deregulation has since occurred in other segments, as free markets have come to the fore around the world. Once electrical utilities are deregulated, then the last bastion of monopoly in this country will be the Postal Service. Where else but in a monopoly can the sole provider raise prices while demand fails?

*Threat of retaliation by incumbents*—This occurs rarely, but is a treat to watch when it does. Before the movie-theater industry fell on hard times, Carmike owned a prime movie location in a city in Oklahoma. The location was in impeccable condition, but remained closed. Several times over a four-year period, another chain operator announced it was opening a new theater in that city. Each time, Carmike responded by announcing that it, too, would open its closed theater. Because tickets, like airline fares, are sensitive to even minor changes in the supply-demand relationship, the excess supply that resulted from Carmike's action caused the would-be new player to rescind its plan. Carmike

would too, and everything would just rock along until the next instance. The threat of retaliation often occurs in industries where the cost structure is high fixed, low variable.

Before we leave the subject of barriers to entry, several observations are in order. The first is that barriers to entry change as markets and industries change. Sometimes, the reason for a given change is beyond the control of an individual company. But, just as surely, an individual firm can, with savvy and foresight, influence the evolution of entry barriers in its favor.

And it better if it is in a highly profitable industry or industry group. That is because high profitability attracts new players. The usual (but not inevitable) result is that relative profitability falls due to increased competition.

Finally, an existing player in one industry can face lower barriers in another by virtue of its existing product lines or relationships. A good example is the action by Philip Morris in acquiring Miller Brewing, Kraft, and General Foods in the second half of the last century. New brewers or food processors would have had a far more difficult time than Philip Morris did because of its existing distribution channels.

### **FORCE #2: BARGAINING POWER OF SUPPLIES**

Supplier groups may have bargaining power over the industry or strategic group to which they sell. That bargaining power manifests itself in the suppliers' ability to raise prices, reduce quality, or both. In essence, what such a supplier group does is to appropriate some of the industry's profits to make them its own.

The result is that *aggregate* profitability in the industry or segment will fall. Remember, though: Our unit of analysis here is the industry. So, despite the fact that an industry's profits may fall, those of a particular competitor might not. We need only look at Southwest Airlines for an

example of a player whose profits are not plummeting, even as its rivals lay off tens of thousand of employees, cancel flights, and decrease capacity in the wake of the accelerating recession following the atrocities of September 11, 2001.

A supplier group likely has bargaining power if any of the following conditions exist:

- It is more concentrated than the industry or strategic group to which it sells.
- Its products or services have built-in switching costs.
- Its products or services are differentiated.
- It can threaten credibly to integrate forward and compete with its customers—expand from manufacturing to, say, distribution.
- Its product or service is crucial to the industry to which it sells.
- The industry to which it sells is not an important customer.
- There are no substitutes for its products or services.

### **FORCE #3: BARGAINING POWER OF CUSTOMERS**

The bargaining power of customers (not consumers) is the converse of that of suppliers: Customers can force an industry to reduce its prices, increase its quality, or both. Again, the effect is to reduce *aggregate* industry profitability.

Customer groups' increased bargaining power generally stems from conditions that are the opposite of those for suppliers, plus two other conditions: (1) the industry earns low profits (which motivates it to bargain hard and search for alternatives), and (2) customers have full information (ask any car dealer about the effect of the Internet on new-car profits.)

### **FORCE #4: RIVALRY**

Rivalry between existing competitors may be intense, or it may be pretty casual. More often, it's somewhere in between. Rivalry intensifies when a competitor tries to build market

share at the expense of its opponents. Because in all but the most fragmented of industries, there is shared dependency among competitors, such an action may end up hurting the entire industry or strategic group. Image: two gas stations on opposite side of an intersection. One cuts price. What does the other do? In the passenger airline industry, price-cutting generally has the effect of leaving all of the airlines worse off. And look at the impact of General Motors' 0% financing program on struggling Ford.

Certain circumstances intensify rivalry. That creates margin pressures *for an industry*. Such circumstances include the following:

- Industry growth is slow or slowing.
- The industry's cost structure is heavily biased towards fixed costs.
- The product or service is perishable (hotel rooms, seats on a scheduled flight).
- Capacity is added in large increments (semiconductors, commercial aviation).
- The product has high storage costs (auto dealerships).
- There is no differentiation (corn, diesel fuel, T-shirts).
- There are no switching costs.
- Exit barriers are high (remember how long it took Sears to exit from catalogs).
- Rivals have very different views of competition (even today, many small CPA firms are still trying to be all things to all clients; sooner or later, the tort bar will solve that problem unfortunately).
- Competitors are numerous (that is, the industry or group is fragmented).
- Rivals have roughly equivalent market shares (this occurs in oligopolies in which one player decides to cut price).

Understanding the nature of intense competition leads to a key conclusion: Price-based competition creates instability. Cutting price requires no brains, no imagination, no guile. It works only for the largest

players, those with enough units of output over which to spread their fixed costs. For everyone else, competing on the basis of price qualifies as self-destructive behavior.

And for a small company, it is often lethal. Small-business owners often believe that they can 'beat' the big competitors through 'lower overhead.' Well, they might survive doing that, but they'll never earn even an industry-average rate of return. For small competitors more than for anyone else, differentiation is an essential practice. But we continue to be amazed at the number of businesses, and CPAs, that fail to recognize that basic fact of economic life.

#### **FORCE #5: THREAT OF SUBSTITUTION**

The existence of a substitute product or service creates pricing havoc for an industry by placing a ceiling on what it can charge for its output. A substitute is *not* the same product or service offered by a competitor. Instead, it is an entirely different product or service that meets the same need of the customer.

Every tax professional knows the pre-eminent substitute of our time:

Turbotax. It encourages otherwise sane human beings to believe they really can do their own tax returns. For any but the simplest returns, nothing can be further from the truth, of course, as witness the continuing increase in the percentage of taxpayers who get their returns prepared by a professional. At last reading, it was just over 57%! A tax code that is over 45,000 pages long is a surefire guarantee of annuity income for those who can master its complexity.

There are other substitutes. They include electronic security alarm systems (vs. security guards), high-fructose corn syrup (vs. sugar), and word-processing software (vs. typewriters). But Wendy's isn't a substitute for McDonald's anymore than Budweiser is a substitute for Coors.

#### **MEASURING INDUSTRY FORCES**

As with macroenvironmental forces, we include at the end of our industry analysis an estimate of where, on a scale of 1 (maximally friendly) to 5 (maximally hostile) with point increments, we believe the aggregate structural forces of the industry or

strategic group lie. We then quantify an industry premium based on that estimate. In our experience, this premium falls in the range of plus or minus three percentage points.

Remember, unsystematic risk need not always *increase* a discount rate or reduce a multiple. In benign circumstances, it does just the opposite.

And keep in mind that the closer our analysis gets to the company being valued, the greater is the potential of threat or opportunity. Therefore, because of their proximity to the company, industry forces tend to be more important than macroenvironmental ones.

Most important is the company itself. Before we take on that complex topic, we will deal in our next installment with a subject that most valuation reports we've read ignore: competitive analysis. ❧

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## **INTANGIBLE ASSETS AND GOODWILL IN A BUSINESS COMBINATION**

Steven D. Hyden, CPA, ASA and Michael J. Mard, CPA/ABV, ASA

On June 29, 2001 the Financial Accounting Standards Board (FASB) voted unanimously to issue two statements the following month: Statement of Financial Accounting Standards (SFAS) No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets*. These statements will have a significant impact on accounting for mergers and acquisitions, particularly with respect to judgments concerning identifying and valuing intangible assets, identifying reporting units and allocating assets, liabilities, and good-

will to these units and determining their fair value.

#### **SFAS NO. 141, BUSINESS COMBINATIONS**

According to SFAS No. 141, a business combination occurs when an enterprise acquires net assets that constitute a business or equity interest of one or more enterprises, thereby obtaining control. The purchase method of accounting should be used to account for all business combinations although there are limited exceptions. Use of the pooling of interest method is prohibited

immediately. Application of the purchase method requires identification of all tangible and intangible assets of the acquiring enterprise. Any excess of the cost of an acquired entity over the net amounts assigned to the tangible and intangible assets acquired and the liabilities assumed will be classified as goodwill.

This regulatory change essentially reflects the FASB's philosophy of increased emphasis on balance sheet reporting and will bring the U.S. accounting standards closer to Generally Accepted Accounting Principles (GAAP) as practiced outside the U.S.

The definition of intangible assets encompasses current and non-current assets (not including financial instruments) that lack physical substance. SFAS No. 141 states, "an

acquired intangible asset shall be recognized apart from goodwill if that asset arises from contractual or other legal rights. If an intangible asset does not arise from contractual or other legal rights, it shall be recognized apart from goodwill only if it is separable. That is, it must be capable of being separated or divided from the acquired enterprise and sold, transferred, licensed, rented, or exchanged (regardless of whether there is an intent to do so). An intangible asset that can not be sold, transferred, licensed, rented, or exchanged individually is still considered separable if it can be paired with a related contract, asset or liability and sold, transferred, licensed, rented, or exchanged.”

An important exception to the individual recognition of intangible assets is the value of an assembled workforce of at-will employees. Not bound by an employment agreement, the fair value of an employee group acquired in a business combination will be recorded as goodwill regardless of whether the asset meets the criteria for recognition apart from goodwill. The sidebar on page 7 details examples of the acquired intangible assets that the FASB believes meet the criteria for recognition separate from goodwill.

SFAS No. 141 requires significant disclosures about a business combination and the tangible and intangible assets acquired. For intangible assets subject to amortization, these disclosures include:

- The total amount assigned and the amount assigned to any major intangible asset class.
- The amount of any residual value, in total and by major intangible asset class.
- The weighted average amortization period, in total and by major intangible asset class.

For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible asset class must be disclosed. For goodwill, disclo-

tures are required for the total amount of acquired goodwill and the amount that is expected to be deductible for tax purposes. Further, the amount of goodwill allocated by reporting segment (pursuant to SFAS No. 131, *Disclosures about Segments of Enterprise and Related Information*), should also be disclosed. There are many other requirements for disclosure, which are discussed later in this article. The appraiser is urged to work closely with the auditor in defining the scope of the appraisal to ensure all the elements of disclosure are included.

#### **SFAS NO. 142, GOODWILL AND INTANGIBLE ASSETS**

SFAS No. 142 will apply to all acquired intangible assets whether acquired singly, as part of a group, or in a business combination. The statement prohibits the amortization of goodwill. Rather, goodwill should be tested for impairment at least annually at the reporting level. Although the FASB has an outstanding statement on impairment (FASB SFAS No. 121, *Accounting for the Impairment or Disposal of Long-lived Assets*), goodwill will be tested for impairment according to the guidelines in SFAS No. 142.

All goodwill reported on the financial statements of a subsidiary should be tested for impairment by the subsidiary as if it were a stand-alone entity. A reporting unit is the same as an operating segment (see SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*) or one level below an operating segment (called a component). A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component. Goodwill is to be determined and allocated at the component level. Entities that are not required to report segment information in accordance with

SFAS No. 131 are nevertheless required to test goodwill for impairment at the reporting unit level.

All acquired goodwill should be assigned to reporting units. This will critically depend on the assignment of other acquired assets and assumed liabilities. These assets and liabilities will be assigned to reporting units based on the following criteria:

- The asset will be employed in or the liability relates to the operations of a reporting unit.
- The asset or liability will be considered in determining the fair value of the reporting unit.

Goodwill is defined as the excess of cost over the assets acquired and liabilities tendered or assumed. The determination of the assignment to a reporting unit is contingent on the expected benefits from the synergies of the combination. This is required even though other assets or liabilities of the acquired entity may not be assigned to that reporting unit. A relative fair value allocation approach similar to that used when a portion of a reporting unit is disposed of (see SFAS No. 121) should be used to determine how goodwill is to be allocated when an entity reorganizes its reporting structure in a manner that changes the composition of one or more of its reporting units. Otherwise, SFAS No. 121 should not be followed. Rather, goodwill should be tested for impairment annually.

The fair value measurement can be performed at any time during the fiscal year as long as the measurement data are consistently used from year to year. Although different measurement dates can be used for different reporting units, whichever date is selected for a subject reporting unit should be consistent from year to year. A detailed determination of the fair value of a reporting unit may be carried forward from one year to the next if all of the following criteria have been met:

- The assets and liabilities comprising the reporting unit have not changed significantly since the

most recent fair value determination.

- The most recent fair value determination results in an amount that exceeds the carrying amount of the reporting unit by a substantial margin.
- Based on an analysis of events, it is determined that the possibility is remote that a fair value determination will be less than the current carrying amount of the reporting unit.

Goodwill of a reporting unit should be tested for impairment on an interim basis if events occur that would more likely than not reduce the fair value of a reporting unit below its carrying value. Such events include changes in business climate or market, a legal issue, action by regulators, loss of key personnel, and so forth.

### GOODWILL IMPAIRMENT TEST

Goodwill should be tested for impairment using a two-step approach. The first step compares the fair value of a reporting unit to its carrying amount, including goodwill. If the fair value exceeds the carrying amount, goodwill is not considered impaired. On the other hand, if the fair value is less than the carrying amount, comparison must be made of the implied fair value of goodwill with the carrying amount. The excess of the carrying amount over the implied fair value would be considered an impairment loss.

The implied fair value of goodwill should be calculated in the same manner that goodwill is calculated in a business combination. The entity should allocate the fair value of the reporting unit to all the assets and liabilities of that unit including any unrecognized intangible assets as if the reporting unit had been acquired in a business combination and the fair value of the reporting unit was the purchase price. The excess of the purchase price over the amounts assigned to assets and liabilities would be the implied fair value of goodwill.

## Illustrative Examples: Intangible Assets That Meet the Criteria for Recognition Separately from Goodwill

The following are illustrative examples of intangible assets that, if acquired in a business combination, generally would meet the criteria for recognition as an asset separately from goodwill. The determination of whether a specific identifiable intangible asset acquired meets the GAAP criteria for recognition separately from goodwill should be based on facts and circumstances of each individual business combination.

Intangible assets that would generally be recognized separately from goodwill because they meet the contractual-legal criterion.

Intangible assets that do not arise from contractual or other legal rights, but should nonetheless be recognized separately from goodwill because they meet the separability criterion.

### Marketing-related intangible assets

- Trademarks, trade names
- Service marks, collective marks, certification marks
- Trade dress (unique color, shape or package design)
- Newspaper mastheads
- Non-competition agreements

### Customer-related intangible assets

- Order or production backlog
- Customer contracts and related customer relationships
- Customer lists
- Non-contractual customer relationships

### Artistic-related intangible assets

- Plays, operas and ballets
- Books, magazines, newspapers and other literary works
- Musical works such as compositions, song lyrics, advertising jingles
- Pictures and photographs
- Video and audiovisual material, including motion pictures, music videos, and television programs

### Contract-based intangible assets

- Licensing, royalty, standstill agreements
- Advertising, construction, management, service or supply contracts
- Lease agreements
- Construction permits
- Franchise agreements
- Operating and broadcast rights
- Use rights such as landing, drilling, water, air, mineral, timber cutting, route authorities and so forth
- Servicing contracts such as mortgage servicing contracts
- Employment contracts

### Technology-based intangible assets

- Patented technology
- Computer software and mask works
- Internet domain names
- Databases, including title plants
- Trade secrets including secret formulas, processes, recipes
- Unpatented technology

## FAIR VALUE MEASUREMENTS

The fair value of an asset (or liability) as stated by the FASB is as follows:

*The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties; that is, other than in a forced or liquidation sale.*

According to the FASB, the fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are considered the best evidence of fair value and should be used as the basis for the measurement, if available. However, the market price of an individual share of stock (and thus the market capitalization of a reporting unit with publicly traded stock) may not be representative of the fair value of the reporting unit as a whole. Therefore, the quoted market price of an individual share of stock need not be the sole measurement basis of the fair value of a reporting unit. If a quoted market price of the shares of a reporting unit is not available, the estimate of fair value should be based on the best information available, including prices for similar assets and liabilities and the results of other valuation techniques. A valuation technique based on multiples of earnings, revenues, or a similar performance measure may be used to estimate the fair value of a reporting unit if that technique is consistent with the objective of measuring fair value.

Use of multiples of earnings or revenues in determining the fair value of a reporting unit may be appropriate, for example, when the fair value of an entity that has comparable operations and economic characteristics is observable and the relevant multiples of a comparable entity are known. Conversely, use of

multiples would be inappropriate in situations in which the operations or activities of an entity for which the multiples are known are not of a comparable nature, scope, or size as the reporting unit for which fair value is being estimated.

A present value technique is often the best available technique with which to estimate the fair value of a group of assets (such as a reporting unit). If a present value technique is used to measure fair value, estimates of future cash flows used in that technique should be consistent with the objective of measuring fair value. Those cash flow estimates should incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. Otherwise an entity may use its own assumptions.

These cash flow estimates should be based on reasonable and supportable assumptions and should consider all available evidence. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. If a range is estimated for the amounts or timing of possible cash flows, the likelihood of possible outcomes should be considered (see FASB Concepts Statement 7, *Using Cash Flow Information and Present Value in Accounting Measurements*).

## IMPAIRMENT OF INTANGIBLE ASSETS OTHER THAN GOODWILL

A recognized intangible asset should be amortized over its useful life and reviewed for impairment in accordance with SFAS No. 121. If an impairment test of goodwill and any other asset occurs at the same time, the other asset should be tested for impairment first. The impairment test for goodwill would thus be done after all other impairments have been recorded.

Residual value should factor into

determining the amount of an intangible asset to be amortized. Residual value is defined as the estimated fair value of an intangible asset at the end of its useful life to an entity less any disposal costs. A recognized intangible asset with an indefinite useful life should not be amortized until its life is determined to be no longer indefinite. If no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset, the useful life of that asset should not be considered indefinite. The term indefinite does not mean *infinite*. A recognized intangible asset that is not amortized should be tested for impairment annually and on an interim basis if an event of circumstance occurs between annual tests indicating that the asset might be impaired.

## DISCLOSURES

The appraiser must be aware of significant disclosures related to intangible assets and goodwill that are required of the auditors. For intangible assets subject to amortization, the disclosures will include the following:

- The total amount assigned and the amount assigned to any major intangible assets class.
- The amount of any significant residual value, in total and by major intangible assets class.
- The weighted average amortization period, in total and by major intangible assets class.

For intangible assets not subject to amortization, the total amount assigned and the amount assigned to any major intangible assets class must be disclosed. Further the amount of purchased in-process research and development assets acquired and written-off in the period and the line item in the income statement in which the amount is written off or aggregated must be disclosed.

For each period for which a statement of financial position is pre-

sented (that is each subsequent period to the acquisition), disclosure should include the following:

- The total gross carrying amount and accumulated amortization by major class for intangible assets subject to amortization.
- Total amortization expense for the period.
- The aggregate amortization expense for each of the five succeeding fiscal years presented.

For intangible assets not subject to amortization, the total carrying amount and the carrying amount for each major intangible assets class must be disclosed, as well as the changes in the carrying amount of goodwill during the period including the following:

- The aggregate amount of goodwill acquired.
- The aggregate amount of impairment loss recognized.
- The amount of goodwill included in the gain or loss on disposal of all or a portion of a reporting unit.

Disclosure is more involved when an impairment loss is recognized. In such a situation for goodwill, disclosure is required as follows:

- A description of the facts and circumstances leading to the impairment.
- The amount of the impairment loss and the method of determining the fair value of the associated reporting unit (whether based on quoted market prices, prices of comparable businesses, or a present value or other valuation technique).
- If a recognized impairment loss is an estimate that has not yet been finalized, that fact and the reasons for it should be disclosed. Further, in subsequent periods, the nature and amounts of any significant adjustments made to the initial estimate of the impairment loss must be disclosed.

For intangible assets other than

goodwill, including intangible assets not subject to amortization, SFAS No. 121 must be followed.


#### TRANSITIONAL ASSESSMENT

At the date SFAS No. 142 is applied initially, an entity should establish its reporting units using its current reporting structure and the reporting unit guidance from the statement. Recognized net assets, excluding goodwill, should be assigned to those reporting units. Recognized assets and liabilities that do not relate to a reporting unit, such as an environmental liability for an operation previously disposed of, need not be assigned to a reporting unit. All goodwill recognized in an entity's statement of financial position should be assigned to one or more reporting units based on a reasonable and supportable analysis. Goodwill in each reporting unit should be tested for impairment as of the beginning of the fiscal year in which SFAS No. 142 is initially applied in its entirety. The amounts used in the transitional goodwill impairment test should be measured at the beginning of the year of initial application and the first step of the impairment test should be completed within six months of adoption. Further, if events or changes in circumstances indicate the goodwill of a reporting unit might be impaired before completion of the transitional impairment test, goodwill should be tested for impairment when the impairment indicator arises.

In addition to the transitional goodwill impairment test, an entity should perform the required annual goodwill impairment test in the year of adoption of the statement. That is, the transitional goodwill impairment test may not be considered the first year's annual test unless an entity designates the beginning of its fiscal year as of the date for its annual impairment test.

#### FASB'S NEW PROJECT

SFAS Nos. 141 and 142 will significantly alter the measurement and reporting of intangible assets. Approximately \$6 of reported market value is supported by \$1 of recorded tangible assets. The \$5 spread must now be identified, at least for externally acquired intangibles. Further, the FASB has recently announced a new project in which it will consider the possibility of requiring the measurement and reporting of *internally* generated intangible assets and goodwill.

It is imperative for the valuer to recognize that services pursuant to SFAS Nos. 141 and 142 (and 144) are audit services, which use valuation techniques. Fair value per the statements is not fair market value as the term has heretofore been understood by valuers. "Fair value" work papers should in the future be part of the audit file; the valuer will have to work more closely than ever with the auditor. The adoption of SFAS Nos. 141 and 142 will provide new markets for the valuer to showcase advanced training and methodology, but the audit perspective will provide the overriding framework. 

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## EXPERT *Opinion*

# UNREASONABLE COMPENSATION IN A PROFESSIONAL CORPORATION

*Pediatric Surgical Associates: Judge Halpern Strikes Back*

Mark O. Dietrich, CPA/ABV

The following article is an abridged version of a longer article posted by the author to his website: [www.cpa.net](http://www.cpa.net). In the full version, he offers more details of this case at hand as well as related cases, and he highlights additional issues raised in this case. Mark O. Dietrich, CPA/ABV, is author of *Medical Practice Valuation Guidebook—2000/2001, Including Comprehensive Financial Analysis and the Influence of Managed Care (San Diego: Windsor Professional Information, LLC, 2001)*.

Professional services firms may need to reevaluate their compensation schemes. If Tax Court Memo 2001-81 *Pediatric Surgical Associates v. Commissioner* (April 2) is considered precedent, then many compensation arrangements may be at risk for challenge by the IRS. Only a few cases have addressed the issue in this case: unreasonable compensation in professional firms.

Pediatric Surgical Associates is a Texas corporation. At the time of the tax audit, it employed four stockholders as surgeons (one who retired in the second audit year), in addition to two employee-surgeons. The initial deficiency notice disallowed \$598,710 (46%) of the \$1,300,231 paid stockholders resulting in a balance due of \$206,455 plus 20% \$6662 penalty for calendar 1994. For 1995, \$805,469 (53%) of the \$1,528,125 paid stockholders was disallowed resulting in a balance of \$287,606 due plus 20% \$6662 penalty. The IRS later amended its disallowance to \$140,766 and \$19,450 respectively. The Court

ultimately disallowed \$61,234 and \$9,037 respectively. The average stockholder salary in each of these years was \$325,058 and \$382,031, respectively, certainly not anything extraordinary for pediatric surgeons with the subjects' level of productivity.

The physicians were each paid a monthly salary of \$16,500 per month, plus periodic bonuses. Notable in the court's view was the fact that two of the four stockholders had countywide noncompete clauses in their employment contracts containing a penalty of \$5,000 per month for 96 months.

The nonshareholder physicians had two-year employment contracts with fixed salaries of \$12,000 or \$12,500 per month, without bonuses. They had similar noncompete provisions with terms of 36 to 96 months and monthly penalties of \$6,000 to \$8,000.

The court reviewed individual surgeon productivity for each year, finding "no reliable records of collections" for 1994. The 1995 data appeared as follows (Dr. Ellis was apparently part-time and then retired). Note that the two employee physicians generated very little of the collections:

	Collections	Salary
Ellis	\$351,121	\$172,896
Mann	519,396	452,969
Miller	772,752	450,485
Black	592,821	451,775
Subtotal	2,236,090	1,528,125
Vaughan	125,467	76,061
Snyder	4,339	0
<b>Total</b>	<b>\$2,365,896</b>	<b>\$1,604,186</b>

The court also noted in its opinion that (predictably) "The petitioner has never declared a dividend."

### INTERNAL REVENUE SERVICE'S POSITION

The IRS argued in its brief that "...the petitioner is entitled to deduct as wages the actual collections of the shareholder-employees, less their share of the petitioner's expenses." These expenses were apparently directly allocated where applicable, such as payroll taxes or individual fringe benefits and then overhead items were equally allocated.

### TAXPAYER'S POSITION

Physicians' counsel relied heavily on the fact that all payments to stockholders were treated as wages and reported on W-2s. Judge Halpern referred to the following statement from the physicians' counsel as "Petitioner's principal argument"(!): "In the instant case, the payments made to the shareholder surgeons were clearly compensation for services rendered and not disguised dividends. Petitioner issued W-2 forms to its shareholder surgeons and that income was duly reported on the surgeon's personal income tax returns. Moreover, the salary payments were properly deducted as such on Petitioner's tax returns." The court noted that elsewhere the regulations under §1.162 state that "Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible." Petitioner also argued that the amounts were "reasonable" because they received less than their gross collections. Judge Halpern did not find this argument persuasive.

### ISSUE FOR DECISION

Curiously enough, Judge Halpern wrote: "We do not believe, however, that whether the return amounts were reasonable in amount is actually in question. The question framed by the parties' briefs is whether the remaining amounts

[i.e., the disallowed amounts in question] were paid to the shareholder surgeons *purely for their services.*" (*Emphasis added*) This is an interesting and subtle distinction.

Only two possibilities explain this case's outcome: a seriously deficient presentation by counsel for the taxpayers, or an inexplicable decision by the Judge. Cases must, of course, be decided upon the record, and Judge Halpern indicates at several points that the record lacks certain information he would have liked to have.

The IRS's position presented in the original Revenue Agent's Report was preposterous on its face, and one wonders what the Appeals Conference that must have preceded the trial was like. As noted above, by the time of trial, IRS had conceded nearly \$1,250,000 of its original \$1,400,000 proposed disallowance.

#### QUANTITATIVE APPROACH

The Court ultimately accepted, with modification, the IRS's position that the deductible compensation paid to the shareholders was *limited to their individual receipts less their allocable share of corporate expenses.* Do we now have an *obiter dictum* version of an acceptable compensation plan?

In computing the disallowance, another problem for the Judge was the lack of data for 1994. The IRS's position at trial was that *the dividend received by the shareholders was equal to the profit on the nonshareholders.* To determine this profit, it was, of course, necessary to know both receipts and expenditures allocable to those nonshareholders. In the absence of data on those collections, the IRS maintained that the nonshareholders' collections should be equal to net billings (\$245,597), which appears to be defined as the amount *expected to be collected* from insurers. This is a patently ridiculous position, as anyone familiar with medical billing would know, and particularly so in light of the fact that the nonshareholder physician (Dr. Snyder) worked for the taxpayer for

only one-half of the year. The taxpayer's accountant submitted an exhibit that claimed the receipts were \$146,837, but the court stated this was not "supported by the evidence." Ultimately, the court used \$171,918 in its calculations. Given that this taxable year generated almost all of the adverse result for the taxpayer, better data might have carried the day.

As to expenses, "Both parties' allocations of expenses to Dr. Snyder's collections for 1994 and Dr. Vaughan's collections for 1995 consist of the salary paid to each plus one-tenth (one-fifth for the one-half of the audit year during which each was employed) of other expenses considered equally apportionable to the five surgeons during each year." There was a dispute as to whether certain of the expenses were at all allocable to Drs. Snyder and Vaughan. "We accept respondent's [IRS'] proposed allocation of expenses as reasonable with the following additional allocations: There should be a pro-rata (one-tenth) allocation of rent, repair and maintenance expenses, depreciation of office equipment (other than shareholder automobiles), telephone expenses, and equipment lease expenses to the nonshareholder surgeons' collections." This indicates that the IRS had not allocated *any* of these expenses against the nonshareholders; another ludicrous premise in a case that seems filled with them.

As best as could be determined from the opinion, 1995 expenses are as follows:

<b>Salaries</b>	<b>\$273,524</b>
<b>Repairs</b>	<b>8,930</b>
<b>Rents</b>	<b>57,954</b>
<b>Taxes</b>	<b>64,176</b>
<b>Interest</b>	<b>174</b>
<b>Contributions</b>	<b>5,480</b>
<b>Depreciation</b>	<b>27,592</b>
<b>Pension</b>	<b>134,917</b>
<b>Other</b>	<b>268,867</b>
<b>Subtotal</b>	<b>841,614</b>
<b>Officers salary</b>	<b>1,528,125</b>
<b>Total Expense</b>	<b>\$2,369,739</b>

The final result appears as follows:

	<u>1994</u>	<u>1995</u>
<b>Collections</b>	<b>\$171,918</b>	<b>\$129,806</b>
<b>Expenses</b>	<b>110,684</b>	<b>120,769</b>
<b>Profit</b>	<b>\$61,234</b>	<b>\$9,037</b>

My analysis of 1995 indicates that the IRS must have excluded *all* of the pension contribution and most of the "other expenses" from the computation, including insurance (for example, health and malpractice), which the opinion notes totaled \$113,889. In fact, it appears that more than \$187,000 of "other expenses" was excluded from the IRS's computation, and for the most part from the court's. I was unable to generate a rational scenario in which there was a profit in 1995 on the nonshareholder. In fact, there appeared to be a loss in every conceivable circumstance. Based upon the court's computation of receipts of \$129,806 and a salary to Dr. Vaughan of \$76,061 plus the fringe benefits required such as FICA, unemployment tax, workmen's compensation, health and malpractice insurance to name a few, a profit seems unimaginable.

#### LEGAL APPROACH

Judge Halpern called attention to the corporate balance sheet, and discussed likely "nonbalance-sheet" assets including "...both the shareholder and nonshareholder employment contracts, petitioner's arrangement with the hospital to provide on-call services in the hospital's emergency room, and the goodwill that petitioner undoubtedly built up during its almost 20 years in business in the Fort Worth area." He goes on to say "Together, the balance-sheet and nonbalance-sheet assets account for the in-excess-of \$2 million in gross receipts that petitioner reported for each of the audit years." This seems to indicate that the Judge based his decision at least in part on a "return on assets" approach.

It seems as though the noncompetes of the two junior physician shareholders and the employee-

physicians were *corporate* assets. Unfortunately, this ignores the almost certain fact that the senior shareholders, who did *not* have non-competes, possessed the bulk of the personal goodwill and had *not* assigned it to the corporation. In the real world of medical practice, it is the personal reputation and skill of a surgeon that generates referrals, not the existence of a corporation or an employment contract.

The Court mentions an "arrangement" with the hospital for emergency room services. If this agreement was in writing, it may have contained significant information as to the import of the particular *individuals* covering the emergency room and highlighted the personal goodwill argument. A wiser analysis pre-trial by petitioner's counsel might have addressed these issues in the brief.

Perhaps the taxpayer would have

won what appears to be an easily winnable case had the brief focused on statistical evidence of reasonable compensation. Surely, if one is to retain surgeons of exceptional caliber, one will need to compensate them at salaries comparable to similar individuals. No evidence was apparent in the opinion that a comparable pay analysis was submitted, generally the most important test for reasonable compensation. Further, there is no mention of what administrative responsibilities the shareholder surgeons must have had, although the Judge noted specifically that the nonshareholders did not have any such responsibilities.

#### CONCLUSION

Bad presentations make for bad decisions. Given the dearth of cases on this topic and the implications for professional practices in general, this case is likely to be given far more

weight than the written opinion indicates it deserves. If it is to be considered precedent, then CPA, law, architectural, consulting, and a host of other firms need to reevaluate their compensation schemes immediately. S corporations (in particular) and LLCs taxed as partnerships look extremely attractive in such an environment.

Finally, the most worrisome aspect of the decision is Judge Halpern's making his decision on this issue: "The question framed by the parties' briefs is whether the remaining amounts [that is the disallowed amounts in question] were paid to the shareholder surgeons *purely for their services*." This would appear to expose any compensation arrangement not supported by a quantitative methodology to challenge. ❏

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