

**PRESIDENT'S MESSAGE**  
**August 2009**

**President's Message:**

To My Fellow ICBC Members:

Where can you go to network with leading, multi-disciplined, industry experts who [will](#) provide you with income-producing ideas???

**Minneapolis September 23<sup>rd</sup>-26<sup>th</sup>!!!**

Nuggets of knowledge, words of wisdom, and best practices in a tough economic environment – these are but a few of the terms I like to describe the opportunity we all have when we attend ICBC's upcoming annual conference in Minneapolis. Many of your Board and certainly the conference speakers have experienced disruptive and/or poor economic markets. We can all tell you that now is not the time to “hibernate”, or re-trench and not attend anything. YOU need to attend to discover and understand how transactions are being closed and how clients may be helped in this environment – because the pros are getting it done! Join us in Minneapolis for the best networking event of its kind.

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The Certified Business Counselor is published for members of the Institute of Certified Business Counselors. Annual subscriptions are available for non-members at \$95.00 US.

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## Editors Column

### Fellow ICBC members:

**I have had the great pleasure of being a member of ICBC for the last twenty plus years. This year's conference has a truly great line up of speakers.**

**I would highly recommend signing up if you have not already.**

**In economic times such as these when markets are slow we need to take the time out to hear expert business tips and share ideas.**

*Use this opportunity to meet and build relationships with experts in our field and allied industries. These can provide opportunities for future business.*

*P.S. I Hear the sunset boat and dinner cruise is fantastic and we are almost sold out.*

**Looking forward to seeing you, in Minneapolis, September 23-26, 2009!!**

### Newsletter Editor



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SAVE THE DATE!!!

ICBC CONFERENCE 2009  
MINNEAPOLIS

SEPTEMBER 23RD-26TH

MERGING GREAT MINDS TO TACKLE BUSINESS  
SOLUTIONS FOR TODAY'S STRUGGLING  
ECONOMY!



MARK YOUR CALENDAR  
WE LOOK FORWARD TO SEEING YOU THERE!!

# Don't Miss Our Exciting Line Up Of Speakers With A Wide Range Of Topics And Expertise!

Andy Amoroso, Business Development Specialist with U.S. Small Business Administration  
“Criteria, Guidelines, and Regulations Of Appraisals And New SBA Recovery Highlights”

Grant Cook, Auctioneer,  
“Move The Company F/F/E, Find Out How To Effectively Use Auctions”

Jim Cornell, President, MBA, MCBC, CMC, CM&AA, CTP, CPA, CVC, CPP  
with Praxiis Business Advisors, “Update on Securities Licensure”

Dick Thorsen, CPA/ABV, CMEA, CVA,  
“Pass Through Entities And How It Affects You”

Monty Walker, CPA, CBI, BCB, BBA, CBC with Walker Advisory Associates,  
“Tax Strategies”

Tim Cleary, Vice President of Consulting with Principal Financial Group,  
“ESOPs”

Neil Friedman with AVP Business Development First American Exchange  
“1031 Exchanges”

Carl Lidstrom with Risk Management Resources Inc.  
“Risk Management 101”

Joe Huguelet  
“Transaction Due Diligence After The LOI”.

Randall Schostag with Minnesota Business Valuation Group  
“Fair Value, The Standard Of Value Used For Accounting Applications Of Valuation”

## BREAKOUTS SESSIONS:

George Abraham, MCBC, CMEA, CSBA, FCBI with Business Evaluation Systems  
“Business Valuation 101”.

John Harris, MCBC, ASA with Marketing and Consultant Services Inc.  
“How To Place A Value of Equipment”

KC Conrad  
“USPAP and You...Are You In Compliance?”

Debra Baker, Vice President with 31 Corporation and Sara Baker  
“How To Get Results From Your Marketing”

CONFERENCE & EXPO REGISTRATION  
MINNEAPOLIS, MN  
SEPTEMBER 23 - 26, 2009

**REGISTER EARLY AND SAVE!**



In conjunction with NEBB ad SBA.

Name: \_\_\_\_\_ Name on Badge: \_\_\_\_\_

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Telephone: \_\_\_\_\_ Email: \_\_\_\_\_

Spouse Name: \_\_\_\_\_ Name on Badge: \_\_\_\_\_

**Early Bird Conference Registration Fee Before September 1st 2009:** \$495 \_\_\_\_\_

**Spouse Registration Fee (Meals):** \$150 \_\_\_\_\_

Conference Registration After August 1st 2009: \$595 \_\_\_\_\_

New Member's First Year Dues: \$100 \_\_\_\_\_

Lake Minnetonka Cruise Per person Thursday September 24th \$56 \_\_\_\_\_

Total Amount Due: \$ \_\_\_\_\_

Type of Credit Card (All types accepted): \_\_\_\_\_ Amount Authorized to Charge: \_\_\_\_\_

Card No. \_\_\_\_\_ Exp date: \_\_\_\_\_ Secure Code: \_\_\_\_\_

Check Accompanying Registration:  Yes  No

**Fax: Completed Application To: 503-292-8237 or Mail To: 18831 Willamette Drive, West Linn, OR 97068**

*Have You Made Your Hotel Reservation Yet?      Make Your Flight Registrations Early For A Low Cost Ticket!*

**Cancellation Policy: If you are required to cancel your registration for any reason, please be advised that cancellations must be in writing. You will receive a 50% refund 60 days before the Conference, a 10% refund 30 days before the Conference and 0% if you register but do not show up for the Conference.**

## **Transferring Corporations with Accumulated Net Operating Losses**

*By Monty W. Walker CPA, CBI, BCB*

A corporation with accumulated unused losses, called suspended losses, is referred to as a Loss Corporation. What this means is the corporation has accumulated unused losses which can be used as a deduction against future income.

The longer a business loses money the more difficult it becomes to sell the business because most Buyers do not want to purchase a business which is losing money.

A common issue which arises for corporations with existing losses is the corporate owners or their advisors decide to sell the business based on the value of the accumulated losses. The thought is a Buyer will certainly be interested in reducing future taxes by using the accumulated losses as a tax deduction.

It is true that Buyers are certainly interested in reducing future taxes but a question to be answered is “What is the real value of a corporation with accumulated unused losses?” In other words, “What will a Buyer likely be willing to pay for a corporation with accumulated unused losses?”

### **Background:**

At one time, an important motive for many corporate acquisitions or mergers was the availability of Net Operating Loss or Tax Credit Carryovers in the target corporation that could be used to offset taxable income of the acquiring corporation. Transactions frequently occurred, not for legitimate business reasons, but instead for the purpose of transferring Net Operating Losses. These corporations, with accumulated Net Operating Loss or Tax Credit Carryovers, are referred to as Loss Corporations.

To curb this so called “NOL Trafficking”, Congress enacted a series of tax reforms, including IRC Sections 269, 382, 383, 384 and 482. These regulations have greatly restricted the ability to offset an acquiring corporation’s taxable income by the Net Operating Loss or Tax Credit Carryovers contained in a Loss Corporation.

In general, the Internal Revenue Code severely limits the use of Net Operating Losses if the Loss Corporation undergoes an ownership change. Typically, an ownership change occurs when 50% or more of the stock has changed hands. An ownership change can also occur as a result of a merger or similar tax-free reorganization.

IRC Section 382 is the code section which places a limitation on the use of Net Operating Losses after an ownership change.

The maximum annual amount of Net Operating Loss that an acquiring corporation can use to offset taxable income after an ownership change date is an amount equal to the value of the Loss Corporation immediately before the ownership change multiplied by the federal government’s published long-term tax-exempt rate. This is referred to as a Loss Offset Limitation.

The long-term tax-exempt rate is the highest of the federal long-term rates determined under IRC Section 1274(d). The published long-term tax-exempt rate, as of the date of this article, is ----- 4.61%.

*(Continued on page 7)*

**Business Value and Related Loss Limitation:**

The Internal Revenue Code allows unused losses to be taken as a deduction against future income. Each year a loss is incurred those specific losses can be moved into the future for a period not to exceed 20 years. If the losses cannot be used in that 20 year period, the losses expire and are lost forever.

Assuming the corporate federal rate is 34%, the state tax rate is 5% for the corporation and for the corporate shareholders and the federal dividend rate is 15%, if a corporation earns \$2,000,000, the shareholders will ultimately only net \$1,000,000 because of the taxes paid to the various taxing authorities.

If though a \$2,000,000 loss can be used as a deduction against this income, the shareholders will net \$1,600,000.

So the question to be answered is, how much will a Buyer pay for a corporation with accumulated unused losses?

For discussion purposes, let's assume the shareholders try to sell the corporation for \$1,000,000.

Based on the loss offset limitation calculation, as explained in the background section, the annual accumulated loss use limit is \$46,100. The calculation to determine this limit is [Loss Corporation's value before the ownership change \$1,000,000 \* federal government's published long-term tax-exempt rate of 4.61% = \$46,100].

This means that \$46,100 can be used annually to offset future income until the applicable losses expire. A maximum of 20 offset years may be possible resulting in \$922,000 of losses used over this period. This will result in approximately a \$300,000 overall net tax savings benefit.

Additionally, IRC Section 382(c) disallows ALL Net Operating Loss Carryovers if after the change in ownership the Loss Corporation does not continue substantially the same trade or business for two years after the ownership change. Thus, the annual loss limitation will be reduced to Zero (\$0) if this requirement is not met.

Thus, if a corporation is losing money, considering the limitation on the use of the loss carryovers and considering the time value of money, what is really going to be the true value of a loss corporation if the value is being driven by the intent to sell the corporation based on its accumulated unused losses?

In most cases, probably not much.

**About the Author:**

*Monty W. Walker is the senior principal of Walker Advisory Associates and Hutcheson Walker Advisors. These firms provide strategic business and transaction advisory services to the closely-held business market with the focus of Hutcheson Walker Advisors being innovative retirement strategies. Monty Walker works with Entrepreneurial clients throughout the country advising them in the areas of Business Transactions, Business Structuring & Design, Business Tax Planning and Business Exit Planning.*

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**The Income Approach**  
**By George Abraham**  
**CEO, Business Evaluation Systems**

The income approach is a general way of determining the value of a business or an intangible using methods that convert anticipated economic benefits into a present single value.

Under the Income Approach, appraisers will use three valuation methods; the Capitalization of Earnings (or benefits), Discounted Future Earnings (or the Discounted Cash Flow Method) and the Excess Earnings Method. The two main points to remember under this approach are:

- 1) We are using earnings that represent "future benefits (earnings)" and not historical earnings, unless the earnings from prior years help us to formulate our opinion as to the future earnings of the company we are appraising. Revenue Ruling 59-60 directs the appraiser to use a "prophecy as to the future" and to consider the earning capacity of the company to arrive at the value.
- 2) We must use the right terminology. Business appraisers have not been able to agree on terminology but we are currently making some progress. We need to differentiate which income we are using, future benefits, future earnings, net income, cash flow or net cash flow, or free net cash flow. For purposes of this article we will use earnings.

**Capitalization of Earnings Method**

Simply explained, the economic benefits for a representative single period are converted or valued through division by a capitalization rate. The discount rate minus the long term growth rate is the capitalization rate. An example would be the Build up Method:

Safe rate	5.25% 1
Equity risk premium	7.00% 2
Small company risk premium	3.25% 3
Specific company risk premium	4.00% 4
Discount rate	19.50%
Less: Long term-growth	-3.00%
Capitalization rate	16.50%

Multiple of Earnings (100/19.5) = 5.13  
Rounded: 5

- 1 Information from the Federal Reserve Board
- 2 Ibbotson Associates
- 3 Ibbotson Associates
- 4 Appraisers judgment from analysis of the company

To determine the specific company risk premium we look at key risk factors of the company and from our research of the company, industry forecasts and financial analysis. The following risk factors can form your premium:

Company Specific Risk Component	Risk Factor
Labor	0.5%
Financial position of the company	1.0%
Facilities and location	0.0%
Management	0.5%
Competition	1.0%
Diversity of accounts	0.0%
Future outlook	0.5%
Owner Importance	0.5%
Total Company Specific Risk:	4.0% 4

The Capitalization of Earnings method assumes that growth in the future will be constant or stable and is mathematically simple, but the difficult part is the selection of the capitalization rate. Some appraisers will add another component called "Industry Risk Premium" in forming the discount rate. James H. Schilt, a noted authority on capitalization rates, suggests that a risk premium of 6 to 30 percent will cover the broad categories of small businesses. Other professionals suggest a slightly narrower range of values: "A range of specific risk premiums from 12 to 24 percent will cover the wide range of profitable small businesses".

Section 6 of Revenue Ruling 59-60 states "In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation."

The process may seem highly subjective and, it is. What is important to remember that the simple definition of an appraisal is nothing more than a supportable opinion of value by an expert. When you perform an appraisal the client is paying for your expert opinion. The main part of that definition is the word "supportable". A good starting point in helping to choose capitalization rate is to research comparable sales to get a good range of multiples and narrow the range of companies that have sold that are the closest to the subject company. The appraiser should research the company's financials, capital requirements, its performance compared to industry standards as well as other internal research such as potential for growth, labor and management (age and the degree of difficulty to replace them), competitive position, customers, suppliers, the economic forecasts for the country and the company's trade area, and the facility's suitability. Each one of these factors, the appraiser must forecast its risk and impact it will have on the company in the future. It is all about the future! Once we begin to feel that it is not very subjective we are ready to start applying the methods and mathematics. Once we feel we are absolutely positive it is no longer subjective we can place the final value. Unfortunately only business appraisers can arrive at this enlightened state of egotism. Usually a good attorney can cure this phenomenon very quickly on the witness stand.

In all seriousness the point I am trying to make is twofold; everything is about predicting the future and whatever value you arrive at, be convinced from your research that you can definitely support it. Again it's only your opinion and there is no such thing as the correct value, only the most believable and supportable value. Even Revenue Ruling 59-60 gives credence to this in Section 3, Approach to Valuation. It states:

Valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

Revenue Ruling 59-60 has been around for 40 years and has stood the test of time when it comes to the fundamental principles of valuing a business. When you think back 40 years ago and what businesses looked like then as to what they look like today, that's an impressive piece of work.

### **Discounted Future Earnings Method**

A method within the Income Approach whereby the present value of future expected economic benefits is calculated using a discount rate. In simple language, value is estimated as the sum of the present values of the benefit stream for the projection period plus the present value of the terminal value. The terminal value is the present value of the stabilized benefit stream capitalized into the future. The terminal value can also be the present value of the sale or liquidation proceeds of the company. You can use one or the other, but not both. The method assumes, by the residual from the terminal value, that at some point in the future the income stream will stabilize and the stabilized income stream can then be capitalized into perpetuity and discounted back to the valuation date. It is an excellent method if the company is expected to have a limited life.

Unlike the Capitalization of Earnings Method that assumes the earnings will be constant or stable in the future, the Discounted Future Earnings Method assumes that earnings will not be stable in the future and that an analysis of multi-period projections are appropriate. Unstable earnings may exist in startup businesses or any business whereby a change in operations is expected in the future. However theoretically, using this method with stable earnings over multiple periods, the values should be the same as derived from the Capitalization of Earnings method.

Its foundation is in the principle of future benefits which states that the value of a business is the present value of all the "benefits" it can reasonably be expected to generate in the future. These "benefits" are generally considered to be the future cash flows available to the owners from the business.

The calculations are generally mathematically simple and present value calculations and tables are easily available. The hard part is the projections and what the expected changes will do to profits, working capital, capital expenditures and requirements in each of the projected years and when the company's income stream will finally stabilize. As stated before, it's all about the future and is highly subjective. The best we can do is support the value opinion so that the reader of the report can follow our logic and calculations and arrive at the same conclusion.

Although when used correctly, it is a theoretically one of the best valuation methods, but there are some problems with its believability to the public and the courts, as it relies solely on projections or prophecy that may not resemble any past performance of the company. Since potential future earnings are not to be considered as a marital asset, although theoretically sound, this method cannot be considered in valuing a closely held business in many divorces. The courts have found that the projections of "potential future earnings" associated with small businesses is not an asset subject to equitable distribution and that the projections associated with small businesses are frequently so speculative that it can carry no weight in the valuation process.

### **Excess Earnings Method**

This method is a specific way of determining a value indication of a business as the sum of

(a) the value of the assets and (b) the value of the intangible assets derived by capitalizing excess earnings. Excess earnings are the amount of the anticipated economic benefits that exceeds an appropriate rate of return on the value of a selected asset base used to generate those anticipated benefits.

Many appraisers feel the excess earnings method is more of an asset-based approach than it is an income approach. The excess earnings method is really a hybrid of both approaches as the return on tangible assets is derived from the market (market approach) and the excess earnings is capitalized (income approach), but since the majority of appraisers refer to it as an income approach I will follow the crowd on this one.

However, not to get off on the subject of the excess earnings method, but maybe all the methods are hybrids that use an array of components of one or the other two approaches. Maybe this is why it is not a major controversy among appraisers. This is certainly an anomaly in our industry as anything controversial will be debated and written about extensively. The debates get so mathematically complex that when we finally come to the conclusion that it cannot be proven by mathematics, we all lose interest.

In any case, think of this, since we use the market approach to research companies that have sold in order to derive a Price to Earnings (P/E) ratio. Isn't this an income approach? The selected ratio is a multiple of earnings and a multiple of earnings is the same as a capitalization rate except instead of dividing you are multiplying, but the results are the same. Is the cost approach really just cost? Not really because when you adjust the balance sheet you are using comparable sales (Market approach) to value the hard assets. The same would be true for stocks and securities on the balance sheet. Also on the balance sheet you will find intellectual assets such as patents, copyrights etc. These would most likely be valued using the market approach and the income approach. In the end it really makes no difference and the three approaches make good folders to store your methods in. One fact is definitely true, there are only three approaches to value; the cost approach (what it costs to create), the market approach (what other similar items are selling for) and the income approach (value based on a return on investment from the anticipated earnings from an income stream).

There are three extremely important principles that constitute the foundation of valuation theory:

**A. Principle of Alternatives**

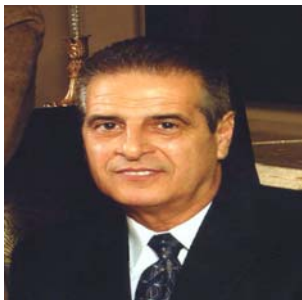
Simply put, there are generally alternatives to the investment. I have alternatives for whether I sell my business, how much I ask for it, and who I sell it to.

**B. Principle of Substitution**

Individuals will not pay more for something than they would pay for an equally desirable substitute.

**C. Principle of Future Benefits**

Economic value reflects anticipated future benefits. In other words, a purchaser would feel that historic earnings were not as important as prospective earnings.



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