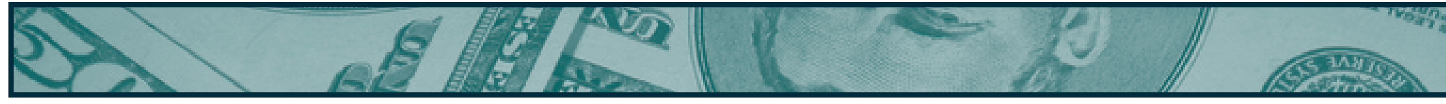
FOCUS ON FUN
Accountants & Humor
– A Sociological Fable

1. A wealthy, dying man calls his lawyer, doctor and accountant into his bedroom. With much of his remaining energy he says, "I've made each of you rich over the years from my fees. In return I'd like you to do me this one final favor. They say that 'You can't take it with you.' I want to prove them wrong. Here's $10,000 cash for each of you. When I die, I want you to bury it with me." The client dies several days later. At the gravesite the three men watch closely as they each drop envelopes into the hole as it is being filed in over the coffin. They decide to have a cup of coffee together and share some stories about the departed meal ticket. The lawyer starts grousing, "He was a difficult client, bothering me with nuisance lawsuits and endless contract revisions. He always argued about my bill and didn't want to reimburse me for expenses. I threw in only $7,500." The doctor chimed in, "He was always calling me in the middle of the night to make house calls when he could have taken two aspirin and called me in the morning. I put $5,000 in the envelope." The accountant rose indignantly and said, "You cheap SOBs, I gave him a check for the full $10,000."
2. Sitting in a compartment on a train were the tooth fairy, an expensive accountant and a cheap accountant. On a table between them was placed a briefcase full of money. Suddenly the train entered a tunnel and everything went dark. When the train exited the tunnel and the light returned, the briefcase was gone. Who took the briefcase?.... Well, it's obvious really. It had to be the expensive accountant as there is no such thing as the tooth fairy or a cheap accountant.
3. A job interview is in progress, a bright and experienced accountant is interviewing for the position of CFO. He is being interviewed by the members of the Board of Directors and the CEO. During the interview, the CEO suddenly asks, "Tell me, what is seven multiplied by three?" The accountant thinks fast and answers "22". Once the interview is over, the accountant takes out his calculator and finds the answer – 21. Disappointed, he goes home. Next morning he gets a call from the CEO, "Hey, you got a job." The accountant is pleasantly surprised. He cannot help but ask, "Thank you very much for the job, but what about seven multiplied by three?" The CEO tells him – "of all the candidates we interviewed, you came the closest."



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Calendar

Recent & Upcoming Events

Speeches:

August 2009
21 - Business Valuation in a Recession – ICLE (Atlantic City, NJ)

September 2009
10 - Current Issues in Business Valuation – Rhode Island CPA Society (Providence, RI)

November 2009
5 - Unreported Income in a Divorce Action – Louisiana CPA Society (Lafayette, LA)

Books:

January 2010 – Divorce – It Can Get Personal (50 pages; complimentary copies for the asking)

Winter 2011 – Projected Release – Divorce: How An Accountant Makes the Difference (AICPA)

CLE Ongoing

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Janet Barson & Laura Johnson
(Editorial, Design & Layout)

The Gospel According to Revenue Ruling 68–609

Of all the IRS Revenue Rulings applicable to business valuations, the second most well-known and used is 68-609. This is often called the formula, or excess earnings, approach to valuation. The reality of the situation is that this is also often the most used approach to valuation because it's a dicta by the IRS, well recognized, and mechanically and arithmetically easy to apply – as a result, it is also often abused and misused.

The Ruling itself cautions the reader that if something better exists, that something should be used. The reality is that, for various small businesses, sometimes better approaches do not exist. The Ruling requires the business appraiser to make at least four judgment calls, above and beyond various other judgment calls that are necessary simply in the act of doing this type or work. These involve:

▶ ***The determination of reasonable compensation......***
When valuing a closely-held business, it must be recognized that the stated officer's (or owner's) compensation does not necessarily have any relationship to what that person would receive were he/she to work for a company that he/she did not own. That is, the incidence of ownership permits one to receive a compensation package that does not necessarily have any sense of reality. To the extent that the Company has profits and cash flow to support those profits (or to the extent that the officer/also-owner has the ability to cause the Company to borrow funds), it can pay almost any figure. It is correct and common practice in the valuation of a closely-held business to "permit" as an operating and normal expense for the business only a fair compensation for the owner(s). This can be a difficult exercise – trying to determine the appropriate level of compensation to impute. This amount can be more or less (or even the same) as is currently reflected on the Company's books. Furthermore, the differences can be significant, and the differences, as well as the direction of the differences, can fluctuate widely from year to year.

▶ ***The number of years to use for valuation......***
This is an often overlooked shortcoming in the application of this Ruling. Too many accountants, when applying 68-609, as a knee-jerk reaction, use five years. After all, we have five years of information, the Ruling suggests the use of five years, therefore why not use them? However, the Ruling states that one or more years should not be used if they are not reflective of the ongoing operations of the business – they are not

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appropriate for the valuation exercise. Sometimes, when common sense should have made it obvious that one or more years simply were inappropriate for use in valuation, that judgment call was not made. Rather, the easy way out was taken – five years were used. A simple illustration of why one year should not be included – if after making all our adjustments, the middle of the five years had a large loss, while all the other four years had substantial incomes, barring some unusual explanation to the contrary, it would be reasonable to assume that the one loss year of five is not reflective of this company, and is something that no one would consider when determining value. Typically, the reasons for one bad year as just described might include a strike with downtime, one unusually bad job or project that might have seriously depressed that year's results, a reduction in sales from a large customer, etc. The point is, if all adjustments have been made and this is what you are left with, proper technique may call for the non-use of the aberrant year.

▶ ***Return on equity/investment……***

Applying this Revenue Ruling requires determining excess income and then determining what that excess income is worth (how much goodwill is in the business). Before we can determine "excess" income, we must realize that there is a pool of assets that constitute this business (stockholders' equity or owner's capital – the excess of assets over liabilities). Whatever this equity represents in dollar value constitutes net assets which, if invested, would yield a return thereon independent of being involved in a business. Therefore, before one applies a multiple factor or capitalization rate (which will be discussed below) to the income of a business, one must first subtract what a reasonable return would have been on the net equity of the business – because only the amount in excess of such is truly the return on the goodwill. The difficulty here is to determine the appropriate return.

▶ ***Capitalization rate……***

Typically, along with the issue of reasonable compensation, this is the most significant of the judgment calls required and also (again jointly with reasonable compensation) the most contentious of the elements used in this Ruling. A capitalization rate is the flip side of a multiple factor. For instance, a capitalization rate of 20% means that an investor would expect a 20% return on his/her money, requiring in effect a recapture of one's investment in five years. That five years is the multiple factor – if one were to divided by the 20% capitalization rate, that is the same as multiplying by a factor of five. Likewise, a 25% capitalization rate represents a multiple of four, etc.

If it has been determined that the use of Revenue Ruling 68-609 is appropriate, these various areas requiring judgment must be approached professionally and intelligently.

Don't Be a Victim

A common concern, as unfortunate a sign of the times as it may be, is the prevention and, when that doesn't work, the detection, of fraud and embezzlement. Once a business has other than the owner working in it, there is a concern as to whether that employee (or co-owner) is in any way taking personal advantage of company assets/funds in a fashion that would suggest fraud or embezzlement.

Certainly, in most situations, this is not the case. Fortunately, most employees, as well as most co-owners or partners, are honest people who do not steal from their employers. However, we need always be vigilant to make sure that the few who would steal are prevented from doing so, or are discovered as early on as possible.

It is also most important to recognize that the failure to prevent these types of illegal actions, and then the compounding of that failure by failing to detect them when they happen, tends to engender a culture or philosophy among the employees of any company (or firm – law firms are not immune from these problems) that in effect rationalizes these types of actions somewhat along the lines of "Joe or Jane has been stealing from this company so long, management must know about it and not care. If that's the way this company operates, I guess it's okay for me to get my share." Your failure to make it obvious that you will not tolerate this type of action simply encourages the weaker of your employees to follow what they perceive to be the crowd.

Fraud and embezzlement most commonly occur where internal control procedures of a business are poor or lacking. Such a condition is not all that unusual for many small businesses – it would simply take too many people to allocate administrative responsibilities in a fashion so as to (nearly) guarantee the prevention of wrongdoing. However, many times, even in larger organizations, we see weak internal control procedures that invite the unscrupulous to take advantage. It is strongly

recommended that businesses ask their outside accountants to get involved with an analysis of their procedures, specifically engaging the accountants to do an internal controls procedure with an eye towards preventing and detecting fraud and embezzlement. Have that accounting firm come back to you with solid recommendations for improvement. In many situations, those actions will pay for themselves many times over and almost immediately.

To get an idea if you are at some level of exposure, ask yourself questions such as "How much latitude does my controller or bookkeeper have; how many hands control the receipt of funds and the depositing of them into the bank; how difficult is it for one individual to make entries into the accounting system; who does the bank reconciliations (it is often the same person who receives income and deposits it); who reviews purchase invoices, and who checks calculations on purchases and sales?" Very often the answer to these questions is that one or two people have an extraordinary amount of responsibilities (and therefore power) within a business entity.

What we have seen all too often is that a business will look to save a few dollars in pushing too many responsibilities on one or two individuals, rather than distributing those responsibilities more reasonably. Even for a medium-sized business, while there is a natural reluctance to hire someone without an obvious and pressing need for that position, there are many times when the facts are such that a less tight-fisted attitude towards running your business would clearly show that another employee is necessary, various responsibilities should be allocated, and that the company will benefit from these actions.

There are any number of business operations which compound the above shortcoming by then holding back on using its outside accounting firm by not asking it, let alone allowing it when it is raised as an issue, to do the appropriate internal control studies and recommend the implementation of the appropriate preventive measures. Even if you are unlikely to install such measures, even if the cost of doing same is unacceptable, merely doing the appropriate study and review of systems will almost invariably lead to recommendations for improvements that may not cost you anything – and in any case will certainly save you. Also, as a not insignificant intangible, the very process of your outside accountants rummaging around, being there, asking questions, sends a message to your employees that you are willing to commit resources to prevent this type of theft.

Whether for your own business, or for that of clients, the following are warning signs of situations with a greater than average possibility for fraudulent activities:

- Were there any changes in ownership recently, even in part – and did a large order or a loan request follow that change?
- Do you have someone in a sensitive financial position, who repeatedly is late in reconciling bank accounts and who repeatedly postpones the outside accountants?
- Was a financial statement submitted to you, perhaps for credit purposes, a copy rather than an original?
- Does an employee appear to be in debt and repeatedly experiencing financial problems?
- Has the company experienced recent and frequent changes in key personnel, outside professional and bank relationships?
- Are there too many photocopies of invoices in files instead of originals?
- Do bad debt write-offs occur too frequently?
- Are certain costs or ratios out of sync?

The above are merely some of the flags that should make you (even the non-trained eye) concerned and more aware of the possibility of fraud and embezzlement. If you, or any of your clients or business relationships, are in a situation that seems to be in concert with anything described above, give it some extra attention and consider taking the appropriate preemptive action

"The Majesty & Glory of Unreported Income" – our newest book, 40 pages. Available now – complimentary copies for the asking. Contact us if you haven't received your copy.

Still available – our previous books: **Reading & Understanding Tax Returns, Financial Issues in Divorce Practice; Business Valuation – The Basics –** complimentary copies for the asking. Contact us if you haven't received your copy.