

# BUILDING VALUE

## SUCCESS THROUGH COLLABORATION

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A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

# BNKJ

**Babush, Neiman, Kornman & Johnson, LLP**

5909 Peachtree Dunwoody Rd., Ste. 800

Atlanta, Georgia 30328

Bill Johnson, CPA/ABV • (770) 261-5435 • wjohnson@bnkj.com

James Lahm, CPA/ABV • (770) 261-5452 • jlahm@bnkj.com

## KEY FINANCIAL METRICS FOR SOFTWARE COMPANIES

Software company executives often ask business appraisers, “What are the most important financial metrics (Performance Measures) they should monitor in their companies?” Although each company could have key metrics that vary from the next software company, here is a generic list that every company *should* monitor. Companies that do not regularly monitor performance measures should start with the core metrics and then quickly add the secondary metrics.

Remember that they should be monitored in three ways:

1. Over time – to look for trends (improvements and declines).
2. Against specific competitors (if this information is available) – to identify strengths and weaknesses and areas for improvement.
3. Against general industry studies – to identify strengths and weaknesses, and areas for improvement. General industry studies would include companies in addition to those identified as competitors in #1 above.

This analysis is not as targeted as comparisons with specific competitors.

Generally, it is advantageous to use the assistance of a consultant to select the appropriate metrics and assist companies with



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## TIPS FOR ATTORNEYS WORKING WITH A BUSINESS APPRAISER IN ESTATE AND GIFT SETTINGS

Even though the definition of fair market value is well known in the estate and gift context, the actual calculation is subject to a great deal of judgment. A properly prepared and documented valuation report may avoid needless arguments with an IRS auditor, as well as penalties and interest. The IRS will often pick the “low hanging fruit” and may select poorly prepared valuation reports for examination over well-prepared reports, even when the latter may have higher discounts. A properly prepared report is also critical to protecting the three-year statute of limitations for gifting. The following suggestions will help ensure an appraisal report of the highest quality.

### Select An Expert Carefully

Not everyone who thinks they are qualified to appraise a business is. For example, even CPAs and other financial experts without specialized valuation training may not have the necessary qualifications, especially in the post-*Daubert* era. There are a number of organizations that hold training and issue certifications for business appraisers. The experience required and difficulty of testing varies among the organizations. Experts should be willing to explain their qualifications and credentials. In many valuation assignments, industry expertise is certainly helpful, but not essential. It is also critical that the appraiser is able to write well and is reasonably articulate.

### Make Sure the Expert is Independent

There is a special place in Tax Court Hell for appraisers who are considered to be



“hired guns.” Consider if there are past relationships that may call the appearance of the appraiser’s independence into question. For example, a CPA who previously advised the subject business may have given advice that would be contrary to the estate appraisal. Also, see Estate of *H.A. True, Jr.*, T.C. Memo 2001-167, July 6, 2001 (citing *Lauder II*, T.C. Memo 1992-736, Dec. 30, 1992), for a discussion of the importance of independent advice in determining fair market value for buy-sell purposes.

### Determine How the Appraiser Will Treat Known Controversial Issues

The appraiser should be willing to discuss controversial appraisal issues before being engaged. Such issues may include imputed income taxes on an S corporation or partnership income or imputed taxes on trapped-in gains. The appraiser should explain his or her position on these topics, when applicable, and whether that position is consistent with previous testimony or published articles. If the appraiser’s approach is not

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understanding how to manage based on the firm’s performance measures. FCG members are trained to help companies identify these key metrics and develop strategies to enhance performance.

Key software company performance measures are:

**Core metrics**

- Sales growth
- Size of user base
- Profit margins
- EBITDA
- Size of market place

- Market penetration
- Free cash flow
- Return on equity

**Secondary metrics**

- Return on R&D
- Receivables
- Debt to net worth
- Interest coverage

- Percentage of R&D to sales
- Percentage sales and marketing to R&D
- Asset turnover

— James S. Rigby,  
CPA/ABV, ASA

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acceptable, it is best to select a different appraiser at the outset.

**Agree on the Treatment of Entity Owned Life Insurance for Estate Valuations**

The estate tax regulations §20.2031-2(f) and §20.2042-1 require that life insurance proceeds be included in determining the fair market value of business interests. Under *Huntsman* (Estate of Huntsman v. Commissioner - 66 TC 861), the proceeds are only to be given “consideration” in determining fair market value. In *Cartwright* (Estate of Robert E. Cartwright v. Commissioner - TCM 1996-286, aff’d 9th Circuit 7/12/99), the entity valuation did not include life insurance proceeds whose use was restricted to retire decedent’s ownership. Determining how to treat life insurance in the appraisal may be outside of the knowledge of the business appraiser without assistance of the estate’s counsel.

**Consider Who Should Hire the Appraiser**

The attorney should hire the appraiser in case the attorney needs to assert work product privilege if he or she is unhappy with the appraisal result. The appraiser can be instructed to initially prepare an oral report to be presented only to the attorney until authorized to prepare a written report. Attorneys who are familiar with the appraiser’s work may not find this necessary. The attorney should make this decision early in the process and decide who will actually retain the appraiser.

**The Expert is Not An Advocate**

Remember the expert is not an advocate for a client’s position, but reaches an independent conclusion, and then is an advocate of that conclusion. Trying to turn an expert into an advocate can seriously

erode his or her credibility. For example, appraisers should be using discounts they believe are supported by the facts and circumstances of the case at hand, not discounts that represent just an opening offer in a negotiation process with the IRS.

**Make Sure the Appraiser Understands the Important Legal Documents**

Provisions in partnership agreements, articles of incorporation, buy and sell agreements, and similar documents may require a legal interpretation. If the appraiser makes his or her own interpretation of these documents, the attorney should agree with that interpretation.

**Consider Asking for a Draft Appraisal Report for Careful Review**

The attorney can ask the appraiser to submit a draft report for review by the client. The appraiser may make assumptions about future courses of action about such things as cash distributions, and these must be an accurate reflection of what management intends to do. Watch for leaps of faith appraisers often make. Appraisers typically have a technical orientation and may believe that a series of detailed calculations and conclusions captured within the bowels of the report are self-evident. If the report narrative does not logically and convincingly explain the concluded fair market value, suggest some revised or additional report verbiage. While appraisers usually won’t take kindly to unfounded suggestions that their fair market value determination is incorrect, a good appraiser will be receptive to input that will improve report writing skills and enhance what needs to be communicated.

Realize that the appraiser may retain a copy of the draft report, and may be asked to produce that draft. Although retaining draft reports is a hot topic in litigation, we have not yet seen that issue percolate to the tax arena, but it certainly could.

**If the Return is Audited, Involve the Appraiser**

No matter how good the appraisal, some estate and gift returns will be selected for audit. Let the appraiser know the IRS position and solicit help in rebutting the IRS arguments early in the process.

**Work as a Team**

The attorney and the appraiser both bring unique and complementary talents to the estate and gift planning and compliance process. Attorneys and appraisers who understand and appreciate what each party brings to the estate and gift planning table and who work together effectively can benefit their client’s objectives immensely.

— John R. Gilbert, CPA/ABV, ASA, Cr.FA



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We encourage you to forward *Building Value* with attribution to other interested parties. Please contact us to discuss any of your valuation needs.

wjohnson@bnkj.com or  
Jlahm@bnkj.com