# Viewpoint on Value

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# The ABCs of valuation

## Understanding the process

If you know the steps involved in valuing a business, you'll experience fewer unwanted surprises. In addition, you'll be able to facilitate matters by anticipating information requests. Of course, each valuation may vary somewhat depending on an appraiser's preferences as well as protocol and case requirements. But most valuations follow an established set of steps that include certain elements. Let's take a look at some.

### Defining the engagement

Detailed directives are imperative to accurate conclusions. Most valuators create letters that spell out the engagement's scope. Here are some key elements appraisers include when defining an engagement along with hypothetical examples in parentheses:

- **Business name** (ABC Company),
- **Client name** (Mr. Smith, owner of ABC Co., or Ms. Jones, Esq.),
- **Interest size** (100 shares or 10% of the common stock),
- **Effective date** (as of Dec. 31, 2007),
- **Standard of value** (fair market value or fair value),
- **Basis of value** (minority or controlling; marketable or nonmarketable),
- **Premise of value** (in orderly liquidation or as a going concern),
- **Purpose** (for marital dissolution or business planning purposes), and
- **Report type** (full or limited written report).

The engagement letter also may include a timeline for milestones such as issuing a draft report or conducting a site visit, liability clauses, and information regarding professional fees and retainers. Valuators typically expect their clients to sign the engagement letter before starting the work.

Note how an engagement letter defines the assignment to ensure that you and the expert share the same goals. Seemingly insignificant differences can lead to huge headaches. For example, in one gift tax case, the appraiser

mistakenly valued the wrong number of shares as a result of miscommunication among the appraiser, the client and the attorney. That seemingly insignificant oversight discredited the expert in Tax Court.

### Gathering relevant information

Shortly after the details have been ironed out in an engagement letter, a valuator typically sends his or her client an extensive list of requested documents. Relevant documents might include financial statements and tax returns for the past five years and the current reporting period, fixed asset listings and depreciation schedules, budgets and projections, shareholder or partnership agreements, and previous business or asset appraisals.

Along with the document request list, some valuators ask management to complete a questionnaire. Management interviews may supplement (or supplant) that questionnaire. Questionnaires and interviews often cover a broad range of topics, such as product or service offerings, company history, technology, and industry trends.

A site visit provides the valuator with another opportunity to assess business operations and ask questions. Examples of items that the appraiser may assess during a site visit include employee morale, asset condition and security, signage and parking adequacy, and capacity issues.

**An engagement letter defines the assignment to ensure you and the expert share the same goals.**

In adversarial situations — such as a shareholder dispute or divorce — business owners sometimes deny the opposing experts access to records, management or facilities. In these situations, valuators typically formally request specific documents and procedures through court filings early in the discovery process.

## Analyzing data

Next, the valuator crunches the numbers. His or her analyses may include adjusting and analyzing financial statements as well as projecting future cash flows (if management doesn't provide projections). Valuators also analyze databases and research studies to estimate various appraisal metrics, such as pricing multiples (for use in the market approach), the cost of capital (for use in the income approach), and discounts for lack of control or marketability.

The final result of these analyses is the appraiser's value conclusion. Values often are rounded, say, to the nearest dollar, thousands or millions, depending on the business interest's size and the desired amount of implied precision.

Before hiring a valuator, ask about the firm's review process. Supervisor and peer review — including standardized work paper protocol and random mathematical recalculations — can minimize embarrassing mistakes.

## Writing the report

A valuator usually provides a written report that will help a client understand the valuator's thought process. The report also enables disputing parties to pinpoint specific discrepancies between opposing expert opinions. Valuation reports typically explain the appraisal process, business operations, economic and industry conditions, and analyses performed. Most reports also reconcile any known evidence that contradicts the valuator's opinion.

Because valuators must learn about a business quickly, reports sometimes reveal material misunderstandings or undisclosed information. So valuators typically issue a draft report — which enables the client to review and clarify any errors or omissions — before issuing a final one.

In Tax Court, a written report customarily serves as an expert's direct testimony. Full-disclosure reports are especially important when a business interest is being valued for tax purposes.

## Providing expert testimony

Testimony may be the final step when an appraiser prepares a report for litigation purposes. If a case can't be settled out of court, the valuator may be asked to testify about his or her analyses and conclusions. In addition to explaining and defending their own opinions, some experts write rebuttal reports or verbally critique the opposing expert's opinion on the stand.

Expert witnesses need good verbal communication skills, breadth of experience and uncompromising objectivity. When choosing a potential witness, research his or her track record. For instance, how many times has the valuator testified in the past? What were those cases' outcomes?

Finally, find out whether the expert specializes in providing opinions for a particular type of assignment or client, such as monied spouses in divorce or taxpayers in gift and estate cases. Although a specialized expert may possess the requisite experience, the court also may perceive him or her as a hired gun.

## Familiarity breeds respect

Taking the time to familiarize yourself with a valuation's purpose, structure and requirements can help you avoid problems down the road. It will also ensure you get the most out of your valuation. ●

# Convenience has a price

## The ins and outs of marketability discounts

Suppose you owned a minority interest in a closely held business. If you wanted to sell it, where would you go? How long would it take? And how much would it cost? Marketability discounts capture the inconvenience, time and costs associated with selling a private business interest.

### The rationale

Valuators typically use *public* stock data to value *private* businesses. For instance, when applying the income approach, appraisers use public stock returns to quantify the cost of equity for private firms. Or they may use public stock prices to quantify pricing multiples for private firms under the market approach.

Unlike private business interests, shares of publicly traded stock can be converted to cash quickly at minimal cost. Established markets, such as the New York Stock Exchange and NASDAQ, trade public stocks.

When using public stocks to value private companies, valuators apply discounts to reflect the relative lack of marketability inherent in them. Marketability is typically defined as the ease of transfer or salability of an asset, business or business interest.

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Marketability discounts take into account illiquidity — the inability to quickly convert private business interests to cash — as well as the inability to access public capital and costs associated with public offerings. Moreover, marketability discounts reflect that many banks are less willing to accept private company stock than they are to accept marketable securities as loan collateral.

### How these discounts work

Marketability discounts apply exclusively to minority interests. (For information on illiquidity discounts on controlling interests, see "Don't confuse marketability with illiquidity" on page 5.) Marketability discounts are separate from and taken *after* discounts for lack of control (if the latter discount is applicable). Note that the effects of discounts for lack of control and marketability are multiplicative, not additive.

To illustrate, suppose a $100 business interest warrants a 5% discount for lack of control and a 32% marketability discount. The combined discount is *not* 37% (5% plus 32%). Instead, the valuator first reduces the controlling, marketable value by 5% to reflect its lack of control. Then the 32% marketability discount is taken on the $95 minority, marketable value. The final value is $64.60, which results in a 35.4% combined discount.

### Quantifying discounts

Significant dollars are at stake when quantifying marketability discounts. Customarily stated as a percentage of value, their typical range is 25% to 50%. But marketability

discounts can vary significantly from this range, depending on company- and case-specific factors, such as:

- The size of the block of stock,
- Financial performance,
- Actual and expected dividend payments,
- Restrictive shareholder (or partnership) agreement provisions,
- Put rights (especially common among ESOPs),
- The available pool of potential buyers,
- Management quality,
- Quality and accessibility of financial information, and
- Imminence of sale or public offering.

Marketability discounts aren't automatic deductions. The applicability of discounts depends on numerous factors, including the valuator's methodology, the appropriate standard and basis of value, and professional judgment.

## Sources of empirical data

Several research studies have been conducted to estimate marketability studies. This empirical data comes from two primary sources:

**Restricted stock studies.** In the 1970s, researchers began comparing private placements of restricted public stocks to the market prices of unrestricted public shares. Revenue Ruling 77-287 endorses using restricted stock data to quantify private stock marketability discounts.

A public company's restricted stock is identical to its publicly traded shares except that restricted shares can't be traded on the open market for a certain period of time and large blocks may be subject to dribble-out provisions. Before 1997, the holding period was two years; now it's one year.

Private companies weren't affected by these relaxed holding requirements. So restricted stock data after 1997 generally is less relevant in computing marketability discounts for private companies.

**Pre-IPO studies.** In the 1980s, a new source of empirical data emerged. Researchers began comparing pre–initial public offering (IPO) private transactions to the same company's IPO price. These studies provide direct comparisons between a company's private and public prices per share. Accordingly, pre-IPO studies generally report higher average marketability discounts than restricted stock studies.

Despite some confounding variables, such as timing differences, differing block sizes and insider deals, pre-IPO studies are widely recognized as an alternative source of empirical data for marketability discounts.

## Best left to the experts

Empirical study averages and medians are just starting points for quantifying marketability discounts. Valuators often comb through the research to identify which transactions are most comparable to the subject company. And they make subjective adjustments for company- and case-specific items.

The application and magnitude of marketability discounts are matters of professional judgment and can vary significantly from one valuation assignment to the next. Only an experienced valuation professional is equipped to handle this complex issue. ●

## Don't confuse marketability with illiquidity

Valuators make an important distinction between marketability discounts, which apply to minority interests, and illiquidity discounts, which apply to controlling interests.

The rationale underlying illiquidity discounts is that fair market value is a cash equivalent concept. In contrast, a future sale of a controlling interest is speculative and expensive and may include noncash terms, such as employment contracts, restricted stock or installment payments.

For example, it may seem inequitable for a monied spouse to receive $1 million of an illiquid business, while his or her spouse receives $1 million of cash and real estate, which are considerably more liquid assets.

When quantifying illiquidity discounts, valuators estimate the time, costs and risks of selling a private business (or a controlling interest within it). Alternatively, they may estimate the costs of going public.

Illiquidity discounts are somewhat controversial, especially because no official empirical data exists to support them. But all else being equal, most experts agree that illiquidity discounts should generally be lower than marketability discounts.

# Partner with a valuator — for better and worse

Bankruptcy is on the rise, according to information compiled in the Automated Access to Court Electronic Records (AACER) database. Through April 2008, commercial bankruptcies were up 49% over the same period last year. And the situation actually may be worse than this statistic suggests because AACER data excludes companies opting for out-of-court turnarounds and small businesses, financed with their owners' personal funds, that simply close shop.

Hiring a valuator early in the bankruptcy process can help preserve asset values, improve the chances of a successful turnaround and maximize liquidation proceeds.

## Liquidation vs. going concern

Residential builders and subcontractors are among those hardest hit by the current soft economy. But bankruptcies span many industries, such as airlines, automotive parts manufacturers and furniture retailers. Factors contributing to business failures include tighter lending standards, rising energy and commodity prices, and sluggish demand.

Whatever the industry, most appraisals focus on a business's going-concern value. That is, what is the value of a business enterprise that's expected to continue to operate into the future? For distressed businesses contemplating bankruptcy, liquidation value is another important benchmark.

The *International Glossary of Business Valuation Terms* lists two types of liquidation value. In an orderly liquidation, assets are sold piecemeal over a reasonable period of time to maximize proceeds. Alternatively, forced liquidation value assumes assets will be sold as quickly as possible, possibly via auction.

Timing, bankruptcy laws and judicial mandates help determine the appropriate premise of value. Business valuators are familiar with both going-concern and liquidation premises, making them invaluable advisors throughout the bankruptcy process.

## Liquidation analyses serve many purposes

Liquidation value often serves as a "floor" for business value. If liquidation value exceeds going-concern value, a subject company is probably worth more dead than alive.

A valuation also can help managers decide whether to file for Chapter 7 (reorganization) or Chapter 11 (liquidation). Further, it can help stakeholders evaluate the viability of purchase offers, management buyouts and reorganization plans.

Expert analysis starts with the company's balance sheet. The book values of liabilities are generally accurate, but assets may require adjustment to estimate recoverability and current market values. Valuators also consider the existence of unrecorded items, such as patents, trademarks, customer lists, IRS claims, warranties and pending lawsuits.

If a company decides to liquidate, the valuator must factor in liquidation expenses, such as lease obligations, severance pay and professional fees. Typically, money is set aside in an escrow account for these incidentals before the company distributes liquidation proceeds to creditors and investors.

## Beyond liquidation

Liquidation analyses are just the tip of the iceberg. Valuators can advise distressed businesses on other issues, such as:

- Devising and implementing reorganization plans,
- Projecting expected cash flows and estimating going-concern values for reorganization alternatives,

- Negotiating debt restructuring with creditors,
- Coordinating bankruptcy filings,
- Defending against insolvency and fraudulent transfer claims, and
- Providing fairness opinions for management buyouts and third-party acquisitions.

Valuators also might work with, or serve as, court-appointed receivers and turnaround consultants. They are likely to work closely with a client's attorneys if legal issues are involved.

### Money well spent

It may seem counterintuitive to hire a valuator when a company is struggling to pay its operating costs. But valuation advice is money well spent. ●

# When do subsequent events count?

Events that occur after the valuation date — such as key person losses, natural disasters, or postvaluation transactions — can complicate business appraisals. Fortunately, experienced valuators understand how to navigate the treacherous waters of subsequent events.

The fair market value standard requires valuators to assess the collective mindset of hypothetical, informed investors on the effective date. If an occurrence was known (or knowable) on the effective date, its effects may be factored into the valuator's analyses.

### Case-by-case evaluation

Suppose, for example, that a company hired a valuator to conduct an appraisal as of Dec. 31, 2007. The valuator finalized her report on July 1, 2008. She must then decide how to account for these subsequent events:

**The company's year end financial data, even though its audit was finished in spring 2008.** Competent executives stay on top of their companies' current financial condition and profits. Most valuators concede that timely financial data — even if not officially compiled on the effective date — is known (or knowable) on the effective date.

Financial statement cutoff dates don't always match perfectly with the effective dates of appraisals. So, choosing between relevant and available financial data can be tricky.

**The owner's death on Jan. 31, 2008.** Some subsequent events, such as a key person's death, can materially affect future earnings.

When deciding how to handle the owner's death, the "known or knowable" guideline is a logical starting point. For example, if the owner was young and healthy, his or her loss might be unexpected and, therefore, less likely to be factored into the appraisal.

Alternatively, if the owner had been diagnosed with third-stage lung cancer in 2007, the loss might be expected. The valuator, therefore, might consider factoring the probable effect of the loss into his or her analyses.

**The company's sale on June 1, 2008.** Valuators and the courts make a distinction between subsequent events that affect the valuation and those that provide evidence of value. Courts and attorneys sometimes cite postappraisal transactions to support (or refute) value opinions.

A company's selling price and its fair market value could differ for many valid reasons. For example, transactions may involve different-size blocks or a strategic buyer might pay a synergistic premium. When aware of subsequent transactions, valuators usually disclose them and reconcile any differences in their reports.

### Exceptions to the rule

Similar to financial statements, business valuations are valid on a specific date. Valuators generally disregard events that occur after the valuation date — but numerous exceptions exist. In any event, a valuator should interview management and perform an analysis to determine if there are any subsequent events that should be considered, and, if so, properly address these matters. Proper handling and disclosure of subsequent events is a matter of professional judgment and can vary from one assignment to the next. ●

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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

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More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

*To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at* ***203 - 255 - 3805.***
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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.

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