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AN ESTATE PLANNING ATTORNEY'S GUIDE TO BUSINESS VALUATIONS: PART TWO

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Last month, Part One established the foundation for the remainder of the article. It examined the standards of business valuation practice in a federal estate, gift and income tax environment, and then presented the standards of practice promulgated by the professional appraisal organizations. A discussion of the primary tenets of business valuation concluded Part One.

This month, Part Two discusses the valuation of operating companies. This will be accomplished in two segments. We will first review the appraisal process, and then will examine common deficiencies in the valuation of operating companies. As in Parts One and Three, the goal of Part Two is to facilitate the estate planning attorney's critical review of business valuation practice and reports. Our focus in Parts Two and Three, however, will be somewhat different than in Part One. Thus, Part One discussed the theoretical and conceptual aspects of business valuation practice. Part Two makes the transition to examining the factual and practical characteristics of business valuation practice. We start with a description of the valuation process for the valuation of operating entities, which will be followed with a discussion of common deficiencies in the valuation of operating entities.

The Valuation Process

The appraisal process consists of the following components that generally are completed sequentially:

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- Definition of the Appraisal Problem;
- Preliminary Analysis and Data Collection;
- Analysis of the Fundamental Position of the Business;
- Financial Statement Analysis;
- Valuation Methodology and Analysis;
- Value Reconciliation and Conclusion; and
- Communication of the Appraisal Opinion.

Needless to say, adequate execution of each one of the components is essential to produce a credible and defensible opinion of value. The appraisal process parallels the primary tenets of business valuation presented in Part One: (1) definition of the appraisal problem, (2) adequate investigation and research of the empirical capital market evidence, (3) sound analysis of the capital market evidence in relation to the business interest being valued and effective, and (4) cogent communication. Part One discussed in detail the first tenet, definition of the appraisal problem. We pick up with the second tenet, adequate investigation and research of the empirical capital market evidence.

Preliminary Analysis and Data Collection

The first step involved in performing adequate investigation and research in a business valuation assignment is preliminary analysis and data collection. The goal of this phase of the appraisal project is to investigate, compile and analyze the information related to the external environment in which the business operates. Two types of analyses are required: general and specific.

General analysis is related to the identification and study of the social, economic and industry factors influencing the value of the business interest. Examples of general analysis might include an investigation of demographic trends, a review of forecasted interest rates, or in-depth research in the industry of the business. The second type of analysis conducted in this phase of the assignment is specific analysis, which is related to the identification and study of factors related to the actual markets in which the business conducts its operations. For example, specific analysis for a regional food distributor might include a review of competitors and their market shares. The preliminary analysis and data collection phase of the assignment is critical in the valuation process, as research and analysis are the bedrock of the ultimate opinion of value.

ANALYSIS OF THE FUNDAMENTAL POSITION OF THE BUSINESS

Another crucial step in the valuation process is the analysis of the fundamental position of the business being valued. The objective of this phase is to investigate and then analyze the primary *qualitative factors* that influence the business and ultimately influence the value of the

business. In short, *the analyst should strive to tell the story behind the business in terms of its current status and future prospects.*

A key element in achieving this objective is the interview with management, which in many cases will be the source of many answers concerning the fundamental position of the business. The following topics and subsequent questions provide insight into the fundamental position of the business and usually should be among the components of the interview with management:

History of the Business

When and by whom was the company organized?

What are the date and state of incorporation or registration?

What were the original operations?

What were the major developments in the history of the business?

What changes in ownership and control occurred over the years?

Capitalization, Ownership and Management

How many classes of equity does the company have, and what are the features?

Who are the owners of the company?

What are the family relationships of the shareholders?

What are the plans for business succession?

Who are the officers, directors, and key employees?

What are the levels of compensation for the owners and directors?

General Economic and Industry Conditions and Comparisons

What are the general economic conditions that affect the company's prospects for continued business?

What are the industry trends that affect investment decisions and demand?

What type of comparisons are relevant between the industry trends and the general economic trends?

What type of comparisons are relevant between company revenue trends and industry trends?

What are the primary industry associations in the company's industry?

Regulation

What is the current regulatory environment?

What will the future regulatory environment be?

Employees and Management

What is the size and makeup of the workforce?

What type of wage/compensation structure does the business have?

Is the wage/compensation structure reflective of the industry and region?

Are the employees unionized?

What is the rate of employee turnover and attrition? Why?

How are employee-management relations?

Marketing

What markets does the company have?

Who are the company's primary customers and what is the annual sales volume (and percent of total sales) attributable to each of these customers?

What is the company's market share in its market(s)?

Product/Service Lines

What products and services are provided?

How are selling prices determined?

How are the products and services marketed and delivered?

Are there seasonal or cyclical aspects to the company's revenues?

Does the company have any brochures or price lists descriptive of its product and service lines?

Supplier Relationships

What are the key raw materials?

Who are the key vendors?

How are relations with these key vendors?

Competition and Market Position

What is the market niche or market strategy that the firm is trying to exploit?

What is the company's market share?

What are the principal competitive considerations (price, quality, service, etc.)?

What are the company's competitive advantages and disadvantages vis-a-vis the competition?

Who are the important competitors and what are their market shares?

Plant and Equipment

What type of physical facilities does the company occupy?

What are the location, condition and adequacy of the facilities?

What are the condition, age and adequacy of the equipment?

Are there any major, pending capital expenditures?

Company Mission, Strategic Plan

Has the company committed its strategic plan to writing?

Is the strategic plan tied to a budgetary control process?

How do historical results compare with previous budgets?

Past, Current or Contemplated Transactions of Company Stock

Have there been any prior transactions in the company's stock?

If so, what are the details surrounding these transactions?

Are there any current or contemplated transactions?

If there are current or contemplated transactions of the company's stock, do any of these transactions involve an initial public offering or sale of a control block?

FINANCIAL STATEMENT ANALYSIS

The next step in the appraisal process involves the quantitative analysis of the company's balance sheet, income statement and statement of cash flows. The objective of financial statement analysis should be to tie the qualitative analysis, obtained through due diligence and analysis of the fundamental position of the company, to the financial statement, or quantitative analysis. A well prepared valuation is able to make the correlation of the qualitative aspects of the business to the quantitative aspects of the business, for the financial statements represent the story of the business, albeit in numerical form.

Financial statement analysis is accomplished chiefly by an analysis of the balance sheet, the income statement and to a lesser extent, the statement of cash flows. The balance sheet represents a snapshot of the assets, liabilities and owner's equity of a business at a specific point in time, whereas the income statement presents the operational results of a business for a specific time period.

The analysis of the balance sheet often is accomplished with common size analysis. Common size analysis is accomplished by stating each balance sheet account as a percentage of total assets and is typically performed by presenting the balance sheet for the last five or six years. By observing the variation of the percentages of each balance sheet account, the analyst may isolate trends or identify items for further investigation.

Income statement analysis also is chiefly performed by the use of common size analysis, typically over a five or six year period. Individual income statement accounts are presented as a percentage of total revenues. Common size analysis of the income statement facilitates the identification of trends in the income statement and variations in revenue, expense and profit margins. Inquiries should be made of management with respect to material nonrecurring or non-operating items that have occurred for the time period examined, so that the best indicator of income from operations may be determined. Examples of

nonrecurring items are losses from natural disasters, losses from discontinued operations, gains on the disposal of an asset and payments or income associated with a lawsuit. Examples of non-operating items include interest and investment income on non-operating assets. If the company prepares annual budgets, a very good technique for the analysis of the income statement is comparison of the prior budgets with the appropriate corresponding income statement. This may shed insight into a company's future profitability outlook and also may lay the predicate for the next step in the appraisal process—valuation methodology and analysis.

VALUATION METHODOLOGY AND ANALYSIS

Valuation methodology refers to the types of valuation techniques considered, selected and used in a particular valuation assignment. The valuation of the business may be accomplished through one (or more) of three basic approaches: the market approach, the income approach and the asset approach. Within each of these three basic approaches to valuation are various methods relating to each approach. Our objective in reviewing the basic valuation approaches and corresponding methods will be to describe in detail each approach, discuss the advantages and disadvantages of each, and introduce the various methods commonly used under each approach.

The Market Approach

The market approach is defined by the American Society of Appraisers as "a general way of determining a value indication of a business, business ownership interest or security using one or more methods that compare the subject to similar businesses, business ownership interests or securities that have been sold."[1] Under the market approach there are two general methods, the guideline company method and the merger and acquisition method. The merger and acquisition method generally is applicable to the valuation of controlling interests. As the objective of this article is the valuation of medium to large-sized closely held companies on a minority interest basis for estate planning purposes, our discussion generally will be restricted to the guideline company method. First, a discussion of the advantages and disadvantages of the market approach is in order.

A major advantage that the market approach has over the income and asset approaches is that the market approach relies upon objective data from the capital markets. These data are then used to derive a value for the subject company. The result is that, often, there is less subjectivity in the valuation process. In comparing the market approach to the income approach, Tax Court Judge David Laro has stated, "tax valuations often

rely on market-driven multiples such as price earnings, price cash flow, or price book value ratios, because it is difficult, if not impossible, for the appraiser to (1) confidently make future projections which would be readily accepted by hypothetical willing buyers and (2) establish a universally acceptable discount rate."[2] Another advantage of the market approach is that there is a great body of financial and other data available on publicly held companies. The market prices of publicly traded guideline companies represent arm's length, minority interest transactions by many buyers and sellers, and therefore the approach is particularly appropriate for minority interest valuations. Finally, the market approach is easy to explain and understand.

There are also several disadvantages associated with the market approach. Often, it is hard to find suitable publicly traded companies that are sufficiently similar to the subject company, particularly when the company is very small. In addition, the proper interpretation of stock market data (both price and financial data) poses challenges to the analyst.

As stated previously, our discussion relative to the methods used in the market approach will be confined to the guideline company method. As the name implies, the guideline company method relies on multiples derived from publicly traded guideline company data. Appropriate multiples are applied to the benefit stream or other variable (e.g., dividends or book value) for the business interest being valued.

The guideline company method sometimes is also referred to as the comparative company method. Companies used to provide valuation guidelines are often called "comparative companies" or "comparable companies". It is seldom, if ever, possible to identify publicly traded companies that are "just like" the company being valued. But a comprehensive review of possible companies in the same or similar industries can produce companies that will provide viable valuation guidelines. *In this sense, the selection of these "guideline companies" will enable the analyst to present empirical capital market evidence representative of alternative investment opportunities for the owner of the closely held business interest.* After appropriate adjustments for various qualitative aspects that differentiate the company being valued from the guideline companies, the analyst is then able to quantify the risk of ownership in the closely held entity. Thus, an informed and reliable valuation conclusion may be reached.

The Internal Revenue Service is a strong proponent of the guideline company method, as evidenced by the following excerpt:

> As a generalization, the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations and industries represented. When a stock is closely held, is traded infrequently, or is traded in an erratic market, some other measure of value must be used. In many instances, the next best measure may be found in the prices at which stocks of companies engaged in the same of similar line of business are selling in a free and open market.[3]

The steps involved in the application of the guideline company method include: (1) selecting the guideline companies; (2) making necessary financial statement adjustments to the guideline companies; (3) comparing the guidelines with the company being valued; (4) developing appropriate valuation ratios; (5) considering differences between the guidelines and the subject company; (6) adjusting the valuation ratios to account for the differences between the guidelines and the subject company; and (7) applying the adjusted valuation ratios to the subject company. The subsequent paragraphs discuss these steps.

In order to obtain a suitable group of guideline companies, several procedures are in order. First, the analyst must establish objective selection criteria. These criteria should vary depending on the nature of the subject company. Because a fundamental objective of the guideline company method is to provide empirical capital market evidence of alternative investment opportunities for the closely held company, *the guideline companies selected should parallel the investment characteristics of the subject company.* Selection criteria may include products or services offered, company size, capital structure, markets, geographic diversification, earnings patterns, supplier risk, competition and industry position. The companies selected must publish financial data and should trade in active markets. Guideline company information may be obtained from such sources as Moody's, Standard and Poor's, Compact D Disclosure, the Securities and Exchange Commission EDGAR database and other online databases. Subsequent to the search, the analyst commonly prepares a table presenting all of the potential guideline companies indicated by these reference sources.

Generally speaking, adjustments to the financial statements of the guideline companies should be similar to those made to the financial statements of the subject company. Examples of these adjustments include removing nonrecurring items from income statements, restating the guideline companies on a comparable accounting basis (e.g., restating

balance sheets to a FIFO accounting basis) and removing nonoperating assets and the effects of discontinued operations.

In order to facilitate the analytical process, the analyst then calculates ratio analyses whereby the subject company is compared against the guideline companies. Both financial (balance sheet) and operating ratios (turnover and profitability) are used in this process. Financial ratios, such as the current ratio, current asset to total asset ratio and leverage ratios, are commonly used. Operating ratios, such as turnover ratios, profit margins and return on equity indicators also are useful. Long term revenue and profitability trends often are commonly analyzed. The objective of ratio comparisons between the subject company and public guidelines should be to identify similarities and differences, which later assist in the selection of the most appropriate valuation ratios for the subject company.

The next step, the development of valuation ratios, is central to the guideline method. In the development of valuation ratios, the total market value of each guideline company must be computed. Once the total market value of each guideline is developed, ratios that compare these market values and such factors as net worth (book value), earnings, cash flow and dividends are commonly prepared. Market value to earnings (commonly referred to as price-earnings ratios) are commonly used. An important consideration in the preparation of any valuation ratio is consistency. For example, with the use of market value to earnings it is critical to identify the most appropriate base of earnings to be used. Earnings may be stated as average earnings, latest twelve month earnings, weighted average earnings, and so forth. It is imperative to use the same earnings base for the guideline companies as for the subject company. In some cases, industry specific ratios are useful. Examples of this are newspaper valuations, where a price to subscriber or price-revenue ratios may be helpful; in the health care industry, price to bed ratios are commonly used; in the valuation of a mining concern, a price to production ratio or a price to reserve ratio may be appropriate.

Differences, both qualitative and quantitative, between the guideline companies and the subject company must then be considered. Qualitative differences might relate to differences in size, management depth, and geographic, customer and supplier diversification. Quantitative differences include items such as relative rates of long term growth, sales and income, inferior or superior margins and rates of return, and inferior or superior financial (balance sheet) condition.

After these differences have been identified, adjustments to the valuation ratios are made to account for the differences. Relative strengths and weaknesses of the subject company versus the guideline companies should be reflected in the adjustments.

The final step in the application of the guideline company method is applying the adjusted valuation ratios to the subject company. This process yields various indicators of value (commonly, one each based upon book value, earnings, cash flow, dividend-paying capacity and, potentially, industry specific valuation ratios). The weight or importance of each indicator depends on its relative significance. For example, earnings and cash flow are often important indicators of value in the case of a manufacturing or service company. Book value and net assets are commonly important indicators of value in the case of an asset rich company. Once the analyst applies the pertinent ratios, a per share, freely traded value is obtained. This value may then be reduced by an allowance for lack of marketability, as will be discussed in detail in Part Three next month.

The Income Approach

The income approach is defined by the American Society of Appraisers as "a general way of determining a value indication of a business, business ownership interest or security using one or more methods wherein a value is determined by converting anticipated benefits".[4] The theoretical foundation for the income approach is that the value of the business interest is equal to the present value of future benefits into perpetuity. The income approach often is used when no reliable market guideline companies are available, or as corroboration for a market based result.

The income approach may take the form of several methods. These methods are further divisible into two general categories, capitalized returns methods and discounted future returns methods. Capitalized returns methods include capitalization of earnings, capitalization of net cash flow and capitalization of gross cash flow. Discounted future returns methods include discounted net cash flow and discounted future earnings. This discussion will be confined to the two major methods, the capitalized returns and the discounted future returns methods, as the specific methods thereunder are essentially variations of these fundamental methods.

The capitalized returns method involves the conversion of an estimate of normalized cash flow or earnings into an indication of value in one step by dividing the cash flow or earnings estimate by a capitalization rate. A capitalization rate is defined as "any divisor (usually expressed as a percentage) that is used to convert income into value".[5]

The discounted future returns method is based on the future benefits (in terms of earnings or cash flow), discounted to a present value at an appropriate (risk-adjusted) discount rate. A discount rate may be defined as "a rate of return used to convert a monetary sum, payable or receivable in the future, into present value."[6] It is important to note the distinction

between capitalization rates and discount rates. "In most situations, a discount rate can be converted into a cap (capitalization) rate by subtracting the company's expected average annual compound percentage growth rate. A cap rate determined in this manner will thus be less than the discount rate."[7]

There are several advantages and several disadvantages of the capitalized returns method. The capitalized returns method is relatively straightforward, easy to understand and widely accepted by the business valuation profession. In addition, because the capitalized returns method uses a current measure of cash flow or earnings, it generally is more reliable, because current cash flow or earnings are more easily estimated than future cash flow or earnings. Disadvantages of the capitalized returns methods include criticism that it is too simplistic for use in valuing complex business entities, that difficulties exist in estimating an appropriate capitalization rate from the market and that the value conclusion is sensitive to moderate changes to either the capitalization rate or benefit stream.

There also are several advantages and disadvantages of discounted future returns method. One advantage of the method is that—unlike the capitalized returns method—the discounted returns method can incorporate a forecast of more than one year's financial results in estimating value. This allows the analyst to allow for variations in future results of the company. The approach also is particularly useful when the subject company has a long history of preparing budgets and the prior budgets are highly correlated with the actual results of those periods.

There are, however, several major disadvantages associated with the discounted future returns method. A forecast of future earnings or cash flow is a relatively complex capital budgeting exercise incorporating economic assumptions, sales forecasts, purchase forecasts, payroll forecasts, nonpayroll operating expenses forecast, capital expenditures forecast, taxes forecast and financing forecast. Because of the layering of assumptions inherent in this process, errors at any one stage of preparing a forecast may multiply.

Some models of discounted future returns method are very sensitive to the underlying assumptions and can yield wild swings in value conclusions based on changes to these assumptions. As one commentator has noted, "... the discounted economic income methods are extremely sensitive to changes in the input variables—that is, the projected cash flows and the discount rate."[8] Another commentator noted, "In theory, this approach (the discounted cash-flow approach) is fundamentally sound and even widely accepted as most pure and correct. However, it can be a

minefield for the analyst if it is not carefully developed."[9] A third commentator stated, "when faced with the reality of the marketplace, the task of projecting earnings, dividends, and a stock price into the future and determining an appropriate discount rate may be too fraught with uncertainty for analysts to rely on discounted cash flow (DCF) analyses in the determination of value."[10] In addition, many times the value of the company at the end of the forecast period (known as the terminal or continuing value) represents the majority of the value of the entity. Moreover, volatility in estimation of the terminal value can cause wide variations in value conclusions. Finally, there is some disagreement within the business valuation profession as to whether a control based value or a minority based value is derived through the use of a discounted future returns approach. The central issue in these disagreements are the specific procedures employed in formulating the forecasts and in estimating the required rate of return.

Procedurally, the analyst performs several steps in preparing the capitalized returns method. The analyst will first typically adjust the financial statements for items of a nonrecurring or unusual nature (this is similar to the procedure explained in the market approach). If a cash flow forecast is being used, the analyst will then make adjustments to convert earnings to cash flow, such as adding back non-cash charges (commonly depreciation and amortization), anticipated capital expenditures and changes to working capital. An estimate of the capitalization rate is then prepared using a recognized method such as the built-up method, the Capital Asset Pricing Model (CAPM) or the Arbitrage Pricing Theory (APT). Provisions for long term growth are also made at this juncture. The analyst then determines the benefit stream that is to be capitalized; e.g., the latest year results, an average of prior year results or weighted average of prior year results. The value of the ongoing business entity is then obtained by dividing the benefit stream by the capitalization rate. The capitalized returns method also must consider the value of nonoperating assets, if any, that will add to the value of the ongoing business entity. Depending on the value necessary for the specific assignment (i.e., marketable minority, etc.), the value may then be adjusted by a marketability discount and/or a control premium.

The preparation of the discounted future returns method also is accomplished in a series of procedures. First, a forecast of future financial results must be either obtained or prepared. The analyst then adjusts the financial statements for items of a nonrecurring or unusual nature. As discussed previously, if a cash flow forecast is desired, additional adjustments are then made to convert earnings to cash flow. An estimate of the appropriate discount rate is then completed by using one or more of the

recognized methods that are discussed under the capitalized returns method. (As stated previously, an important distinction between a capitalization rate and a discount rate is that future growth of the business is implicitly incorporated into a capitalization rate by subtracting the company's expected average annual compound percentage growth rate from the discount rate. Thus, the capitalized future returns method implicitly considers future growth, while the discounted future returns method explicitly considers growth of the entity in the discrete forecast of the future benefit stream.) The terminal value at the end of the forecast period often is then estimated by the use of the Gordon Growth model in which an estimate of the terminal value is derived by estimation of terminal year financial results, which are then divided by a terminal year capitalization rate. The terminal year value is converted to a present value by discounting the terminal value by the discount rate for the appropriate time period. The estimate of value of the discrete forecast period is then estimated by discounting each year's benefit stream to a present value by the discount rate. Again, as with the capitalized returns method, the value of nonoperating assets, if any, are added to the value of the ongoing business entity and adjustments are made for lack of marketability and control as warranted.

The Asset Approach

The asset-based approach is defined by the American Society of Appraisers as "a general way of determining the value indication of a business's assets and/or equity interest using one or more methods based directly on the value of the assets of the business less liabilities."[11] The asset approach comprises two primary methods, the net asset value method and the liquidation value method. The major distinction between these two methods is a difference in the underlying premise of each method. The net asset value method assumes that the business is a going concern, while the liquidation value method assumes that the value of the assets will be realized through a forced or orderly liquidation of its assets.

The asset approach is particularly relevant in valuing investment holding companies and asset-rich companies. Revenue Ruling 59–60 notes "that adjusted net worth should be accorded greater weight in valuing stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity."[12] As a result, the asset approach has received significant attention in recent years as the primary means for valuing family limited partnerships and other investment holding vehicles.

There are several advantages associated with the asset approach. The approach is easy to understand in both theory and application. The approach is particularly well suited for the valuation of a failing industrial firm, especially in the context of a controlling interest valuation (when the business is worth more dead that alive). The approach also may be useful when the entity being valued has no history of earnings.

As with the other appraisal methods, there are several disadvantages to the asset approach. First, the approach requires competent appraisals or management representations as to the fair market value of the assets. Verification and risk associated with the collection of accounts receivable may be required. In the context of a going concern value, the asset based approach generally disregards earnings, except to the extent competent intangible asset appraisals are incorporated into the valuation process.

As with the market and income approaches, the steps involved in preparing the asset approach to value follow a logical progression. The analyst must first obtain a balance sheet for the subject company as close to the date of value as reasonably possible. The next step is to review the balance sheet in order to identify those assets and liabilities that require a revaluation adjustment and then to restate historical book values to fair market value. The analyst should then incorporate into the analysis any material off-balance sheet assets and liabilities. The resulting subtotal (adjusted asset values less liabilities) is known as "net asset value." Net asset value is converted to fair market value by the appropriate discounts (i.e., minority interest and lack of marketability).

VALUE RECONCILIATION AND CONCLUSION

If more than one approach is used, a reconciliation process is necessary to derive a final value conclusion. The approach to value that yields the most representative value for the subject business should be given the greatest weight in this process.

Value reconciliation may be accomplished using two primary approaches, mathematical weighting and subjective weighting. Mathematical weighting assigns a percentage weight to each approach, method or indicator in arriving at a final, blended value conclusion. Subjective weighting involves an assessment and description of the factors considered in arriving at the final value estimate. Mathematical weighting may lead the user of the report to conclude that the reconciliation process is more precise than it actually is. Indeed, Revenue Ruling 59–60 does not recommend the use of mathematical weighting; however, mathematical weighting clearly presents the relative importance the appraiser places on the approaches, methods, and indicators used in the valuation.

COMMUNICATION OF THE APPRAISAL REPORT

Of utmost importance is the communication of the appraisal report, both in written form and in oral form. The written appraisal report should be written in such a manner that the reader of the report should be able to replicate the steps used by the appraiser to arrive at an opinion of value. The report should represent the appraiser's original work and be persuasive as to the value opinion rendered. (The United States Tax Court broadly mandates what must be contained in a written expert witness report, including a valuation report [TC Rule 143(f)]). The report also should include the appraiser's qualifications as an expert and should express the appraiser's valuation opinions, and describe the facts or data upon which the opinions are based. Furthermore, the written report must set forth, in detail, the reasons for the appraiser's opinions and conclusions.[13]

Oral reporting in the form of explaining an opinion of value before a written report is delivered, or assisting the attorney in the negotiation process or providing testimony either in depositions or courtroom testimony may be as important as the written report. In explaining a value conclusion before a written report is required, the appraiser must be adept at presenting the salient valuation factors that support the opinion. Succinct and cogent discussion of the value opinion will aid the attorney in understanding the logical progression of the appraisal process leading to an opinion of value. In assisting the attorney in negotiations subsequent to the written report, oral reporting and communication of the valuation process and conclusion are critical to reinforce the written report. Finally, if needed for testimony purposes, the appraiser should be prepared to communicate the results of any valuation in a cogent, concise and persuasive manner. In all aspects of both written and oral communication of the appraisal report, the appraiser should be a strong advocate for his or her value conclusion, but not an advocate for a particular result.

Common Deficiencies in the Valuation of Operating Companies

A primary objective of this article is to facilitate the estate planning attorney's critical review of business valuation reports. One way of accomplishing this objective is to: (1) identify the common deficiencies in business valuation reports, and (2) where possible, provide examples of these deficiencies in recent practice before the United States Tax Court. It is hoped that this process will provide a roadmap in the use of business valuations and put the attorney in the position to critically review, and thus optimally utilize, business valuations in an estate planning context.

COMMON DEFICIENCIES IN BUSINESS VALUATION PRACTICE

Our discussion of common deficiencies in business valuation practice will be segregated into four areas: deficiencies related to inadequate due diligence, deficiencies related to valuation methodology (i.e. the market, income and asset approaches), deficiencies related to the reconciliation process, and deficiencies related to report preparation. Deficiencies related to discounts and premiums will be addressed in Part Three of the Article.

INADEQUATE DUE DILIGENCE

Inadequate due diligence in the preparation of an opinion of value for a closely held business may be compared to not laying a firm foundation for a building. Due diligence for the preparation of an appraisal opinion may be described as the investigation and compilation of all of the information necessary to support an opinion of value. This article has previously addressed many of the due diligence aspects of an appraisal engagement for the valuation of a closely held business.

The deficiencies related to inadequate due diligence are commonly related to the analysis of the fundamental position of the subject business. The following items represent examples of inadequate due diligence in the preparation of a business appraisal for Federal estate, gift and income tax purposes:

1. Lack of a site visit (see Estate of Arthur G. Scanlan v. Comm., TC Memo 1996–33).
2. Lack of or inadequate management interview (see Estate of Frederick Carl Gloeckner v. Comm., TC Memo 1996–148 and Estate of Ross H. Freeman v. Comm., TC Memo 1996–372).
3. Failure to consider applicable state corporate law, corporate bylaws and corporate articles of incorporation (see Estate of Clyde Wright v. Comm., TC Memo 1997–53).
4. Failure to consider such features or restrictions affecting ownership rights as options, rights of first refusal, buy-sell agreements, and voting rights. (See Estate of Richard R. Simplot v. Comm., 112 TC No 13. Here, one of the estate's experts concluded that the decedent's voting and nonvoting shares were "functionally equivalent," because they did not represent voting control and therefore should have the same value per share. The IRS disagreed, and the Court concluded that the per share value of the voting shares was 63 times greater than that of the nonvoting shares.)

5. Failure to consider or report on transactions in corporate stock or make inquiries about prospective transactions, such as mergers, private placements or initial public offerings. (See Estate of Ross H. Freeman v. Comm., TC Memo 1996–372.)

With respect to the last item, actual arm's length sales of the business interest being valued within a reasonable time of the valuation date may be a persuasive indicator of market value. (See Ward v. Comm., 87 TC 78, 101 (1986); Estate of Andrews v. Comm., 79 TC 938, 940 (1982). In determining the value of unlisted stock, actual arm's length sales of such stock in the normal course of business within a reasonable time before or after the valuation date are the best criteria of market value. Duncan Industries v. Comm., 73 TC 266, 276 (1979). This notion also was reflected in the recent decision, Estate of Frank A. Branson v. Comm., TC Memo 1999–231. (For interesting decisions related to post valuation date private placements and initial public offerings please see Scanlan and Freeman, supra). In dealing with issues concerning post valuation date liquidity events, it is important to note that clients must be forthcoming with all of the information regarding prospective transactions. The professional appraiser will be able to effectively deal with any fact scenario, if adequately apprised of the developments.

DEFICIENCIES RELATED TO VALUATION METHODOLOGY

The deficiencies related to valuation methodology may be organized by the approaches used in formulating the value opinion (i.e., market, income and asset). Our discussion of deficiencies related to the market approach will be confined to the guideline company method. Our discussion of deficiencies related to the income approach will be confined to the capitalized returns and the discounted returns methods.

Deficiencies in the Market Approach

Central to the guideline company method is the proper selection of the guideline companies used in the analysis. The analyst must give significant attention to avoid selecting inappropriate or inadequate guideline companies. (See Estate of Emanuel Trompeter v. Comm., TC Memo 1998–35. See Estate of Alice F. Kaufman v. Comm., TC Memo 1999–110.) Inherent in the process of selecting adequate guideline companies is that many publicly traded guideline companies may be significantly larger concerns than the closely held entity being valued. On the other hand, using overly restrictive selection criteria may result in only one or very few guideline companies. If the analyst performs the analysis with only one or two guideline companies, the results may be suspect and open to attack since "one sale does not make a market". On the other hand, if the analyst does not use the guideline company method, a potentially viable

way of appraising the company may have been overlooked. The landmark case Hall v. Comm., 92 TC 312 (1989) provides some insight on the issue of what constitutes a guideline company.

The analyst also must avoid the inconsistent application of adjustments. What's good for the goose (the private company) is good for the gander (the guideline companies). For example, if half of the guideline group employs LIFO inventory valuation methods, yet the remainder and the subject private company use FIFO, then most analysts will adjust all LIFO companies to FIFO (using the LIFO reserve data in the financial statement footnotes). In all cases, a consistent adjustment process is critical, otherwise the results may be suspect and open to attack.

Similar to this idea of consistency is the notion of clearly defining each valuation multiple. For example, if the valuation multiple is a price to earnings ratio, what level of earning power is being considered? Earnings may be defined as pre-tax, after-tax, or earnings before interest and taxes ("EBIT"). Careful attention must be given to the definition of each valuation multiple, and the multiples must be consistently applied throughout the guideline company analysis.

Another trap in the application of the guideline company approach is applying average or median valuation ratios or multiples without considering the positive and negative aspects of the subject company versus the guideline companies. "Blind applications of publicly traded valuation ratios can result in distorted results. Adjustments may have to be made of comparability, size, diversification, thin management and risk, among others."[14] For example, applying a price to sales multiple without considering differences in profitability among the guideline companies and between the guideline group and the subject company may result in an unreliable value indication.

An all too frequent error is the application of a minority interest discount to a value derived by the guideline company method. Because trading in publicly traded guideline company stocks involves blocks of minority interests (e.g., 100 or 1,000 shares), the multiples derived from public guideline companies are almost always on a minority interest basis. Thus, the application of a minority discount in this setting involves double-counting.

Deficiencies in the Income Approach

Here, our discussion centers on the deficiencies associated with the discounted future returns method, although we will touch on the capitalized returns methods. Thus, a major criticism of the discounted future returns method is that, given the inherent weaknesses of the method, it is probably seen too much in practice. In essence, the discounted future

returns method is an exercise in capital budgeting; therefore, the method is a relatively complex process for estimating value. In practice, it often is applied in a cursory fashion.

Fundamental to the construction of a reliable discounted future returns method is the reliability of the forecast used in the analysis. There are many specific areas in the construction of a financial forecast that are ripe for error. First, the analyst must ensure that, when making forecasts of growth into the future, sufficient working capital is available to fuel such growth. Along with the corresponding increases of sales and earnings, the analyst must incorporate incremental working capital funding in the forecast. Second, care must be taken with assumptions involving the terminal or continuing value. It is very hard to justify perpetuity growth rates in excess of long-term inflation expectations, because companies typically go through a life cycle of inception, growth, maturity and decline. If a company is currently in the growth phase of the business life cycle, the question is how long, not if, it will remain there. Third, errors occur when only the recent past and not a full economic cycle is considered in forecasting future financial results. Many businesses—for example, construction companies—experience periodic business cycles linked to prevailing interest rates and economic activity. In preparing a discounted future earnings forecast for a business in such a cyclical industry, the analyst can err by assuming that recent trends will continue, when, in actuality, the business is at the peak or trough of a business cycle. Finally, many times deficiencies are observed in assumptions related to the terminal year. Because of the nature of many discounted returns method models, much of the value obtained resides in the terminal year forecast. As a result, the analyst must make sure that assumptions related to the terminal year are sound in all respects. (See Nathan P. and Geraldine V. Morton v. Comm., TC Memo 1997–166.)

Errors occur in developing discount and capitalization rates. First, the formulation of the capitalization or discount rate should reflect accepted methodologies for deriving the rates, such as the built-up method or the Capital Asset Pricing Model ("CAPM"). (See Morton, supra.) Second, the discount or capitalization rate must be consistent with the benefit stream used in the analysis. It would be just as inappropriate to apply a capitalization or discount rate that is unadjusted for taxes to after-tax income as it would to apply a pretax price-earnings ratio to after-tax net income. (See Charles C. Dockery v. Comm., TC Memo 1998–114. Gross v. Comm., TC Memo 1999–254.) Third, the capitalization or discount rate must be consistent with the level of value to be determined. For example, if enterprise value inclusive of debt and equity is the goal, then the capitalization or discount rate should reflect the weighted average

cost of capital (debt plus equity), not just an equity rate of return. Conversely, if an equity value is desired, a cost of equity rate should be used.

Deficiencies in the Asset Approach

The asset approach may be a reliable approach for valuing holding companies, capital intensive businesses and businesses in such financial distress that liquidation of the company's assets may result in the company's maximum value. The asset approach generally is not a reliable way to value profitable service or operating companies and other businesses possessing significant intangible value or goodwill. (See Cidulka, supra.) In all cases, the analyst should support the use of the asset approach or any approach by a discussing of the appropriateness of the approach in the report. Finally, essential to the preparation of the asset approach is for the analyst to make sure that adequate substantiation exists for adjustments to assets and liabilities in the determination of net asset value.

Deficiencies in the Reconciliation Process

In the reconciliation process, it is critical to ensure that all of the methods used in the valuation process are applied on a consistent basis in reconciling the final value. For example, if a minority interest value is desired and the analyst uses income and asset approaches to value, the asset approach should be adjusted to a minority basis, as net asset value generally reflects gross asset values available to the holder of a controlling interest basis. This theme of consistency also is important when both invested capital and equity derived values are used in one valuation assignment.

Deficiencies in Report Preparation

Several problem elements pertaining to the report preparation and the written communication for an appraisal opinion are worthy of discussion. The attorney should look for answers to various questions.

First, is the report is self-contained? Self-contained is a term that refers to the ability of the report to be clearly understood by the reader. The business valuation report should be clearly presented so that the reader can recreate the procedures completed by the appraiser leading to the opinion of value.

Is the report internally consistent? The appraiser should link all the assumptions and observations in a clear and logical fashion. The quantitative analyses should support the valuation multiples selected.

Is the report free of assertions? Judgment calls should be quantified wherever possible. Once again, capital market evidence often can assist in this regard. Remember, because the written report constitutes the direct testimony of the appraiser before the United States Tax Court, it must be

a thorough documentation of the appraisal process and the value conclusion reached.

Is the report "fresh" in relation to the date of valuation? "A consistent judicial reaction to expert testimony is that it should be based on data as current to the valuation date as reasonably possible. While this seems eminently reasonable, in a surprising number of cases, expert testimony has been based on outdated data, and the judicial reaction is to reject it. For example, Judge Laro described the IRS position as "incredible", but nevertheless rejected the testimony of the taxpayer's expert. For a 1991 valuation date, the taxpayer's expert "prepared the report relying heavily on the 1989 report"[15] (See Scanlan and Kaufman, supra). In the Kaufman decision, the Tax Court did not admit the report of the Service's expert because the date of valuation was approximately four months prior to the applicable (alternate valuation) date.

This concludes Part Two and our discussion of the valuation of operating companies. We will complete the article next month with a discussion of the valuation of holding companies, as well as the common deficiency in using discounts and premiums.

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FOOTNOTES

[1] American Society of Appraisers Business Valuation Committee, Business Valuation Standards at 11.

[2] The Honorable David Laro, "Business Valuation: A View from the United States Tax Court," American Society of Appraisers International Appraisal Conference, Denver, Colorado, June 20, 1995 at 15.

[3] Rev Rul 59–60, 1959–1 CB 237.

[4] American Society of Appraisers Business Valuation Committee, op. cit. at 9.

[5] American Society of Appraisers Business Valuation Committee, loc. cit. at 20.

[6] Loc. cit.

[7] Fishman, Pratt, Griffith and Wilson, Guide to Business Valuations at 5–6.

[8] Pratt, Reilly and Schweihs, Valuing a Business, Third Edition at 191.

[9] Fodor and Mazza, "Business Valuation Fundamentals for Planners", Journal of Financial Planning, October 1992.

[10] Block, Stanley, "A Study of Financial Analysis: Practices and Theory", Financial Analysts Journal, July/August 1999.

[11] American Society of Appraisers Business Valuation Committee, op. cit. at 19.

[12] Rev Rul 59–60, 1959–1 CB 237.

[13] Elliott, Culp and Marsh, Valuation Practice in Estate Planning and Litigation at § 11–5.20.

[14] Hitcher, "Valuation of Closely Held Businesses," The Tax Advisor, July 1992.

[15] Pratt, "Judicial Reactions to Valuation Testimony," op. cit. at 22.