

**MSG**

ACCOUNTANTS,  
CONSULTANTS &  
BUSINESS VALUATORS

HIT YOUR TARGET<sup>SM</sup>



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# VALUING CLOSELY HELD BUSINESSES

# HISTORY OF BUSINESS VALUATION



- 1920 – ARM 34
- 1952 – American Society of Appraisers Formed
- 1959 – Rev Rul 59-60
- 1968 – Rev Rul 68-609 (Formula Method)



## HISTORY OF BUSINESS VALUATION – CONT'D

- **1978 – Institute of Business Appraisers Founded**
- **1981 – Business Valuation Committee of ASA formed**
- **1991 – National Association of Certified Valuation Analysts – Create CVA Credential**
- **1997 – AICPA establishes “Accredited in Business Valuation (ABV) credential**

# VALUATION CONSULTANTS ROLE



- **Independent Consultant**
  - Perform an objective valuation
- **Client advisor**
  - Assist with determining a value most beneficial to the client




## COMMON REASONS FOR BUSINESS VALUATION ENGAGEMENTS

- Estate and Gift Tax
- Divorce
- Buying/Selling a Business (or interest in a business)
- Economic Damages – breach of contract
- ESOP's

# AICPA STANDARDS



- **AICPA Code of Professional Conduct**
- **AICPA Consulting Practice Aid 93-3, Conducting a Valuation of a Closely Held Business**
- **AICPA Consulting Services Special Report 93-1, Application of Professional Standards in the Performance of Litigation Services**
- **AICPA Statement on Standards for Consulting Services No. 1, Consulting Services: Definitions and Standards**
- **Standards just released - 2007**



## UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE (USPAP)

- Issued by The Appraisal Standards Board of the Appraisal Foundation
- Developed in 1987 and updated annually
- Must be adhered to for appraisals involving federal regulatory agencies
- Several organizations such as the ASA and IBA have adopted
- AICPA refers to USPAP in Consulting Services Practice Aid 93-3 but has not formally adopted

# ENGAGEMENT LETTER



- Define the client
- Specify property to be appraised
- Identify the valuation “as of” date
- Determine purpose of the appraisal



## ENGAGEMENT LETTER – CONT'D

- Determine the standard of value
- Specify the work product/report
- Identify timing requirements/expectations
- Define the fee arrangement

# THE CLIENT



- **Make sure you know who you're working for – especially if litigation is involved**
- **Prospective buyer**
- **Seller**
- **Trustee**
- **Attorney**
- **Company being valued**



# PROPERTY BEING APPRAISED

- **Clearly define the entity or interest being appraised**
- **Legal name**
- **State of incorporation/organization**
- **Form of organization (S Corp, C Corp, LLC, LP, GP, Sole Proprietorship, Etc)**
- **Voting vs. Non-voting interest**

# VALUATION DATE



- The appraisal must be “as of” some specific point in time - generally referred to as the “effective” or “valuation” date
- Very important because the entity’s value will change over time (sometimes in short periods of time)



# PURPOSE OF THE APPRAISAL

- **The purpose is critical to determine:**
  - **Standard of value**
  - **Valuation approaches and methods to be used**
  - **Financial Statement adjustments to be made**

# STANDARDS OF VALUE



- The three most common standards of value:
  - Fair Market Value
  - Fair Value
  - Investment Value



# FAIR MARKET VALUE

- Generally used for all tax related valuations  
Revenue Ruling 59-60
- IRC Section 2031
  - Section 20.2031-1(b) of the Estate Tax Regs.
- IRC Section 2512
  - Section 25.2512-1 of the Gift Tax Regs.

# FAIR MARKET VALUE DEFINED



- **Fair Market Value is defined as:**
  - “the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts”



# FAIR VALUE

- Created by statute for certain specific purposes such as dissenting stockholder disputes
- Defined by the Uniform Business Corporation Act as “The value of the shares immediately before the effectuation of the corporation action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable”

# FAIR VALUE – CONT'D



- Generally considered the value of the business enterprise as a going concern to the existing shareholders
- Often used for equitable distribution of marital property
- Case law very important



## INVESTMENT VALUE

- **Investment value defined as:**
  - The value of an asset or business interest to a specific owner or prospective owner
- Consider the current or prospective owner's knowledge, abilities, potential, etc

# OWNERSHIP CHARACTERISTICS



- **Minority vs. Control**
  - **Minority interest is less than 50% of the voting interest in the enterprise**
  - **A 50% interest is neither minority or control**

**A minority interest is generally less marketable than a control interest**



## PREMISE OF A VALUE

- **Going Concern Value**
  - The value of the business enterprise as an on-going business
- **Liquidation Value**
  - **Orderly liquidation** – assumes normal exposure time in the marketplace
  - **Forced liquidation** – assumes all assets are sold as quickly as possible (auction)

# THE REPORT



- The only tangible product the client receives
- Basis for judging the quality of the valuation consultant's work



## TYPES OF REPORTS

- **Full, written reports**
  - Covers all relevant points supporting the value conclusion including detailed calculations and financial data
- **Summary letter reports**
  - Same material as full written report except it's summarized instead of fully explained
- **Oral reports**
  - Generally only used for informal engagements

## INFORMATION THAT SHOULD BE INCLUDED IN THE REPORT



- Introduction
- Economic data and analysis
- Industry information and analysis
- Financial analysis
- Valuation computations and conclusions
- Discount /premium adjustments
- Value conclusion
- Appendix



# FINANCIAL INFORMATION IN VALUATION REPORTS

- **General (unrestricted) 3<sup>rd</sup> party use**
  - Follow SSARS, SAS requirements
- **Restricted use**
  - Follow SSARS, SAS requirements, or
  - Follow SSCS requirements
- **Used only in Court of Law**
  - Follow court's requirements if applicable

# STATEMENT ON STANDARDS FOR CONSULTING SERVICES “SSCS”



- For CPA's that follow the MCS school of thought, the following paragraph should be included:
  - “The historical financial information presented (above) (at Exhibit \_ ) is included solely to assist in the development of the value conclusion presented in this report, and should not be used to obtain credit or for any other purpose. Because of the limited purpose of this presentation, it may be incomplete and contain departures from generally accepted accounting principles. We have not audited, reviewed, or compiled this presentation and express no assurance on it.”



# VALUATION APPROACHES

- **Market Approach**
  - A general way of estimating value by comparing the subject company to similar businesses or business interests that are for sale or have been sold
- **Income Approach**
  - A general way of estimating value based on the future benefits expected to be generated by the business over a period of time
- **Asset Approach**
  - A general way of estimating value based on the value of the individual assets and liabilities of a business

# MARKET APPROACH



- **Guideline Public Company Method**
- **Merger and Acquisition Method**
- **Past Transactions involving subject company**



## GUIDELINE PUBLIC COMPANY METHOD

- Produces a minority, marketable value
- Usually requires adjusting financial data to make financials as compliable as possible
- Use valuation multiples such as:
  - Price/Earnings
  - Price/EBITDA
- Generally used for larger companies

# MERGER AND ACQUISITION METHOD



- Produces a control, marketable value
- Data derived from transactions involving transfers of entire companies or major interests in companies
- Use valuation multiples such as:
  - Price/sales
  - Price/book value
- Data bases include: Pratt's Stats, BIZCOMPS, IBA Market Database



## PAST TRANSACTIONS METHOD

- **Types of transactions:**
  - Changes in control ownership
  - Changes in minority ownership
  - Prior acquisitions made by the company
- **Important to determine whether the transactions were at arm's length**

# INCOME METHODS



- **Discounted Economic Income Method**
  - Discounts expected future economic income
- **Capitalized Economic Income Method**
  - Capitalizes expected future economic income



# INCOME METHODS & KEY FACTORS

- **Definition of Income**
- **Discount/Capitalization rate**
- **Anticipated long-term growth rate**

## DEFINITION OF INCOME



- Definition of income must agree with method used
- If using Ibbotson's data to develop the discount rate, the rate is applicable to net cash flow available to the equity investor



## NET CASH FLOW TO EQUITY

- **Net cash flow available to shareholders:**
  - **Net income (after tax)**
  - **+ Non-cash charges (depr, amort)**
  - **- Capital expenditures**
  - **+/- Changes in long-term debt**
  - **+/- Working capital adjustments**

## NET CASH FLOW – CONT'D



- Normalization adjustments:
  - Accounting methods (Lifo/fifo, etc)
  - Non-operating assets
  - Non-recurring expenses
- Control Adjustments
  - Excess compensation
  - Personal expenses



## COST OF “EQUITY” CAPITAL

- The expected rate of return that the market requires in order to attract funds to a particular investment
- A function of the investment, not the investor
- Opportunity cost
- Discount rate

# DISCOUNT RATE



- **Two ways to determine a discount rate for the income approach:**
  - **Buildup Method**
  - **Capital Asset Pricing Model (CAPM)**



## BUILD-UP METHOD

- **Discount rate = Risk free rate + Equity risk premium + Size premium + Specific Company risk premium**
- **Capitalization rate = Discount rate – long-term growth rate**

# BUILD-UP METHOD EXAMPLE



- |                                |             |
|--------------------------------|-------------|
| • Risk free rate               | 5.6%        |
| • Equity risk premium          | 7.8%        |
| • Size premium                 | 2.6%        |
| • Specific Co. risk premium    | <u>4.0%</u> |
| • Total cost of equity capital | 20.0%       |




## CAPITAL ASSET PRICING MODEL

- Same as buildup method except uses beta adjusted equity risk premium
- Discount rate = Risk free rate + Beta(Equity risk premium) + Size premium + Specific Company risk premium

# LONG-TERM GROWTH RATE



- Long-term growth rate is critical in developing an appropriate discount or capitalization rate
- Used in projecting anticipated future net cash flows to be discounted
- Should be based on specific company and industry factors not just rate of inflation, etc.



## DISCOUNTED ECONOMIC INCOME METHOD

- Anticipated future cash flows must be projected for a number of years
- Discount future cash flows to present value using discount rate
- Compute terminal value
  - Determined when cash flows expected to level off in-line with the growth rate
  - Compute present value using capitalization rate

# CAPITALIZED ECONOMIC INCOME METHOD



- Used only when anticipated future cash flows are expected to be level (except for growth rate)
- Short-hand version of discounted economic income method



## ASSET BASED METHODS

- **Net Asset Value Method (NAV)**
- **Capitalized Excess Earnings Method**

# NET VALUE ASSET METHOD



- All assets and liabilities are adjusted to their current fair market values
  - Off balance sheet assets and liabilities must be valued and included
  - Usually requires independent appraisal of assets/liabilities
  - Value of equity = adjusted assets minus adjusted liabilities



## CAPITALIZED EXCESS EARNINGS METHOD

- Considered a “hybrid” method because it attempts to value both the tangible and intangible assets
- Revenue Ruling 68-609
- Normally only appropriate when no other method can be used
- Often used to value professional practices (medical group, CPA firm, law firm)

## CAPITALIZED EXCESS EARNINGS METHOD – CONT'D



- Steps in applying excess earnings method:
  - Adjust tangible assets to current value
  - Determine fair rate of return on tangible assets
  - Subtract fair return on assets from normalized earnings
  - Capitalize the “excess” using an appropriate capitalization rate
  - Add the capitalized excess earnings to the adjusted asset value
    - If valuing equity, subtract liabilities



## WEIGHING OF APPROACHES & METHODS

- Operating companies generally valued more heavily based on earning power (market and income approaches)
- Non-operating “holding” companies generally valued more heavily based on the value of underlying assets
- No set formula – depends on the facts and circumstances of each engagement

# DISCOUNTS AND PREMIUMS



- It is critical to understand what ownership characteristics are implied by each valuation method used.
- The most significant discounts and premiums relate to two basic categories of ownership – minority v. control



## MINORITY AND MARKETABILITY DISCOUNTS

- “Minority” interest discount addresses the elements of control that are or are not possessed by the owner
- “Marketability” discount addresses how readily the owner can convert the asset into cash
- If both discounts are appropriate, they are multiplicative not additive

## MINORITY AND MARKETABILITY DISCOUNTS –CONT'D



- **Example:**
  - Control value per share 100
  - Minority interest adjustment (20%) (20)
  - Marketable, minority value 80
  - Marketability adjustment (30%) (24)
  - Non-marketable, minority value 56



## MINORITY INTEREST DISCOUNT

- **Control owner has rights that minority owner does not such as:**
  - **Make management changes**
  - **Set compensation amounts**
  - **Determine policy matters**
  - **Buy and sell assets**
  - **Borrow money**
  - **Declare and pay dividends**
- **Because of these rights, control shares are generally worth more than minority shares**

# MARKETABILITY DISCOUNTS



- Refers to how easily an ownership interest can be converted into cash
- The standard for marketability is the U.S. securities market
- Minority interests are generally less marketable than majority interests



## DEVELOPING A MARKETABILITY DISCOUNT

- **Factors to consider:**
  - **Minority vs. control interest**
  - **Financial condition of the entity**
  - **History of dividend payments**
  - **Restrictive (buy/sell) agreements**
  - **Stability of earnings**
  - **Diversification of product line**

# EMPIRICAL DATA USED IN QUANTIFYING MARKETABILITY DISCOUNT



- **Restricted Stock Studies**
  - Shares of public companies that are temporarily restricted (SEC Rule 144)
- **Pre-IPO Studies**



## RESTRICTED STOCK STUDIES

- **SEC Study (1971) - 32.6% average**
- **Gelman Study (1972) - 33% mean**
- **Trout Study (1977) – 33.5% mean**
- **Maher Study (1976) – 35.4% mean**
- **Willamette Study (1984) – 31.2% mean**
- **Silber Study (1991) – 33.75% mean**

# THE INDUSTRY



- **Very important to understand the client's industry**
  - **Valuation drivers**
    - **What drives revenues**
  - **Current issues that could effect value such as:**
    - **New technologies**
    - **Changing trends**



## ECONOMIC INFORMATION

- **Federal Reserve**
  - **Monthly Bulletin**
  - **Beige Book**
- **National Economic Review**
  - **John Wiley & Sons, Inc**
- **Banks**
- **Universities**
  - **U.T. Center for Business and Economic Research**

# **SIGNIFICANT RULINGS AND CASES – REVENUE RULING 59-60**



- **Purpose – provide guidance related to the approaches, methods and factors to be considered when valuing shares of closely held companies for estate and gift tax purposes**



## **SIGNIFICANT RULINGS AND CASES – REVENUE RULING 59-60 – CONT'D**

### **•Establishes eight factors to consider:**

- 1. Nature of the business and it's history
- 2. Economic outlook (in general and industry)
- 3. Book value and financial condition
- 4. Earnings capacity
- 5. Dividend paying capacity
- 6. Whether the enterprise has goodwill
- 7. Sales of the stock and size of the block
- 8. Market value of similar public companies

# **SIGNIFICANT RULINGS AND CASES – REVENUE RULING 59- 60 – CONT'D**



- **Weighting of factors:**
  - “In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.”



## **SIGNIFICANT RULINGS AND CASES – REVENUE RULING 68-609**

- **Discusses the “formula method” for determining FMV of intangible assets**
- **Generally referred to as the “Capitalized Excess Earnings Method”**
- **Supersedes ARM 34**



# **SIGNIFICANT RULINGS AND CASES – REVENUE RULING 77-278**



- **Recognizes relevance of restricted stock studies in determining lack of marketability discounts**



## **MANDELBAUM v. COMMISSIONER**

- **Primary issue – marketability discount**
- **Developed 10 step criteria for determining a marketability discount**
- **Finding: 30% marketability discount**
- **Cite: T.C. Memo 1995-255 (June 12, 1995)**
- **Judge: Laro**

# MANDELBAUM v. COMMISSIONER – CONT'D



## Judge Laro's 10 criteria for determining marketability discount:

- 1. Value of subject v. similar public company
- 2. Analysis of subjects financials
- 3. Dividend paying capacity and history
- 4. Nature of the corporation and it's industry
- 5. Corporation's management
- 6. Degree of control transferred
- 7. Restrictions on transferability of the stock
- 8. Expected holding period
- 9. Corporation's redemption policy, and
- 10. Cost of effectuating a public offering



## ESTATE OF DAVIS v. COMMISSIONER

- **Primary issue: tax liability related to built-in capital gain property**
- **Holding: a discount (adjustment) for built-in capital gains should be taken into account even though the company has no plans to sell the property**
- **Additional marketability discount was also allowed based on other factors**
- **Cite: USTC: 9337-96 (June 30, 1998)**

# EISENBERG v. COMMISSIONER



- Another built-in capital gains case
- C corp that owned real estate
- No plans to liquidate or sell the property
- Held: hypothetical willing buyer would likely take the built-in capital gains tax liability into consideration in determining fair market value
- Cite: 98-2 USTC 60,322 (August 18, 1998)



## ESTATE OF RICHARD SIMPLOT v. COMMISSIONER

- **Primary issues:**
  - Voting premium
  - Marketability discount
  - Built-in capital gains tax liability
- **Significant facts:**
  - Decedent owned 23.55% of the voting and 2.79% of the non-voting shares (2.8% combined)
  - Large operating company
  - Owned 5,259,800 (13.36%) of Micron Technology
    - Large built-in capital gain

# ESTATE OF RICHARD SIMPLOT v. COMMISSIONER – CONT'D



- Significant findings:
  - Class A voting shares should be accorded a premium
    - Minority interest but still a “sizeable” holding
    - Voting premium computed based on pro-rata share of the value of the class as a whole
  - Built-in capital gains tax liability should be taken into account in determining fair market value
  - Marketability discount
    - 35% for the voting shares
    - 40% for the non-voting shares



## **SIMPLOT REVERSED (IN PART)**

- **Ninth Circuit reversed the voting premium part of the Tax Court's decision**
  - **Shouldn't base the premium on the entire class of shares since not valuing the entire class**
  - **Premium not appropriate unless a hypothetical purchaser would gain economic advantage**
  - **FMV based on hypothetical willing buyer – can't narrow potential buyers to the remaining shareholders**

# ESTATE OF KAUFMAN v. COMMISSIONER



- Significant facts:
  - Operating company
  - Decedent owned 21.51% of the Class A voting stock (19.86% of total outstanding)
  - Insider sale transactions prior to DOD
- Significant issues:
  - Past transactions represent FMV?
  - Appraisal methods and related report



## ESTATE OF KAUFMAN v. COMMISSIONER – CONT'D

- Findings:
  - Prior transactions in Company's stock disregarded
    - Reason – sale price was not based on an appraisal or meaningful financial review
  - Appraiser criticized for not applying all three valuation approaches and stated that:
    - Valuation experts must thoroughly analyze all applicable methods of valuation and not simply assert without sufficient explanation that they have concluded that a particular method is irrelevant.

# MORRISSEY v. COMMISSIONER



- This decision effectively reverses Kaufman
- Held that:
  - Lower court ignored arm's length sales of stock that occurred close to the valuation date without good reason
  - Actual arm's length transactions more relevant and should be accorded more weight as articulated in Rev Rul 59-60



## END RESULT

- **A good number**
  - The correct value given the circumstances
- **A good report**
  - Well written and understandable
- **Remain independent**
  - Be an advocate of your work not of the client