What's it Worth? Important Issues in Business Valuations

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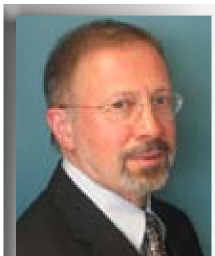
Introduction

In the popular PBS series *Antiques Roadshow*, professional antique appraisers travel to various regions answering the recurring question of curious owners, "what's it worth?" These appraisers value anything from vintage sheet music to old duck decoys to precious art. Oftentimes, their conclusions echo the adage that "one person's trash is another person's treasure." Sometimes the hope of cashing in on Aunt Betty's collection of Betty Crocker cookbooks is realized. Other times, Uncle John's vintage Victorian gas lamp is exposed as a poorly crafted knock-off.



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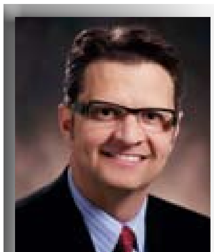

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In much the same way, parties with interests in the same business may have vastly different perceptions of the value of their interests. Attorneys often need to help their clients establish accurate values. This article discusses some of the common issues to consider in attempting todetermine business values.

Situations often requiring valuations

In the practice of law, many different situations give rise to the need to establish the value of a business. Some examples include:

- drafting or assisting with implementing buy-sell provisions in agreements between and among shareholders, partners and limited liability company members.
- business acquisitions and mergers.
- change in business ownership or control among shareholders.
- business dissolution.
- litigation matters where a measurement of economic damages is the diminution in the value of a business.
- bankruptcy matters and determining whether to keep operating a business and/or sell it, or liquidate it.
- marital dissolution proceedings.
- condemnation proceedings.
- gifting for estate planning purposes.
- establishing values of a decedent's estate.

Common terms applying to valuations

To understand the valuation process, one must first understand some of the common valuation terminology, including the following:

Approach—there are three general approaches for establishing business values. Depending on the circumstances, one of them may be used or a weighted average of more than one of them may be used:

- o the *income approach*: past or future income or cash flow streams are applied to a capitalization rate or discount rate;
- o the *market approach*: values or sales of comparable businesses, or interests in comparable businesses, are the bases for value of the subject business; and/or
- o the *asset approach* (or asset-based approach, adjusted net asset approach, and other variations on the term): a value for each balance sheet item is determined (including intangibles, which may or may not appear on the balance sheet) and then added together (assets less liabilities).

Method (or methodology) — Examples of methods include:

- o for the *income approach*: capitalization of earnings, capitalization of excess earnings (i.e., after calculating a return on assets) or discounted future earnings plus residual value;
- o for the *market approach*: use of comparable public company data and of comparable merger and acquisition data; and
- o for the *asset approach*: establishment of fair market value, replacement value or liquidation value of the assets and liabilities.

Standard of value — Examples of standard of value are *fair market value* (i.e., buyer and seller are willing parties, but are not compelled to enter into the transaction and have "reasonable knowledge of the relevant facts" (as paraphrased and quoted from IRS Revenue Ruling 59-60 and sections of the estate and gift tax regulations)), *fair value* (which may have different meanings, depending on the jurisdiction or the parties involved), *intrinsic value* (usually means value to the holder), *investment value* (the value to a particular investor or a strategic buyer), *forced liquidation value*, or *voluntary (or orderly) liquidation value*.

Premise of value — There is some overlap in the meaning of this term with the term standard of value, but premise of value essentially refers to whether the entity is valued on a going concern basis or a liquidation basis.

Capitalization and discount rates — These rates are used under the income approach and may be determined by various means (a comprehensive discussion about these rates is beyond the scope of this article).

A *capitalization rate (or "cap rate")* is applied to an earnings figure that is expected or is most likely to occur, i.e., a projected earnings amount for the following year that is indicative of the earnings for all future years. Depending on the circumstances, this projected earnings figure may be based on the average or weighted average of prior years' net income, pre-tax income, EBIT, EBITDA, cash flows or some other measurement of earnings. Of course, the historical data needs to be adjusted for any anomalies or anything else that is not recurring or representative of future events.

A *discount rate* is applied to the stream of future earnings for a specified number of years and the sum of the present value of each year's discounted earnings is then added to the value of the business as of the end of the last year specified (i.e., terminal value). This terminal value is normally determined by applying a capitalization rate to the earnings in the final year and then discounting this capitalized earnings amount to present value.

A *discount rate* applied to a stream of future earnings inherently includes a growth rate and thus is higher than a capitalization rate applied to a projected earnings amount (unless there is negative growth, in which case the discount rate would be lower than the capitalization rate).

- **lack of marketability (or non-marketability) discount**— the extent of the discount principally depends on the time it may take for the business or, more commonly, the business interest to become liquid to the seller, i.e., when cash from the sale is received.
- **lack of control discount**—applied when the ownership interest in the business is fifty percent or less. When a business interest being valued is less than one-hundred percent but fifty percent or greater, however, a discount may still be appropriate by virtue of having less than complete control. The lack of

control or non-controlling interest discount is applied to the owner's pro rata portion of the total value of the entity. The amount of the discount is based on limitations associated with the business interest as a result of agreements, statutes, practicalities or other factors. This discount is applied before the marketability discount is applied, i.e., as if the minority interest is completely liquid.

- **control premium**—this premium is generally applicable when an interest in a business being valued is or will become one of control or partial control (unless, as is sometimes the case, the value of the business is based on financial data that was already adjusted as if there had been a controlling interest).

In the process of determining how the above terms (and possibly others not mentioned here) might apply in a situation, the valuator needs to gather extensive information on the business or entity (both quantitative and qualitative), the industry in which it operates, and economic conditions and other items that impact the value. This kind of information, along with knowledge regarding the purpose(s) of the valuation and the parties involved, is assessed and analyzed in deciding the application of the various factors for determining value.

Sometimes the valuator is unable to obtain all necessary information to arrive at a conclusion of value due to unavailability or other limitations on the scope of the valuation work performed. In such instances, the parties may accept (or must accept under the circumstances) something less than a conclusion of value, as long as the valuator is comfortable providing a qualified valuation based on the information obtained. In this regard, among the various organizations that establish reporting standards and terminology for credentialed valuators, some differences exist in the way limited scope situations should be treated. However, for the most part these organizations have established very similar principles and practices for valuation engagements and the valuation process. The applicable standards may preclude the valuator from issuing any type of report if sufficient documentation and other information is not obtainable.

The valuator needs to consider whether certain adjustments should be made to the financial statements so that they are stated on a basis equivalent to that of the comparable companies.

The term "appraisal" as used in referring to the appraisal of business interests or other assets is often used interchangeably with the term "valuation." In some circles there are subtle differences between the terms, but for all intents and purposes they are synonymous, as are "appraiser" and "valuator."

Examples of valuation scenarios

The following illustrate how the purpose of the valuation and intention of the parties have an effect on which of the above terms that may apply apply:

Sales/transfers of entire businesses

A threshold question is whether the net assets or the capital stock (in the case of a corporation) or another form of equity holding in the entity, is being sold. Besides the assumption of actual liabilities in one instance and not in the other having a direct effect on value, there are other items impacting the value relating to a potential sale of a business. These include: (1) the existence of contingent liabilities and possible unknown liabilities at the time of consummation (usually more so in stock sales, but will depend on indemnifications and the ability to enforce them); (2) the presence of simultaneous agreements, such as consulting contracts for management personnel retained after the sale, provisions for non-competition, and licensing arrangements; (3) if a company is a corporation, whether it is a C or S corporation and the affect of distributions to stockholders; (4) whether the entity or the owners are subject to income taxes on earnings (e.g., determined by whether the company is a C corporation or an S corporation, or a partnership or a limited liability company); and (5) sales tax and other transfer taxes that may be imposed.

Another issue to consider when establishing a value for a potential sale of a business is that often the buyer and seller and other parties involved may have presupposed that the sales/purchase price is to be based on fair market value or on some other standard of value. The term "fair market value" may suggest something different to the buyer than to the seller. Therefore, he party or parties for whom the valuation is performed must be clear on the standard of value that is to be applied.

The generally accepted definition of fair market value ("FMV") is a hypothetical value arrived at when the buyer and seller are willing parties, but are not compelled to enter into the transaction and have "reasonable knowledge of the relevant facts."[1] In reality, there are numerous possible scenarios to a sale. Examples include: a buyer looking for a strategic purchase and/or a seller looking for such a buyer who will pay a premium; the seller may be eager or forced to sell for some reason; the buyer may want to be very active in the business and have it as a means to provide a steady income in the form of compensation; or the buyer may want to be only a passive investor and is willing accept a steady, but small rate of return.

Generally, when valuing a business for purposes of sale, the standard of value will be either FMV or investment value. FMV may be used, for example, when the seller has no particular preference as to a buyer and is not compelled to sell; an agreement calls for FMV; a FMV is necessary only as a starting point for negotiations (e.g., there may be compelling reasons to sell, the buyer might want to be active and might be looking for security); or the sale is to a related party, as the Internal Revenue Service requires FMV for income tax purposes (as well as for gift tax and estate tax reporting purposes). Investment value will normally be used when there is a possible synergistic buy/sell (although FMV could be a starting point) or when an investor is looking for a particular rate of return.

The approach used when the standard is FMV will depend mainly on the purpose of the valuation and available data. Usually, the market approach is a primary consideration and should be used, at least as one of the approaches, but only if sufficient information about sales and/or values for comparable companies are available. For certain personal service businesses, and especially professional practices such as law, accounting and smaller medical practices, the market approach may not be a good indicator of value due to the shortage of sufficient market data. The market approach, however, may not always be practicable for other privately held businesses. The number of companies similar to the business being valued might be insufficient so that producing a meaningful comparison is not possible, or because important quantitative data about the companies are incomplete and/or information about relevant qualitative factors is lacking.

Generally, for privately held businesses, if the market approach can be used, it will usually be done in conjunction with the income approach. The two approaches will be weighted (not necessarily equally) in arriving at a value. Even if comparable market data is relatively scarce, the market approach should be considered and, if at all possible, be given some weight or at least be used as a "sanity check" against the results arrived at in using the income approach. The asset approach may be used in conjunction with either or both the market and income approaches. The asset approach is usually the sole approach in situations such as when a business has a history of losses, or in the event of liquidation or in other piecemeal valuation situations. This is because the value of the net assets of the business will normally realize a greater fair market price than will the income stream (if any) of the business as a going concern.

As for the method applied, this first depends on the approach that is used, as each approach has its own distinct available methods. For the income approach, the method will be determined based on the type of business being valued (e.g., service, manufacturing), its financial history, and various other influences. For the market approach, the data that is best available and most relevant is what should determine the method.

When valuing a start-up business or one whose major asset(s) is intellectual property, the method and other factors need to be considered very carefully. The valuator might find other businesses or similar types of intellectual property with historical data and having some characteristics similar to those expected of the subject business, and/or might find justification for using an estimated future income stream for the subject business as a basis for the valuation. In most cases, however, the uncertainties are greater with start-ups and with untested intellectual properties than with an established business or income stream. Accordingly, forecasts of expected income and other factors will often need to be used as bases in arriving at a value in these types of businesses.

Transfers of a partial interests in businesses

When a partial interest in a business is valued, such as for the purpose of a potential sale, gifting or estate tax reporting, lack of control and marketability discounts will normally be applied to the holder's portion (percentage) of the full value of the entire business. Since a non-controlling interest holder is usually at the mercy of those in control, however, applying a lack of control discount to the value of this interest when it is based on expected cash flows , will normally be redundant and thus not indicated. The purpose of the valuation will determine whether the method of applying a capitalization/discount rate to the expected cash flows attributable to the non-controlling interest should be used; whether the value of the entire business should be determined, and then a lack of control discount applied to the percentage interest in the business; or whether some other method is most appropriate. Another method, under the market approach, may be applied if there have been recent minority interest (or lack of control) transactions similar to the subject interest. Values determined in similar transactions may be used as the guideline.

In certain situations, there may be two or more tiers of lack of control discounts. Such situations are frequently seen in the gifting of partial interests in family limited partnerships or limited liability companies. An entity itself may own non-controlling interests in assets, which are discounted, and then the interest in the entity (with the value of its assets having been discounted) is further discounted for the fact that it is a non-controlling interest. Presently, there are campaigns in Congress and the current administration to do away with such discounts for gift tax purposes.

For lack of marketability discounts, and in many cases for lack of control discounts, there are various studies and other data that should be referred to and properly applied based on the specific set of circumstances of the partial interest being valued. Too often "rules-of-thumb" or data that are not complete are used or misapplied. A thorough analysis of all relevant information must be performed for arriving at appropriate and supportable discounts. In gift tax, estate tax and other tax cases, the tax courts and appellate courts in recent years have scrutinized discounts more closely and demand that discounts are based on objective criteria.

Business disputes and litigation

In adversarial situations, there is often difficulty in obtaining all the information necessary to arrive at or opine to a value. When these conditions exist, there may be enough basic information so as to estimate a value, or make assumptions under different likely scenarios that lead to a range of values.

Frequently, the nature of the dispute or litigation will determine the standard of value and other applicable factors. In an action involving a damaged or dissenting shareholder, for example, each side may have different views on what should be the appropriate standard of value, approach, method, capitalization/discount rate, and so forth. If the action is brought under the statute of a state dealing with dissenting shareholder matters, the standard of value required is usually "fair value". The term "fair value" has different meaning among jurisdictions. Thus the valuator must have a clear understanding of how "fair value" is to be applied. Idaho Code Section 30-1-1301(4) defines fair value in this context as follows:

> (4) "Fair value" means the value of the corporation's shares determined:
>
> > (a) Immediately before the effectuation of the corporate action to which the shareholder objects:
> > (b) Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
> > (c) without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to section 30-1-1302(1)(e), Idaho Code.

The term "value" is not directly defined, but rather is to be "determined" using "customary and current valuation concepts and techniques…". The Official Comment to Section 30-1-1301 states, in part, "Subsection (b) adopts the accepted view that different transactions and different contexts may warrant different valuation methodologies."[2] The statute gives deference to the idea that valuation methods may indeed evolve, consistent with business climates and evolving economic conditions.

Diminution in value may be another way to quantify economic damages from the loss of a company or a substantial reduction in the level of its business. Diminution in value is measured from the date immediately preceding the occurrence of the event to some specified date afterwards. FMV is usually used for both valuation dates. Clearly, this is only one way to measure the loss and, in many cases, not the preferable way. Arguably, a different standard of value (and other factors) might be considered more appropriate in the circumstances. For example, if an individual owns a business that generated a relatively constant rate of return for many years, after he draws a "reasonable" salary, then the loss of the business to him might be based on what the business is worth to him (e.g., investment value), which is a steady rate of earnings using a low-risk capitalization rate. The security of his receiving the consistent compensation from the business, his age and the likelihood of obtaining similar work elsewhere are some factors that may be used to assess damages in addition to the loss of the business.

When to "normalize" financial statements

As part of the process of performing a valuation for a business on a going concern basis, the earnings and other components of the financial statements are used as the basis for determining value. With the income approach, a capitalization/discount rate is applied to earnings, and such rate is derived, in part, by comparing elements of the financial statements and various financial ratios to corresponding data of other, comparable companies. With the market approach, the values and/or sales prices of comparable companies are used as the basis for the subject company's value. Usually, information on comparable companies is obtained from various sources that compile financial data by industry, SIC code, NAICS code or some other meaningful categorization.

Some elements of the financial statements and other financial data of the subject business may not be considered "normal", i.e., not equivalent to the corresponding financial information of comparable companies. The valuator needs to consider whether certain adjustments should be made to the financial statements so that they are stated on a basis equivalent to that of the comparable companies. Examples of the types of items that may warrant adjustment are owner salaries and perquisites. Other such adjustments are usually more prevalent when the form of earnings used as a factor in determining value is something other than cash flows. In these situations (which can be under the income approach, and are most certainly under the market approach as discussed earlier), the adjustments are usually made for conforming the financial statement reporting to generally accepted accounting principles, or to account for unusual or nonrecurring transactions or events.

There are circumstances where adjustments are not made, even though necessary to properly "normalize" the financial statements. For example, an adjustment will not be made for compensation where a minority interest is transferred, with the minority interest holder (and particularly the transferee) having a lack of control. Some other circumstances where adjustments, or certain adjustments, are not or might not be appropriate include when the standard of value is investment value, the approach is the asset approach, or when the purpose for the valuation is for litigation, property settlement in a marital dissolution, or bankruptcy.

When determining the applicability of certain normalizing adjustments, particularly for owner salaries and perquisites, the valuator needs to consider the implications of reducing the expenses for these items vis-à-vis absentee owners or the Internal Revenue Service. Parties who may gain access to the valuation documentation may draw inferences that the expenses actually incurred were excessive. Of course, the fact that certain expenses were reduced for the purpose of preparing a valuation does not automatically mean that owner compensation or other expenses were excessive. Also, inferences should not be drawn that the adjustments for reducing expenses were made to increase earnings and thus (artificially) augment the value.

There are many valid reasons for expenses to be normalized for valuation purposes. For example, in the case where actual owner compensation has been reduced for the normalized financial statements, the owner: (i) may have been performing various functions for many years and to replace him with other, newly hired personnel will cost less; (ii) may have special skills or personal customer relationships and, if there were a sale, will be retained on a consulting basis at a much reduced compensation amount, which, when added to a replacement's compensation, will be less than the owner's current compensation; or (iii) may have taken insufficient compensation in prior years to preserve the company's working capital and thus his compensation in recent years included the shortfall. The parties involved in the valuation need to make certain they not only allow for the appropriate normalization adjustments, but also can support them.

Effectively using a business valuation expert

If an independent business valuation expert is called upon to assist in establishing a value and/or opine on a value, the expert must have access to all relevant information to determine which factors apply in the particular situation. The attorney and client need to allow and encourage open communication among themselves and the valuator. Too often the intentions of the parties are not apparent, understood or properly articulated, and the facts and circumstances surrounding the true purpose of the valuation are not adequately disclosed. Also, the valuator should know the identities of all the parties affected by the valuation. Certainly, the valuator has a responsibility to seek all information necessary to do a thorough job, but all other parties involved have to be willing to collaborate in the effort of providing whatever information they and the valuator may deem pertinent.

Conclusion

Much like the valuations given by the appraisers in *Antiques Roadshow*, a business valuation is only as accurate and useful as the information upon which the value is based. The antiques appraiser examines items carefully and often brings years of experience and specific research to determine an accurate value. Likewise, understanding not only the common terminology in business valuations, but also the applicability of the various valuation methodologies will help you, your clients and valuators determine accurate and useful business values that can withstand potential challenges.

About the Authors

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Endnotes

[1] (Paraphrased and quoted from IRS Revenue Ruling 59-60 and sections of the estate and gift tax regulations.)
[2] I.C. § 30-1-1301 Official Comment.