Introduction to Business Valuation Concepts for Attorneys

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How To Facilitate the Study of a New Field

In gaining understanding of any new field, it is very helpful to first identify its *prime postulate*. Once known, the postulate becomes the stable orientation point around which subsequent information and inevitable complexities can be aligned and understood. For example, Chinese general Sun Tzu wrote in 500 B.C., “All warfare is based on deception.”[1] This provided the student of warfare with a reference point to orient further study. Similarly, once the prime postulate is known for business valuation, all subordinate concepts can align to it, allowing a consistency, structure and order to further study, research and application.

The Significance of Revenue Ruling 59-60

One of the earliest expositions on business valuation was published in 1959 by the Internal Revenue Service in Revenue Ruling 59-60.[2] Today, over 50 years later, it continues to offer refreshing clarity to business appraisers. Perhaps the most frequently quoted section lists the eight factors which must be considered in a full valuation report. These eight factors are central to the valuation process:

(a) The nature of the business and the history of the enterprise from its inception.
(b) The economic outlook in general and the condition and outlook of the specific industry in particular.
(c) The book value of the stock and financial condition of the business.
(d) The earning capacity of the company.
(e) The dividend-paying capacity.
(f) Whether or not the enterprise has goodwill or other intangible value.
(g) Sales of the stock and the size of the block of stock to be valued.
(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.[3]

Attorneys should consider this the first reference on business valuation they read.

The Fundamental Postulate of Business Valuation

It is from Rev. Rul. 59-60 that a workable fundamental postulate emerges:

- Valuation is, in essence, a prophesy as to the future,[4] thus
- For an operating going concern, value is based upon the risk-adjusted net present value of the expected future benefit stream.[5]

Indeed, discounts, premiums and further calculations, assumptions and limiting conditions must be considered in arriving at the value conclusion.   However, the basis of business valuation is conceptually grounded on the above postulate.

Many family law courts have historically been reluctant to fully embrace the fundamental concept of business valuation as a "future prophesy," which is central to generally accepted valuation theory and methodology, but which also conflicts with the expectation that valuation of marital assets should be free from "speculation."

Moreover, the generally-accepted assumption that the business will change hands is often not the case in marital dissolutions. Often the "in-spouse" is expected to retain and continue operating the business after the split up rather than selling the business to a third party purchaser. This determination affects, among other things, whether a discount for lack of marketability is appropriate.

Additionally, there may be more complexities arising where the community owns a portion of a business, with either a controlling interest or a minority, non-controlling interest. The degree of control affects value through the imposition of valuation discounts and premiums. Partial interests in a business should be valued based on the requirements of the court.

Although some courts have shown some enlightenment on the "future prophesy" issue, it has neither been fully nor broadly resolved. Valuators who specialize the family law business appraisals have learned how to navigate this issue diplomatically and discretely. Some valuators have gradually introduced more accepted valuation fundamentals and some family courts have accepted these more theoretically-grounded appraisals. Each jurisdiction has it's own interpretation and guidelines, which should be clearly understood before presenting a line of reasoning that may be troublesome for the court to accept and may invite the possibility of a malpractice suit.

Principles of Valuation

The foundation of business valuation theory is governed by three fundamental principles:

1. Principle of Alternatives - Each party to the transaction has alternatives to fulfilling the transaction, for what price and with whom.[6]

2. Principle of Substitution - Substitution acknowledges how parties to a transaction will behave regarding alternative choices among comparable properties when prices vary. A prudent investor will not pay more for one investment than another equally desirable substitute. Derived from investment theory, an investor will choose the higher return between two choices of equivalent risk.[7]

3. Principle of Future Benefits - Valuation is based on the future outlook of the business in the form of capital appreciation or dividends, or both, all distributed in the

form of cash flow. Investors do not buy historical earnings, but history is relevant in assessing achievability of projections and assessing the risk associated with realizing future economic benefits.[8]

How the Body of Knowledge Is Organized

Valuation methodology is organized into a hierarchy of three basic levels:

1. Approaches,
2. Methods, and
3. Procedures.

Three Valuation Approaches

The Approach defines the general course of action in which an indication of value is to be developed. There are three Approaches: Asset (or Cost), Income and Market. All three must be considered to conform to the guidelines of Rev. Rul 59-60. An inappropriate Approach may be rejected if justified by the appraiser.

All three approaches are dependent upon one another. The diagram in Figure 1 illustrates their interdependence. For example, a method under the Income Approach is dependent on the market to develop its discount and capitalization rates. A method under the Asset Approach capitalizes excess income which depends on the market for capitalization rates. Certain methods under the Market Approach must consider revenue and income variables to calibrate its guideline companies for appropriate comparison purposes.

For operating businesses, Rev. Rul. 59-60 suggests the Income Approach is most appropriate. For holding companies or start-ups, where assets are the basis of value, Rev. Rul. 59-60 suggests the Asset Approach.[9] There are no hard and fast rules in business valuation like those that provide guidance and comfort in public accounting. Indeed, Rev. Rul. 59-60 says,

> A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate influence.[10]

Valuation Methods

Under the Approaches, each has their Methods for computing a value indication. A Method is a way an Approach can be implemented. The use of all Methods within an Approach is not required, but in some cases, appraisers many choose multiple Methods for deriving indications of value, then synthesize these indications into a conclusion of value.

Valuation Procedures

A Procedure is a technique implementing a Method. The choice of the Method and Procedure is based on the application of the appropriate theory and methodology and the judgment of the appraiser given the facts and circumstances of each case.

Valuation Premises

Overlaid amongst the Approaches and Methods is the concept of Premise, which is defined as "an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation.[11] The Premise, along with other variables, determines the procedures used to calculate the value.

Many valuation authorities recognize three common Premises:

1. Value as a going concern,
2. Value as an orderly disposition,
3. Value as a forced liquidation.[12]

However, another authority recognizes a less common Premise:

4. Value as an Assemblage of Assets. This is used primarily when operations have not commenced, and a premise of going concern, disposition or liquidation is not an appropriate premise of value.[13]

The Premise becomes especially significant when the Income and Market Approaches yield little or no value when the company historically has weak profits or continued expected losses. Then, the presumption of a going concern Premise is tested against a liquidation Premise which may yield a higher calculation of value. If both premises yield a negative value, then the appraiser must look to the possibility that the company has little or no value.

By the way, this nuance introduces another implicit assumption in business valuation:

the concept of the highest value and best use, borrowed from a well established principle in real property appraisals. This concept is included in the professional appraisal standards of leading appraisal organizations.[14] Thus, it is wise for the appraiser to refrain from stipulating the valuation premise before commencing the valuation engagement.

**Figure 2 (below) shows the basic organization of valuation methodology. Procedures are not included to avoid over complicating the diagram.

The Capitalization of Excess Earnings Method is a hybrid of the Income and Asset Approaches. Some authorities assign this Method to the Asset Approach, while others assign it to the Income Approach. Valuation is an integrated discipline. Most Methods rely on the interaction of more than one Approach.

Some Methods are mutually exclusive to others. For example, within the Income Approach, the appraiser may select the Capitalization of a Single Period Method, or the Discounted (Multi-Period) Cash Flow Method. There are guidelines as to which is appropriate. However, it would be a gross technical error to use both of these Methods within the Income Approach.

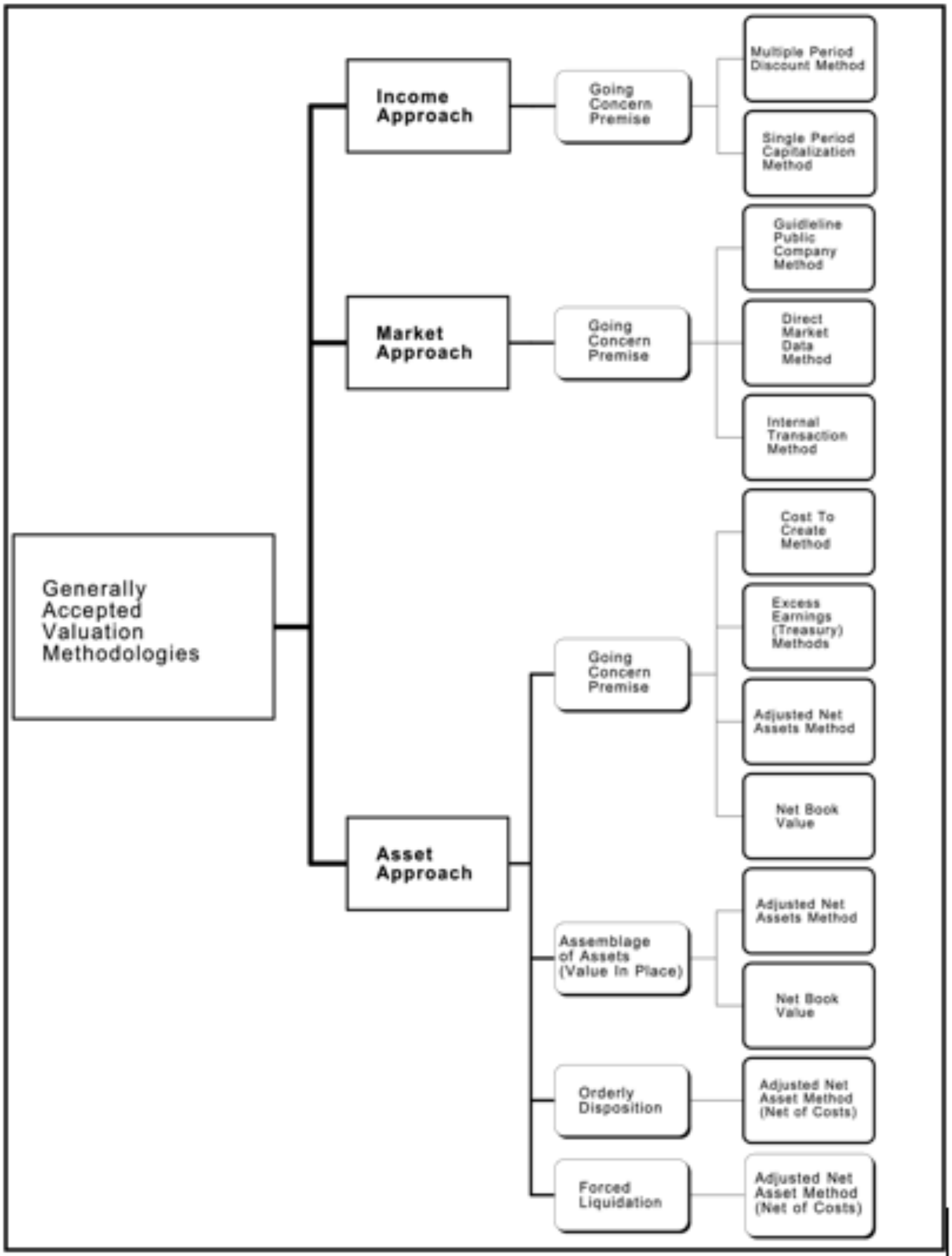
Standard of Value

The same asset can have different values to different investors. This variable is addressed by defining the value attributes. The definition (or standard) of value answers the question, “Value to whom?” A competitor, a spouse, a disinterested investor?

The most common standards of value are:

- Fair Market Value
- Investment Value
- Intrinsic Value
- Fair Value

Choosing the standard of value has a significant impact on the value conclusion, as each will require different procedures, yielding different value indications, all based on the same set of facts. Using the wrong definition of value would likely result in the wrong value conclusion. The standard of value should not be determined by the appraiser and should be disclosed as such in the engagement letter.


Generally Accepted Valuation Methodologies
Income Approach
Going Concern Premise
Multiple Period Discount Method
Single Period Capitalization Method
Market Approach
Going Concern Premise
Guidleline Public Company Method
Direct Market Data Method
Internal Transaction Method
Asset Approach
Going Concern Premise
Cost To Create Method
Excess Earnings (Treasury) Methods
Adjusted Net Assets Method
Net Book Value
Assemblage of Assets (Value In Place)
Adjusted Net Assets Method
Net Book Value
Orderly Disposition
Adjusted Net Asset Method (Net of Costs)
Forced Liquidation
Adjusted Net Asset Method (Net of Costs)

Fair Market Value

Most common standard of value is Fair Market Value. The most commonly cited authoritative definition is:

> ... the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.[15]

Investment Value

Investment value is "the value to a particular investor based on individual investment requirements and expectations."[16] For example, if an independent neighborhood nursery would sell to anyone, the buyer is hypothetical and fair market value would be the most appropriate standard of value. Conversely, if the nursery sells to a national chain which wishes to enter the local market, certain special benefits through expectations of synergy inure to the national chain, thus increasing the value to the chain over the value to an independent buyer.

Intrinsic Value

Intrinsic value, involves a rigorous analysis of the company's "fundamentals," typically in the context of security analysis in determining the theoretical value of an equity without consideration of a hypothetical or specific investor. Thus, if a stock's market value is below an analyst's conclusion of intrinsic value, the stock would be considered a "buy." Conversely, the stock would be a "sell."[17]

Fair Value

The fair value standard has multiple meanings depending on the context and the jurisdiction involved. For example, in an accounting context, the standard is defined by FASB 141 as:

> The fair value of an asset (or liability) is the amount at which that asset (or liability) could be bought (or incurred) or sold (settled) in a current transaction between willing parties, that is, other than a forced or liquidation sale. [18]

In a marital dissolution context, the standard is usually defined by each jurisdiction, usually ignoring marketability or minority interest discounts. In other cases, fair value is defined nearly identically to fair market value. Thus, fair value must be carefully understood by the appraiser in the context and purpose with which the valuation assignment is concerned.

A Subtle But Common Error in Using Fair Market Value

As harmless as it may seem, fair market value is riddled with subtle but critical implications. For example, the implications of a hypothetical buyer and seller are lost in some appraisal reports for valuing a small business in contemplation of sale. As a practical matter, it is unlikely that the owner will sell a small business to anyone but a buyer who is familiar with its operation, thus violating the hypothetical nature of the participants which the Fair Market Value standard requires.

Nonetheless, about 40% of demonstration reports for small business valuations submitted to a credentialing organization's quality review committee ignored this nuance. Thus, the value conclusion was understated because these appraisers used the inappropriate *fair market value* standard.[19] The more appropriate standard for a small business, especially a labor intensive "main street" business in contemplation of a sale would be *investment value*, where neither the seller nor buyer is hypothetical. Depending on the synergies involved, the value conclusion using *investment value* can be as much as 20% higher than using *fair market value*.

The Valuation Date

The valuation date is the "specific point in time as of which the valuator's opinion applies (also referred to as the 'Effective Date' or 'Appraisal Date')."[20] The valuation date for business appraisal has significant implications beyond the concept used in public accounting. For example, for audited or reviewed financial statements, accounting standards require significant subsequent events to be disclosed, while valuation methodology generally requires these events to be ignored.

Numerous cases of valuation disasters surround the issue of valuation date, both because understandings were not documented in engagement letters, or because misunderstandings were discovered during litigation. Entire cases are lost on the inadmissibility of the expert's appraisal report because of erroneous valuation dates. Do not accept the notion that valuation dates are "close enough for government work."

Eligibility of Data

One subtle factor sometimes gets overlooked regarding the valuation date and the hypothetical investor. Remember, Rev. Rul. 59-60 endows the hypothetical investor with the presumption of prudence in performing reasonable due diligence. The appraiser, attempting to reconstruct this hypothetical transaction, simulates the probable actions of the investor by a similar degree of due diligence.

Further, the reconstruction of the hypothetical event cannot consider subsequent events which are not reasonably foreseeable by the investor *at the valuation date*. Thus, when conducting economic and industry research or using comparative industry financial data, the appraiser must be certain that the data is not published after the valuation date, lest it be disqualified as ineligible for use in the valuation analysis under the hypothetical buyer standard of Rev. Rul. 59-60.

For example, if the valuation date is December 31st, the appraiser may be tempted to use 4th quarter economic information for assessing economic conditions. However, the 4th quarter economic reports are not usually published before the following April. Thus, if the appraiser matches the December 31st valuation date with the 4th quarter economic research, it would be ineligible for inclusion in the report. Perhaps the most current economic data available at the valuation date would be the 3rd quarter, perhaps published in late December, which would be eligible at the valuation date, December 31st.

Controversy continues over the validity of using the December 31st financial statements based on the same line of reasoning. However, protagonists for ineligibility offer two justifications: the financial statement data could have reasonably been made available by December 31st, as most of the transactions could have been accessible in rough form, and the general idea is to avoid a "slippery slope," where the possibility of subsequent information would enter into the analysis by gradual increments. This is still a controversial area, but the basic limitations should be followed when possible. The general standard on eligibility of data is whether the information "would have been known on the valuation date by a reasonably informed person."[21]

The Valuation Purpose

The Purpose of the valuation is clearly another variable which sets the direction and defines many of the processes which will be used to perform the appraisal. The same subject company with the same valuation date will be valued differently depending on the Purpose.

For example, if the Purpose is to value a non-marketable minority interest for estate tax purposes, the valuation procedures are specific to that Purpose, yielding a specific result. Then, there are regulatory requirements which influence the valuation process. The valuation of ESOPs are generally more involved because of additional requirements imposed by the Department of Labor.

Because the purpose has a dominant impact on the valuation process and the valuation result, a single valuation cannot serve more than one Purpose.

Recasting the Financial Statements

Though rarely done in public accounting, recasting the historical financials are almost always done in business valuation. Firstly, if the historical financials are prepared on the Cash, Income Tax or Other Comprehensive Basis of Accounting (OCBOA), they must first be recast to Generally Accepted Accounting Principles (GAAP), tax adjusted, using the corporation's effective tax rate.[22] This process would include adjustments such as recognizing inventory, accounts receivable, prepaid expenses, accounts payable, accrued salaries, pension plan obligations, unearned income among other possibilities, depending on the nature of the business and the condition of the books. These adjustments are made to reflect the effect of income taxes, as additional expenses would be tax deductible while additional income would be taxable.

Next, as is almost always appropriate, the GAAP-adjusted historical trend income statements are adjusted for excess, discretionary, non-operating, personal, non-recurring or understated expenses. This process is called "normalizing" the financials. The normalization adjustments are tax-adjusted as were the GAAP adjustments. Then the balance sheet at the valuation date is normalized for excess, deficient, non-operating or unrecorded assets and liabilities, both tangible and intangible. Working capital is assessed for adequacy, either using industry comparative studies or using the "Bardahl" formula, which is sanctioned by the IRS for use in determining appropriate working capital levels for purposes of excess earnings tax issues.

If the equity interest being valued is a controlling interest and has the legal authority to hypothetically implement the adjustments, then normalization adjustments are appropriate. In some cases, a minority interest may have the authority to impose limited changes, such as in a suppressed stockholder action. Only those normalization adjustments which are legally possible should be included in the appraiser's analysis. The result is a normalized controlling interest net income stream. Care must be taken to avoid double counting the controlling interest characteristic by mismatching the capitalization rate or later applying a control premium, for example.

It is from these normalized financial statements that the projections are used for converting the normalized net income into net cash flow, after which the result is either capitalized in the single period method or discounted in a multi-period method under the Income Approach. It would be a gross technical error to ignore the normalization process entirely.[23]

Connectivity in the Assessment of Risk

If the basic procedures have been properly followed, the math checked, the calculations checked for having matched the appropriate variables, still another common weakness in many appraisal reports is the poor support for the risk-affected judgmental decisions by the research performed by the appraiser. The author refers to the support factor as "connectivity."

For example, once the economic studies have been performed, Does that section of the report conclude in a risk assessment for the subject company? Once the industry research has been performed, Does the appraiser conclude in an assessment of the risk the industry imposes on the subject company? After the appraiser drudges through pages of analysis on the financial statements, shows comparative trends and exhaustive comparisons of ratio analysis, Does the report conclude in an assessment of these findings as to risk of the company and a basis for projecting growth in the cash flow stream?

Much analysis and careful research are usually present in many reports, but sometimes these sections appear to be cut and paste exercises, either from internet research sources, “canned” analyses prepared by appraisal organizations or sections endlessly copied from appraiser’s previous valuation reports. Connectivity provides the support required to render the valuation conclusion credible, step by step, along the entire path of sequential “decision gates,” through which the valuation process passes.

Conclusion

Attorneys should not be dismayed by the seeming lack of precision in the appraisal profession. It is not a science of sums-certain as is the accounting profession. After all, the value conclusion depends on the judgment of the appraiser in the selection of key variables along an unbroken supportable line of reasoning, finally arriving at the destination of an estimate of value. The process is tempered by common sense and guided by a convergence of a body of generally accepted valuation methodology and theory. Even Rev. Rul. 59-60 acknowledges that the appraiser “...should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science.”[24]

Thus, the field is both art and science, dynamically invoking its presence with other professional financial disciplines. Savvy attorneys are informing their clients about the demise of the “Rule of Thumb” mentality, the dangers of substandard internet valuation mills, and the emergence of the professional appraisal community. The author’s purpose for this article is to provide a better understanding of the valuation process, the variables and judgments involved in determining business value, and a general guideline for attorneys to calibrate the quality of valuation reports as an expansion of their role to the clients they serve.

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Endnotes

[1] Sun Tzu, The Art of War, Translated by Samuel B. Griffith (Oxford, Oxford University Press, 1963) 41

[2]Internal Revenue Service, Revenue Ruling 59-60, 1959-1 C.B. 237

[3] Revenue Ruling 59-60, Sec. 4. Factors to Consider, paragraph .01

[4] Revenue Ruling 59-60, Sec. 3. Approach to Valuation, paragraph .03

[5] Revenue Ruling 59-60, Sec. 5. Weight to Be Accorded Various Factors, paragraph (a)

[6]Gary R.Trugman, Understanding Business Valuation, 2nd Ed. (New York: American Institute of Certified Public Accountants, 2002) 55.

[7]Trugman, 56.

[8]Trugman, 56.

[9]Revenue Ruling 59-60, Sec. 5. Weight to Be Accorded Various Factors, paragraph (a)

[10]Revenue Ruling 59-60, Sec. 3. Approach to Valuation, paragraph .01

[11]International Glossary of Business Valuation Terms (American Institute of Certified Public Accountants, et al, 2001)

[12]James R. Hitchner, Financial Valuation Application and Models (Wiley, 2003) 6.

[13]Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, Valuing a Business, Fourth Edition (New York: McGraw-Hill, 2000) 33.

[14]The Institute of Business Appraisers, Inc., Business Appraisal Standards, §5.3(j)(ix)

[15]Revenue Ruling 59-60, Sec. 2. Background and Definitions, paragraph .02

[16]International Glossary of Business Valuation Terms

[17]Pratt, 31.

[18]Hitchner, 755.

[19]Rand M. Curtis, CBA, ASA, "Improving Your Appraisal Reports Some Constructive Suggestions," Business Appraisal Practice (The Institute of Business Appraisers, Inc., Premiere Issue Winter 1999) 42.

[20]International Glossary of Business Valuation Terms

[21]The Institute of Business Appraisers, Inc., Business Appraisal Standards, §1.20

[22] The valuation community is generally divided on this controversial issue, especially in light of the *Gross* decision (*Walter L. Gross, Jr. et us., et al. v. Commissioner*, T.C. Memo 1999-254 (July 29, 1999)).

[23]The author has seen instances where the normalization process has been incorrectly substituted by valuation "mill" operators as the weighted average income of the prior three years, calling this process "normalization."

[24]Revenue Ruling 59-60, Sec. 3. Approach to Valuation, paragraph .01