Attorney
CLE Series

The Cost/Asset Approach to Business Valuation

UNDERSTANDING THE APPROACH AND REVIEWING EXPERT REPORTS

June 23, 2011

Presented by the Business Valuation Services Group

GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

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Bob brings extensive experience in tax and valuation issues that affect privately held businesses and their owners. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth.

As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena. His expertise in specific purpose valuations is well known, and he is a frequent speaker, regionally and nationally, on tax and valuation matters.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

Bob has written numerous articles for several area business publications and professional trade journals. He is a national instructor for both the American Institute of Certified Public Accountants and the National Association of Certified Valuators and Analysts and has served as an adjunct professor for Duquesne University's MBA program.

A member of the American and Pennsylvania Institutes of Certified Public Accountants, Bob previously chaired the Pittsburgh Committee on Taxation. He is also the past chair of the Education Board of the National Association of Certified Valuation Analysts as well as a former member of the organization's Executive Advisory Board, its highest Board.

He is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the Pittsburgh Chapter of the American Society of Appraisers. Bob has held numerous offices and directorships in various regional not-for-profit organizations. He received the 2003 Distinguished Public Service Award from the Pennsylvania Institute of Certified Public Accountants and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two children, Matthew and Alyssa.

Melissa A. Bizyak, CPA/ABV/CFF, CVA

Melissa has practiced in public accounting for over 16 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of professional practices, as well as companies in the manufacturing, oil and gas and technology industries.

These valuations have been performed for a variety of purposes such as Employee Stock Ownership Plans (ESOPs), marital dissolutions, buy/sell transactions, dissenting shareholder disputes, value enhancement and gift and estate tax purposes.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include membership in the National Association of Certified Valuators and Analysts (NACVA) as well as the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA). She is also serves on the Board of Directors of the Estate Planning Council of Pittsburgh as Vice President.

Melissa has authored articles appearing in professional publications and has written business valuation course-related materials for NACVA and the AICPA. She serves as a national instructor for NACVA.

Melissa is a graduate of the Leadership Development Initiative, a Leadership Pittsburgh, Inc. program. She serves on the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative.

Melissa resides in the South Hills of Pittsburgh with her husband and their two sons.

Amy E. Mattie, AVA

Amy has practiced in public accounting for more than 11 years. She has significant experience performing business valuation work for privately-held concerns and their owners.

Amy's business valuation experience spans several industries, including manufacturing, retail and professional services. These valuations have been performed for a variety or purposes, such as marital dissolution, financial reporting, estate and gift tax compliance and planning purposes and buy/sell transactions.

After graduating from Robert Morris University in 1994 with a B.S. degree in Business Management/Accounting, Amy spent several years in local government and employed by a large local bank. She also has nearly a decade of experience in public accounting – working for both regional and international firms in Pittsburgh.

Amy earned the Accredited Valuation Analyst (AVA) designation conferred by the National Association of Certified Valuators and Analysts (NACVA) in 2001. She has also begun the education process necessary to obtain the designation of Accredited Senior Appraiser (ASA) through the American Society of Appraisers. Her professional affiliations include membership in ASA and NACVA.

Committed to community service, Amy has volunteered for a local animal shelter, helping to plan the annual walk-a-thon. She is also involved at her church with various volunteer duties. As a hockey mom, Amy has been involved in many fundraising campaigns as well.

Amy resides in Sewickley with her husband Tom, and their sons, Hunter and Noah.

Sara L. Bergman, AVA

Sara provides industry, economic and corporate research as well as performing calculations required for the preparation of business valuation reports and other consulting projects. She primarily provides services to privately held concerns and their owners.

During her time at Grossman Yanak & Ford LLP, Sara has played a significant role in preparing business valuations for a variety of purposes including marital dissolutions, gift and estate tax purposes, dissenting shareholder disputes, and buy/sell transactions. She is also a frequent speaker at firm-sponsored events and seminars.

Sara graduated cum laude from Mount Union College in 2006. She earned Bachelor of Arts degrees in two majors – business administration and sport management, with a concentration in finance and a minor in accounting.

After graduation, Sara joined the Business Valuation Services Group at Grossman Yanak & Ford LLP. She has completed the training, certification and examination requirements to earn the Accredited Valuation Analyst (AVA) designation as conferred by the National Association of Certified Valuators and Analysts (NACVA).

She continues to pursue additional training and expertise, frequently attending seminars and classes sponsored by NACVA, the American Institute of Certified Public Accountants (AICPA), and the Pennsylvania Institute of Certified Public Accountants (PICPA).

In her spare time, Sara is active in her church and enjoys golfing with family and friends. Sara currently resides in the North Hills with her husband, Josh.

Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation and technology services. Led by five partners, the 20-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities in western Pennsylvania, eastern Ohio, northern West Virginia and New York.

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Cost/Asset Approach to Business Valuation

Chapter I – *Introduction*

The Cost/Asset Approach, hereafter referred to as the "Asset Approach," to business valuation encompasses a determination of value predicated upon an assessment of each of the subject company's assets, both tangible and intangible, recorded and unrecorded, on its historical financial statements. Somewhat of a misnomer, the Asset Approach also requires a determination of value of each of its liabilities, both recorded and unrecorded, on its historical financial statements.

As a result of valuing each asset and/or liability, the historical balance sheet prepared under generally-accepted accounting principles (GAAP) is converted to an economic balance sheet – one that reflects those assets and liabilities on a fair market value (or some other applicable standard of value) basis.

Subtracting the economic balance sheet liabilities from the economic balance sheet assets yields the economic value of the equity of the Company. Depending on the nature and purpose of the engagement, additional considerations might include discounts for lack of control and lack of marketability, among others, as well as "tax affecting" assets that have been written up from the historical balance sheet carrying values to the economic balance sheet appraised values. After proper application of these discounts and adjustments, if applicable, one can conclude that the result of the process is an accurate indication of value.

Oftentimes, the Asset Approach is referred to as the "Cost/Asset Approach." The word "Cost" in this title references the users of the approach to consider original historical cost of applicable assets. If appropriate, that cost will be adjusted forward through the date of valuation for inflation and other influences on cost, less an adjustment for wear and tear, as well as obsolescence.

The fundamental precept behind the Asset Approach is that an astute investor would not pay more for a collection of assets, net of liabilities, than the price for which those same assets could be purchased or constructed.

Methodologies vary under the Asset Approach, but most often include the following four methods.

- Asset Accumulation Method
- Excess Earnings Method
- Rules of Thumb (asset-based)
- Sellers Discretionary Cash Flow

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The primary methods most often employed under the Asset Approach are the first two – the Asset Accumulation Method and the Excess Earnings Method. These methodologies will be the focus of this program.

The Asset Approach is commonly utilized by business valuation professionals. The basis for this popularity is often thought to be the simplicity of the methods available under the approach. Most finders of fact and users of business valuations are familiar with balance sheet formats and are able to generally interpret a balance sheet.

Unfortunately, the methods under the Asset Approach are not so simple that due care in both application and interpretation is not required. Therein lies the danger. Oftentimes, proper and due care is not taken when these methods are applied in a business valuation. As a result, the conclusions set forth in those reports are erroneous.

Further, the Asset Approach is not as useful as the income approach and the market approach in valuing operating companies with significant unrecorded intangible value, such as goodwill.

Most often, the approach is used as a primary approach only in the instance where the value of the entity's equity is based on the value of its underlying tangible assets. As a consequence, the application of the Asset Approach is restricted to asset holding companies and smaller companies with little or no goodwill.

Identifying these issues in the context of understanding expert reports is, of course, paramount to reaching proper resolution of any number of legal contests dependent on valuation. This program is intended to familiarize our friends and contacts in the legal community with the fundamental aspects of the Asset Approach and help them to determine the reasonableness of expert conclusions obtained under that approach.

The second portion of today's program aims to provide guidance to practitioners in the legal community regarding review of expert reports. The complexity inherent in the business valuation process, under the profession's development and reporting standards, can often lead to confusion for users who are not specifically trained in the discipline.

However, with care and a fundamental understanding of the process, it is possible to review an expert report and develop a broad assessment of the strengths and weaknesses of the expert's opinion of value. Such assessments will lead to better communication with the experts, and ultimately, better representation of clients.

The program includes a listing of key elements of the business valuation process that often play a significant role in the determination of value. Quickly assessing the reasonableness of these key elements will aid in understanding the reasonableness of the business valuation professional's conclusion of value.

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Chapter II – *Fundamental Theory*

Accounting records and financial statements are generally maintained on a historical cost basis. Until very recently, with the worldwide movement toward fair value accounting (i.e., mark-to-market), companies have recorded both assets and liabilities at original cost or face value and allowed for valuation allowances through the use of deprecation, amortization and the use of reserves. As such, the goal of historical accounting has been to present a "snapshot" of a company's financial position at any certain date in time, based on the adjusted original "cost" of assets and liabilities.

The most significant problem encountered in the valuation analysis of a company's financial position under historical accounting rules, is that those asset and liability carrying values on the records and financial statements are likely to change in fair market value (or other appropriate standards of value) over time, in amounts that are not likely to coincide with historical accounting.

As an example of this problem, think of a company that in 1998, purchases a parcel of real estate with a small manufacturing plant located on it for $1,000,000. Assuming an allocation of $100,000 to the underlying land, $900,000 would be allocated to the building and depreciated over its useful life. If the Modified Accelerated Cost Recovery System (MACRS) tax life was determined to be 39 years, the carrying value (cost less depreciation) set forth on the historical cost balance sheet at December 31, 2009, would be $650,000 (rounded).

Assuming the building and land appreciated at just 3% per year, the property's value would be appraised at approximately $1,250,000. Thus, the difference between the appraised value and the historical cost value, as depreciated, is $500,000. This discrepancy is not an anomaly. It occurs in nearly every valuation where application of the Asset Approach is deemed to be a valid option.

Note that similar problems can arise with respect to any asset or liability, but is often most prevalent in appreciating assets. Note also that it is common to have assets and liabilities recorded under historical cost accounting where values must be adjusted downward.

The key point to keep in mind when reviewing historical cost balance sheets in an attempt to ascertain an indication of value is that equity and net worth on these balance sheets (commonly referenced as "book value") will reflect fair market value <u>only</u> by coincidence and will almost never provide a correct indication of that value.

Why then do we look at asset values as possible indicators of equity and/or enterprise value? Revenue Ruling 59-60, 1959-1 C.B. 237, the Internal Revenue Service's primary authoritative pronouncement over the last 50 years on the valuation of privately-held business interests, discusses use of the Asset Approach as follows:

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"Earnings may be the most important criterion of value in some cases, whereas, asset value will receive primary consideration in others. 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 of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued."

Revenue Ruling 59-60 goes on to say that:

"The value of the stock of a closely-held investment or real estate holding company, whether or not family-owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair market values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be afforded greater weight in valuing the 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."

Professional business valuation development standards and guidance promulgated by the governing bodies with the profession require consideration of this approach as well. For example, the American Institute of Certified Public Accountants (AICPA) Statements on Standards for Valuation Services (SSVS) No. 1 notes,

"The underlying theme of the governing literature is the applicability of the Asset Approach to those types of companies where the value of the underlying assets best defines value of the entity. Most often, these companies are asset holding companies formed either in a traditional holding company structure or in a structure driven by financial or tax planning, such as family limited partnerships."

An example of a business that is most likely an appropriate subject for valuation under the Asset Approach is a family limited partnership (FLP) whose assets consist solely of certain real estate and marketable securities. Another example might be an S corporation in the natural resource industry where the largest asset is 30,000 acres of timberland or land with substantial limestone reserves. Finally, the Asset Approach might be useful in valuing very small businesses or professional practices, where there is little or no entity/business goodwill.

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The usefulness of this approach is limited when the business has the ability to generate free cash flow in excess of a required return on tangible and current assets. Such excess cash flow is presumed to be generated by the subject company's intangible assets. Most often, all or some portion of these intangible assets includes goodwill. Since the identification and quantification of unrecorded intangible value is critical to the determination of business entity value, the Asset Approach does not lend itself well to the valuation of operating businesses.

Other Issues

Various other issues that must be considered in the application of the Asset Approach include premise of value, levels of value, marketability and potential deferred income tax liabilities on built-in gains, which are discussed in further detail on the following pages.

- ***Premise of Value*** – Premise of value looks to the basic concept of continued business operation. If it is expected that the business will continue to operate as it does at the date of valuation, the premise of value is "going concern." This premise is the one most frequently used in business valuation. If it is determined that the business is not expected to continue as an operating entity, the premise of value defaults to "liquidation value." Liquidation value, as a premise of value, is further divided into "orderly" liquidations and "forced" liquidations. Obviously, the ordering of the three premises of value as they influence the conclusion of value from highest to lowest is going concern, orderly liquidation and, finally, forced liquidation. As will be discussed in Chapter IV of these materials, there are additional premises of value applicable to tangible asset appraisals.

- ***Level of Value*** – Understanding the level of value obtained under the Asset Approach is critical to proper interpretation of the result and reconciling that result to project requirements. Generally, the result obtained under the Asset Approach is deemed to be a control indicator of value. As such, if project parameters require determination of a minority interest, it may be necessary to apply a minority discount

- ***Marketability*** – The ability to quickly convert an asset into cash is the basis on which degrees of marketability are measured in business valuation. Generally, the result obtained under the Asset Approach is deemed to be a marketable indication of value. In most instances of privately-held business valuations, the equity interest is not marketable. As such, it will be necessary in most business valuation projects to consider, and apply, a discount for lack of marketability.

- ***Built-in Gains*** – Writing up assets to reflect appraised values is often accompanied by the creation, or enlargement, of a built-in taxable gain (appraised value less tax basis) at the date of valuation. A

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controversial issue in a number of venues, the deferred income tax liability associated with this built-in gain, must still be considered in the context of determining value in every circumstance. Chapter V will explain this issue in detail.

These fundamental matters are intended to serve as a foundation for developing a good understanding of the Asset Approach and how the approach is being applied by experts in your practices. The following chapters will expand upon these fundamentals and incorporate many of them into illustrations and examples intended to clarify and enhance participant understanding.

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Chapter III – *Cost/Asset Approach Methodologies*

The Asset Approach to valuing privately-held business ownership interests is primarily a function of modifying balance sheet assets and liabilities from historical "carrying" values to date of valuation economic values (generally, fair market value). Once adjusted, the enterprise value or total value of the subject company is determined simply by netting assets and current liabilities, including all non-interest bearing debt obligations.

Taking this process one step further and valuing just the equity of the subject company requires that long-term interest bearing debt be subtracted from enterprise value, as determined above. A shortcut method to the valuation of equity is simply to subtract all liabilities from assets on the modified economic balance sheet at the date of valuation.

As noted in the introduction to these materials, the Asset Approach seems very simple and direct. However, careful and prudent application and interpretation of the approach clearly demonstrates a number of complex aspects which must be considered prior to accepting results produced under this approach.

Asset Accumulation Method

The most common method under the Asset Approach is the Asset Accumulation Method, sometimes referred to as the Net Asset Method. The application of this method encompasses the fundamental concepts of the Asset Approach most directly. Those steps necessary to properly apply the Asset Accumulation Method are as follows:

- ***Step 1*** – Obtain a balance sheet (sometimes referred to as a Statement of Financial Position) at a date proximate with the date of valuation. As a balance sheet represents an indication of a company's asset, liabilities and equity, or net worth, at the specific date of presentation, it is critical that this information be on, or very near, the date of valuation.

- ***Step 2*** – Adjust the balance sheet, if necessary, for any items required to present the balance sheet on a generally accepted accounting principle (GAAP) basis. Most often this step encompasses converting a cash-basis balance sheet, used primarily for tax purposes, to an accrual-basis balance sheet, reflecting all accounts receivable and accounts payable, as well as prepaids, other receivables and accruals.

- ***Step 3*** – Once the assets and liabilities are reflected on a GAAP basis, it is necessary to adjust the values of each upward or downward to reflect their current values as appraised. In most cases, current assets and current liabilities are presumed to have fair market values equal to their GAAP values and require no adjustment. However, non-GAAP balance sheets may require adjustments to accounts receivable for

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uncollectable accounts as might inventory for obsolescence, etc. Most often, real property will be adjusted to appraised values, as will machinery and equipment, and, if present (Step 5) intangible value will be recorded.

In making these adjustments to reflect economic value, it is imperative that the tangible asset appraisals (both real property appraisals and machinery and equipment appraisals) are fully understood and reflect the same standard of value and premise of value that is required in the overall engagement. To that end, it is important to communicate early in the process with any asset appraisers to ensure that the results of those appraisals match the project parameters.

Note that the method is adjusting only the balance sheet as of the date of valuation. As such, the accounting entry to increase asset value on the "asset" or left side of the balance sheet (perhaps increasing the value of a building from its historical carrying value to fair market value, as appraised) is offset or balanced by increasing equity value on the owner's equity or right side of the balance sheet. Thus, a write up of asset value equates to a dollar-for-dollar increase in equity value under the Asset Accumulation Method.

- ***Step 4*** – Review financial records, meet with management and apply forensic accounting procedures, if necessary, to identify and quantify unrecorded assets and liabilities. Finding unrecorded assets and liabilities is often the most arduous aspect of applying this method. The breadth of procedures will be based on the quality of the starting balance sheet that is available. An audited balance sheet will ultimately carry greater reliability than a compiled balance sheet or one simply extrapolated from the business tax return.

  Examples of unrecorded assets may be both tangible and intangible, though significant unrecorded assets tend to be intangible (unless intentional and professional abuse of assets or theft, is suspected to have occurred). Unrecorded liabilities may be discernible through a review of financial statement footnotes, if available, interviews with management, review of corporate minutes and audit inquiries of legal advisors. Examples of unrecorded liabilities are environmental obligations, contingent claims and potential tax issues, including interest and penalties.

- ***Step 5*** – If the method is being used to value an operating company, an assessment of the presence and quantification of goodwill or other intangible value must be undertaken. Most often, this exercise is based upon an excess earnings method (discussed on page 10 of these materials). The excess earnings method calculates total intangible value by virtue of capitalizing those cash flows or earnings in "excess" of a reasonable and appropriate return on tangible assets within the subject company.

- ***Step 6*** – If asset and liability adjustments result in differences between the tax basis of those assets and liabilities and their fair market values, consideration must be given to making an adjustment to reflect the deferred income tax effect of any gains or losses. Discussed further in Chapter V of these materials, certain venues, such

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as various family courts, do not permit a reduction in value for taxes payable in the future unless a sale or other taxable disposition is imminent.

- ***Step 7*** – Adjustments to value based on control prerequisites or lack thereof, as well as a lack of marketability, must be considered and applied when using the Asset Accumulation Method to value a non-controlling, nonmarketable fractional ownership interest.

ASSET ACCUMULATION METHOD EXAMPLE

Assumptions: Building has tax basis of zero. Building is appraised at $15,000.

Historical Balance Sheet

Assets		*Liabilities*	
Cash	$ 5,000	Accounts Payable	$ 15,000
Accounts Receivable	20,000	Other Current Liabilities	10,000
Inventory	10,000	Long Term Debt	20,000
Building	10,000		
Less: Accumulated Depreciation	(5,000)		
Other Assets	20,000	Equity	15,000
Total	$ 60,000		$ 60,000

Economic Fair Market Value Balance Sheet

Assets		*Liabilities*	
Cash	$ 5,000	Accounts Payable	$ 15,000
Accounts Receivable	20,000	Other Current Liabilities	10,000
Inventory	10,000	Taxes Payable	6,000
Building	15,000	Long Term Debt	20,000
Other Assets	20,000	Equity	19,000
Total	$70,000		$70,000

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Excess Earnings Method

The Excess Earnings Method is a hybrid Asset Approach/Income Approach methodology promulgated by the Internal Revenue Service, but most often categorized as a method under the Asset Approach. Be aware that the Excess Earnings Method is often referred to as the "Treasury Method," the "Formula Method," and/or the "Excess Cash Flow Method."

This methodology is most recently supported by Internal Revenue Service Revenue Ruling 68-609, 1968-2 C.B.327. It is used most often to value smaller businesses and professional practices and is extremely popular in family court applications. Generally used to value entire enterprises, the ruling states:

"The 'Formula' approach may be used in determining fair market value of intangible assets of a business only if there is no better basis available for making the determination."

Those steps required to properly apply the Excess Earnings Method are as follows:

- ***Step 1*** – Fair market value of each tangible asset must be determined. Then, the separate assets, at fair market value, must be added together and "netted" against the company's operating liabilities.
- ***Step 2*** – Next, the total normalized earnings that apply to all invested capital must be determined.
- ***Step 3*** – A rate of return required to generate investment in the tangible assets must next be determined, based upon those assets' relative risk factors (often based on industry returns) and that portion of the total normalized earnings, developed under Step 2 above, must be applied to the net tangible asset value determined under Step 1 above.
- ***Step 4*** – The portion of total normalized earnings in excess of the earnings serving as a return on tangible assets in Step 3 above must be determined. These "excess" earnings are then deemed to be attributable to the subject company's intangible assets.
- ***Step 5*** –Applying a rate of return that is developed in consideration of the relative risk factors of the intangible assets, the excess earnings are capitalized under a normal capitalized earnings method to produce the fair market value of the intangible assets.
- ***Step 6*** – Add the fair market value of the intangible assets to the fair market value of the tangible assets, determined under Step 1 above. The result is fair market value of all invested capital (both debt capital and equity capital).

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- ***Step 7*** – Reduce the fair market value of all invested capital by long-term debt to derive the fair market value of equity capital.
- ***Step 8*** – Adjustments to value based on control prerequisites or lack thereof, as well as a lack of marketability, must be considered and applied when using the Excess Earnings Method to value a non-controlling, nonmarketable fractional ownership interest.

EXCESS EARNINGS METHOD EXAMPLE

Net tangible asset value (fair market value less operating liabilities)	$ 10,000,000
Total normalized earnings	3,000,000
Rate of return – tangible assets – 12%	
Normalized earnings to tangible assets (12% x $10,000,000)	(1,200,000)
Excess normalized earnings	
Attributable to intangible assets	1,800,000
Capitalization rate for intangible assets	30%
Fair market value of intangible assets	6,000,000
Fair market value of tangible assets (from above)	10,000,000
Fair market value of invested capital	16,000,000
Less: Long-term debt (assumed)	(12,000,000)
Fair market value of equity capital	$ 4,000,000*

* *On a control, marketable basis*

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Chapter IV – *Tangible Asset Appraisals*

Tangible assets include land, buildings, site improvements, computers, furniture, machinery, vehicles and other equipment. Business valuation experts are not expected to be expert appraisers of tangible assets. The business valuator, however, should know the basics of how these appraisals are conducted. All appraisal disciplines recognize the three basic valuation approaches including income, market ("sales comparison") and cost.

In valuing a business, it is not uncommon to use real estate appraisers to value the real property segment of the business and machinery appraisers to value the personal property segment. The business appraiser assembles the value of tangible assets prepared by knowledgeable appraisers, then values any intangible assets and concludes on the overall business value under the consistent-use theory.

This chapter will provide relevant information with respect to tangible asset appraisals. The information presented herein will be separated between appraisals of real estate and appraisals of machinery and equipment, as these specialties are considered separate and distinct.

Real Estate Appraisals

In the appraisal of real estate it is important to distinguish between real estate and real property. Legally defined, real estate includes land and all things that are a natural part of it (i.e., minerals) and all things that are attached to it by people (i.e., building and pavement). Real property includes the bundle of rights that is inherent in the ownership of real estate. The following highlights the key aspects involved in the appraisal of real property.

Types of Interests

The bundle of rights theory maintains that ownership of a parcel of real estate may embrace a great many rights, such as the right to its occupancy and use; the right to sell it in whole or in part; the right to bequeath; the right to transfer by contract for specified periods of time, the benefits to be derived by occupancy and use of the real estate. It is possible to own all of the rights in a parcel of real estate or only a portion of them. For most common situations, the fee simple interest is explicitly assumed since it is the most complete bundle of rights available.

While there are many different possible interests in real estate, the three most common are:

- Fee simple estate – This is the most complete ownership in real estate, subject to the limitations imposed by governmental powers of taxation, escheat, eminent domain and police power.
- Leased fee estate – This is simply the fee simple interest encumbered by a lease. If the lease is at market rent, then the leased fee value and the fee simple value are equal. However, if the tenant pays more or less than

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market, the residual owned by the leased fee holder, plus the market value of the tenancy, may be more or less than the fee simple value.

- Leasehold estate – The interest held by a tenant through a lease conveying the rights of use and occupancy. If the tenant pays market rent, then the leasehold has no market value. However, if the tenant pays less than market, the difference between the present value of what is paid and the present value of market rents would be a positive leasehold value. For example, a major chain retailer may be able to negotiate a below-market lease to serve as the anchor tenant for a shopping center. This leasehold value may be transferable to another anchor tenant, and if so the retail tenant has a positive interest in the real estate.

Standard of Value

- Market value is the most commonly used standard of value. While the *Uniform Standards of Professional Appraisal Practice* (USPAP) does not define market value, it provides general guidance for how it should be defined:

  "a type of value, stated as an opinion, that presumes the transfer or sale of a property as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal."

  The market value standard recognizes value to a theoretical market, based upon exposure time required for similar properties.

- Value-in-use is the net present value (NPV) of a cash flow that an asset generates for a specific owner under a specific use. Value-in-use is the value to one particular user, and is usually below the market value of a property. For example a special-purpose manufacturing facility may have a higher market value in use to its current owner which is much higher than its value in exchange to an alternate owner.

- Investment value is the value to one particular investor, and is not necessarily the value in the marketplace.

- Going concern value is "the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct form the value of the real property. The value of the going concern includes an intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of land, buildings, labor, equipment and the marketing operation. The assemblage creates an economically viable business that is expected to continue. The value of the going concern refers to the total value of a property including both the real property and the intangible property attributed to the business value."[1]

[1] *The Appraisal of Real Estate,* 11th Edition

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- Insurable value is the value of real property covered by an insurance policy. Generally it does not include the site value.
- Liquidation value may be analyzed as either a forced liquidation or an orderly liquidation and is a commonly sought standard of value in bankruptcy proceedings. It assumes a seller who is compelled to sell after an exposure period which is less than the market-normal timeframe.

Highest and Best Use

"Highest and Best Use" is a term of art in the appraisal process. It is a process to determine the use of the property that produces the highest value for the land, as if vacant. There are four steps to the process.

First, the appraiser determines all uses which are legally permissible for the property. Second, of the uses which are legally permissible, the appraiser determines which ones are physically possible. Of those, the appraiser determines which ones are financially feasible. Of those uses which are feasible, the appraiser determines which one and only use produces maximum profits for the site.

In a simple context, the appraiser must do this twice, comparing the results – as if the land is vacant and in the as-is-improved state, taking into account the costs of demolishing any existing improvements. The outcome of this process is the highest and best use for the site. An appraisal of market value must explicitly assume that the owner or buyer would employ the property in its highest and best use, and therefore value the site accordingly.

In more complex appraisal assignments (i.e., contract disputes, litigation or contaminated property valuation), the determination of highest and best use may be much more complex, and may need to take into account the various intermediate or temporary uses of the site, the contamination remediation process and the timing of various legal issues.[2]

Approaches to Value

As previously noted, all appraisal disciplines recognize the three basic valuation approaches including income, market ("sales comparison") and cost. All three approaches are commonly applied in the context of real estate appraisals.

- Cost Approach – The cost approach was formerly called the summation approach. The theory behind this approach is that the value of a property can be estimated by summing the land value and the depreciated value of any improvements. The value of the land is the value of its highest and best use. The value of the improvements is referred to as the *reproduction cost new less depreciation* or *replacement cost new less depreciation*.

[2] www.wikipedia.org, *Real Estate Appraisals*

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Reproduction refers to reproducing an exact replica. *Replacement cost* refers to the cost of building a house or other improvement which has the same utility, but using modern design, workmanship and materials. Typically in practice, appraisers use replacement cost and then deduct a factor for any functional dis-utility associated with the age of the subject property.

In most instances when the cost approach is involved, the overall methodology is a hybrid of the cost and sales comparison approaches. For example, while the replacement cost to construct a building can be determined by adding the labor, material and other costs, land values and depreciation must be derived from an analysis of comparable data.

The cost approach is considered reliable when used on newer structures, however, the method tends to become less reliable for older properties. The cost approach is often the only reliable approach when dealing with special use properties.

- <u>Market (Sales Comparison) Approach</u> – The market (hereinafter referred to as sales comparison) approach in a real estate appraisal is based primarily on the principle of substitution, which assumes a prudent buyer will pay no more for a property than it would cost to purchase a comparable substitute property. The approach recognizes that a typical buyer will compare asking prices and seek to purchase the property that meets his or her wants and needs for the lowest cost.

  The sales comparison process involves the judgment of the real estate appraiser as to the similarity to the subject property and the comparable sales or listings relative to numerous factors including location, size, quality of construction, age and condition. Further, the real estate appraiser attempts to interpret and measure the actions of parties involved in the marketplace, including buyers, sellers and investors.

  Since comparable sales are not always identical to the subject property, adjustments are frequently made for date of sale, location, style, square footage, site size, etc. The primary objective is to simulate the price that would have been paid if each comparable sale were identical to the subject property.

- <u>Income (Income Capitalization) Approach</u> – The income capitalization approach (herein-after referred to as the income approach) is used to value commercial and investment properties. Because it is intended to directly reflect or model the expectations and behaviors of typical market participants, this approach is generally considered the most applicable valuation technique for income-producing properties, where sufficient market data exists to supply the necessary inputs and parameters.

  The approach includes capitalizing or discounting an income stream to produce a value of the subject property. The income stream is Net Operating Income (NOI), which is defined as gross potential income (GPI), less vacancy and collection loss less operating expenses (but excluding debt service, income taxes, and/or depreciation charges).

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The real estate appraiser will consider all of the aforementioned factors in preparing his or her appraisals. Additionally, credentialed appraisers will adhere to certain standards relative to due care, development and reporting. It is important to note that the conclusions provided in real estate appraisals will include a period of time that the property is exposed to the market.

Machinery and Equipment Appraisals

Machinery and equipment (hereafter sometimes referred to as "M&E") appraisals are not as location-specific as real estate. In many cases an appraiser of M&E has a niche expertise, for example a specific industry or asset. M&E appraisals may be performed for a number of purposes including purchase price allocation, financing, insurance, litigation, leasing or property tax. The following highlights the key aspects involved in the appraisal of machinery and equipment.

Standard of Value

- Fair Market Value is defined by the American Society of Appraiser's Machinery and Technical Specialties Committee as an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, as of a specific date.

- Fair Market Value – Removal is an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, as of a specific date, considering the cost of removal of the property to another location.

- Fair Market Value in Continued Use is an estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date and assuming that the business earnings support the value reported. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs necessary to make the property fully operational.

- Fair Market Value – Installed is the estimated amount that may reasonably be expected for a property in an exchange between a willing buyer and a willing seller, with equity to both, neither under any compulsion to buy or sell, and both fully aware of all relevant facts, including installation, as of a specific date. This amount includes all normal direct and indirect costs, such as installation and other assemblage costs to make the property fully operational.

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Premise of Value

- Orderly Liquidation Value is the estimated gross amount, expressed in terms of money, that could be typically realized from a liquidation sale, given a reasonable period of time to find a purchaser, with the seller being compelled to sell on an as-is, where-is basis, as of a specific date.

- Forced Liquidation Value is the estimated gross amount, expressed in terms of money, that could be typically realized from a properly advertised and conducted public auction, with the seller being compelled to sell with a sense of immediacy on an as-is, where-is basis, as of a specific date.

Approaches to Value

All three approaches to value are considered when valuing M&E, however, the income approach is not commonly used to determine the value of an individual piece of machinery and equipment. This is due to the inability to isolate the given piece of M&E to determine its income stream. However, the cost and market approaches are widely used for M&E.

- Cost Approach – This approach is the best determinant of value for a special-purpose asset or one without an active secondary market. Using this approach an appraiser will compute one of two costs: *reproduction cost new* or *replacement cost new*. The *reproduction cost new* is the cost to create an exact duplicate of the subject, while the *replacement cost new* is the cost to create one with equal capacity and utility as the subject, but using current technology. An appraiser is likely to use one of three methods to determine the *current cost new*. These methods include direct unit pricing, trending and cost/capacity.

  The direct unit pricing method involves the appraiser inventorying the assets at the facility and recording and identifying information relative to the assets (manufacturer, model and serial number, year manufactured, etc.) Additionally the appraiser will consider the machine's installation in the facility. Each asset is individually identified and valued.

  The trending method is when the appraiser uses existing accounting records as the basis for the inventory of assets to be valued. The appraiser then uses a unit of production method, where costs will be known to manufacture an entire facility or a major component of a process plant. This method results in a check on the sum of the trended individual costs for that facility as a whole. Therefore, it is not necessary to comment on each individual line item.

  Finally in the cost/capacity method, the costs of similar equipment or process plants can vary based on size or capacity raised to a power. The formula used is: $C_2/C_1 = (Q_2/Q_1)^x$

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In the formula C_2 is the desired cost of capacity (Q_2) and C_1 is the known cost of capacity (Q_1). These costs are scaled using factors typically called the six-tenths factor, where costs can be scaled up or down within reasonable ranges. The formula is used as a check on the reasonableness of the sum or the trended costs for a facility, in part or in whole.

There are three categories of adjustments to value that account for physical depreciation and functional and economic obsolescence. The adjustments are beyond the scope of these materials.

- Market (Sales Comparison Approach) – This approach includes an analysis of recent sales and current offerings of similar pieces of machinery. It is often used in determining value for financial purposes and can be the most supportable approach in terms of market indicators. The strength of the market approach is its ability to contemplate all forms of depreciation.

  The identification of comparable sales and offerings of similar property is similar to that described for real estate appraisals. Once adjustments are made to comparable sales and asking prices, the addition of allowances for direct and indirect costs necessary to assemble the property as an integrated, functional unit will result in fair market value in continued use.

- Income Approach – This approach is used primarily for the valuation of integrated production facilities, special-purposes assets, and to quantify obsolescence penalties. Usually a personal property appraisal includes the finite life of personal property.

  The methods under the income approach include direct capitalization and discounted future cash flow. Asset value will be affected by the ability of the entity to have sufficient earnings to support concluded values for various components of a going concern. If there are no earnings, the assets may be appraised at orderly or forced liquidation value.

As in the appraisal of real estate, the machinery and equipment appraiser will consider all of the aforementioned factors in preparing his or her appraisals. Additionally, credentialed appraisers will adhere to certain standards relative to due care, development and reporting.

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Chapter V – *Built-In Gains*

Deferred income taxes resulting from "built-in" or deferred gains on a company's balance sheet have long been recognized under Accounting Principles Board Opinion No. 11, and later in Financial Accounting Standard No. 109, as a necessary adjustment to the balance sheet. Clearly, when writing up fixed assets to fair market value for valuation purposes, it is likewise relevant to consider the application of a deferred tax liability to reflect the economic reality of the company's balance sheet.

In an open market transaction, there is little argument that a willing buyer would alter his or her offer price for the stock in a C corporation due to the tax liability associated with appreciated assets inside the corporation since the liability still remains even when ownership changes. The Internal Revenue Service has historically argued that provisions within the Internal Revenue Code could shelter such built-in gains.

According to these provisions, the tax payable on the built-in gains was too speculative and should not be included in the valuation. However, since the General Utilities doctrine was revoked under the Tax Reform Act of 1986, a tax liability upon liquidation is not necessarily speculative.

The IRS continued to argue that corporate liquidation itself cannot be contemplated; as such, a reduction for built-in gains taxes should not be taken. Moreover, in Technical Advice Memorandum 9150001, the IRS noted that unless liquidation is imminent, there is no accurate way to estimate the liability due to potential future tax law changes.

Over the last decade (beginning in 1998) valuators have seen the first truly salient decisions on this matter coming from the Tax Court with resolution of this issue seeming to be on the horizon. A review of these cases, including the watershed *Estate of Davis* decision, and most recently *Estate of Jelke*, will be undertaken in this chapter. After understanding the current position of the Courts in this matter, discussion will focus on alternatives to properly compute the adjustment.

Built-In Gains Tax Discount

Prior to *Davis* and *Eisenberg*, no element of business valuation was more intensely debated than that related to the federal and state income tax liabilities associated with corporations holding appreciated assets or assets that have been substantially depreciated below their fair market value at the date of valuation. The long-standing applicability of Revenue Ruling 59-60 and its mandate that fair market value is based upon a hypothetical willing buyer and willing seller, each acting prudently and in their own best interest, absolutely requires that the valuator consider the corporate level trapped-in gains in completing business valuations.

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Technical Advice Memorandum 9150001 documents the position of the IRS with regard to the issue – the National Office concluded that no discount was appropriate for two reasons:

- A number of courts had previously disallowed such a discount, arguing that any sales of appreciated assets giving rise to a corporate level tax liability were too speculative for consideration.
- There is no definitive proof that a buyer would buy the stock being valued with an intent to sell or liquidate the underlying assets.

In a footnote, the National Office noted that a buyer may, in some circumstances, elect S status. If the S corporation held the assets for more than ten years prior to sale, the tax under Internal Revenue Code §1374 (Built-in Gains) would not apply.

Until recently, the Internal Revenue Service, U.S. Tax Court and many family courts did not recognize the impairment of value offered by these tax liabilities unless a sale was imminent. (*Ronald Hay v. Marilyn Hay*, Court of Appeals of Washington, Division 3, December 16, 1995) Most practitioners feel the impact of capital gains taxes must be considered when estimating value. However, whether that impact is incorporated via a discount or in some other element of the value estimate, is best left to the judgment of each valuation professional in light of the specific facts and circumstances of the project.

The following summary of relevant cases addressing the built-in gains tax illustrates the thinking of the courts on this issue.

Eisenberg v. Commissioner – 74 T.C MEMO 1046

- Taxpayer owned 100% of the outstanding stock of NY real estate holding company, (a C corporation)
- Taxpayer made minority gifts on three different occasions, and the values of the gifts were stipulated (including minority interest discount of 25%)
- Taxpayer had no plan to liquidate, sell, distribute property, etc.
- Taxpayer argued that gain was a virtual certainty, and a "knowledgeable" willing buyer would reduce the price paid for the stock by the full amount of the tax
- The IRS argued for non-recognition of built-in gains tax, noting that a "hypothetical buyer" can continue in corporate form, indefinitely deferring taxes
- The Court ruled against a discount for built-in gains tax as liquidation was not "imminent"
- The decision was reversed (*Eisenberg v. Comm.*, U.S. Court of Appeals, 2nd cir., August 1998)

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- The Court stated:

  "In the past, the denial of a reduction for potential capital gains tax liability was based, in part, on the possibility that the taxes could be avoided by liquidating the corporation. These tax-favorable options ended with the Tax Reform Act of 1986 (TRA).

  Now that the TRA has effectively closed the option to avoid capital gains tax at the corporate level, reliance on these cases in the post-TRA environment should, in our view, no longer continue."

- The Second Circuit went on to elaborate:

  "Our concern…is not whether or when the donees sell, distribute or liquidate the property at issue, but what a hypothetical buyer would take into account in computing fair market value of the stock.

  The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying. While prior to the TRA any buyer of a corporation's stock could avoid potential built-in capital gains tax, there is simply no evidence to dispute the fact that a hypothetical willing buyer today would likely pay less for the shares of a corporation because of the buyer's inability to eliminate the contingent tax liability."

Welch v. Commissioner – No. 27513-96 1998 WL 221312 (U.S. Tax Court, May 6, 1998)

- Estate tax case in which the valuator excluded real properties from calculation since they were expected to be sold to the city of Nashville, and a built-in gains tax at 34% was considered
- The properties were condemned, and the corporation elected gain deferral under IRC 1033(a)(2)
- Tax Court cited Eisenberg, stating that gain recognition was too speculative
- The Court of Appeals reversed the decision (2000 U.S. App. LEXIS 3315)
- The Sixth Circuit stated that the availability of the §1033 election does not automatically prevent application of a capital gains discount – it must be considered as a factor in determining fair market value as a hypothetical willing buyer would
- The corporation's election after the valuation date in this case was irrelevant

Estate of Davis v. Commissioner – Docket No. 9337-96 (U.S. Tax Court, June 30, 1998)

- Gift and estate tax case involving valuation of two minority blocks of stock in ADDI&C, a C corporation (primarily a holding company)
- The company's primary asset was low basis Winn-Dixie stock (over 1 million shares)

Cost/Asset Approach to Business Valuation

- IRS argued for no built-in gains relief, no blockage discount, and a 23% discount for lack of marketability (based on DLOM on letter stock studies)
- Petitioner argued for full discount for corporate level trapped capital gains, a blockage discount, and a 35% discount for lack of marketability (based on DLOM on letter stock and IPO studies)
- The Court decided for no blockage discount, included a higher-end discount for lack of marketability, and added a 15% discount for built-in gain (calculations follow)
- Perhaps the most important statement in the Court's opinion:

  "We reject respondent's position that, as a matter of law, no discount or adjustment attributable to ADDI&C's built-in capital gains tax is allowable in the instant case.

  ...we find, that, even though no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date, a hypothetical willing seller and a hypothetical willing buyer would not have agreed on that date on a price for each of the blocks of stock in question that took no account of ADDI&C's built-in capital gains tax.

  ...and we find, that such a willing seller and such a willing buyer of each of the two blocks of ADDI&C stock at issue would have agreed on a price on the valuation date at which each such block would have changed hands at less than the price that they would have agreed upon if there had been no ADDI&C's built-in capital gains tax at that date."

ESTATE OF DAVIS – NET ASSET VALUES WITHIN ADDI&C

Asset	Historical Cost Basis	Fair Market Value	Built-In Gain/(Loss)	Gross Federal Tax*
Feeder cattle	$ 6,474,368	$ 8,474,368	$ 1,600,000	$ 560,000
Breeding cattle	1,072,843	1,894,400	821,557	287,545
Winn-Dixie stock	338,283	70,043,204	69,704,921	24,396,722
DDI Stock	120,263	535,162	414,899	145,215
Equipment	172,999	130,294	(42,075)	(14,947)
Other Assets	1,295,539	1,295,539	—	—
Total	9,474,295	81,972,967	72,498,672	25,374,535
Less: Liabilities	(1,832,698)	(1,832,698)	—	—
	$ 7,641,597	$ 80,140,269	$ 72,498,672	$ 25,374,535

*Estimated at 35%. The case did not address state income taxes.

Cost/Asset Approach to Business Valuation

ESTATE OF DAVIS – NET ASSET VALUES WITHIN ADDI&C

	Estate's Experts		IRS Expert	IRS	Tax Court
	Howard	Pratt	Thompson	Position	Decision
Value of Net Assets	80,140,269	80,140,269	80,140,269	80,140,269	80,140,269
Less: built-in gains tax	(25,395,109)				
	54,745,160	80,140,269	80,140,269	80,140,269	80,140,269
Less: blockage discount					
4.9% Winn Dixie FMV	(3,432,117)				
10.0% Winn Dixie FMV		(7,004,320)			
	51,313,043	73,135,949	80,140,269	80,140,269	80,140,269
Less: minority discount					
12%			(9,616,832)		
15%	(7,696,956)			(12,021,040)	(12,021,040)
20%		(14,267,195)			
	43,616,087	58,868,754	70,523,437	68,119,229	68,119,229
Less: marketability discount					
23%				(15,667,423)	
35%	(15,265,630)				
38%			(26,798,906)		
50%		(29,254,391)			
41%					(28,000,000)
Value, minority, nontradable	28,350,457	29,614,363	43,724,531	52,451,806	40,119,229
Value of each 25.77% block	7,306,825	7,539,800	11,250,000	13,518,500	10,338,725
Value per share	292,273	301,592	450,000	540,740	413,549
Net Asset Value per share	826,086	826,086	826,086	826,086	826,086
Less: Discounts per share	533,813	524,494	376,086	285,346	412,537
	292,273	301,592	450,000	540,740	413,549
Percentage Discounts	64.62%	63.49%	45.53%	34.54%	49.94%
DLOM attributable to built-in gains tax		8,776,317	10,578,516		9,000,000
		15%	15%		13%

Cost/Asset Approach to Business Valuation

Estate of Jameson v. Commissioner – Docket No. 2322-96, T.C. Memo 1999-43 (February 1999)

- Estate held a 98.4% block of stock in a corporation whose primary asset was a large, productive tract of private timberland
- Estate expert considered a reduction in value for the built-in capital gains tax; IRS expert did not
- Court held that it was correct to consider capital gains tax and treated the taxes as a separate value reduction
- On appeal, the Fifth Circuit Court vacated the Tax Court Judgment (2001 U.S. App. LEXIS 20598, 5th Circuit, September 18, 2001)
- Case remanded for further proceedings to reconsider the amount of the capital gains discount

Estate of Simplot v. Commissioner – 112 T.C. No. 130, 1999 (March 22, 1999)

- The company held appreciated common stock interest in Micron Technology, Inc.
- Built-in gains tax set forth by both experts as direct dollar reduction to the estates
- Court accepted the reduction of value for imbedded capital gains
- The conclusion reached by the Tax Court in this decision is a confirmation of the position held by many valuators at least since the Tax Reform Act of 1986 and the repeal of the General Utilities doctrine, and the decision seemed to be the final step in finally reaching a conclusory position with respect to this issue
- On appeal, the Ninth Circuit Court did not alter the built-in gains tax issue (No. 00 – 70013, Ninth Circuit, May 14, 2001)

Estate of Dunn v. Commissioner – T.C. Memo 2000-12 (January 12, 2000)

- Case focused on determining the value of a 62.69% stock interest in a Texas C corporation that was in the heavy equipment rental business
- Super-majority vote of 66-2/3% required to approve liquidation
- In arriving at asset value, estate expert deducted 100% of built-in gains tax liability
- Court allowed a 15% discount for lack of marketability (undisputed by experts) and a 7.5% discount for lack of super-majority control
- Court allowed only 5% of the built-in gains tax, noting that the taxpayer's expert:

  "...failed to consider that hypothetical buyer who did not wish to continue operating the company, and who was able to convince additional shareholders to form a super-majority, had other options besides liquidation.

Cost/Asset Approach to Business Valuation

A new owner who wished to change the business of the company into, for example construction rather than equipment rental, would not have a need to buy new equipment every few years, and could use the equipment the company owned for its entire useful life, eliminating the realization of built-in gain."

- Court believed that the probability of a hypothetical buyer purchasing with intent to liquidate, while low, did exist
- Appellate Court found level of discount for built-in gains to be inappropriate – case remanded back to Tax Court to apply a 34% reduction of the asset-based value for built-in capital gains

Estate of Borgatello v. Commissioner – T.C. Memo 2000-264 (August 18, 2000)

- Case focused on determining value of an 82.76% stock interest in a real estate holding company
- Discounts were driven by the tax liability inherent in the built-in gain on the company's assets and the lack of marketability
- Both experts (estate and IRS) applied the net asset approach to valuing the interest due to the fact the interest was in a holding company with earnings that "are relatively low in comparison to the fair market value of the underlying assets"
- Both sides agreed that a discount for built-in capital gain tax should be applied, however they were at odds over what percentage should be applied
  - The IRS expert's key assumption in determining the applicable discount rate was based on a potential buyer holding the property for 10 years and a 2% growth rate for a discount of 20.5%
  - The estate's expert was considered unrealistic as it did not consider a holding period for a resultant 32.3% discount
- Estate expert applied a 35% discount for lack of marketability
- IRS expert applied a 27% discount for lack of marketability, broken out as follows:

– Shareholder dividends and compensation paid	-5%
– Local economy and real estate market	+5%
– Management continuity	-2%
– Potential corporate gain and tax	+19%
– Restrictions on stock transfer	+3%
– Transaction and other costs	+7%
– Total:	+27%

Cost/Asset Approach to Business Valuation

- Court agreed with the estate's argument that the IRS expert's 5% reduction in the discount based on the payment of shareholder dividends and compensation was inappropriate, as it was taken into consideration in the calculation of the cash flow and also disregarded the 5% increase for the IRS expert's risk associated with the local economy and real estate market
- Court believed the management continuity risk was neutral and did not apply it
- Court applied a 24% discount based on the positions of each expert's analysis as well as a 6% discount for liquidation costs (discount fell between the IRS expert's 7% and the estate expert's 5.7% discounts)
- In total a discount of 33% for lack of marketability (which includes the discount for built-in capital gains) was applied by the court

Estate of Frazier Jelke III v. Commissioner – T.C. Memo 2005-131 (May 31, 2005)

- Decedent's estate included a 6.44% interest in a well managed, closely held corporation with assets consisting of a diversified portfolio of marketable securities with a market value of approximately $178 million and a built-in gain tax liability of approximately $51 million (if all securities were sold on that date)
- The net asset value of the entire company was $188 million (without consideration of the built-in capital gain tax liability)
- Company had a high rate of return (annual dividends) in addition to capital appreciation of approximately 23% on an annual basis for the five-year period prior to Mr. Jelke's death
- At the time of Mr. Jelke's death there was no intent to completely liquidate the corporation
- The estate's expert reduced the net asset value by entire built-in gain tax liability
- The IRS contended that the built-in gain tax liability should be discounted to account for time value because the liability would be incurred in the future rather than immediately; after calculating an average asset turnover rate, the reduction for built-in gain tax liability was $21 million
- Tax Court did not apply dollar-for-dollar unrealized capital discount asserted by taxpayer's expert
- Following the analysis of the IRS expert, Tax Court used the corporation's 5.95% average annual turnover rate in the five years preceding valuation date to determine that the corporation's $51.6 million capital gain tax liability would be incurred over a 16.8 year period (100% ÷ 5.95%)
- Tax Court divided the $51.6 million tax liability by 16.8 years to arrive at the average annual capital gain tax liability which would have been incurred each year ($3,266,680.25 – $51.6 million divided by 16.8)
- Tax Court discounted the annual cost to present value using a rate of 13.2% – the total discount from net asset value was $21,082,226, resulting in an overall 11.2% reduction in value for built in capital gains tax liability

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- On November 15, 2007, the 11th Circuit reversed the Tax Court's decision with respect to the unrealized capital gains tax liability discount issues and applied a dollar-for-dollar reduction for the entire unrealized capital gains tax (*Estate of Jelke III v. Comm.*, 507 F.3d 1317, 11th Cir. 2007)
- The Eleventh Circuit noted, "[t]his 100% approach settles the issue as a matter of law, and provides certainty that is typically missing in the valuation arena."
- The logic of this approach is best understood in terms of the example used in the Eisenberg case that the court quoted at Footnote 25 of the Opinion:

  "Second Circuit used an example from tax treatise, Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶10.41[4] n.11 (Warren, Gorham & Lamont, 6th ed.1998), to illustrate that a hypothetical buyer and seller would allow a discount for built in capital gains tax:

  In the example, A owns 100% of the stock of X corporation, which owns one asset, a machine with a value of $1,000, and a basis of $200. Bittker assumes a 25% tax rate and points out that if X sells the machine to Z for $1,000, X will pay $200 tax on the $800 gain.

  Bittker adds that if Z buys the stock for $1,000 'on the mistaken theory that the stock is worth the value of the corporate assets,' Z will have lost $200 economically, 'because it paid too much for the stock, failing to account for the built-in tax liability (which can be viewed as the potential tax on disposition of the machine, or as the potential loss from lack of depreciation on $800 [of] basis that Z will not enjoy.')

  Because of Z's loss, Bittker concludes, 'Z will want to pay only $800 for the stock, in which even A will have effectively "paid" the $200 built-in gains tax.'"

  (507 F.3d at 1326, fn 25, citing *Eisenberg v. Commissioner*, 155 F.3d 50, 58 n.15)

- In his dissenting opinion, Judge Carnes criticized the majority's opinion, stating,

  "[i]t would be economically foolish for the majority shareholders to gut the golden goose and bring down on their heads the embedded capital gains tax liability simply because of the death of a minority shareholder, an event of no relevance to their economic interests.

  Further, in answering the question of why a buyer would adjust downward his or her purchase price to reflect the full dollar-for-dollar tax liability, he answers, 'the buyer could not reasonably expect the seller to agree to a price that ignored completely the time value of money.'

  Finally, he criticizes his colleagues for accepting dollar-for-dollar deduction, alleging that they have adopted the 'doctrine of ignoble ease and seductive simplicity'."

- The U.S. Supreme Court received the IRS petition for writ of certiorari in *Commissioner v. Estate of Jelke*, the Eleventh Circuit's approval of a dollar-for-dollar discount for embedded capital gains; the taxpayer filed a response in August; the IRS replied on September 3, 2008
- On October 6, 2008, the Supreme Court denied the government's petition for certiorari to review the Eleventh Circuit's decision

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Litchfield v. Commissioner – 2009 WL 211421, U.S. Tax Court (January 29, 2009)

- Estate had $26.4 million in assets, minority stock interests in two closely-held, family-owned companies (43.1% interest in LRC, 22.96% interest in LSC)
- IRS and estate experts agreed on net asset values of estate's interests
- Experts disagreed on discounts on first company, LRC
  - IRS Discounts: 2.0% discount for capital gains tax, 10.0% lack of control discount, 18.0% marketability discount
  - Estate Discounts: 17.4% discount for capital gains tax, 14.8% lack of control discount, 36.0% marketability discount
  - Final Values: IRS final value of $10.1 million; Estate final value of $6.5 million
- Experts disagreed on discounts on second company LSC
  - IRS Discounts: 8.0% discount for capital gains tax, 5.0% lack of control discount, 10.0% marketability discount
  - Estate Discounts: 23.6% discount for capital gains tax, 11.9% lack of control discount, 29.7% marketability discount
  - Final Values: IRS final value of $9.6 million; Estate final value of $5.7 million
- Court's decision:
  - Discount for capital gains: accepted estate expert's discounts due to expert's reliance on more accurate data, including speaking with management and reviewing current sales
  - Discount for lack of control: estate expert's discounts were accepted as he accounted for the composition of the estate's holdings (assets and marketable securities) by using a weighted average
  - Discount for lack of marketability: without further discussion, used DLOMs of 25% and 20% for LRC and LSC, respectively
- Noted that estate's DLOMs were too high at 36.0% and 29.7% for LRC and LSC, respectively
  - Final Values: LRC – $7.5 million, LSC – $6.5 million

Cost/Asset Approach to Business Valuation

Other Issues to Consider

Two other areas of legal practice have had somewhat recent developments regarding consideration of built-in capital gains. The first area deals with the inheritance tax rules in the Commonwealth of Pennsylvania. Language contained in 72 P.S. Section 9102, addresses the definition of value,

> *"In determining the value of property, no reduction shall be made on amount of income, excise or other taxes which may become payable subsequent to the valuation date by the transferee or out of the property."*

The Commonwealth has successfully used this definition to exclude reductions in the valuation of C corporation stock for inheritance purposes. It appears to the authors of these materials, that the Commonwealth's position and use of this provision to disallow reductions in value for inheritance tax purposes is flawed and overstates taxpayers' taxable estates subject to the tax.

The second, more recent, development in this area relates to practice in family law. Under the 1980 Pennsylvania Divorce Code, section 401(d)(10), as originally enacted, did not list potential tax liability as a factor to be considered in making an equitable distribution award. In May 1988, the Supreme Court ruled to allow for the consideration of potential tax liabilities in the valuation of marital assets only where a taxable event has already occurred as a result of the divorce or equitable distribution or is certain to occur within a timeframe such that the tax liability can be reasonably predicted. Thus, for consideration of tax liabilities in Family Court, it was historically necessary to have an actual sale of the asset or an imminent sale.

In January 2005, the Code was amended to allow that factors that are relevant to equitable division of marital property include[s]:

> *"The Federal, State and local tax ramifications associated with each asset to be divided, distributed or assigned, which ramifications need not be immediate or certain."*

Thus, it is allowable in Family Court to decrease value under an Asset Approach for built-in gains tax liabilities, even if the sale of the assets is not imminent.

Summary

In light of the significant number of court decisions reflecting the court's approval of built-in gains tax consideration in estate and gift tax cases, it appears the question as to validity of this issue is now resolved. The open issue at this time results from the lack of guidance on calculating the value effect and the many accepted variations of calculating this effect in the rulings. It is incumbent upon the valuator to understand these cases and to fully consider their implications as he or she deals with built-in gains in a business valuation context.

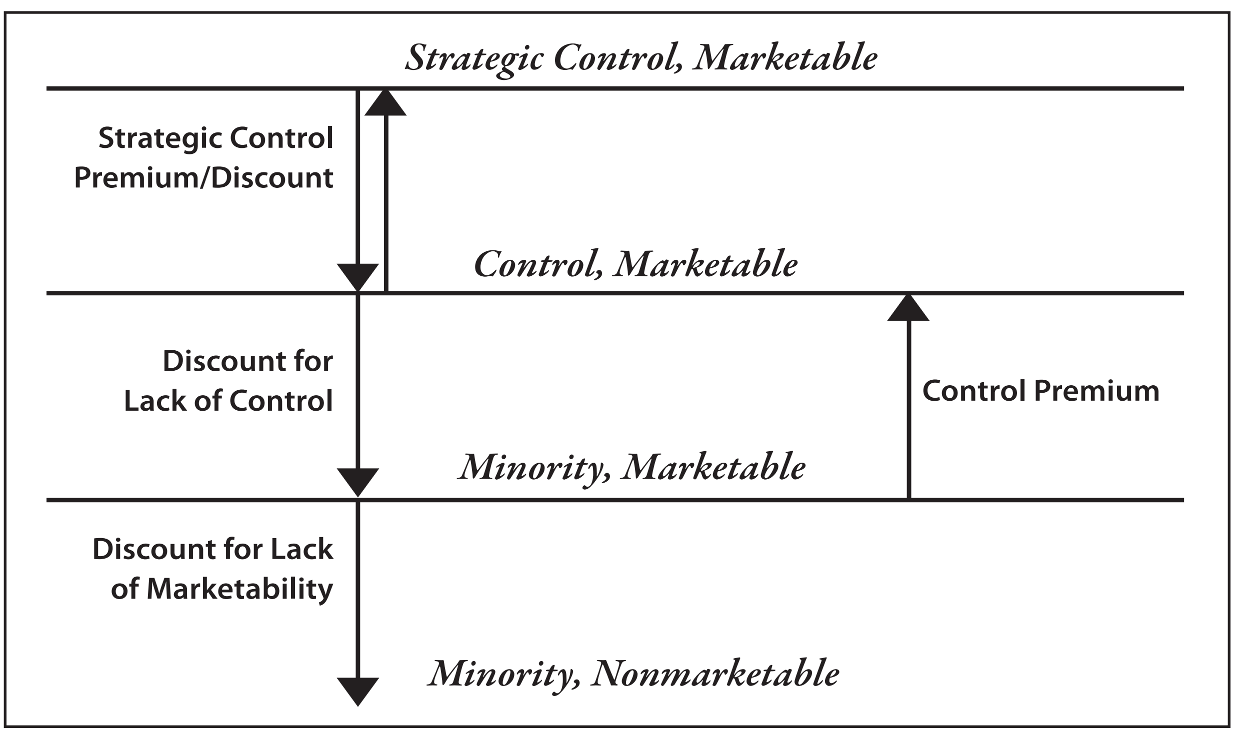
Cost/Asset Approach to Business Valuation

Chapter VI – *Propriety of Discounts*

Conclusions of value obtained under the Asset Approach are generally held to be control interest values. That is to say, that only a controlling interest owner would have the requisite equity ownership rights to "realize" the value under this approach. Conversely, a minority interest owner, by virtue of his or her ownership interest, will not have the ability to facilitate a sale of assets, hypothetical or otherwise.

There is a school of thought within the business valuation community that would suggest that it is inappropriate to use an Asset Approach to value a non-controlling or minority ownership interest. This thinking is primarily based on the inability of the non-controlling interest owner to force the sale of assets to realize the underlying value.

The problem with eliminating the Asset Approach from consideration in valuing non-controlling interests in a privately-held business is twofold. First, professional standards and governing authority require that the approach be considered. Second, and more importantly, there is often no better method for valuing certain entities, even if the subject ownership interest is on a non-controlling basis. For example, if one considers a family limited partnership, created to facilitate protection and management of the family's assets, often the value of the partnership is simply the summation of all of its assets. If minority interests in that partnership require valuation, it may be necessary to apply discounts for lack of control.



Cost/Asset Approach to Business Valuation

The conclusions of value obtained under the Asset Approach are also deemed to be marketable values. The underlying assumption in this context is that each of the assets are appraised or considered in the valuation approach at their fair market values (which should reflect marketability risk). As such, the collective group of assets driving the Asset Approach conclusion is deemed marketable.

Interestingly, the asset under valuation is not any specific asset of the subject business entity, but rather, the entity or the fractional ownership interest being considered. Given the limitations, characteristics and risk attendant to the marketability of this interest, it is likely that a discount for lack of marketability will be required at the entity or fractional interest level.

It is worth noting that many tangible asset appraisals, and especially real property appraisals, consider a "reasonable time period for sale" of that asset. That being the case, it is important that the entity or fractional interest discount for lack of marketability not "double up" on marketability risk included in the underlying appraisals.

As the Asset Approach is most often applied to smaller entities without intangible value or to asset holding companies, the method to determine appropriate discounts is based on the types and quality of the underlying assets themselves.

For example, assuming a family limited partnership (FLP) holding various assets including marketable securities and real estate, the discounts attendant to a fractional interest in the FLP should be developed by focusing on the particular classes of underlying assets. There have been several Tax Court cases that threw out substantial discounts that were applied to fractional interests in FLP's holding primarily marketable securities. Generally, the less risky the underlying partnership assets, the higher the value of the FLP.

Numerous sources of information exist that can assist the valuator in qualifying discounts for lack of control and marketability. The specific data source will be dictated by the underlying classes of assets held by the entity.

In the example where the FLP holds marketable securities, a widely-used source of discount data is closed-end funds. A closed-end fund is a regulated investment company that issues a fixed number of shares that are listed on a secondary market. The price of a share in a closed-end fund is determined partially by the value of the investments in the fund, and partially by the premium (or discount) placed on it by the market. Ownership interests in closed-end funds have many of the control restrictions that are seen in fractional ownership interests in FLPs, which allows for a more meaningful discount.

Databases exist that allow a valuator to search a population of closed-end funds using various criteria (i.e. the percentage of the fund invested in domestic securities and the industry sector(s) in which the fund invests), and that allow the valuator to match the portfolio structure of the closed-end fund to the marketable securities held by the FLP.

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Discounts for fractional interests in FLPs holding real estate can be quantified using data relative to transactions in real estate limited partnerships (RELPs). RELPs trade on a secondary market. Holders of interests in RELPs have many of the characteristics of holders of fractional interests in FLPs (including lack of control over distributions, no management participation, and no control over liquidation of assets).

The most widely used source of RELP transaction data is Partnership Profiles, Inc., located in Dallas, Texas, which publishes an annual study. While the study does not identify a specific discount allocable to minority ownership attributes and lack of marketability attributes, it offers reasonable insight into underlying cost to fair market value discounts.

In order for the discount data to be relevant, two common elements must apply, regardless of the type of ownership entity. First, the interest being valued must be a non-controlling interest – meaning the holder cannot control or influence management decisions solely. Second, the interest must have marketability issues. Transactions of RELPs in the study can be searched using criteria including type of partnership (warehouse, apartment complexes and retail), debt level, and distribution yields.

It is important for the valuator to understand the type of discount that is derived from the particular source used. For instance the RELP data from Partnership Profiles provides both a discount for lack of control and lack of marketability, while closed-end fund data provides discounts for lack of control only.

Once discounts are quantified for the various asset classes held by the FLP, an overall discount for the subject fractional interest can be developed by considering each asset class' percentage of the overall asset holdings of the entity. An illustration follows.

FAMILY LIMITED PARTNERSHIP – RECONCILIATION OF DISCOUNTS

	DISCOUNTS				
Asset	Minority	Marketability	Combined	% of Total Assets	Weighted Discount
Investments					
Domestic Stock	4.1%	23%	26%	20.0%	5.2%
International Stock	8.2%	23%	29%	10.0%	2.9%
Bonds	3.8%	23%	26%	10.0%	2.6%
Real Estate	*	*	31%	60.0%	18.6%
Total					29.3%

* *Partnership Profiles database produces a combined discount*

Cost/Asset Approach to Business Valuation

Summary

It is of the utmost importance that the valuator has an understanding of the objective of the engagement he or she is engaged to perform, the fundamental levels of value, and the proper development and quantification of discounts in the instance they are appropriate.

Cost/Asset Approach to Business Valuation

Chapter VII – *Reviewing Expert Reports*

Perhaps no part of the practice of law presents a greater challenge than the review and evaluation of expert reports. Understanding the concepts and mechanics of these reports is critical to proper representation of clients in any number of circumstances. Further, assessing and understanding strengths and weaknesses of expert reports can be critical to strategic planning for the matter at hand, as well as negotiations, mediation and trial planning, if such becomes necessary.

Without question, the starting point for development of an assessment of a valuation expert report is looking to the business valuator directly. To that end, the training, experience and reputation of the business valuator should be carefully evaluated.

<u>Questions that are relevant to an evaluation of the expert should include the following</u>:

- *What is the breadth of the formal educational background that qualifies the expert for expressing an opinion on value?*
- *What specific training or education has the expert undertaken related to business valuation?*
- *What, or which, professional accreditations related to business valuation does the expert carry?*
- *What are the dates the expert's business valuation accreditations were granted? (In other words, how long has the expert been practicing under these accreditations?)*
- *Are all accreditations maintained by the expert current and in good standing?*
- *What other accreditations, J.D., MBA, MST and/or CPA etc., does the expert hold that might add credibility to his or her opinions?*
- *How many years has the expert practiced in the discipline of business valuation?*
- *Has the expert ever been brought before a disciplinary board of any credentialing organization?*
- *Has the expert prepared valuations in the past for the specific purpose in the attendant case?*
- *What is the expert's general reputation in the region of the legal matter, as a whole?*

There are, of course, numerous other questions to be considered in the evaluation and selection of a business valuation expert, but proper findings to these few questions will go a long way in determining, on a layman's level, the credibility of the report.

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In evaluating specifics related to the information contained in the report, it is first necessary to understand the professional standards governing business valuation work product. Most business valuation practitioners, and their work, are governed by one or more of the professional standards developed and published by the following organizations:

- National Association of Certified Valuation Analysts (NACVA) – Professional Standards
- The Appraisal Foundation – Uniform Standards of Professional Appraisal Practice (USPAP)
- American Institute of Certified Public Accountants (AICPA) – Statement on Standards for Valuation Services (SSVS No.1)
- Institute of Business Appraisers (IBA) Standards
- Internal Revenue Service Business Valuation Guidelines

Commonalities exist across all of the standards, and it is important to note that each set of standards is generally bifurcated into two separate and distinct areas:

- Development Standards – govern the actions of the expert in developing a conclusion of value
- Reporting Standards – govern the manner on which the expert will report a conclusion of value

While the Reporting Standards provide flexibility in how the conclusion of value may be reported and communicated to the user, there is no flexibility in the Development Standards. The Development Standards impose upon the valuator, certain required steps and procedures to produce a complete and appropriate conclusion of value. Obviously, failure to comply with Development Standards will likely result in an erroneous conclusion of value.

Type of Reports

Valuation reports are written or oral communication to a client that contain the conclusion of value or the calculated value of the subject interest. As to presentation and communication formats imposed by the Reporting Standards, there are generally three broad levels of reports, used in different situations, as described below.

- *Detailed report* – A detailed report is only used to communicate the results of a full business valuation, not a calculation. According to SSVS, "the report is structured to provide sufficient information to permit intended users to understand the data, reasoning and analyses underlying the valuation analyst's conclusion of value." The components of a detailed report are outlined in the AICPA's SSVS No. 1.
- *Summary report* – The SSVS state that "a summary report is structured to provide an abridged version of the information that would be provided in a detailed report, and therefore, need not contain the same level of detail as a detailed report." Again SSVS lists the items that should be included in a summary report.

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- *Calculation report* – A calculation report is the only type of report that should be used to document the results of a calculation engagement. This type of report should state that it does not include all of the procedures required in a valuation engagement and had a valuation engagement been performed, the results may have been different.

It is important to note that an oral report may be used for either a valuation or calculation engagement in place of a written report. The valuator giving the oral report should, however, document the substance of the oral report communicated to the client.

In addition to the above-noted reports, there is also a simple "letter report" that is generally just a few pages long and sets forth only the most fundamental information as well as the conclusion of value. Seldom used, the letter report is not specifically set forth in current professional standards but sometimes still requested by attorneys.

The Reporting Standards from all of the major standards-setting bodies do no apply in a litigation setting if legal counsel wishes to communicate the conclusion of value in an alternative manner that best supports his or her client's position. Note that the level of reporting, set by the expert or the attorney, does not, in any way, alter the expert's responsibilities under the Development Standards. As such, the underlying work is always the same.

Most often, the level of report requested by users of business valuation reports is a Detailed Full or Self-Contained Report. Such reports can be very extensive, as they are intended to be comprehensive in scope, and lend to an absolute understanding of all relevant information utilized by the expert in developing his or her conclusion of value.

Report Review Summary

In conjunction with a review of such detailed reports, the checklist on the following page is intended to allow the legal practitioner to effectively evaluate the report's key components. The checklist is not intended to delve into technical and complex theoretical and mechanical calculations; rather, it is intended to ensure that assignment parameters and objectives have been met in the course of the expert's work and to ascertain that the conclusions obtained therein are in furtherance of legal counsels' representation strategies on behalf of their client(s).

No amount of checklist confirmation can replace attorney questions generated by a thorough and careful reading of the expert's report. While such an effort can seem daunting on first blush, the knowledge gained by experience will quickly lead to a more effective report and expert evaluation process.

In any case, the technical aspects of the report will almost always be best addressed by your expert, who should always be comfortable in identifying the strengths and weaknesses of his or her report, as well as the other expert's report.

Cost/Asset Approach to Business Valuation

REPORT REVIEW CHECKLIST

Professional Competency

- Valuation date
- Subject interest percentage
- Subject entity and its industry
- Scope of the engagement
  - Purpose
  - Assumptions and limiting conditions
  - Standard of value
  - Premise of value
  - Type of report to be issued, intended use and users of report
  - Restrictions on the use of the report
  - Government regulations/professional standards

Nature and Risk of Valuation Services and Client Expectations

- Terms of the engagement
- Identity of the client
- Nature and ownership rights in the subject interest, control characteristics, degree of marketability
- Procedural requirements
- Any obligation to update the valuation

Report Sections

- Basic company information
- Industry outlook
- Economic outlook
- Financial statement analysis
- Valuation methodology
  - Discussion of three valuation approaches (income, market, asset and why each was or was not relied upon)
- Discussion of discounts applied (marketability and minority interest)
- Valuation synthesis and conclusion
- Assumptions and limiting conditions
- Appraisal certification
- Sources of information relied upon

Additional Considerations

- Was the expert objective?
- Were there any conflicts of interest?

Cost/Asset Approach to Business Valuation

Chapter VIII – *Conclusion and Practical Considerations*

The key to interpreting conclusions of value under the Asset Approach is understanding the basis for setting historical asset and liabilities at their respective fair market values. The essence of a defendable position under this approach is to properly align the tangible asset appraisals' "standard of value" and "premise of value" to ensure there is a matching of those appraisals to the assignment requirements. Most often, assignment requirements are set by legal counsel based on the nature of the matter at hand and the venue in which he or she expects to execute the case or planning strategy.

Note also that most business appraisers who hold valuation credentials do not have the experience, training or other qualifications to appraise tangible assets – whether those assets be real or personal. As such, it will be necessary to engage outside independent appraisers for this work, adding to the cost of the engagement.

It is important to note the additional cost to the client at the outset and engage the appraisers as soon as possible in the assignment. Another issue regarding the use of appraisers is to communicate early and thoroughly. Such communication will prevent later inefficiencies and minimize cost.

With respect to identifying and quantifying unrecorded assets, forensic principles apply. If counsel suspects an abuse of assets, the engagement may require a transition from a valuation assignment to a forensic assignment. As one might imagine, exploratory forensic analysis of historical financial and operating information can be a time-consuming and costly process. Thus, the quantification of any abuse of assets is necessary, at least on an estimated basis, to determine if those forensic procedures are cost-beneficial.

Even with its complexities, the Asset Approach has found broad acceptance in the courts and, if properly applied, will provide a very defendable and reasonable indication of value. Such being the case, and as required by professional standards, it is incumbent upon the business valuator to focus on this approach and its underlying methodologies.

Understanding of this approach by members of the legal community will allow for greater capabilities in reviewing any number of legal issues, including, but not limited to, tangible and intangible asset valuation, business valuation and other asset-based litigation matters.