Attorney
CLE Series

Understanding the Business Valuation Process

GROSSMAN YANAK & FORD LLP
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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, ERP solutions and consulting services. The firm is led by six partners and employs approximately 55 personnel who serve corporate and not-for-profit entities.

Our firm was founded in 1990 on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

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Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance & Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

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Robert J. Grossman, CPA/ABV, ASA, CVA, CBA

Bob heads our firm's Tax and Business Valuation Groups. He has over 35 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. 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 business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. Bob is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA). He has served as an adjunct professor for Duquesne University and Saint Vincent College. He has also written articles for several area business publications and professional trade journals.

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 AICPA. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the PICPA Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received NACVA's "Thomas R. Porter Lifetime Achievement Award" for 2013. The award is presented annually to one of the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period.

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

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

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

Melissa, a partner in the firm's Business Valuation & Litigation Support Services Group, has practiced in public accounting for more than 21 years. She has significant experience in business valuation and tax-related issues for privately-held concerns and their owners.

Her business valuation experience is very diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs), value enhancement and gift and estate tax purposes. Melissa also provides litigation support services including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent 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 the AICPA, the Pennsylvania Institute of Certified Public Accountants (PICPA) and the Estate Planning Council of Pittsburgh. She is a member and serves as the Chair of the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

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

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa is also a mentor for women business owners through Chatham University's MyBoard program.

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

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- *Market Approach to Business Valuation*
- *Cost/Asset Approach to Business Valuation*
- *Quantification and Application of Valuation Discounts*
- *S Corporations vs. C Corporations: Understanding Valuation Differences*
- *Special Purpose Valuations: ESOPs & Buy-Sell Agreements*
- *Special Purpose Valuations: Estate & Gift Tax Planning*
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- *International Taxation*

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I. Introduction

Business valuation is, perhaps, the most complex of all financial disciplines. The primary reason for this complexity is that business valuation is not totally a professional discipline within itself, but rather, a combination of accounting, economics and finance melded into an analytical assessment of specific-entity attributes. The proper understanding and application of the concepts and methodologies encompassed in these multiple disciplines are then combined with those analytical, procedural and theoretical concepts and methodologies integral to the valuation of privately-held ownership equity interests to produce a proper and accurate assessment of value.

It is this complexity that often confuses users of business valuation services and the reports summarizing the results of those services. Often, the detail required to meet professional standards can result in reports that exceed 100 pages in length, making the document almost unreadable to laymen.

It is likely that business valuators will always be required to explain the procedures undertaken and their resultant conclusions; however, a fundamental understanding of the processes undertaken in a business valuation engagement along with a knowledge of "why" will aid the reader significantly in navigating the report.

Nowhere is it more important to understand the business valuation processes, as well as the resultant conclusions and report, than in the legal arena. Practicing attorneys acting on behalf of their clients are often called upon to structure monetary settlements and transactions based on information provided in these assignments. Even more critical is the understanding required by an attorney to move to trial.

The program today is intended to provide our friends in the legal community with a basic understanding of the business valuation process and how that process is set forth in a business valuation report. The course content, while general in nature, can serve as a foundation for future use when issues related to value come into play. Note, the terms "valuator," "appraiser" and "analyst" are used interchangeably to refer to valuation professionals.

Chapter II begins with a discussion of the purpose for which a business valuation engagement is requested and how that purpose can influence the value conclusion. The chapter also focuses on the importance of determining the date of valuation and various items to be considered when searching for a business valuator.

Chapter III will focus generally on those items that require assessment in the business valuation process and discusses how these items assimilate into the valuation conclusion.

Chapter IV will build on the earlier chapters by detailing and explaining those steps generally undertaken in a business valuation engagement designed to meet or exceed existing professional standards.

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Chapter V focuses on challenges by the courts related to federal rules of evidence and expert witness qualification, as well as Internal Revenue Service and United States Tax Court challenges.

Chapter VI concludes these materials with a brief focus on various items of a practical nature that should be considered by attorneys contemplating the need for a business valuation.

Today's program will serve as a refresher for many of today's participants, while a number of the attendees will encounter some new information. As with all of our seminars, it is our hope that everyone will be benefit in some way from attending, and that each of you will be able to return to your practices with a better understanding of those nuances that should merit your attention and consideration in advising your clients on topics related to valuation.

We appreciate that you have taken time from your busy schedule to join us today and also thank you for your attendance at our Firm's Continuing Legal Education series. Our seminars have proven to be a great success, and we hope that you find the content to be informative and helpful.

The authors will be available after the presentation to answer any questions you may have, or please do not hesitate to contact them at a later date. Their phone numbers and email addresses are listed below.

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We appreciate the support you have shown our Firm in the past and we look forward to working with each of you in the future.

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II. Required Skill Set and Professional Credentials

It is of primary importance for members of the legal community to have an understanding of the role a business valuator can assume in a given project. It is also important to be knowledgeable of the specialized skills necessary for an appraiser to complete specific engagements.

Business appraisers can perform many functions including the following:[1]

- ***Advising legal counsel or a client on a business valuation independent of a controversy related to the subject valuation.*** These valuations can be prepared in the context of sales, mergers, acquisitions, spin-offs, incentive stock options and financial restructuring. The majority of business valuations are performed for clients in everyday business transactions that do not become the subject of controversy. One reason that some transactions do not lead to controversy is that the event is supported by a qualified (and credentialed) appraiser who provides a well-reasoned (and documented) report.
- ***Providing an opinion of value that will be used before the Internal Revenue Service in an audit or an appeal at the Appellate Division.*** Appraisers are often called upon at the audit stage to provide an explanation of the valuation estimates for taxable gifts and estates. Most controversies are resolved at this level based on the taxpayer providing adequate support for the transaction.
- ***Assisting legal counsel out of court in understanding technical issues and preparing for the case.*** This role would entail educating legal counsel regarding various valuation approaches and/or methods and providing counsel with adequate understanding of the issues and the tools to be more effective in questioning the valuation-related witness.
- ***Testifying in court relative to an opinion that will be included in a trial record.*** Many business appraisers are called upon to testify as experts from time to time, and some serve as expert witnesses as a major part of their practice. In almost every case where a business appraiser is called upon to testify as an expert witness, the appraiser is asked to offer an opinion of value – usually the value of some type of business interest.

Each of the aforementioned tasks requires different skills from the appraiser/expert. Therefore, the appraiser/expert should be selected based upon the purpose for which the services are required, as well as the specific skills and knowledge of the professional.

[1] *Business Valuation and Taxes, Procedure, Law and Perspective*, David Laro and Shannon P. Pratt

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<u>Five factors that should be considered in connection with the effective use of appraisers/experts</u>:[2]

- ***The appraiser/expert must be qualified to perform the necessary analysis and formulate an informed and meaningful opinion.*** Engaging an accredited appraiser with experience in the type of issue or transaction at hand is inevitably more effective than using one who lacks these qualities.

- ***The appraiser/expert has credibility with the court.*** One way in which credibility can be established is by researching prior cases where the expert has testified. Courts will often comment on the qualifications and reliability of the expert, providing a wealth of information relative to the consistency and thoroughness of the appraiser/expert.

- ***The appraiser/expert refrains from advocacy.*** The role of the appraiser/expert is to guide the trier of fact to the truth, even if that truth conflicts with the client's position. Courts are concerned that attorneys may make the valuator/expert a surrogate advocate for the client's position, and are resolving this by appointing their own experts under Federal Rule of Evidence 706.

- ***If the appraiser/expert is a certified public accountant, he/she should refrain from providing audit and valuation services contemporaneously.*** The Sarbanes-Oxley Act of 2002 imposes certain restrictions with respect to nonaudit functions including valuation services.

- ***The appraiser/expert must offer reliable and relevant analysis and opinions.*** Opinions of value should be based on careful and thorough research of the events and circumstances surrounding the business interest.

It is important to remember that merely being qualified as a business appraiser does not qualify one as an expert in the field. Experts are distinguished by their credentials, skills, experience and training.

In addition to the valuator's credentials, consideration of the business valuator's role in the project will also serve to influence the selection decision. Generally, business valuation specialists are engaged as independent experts. In this capacity, the business valuator can only be an advocate for his or her position and not for the client. All services must be rendered from a completely objective and independent viewpoint, and there must be no conflicts of interest, either real or perceived.

Alternatively, legal counsel may engage a business valuator as a consulting expert who will provide services in the capacity of an advocate. Keep in mind, however, that consulting experts cannot easily be converted to independent experts and testify on your client's behalf, if at all.

[2] Ibid

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Purpose of Valuation

Integral to every business valuation conclusion is the purpose of that valuation. Oftentimes, nuances to the business valuation process are predicated upon the purpose for the valuation, and failure by the valuator to consider these nuances can have a profound effect on the conclusion. It is, without exception, critical to the value conclusion that the purpose be matched with the appropriate procedures to produce a correct result.

The question of purpose is one of facts and circumstances. A sample of just a few of those purposes for which business valuations may be prepared include:

- Estate and gift tax planning and compliance,
- Employee Stock Ownership Plan (ESOP) stock purchases,
- Marital dissolution/equitable distribution proceedings,
- Minority shareholder challenges,
- Buy/Sell Agreement disputes,
- S corporation built-in gain computations,
- Transactional litigation,
- Accounting-based valuations for FASB ASC 820, FASB ASC 805, FASB ASC 35 and FASB ASC 360,
- Stock option valuation under FASB ASC 178,
- Bankruptcy,
- Internal Revenue Code section 409A deferred compensation, and
- Purchase/sale of a business

Within these varied "purposes" for obtaining a business valuation, it is necessary for the valuator to consider a number of technical items that might influence both the work and the conclusion of value, including:

- What is the appropriate standard of value?
- Is the premise of value a going concern premise or, alternatively, liquidation?
- Is it appropriate or permissible to apply discounts for lack of control and/or lack of marketability?

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By way of example, assume that the purpose of obtaining a business valuation is to provide legal counsel with an indication of value of a fractional interest in an operating company to aid in the facilitation and implementation of an estate planning strategy. Here, the standard of value is "fair market value" as defined by Revenue Ruling 59-60, 59-1 C.B. 237 and United States Treasury regulations.

Defined later in these materials, it is sufficient at this point to understand that fair market value under these rules includes discounts. Alternatively, assuming the same fractional ownership interest, if the purpose were to assist in resolving a minority shareholder dispute in Commonwealth court, the standard of value would shift to "fair value," and discounts would likely not apply.

In addition to carefully defining the purpose of the valuation, the attorney must also determine the date of valuation. Value is a "point in time" assessment, and it is important to understand that the date of valuation, or the "as of" date, is a single date. Thus, the determination of that date is critical to the usefulness of any business valuation.

Excepting practice in litigation or family law, identifying the date of valuation is generally a rather matter-of-fact issue. However, this date should not be confused with the date of the report, which generally coincides with that date on which the field work on the engagement was completed.

Note that it is not the responsibility of the business valuator to set the date of valuation. While most business valuator's will be open to providing professional insight, legal counsel must provide that date for which he/she wants to establish a value conclusion.

Once legal counsel has determined the purpose and date of the valuation, the search for a qualified business valuator can begin. Selection of a business valuation professional should first, and foremost, focus on education and training, followed closely by field experience.

Often, both of these elements can be confirmed by noting the valuator's professional credentials. A variety of professional organizations and associations offer business valuation credentials as a result of meeting certain experience requirements and/or passing a test and/or submitting sample business valuation reports.

Professional Credentials

American Institute of Certified Public Accountants (AICPA)

The American Institute of Certified Public Accountants is the national membership organization of certified public accountants (CPAs) in the United States. It is noteworthy that a CPA credential is not necessary for membership, nor is membership required for certified public accountants.

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The AICPA sets various rules, professional standards and guidelines for its members. However, the AICPA does not oversee the uniform certified public accounting examination or issue the CPA credential. Both of these activities come under the auspice of each state's Board of Accountancy. Even if a CPA chooses not to join the AICPA, he or she may still be subject to the AICPA rules, as many state Boards of Accountancy adopt the AICPA rules (especially those relevant to professional conduct) in lieu of issuing separate rules.

The AICPA does issue a business valuation credential – Accredited in Business Valuation" (ABV). Only CPAs can obtain this credential, and the proper display of this credential is CPA/ABV. The ABV credential is business-valuation specific and, as noted, first requires a CPA license and membership in the AICPA. To obtain this credential, the CPA must pass a written examination and provide proof of experience by demonstrating "significant" involvement in at least six business valuation assignments or, alternatively, provide evidence of 150 hours that demonstrate substantial experience and competence.

National Association of Certified Valuators and Analysts (NACVA)

The Certified Valuation Analyst (CVA) credential is awarded to NACVA members who are CPAs and have completed a five-day training program, passed written examination and completed a rigorous business valuation case study. Additionally three personal and three business references are needed.

The Accredited in Business Appraisal Review (ABAR) credential is designed for business valuators whose work involves the review of valuation reports and analysis performed by others. A candidate for the ABAR designation must be a NACVA member who meets the education requirements and has a professional valuation designation awarded by a recognized professional association. To earn the credential, a professional must submit four references, complete a five-day course, pass an examination and prepare and successfully complete one business appraisal review report.

Earning the Master Analyst in Financial Forensics (MAFF) credential requires consideration of all of a professional's qualifications and commitment to the discipline. To earn the MAFF credential, candidates must attest to having met prerequisites and experience requirements and pass an exam focusing on financial forensics.

American Society of Appraisers (ASA)

The first ASA credential is the Accredited Member (AM) designation. An individual striving to become an AM must have a college degree and two years of full-time business appraisal experience. He or she must also complete four courses (three days each) with the successful completion of one half-day exam following each of the four courses or the successful completion of one all-day challenge exam. Additionally, an applicant must submit two appraisal reports to a Board of Examiners for review as evidence of professional capability.

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The next, higher designation is the Accredited Senior Appraiser (ASA). This designation is earned by meeting all of the AM requirements, plus an additional three years of full-time or full-time-equivalent experience.

A final credential is the Fellow of the American Society of Appraisers (FASA). An individual could become a FASA if he/she has met all of the above requirements and has been voted into the College of Fellows on the basis of technical leadership and contribution to the profession and the ASA as a whole.

Institute of Business Appraisers (IBA)

The Institute of Business Appraisers offers two different certifications relative to business valuation.

The Certified Business Appraiser (CBA) designation is earned by an individual who is an IBA member and has met the requirements for education and business valuation experience. Candidates must complete certification training and an appraisal workshop, pass a five-hour written examination and submit two business appraisal reports to demonstrate a professional level of competence. Professionals holding credentials from other recognized professional organizations can fast-track this process.

An individual who meets the above requirements, has a post-graduate degree, has held the CBA designation for at least 10 years, and has 15 years of experience can earn the Master Certified Business Appraiser (MCBA) credential. Three professional references are also required. The MCBA credential is the highest professional designation awarded in the business valuation industry and recognizes the extraordinary competence of a few highly skilled and experienced individuals.

Types of Engagements

Valuators must be knowledgeable of any government regulations and other professional standards applicable to the engagement, and the extent to which they apply to engagements to estimate value. Compliance is the responsibility of the appraiser. With this said, there are two types of engagements to estimate value including a valuation engagement and a calculation engagement. In the simplest terms, a calculation engagement does not include all of the procedures required in a valuation engagement.

The type of engagement is established in the understanding with the client and end-user of the work product. This should be done at the outset of each engagement. The following is a summary of the differences between a valuation and a calculation engagement, pursuant to professional standards.[3]

[3] *Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,* Issued by the AICPA Consulting Services Executive Committee

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An appraiser performs a ***valuation engagement*** when the project calls for the valuator to estimate or opine on the value of the subject interest. The appraiser is free to apply the valuation approaches and methods he/she deems appropriate in the circumstances. The procedures applied should be in compliance with all applicable valuation standards. The appraiser expresses the results of the valuation as a ***conclusion of value*** – either a single amount or a range.

<u>In performing a valuation engagement the appraiser should</u>:

- Fully understand and analyze the subject interest;
- Consider and apply appropriate valuation approaches and methods; and
- Prepare and maintain appropriate documentation.

Valuations involve an ongoing process of gathering, updating and analyzing information. There are numerous detailed procedures that are performed by the valuator in connection with each of the above. These procedures are the subject of this material and will be discussed in Chapters III and IV.

The purpose of a ***calculation engagement*** is to estimate value, wherein the appraiser and the client agree on the specific valuation approaches and methods that the appraiser will employ and the extent of the valuation procedures that he/she will perform to estimate the value of the subject interest. Therefore, the appraiser is not free to apply any and all approaches and methods he/she deems appropriate. The appraiser expresses the results of the calculation engagement as a ***calculated value***, which may be either a single amount or a range.

<u>In performing a calculation engagement the appraiser should consider the following</u>:

- Identity of the client and the subject interest
- Purpose and intended use of the calculated value
- Intended users of the report and limitations on its use
- Effective date of the calculation
- Applicable premise of value and standard of value
- Whether or not the business interest has ownership control and its degree of marketability
- Sources of information used in the calculation
- Valuation approaches and methods agreed upon with the client
- Subsequent events, if applicable

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The calculation report should note that the engagement does not constitute a full valuation as applicable standards define, and had a valuation been undertaken, the results might have been different. Appendices or exhibits may be used by the appraiser for required information or information that supplements the calculation report. The appraiser's assumptions and the limiting conditions should also be detailed in the calculation report.

Hypothetical conditions affecting the subject interest may be required in some instances. When hypothetical conditions are employed during a valuation or calculation engagement, the appraiser should indicate the purpose for including such conditions and disclose these conditions in the report.

There have been instances in practice where a calculation is performed for a client, and subsequently, the need arises for a full valuation. Consideration of the information and methods employed in the calculation engagement can be used to efficiently transition to a full valuation.

There are many factors that must be considered in the determination of whether a particular circumstance can call for a calculated value versus an opinion of value. All parties involved in the process should have an understanding of the differences between the two types of engagements and the procedures undertaken prior to commencing the project. *Please note that calculation engagements will not be discussed any further in these materials*.

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III. Accepted Guidance and Theory

The valuation of a closely-held business requires the application of generally accepted business valuation methodologies and practices. Over many decades, value determinants have been identified by members of the business valuation community, as well as by finance and economic professionals. The theory set forth over this period has led to a body of knowledge that has evolved into an accepted listing of critical criteria that must be considered in the course of a business valuation assignment.

The foundation of much of the accepted theory, at the date of this presentation, is based upon early developments by the various engineering groups at the Internal Revenue Service. It is commonly accepted within the business valuation community that those concepts and methodologies, developed in conjunction with a long line of judicial decisions and Internal Revenue Service rulings, set forth key criteria in the determination of fair market value for U.S. estate and gift tax purposes. Moreover, as the business valuation profession has evolved, modern treatises have built upon the foundation established by the Internal Revenue Service and past judicial decisions.

The primary fundamental requirements for a fair market value determination were first formally set forth in Revenue Ruling 59-60, 1959-1 Cumulative Bulletin 237. The ruling notes that a determination of fair market value, being a question of fact, will depend upon the circumstances in each case.

The ruling requires the appraiser to "maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

While the ruling emphasizes the review and analysis of all relevant factors, it also presents a listing of specific, though not all-inclusive, fundamental factors to be considered in the valuation process. These factors are listed below and discussed in greater detail to provide an overview of how they are considered in the valuation process.

- The nature of the business and the history of the enterprise from its inception
- The economic outlook in general and the condition and outlook of the specific industry in particular
- The book value of the stock and the financial condition of the business
- The earnings capacity of the company
- The dividend-paying capacity of the company

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- Whether or not the enterprise has goodwill or other intangible value
- Sales of the stock and the size of the block of stock to be valued
- The market price of stocks of corporations engaged in the same, or a similar, line of business, having their stocks actively traded in a free and open market, either on an exchange or over-the-counter

The nature of the business and the history of the enterprise from its inception

To provide an opinion of value that meets current professional standards, it is first necessary to intimately understand all of the qualitative information about the company's management and its operations.

If one thinks of stock pricing in the public stock market, a great deal of weight is placed on the judgment of stock analysts, whose job it is to keep abreast of historical, current and expected future management and operational events that might influence the subject stock's value. These individuals are generally knowledgeable of a very broad spectrum of company-specific information.

It is this type of information that is just as critical to the business valuator when determining the value of a privately-held company. Intimately understanding where the company has been and where it intends to go requires the business valuator to carefully assess all of the available information.

This understanding begins with a substantial information gathering and review process. Such a process (discussed in detail in Chapter IV) includes a review of financial statement items, including accounts receivable, aging detail, inventory detail and debt detail; a review of sales literature; an understanding of competitors, market size, work force constraints, supplies, facilities, regulatory influences, pending litigation and environmental issues; and knowledge of company entity structure and equity dispersion.

Observations gleaned from these analyses are then confirmed by physical site visits and meetings with management. Conclusions garnered through this process will be utilized in developing a listing of the company's strengths and weaknesses and how they may influence the value of the entity.

The economic outlook, in general, and the condition and outlook of the specific industry, in particular

An understanding of the economic and industry outlook is fundamental to developing reasonable expectations about the subject company's prospects. The outlook for the economy and industry should be clearly related to the company being valued, and an assessment of how the outlooks will affect the subject company should be performed.

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The general economic outlook influences all industries and all companies. Research is undertaken with respect to the most important leading economic indicators, including measuring economic growth through the gross domestic product (GDP), inflation, employment, consumer spending, business investment, interest rates, construction and population trends. Each segment of the economy may be affected differently by a particular trend or event. The impact of each relevant factor on the subject company should be the focus of the valuator.

The valuator must gain an understanding of the industry in which the subject company operates to grasp where the company fits into the industry, as well as which industry factors are most relevant to the company. Research should be analyzed to evaluate how the subject company is affected by shifts in demand, changes in technology and shifts in the competitive landscape.

Abundant sources of information are available to assist valuators in this step of the process. The research, analysis and resultant conclusions derived in connection with the industry and economy will be considered by the appraiser in the selection of discount and capitalization rates, valuation pricing multiples and other valuation variables.

The book value of the stock and the financial condition of the business

Book value is somewhat of a misnomer, in that the term is grounded in accounting literature and in no way is associated with the value of the business. From a definitional standpoint, book value is measured on historical financial statements as the difference between a business' total assets and its total liabilities. Generally, book value is the summation of a company's net equity capital raised (book value of stock) and its cumulative economic results since inception. Cumulative positive earnings obviously reflect a stronger financial condition than cumulative negative earnings, or losses.

While book value does not provide valuators with a direct indication of value, it is useful in allowing the valuator to assess the financial well-being of the company under valuation. However, this assessment tool is just one of many financial statement analytical procedures and tools utilized by the business valuator in his/her process of determining the financial well-being of the subject company.

Understanding the book value of the stock and the financial condition of the company enables the business valuator to confirm the current overall financial condition and how the company compares to others in its industry. Such confirmation, therein, is used to estimate the risk associated with the company's future expected performance. This knowledge will aid in the development of discount and/or capitalization rates and provide a foundation from which to apply certain valuation approaches and methodologies.

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The earnings capacity of the company

Earnings capacity refers to future expected earnings. Often this future expected earnings is defined as net free cash flow, but valuators also use earnings.

A fundamental precept in business valuation is that all value is forward-looking. Thus, the determination of future earnings capacity is critical to the overall conclusion of value and plays a direct role in many of the methodologies employed by business valuators in establishing an indication of value.

Earnings capacity goes to the heart of all investment analytics. In determining the proper amount to pay for any investment, an investor is most concerned with future economic gains attributable to holding that investment through the date of disposition. Earnings, whether defined as net income before tax, net income after tax, free cash flow or some other measure, directly measures the expected future economic gains.

As all determinations of value are forward-looking, the only relevant earnings capacity is that expected after the date of valuation. Historical earnings are relevant only to the extent that they can aptly serve as a proxy for future expected earnings.

Finally, earnings capacity, in the context of business valuation, envisions an economically "normalized" future expected earnings. Nonrecurring income and expenses from the past should not be considered on a go-forward basis. Excess owner perquisites, out-of-market-rate rents, salaries, etc. should, likewise, not be considered. All items of income and expense associated with nonoperating assets must be adjusted, as well.

The dividend-paying capacity

Focus on dividend-paying capacity is closely related to understanding and analyzing the subject company's earnings capacity. Primary consideration should be allotted to the dividend-paying capacity of the company rather than the actual dividends paid historically. In making any such determination, it is important to consider the necessity of retaining a reasonable portion of the profits in the company to meet competition. Dividends paid in the past may not be any indication of the dividend-paying capacity of the company. As with earnings capacity, dividend-paying capacity, in the context of business valuation, means future dividend-paying capacity.

In the instance where an actual or effective controlling interest in a business is to be valued, the dividend-paying capacity factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders. The controlling shareholder can substitute salaries and bonuses for dividends, thereby reducing net income and understating the dividend-paying capacity of the company.

Understanding the Business Valuation Process

Whether or not the enterprise has goodwill or other intangible value

In the determination of enterprise value or total business value, it is important to address both tangible assets (machinery, furniture, buildings, vehicles, etc.) and intangible assets (goodwill, going concern value, names, licensing rights, etc.) For many valuations prepared for a tax-related purpose, all intangible assets are combined into goodwill.

Goodwill is based on earnings capacity. The existence of goodwill is the result of net earnings over and above the fair return on the net tangible assets. While the presence of excess earnings indicates goodwill or other intangible value, other factors, including the prestige and renown of the business, ownership of a well-recognized brand or trade name, know-how and a record of successful operation of the business, also support the existence of intangible value.

In valuing a business interest, those methods employed under the income and market approaches generally value the entire enterprise, including both tangible and intangible assets. To arrive at a total value for all intangible assets, one simply subtracts the appraised value of tangible assets from total enterprise value. To calculate the value of specific intangible assets within total intangibles is a much more complex process, and is beyond the scope of these materials.

Sales of the stock and the size of the block of stock to be valued

Sales of the stock of a closely-held company should be carefully investigated to determine whether they represent transactions conducted at arm's-length. Transactions involving companies under a forced or distressed sale are generally not representative of fair market value.

The size of the block of stock to be valued is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

It is also important in assessing the size of the block under valuation to consider total dispersion of remaining equity interest or shares in the company under valuation. Such dispersion can have a profound effect on value of a subject equity ownership interest.

Understanding the Business Valuation Process

The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter

This factor encompasses the market approach of valuation. The theory of the market approach to valuation of any asset, including privately-held business ownership interests, is the economic principle of substitution. An investor would not pay more than one would have to pay for an equally-desirable alternative.

Section 4.02 of Revenue Ruling 59-60 states:

"Section 2031 (b) of the Code [Internal Revenue Code of 1986, as amended] states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks, which are actively traded by the public.

In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies that have stocks actively traded in the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date.

In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration,…a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion."

While no two companies are identical, proponents of the market approach advocate the identification of market transaction companies that are sufficiently similar to provide users with "guideline" indicators of value. Consideration of the theory above is advocated by all commonly-accepted business valuation treatises for determination of value for a broad array of business valuation and economic purposes. In addition, use of the market approach has been widely accepted by the U.S. Tax Court, U.S. District Court in bankruptcy proceedings, various family and appellate courts in divorce and marital dissolution, and in various other state and federal courts.

Summary

As noted, the valuation of closely-held corporate stock entails the consideration of all relevant factors as described herein. Depending on the circumstances of each case, certain factors may carry more weight than others because of the nature of the subject company's business.

Understanding the Business Valuation Process

IV. The Business Valuation Process

Defining the Assignment

Defining the valuation assignment is the logical beginning of the valuation process, providing focus for all valuation considerations and efforts undertaken in the engagement. The first stage of the business valuation process is to establish the basic parameters for the engagement, including determining the purpose of the valuation, standard of value, premise of value, date of valuation, definition of the interest or interests to be valued and the deliverable (meaning the valuation report).

The context in which the valuation is to be used is a critical factor. Different statutory, regulatory and case-precedent standards govern valuations of businesses and business interests under various jurisdictions for diverse purposes. Much litigation over business valuations arises because the parties failed to match the valuation methods to the intended purpose of the engagement. The purpose of the valuation often determines the applicable standard of value. Chapter II presented a few of the purposes for which business valuations may be prepared.

A great deal of confusion in requesting a business valuation or interpreting its meaning could be avoided by properly focusing on the selection and utilization of the appropriate standard of value. Often, the appropriate standard of value is dictated by statutory guidance such as the Internal Revenue Code. Under other circumstances, the standard of value has evolved through judicial decisions and guidance issued by regulatory agencies and authorities. It is not unusual in a litigation environment for both sides to agree on a desired standard of value.

It is not difficult to understand what a standard of value is. Though labeled a "standard," it is nothing more than a definitional explanation of different, commonly-utilized types of value. However, it is incumbent upon the business valuator and the user of his/her work product to fully understand the ramifications and implications of each definition.

Please Note: While it is generally the role of the business valuator to fully explain and educate the attorney as to the definition and nuances of each standard of value, it is the attorney's role to dictate the standard of value that is required in conjunction with his/her case. This is especially true where judicial history subject to legal interpretation sets the precedent.

The standards of value most commonly encountered by business valuators and users of valuation reports are:

- Fair Market Value
- Investment Value
- Intrinsic/Fundamental Value
- Fair Value
  - State statutory value
  - Financial reporting value

Understanding the Business Valuation Process

Standards of Value

Fair Market Value

By far the most common standard of value, fair market value, is applied in income, estate and gift tax, marital dissolution[4] and, often, non-shareholder oppression litigation. Fair market value is defined in the U.S. Treasury regulations (20.2031-1(b)) and Rev. Rul. 59-60, 59-1 CB 237 as:

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

The definition requires that the valuation result be driven by a hypothetical sale transaction. Thus, it stands to reason, that focus and attention must be given by a valuator to those hypothetical buyers and sellers, and to the concerns and issues that a potential hypothetical buyer and seller might consider prior to entering into a transaction. A key component of this definition is that a value determination based on special motivations of either a specific buyer or a specific seller would not be considered fair market value. Fair market value also anticipates that both the hypothetical buyer and seller have the ability, as well as the willingness, to enter into the hypothetical transaction.

The definition of fair market value anticipates a value determination under prevalent economic and market conditions at a particular date of valuation. To assume an economic or market turnaround at a point in time beyond the date of valuation will result in a value other than fair market value.

Further, the definition also assumes that payment in the hypothetical transaction will be made in cash, or its equivalent, at the date of valuation. Thus, consideration of any deferred financing or special purchase arrangement is not appropriate when the goal is to identify fair market value.

Finally, fair market value, by definition, must allow a reasonable time for exposure in the open market. For equity ownership interests requiring longer periods of exposure, marketability or, rather, the lack of marketability, presents a greater investment risk and, therefore, a value detriment. Often this value detriment is addressed in the business valuation process as a discount.

4 Many states use the term "fair market value" in their marital dissolution cases. The definition of fair market value may vary from state to state and will not necessarily be the same definition applied for federal tax purposes.

Understanding the Business Valuation Process

Investment Value

Investment value is generally defined as the specific value of an investment, to a particular class of investors, based on individual investment requirements. In consideration of valuing an equity ownership interest, investment value differs from fair market value, which is not buyer- or seller-specific.

Often, investment value is also referred to as synergistic or strategic value. This reference reflects the impact of those synergistic or strategic benefits one particular buyer may bring to the negotiating table in determining investment value.

Such buyer-specific benefits might include:

- An ability to enhance future operating performance,
- An ability to mitigate certain risks inherent in the subject company,
- An ability to more efficiently finance the acquisition of the subject company, and
- An ability to assimilate current operations synergistically with the subject company.

In most instances, investment value will exceed fair market value, primarily as a result of the supply and demand continuum for target companies. Simply put, demand for acquisition targets far exceeds available supply. As competitive bidding progresses in the negotiation process, the marketplace reveals that prospective specific buyers are generally willing to pay a premium beyond fair market value to close the deal. Additionally, anticipated post-acquisition cost reductions due to operational synergies may allow for the payment of a premium.

Intrinsic or Fundamental Value

Perhaps the most difficult standard of value to grasp, intrinsic value represents a specific valuator's judgment of value, based on the perceived characteristics inherent in the specific investment. The intrinsic value does not contemplate the specific motivations of a particular buyer but, rather, how that one valuator's perception of the characteristics attendant to the subject equity ownership interest compares to other valuators' perceptions.

An easy way to envision intrinsic value is to consider how it might apply to a capital stock investment. Essentially, intrinsic value is that value, based on the valuator's "fundamental evaluation" of all available information, that the valuator believes reflects the "true" or "real" worth of that stock. When all valuators perceive the stock's value as the same number, the intrinsic value moves to fair market value.

The term intrinsic value is often discussed in case law; however, it is rarely defined. Attempts to utilize this standard of value in New Jersey family courts have been met with controversy.

Understanding the Business Valuation Process

Fair Value under State Statutes

In most states, fair value is the statutory standard utilized to resolve shareholder disputes for both dissenting-shareholder and oppressed-shareholder lawsuits and civil actions. Fair value, for these purposes, is generally defined, with respect to the dissenter's shares, as the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable. While most states have a fair value statute, the majority of those offer little insight into its computation.

It is noteworthy that state courts have not considered fair value, for these purposes, as being equal to fair market value. Generally, damages to the harmed party are determined by the difference between the value of the dissenting shareholder's percentage ownership interest before and after the corporate action, without consideration of any discounts for lack of control or lack of marketability.

Fair Value for Financial Reporting

As international accounting rules, including those used in the United States, move from an historical basis of accounting to a "fair value" basis of accounting, more attention has been focused on the definition of fair value for financial reporting purposes. Note that fair value for financial reporting has no relationship whatsoever to fair value under state statutes.

Issued by the Financial Accounting Standards Board (FASB) on September 15, 2006, Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS No. 157) provided guidance on the measurement of fair value as a market-based measurement. [The Standard is now called FASB Accounting Standards Codification 820, *Fair Value Measurement and Disclosures* (ASC 820).] It provides guidance on the measurement of fair value as a market-based measurement.

Paragraph 5 of the Standard gives a single definition of fair value:

> *"Fair value is the price in an orderly transaction between market participants to sell the asset or transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability."*

It is clear from FASB releases that fair value for financial reporting is not fair market value, as noted earlier.

Understanding the Business Valuation Process

Other Assignment Parameters

In addition to defining the standard of value, it is important to determine the applicable ***premise of value***. The premise of value is an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation. Premises of value include either going concern or liquidation.

Most often, valuation professionals work under the going concern premise of value, meaning that the existing management of the subject company will remain into the future and will maintain the character and integrity of the company. A liquidation premise would provide the net amount that would be realized if the business terminated and the assets were sold piecemeal. Liquidation can be either "orderly" or "forced."

The date or dates on which the subject business will be valued is critically important because events and circumstances can arise that can cause value to vary materially from one date to another. The ***date of valuation*** influences the information available for the valuation. It is the perspective from which all analysis is performed in the valuation. There are instances in which there is more than one date of valuation, including a marital dissolution, where the parties may be concerned with the change in value that occurred during the marriage. In some litigated cases the valuation date is an issue to be resolved by the court.

Description of the specific interest or interests that are the subject of the valuation must be articulated clearly to result in a meaningful conclusion. The interest can include equity stock (common or preferred, voting or nonvoting) of a corporation or S corporation, partnership interests (including general and limited partners), or limited liability company (LLC) member interests. It must be known if the valuation subject is a partial (or fractional) interest and the relationship of the partial interest to the whole. This is a point at which the interest can be characterized as a controlling, a noncontrolling or a minority interest, and a marketable or non-marketable interest.

The last assignment parameter to ascertain the ***deliverable***. In many cases, the purpose of the assignment largely determines the form of the report. A valuator's report to the client can be oral or written. In most cases, especially those involving tax-purpose valuations, such as gift and estate tax, the appraiser will be required to prepare a formal written report that is in compliance with regulations involving a qualified report.

Once the valuation assignment is properly defined, the valuator will prepare a work schedule based upon the objectives of the engagement and any timing considerations of legal counsel. It is important for the appraiser and the client to carefully think through and come to a consensus on the details of the assignment as thoroughly as possible at the outset of the engagement. All of the aforementioned considerations in defining the assignment will be incorporated into the engagement letter.

Understanding the Business Valuation Process

Information Gathering and Analysis

This step in the business valuation process is time-consuming and critical, in that proper collection of company information and historical data sets the stage for an efficient and cost-effective study. Company-specific data is gathered from management in written form, during site visits and interviews with the individuals knowledgeable about the subject company. The valuator's understanding and impressions of the business will be enhanced with the proper application of this step in the process.

Understanding how the company has evolved, as well as current and potential changes that might cause the company's future to differ from that indicated by a mere extrapolation of historical information, is integral in moving through the remaining stages of the valuation process. Understanding the company history helps determine how many years of financial data are relevant to the current valuation project.

The gathering, review and analysis of company information and communication with the client is ongoing during the valuation process. The information, which typically includes the items detailed below, may be gathered through interviews of management and/or completion of an extensive questionnaire.

Typical information gathered for the valuation process:

- Company history
- Description of the business
- Description of management and their duties
- Operational information
  - Suppliers
  - Relationship with employees
  - Plant and equipment
  - Inventory
  - Markets and marketing
  - Competitive landscape
  - Capacity
- Prior arm's-length transactions
- Management plans for the future
- Financial information
  - Accounting policies
  - Identification of any non-recurring or non-operating items
  - Existence of intangible assets
  - Assessment of quality of fixed assets
  - Types of liabilities
  - Capital structure
  - Off-balance-sheet items
  - Profitability and budgeting
  - Insurance
  - Dividend policy
  - Related-party transactions

Understanding the Business Valuation Process

In addition to the previously-noted data, an information request is submitted for collection of other data relative to the subject company, including the following:

- Company documents
  - Articles of incorporation, by-laws and any amendments
  - Franchise or operating agreements
  - Any buy/sell agreements or options to purchase stock
- Historical financial statements for relevant period
- Income tax returns for a relevant period
- Latest interim statements and interim statements for comparable period(s) of the previous year
- Other financial data
  - Fixed asset/depreciation schedule
  - Aged accounts receivable and payable
  - Marketable securities
  - Inventory summary
  - Synopsis of leases for facilities and/or equipment
  - Listing of contracts (i.e. non-compete, employment agreements, supplier agreements, royalty agreements, labor contract, etc.)
  - Schedule of insurance in force
  - Budgets and projections
  - Business plans
  - Key personnel compensation, including benefits and personal expenses
- Other information
  - List of stockholders and shares owned
  - Organization chart
  - Marketing literature
  - Resumes of key personnel
  - Any filings or correspondence with regulatory agencies
  - Any indicators of asset values including property or machinery and equipment appraisals
  - Trade associations to which the company belongs

Understanding the Business Valuation Process

The historical financial statements of the subject company will be initially reviewed by the valuator. The balance sheet of the subject company will disclose to the appraiser the liquid position, gross and net book value of principal classes of fixed assets, working capital, long-term indebtedness, capital structure and net worth. Consideration is also given to assets that are nonessential to the ongoing operations of the subject business. Comparison of company balance sheets over several years can reveal such developments as the acquisition of additional facilities, subsidiary companies, improvements in financial position, and instances of recapitalizations and changes in company stock.

Review of the subject company's income statement will show gross income by principal items; principal deductions from gross income including major operating expenses, interest expense on long-term indebtedness, officers salaries, income taxes and deprecation/amortization; net income available for dividends; rates and amounts of dividends paid on each class of stock; and the remaining amount carried to surplus.

After gaining a sufficient understanding from review of the financial information, analysis of this information is undertaken. To facilitate a proper analysis and interpretation of the subject company's financial statements, the statements should first be adjusted to reflect the economic realities of "normal" operating conditions. This "normalization process" will present the company's data on a basis more comparable to that of other companies operating within the industry and will identify the strengths and weaknesses of the subject company relative to its peers. Most importantly, it can provide what a willing buyer would expect the operating results to be.

<u>The normalization process includes adjusting the subject company's financial statements for</u>:

- Nonrecurring items
- Extraordinary items (both unusual and nonrecurring)
- Nonoperating items
- Changes in accounting principles
- Nonconformance with generally accepted accounting principles
- Discretionary and related-party items

The appraiser should ascertain instances of nonrecurring items of income and expense, distinguish between operating and investment income, and determine the percentage of earnings retained for business expansion. Potential future income is a major factor in any valuation of a closely-held business, and all information concerning past income that might be helpful in predicting future benefits should be secured. Prior earnings records are usually the most reliable guide as to future expectations; however, relying on arbitrary five- or eight-year averages, without regard to current trends or future prospects, will not produce a realistic valuation.

Understanding the Business Valuation Process

Once the subject company's financial statements have been normalized, valuators employ analytical methodologies to identify operational trends. These methodologies include vertical (common-size) and horizontal (growth) analysis, trend analysis and ratio analysis (liquidity, efficiency, turnover and debt ratios). This analysis process will help identify and quantify some of the company's strengths and weaknesses, both on an absolute basis and relative to other companies or industry norms.

The assessment of the financial condition of the company will assist the appraiser in understanding the risks facing the company, which will aid in the development of discount and/or capitalization rates and provide a foundation from which to apply certain valuation approaches and methodologies.

Also at this stage, the valuator will research and analyze the outlook for both the economy and the industry in which the company operates. The purpose of economic research is to understand the effects of the economic conditions relative to the subject company at both the national level and the company's geographical level. These factors are those over which the subject company has no control.

As previously noted, economic research is focused on the most important, leading economic indicators, including measuring economic growth through the gross domestic product, inflation, employment, consumer spending, business investment, interest rates, construction and population trends. Trends are identified that are particularly favorable and unfavorable to the subject company. For example, low mortgage interest rates are favorable if the company is a builder/contractor. Low unemployment could be unfavorable if the company is labor-intensive.

National economic information can be derived from the Federal Reserve, the U.S. Census Bureau, The Conference Board and numerous national economic reviews. Local economic information should be considered to determine its impact (if any) on the subject company. Local economic information can be obtained from banks providing monthly or quarterly economic updates, data published by the Federal Reserve system on the twelve Federal Reserve Districts, the U.S. Census Bureau, and numerous websites that provide useful information.

<u>Factors to consider include</u>:

- Population growth
- Median income levels
- Openings and closings of major plants/facilities
- Whether the economy is dependent upon a single employer or industry
- Composition of the local labor market
- The condition of the region's infrastructure

The appraiser must also gain an understanding of the industry in which the subject company operates to grasp where the company fits into the industry, and which industry factors are most relevant to the company. Historical and projected growth in the industry, number of competitors and their respective market shares, and prospects for consolidation should all be considered.

<u>The following factors should also be identified and considered at this phase of the process</u>:

- Future prospects for growth
- Competitive forces
- Forces required to change the industry trends
- Size of the industry
- Barriers to entry
- Whether the industry is regulated
- Dominance by a few large companies
- Merger and acquisition activity
- Public companies participating in the industry

Industry information can be derived from sources such as First Research, Integra Information, MarketResearch.com, Standard & Poor's Industry Surveys and Forms 10-K and 10-Q (annual and quarterly) as filed with the SEC by publicly-traded companies in the subject company's industry.

The research, analysis and resultant conclusions derived in connection with the industry and economy will be considered by the valuator in the selection of discount and capitalization rates, valuation pricing multiples and other valuation variables. During this stage of the valuation process there is ongoing communication between the appraiser and representatives of management of the subject company.

<u>Method Selection and Calculation of Value</u>

Once the information is gathered and properly analyzed, the next steps include selecting the method(s) and preparing the calculation(s) of value. The discipline of business valuation focuses primarily on three broad approaches to value: the income approach, the market approach and the cost/asset approach.

All three approaches should be considered, along with the facts and circumstances attendant to a particular valuation engagement, to determine which approach is most appropriate. If multiple approaches are used, the results should be analyzed to determine the reasonableness of the value produced by each approach.

Understanding the Business Valuation Process

- The ***income approach*** attempts to value future economic benefit streams (usually cash flow) in present value dollars at the date of valuation.
- The ***market approach*** requires the valuator to identify transactions that have occurred in the marketplace, which are sufficiently similar to the subject company, to afford some indication of value, generally through the use of various valuation multiples.
- Finally, the ***cost/asset approach*** requires the valuator to determine the cost to construct or develop an asset, less any adjustment downward for obsolescence.

Within these three broad approaches are numerous methodologies that require a wide variety of inputs and analysis – many of which are subject to the professional judgment of the business valuator. A synopsis of these approaches and the underlying methods are set forth below.

INCOME	***Capitalized returns***	• Capitalization of earnings
		• Capitalization of net cash flow
		• Capitalization of gross cash flow
	Discounted future returns	• Discounted net cash flow
		• Discounted future earnings
MARKET	***Value multiples using comparative company data or transactions***	• Price/earnings
		• Price/dividends
		• Price/gross cash flow
		• Price/book value
		• Price/revenues
		• Price/net asset value
COST/ASSET	***Underlying assets***	• Net asset value
		• Liquidation value
	Other	• Excess earnings
		• Rules of thumb
		• Seller's discretionary cash flow
		• Company-specific methods

Understanding the Business Valuation Process

Income Approach

The most common methods used by valuation professionals for privately-held businesses are ***capitalized returns*** and ***discounted future returns.*** The conclusions attained using these methods are marketable values. Thus, if the equity ownership interest under valuation is not marketable, it is incumbent upon the valuator to use a discount for lack of marketability.

The primary theoretical justification for this position is that the data used by valuation professionals to construct risk rates (i.e., capitalization and/or discount rates) comes from public-company information. As such, this data reflects equity returns in consideration of a high level of marketability and liquidity. Whether these methods produce a control or minority value is a different matter altogether, and is wholly dependent upon whether the forecast of future economic performance reflects the returns that a control owner would make as a result of control ownership.

It is clear, mechanically, that a control or minority conclusion under these methods is solely a factor of the adjustments to the numerator in the calculations. Note that the adjustments to the future economic benefit stream must be related to control perquisites to shift from minority to control. The example below shows a calculation for a discount for lack of control using the income approach, and emphasizes this concept.

INCOME APPROACH – CONTROL vs. MINORITY

	Control		Minority
Cash Flow	$ 750		$ 750
Control Adjustment	250		0
	1,000		750
Capitalization Rate	.20		.20
	$ 5,000		$ 3,750
Difference		$ 1,250	
Discount for Lack of Control		25%	

Market Approach

The market approach, if properly applied, allows valuators the opportunity to tie their conclusions to marketplace data more directly. Since the data for both primary methods, the ***guideline company method*** and the ***transaction method***, trail public and private market activity, the results are generally deemed to represent marketable conclusions.

Understanding the Business Valuation Process

Historically, under a guideline company method, with valuation multiples developed from public stock market data, the business valuation profession presumed that the value conclusions were minority conclusions. This thinking is one of the most prevalent positions taken by valuators. However, there is a newer school of thought gaining ground within the profession that the conclusions attained under the guideline company method are neither minority nor control.

This position assumes that companies listed on public exchanges are subject to a very high level of analysis and scrutiny by the Securities and Exchange Commission and financial and industry analysts and, therefore, are likely run at the highest level of performance attainable. Thus, there are no value detriments attributable to minority ownership.

The second market approach method, the transaction method (also commonly referred to as the mergers and acquisition method), simply requires the valuator to identify guideline companies from various private transaction databases of completed transactions. As such, the conclusions garnered under this method are control, marketable values.

Cost/Asset Approach

The ***underlying assets methods*** are more suited to valuing controlling interests. Generally, these methods should only be used to value minority interests if those interests can cause the company to sell its assets, or if the company is the type of company whose stock should normally be valued primarily on an asset basis (i.e., an investment holding company.) As a result, these methods generally produce a control, marketable value.

When utilizing ***excess earnings methods***, variations in model inputs can change the result to minority, but such a result is extremely difficult to reconcile and defend. As such, in most cases, the excess earnings methods produce a control, marketable value. Because the inputs to models under the ***multiple of discretionary earnings method*** are based on purchase and sales transactions, the result is generally control, marketable values.

In the area of premiums and discounts, a user of business valuation reports must understand how valuator inputs influence where each method's conclusion falls on the levels-of-value chart. Such an understanding, then, confirms or rejects the precept that use of a premium or discount is warranted.

Levels of Value

Implicit to determining the propriety of premiums and discounts is an understanding of levels of value. Such levels are usually defined by the attributes of ***control*** and ***marketability***.

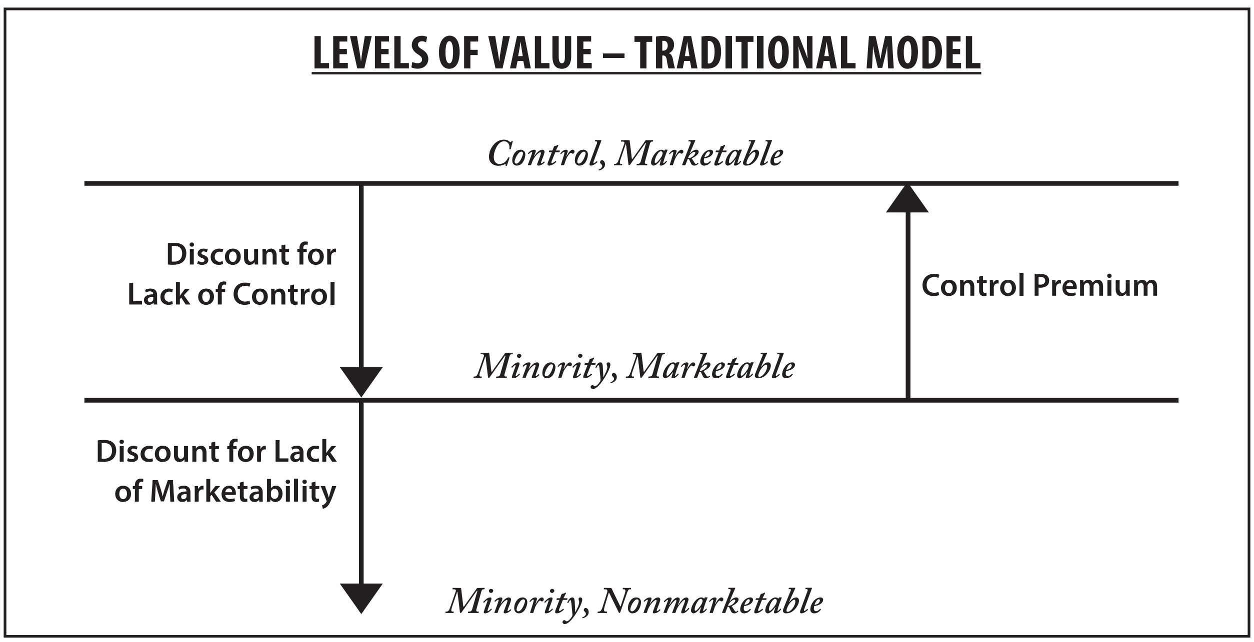
Understanding the Business Valuation Process

From a risk perspective, owning an equity interest that allows the holder all perquisites of control over entity operations is more valuable than an identical interest that does not allow for control. Similarly, the attribute of marketability adds value by lowering risk, while the lack of marketability does just the opposite.

Historically, the business valuation and finance communities have assumed three basic levels of value:

- Control, marketable interest value
- Minority, marketable interest value
- Minority, nonmarketable interest value

The traditional levels of value set forth above are often demonstrated in the graphic below.



In utilizing this traditional model, the critical presumption is that the type of value encompassed in the presentation is a financial value (the base for fair market value). In other words, the traditional model envisions the same measurement type with varying equity ownership interest characteristics.

Note, also, that the mechanics of applying discounts in a multiplicative fashion (versus an additive method) results in the sum of the discounts for lack of control and lack of marketability producing an overall lower discount than simply adding the two raw numbers together. An example illustrating this concept, assuming a 20% discount for lack of control and a 25% discount for lack of marketability, follows. Note, that while the two discounts add up to a total of 45%, in proper application, the two discounts net to 40%.

Understanding the Business Valuation Process

LEVELS OF VALUE – MULTIPLICATIVE APPLICATION OF DISCOUNTS

DISCOUNTS		VALUE
100%	*Control, Marketable*	$ 10.00
20%		(2.00)
80%	*Minority, Marketable*	$ 8.00
25%		(2.00)
60%	*Minority, Nonmarketable*	$ 6.00

Another key element of understanding the mechanics of premiums and discounts is that the control premium is generally the algebraic inverse of the discount for lack of control. In fact, most discounts for lack of control drive from market-observable control premiums. The examples below illustrate this inverse relationship.

CONVERTING A CONTROL PREMIUM TO A DISCOUNT FOR LACK OF CONTROL

Formula: **x = 1 - [1 / 1+y]**

Where y = median premium paid x = implied minority discount

Assume y = 24%

x = 1 - [1 / 1+.24]

x = 1 - .806

x = 19.4%

Reversing the calculation results in the following formula:

CONVERTING A DISCOUNT FOR LACK OF CONTROL TO A CONTROL PREMIUM

Formula: **y = [1 / 1 - x] - 1**

y = [1 / 1 -.194] - 1

y = [1 / .806] - 1

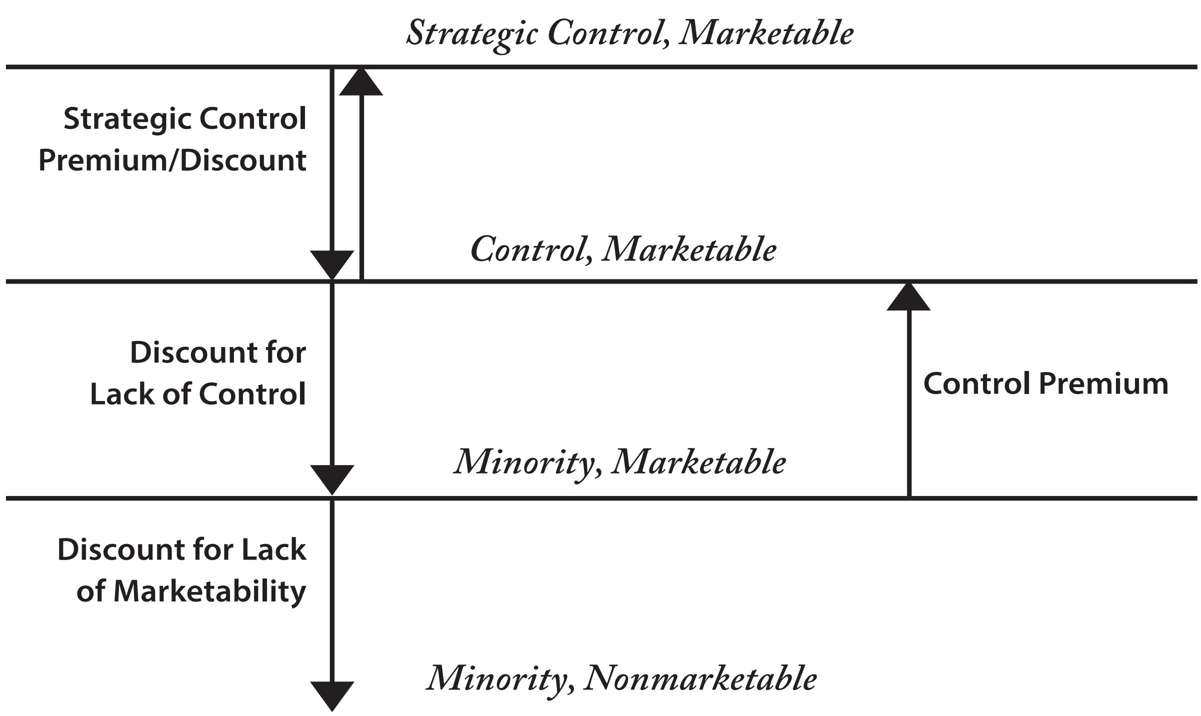
y = 1.240 - 1

y = 24.0%

Understanding the Business Valuation Process

Over time, it has become apparent to the business valuation community that the use of discounts for lack of control developed by using the algebraic inverse of the market-observable control premiums was not totally accurate. As a result, it is now the position of most valuators in the profession that market-observable control premiums include a synergistic or investment premium. Such thinking has led to an expansion of the traditional levels of value model as shown below.

LEVELS OF VALUE – EXPANDED MODEL



The key aspect of interpreting the expanded model of levels of value is understanding that all levels in the traditional model are based on a financial value; whereas, the fourth level in the expanded model is based on strategic or synergistic value. This fourth level cannot be properly considered in the determination of fair market value unless the synergistic premium is removed. Unfortunately, at the current time, empirical studies have not been developed by which the synergistic premium can be quantified.

As can be discerned, numerous alternative levels-of-value models have been proposed by commentators. Most of these have very defined and sophisticated variations that remain highly theoretical and of little practical use in day-to-day application. It is critical that users of business valuation reports fully understand the different levels of value in interpreting the information provided in the reports.

Understanding the Business Valuation Process

Valuation Synthesis and Conclusion

After all relevant valuation factors have been analyzed and assessed, they will be brought together to produce a final conclusion of value. There are circumstances in valuation where one single method or approach should be relied upon. In other cases, in which two or more approaches result in similar conclusions, all conclusions of value can be considered meaningful and should be weighted based upon the facts and circumstances. Finally, in many cases, the application of different valuation approaches and methods results in values that are materially different. In this instance the indications of value should be reconciled into a single value estimate.

There are no guidelines or quantitative formulas for selecting the appropriate approaches and methods that are most applicable in a given engagement. However, the following list provides some common factors that valuators consider when selecting among various approaches.[5]

- The quality and quantity of available financial and operational data
- The availability and quality of private transactional (M&A) data
- The availability of publicly-traded (or guideline) company data
- The type and nature of the business and nature of its assets
- The type of industry
- Statutory, judicial and administrative considerations
- The purpose and objective of the valuation
- The professional judgment of the valuator

The valuation process should be presented in such a way that leads the user of the valuation to the same final conclusion of value opined by the valuator. The valuator's significant judgments and thought processes should be summarized in the valuation.

Conveying the Results: Levels of Reporting

The final step in the valuation process is to prepare the business valuation report. It is the valuator's ultimate responsibility to effectively communicate the results of the valuation process to the intended users. Note that reports issued for purposes of client controversy proceedings are exempt from reporting standards. There are options relative to the type (or level) of report that can be provided, which include a detailed report or a summary report, however, this discussion is beyond the scope of these materials.

[5] *Valuing a Business, The Analysis and Appraisal of Closely Held Companies*, Third Edition, Shannon P. Pratt

Understanding the Business Valuation Process

Credentialed valuators will prepare their reports in compliance with certain standards including Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by The Appraisal Foundation, the AICPA's Statement for Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security or Intangible Asset*, and NACVA's reporting standards, to name a few. Each credentialing body's standards provide professional guidance for valuators in preparing quality reports. Of course, only members of each organization are bound to follow their individual reporting standards.

Valuation reports are structured to provide sufficient information to permit intended users to understand the data, reasoning and analyses underlying the valuator's conclusion of value.

<u>A full, self-contained report should include the following sections</u>:

- Letter of transmittal
- Table of contents
- Introduction
- Analysis of the subject entity
- Outlook for the industry and the economy
- Financial statement analysis
- Valuation methods and methods considered
- Valuation adjustments
- Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets (if any)
- Reconciliation of estimates and conclusion of value
- Certifications and qualifications of the valuator
- Sources of information
- Assumptions and limiting conditions
- Appendices and exhibits

As previously noted, the valuation process should be documented in such a way that leads the user of the valuation to the same final conclusion of value opined by the valuator. Effective valuation reports are clear, convincing and cogent.

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V. Challenges by the Courts

Business valuators are involved in valuation matters for legal counsel and their clients in many different venues, including estate and gift tax issues, divorce, shareholder disputes and damages assessments, just to name a few. It is important to note that there are some valuators that specialize in a single aspect of valuation, including employee stock ownership plans (ESOPs), limited partnerships or intangible assets.

Business valuation is based on well-settled financial theory, but applying these theories to the valuation of interests in closely-held businesses, is widely acknowledged to include a degree of art. There often is no practical way to test the validity of a certain opinion of value, and the valuator's opinion is usually based on his or her special skill, knowledge and experience, rather than directly on an easily-articulable scientific theory or technique. Any opinion of value includes some degree of subjectivity, or there would be no need for the valuator's opinion.

Because of the need to rely upon the appraiser's opinion, the qualifications and credibility of business valuators should be of the utmost importance to the party engaging them. Certification recognizes that the valuator, whose responsibility is to render an opinion on valuation issues, is qualified to do so. The process of making this determination is not always as clear-cut as it sounds, as there are no mandatory criteria for qualifications of business valuators. Of course there are guidelines set forth by the Internal Revenue Service (qualified appraiser regulations) and the courts (federal rules of evidence).

Federal Rule of Evidence (FRE) 702, "testimony by experts" provides that an expert may testify "if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case." The valuator/expert should be prepared to prove that methods and theory being used are generally accepted in the professional community. The valuator/expert should know the relevant professional standards and apply them appropriately. Since 1993, some state courts have adopted stricter criteria for the admissibility of expert testimony.

In 1993 the "Frye Test" was superseded in Federal courts by ***Daubert v. Merrell Dow Pharmaceuticals, Inc.***, 509 U.S. 579. ***Daubert*** was a product liability case where the link between birth defects and medication was in question. The U.S. Supreme Court held that FRE 702 imposes a special obligation upon a trial judge to ensure that scientific testimony is not only relevant, but also reliable. This decision articulated the duty of the trial court to perform a "gatekeeping" function to screen scientific expert testimony to ensure that the testimony was reliable.

Daubert set forth four specific factors which are to be used to determine the reliability of scientific expert testimony. Even though the ***Daubert*** case specifically involved a scientific expert, the court set forth the criteria by which a trial judge could evaluate the reliability of all expert testimony.

Understanding the Business Valuation Process

The ***Daubert*** factors include:

- Whether a theory or technique has been tested;
- Whether the theory or technique has been subjected to peer review and publication;
- In the case of a particular scientific technique, the known or potential rate of error and the standards controlling the technique's operation; and
- Whether the theory or technique has general acceptance in the community.

The holding that trial courts must make a threshold decision relative to the reliability of the proposed expert's testimony in potentially every case, regardless if challenged by opposing counsel, has a significant impact on how valuators prepare their work and offer opinions of value to the trier of fact.

Many experts felt the ***Daubert*** decision left open to question whether the four specific factors even apply to the other kinds of non-scientific opinion testimony contemplated by Federal Rule of Evidence 702. A court decision subsequently handed down by the U.S. Supreme Court, ***Kumho Tire Co., Ltd v. Carmichael,*** seemed to answer some of these questions and may help business valuators/experts to meet the threshold test of reliability.

At the trial court level, ***Kumho Tire*** argued that the plaintiff's expert testimony was unreliable and should be inadmissible based on a "gatekeeper" theory as defined in ***Daubert***. The trial court agreed, stating that even though the plaintiff's expert testimony was "technical" rather than "scientific," the expert's methodology did not satisfy the reliability factors indicated above. The Eleventh Circuit reversed the trial court's decision, stating that ***Daubert*** only applies where the expert was relying on "the application of scientific principles" rather than "on skill or experienced-based observation."

The Supreme Court agreed with the trial court and reversed the Eleventh Circuit. The Court stated that the "gatekeeping" function mandated by Federal Rules of Evidence and ***Daubert*** applied to all expert testimony. The Court noted that a rule differentiating scientific from technical or other specialized knowledge would be difficult to apply. In addition, the Court noted that such a distinction was unnecessary because "experts of all kinds tie observations to conclusions through the use of…general truths derived from specialized experience."

The Court reiterates that, "***Daubert's*** general principles apply to the expert matters described in FRE 702. The Rule establishes a standard of evidentiary reliability. It requires a valid connection to the pertinent inquiry as a precondition to admissibility. Where such testimony's factual basis, data, principles, methods or their application are called sufficiently into questions, the trial judge must determine whether the testimony has a reliable basis in the knowledge and experience of the relevant discipline."

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The Court also stated that the ***Daubert*** factors must be applied flexibly. These factors are not a definitive test or checklist. The Supreme Court indicated that the trial judge must have considerable leeway in determining how to assess the reliability of an expert's testimony in a particular case. The factors listed in ***Daubert*** are to be considered only when they are reasonable measures of reliability.

There has been no attempt to codify any specific factors related to reliability of expert testimony. Subsequent courts found and applied four other factors deemed relevant in determining the reliability of expert testimony:[6]

- Whether the expert is proposing to testify regarding matters related to research conducted independent of the litigation
- Whether the expert has unjustifiably extrapolated from an accepted premise to an unsubstantiated conclusion
- Whether the expert has accounted for alternative explanations
- Whether the expert employs, in the courtroom, the same level of intellectual rigor that characterizes the practice of the expert in the expert's workplace

Valuators' expert testimony clearly falls within the "technical or other specialized knowledge" described by the Court. Members of the legal community and their clients utilizing expert testimony must be aware of potential heightened scrutiny of such evidence. In addition, experts must be prepared to explain their valuation methods and convince the trial judge that their analysis is relevant and reliable.

PricewaterhouseCoopers (PwC) produces an annual whitepaper, ***Daubert*** Challenges to Financial Experts. The most-recent report analyzes the 7,411 cases that have cited the ***Daubert*** and/or ***Kumho Tire*** rulings between 2000 and 2015. Highlights from the report include:

- 44% of financial experts were excluded in 2015. This is consistent with the 16-year average.
- Over the 16 years, the most common reason for financial expert exclusions has been lack of reliability.
- Testimony "based on sufficient facts or data" is a common stumbling block for financial experts, and is the most frequent reason for reliability exclusions.
- In 2015, accountants faced the highest number of challenges and experienced the highest exclusion rate.
- In a majority of cases (78%), appellate courts agree with lower court ***Daubert*** rulings on financial experts.

[6] *Valuing a Business, The Analysis and Appraisal of Closely Held Companies*, Third Edition, Shannon P. Pratt

Daubert Challenges in Court

The following is a brief summary of current cases that have challenged valuators/experts under ***Daubert*** and ***Kumho Tire*** standards. Please note that the following is not intended to be an all-inclusive compilation.

Greater Southeast Community Hospital Corp., 2007 Bankr. LEXIS 1 (January 2, 2007)

In a case in the District of Columbia bankruptcy court, the defendants claimed that the valuation expert was neither qualified nor independent, as he relied on third-party appraisals to prepare a net asset valuation, and his income approaches were allegedly biased and based on flawed methodologies.

A review of the expert's "extensive" background in business valuation quickly led the Court to qualify him as capable of offering "expert net asset valuation and solvency opinions." And though the expert had apparently conceded his lack of qualification to perform real estate or equipment appraisals, all he needed to show was the "requisite knowledge, skill, experience, training, or education to competently render a net asset valuation opinion based on the opinions of others."

The defendants also argued that since the expert had acted as a "virtual member" of the Trust's legal team by certain acts, he was "biased and cannot be trusted to offer an objective and reliable expert opinion." The Court simply deferred these allegations to trial, when they would factor into the weight of the expert's opinion, not its credibility.

However, the defendants had also accused the expert of "selective reliance on data favorable to the Trust's litigation position." In particular, when valuing the improved real estate, he had allegedly excluded the one appraisal which contradicted the Trust's claims. This "self-serving determination" of reliability constituted an "impermissible weighing of the evidence," according to the defendants, sufficient to warrant its exclusion.

The judge disagreed, and permitted the expert to offer his report, warning that the finder of fact will address at trial whether the reasons asserted by the expert for disregarding the [appraisal] are sufficiently logical and persuasive to conclude that an expert in [his] field would reasonably not rely upon the appraisal.

Experts are "virtually always" required to make certain threshold determinations regarding which data to consider or reject, "nevertheless, an expert's selective exclusion of only that data which is unfavorable to his client's litigation position warrants close scrutiny by the Court," and any expert should be prepared at trial "to address what objective criteria he relied upon in making such determinations."

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***Physicians Dialysis Ventures, Inc. v. Griffith*, 2007 U.S. Dist. LEXIS 78879 (October 24, 2007)**

In this case, the U.S. District Court (N.J.) articulates the qualifications that may help make a business valuation expert nearly "bulletproof." In his counterclaims against an underwriter of a dialysis clinic in Newark, New Jersey, the defendant engaged a CPA with one of the largest forensic accounting firms in the New York metropolitan area.

In addition to being an author on lost-profits calculations, the Court observed that the expert was "actively involved in the preparation of business valuations for more than seven years." She was certified by both the American Society of Appraisers and the National Association of Certified Valuators and Analysts, and held the CPA/ABV credential from the American Institute of Certified Public Accountants. Prior employers included "Big 4" accounting firms and at the time of trial, she was senior manager of her firm's Business Litigation Group.

Although this was the expert's first experience valuing a dialysis center, she had appraised a distributor, a manufacturer, a professional practice, a physician's practice, an outpatient surgical center, a car dealership, a restaurant, a photo-finisher, a specialized metallurgical manufacturer, a foreign sales corporation and a minority interest in a family limited partnership. "She has developed specific expertise in the appraisal of business damages," the Court noted, "both in the form of lost profits and lost business value." During her career, she formulated opinions in 60 valuation engagements, signed 17 reports and made "significant contributions" to others.

Further the Court noted that while she may not have been a "'dialysis center expert,' she is indeed an 'expert…on the valuation of businesses,'" the Court added. It would be an abuse of discretion to exclude an expert for not being the "best" qualified or the "most" appropriate, and the Court ruled her testimony admissible under FRE 702.

***Cooper Tire & Rubber Co. v. Farese*, 2008 WL 5188235 (N.D. Miss.) (Dec. 9, 2008)**

The stock of Cooper Tire & Rubber Company plummeted $500 million within one hour after the defendants wrongfully disseminated a sworn (and disparaging) affidavit. By the end of the day, Cooper's stock had fallen nearly 11%, with a trading volume of over 7.65 million shares. The company filed suit in federal court and, before trial, the defendants challenged the plaintiff's damages expert under ***Daubert*** and ***Kumho Tire*** standards, as well as the ***Joiner*** case.

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In their motion in limine, the defendants claimed that:

- The plaintiff's expert was neither competent nor qualified to give an opinion on damages to a publicly-traded company as a result of a drop in share price;
- His methodology was unsupported by research or the experience of valuation experts generally; and
- He was an unreliable expert, with a "penchant for testifying beyond his own qualifications and facts."

The U.S. District Court (N.D. Mississippi) reviewed the requirements of FRE 702 under all of the relevant case law. As to each of the three challenges, it found:

- ***Qualifications*** – The expert was a CPA and CMA (certified management accountant) and a former partner at large accounting firms, including KPMG and Arthur Anderson. Although not accredited in business valuation, he had earned an MBA and taken professional courses in business valuation, accounting and business law. However, he had never conducted a formal study on valuing a public company, nor did he have any prior consulting experience in the tire industry. Nevertheless, the Court permitted the expert to testify regarding the plaintiff tire company's damages. A qualified expert witness is not strictly confined to his area of practice, it said, but may testify concerning related applications. "[A] lack of specialization does not affect the admissibility of the opinion, but only its weight."
- ***Reliability*** – In his report, the plaintiff's expert examined the one-day drop in stock value after publication of the disparaging statement, along with the trading volume, and concluded that the company lost over $184.8 million in market capitalization. He further analyzed the price of the company's stock over an 18-year period to determine if the precipitous decline on the damages date was abnormal and could be attributed to the defendants' action. He concluded that a trading volume of over two million shares of plaintiff's stock was atypical, and that price changes exceeding ± 7.5% were likewise atypical. Based on his analysis of subsequent events, he ultimately concluded that the plaintiff's stock never recovered the harm caused by improper dissemination of the defendants' affidavit.

  To rebut the reliability of these conclusions, the defendants first argued that the shares that traded on the proposed damages date belonged to the shareholders, not to the plaintiff; thus, only the shareholders had standing to recover the alleged decline in stock value. However, the Court quickly dismissed this claim. "Definitive" state (Mississippi) law held that an action for diminution in stock value belongs to the corporation, not the shareholder. Accordingly, the plaintiff tire company was the proper party to recover for any damages to its stock value.

  The defendants next argued that the IRS, the SEC and Generally Accepted Accounting Principles did not recognize the plaintiff's alleged losses. The court quoted ***Daubert,*** which held that "[g]eneral

acceptance is not a necessary precondition to the admissibility of…evidence under the Federal Rules." The defendants could better address any questions concerning acceptance by other authorities on cross-examination.

Finally, the defendants opposed the "simple math calculation" the plaintiff's expert used to calculate loss of market capitalization. The math was correct, and the methodology could apply to other civil litigation, but in this case, it was not an "appropriate and accurate measure" of the alleged damages.

These challenges were "battle of the expert issues," the Court said. The method used by the plaintiff's expert was acceptable. "Numerous courts have addressed and admitted testimony of experts who used the market capitalization approach to corporate damages, albeit in cases with dissimilar fact and not as the only method utilized." The expert's testimony was sufficiently reliable to be admissible under ***Daubert***, and any purported weakness could be tested under cross-examination.

- *Relevance* – The Court found that the expert's testimony would assist the trier of fact to "understand or determine whether [the plaintiff] suffered damages as a result of the publication of the…affidavit." The proffered testimony was also beyond the ordinary knowledge of a layperson and had direct connection to a material issue in the case. The Court admitted the expert evidence under FRE 702.

***In re Young Broadcasting, Inc.*, 2010 WL 15444015 (Bkrtcy.S.D.N.Y.) (April 19, 2010)**

In this Chapter 11 case, a consolidation of related broadcasting companies, the debtors, owed nearly $338 million on secured loans and $484.3 million on senior subordinated notes. The debtors proposed a deleveraging plan to create a new company with secured lenders and senior noteholders who would take sufficient equity to satisfy their outstanding claims. The pool of unsecured creditors would be entitled to no more than a pro-rata share of $1 million.

Another plan was proposed by the unsecured creditors that would reinstate the secured lenders' debt and provide the senior noteholders with certain pro-rata equity participation. This plan was supported by a valuation expert who testified with respect to the company's ability to sell/refinance at the maturity of the secured loans and the current, overall value of the company.

Under FRE 702 and the ***Daubert*** standard, the lenders claimed the valuation expert was not sufficiently qualified to perform a valuation. He did not have a valuation credential, MBA or published article on restructuring companies. He was a director of a consulting firm with experience advising media/entertainment clients in M&A, financing, asset sales and restructuring.

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In this case, the bankruptcy court stated, "Academic training is not necessary if an expert's practical experience is sufficient to qualify him." The Court also stated that an expert's working background is "more relevant" than education or published articles. The Court found that the expert was indeed qualified to perform the valuation.

However, the Court found that the expert applied the company facts to an untested valuation method (levered DCF) that did not line up with the "intellectual rigor that characterizes [the] practice of an expert in the field of media valuation." The court disqualified all of the expert's conclusions under ***Daubert***, finding it was not an acceptable variant of a tried-and-true valuation method or a reliable stand-alone method.

***Warren Distributing Co. v. InBev USA, LLC*, 2010 WL 2179167 (D. N.J.) (May 28, 2010)**

This 2010 case brought the ***2006 Malt Alcohol Beverage Practices Act*** into play. Anheuser Busch purchased a number of domestic and European brands from InBev USA, but used its existing distribution network rather than its predecessor's. Anheuser Busch offered the distributors 2.5 times gross margins for their domestic brands and 3.3 times gross margins for the European brands. The three distributors turned down the deal, prompting Anheuser Busch to send notices of termination with checks for $25 million for the terminated distribution rights. The three distributors sued for breach of contract and damages.

The distributors' expert deconstructed the payoff and claimed that Anheuser Busch actually used a 7.32 market multiple, but calculated damages totaling over $45 million, the equivalent of an 8.4 multiple. Anheuser Busch filed a ***Daubert*** motion to exclude the expert's report, arguing that his deconstruction was unreliable, and the DCF used was a poor fit to the case.

The Court found that the expert had sufficient credentials and experience to testify, as he had a CPA/ABV credential and 30 years in an accounting and consulting career, despite only valuing a beer distributor once before.

The majority of the ***Daubert*** challenge focused on the expert's dissection of their one transaction with the cooperative distributor. The expert claimed that the deal occurred under duress, going against the fair market value standard of value. The Court agreed with the defendants that this was "impermissible mind-reading." However, the Court accepted the expert's 7.32 multiple because it was based on the value of two side transactions.

The transactions took place on the same day that Anheuser Busch closed the deal with the cooperative distributor. Inducements of considerable value were contained in the deal, the first being a retention of distribution rights for an entire portfolio of current beer brands, a right of first offer for new brands and a tax liability inducement. The defendants claimed that reliance on a value determined using these inducements was speculative and unreliable.

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The Court excluded the expert's testimony regarding the distribution rights but accepted his opinions regarding the value of the right of first offer for new brands and the tax liability.

The defendants had three final arguments against the expert's DCF. The court dismissed them all and admitted the DCF analysis under ***Daubert***.

***Victory Records, Inc. v. Virgin Records America, Inc.*, 2011 WL 382743 (N.D. Ill. Feb. 3, 2011)**

Victory filed against Virgin alleging that Virgin tortiously interfered with Victory's multi-album recording, publishing and merchandising contract with the rock band Hawthorne Heights. But for Virgin's alleged interference, Victory claims, the sales of Hawthorne Heights' second and third albums would have been substantially higher, and Victory would have released a fourth Hawthorne Heights album to comparable success. Victory seeks several million dollars in compensatory damages and $25 million in punitive damages.

Virgin has moved in limine to exclude the testimony of Victory's proposed damages expert, music industry accountant Bruce Kolbrenner under FRE 702 and ***Daubert***.

Kolbrenner proposes to testify regarding the profits Victory allegedly lost on Hawthorne Heights's second and third albums, which Victory released, and on a fourth album the band was supposed to but did not release under Victory's label. As Victory explained, Kolbrenner calculated lost profits using the "before and after" methodology, which examines a plaintiff's past profits in estimating its future profits, and the "yardstick" methodology, which examines the profits of closely-comparable businesses in estimating a plaintiff's future profits.

Both methodologies have been accepted in music industry tortious interference cases. That said, when an expert uses either or both methodologies, "[h]is assumptions and projections must rest on 'adequate bases,' and cannot be the product of mere speculation." A detailed discussion of the methodology used by the expert is included in the case. The case notes that,

> *"While Kolbrenner's methodology may be opaque in certain respects, one aspect is crystal clear: the starting point for the lost profits analysis for the second album, and thus for the third and fourth albums, is Kolbrenner's assumption that Victory shipped the correct number of units for the second album – in other words, his assumption that Victory's internal sales projections were correct."*

When an expert premises his opinions on an assumption, the assumption must be reliable. The Seventh Circuit has held, however, that an assumption based on the internal projections of the expert's sponsor lacks the reliability demanded by FRE 702. In this case, the proposed expert offered no basis in the two-page narrative

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portion of his expert report or at his deposition for concluding that Victory's internal projections provide an acceptable foundation for an expert's opinion in his field. Thus, while opinion testimony regarding damages founded on a party's internal projections might be permissible when delivered by a lay witness under FRE 701, it may not be delivered by a witness with the gloss of expertise under Rule 702.

Kolbrenner's damages opinion is deficient in a second, independent respect. Kolbrenner applied the yardstick method by drawing upon the record sales of Paramore, a comparable band,on an independent label, as one of the foundations for his methodology in calculating low, median and high sales figures. Kolbrenner's "yardstick," then, rests on a single comparable. Nowhere does Kolbrenner or Victory even attempt to establish that a sample size of one band is an appropriate yardstick among recording industry experts for measuring future performance of another band.

Exacerbating matters, Kolbrenner selected Paramore based, not on his own expertise or analysis, but at the direction of Anthony Brummel, Victory's CEO and owner. This fact, as well as the importance of Paramore to Kolbrenner's overall opinion, is clear from his deposition.

There is a final, independent respect in which Kolbrenner's damages opinion falls short under FRE 702 – he failed to consider alternative explanations for the alleged drop in sales of the second Hawthorne Heights album. This is not to say that all damages experts must take account of alternative explanations for a plaintiff's loss. FRE 702 permits an expert, at least in some circumstances, to assume that the defendant's alleged misdeeds caused the plaintiff's loss.

Showers v. Pfizer, Inc. (In re Pfizer Inc. Sec. Litig.), 2016 U.S. App. LEXIS 6622 (April 12, 2016)

The 2nd Circuit Court of Appeals revived a securities fraud class action involving the drug giant Pfizer. Previously, the case died following the district court's exclusion of the plaintiffs' loss causation and damages expert.

Shareholders in Pfizer sued the company, alleging it made fraudulent misrepresentations about the safety of its Celebrex and Bextra drugs – non-steroidal anti-inflammatory drugs to treat chronic pain and inflammation. According to the plaintiffs, even though Pfizer and the prior owners of the drugs knew about the drugs' dangerous side effects as early as 1998, they kept touting the drugs' safety to keep the public's misperception going and cash in on the drugs' commercial success.

The issue for the plaintiffs was how to show whether Pfizer's fraud, as opposed to the fraud by previous owners of the drugs, caused Pfizer's stock price to fall. The plaintiffs presented an "inflation-maintenance" theory of liability, which said that, even though during part of the class action period (2000-2005) Pfizer did not yet own the drugs, it was liable for all of the misrepresentations because it had control over the statements the then-owners made. Pfizer also made its own misrepresentations and engaged in fraudulent omissions.

The plaintiffs hired one of the most-prominent experts working in the field to prove the fraud actually caused losses and to compute the extent of the loss. He performed an event study to determine whether, and to what degree, Pfizer's stock price changed when investors discovered the risks associated with the two drugs. He explained that he was asked to assume liability in step with the plaintiffs' theory and was hired to identify the "artificial inflation" in the company's stock resulting from the alleged fraud. Pfizer offered rebuttal testimony only. Overall, its expert did not have any major criticism of the event study, but objected to certain assumptions the opposing expert made about certain corrective disclosures.

Almost a decade into the litigation, the district court granted Pfizer's request to exclude the plaintiffs' expert under FRE 702 and ***Daubert***.

It found two irremediable flaws in the testimony. One was an insufficiently-explained adjustment the expert made to his stock price inflation calculation in response to the court's earlier rulings. The other issue was the expert's failure to "disaggregate" the effects of Pfizer's alleged misrepresentations from the effects of statements from the prior owners of the drugs. Without the testimony, the plaintiffs had no more case, and the district court granted judgment in favor of Pfizer.

The 2nd Circuit Court of Appeals said the district court "went astray." Its point about the need to disaggregate was based on a "misapprehension" of the plaintiffs' theory of liability, under which it did not matter which company made the misrepresentations at what point. The expert's loss causation model assumed that Pfizer's misrepresentations repeated the same false messages and served to maintain Pfizer's stock price at a constant, inflated level.

The appeals court allowed that the expert's explanation of the adjustment to the inflation calculation was inadequate and made this aspect of the testimony unreliable. However, this "was but one small part of an extensive economic analysis," the Court of Appeals noted. "When faced with expert testimony that contains both reliable and unreliable opinions, district courts often exclude only the unreliable testimony." Here, the expert's error did "not render the remainder of his analysis useless."

Excluding the entire opinion was an abuse of discretion, the 2nd Circuit concluded, and remanded the case "for further proceedings consistent with this opinion." According to the 2nd Circuit, "parsing" expert testimony and excising the unreliable testimony from the reliable testimony accords with the "liberal admissibility standards" of ***Daubert*** and FRE 702.

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Other Considerations

As previously noted, business appraisers are also called upon to prepare valuations that may be examined by the Internal Revenue Service or, ultimately, the Tax Court. In ***Lehmann***, T.C. Memo. 1997-392, Judge Hamblen set out the factors considered by the Tax Court in evaluating appraisal evidence since the court itself is the trier of fact (valuation being a factual issue, at least in part):

- "Expert testimony sometimes aids the court in determining valuation. Other times it does not. We evaluate such opinions in light of the demonstrated qualifications of the expert and all other evidence of value."
- "We are not bound by the opinion of any expert witness when that opinion is contrary to our judgment."
- "Although we may accept the opinion of an expert in its entirety, we also may be selective in the use of any portion of such an opinion."
- And finally, as the 'bottom line,' the Tax Court stated: "We will take into account expert opinion testimony to the extent that it aids us in arriving at the fair market value of the property."

During a conference for the AICPA's business valuation credential (ABV), tax court judge David Laro provided the attendees with his views on the "top ten" ways appraisers can do even better work in their tax and other litigation engagements as listed below.[7]

- ***Be consistent*** – You don't get different results whether you work for the taxpayer or the government. If you are gearing up your report to get to a certain [valuation] conclusion – something is wrong with that. "Don't do it," he cautions.
- ***Be independent*** – We all have conflicts of interest. We all want business. *(Except the court, he noted)*. Candidly, if a conflict of interest comes to the attention of the court, it completely eradicates your credibility.
- ***Be qualified*** – Be sure to include your credentials in your report – the judges will read them.
- ***Be focused on analysis*** – BV reports are getting more complex, and that's good. Laro wants less boilerplate and more "strength of analysis of the data." In fact, the least important aspect of an appraisal opinion can be the conclusion, which Laro reads last. The most important aspect is the analysis – he reads this word-for-word. "If it's deficient, it isn't going to work."

[7] *Special Report: Laro Offers Candid Views on DLOM, Appraiser Independence and More,* Deluxe BVUpdate™ 1/08

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- ***Be thick-skinned*** – Recent critiques of appraisers by federal tax and circuit courts may have gone too far. For example, it shouldn't really matter what state the appraiser comes from (vis-à-vis the subject interest), as in ***Estate of Thompson***. Neither should it really matter how long an appraiser remains on a site visit, as in ***Caracci v. Comm***. "What matters is what you do there."

- ***Be thorough*** – There are "no shortcuts to doing valuation reports." Don't omit data or management interviews or analysis just to save clients money, as it may not help their case in the long run. Keep drafts and keep the data, especially for cases that go to trial. Set out the standard of value, right out front, along with the valuation date.

- ***Be accurate*** – Your valuation report is tantamount to your direct testimony; once admitted, it becomes evidence in the case, so double (and triple) check for errors. If something isn't in your report, there's no second opportunity to get it in the record or get it right.

- ***Be prepared*** – For appraisers going to court, Laro recommends holding a "mock trial" with your attorneys and colleagues. He described a group that hired a retired judge to preside over the drill.

Penalties for Appraisers

The *Pension Protection Act of 2006* (PPA) brought in a new penalty applicable to appraisers (in addition to the up to $1,000 penalty for aiding and abetting the under-reporting of tax under Section 6701).

The penalty under Section 6695A applies to:

- A person who prepares an appraisal of the value of property and such person knows, or reasonably should have known, that the appraisal would be used in connection with a return or a claim for refund, and

- The claimed value of the property on a return or claim for refund which is based on such appraisal results in a substantial valuation misstatement under chapter 1 (within the meaning of section 6662(e)), or a gross valuation misstatement (within the meaning of section 6662(h)), with respect to such property.

For gift and estate tax valuations, a gross valuation misstatement is one that values the subject property at 65% or less of the amount determined to be the correct value of the property. Thus, in addition to the taxpayer being hit with a 40% addition to tax for a gross valuation misstatement, the appraiser can receive a penalty.

<u>The penalty imposed on appraisers under Section 6695A is equal to the lesser of</u>:

- The greater of 10% of the amount of the underpayment (as defined in section 6664(a)) attributable to the misstatement, or $1,000; or
- 125% of the gross income received by the appraiser.

Appraisers are not subject to the penalty if the appraiser establishes to the satisfaction of the Secretary that the value established in the appraisal was more likely than not the proper value.

Adequate Disclosure

In connection with gifts made after August 5, 1997, and "adequately disclosed" on a Form 709, the Internal Revenue Service cannot revalue the gifts for purposes of Code Section 2001 after a three-year statute of limitations has run. Adequate disclosure is, thus, a very important issue to be considered. "Adequate disclosure" means to apprise the Internal Revenue Service of the nature of the transfer, regardless of whether any gift tax was or was not owed. [Treasury Regulation Section 301.6501(c)-1(f)(2)]

<u>The Regulations set out the following requirements for adequate disclosure:</u>

- A description of the transferred property and any consideration received by the transferor;
- The identity of, and relationship between, the transferor and each transferee;
- If the property is transferred in trust, the trust's taxpayer identification number and a brief description of the terms of the trust, or in lieu of a brief description, a copy of the trust instrument;
- A detailed description of the method used to determine the fair market value of the property transferred (or the submission of an appropriate appraisal in lieu of such description); and
- A statement describing any position taken that is contrary to any proposed, temporary or final regulations or revenue rulings. [Treasury Regulation Section 301.6501(c)-1(f)(2)]

Note the additional adequate disclosure rules for gifts that are subject to Chapter 14 (which would include GRATs, QPRTs and other planning vehicles). If these gifts are not adequately shown on a gift tax return, then "any tax imposed by chapter 12 of subtitle B of the IRC on the transfer or resulting from the taxable event may be assessed, or a proceeding in court for the collection of the appropriate tax may be begun without assessment, at any time." [Treasury Regulation Section 301-6501(c)-1(e)(1)]

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For such a gift to be adequately shown, the return must include:

- A description of the transactions, including a description of transferred and retained interests and the method (or methods) used to value each;
- The identity of, and relationship between, the transferor, transferee, all other persons participating in the transactions, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and
- A detailed description (including all actuarial factors and discount rates used) of the method used to determine the amount of the gift arising from the transfer (or taxable event), including, in the case of an equity interest that is not actively traded, the financial and other data used in determining value. Financial data should generally include balance sheets and statements of net earnings, operating results, and dividends paid for each of the five years immediately before the valuation date. [Treasury Regulation Section 301.6501(c)-1(e)(2)]

Tax Challenges in Court

Valuations that are prepared for tax purposes are challenged on many fronts, including standard and premise of value considerations, methodologies utilized and discounts applied (including lack of control and lack of marketability). The following is a sampling of cases that have challenged valuations prepared in the tax arena. Please note that the following is not intended to be an all-inclusive compilation of recent cases.

Kohler v. Commissioner, T.C. Memo 2006-152 (July 25, 2006)

This is considered a "textbook case" on how to value large, closely-held corporations. The case involved two taxpayer experts and one IRS expert to value the Kohler stock.

Taxpayer expert 1 used the dividend method, a discounted cash flow model, and capital market methods to value the stock at $47.01 million. The expert applied a 45% discount for lack of marketability under the discounted cash flow method and capital market methods and a 10% discount for lack of marketability to the dividend methods. He further applied a 26% discount for lack of control to the discounted cash flow method.

Taxpayer expert 2 used discounted dividend analysis, discounted cash flow, and guideline public company analysis to value the stock at $63.385 million. The expert applied a 35% discount for lack of marketability and a 25% discount for lack of control.

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The IRS expert used a guideline company method and the transaction method to value the Kohler stock, applying a 25% discount for lack of marketability.

Based on the effective presentation of those details by the taxpayer, the attorneys and the appraiser, the Court relied upon Taxpayer experts' calculations to determine a value of just over $47 million.

***Holman v. Commissioner*, 130 T.C. No. 12 (May 27, 2008)**

A husband and wife formed the Holman Limited Partnership (HLP), designating themselves as both general and limited partners (GP and LP) and Mr. Holman's mother as a limited partner, in her dual capacity as trustee and custodian for interests related to their four children. On the same day, the Holmans transferred over $2.8 million of Dell Computer stock to the HLP, receiving proportional shares of HLP interests. Six days later, they gifted limited partnership interests to each child through the trustee/custodian, leaving themselves with a minor GP interest and the LPs owning a substantial majority. The Holmans made smaller gifts of Dell stock in subsequent years, each time causing reconfiguration of the partnership so that they owned 12.3% while the remaining LPs owned 87.7%.

The Holmans had four reasons for forming the HLP: long-term growth; asset preservation; asset protection; and educating the children on wealth and business management. Accordingly, the partnership agreement contained substantial restrictions on the transfer of LP shares, including a "buy-back" provision in the event of a non-permitted transfer. (This provision became a major focus in the avoidance of transfer restrictions and determination of discounts, discussed below.)

In filing gift tax returns (Form 709) for each of the three transfers, the Holmans relied on an independent appraisal that applied an overall 49.25% discount to the fair market value of the LP transfers. In its challenge, the IRS claimed that the first transfer was an indirect gift; that Code Section 2703 voided the transfer restrictions; and that the discounts were excessive.

The Court found the IRS expert's approach more persuasive. The Court "lack[ed] confidence" in the marketability discounts that the taxpayers' expert calculated. The expert failed to persuade the court that his "stopping point" for the level of discount was "anything but a guess."

The Court also believed that the IRS expert correctly considered the partnership buy-back scenario; even if it ran counter to the HLP's stated purpose (to preserve family assets), the purpose might well yield to economic self-interest of the partners. Finally, the Court agreed that the holding period, in this case, carried little weight. In light of the available expert evidence, "we cannot determine any better estimate of an appropriate marketability discount" than the estimate by the IRS expert of 12.5%.

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Bergquist v. C.I.R., 131 T.C. No. 2 (July 22, 2008)

In this case, the taxpayers relied on an appraisal that used the going concern premise to value a medical service corporation that was slated for conversion to a tax-exempt organization. Under these same facts, the IRS assumed a liquidation or book value – and the Tax Court's finding of the correct premise made all the difference, including application of substantial (64%) combined discounts for lack of marketability (DLOM) and lack of control. Because the taxpayers' appraisals were based "entirely on an incorrect valuation premise," the court rejected them as evidence.

The Court considered whether the taxpayers were liable for the 40% accuracy-related penalties pursuant to Code Section 6662 (h). Even though their declared values fell within the penalty range, the taxpayers tried to invoke the provision's exception, claiming that they relied on a "qualified appraisal" by a "qualified appraiser," and made a good faith investigation of the stock's value.

The Court rejected this argument noting that taxpayers "cannot blindly rely on advice from advisers, [or] on an appraisal." All of the factors brought out in the case put the taxpayers "on notice as to the inaccuracy of the claimed donations," the Court held, and found that each of the taxpayers were liable for the 40% accuracy-related penalty.

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

The Litchfield estate held $26.4 million in assets and minority stock interests in two closely-held, family-owned companies. The first was a 43.1% interest in a company called LRC, and the second was a 22.96% interest in a company called LSC. The IRS and the estate experts agreed on the net asset values of the estate's interests but disagreed on the discounts.

For LRC, the IRS used a 2% discount for capital gains tax, 10% lack of control discount and 18% marketability discount. The estate expert applied a 17.4% discount for capital gains tax, 14.8% lack of control discount and a 36% marketability discount. The IRS final value was $10.1 million, while the estate's value was $6.5 million.

For LSC the IRS applied an 8% discount for capital gains tax, 5% lack of control discount and a 10% marketability discount. The estate expert used a 23.6% discount for capital gains tax, 11.9% lack of control discount and a 29.7% marketability discount. The IRS final value was $9.6, million while the estate's value was $5.7 million.

With respect to the discount for capital gains, the Court accepted the estate expert's discounts due to the expert's reliance on more accurate data, including speaking with management and reviewing current sales. For the discount for lack of control, the estate expert's discounts were accepted because he accounted for the composition of the estate's holdings (assets and marketable securities) by using a weighted average.

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Finally, for the discount for lack of marketability the judge used, without further discussion, discounts of 25% and 20% for LRC and LSC, respectively. The judge did, however, note that the estate's DLOMs were too high at 36% and 29.7% for LRC and LSC, respectively.

The Court's final conclusions of value were $7.5 million for LRC and $6.5 million for LSC.

***Pierre v. Commissioner*, 2010 WL 1945779 (U.S. Tax Court), May 13, 2010**

In this case, the taxpayer received a $10 million gift from a friend. She decided to organize a single-member LLC to keep her wealth intact, but she did not elect to treat the LLC as a corporation.

The taxpayer formed two trusts for her son and granddaughter, then she transferred $4.25 million in marketable securities to the LLC. Twelve days after funding the trusts, she exchanged her entire interest in the family LLC for trusts. Ms. Pierre sold each trust a 40.5% membership in return for two promissory notes of $1.09 million and gifted each a 9.5% interest.

An appraiser arrived at the values of the gifts by valuing a 1% interest in the LLC at $26,965, including a 36.5% combined discount for lack of marketability and discount for lack of control. The taxpayer used discounted values to conclude that no tax was due – the IRS disagreed.

The U.S. Tax Court sided with the taxpayer, despite a dissent that would have disregarded the family LLC as a separate entity when assessing federal gift tax liability.

The Court postponed deciding on the valuation issues, including discounts, and ruled to apply the step transaction doctrine, collapsing the separate transactions into one deal. The LLC interests were valued by their value in the taxpayer's hands. The parties agreed that under the fair market value standard, less would be paid for the LLC interests than for an outright purchase of the same block of freely-traded, marketable securities.

The Tax Court held that an 8% discount for lack of control and a 30% discount for lack of marketability were appropriate as determined by the taxpayer's experts.

***Boltar, L.L.C., v. Commissioner*, U.S. Tax Court, T.C. Memo No. 326, T.C. No 14, (April 5, 2011)**

In a dispute over the value of a conservation easement, the Tax Court could refuse to accept a report prepared by the taxpayer's experts. The report was irrelevant because it was not the product of reliable methods, it did not apply reliable principles, and it assumed scenarios that were unrealistic in view of the facts of the case. The court's gatekeeper function in excluding unreliable evidence was not limited to jury trials, but applied to bench trials, as well, especially in light of the standards for reliable evidence set forth in the FRE 702.

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The Court made the decision to exclude the report and said that the exclusions served several purposes:

- It increased the efficiency of the trials and the objectivity of the judgments.,
- It reduced the burden on the parties and the court, and
- It discouraged the cottage industry of experts who function primarily in the market for tax benefits.

Although the taxpayer's expert's report was excluded, the record contained factual evidence of value. The report and the testimony of the IRS valuation expert were sufficient to support the IRS valuation of the easement.

On its 2003 Form 1065, *U.S. Return of Partnership Income*, Boltar claimed charitable contribution deductions of $3,259,000, of which $3,245,000 related to the donation of the subject easement. Boltar reported a fair market value of $3,270,000 for the subject easement as of December 31, 2003. The fair market value was reduced by $25,000 as a claimed enhancement in value to adjacent parcels owned by Boltar as a result of the donation of the subject easement.

Attached to Boltar's Form 1065 was a Form 8283, *Noncash Charitable Contributions*, signed by Gary K. DeClark (DeClark), managing director and principal of Integra Realty Resources in Chicago, Illinois (Integra). Also attached to the return was an appraisal report (the Integra appraisal) prepared by DeClark and Nancy S. Myers (Myers), senior real estate analyst for Integra, on March 7, 2004. A member of Boltar's management team had met DeClark in 1998, and DeClark's firm had evaluated other conservation easements for Laura Lake and related projects. DeClark and Myers reviewed only a draft of the easement before preparing their appraisal; they did not rely on the final version.

The Integra appraisal determined that the "highest and best use" of the subject property was residential development, and determined the easement value as the difference between the "Foregone Development Opportunity of 174 Condominiums on Finished Sites, Discounted to December 31, 2003" (Scenario B) – $3,340,000 less the "Value of Raw, Vacant and Developable Land" (Scenario A) – $68,000. These values incorporated estimated wetlands mitigation costs of $28,000 ($10,000 per acre for the affected 2.8 acres) that DeClark and Myers calculated.

The Integra appraisal asserted that the 174-unit condominium project, consisting of 29 buildings with six units each, was legally permissible, physically possible, financially feasible and maximally productive on the Eased Area. The Integra appraisal relied in this regard on a site plan for a condominium project situated on approximately 10 acres. The Integra appraisal erroneously assumed that the Eased Area was under the jurisdiction of the city of Hobart and zoned as part of the Deep River Pointe PUD.

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The final proposed adjustment was based on a finding by the IRS that, as of December 29, 2003, the value was determined to be $42,400, based on review by one of respondent's valuation engineers. The valuation engineer opined that the Integra appraisal failed to determine the value of the Eased Area before and after the grant of the easement. The valuation engineer concluded that the highest and best use of the subject property was for "development of single-family detached residential homes, but not until the surrounding properties are developed," partly because the land on which the easement was granted was landlocked, with no direct access to a public road.

In accordance with the Court's standing pretrial order and Rule 143(g), the parties exchanged and submitted expert reports. Petitioner's expert report consisted of the Integra appraisal and a transmittal letter to petitioner dated March 7, 2004, and a letter to petitioner's counsel dated April 15, 2010. In the letter dated April 15, 2010, DeClark and Myers addressed the views of the Internal Revenue Service valuation engineer but did not make any adjustments in their value opinion, maintaining that the amount determined in their 2004 appraisal was "supportable and appropriate." Responding to the suggestion that they failed to determine the before and after easement values, they asserted:

"While it is obvious that the impressment of the easement severely impacts the realizable highest and best use of the eight-acre parcel, this impact is part and parcel of the deduction of the "as if raw" (Scenario A) value estimate from the estimate of the "foregone development opportunity" (Scenario B). Meanwhile, neither Scenario A nor Scenario B is described as an "as encumbered" (with the conservation easement) value estimate because that estimate is the result of the deduction process (A from B), rather than a freestanding value available to be measured in the marketplace with comparable sales. So, essentially, neither of the two scenarios represents encumbered land and, unencumbered, the appropriate highest and best use in both the "before" and "after" is, in fact, residential development."

Respondent submitted the expert reports of Nick Tillema and Steven Albert. Tillema testified at trial. Respondent's experts opined that the value of the subject easement was $31,280, the difference between a before-easement value of $100,600 and an after-easement value of $69,320. Respondent's experts determined that the highest and best use of the Eased Area was single-family residential before and after the easement, and they reached their results primarily on the basis of comparable sales. They determined that the unencumbered value of the Eased Area was $6,000 per acre and that the encumbered value was $2,000 per acre, which they applied to acreage including the contiguous parcels owned by Boltar.

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VI. Conclusion and Practical Considerations

Understanding the breadth and complexity of the business valuation process will, hopefully, enable members of the legal community to better educate their clients when the need for such services arises. More importantly, a better understanding of the process will allow attorneys to make better decisions as to when to obtain a business valuation and how to best make use of that valuation once it is finished.

In considering business valuation and understanding its process, it is also necessary to understand what it is not. Most importantly, even if prepared by a business valuator who is a licensed certified public accountant, it is not an audit or review service. As such, most reports will note that the valuator has relied on underlying information, provided by the company representatives and third-party empirical data sources, without any attestation or confirmation procedures applied to the underlying information. As a result of this limitation, there could be instances where the application of attestation or confirmation procedures could cause a restatement to the underlying information, and thereby, influence the conclusion of value.

The complexity of the process also demands that ample time be allowed for the valuator to complete his or her business valuation. To facilitate the preparation of a quality business valuation report, it is imperative that the decision to obtain a business valuation be made early in the attorney's planning process for his or her plan or case, and that the valuator be engaged sufficiently early to allow for adequate time to prepare the valuation.

In normal due course, a valuation cannot be started until most information is gathered. In a case where the valuator is working for counsel representing the propertied litigant with access to all records, such time allotment to gather information can be accomplished in two to four weeks. For litigants or parties not having access to all relevant documents, this process can be excruciatingly long.

Once the information is gathered, it generally requires 80-120 hours to review the data; apply the financial analysis; develop a conclusion of value; and draft a full, self-contained report that can be submitted to a court or tax authority for a single operating company with approximately $25 million in revenue.

Given these time requirements, it is not unusual that 8-12 weeks can lapse between the initial meetings and the delivery of the report. In most cases, this work is turned around by our Firm in four to six weeks after all information is gathered and provided to our firm.

The remaining issue is cost. Due to the nature of this work and the resultant implications of unsatisfactory work product, business valuation consultants tend to be more-senior professionals with extensive business backgrounds. Billing rates per hour are higher for these professionals, thus driving the cost of the work somewhat higher than traditional tax or accounting work.

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It is our belief that the business valuation process, properly executed, will add significantly to the overall planning or case of the attorney guiding that planning. Many times, a solid and defensible business valuation is a cornerstone to the success of those plans or cases.

As noted at the beginning of this program, today's session is not intended to be a complete discussion and conversation on every aspect of the business valuation process. It is our hope, however, that everyone, no matter your experience level, is able to take some information away from the program which will prove valuable and helpful in your practices as you visit with clients now and in the future.

Grossman Yanak & Ford LLP continues to grow by referrals from our clients and friends. We respectfully request that you keep us in mind in the event you encounter a client in need of quality accounting, tax, technology, valuation or litigation support services. We will always do our very best to ensure that the needs of your referral are not only met, but exceeded, and that your referral of our Firm reflects positively on you.

We hope to have the opportunity to work with you in the near future. If you have questions regarding any of the information which was shared with you today, please feel free to contact the presenters.

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Thank you again and we hope to see you again at future seminars!