



***The Business Valuation Process:
Understanding Professional Requirements,
Fundamental Procedures & Practical Considerations***

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***The Business Valuation Process:
Understanding Professional Requirements,
Fundamental Procedures & Practical Considerations***

INTRODUCTION

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The Business Valuation Process

INTRODUCTION

- *Complexity of the business valuation process and the many techniques, approaches and methodologies available to business valuers often leads to user misunderstandings*
 - Procedural misunderstanding
 - Interpretive misunderstandings



The Business Valuation Process

INTRODUCTION

- *Procedural misunderstandings*
 - What does a business valuation engagement contemplate?
 - Why is the process so extensive and costly?
 - Why are business valuation reports written in such detail?
 - Are there alternatives to a full valuation?



The Business Valuation Process

INTRODUCTION

- *Interpretive misunderstandings*
 - What do the report conclusions mean?
 - How were these conclusions developed?
 - Do the conclusions appear logical and reasonable?



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INTRODUCTION

- *Questions specific to the legal community*
 - Will the valuation consultant qualify as an expert witness?
 - Does the valuation consultant have experience in the specific type of valuation/company?
 - Does the potential economic benefit merit the cost of a business valuation?
 - Will the facts and circumstances afford the business valuator access to all required information?



The Business Valuation Process

INTRODUCTION

- *This program primarily intended to address:*
 - Understanding the business valuation process
 - Navigating a business valuation report



The Business Valuation Process

INTRODUCTION

- *Chapter II*
 - Valuator's role in assisting legal counsel, how "purpose" guides the process, differing expert credentials
- *Chapter III*
 - Guidance for business valuations regarding items requiring assessment



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INTRODUCTION

- **Chapter IV**
 - Detailed discussion of the actual steps undertaken in a business valuation model

- **Chapter V**
 - Discussion of court challenges to various business valuation evidence submissions



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INTRODUCTION

- **Chapter VI**
 - Conclusion and practical considerations regarding timing



***The Business Valuation Process:
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REQUIRED SKILL SET
& PROFESSIONAL CREDENTIALS

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- ***Business valuator's role in legal matters***
 - Also dictated by attorney (s)
 - Consulting expert
 - Testifying expert

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Effective use of business valutors*
 - Qualifications
 - Credibility in the courts
 - Restraint from advocacy
 - Independence/objectivity
 - Reputation for reliable, relevant and defensible opinions



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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Purpose of the valuation*
 - Most critical element guiding the business valuation process
 - Common purposes
 - Estate and gift tax planning
 - ESOPs
 - Divorce
 - Minority shareholder disputes
 - S corporation – BIG tax



The Business Valuation Process

REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- ***Common purposes of valuations***
 - Estate and gift tax planning
 - Minority shareholder disputes
 - S corporation – BIG tax
 - Accounting-based valuation
 - Stock option valuation under SFAS 123R & 409A
 - ESOPs
 - Divorce
 - Transactional litigation
 - Bankruptcy
 - Purchase/sale of business

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- ***Purpose-driven considerations***
 - Standard of value
 - Premise of value
 - Applicability of discounts

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Date of valuation*
 - “As-of” date
 - Report date



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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Selecting a valuator*
 - Education and training
 - Experience



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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- ***Credentials and sponsoring organizations***
 - AICPA – Accredited in Business Valuation (ABV)
 - NACVA – Certified Valuation Analyst (CVA)
Accredited in Business Appraisal Review (ABAR)
Master Analyst in Financial Forensics (MAFF)
 - ASA – Accredited Member (AM)
Accredited Senior Appraiser (ASA)
 - IBA – Certified Business Appraiser (CBA)
Master Certified Business Appraiser (CBA)

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- ***Valuation or calculation?***
 - Valuation
 - Fully understand and analyze the subject interest
 - Consider and apply appropriate valuation approaches/methods
 - Prepare and maintain appropriate documentation

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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Valuation or calculation?*
 - Calculation
 - More akin to an “agreed-upon procedures” engagement
 - Significantly limited usefulness – generally cannot be submitted to court



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REQUIRED SKILL SET & PROFESSIONAL CREDENTIALS

- *Valuation or calculation?*
 - Integrating calculation work into a full valuation



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ACCEPTED GUIDANCE AND THEORY

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ACCEPTED GUIDANCE AND THEORY

- ***Value determinants***
 - Influenced by:
 - Finance
 - Economics
 - Statistics
 - Accounting

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ACCEPTED GUIDANCE AND THEORY

- *Early development*
 - Internal Revenue Service
 - ARM 20
 - Revenue Ruling 59-60



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ACCEPTED GUIDANCE AND THEORY

- *“Valuation is not an exact science”*
 - A sound valuation is based on:
 - All relevant facts
 - Common sense
 - Informed judgment
 - Reasonableness



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ACCEPTED GUIDANCE AND THEORY

- **Revenue Ruling 59-60**
 - Primary fundamental requirements for a fair market value determination set forth in IRS Revenue Ruling 59-60
 - Emphasizes review and analysis of all relevant factors
 - Fair market value will depend upon the circumstances in each case



The Business Valuation Process

ACCEPTED GUIDANCE AND THEORY

- **Fundamental factors to be considered**
 - Nature of the business and history of the enterprise
 - Economic outlook (general and industry-specific)
 - Book value of stock/financial condition of business
 - Earnings capacity and dividend-paying capacity
 - Whether enterprise has goodwill/intangible value
 - Sale of stock and size of block to be valued
 - Market price of stocks of similar businesses



The Business Valuation Process

ACCEPTED GUIDANCE AND THEORY

- *Nature of the business and history of the enterprise*
 - Requires an intimate understanding of all qualitative information about company management and its operations
 - Conclusions used to determine company strengths and weaknesses and how they influence value



The Business Valuation Process

ACCEPTED GUIDANCE AND THEORY

- *Economic outlook (general and industry)*
 - Outlook for economy and industry should be clearly related to subject company
 - Research, analysis and conclusions derived are considered in the selection of discount and capitalization rates, valuation pricing multiples and other valuation variables



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ACCEPTED GUIDANCE AND THEORY

- ***Book value of stock/financial condition***
 - Book value is not associated with the value of a business
 - Assessing the financial condition of the company assists in estimating risk associated with future performance and in development of discount and/or capitalization rates, and a foundation to applying valuation approaches and methods



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ACCEPTED GUIDANCE AND THEORY

- ***Earnings capacity of company***
 - Value is always forward-looking
 - Investors are most concerned with future economic gains over the holding period of the investment
 - Historical earnings are only relevant to the extent they serve as a proxy for the future



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ACCEPTED GUIDANCE AND THEORY

- ***Dividend-paying capacity of company***
 - Focus on dividend-paying capacity rather than actual dividends paid
 - Focus on future dividends
 - Dividend-paying capacity is not a material item in instances of a controlling interest



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ACCEPTED GUIDANCE AND THEORY

- ***Goodwill or other intangible value***
 - Important to address both tangible and intangible assets
 - Goodwill is based on earnings capacity
 - Prestige and renown of the business, brand recognition and know-how also support the existence of intangible value



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ACCEPTED GUIDANCE AND THEORY

- ***Sale of stock and size of block to be valued***
 - Sales of stock should be investigated to determine whether they represent arms' length transactions
 - Minority interests in an unlisted company's stock is more difficult to sell than similar block of listed stock
 - Control of a corporation, either actual or in effect, adds an element of value and may justify a higher value for a specific block of stock



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ACCEPTED GUIDANCE AND THEORY

- ***Market price of stock (similar businesses)***
 - Market approach of valuation
 - Follows the economic principle of substitution



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The Business Valuation Process

THE PROCESS – DEFINING THE ASSIGNMENT

- ***Establishing basic parameters***
 - Purpose of valuation
 - Standard of value
 - Premise of value
 - Date of valuation
 - Definition of interest(s) to be valued
 - Specifications of deliverable

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THE PROCESS – DEFINING THE ASSIGNMENT

- *Standard of value*
 - Fair market value
 - Investment value
 - Intrinsic or fundamental value
 - Fair value under state statutes
 - Fair value for financial reporting

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THE PROCESS – DEFINING THE ASSIGNMENT

- *Other parameters*
 - Premise of value
 - Date of valuation
 - Specific interest(s) to be valued
 - Form of deliverable

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THE PROCESS – INFORMATION GATHERING & ANALYSIS

- ***Collection of company and historical data***
 - Company and industry background questionnaire
 - Data collection checklist
 - Interviews with management
 - Site visit



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THE PROCESS – INFORMATION GATHERING & ANALYSIS

- ***Analysis of information***
 - Historical and/or projected financial statements, balance sheet, income statement
 - Normalization process
 - Methodologies used to identify operational trends
 - Sources of national/local economic information
 - Sources of industry information



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THE PROCESS – METHOD SELECTION & CALCULATION

- ***Three broad approaches to value***
 - Income approach
 - Market approach
 - Cost/asset approach



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THE PROCESS – METHOD SELECTION & CALCULATION

- ***Income approach***
 - Capitalized returns and discounted future returns
 - Results in marketable value due to use of risk rates
 - Can produce a control or minority value



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THE PROCESS – METHOD SELECTION & CALCULATION

▪ *Income approach – Control vs. Minority*

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

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THE PROCESS – METHOD SELECTION & CALCULATION

▪ *Market approach*

- Guideline company method and transaction method
- Both methods produce a marketable value
- Transaction method produces a control value
- Current school of thought – guideline company method produces a value that is not minority or control

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THE PROCESS – METHOD SELECTION & CALCULATION

- **Cost/asset approach**
 - Excess earnings methods & multiple of discretionary earnings method
 - More suitable for valuing controlling interests
 - Typically results in a marketable value

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THE PROCESS – METHOD SELECTION & CALCULATION

- **Levels of value**
 - Traditional model – 3 levels
 - Control, marketable
 - Minority, marketable
 - Minority, nonmarketable

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THE PROCESS – METHOD SELECTION & CALCULATION

- *Levels of value*
 - Multiplicative application of discounts
 - Inverse relationship between control premium and discount for lack of control



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THE PROCESS – METHOD SELECTION & CALCULATION

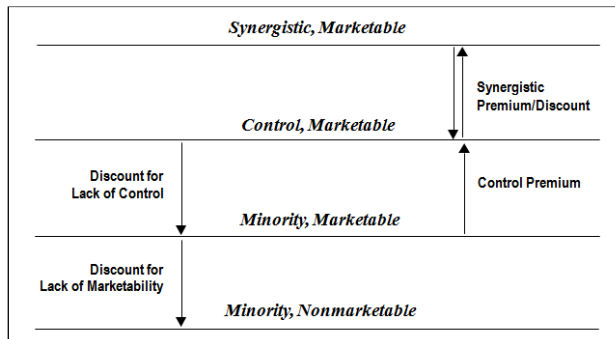
- *Levels of value*
 - Expanded model – 4 levels
 - **Strategic control, marketable** (level added)
 - Control, marketable
 - Minority, marketable
 - Minority, nonmarketable



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THE PROCESS – METHOD SELECTION & CALCULATION

- *Levels of value – expanded model*



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THE PROCESS – VALUATION SYNTHESIS & CONCLUSION

- *Single value estimate with support*

- Using multiple methods will likely result in multiple values
- Must reconcile values into a single value estimate



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THE PROCESS – VALUATION SYNTHESIS & CONCLUSION

- ***Factors to consider in method selection***
 - Quality and quantity of available financial and operational data
 - Availability and quality of private transactional (M&A) data
 - Availability of publicly traded (guideline) company data



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THE PROCESS – VALUATION SYNTHESIS & CONCLUSION

- ***Factors to consider in method selection***
 - Type and nature of the business and the nature of its assets
 - Type of industry
 - Statutory, judicial and administrative issues
 - Purpose and objective of the valuation
 - Professional judgment of the appraiser



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THE PROCESS – REPORT PREPARATION

- ***Effective valuation reports***
 - Comply with professional standards
 - Provide sufficient information to allow users to understand the data, analysis and conclusion
 - Clear, convincing and cogent



The Business Valuation Process: Understanding Professional Requirements, Fundamental Procedures & Practical Considerations

CHALLENGES BY THE COURT



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CHALLENGES BY THE COURT

- ***FRE 702 – testimony by experts***
 - Testimony is based upon sufficient facts/data
 - Testimony is product of reliable principles/methods
 - Principles/methods are applied reliably to the facts



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CHALLENGES BY THE COURT

- ***Daubert***
 - “Frye test” superseded in federal courts by Daubert v. Merrell Dow Pharmaceuticals, Inc.
 - Established “gatekeeping” duty of trial court to ensure reliability of testimony



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CHALLENGES BY THE COURT

- **Daubert factors for expert testimony**
 - Whether theory /technique has been tested
 - Whether theory/technique has been subjected to peer review and publication
 - For particular scientific technique, rate of error and standards controlling operation
 - Whether theory/technique has general acceptance



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CHALLENGES BY THE COURT

- **Kumho Tire**
 - Argued Plaintiff's expert testimony was unreliable and should be inadmissible based on "gatekeeper" theory
 - U.S. Supreme Court stated the "gatekeeping" function applies to all expert testimony
 - Daubert factors should be applied flexibly



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CHALLENGES BY THE COURT

- ***Other factors relevant to reliability of expert testimony***
 - Whether expert is testifying on matters related to research conducted independent of the litigation
 - Whether expert unjustifiably extrapolated from an accepted premise to an unsubstantiated conclusion
 - Whether expert accounted for alternative explanations
 - Whether expert employs in courtroom the same level of intellectual rigor that characterizes the practice of the expert in his/her workplace

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PwC STUDY (May 2016) – DAUBERT CHALLENGES

- ***7,411 cases between 2000-2015 citing Daubert or Kumho Tire***
- ***44% of financial experts excluded in 2015***
- ***Most common reason for expert exclusion is “lack of reliability”***
- ***Failure to meet “based on sufficient facts or data” criteria most frequent reason for exclusion***
- ***Accountants most-frequently challenged and excluded in 2015***
- ***In 78% of cases, appellate courts agree with lower court decisions***

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CHALLENGES BY THE COURT

- **Daubert Challenges in Court**
 - Greater Southeast Community Hospital
 - Physicians Dialysis Ventures
 - Cooper Tire & Rubber
 - Young Broadcasting, Inc.
 - Warren Distributing v. InBev USA
 - Victory Records v. Virgin Records
 - Showers v. Pfizer



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CHALLENGES BY THE COURT

- **Greater Southeast Community Hospital**
 - D.C. bankruptcy court case
 - Defendant claimed valuation expert was not qualified or independent
 - Judge permitted expert to offer his report



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CHALLENGES BY THE COURT

- **Physicians Dialysis Ventures**

- U.S. District Court of New Jersey
- Valuation expert never valued a dialysis center
- Stresses qualifications may help make valuation expert “bulletproof”
- Court noted it would be an abuse of discretion to exclude an expert for not being “best” qualified or “most” appropriate

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CHALLENGES BY THE COURT

- **Cooper Tire & Rubber**

- Defendants challenged Plaintiff’s damages expert under Daubert and Kumho Tire
- U.S. District Court reviewed the requirements of FRE 702 and permitted the expert to testify about damages, noting that the expert’s testimony would be reliable and relevant

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CHALLENGES BY THE COURT

- **Young Broadcasting, Inc.**
 - Defendants claimed expert was not qualified due to lack of credentials, MBA, or published articles, use of unpublished valuation method
 - Court found expert's work background qualified him as expert, disqualified his conclusions using unacceptable variant of valuation method



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CHALLENGES BY THE COURT

- **Warren Distributing Co. v. InBev USA**
 - Daubert motion filed to exclude expert's report which used an 'unreliable' deconstruction and DCF method
 - Court found that expert was qualified, accepted his DCF analysis, but rejected part of his testimony regarding the deconstruction of transactions



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CHALLENGES BY THE COURT

▪ *Victory Records v. Virgin Records*

- Victory filed suit against Virgin; Virgin moved to exclude Victory's expert's testimony under FRE 702 and Daubert challenges
- Court excluded expert's opinions under FRE 702 criteria
 - Were based on assumption that did not meet reliability requirements
 - Yardstick method based only on a single comparable
 - Comparable not selected independently (suggested by Victory CEO)
 - Expert failed to consider alternative explanation for loss of profits

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CHALLENGES BY THE COURT

▪ *Showers v. Pfizer, Inc.*

- Shareholders in Pfizer sued the company, alleging fraudulent misrepresentations about two drugs caused lost profits
- Case had previously died due to Court's exclusion of plaintiff's expert testimony due to two "irremediable flaws"
 - Insufficiently-explained adjustment to stock price inflation calculation
 - Failure to "disaggregate" Pfizer's liability from that of previous owner
- Appeals Court overruled and excluded only the "unreliable" part of testimony in accord with application of FRE 702 and Daubert

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CHALLENGES BY THE COURT

- *Judge Laro “Top 10” list*

- Be consistent
- Be independent
- Be qualified
- Be focused on analysis
- Be thick-skinned
- Be thorough
- Be accurate
- Be prepared



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CHALLENGES BY THE COURT

- *Penalties for appraisers*

- Pension Protection Act of 2006, Section 6695A imposes penalties equal to the lesser of:
 - Greater of 10% of the amount of underpayment attributable to the misstatement or \$1,000, or
 - 125% of the gross income received by appraiser
- Appraisers are not subject to penalty if they establish that the value in appraisal was more likely than not the proper value



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CHALLENGES BY THE COURT

- ***Requirements for adequate disclosure***
 - Description of transferred property and any consideration received by transferor
 - Identity of, and relationship between, transferor and each transferee
 - If the property is transferred in trust, the trust's taxpayer ID number and brief description of terms of the trust (or a copy of the trust instrument)



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CHALLENGES BY THE COURT

- ***Requirements for adequate disclosure***
 - Detailed description of the method used to determine fair market value of the property transferred
 - Statement describing any position taken that is contrary to any proposed, temporary or final regulations or revenue rulings



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CHALLENGES BY THE COURT

- *Challenges by the IRS and the Tax Court*
 - Kohler
 - Holman
 - Bergquist
 - Litchfield
 - Pierre
 - Boltar

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CHALLENGES BY THE COURT

- *Kohler*
 - Case involved 2 experts for taxpayer and 1 for IRS
 - Taxpayer's experts effectively presented their valuations and were deemed by the court to be more reliable
 - Kohler considered a "textbook case" on how to value large, closely-held corporations

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CHALLENGES BY THE COURT

- **Holman**
 - Gifts of limited partnership interests
 - Independent appraisal was prepared to accompany gift tax return
 - Court lacked confidence in marketability discounts taxpayer's expert calculated
 - Court sided with IRS expert due to lack of better evidence

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CHALLENGES BY THE COURT

- **Bergquist**
 - Court rejected taxpayer's appraisals based on an incorrect valuation premise
 - Court held that taxpayers were liable for 40% accuracy-related penalties
 - Taxpayers cannot blindly rely on advice from advisors in an appraisal

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CHALLENGES BY THE COURT

- **Litchfield**
 - IRS and estate expert's agreed on net asset values, disagreed on discounts
 - Court accepted estate's discounts for capital gains and lack of control
 - Without further discussion, judge applied discounts for lack of marketability of 25% and 20%



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CHALLENGES BY THE COURT

- **Pierre**
 - Large gift resulted in LLC formation and subsequent gifts to son and granddaughter
 - Estate claimed no gift tax was due, IRS disagreed
 - Tax Court sided with Taxpayer and stated that the estate's expert's discounts were appropriate, and no tax was due



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CHALLENGES BY THE COURT

- **Boltar**
 - Dispute over the value of a conservation easement
 - Tax Court excluded appraisal report done by taxpayer's experts
 - Experts did not use reliable methods, did not apply reliable principles and assumed unrealistic scenarios
 - Court said exclusion served several purposes
 - Increased efficiency of trials and objectivity of judgments,
 - Reduced the burden on parties and the court, and
 - Discouraged cottage industry of “tax benefits” experts

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CONCLUSION & PRACTICAL CONSIDERATIONS

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CONCLUSION & PRACTICAL CONSIDERATIONS

- *Implications for attorneys*

- Understanding of process enables attorneys to make better use of valuations for clients
- Not an audit or review – relies on underlying data
- Adequate time required for preparation of a quality business valuation report
- Cost reflects use of highly-experienced valuers
- Proper screening of credentials encouraged

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THANK YOU!

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