

Business Valuation 101 for Attorneys- Working with Your Expert

Judith H. O'Dell CPA CVA

O'DELL VALUATION CONSULTING LLC CPA

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BUSINESS VALUATION IS MORE AN ART THAN A SCIENCE

When Are Valuations Needed?

- **Shareholder Disputes**
- **Mergers and Acquisitions**
- **Estate and Gift Taxes and Planning**
- **Marital Dissolution**
- **Commercial Damages**
- **Corporate Planning**

Who Should Perform?

- **CVA- usually a CPA**
- **ABV- always a CPA**
- **ASA**
- **CBA**

All are subject to professional standards that are similar

Reporting-all subject to professional standards- can be oral

Conclusion of Value

- Long form report-Necessary for litigation, IRS (estate, gift)
- Summary report- does not contain all the details

Calculation of Value

- Shorter form report- not all aspects considered
- Client and Valuation Analyst agree on methods to be used
- Useful for getting an idea of what business is worth before entering into negotiations/ estate planning

For Litigation and Tax Cases, Always Insist on a Conclusion of Value Long Form Report



Valuation Initial Considerations

- **The interest being valued**
- **Purpose of valuation- important!**
- **Standard of value- fair market value?
Fair value? Investment value**
- **Premise of value- going concern or
liquidation**
- **Restrictions or limitations in scope**

The Engagement Letter

- To whom is it addressed- client or attorney?
- Who will pay the bill- should be paid in full before testifying
- Most analysts will require upfront retainer
- Will specify assumptions and limiting conditions that will be part of valuation report
- Who may use the report and for what purpose
- May specify extra fees if court appearance is necessary

Assumptions and Limiting Conditions

- **Reliance on information provided- financial, tax returns. If analyst is a CPA, statement that financials were not audited, compiled or reviewed**
- **Limits on use of report**
- **Environmental and ADA compliance not considered**
- **Whether real estate and equipment appraised**
- **Any conflicts of interest**

Fair Market Value- Rev Rule 59-60

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.

What Must Be Considered- Rev Rule 59-60

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

Rev Rule 59-60- continued

- **The dividend-paying capacity.**
- **Whether or not the enterprise has goodwill or other intangible value.**
- **Prior sales of the stock**
- **Size of the block of stock to be valued.**
- **Comparable companies sold**

Client Data Needed

- **Financial statements (5 years preferable)**
- **Income tax returns (5 years preferable)**
- **Corporate documents**
- **Contracts**
- **Employee Information**
- **Leases/Loan documents**
- **Depreciation schedules**

How Accessible is the Data- May be Scope Limitations in Litigation Scenarios

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"After analyzing all your data, I think we can safely say that none of it is useful."

Background Information Obtained

- **History of the Company**
- **Interview with management/site visit**
- **Customers, suppliers, competitors, expectations**
- **National and local economic conditions**
- **Industry background and outlook**
- **Peer comparison- common size and ratios.**
Databases – RMA, Integra etc

This is all included in an opinion of value report

Financial Statements

- Normally 5 years presented
- Report should indicate if financial statements were audited, compiled, reviewed or taken from tax returns
- “Normalization” adjustments made: officer compensation, non-essential expenses removed, non operating assets identified, tax provisions for pass through entities (maybe)
- Cash flows and EBITDA presented

Three Approaches Required to be Considered

- **Asset Approach**
- **Income Approach**
- **Market Approach**

Some may not be applicable

Asset Approach

- **Net Asset Approach-** sometimes is book value but technically fixed assets are appraised, intangible assets are valued and a tax rate is applied to the difference between book and tax and deducted from restated balance sheet
- **Liquidation Approach-** assets are valued at present value of liquidation value, liabilities subtracted and a provision for sales cost deducted

Income Approach

Capitalization of Earnings- assume current earnings continue into the future adding a growth rate

Discounted Future Earnings- earnings forecasted into the future. Used if change is expected like a new product, new technology

- Benefit stream is “normalized”
- Discount or capitalization rate applied to the benefit stream

Discount/Cap Rate

- Method for private closely held companies is usually Build Up Method
- Common source of data: *Duff & Phelps Valuation Handbook*- based on historical returns
- D&P gives risk free, equity risk, and industry risk rates
- Analyst determines company specific risk rate
- Discount rate computed and then converted to Cap rate using the expected growth rate

Example: Capitalization Rate

Discount Rate Method: Build-Up Method

Risk-Free Rate 4.00%

Other Risk Factors / Premiums

Medium Premium over risk free rate 10.80%

Equity Risk Premium Adjustment 0.60%

Specific Company Risk 4.00%

Discount Rate 19.40%

(Applied to future benefit stream.)

Less: Long-Term Growth in Benefit Stream 3.00%

Capitalization Rate 16.40%

Divided by: (1 + Long-Term Growth Rate) 103.00%

Historic Earnings Capitalization Rate 15.92%

(Applied to historic benefit stream.)

It's all About the Cash Flow



"I'm here about the cash flow."

Capitalization of Earnings

Capitalization of Earnings	Normalized Equity Net Cash Flows	Weighting Factor	Weighted Earnings
Fiscal Year End 2014	322,494	1.0	322,494
Fiscal Year End 2015	(216,522)	1.0	(216,522)
Fiscal Year End 2016	688,364	1.0	688,364
Sum of Weighted Earnings			794,336
Divided by: Sum of Weighting Factors			3.0
Weighted Average Equity Net Cash Flows			264,779
Divided by: Historic Capitalization Rate			15.92%
Total Entity Value			1,663,182
Calculated Equity Value			1,663,182
Indicated Equity Value			1,664,000

Market Approach

- **Comparable public companies- hard to find for smaller private companies**
- **Databases- IBA, BIZCOMPS, Pratts Stats commonly used for private companies. Data reported by business brokers**
- **IBA and BIZCOMPS don't give as much detail about the transaction as does Pratts Stats**
- **Databases must be purchased for access**

Example- BIZCOMPS -Fine Dining Restaurant with Sales of \$2MM

Transactions Selected					
	Revenue	SDE	Price	Price / Revenue	Price / SDE
Low	\$1,000	\$72	\$100	0.07	1.29
High	\$3,400	\$500	\$1,100	0.67	3.67
Mean	\$1,598	\$219	\$526	0.32	2.32
Median	\$1,481	\$209	\$442	0.31	2.23
Harmonic Mean	\$1,443	\$162	\$323	0.23	2.13
Standard Deviation	\$607	\$125	\$338	0.16	0.71
Coefficient of Variation	0.38	0.57	0.64	0.50	0.30
Count	18	18	18	18	18

Application of Multiples

BIZCOMPS Price to Annual Gross Sales Multiple Equity Value Calculation

Selected Price to Annual Gross Sales Multiple	0.32
Times: Annual Gross Sales	1,961,339
Invested Capital Value	627,628
Plus: Asset Adjustments	525,378
Adjusted Invested Capital Value	1,153,006
 <u>Invested Capital Value to Equity Value Conversion:</u>	
Less: Total Liabilities	649,796
Calculated Equity Value	503,210
 Indicated Equity Value	 503,200

Problems with Market Approach

- If Company has multiple product lines or services it is difficult to find a comparable
- Only companies that have been sold are in the data bases
- Not all of the detail about the transaction is included
- Pratts Stats gives more information including whether the buyer was a public company and whether stock or asset sale

Conclusion of Value

- Analysts weighs results of all methods and either picks one method or assigns weights to the various methods used
- Sanity checks performed- does this number make sense.
- Would I buy the Company for this amount knowing what I know?

Discounts/Premiums

- If valuing entire entity, analyst considers whether there needs to be a discount for lack of marketability
- If valuing less than 100% interest, analyst considers need for minority interest discount and discount for lack of marketability
- Other types of discounts/premiums- blockage, key person, control premium (voting stock)

New Proposed IRS Regs for Valuations for Estate, Gift and GST Transfers

- **IRC Section 2704 covers valuation rules for valuing intra-family transfers of interests in corps and partnerships subject to lapsing voting or liquidation rights**
- **The proposed changes may impact discounts for lack of control and marketability**
- **Stay tuned- IRS held hearings in early Dec**

What Does a Solid Valuation Report Contain?

- **Company background**
- **Internal and external sources of information**
- **National economic and industry conditions**
- **Historical and normalized financial statements**
- **Analysis- comparison to peers**
- **Valuation approaches**
- **Analyst's conclusion of value- and rationale**

What Does a Solid Valuation Report Contain- continued

- **Discounts/premiums- and rationale**
- **Assumptions and limiting conditions**
- **Analyst's representations**
- **Qualifications of Analyst- can be used in Daubert challenge**

The report should flow, be readable and lead the reader to agree with the analyst's conclusions

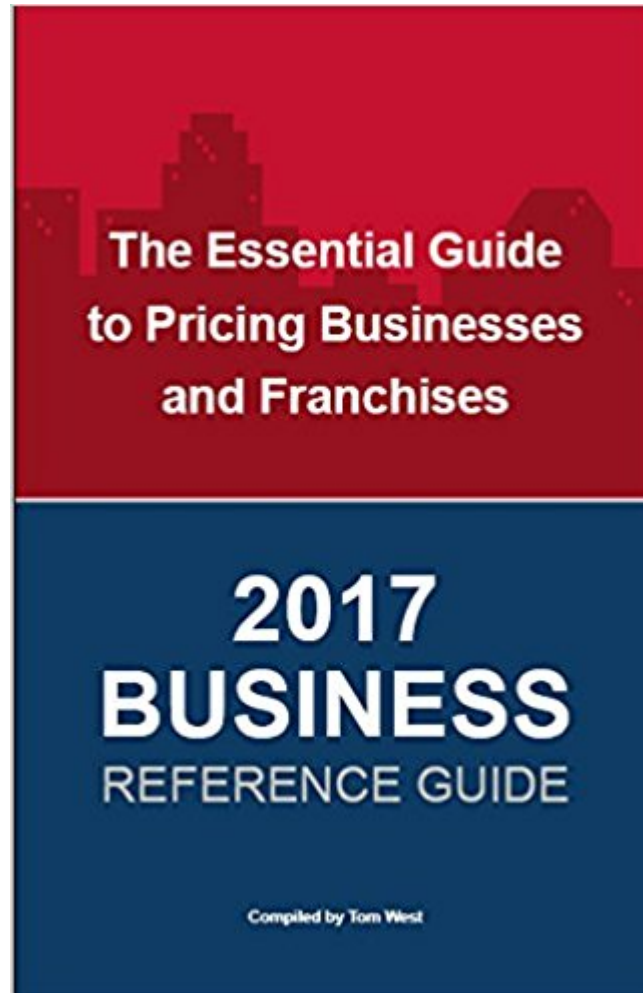
Analyst's Judgments That Could Be Contested

- **Normalization adjustments**
- **Cash flows used in income approach**
- **Discount/capitalization rate-specific company risk, growth rate**
- **FMV of assets in asset approach**
- **Multiples used in market approach**
- **Discounts/premiums applied**

“Rules of Thumb”

- Metrics used by business brokers
- Multiples of EBITDA, EBIT, Sales, Gross Profit
- For small businesses, multiple is of “sellers discretionary earnings” - earnings prior to income taxes, non recurring or non operating income and expense, depreciation, interest expense, owners total compensation for one owner

Good Source for “Rules of Thumb”



Cost of Valuations

- Client meetings to obtain data
- Research must be done to obtain economic, industry, peer comparison and market information- data base access is expensive
- Discount/capitalization rates determined
- Research to determine discounts/premiums
- Even with templates a typical report will take 10-12 hours including proofing to write- even for small companies the report can be 50+ pages

Working with Your Expert

Working With Your Expert

- **Does expert have experience with the industry?**
- **Inform the expert about communication preferences- email, phone to preserve privilege**
- **Provide the expert with as much information as is permissible about the client and the case**
- **Explain your strategy**
- **Remember that the expert must render his/her opinion and not appear biased**

Working With Your Expert

- **Set aside time well before hearings/ settlement meetings/trial/arbitration to review the valuation report to make sure you understand it**
- **Develop a script and rehearse**
- **Identify weaknesses- the expert can help here**
- **Develop answers for weaknesses**

Direct Examination- Top Down Approach

Did you have an opportunity to make an appraisal of the XYZ Corporation?

- **Yes, I did.**

And what, in your opinion, is the value of the company?

- **The value of the company on June 30th of this year was about \$5.4 million.**

Can you explain to the court how you made your appraisal?

Top Down Approach

Use open-ended questions for the testimony

- **And then what did you do?**
- **And then what did you consider?**
- **And what does that mean to a business appraiser?**

Let the expert “tell the story” about what he/she did and allow the testimony to flow logically

Top Down Approach is Better

- **Credibility issue - presenting conclusion first suggest strength in expert's belief in the opinion**
- **“Power of suggestion” to the fact finder – the opinion becomes the target being evaluated during the expert's entire testimony**
- **Simplicity - not confused with lots of data forming the foundation of the opinion**
- **Systematic order of proof – each subsequent segment supports the conclusion**

Direct Examination of Valuation Expert

- **Avoid leading questions which suggest answer**
- **Ask open-ended questions – let expert talk**
- **Act like a “student” learning from the expert**
- **Allow the expert to control the pace and rhythm**
- **Monitor the judge or jury for boredom**
- **Ask questions to explain apparent confusion**
- **Seek a brief recess if expert seems to need it**

QUESTIONS???

jodell@odellvalue.com

443-480-5800