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Insights on VALUATION

Chris Hamilton
CPA, CFE, CVA, DABFA
Arxis Financial, Inc

2468 Tapo Canyon Road
Simi Valley, CA 93063

Phone: 805.306.7875
Fax: 805.306.7891

chamilton@arxisgroup.com
www.arxisfinancial.com

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How About an Annual Business Valuation?

A business valuation is needed at the death of an owner, the gifting of ownership interests, and in certain litigation matters. But is an annual valuation of a business ever required? Yes.

Most of the annual valuation requirements are tax related such as in the administration of an Employee Stock Ownership Plan (ESOP). Beyond the occasional tax compliance matters, there are a few reasons why a business owner may want to consider annual valuations.

It is important, before considering annual valuations, to understand the various levels of valuation services available. Business owners and the valuation firms they call for help often talk about "doing a valuation" that carries with it a price tag of several thousands of dollars. Unless a tax authority or a court requires it, a full valuation report should be avoided as it is overkill both in content and in price. More appropriately, a summary or short-form report should be requested. A less detailed analysis and report can cost a fraction of the full report and provide the guidance the business owner is looking for.

With that in mind, the following is a discussion of situations where it may be appropriate to consider annual business valuations.

Buy-sell agreement—in a fast growing or changing business it may be helpful—or even required by the agreement—to annually assess

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and project the effect of the agreement “as if” a triggering event took place. This assists the owners and management to evaluate insurance needs and to consider whether the formula or other methods dictated by the agreement are still applicable and fair to all parties.

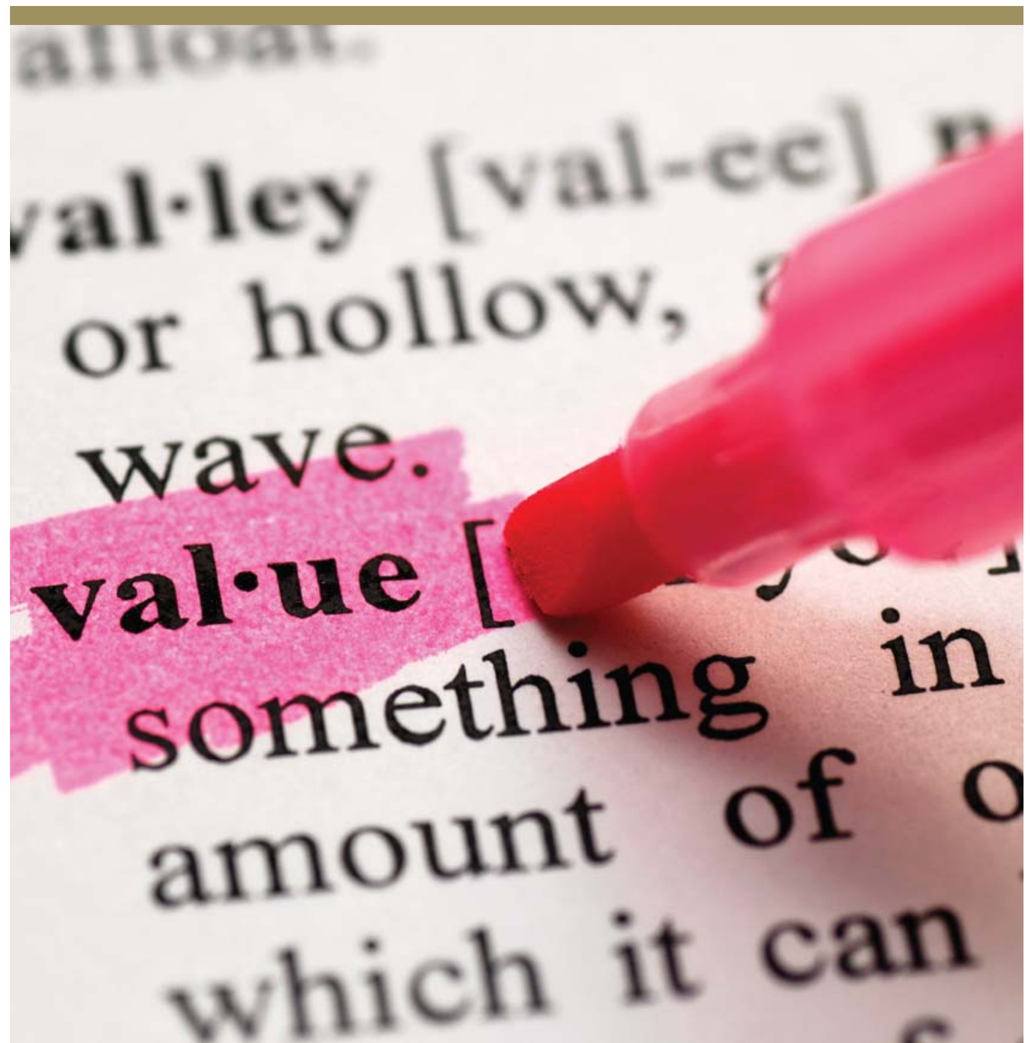
Evaluate management—a large and growing business often establishes criteria to evaluate management that include return on equity investment. The valuation process can assist in the evaluation of the internal cost of capital, the cost of debt, and the proper leveraging of both forms of invested capital.

Bank compliance—in some rare cases a lender will require extensive reporting to demonstrate compliance with covenants and conditions of the loan. This generally happens when the bank loans on the intangible asset value of the business and, consequently, requires reporting on the relative value of the assets.

Home improvements—a homeowner who spends a lot of money upgrading his or her home may decide after completion to call a real estate agent to get “market comps” so he or she can compare the cost of the improvements to the benefit—increase in market value. A business isn’t all that different. An enterprise that sells off units, acquires others, restructures capital, and otherwise changes the business may, afterwards, wish to see what the value of the business is. Since a makeover of a business might take several years, an annual valuation throughout the process may be helpful to establish that management is maintaining and/or improving shareholder value.

Division valuation—a business with several divisions or even geographical locations may wish to see the relative value of those units on an annual basis as either a management tool or as an indicator that a division or location can/should be sold. Maintaining annual price (value) points keeps decision makers in tune with what is happening with significant units that make up the entire business.

Should you need an annual valuation be sure to right size the effort and funds required to get the appraisal done. A competent and experienced valuation expert will be interested in providing the appropriate level of service without over killing the fee or the effort required by management and the shareholders.



Fundamentals of Fair Market Value

All business valuations are context sensitive in that their outcomes depend on what is being valued, why it is being valued, and for whom it is being valued. The choice of an approach or approaches to value and the specific methodology employed should be based on the type and characteristics of the property being valued, any applicable legal requirements, and sensible and rigorous financial and economic analysis. To help define the valuation assignment and choose the appropriate approache(s) to value and the specific methodologies thereunder, the business valuation profession has developed a list of basic elements necessary thereto.

One of those elements is the standard of value being employed in the assignment. Since the word “value” can mean different things to different people, it is essential that the term be defined if the conclusion of value developed in the report is to have any meaning. The standard of value in a report tells the reader what definition of value is being arrived at in the particular assignment. The standard of value is different from the premise of value, which informs the reader as to what assumptions have been made about the situation of the hypothetical transaction environment, e.g., going concern or liquidation.

The critical pieces of information set forth in the standard of value are who the buyer and seller will be—it specifies the parties to the transaction. Put another way, the standard of value

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answers the questions: "Value to whom?" and "Under what circumstances?" In addition, the standard of value will dictate what valuation methodologies are appropriate and what other factors ought to be considered. One of the most prevalent standards of value is fair market value.

The concept first appeared in the Revenue Act of 1918, which provided that "when property is exchanged for other property the property received in exchange shall, for the purpose of determining gain or loss, be treated as the equivalent of cash to the amount of its fair market value."

Advisory Tax Board Recommendation 57 was issued by the Bureau of Internal Revenue in 1919 to define fair market value. The recommendation stated:

> "Market value" is the price at which a seller willing to sell at a fair price and a buyer willing to buy at a fair price, both having reasonable knowledge of the facts, will trade. It implies the existence of a public of possible buyers at a fair price. The adjective "fair" emphasizes the idea of fairness inherent in the conception of market value, and excludes any possibility of a construction of the words "market value" with reference to a market which, or to circumstances of sale under which, for any reason a fair price could not be obtained.

The opening sentence has been carried forward in some fashion to Revenue Ruling 59-60, where it is incorporated into that document's definition of fair market value. The second sentence which requires a "public of possible buyers" to be in place for buyers and sellers to transact at fair market value did not make the cut when Rev. Rul. 59-60 was published. And the last sentence is merely a tautology, or circular reference that was dropped for good reason.

Rev. Rul. 59-60, in Section 2.02, defines fair market value, in effect, 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.

Elsewhere in Rev. Rul. 60 the fair market value price is paid in terms of money or money's worth, making it a cash equivalent price as was originally mentioned in the Revenue Act of 1918. In addition, in 1929, the Board of Tax Appeals, the predecessor to the current Tax Court, developed the idea that the buyer and seller are hypothetical characters, and accordingly, this notion produces a value-in-exchange concept that is without regard to the specific current owner or any specific buyer.

Standards of value put the valuation report reader on notice as to the type of value being used in that valuation engagement. Common standards of value are fair market value, fair value, investment or synergistic value, *ad valorem* value for property tax purposes, etc. Since each of these values is defined in opposition to fair market value, let's see how that standard of value is applied.

Fair market value is a concept that can be used heuristically to determine if a particular conclusion of value has met the definitional standard. For example, if the seller is motivated to sell because of business distress, the traded value will not be at fair market value as the seller is an unwilling seller in that she is under some compulsion and "needs" to sell rather than "wants" to sell. This type of seller is often defined as "motivated." Another example is when the price offered by a competitor who is attempting to gain market share, or perhaps trying to enter a new territory, contains a premium. As the business is worth more to this particular buyer because of the synergies expected to be realized after the purchase, then once more we do not have a transaction at fair market value. We have instead investment value, the value to a specific buyer, rather than a hypothetical buyer.

Very often we hear sellers tell buyers—"my price, your terms." This often results in creative financing where the seller holds paper with a below-market rate of interest. Since this seller financing creates a price that is not cash equivalent, the transaction fails the fair market value test. When the buyer is not informed by the seller that a new competitor will be moving into the neighborhood nine months after the transaction closes, the price paid will not be at fair market value, as one of the parties did not have reasonable knowledge about a very relevant fact. Tied closely to the idea of reasonable knowledge is the concept of what is "known or knowable" as of the valuation date, also known as the subsequent events doctrine. Since buyers and sellers do not have crystal balls and cannot be cognizant of events that will transpire after they transact, so too are business appraisers restricted to what is known or knowable as of the date of valuation. To make use of information that comes to light after the date of valuation is to violate the fair market value standard.

For small businesses, where a financing rule of thumb is one-third each from the buyer, the bank, and the seller, those sellers who are unwilling to carry their third of the deal will not obtain a price equivalent to what the business is worth under the fair market value standard as they are not truly able to sell. Therefore, those sellers who are willing to sell but unwilling to finance are willing but not able sellers.

These examples offer practical applications of what fair market value means when the whole business is being sold. However, when 50% or less of a company's stock is being offered for sale, other concepts must be considered before we can arrive at fair market value. Rev. Rul. 59-60 states: "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..." However, it does not go on to discuss what impact this has on fair market value or how to measure that impact. Further, since minority shareholders cannot force the sale of the company's stock or its assets and are dependent on the majority shareholder for the size and timing of their dividends or distributions and ultimately when the whole business will be sold so they can reap their capital gains, they suffer from what is called a marketability discount. This discount is taken from the company's 100% control value and, depending upon principally the amount of dividends and distributions expected to be received and the date of eventual sale of the whole company, can run as high as 80%. This discount from control value must be taken into account before minority shares can be considered to be at fair market value.

This article has attempted to put the idea of fair market value in some historical context and demonstrate how the ideas contained in its definition permeate the appraisal process by impacting choices of approach, methodology, discounts, and premiums among other items. For more information on fair market value, call us today.

When Disaster Strikes!

2011 seems to be the year of natural disasters of immense proportions. The tsunami in Japan is affecting businesses here in the USA that depend on products and supplies made there. We have had several tornados in the Midwest and New England. And most recently, we have major flooding in the Midwest and South. A major customer, a major supplier, or, God forbid, you yourself might be a victim of disaster.

Have you ever thought about what would happen to your business, and the value of your business, if you got caught in a disaster, natural or otherwise? A fire could wipe out your manufacturing capabilities, your computers, your billing and administrative functions, etc. While good insurance coverage can replace your property and pay for lost net income plus continuing expenses during the interruption, you cannot insure your customer base, your employee roster, your goodwill, and your intangible value.

All businesses should have a disaster plan that covers major disruption and loss of business from such an event. Good insurance coverage is just the base of a plan. The Small Business Administration has disaster assistance loans up to $2 million. You can rebuild what you had. But that takes time.

You also need a plan to operate while the physical rebuilding is happening. For example, a fire destroys your facility and your inventory. How do you recover quickly enough to prevent your customers from establishing new relationships with your competitors? If you've been down for a while, how do you get them back?

Disaster planning checklists usually address three elements: safety and emergency relief during and immediately after the event, physical recovery, and data recovery. Here are a few more things to think about:

- Identify the critical functions and processes in your business
- Identify the facilities that you need to function
- Work through disaster scenarios and how you might be able to recover from them
- Involve your key people in the thought process
- Where can you get substitute facilities quickly?
- From whom can you get replacement materials and supplies?
- How can you get substitute computer systems up and running quickly?
- How can you address your customers' needs while down yourself?
- Who can help you?

For many businesses, there may be no easy answers to these questions. For others, a little forethought can make a big difference. Whether you have been the victim of a disaster or just want to plan ahead, contact us today.

Chris Hamilton
Arxis Financial, Inc
2468 Tapo Canyon Road
Simi Valley, CA 93063