

What To Know About Business Appraisals

Before building a client's financial plan on the basis of an appraiser's report, make sure the report is on solid legal ground.

By Bruce A. Johnson

Only about 12,000 of the 2.9 million corporations in the United States are actively traded in a public market. The rest are closely held businesses and, as such, valuation issues often arise. For example, valuations are commonly required for buy-sell agreements, estate planning and the sale of a business.

Because a business appraisal can play a major role in resolving these matters, companies must be prepared properly and endure in-depth scrutiny. This is crucial in estate tax matters, especially considering a recent study that found 65.2% of the Tax Court's decisions did not coincide with the conclusions of any expert witness in the case.

A well-prepared business appraisal should follow accepted guidelines and include specific information. Before building a client's financial plan on the basis of an appraiser's report, it's a good idea to make sure that the report itself is on solid legal ground.

Appraising The Issues

When evaluating a business appraisal, there are six issues that must be addressed:

■ Does the report conform to the Uniform Standards of Professional Appraisal Practice?

USPAP is a set of standards developed by the Appraisal Foundation, a national self-regulatory organization created in 1987. The standards require disclosure of specific information, such as whether the appraiser "set forth the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions and conclusions."

While this sounds rudimentary, many reports do not disclose this basic information. In fact, one recent survey found that only 29% of a sample of business appraisals prepared by Florida CPAs conformed to USPAP requirements. In fact, because so many appraisals failed to meet those requirements, the Florida legislature has passed laws regulating the business appraisal profession.

All appraisals used in federally related real estate transactions must conform to these standards. However, many people are not aware that USPAP also has specific standards for business appraisals. The Internal Revenue Service Valuation Guide, a training manual for appeals

officers, acknowledges that USPAP was developed "to be used in appraisals of real estate, personal property and businesses, regardless of whether the appraiser was designated by an organization."

■ Does the report consider relevant data such as trends and economic conditions?

Averaging the past five years' income is not an appropriate method of taking the company's historic operations into consideration. The importance of trends and the effect of economic factors on the income-generating ability of a company is fundamental to properly valuing a business. The *Estate of Sullivan* case (1983) highlights the importance of a thorough report: "None of (the petitioner's) reports attempts to analyze what factors relating to the economic health of (the company) . . . would have been considered by a prospective purchaser . . . This failure, when combined with the brevity of the reports . . . leads us to conclude that these reports should be given little, if any, weight."

In addition to customary information specifying the purpose of the valuation, sources of information, date of the valuation and standard of value, an appraisal should include a discussion of the economic factors that affect the subject interest, a financial analysis of the company's operating performance and the rationale of how these factors affect the company.

Important attributes that should be examined include trends of sales and earnings. The seasonality of sales during the year is also often overlooked. Non-recurring income and expenses should not only be recognized, but also

explained so that the reader can understand the rationale if any adjustments are made for financial projections. In summary, understanding economic trends and conditions is a key component of any valuation.

The 'Correct' Earnings Stream

■ Does the report apply an appropriate rate of return or multiple to the correct earnings stream?

When valuing a company or partnership, there are three approaches to value. The most common is the income approach, which determines the present value of an expected future stream of earnings.

It is important to understand what earnings stream is being valued. The term "earnings stream" can describe gross cash flow, net cash flow, net income, income before interest, operating profit, income before taxes and several others. The error many practitioners make is to apply a rate of return (discount rate) to the wrong earnings stream. The discount rate is usually applicable to net cash flow, whereas a price-to-earnings multiple determined from the public market is applicable to net income. The difference can be significant. The application of a discount rate to net income, as opposed to net cash flow, could overvalue a company by 15% to 20%.

■ Does the report rely on previous case history to quantify a value? It shouldn't. It is not appropriate for a practitioner to use a court precedent to justify a position. What the courts have allowed is important, but the specifics of each case are rarely similar enough to apply.

Nonetheless, many business appraisers commonly cite previous court cases to justify a position. It's not uncommon for a practitioner to select five court cases that deal with discounts for lack of marketability, then average the court's conclusions. In *Estate of Berg*, (1991), the Tax Court was clear in its opinion of such a practice: "The fact that the petitioner found several cases which approve discounts approximately equal to those claimed in the instant case is irrelevant. Therefore, in deciding the appropriate discounts in the instant case we . . . do not consider

the amount of discount applied in other cases cited by petitioner as persuasive."

■ Does the report employ the use of averages found in published studies to support discounts for lack of control and lack of marketability? Again, it shouldn't. Reliance on average discounts from published studies is equivalent to reasoning that you can value a house in a specific neighborhood by using the average price of homes in the same state. An examination of historic Tax Court cases reveals that the court has overwhelmingly preferred values derived on an empirical basis. Appraisers will enhance their ability to prevail in Tax Court by showing why the empirical data is relevant and applicable.

The Tax Court has consistently rejected experts' opinions that do not rely on the specific characteristics of the interest being valued. In *Estate of Bell* (1987), the court rejected the petitioner's expert because "the petitioner did not offer evidence to support any discount for lack of marketability." In *Mooneyham v. Commissioner* (1991), the court disapproved of the quantification of discounts by the petitioner because "neither his report nor his testimony at trial gave any reason for choosing 25% . . . an expert's opinion should be based on objective information." Finally, in *Estate of Berg*, the court clearly explained why the IRS prevailed: The IRS appraiser's "analysis is persuasive because he relies on very specific studies of comparable properties . . . (the appraiser for the Berg estate) offers no analysis of the appropriate amount of the discount, and we therefore regard his appraisal as irrelevant."

The Treasury Method

■ Does the report rely on the excess earnings or formula approach to derive a value? The business valuation profession began in the 1920s, during the Prohibition Era. When the government prohibited the manufacture and sale of alcohol, it also agreed to reimburse breweries and distilleries for the value of their businesses. It was therefore necessary to determine how to value the businesses that had been outlawed.

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To determine the value of the goodwill of a brewery or distillery, the IRS developed the Treasury Method, more commonly referred to as the excess earnings or formula method. For the next 48 years, the method was employed by the IRS and taxpayers. In 1968, due to the widespread misuse and manipulation of the method, the IRS issued


Revenue Ruling 68-609 denouncing the method, stating that it is applicable only "if there is no better basis available for making the determination." In a 1978 Appellate Conferee Valuation Training Program, the IRS again rejected the method. However, it is still used by countless practitioners to value companies.

Experts Do Make Errors

Approximately 84% of the business appraisal reports submitted to the American Society of Appraisers as part of the accreditation process are rejected because they contain errors such as those discussed here. The rejected reports were submitted by practitioners ranging from sole proprietors to those employed by national accounting and investment banking firms. This is an alarming statistic, for it shows that not everyone who holds himself or herself out as a business valuation expert is able to do the job.

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However, you can avoid the pitfalls of a useless appraisal by ensuring that the practitioner you engage is competent, has formal training in the discipline of business valuation, has received an accreditation from a well-respected valuation organization and is actively engaged in the area of business valuation. As the financial planner who will be responsible for either engaging the appraiser or relying on the appraisal report, be aware of what constitutes a good, supportable appraisal and be discerning about the practitioner on whom you stake your reputation. 

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