

VALUE ADDED™ Summer, 2001

Ten Items to Check When Reviewing a Business Valuation

Recognizing the complexity of business appraisals today, it is helpful to be aware of typical issues that appraisers scrutinize when reviewing another appraiser's work product.

1. Does the Math Add Up? Excel worksheets are a great tool for tracking changing numbers as the valuation analysis develops, but spreadsheet technology creates the possibility for a different type of error. If the cells in a worksheet are not properly linked, a change in one area may not carry through correctly. A quick check of the math will reveal if the numerator is divided by the proper denominator; if a percentage rate is properly converted to a multiple; or if a column of figures adds up.

2. Valuation Date Agreement. Does the valuation date agree with the transaction date, gifting date, or date of death, or is it stuck to the date of the most recent financial statements? Given the timing for production of financial statements, it is likely that today's current report will be based on financial statements that are 2 - 3 months old. While the analyst can utilize reasonably historical financial statements (assuming ongoing updates and discussions with management and analysis of current events), the valuation date should tie to a specific current date required by the client.

3. Underlying Earnings Power. Does the earnings power determined by the analyst confirm the respective margins and earnings indicated in the projections provided by management? Historical earnings often provide a prognosis for future financial performance. However, in a cyclical business, current favorable earnings may not be reflective of ongoing earnings power. If management has provided financial projections, the implicit earnings should reasonably confirm the analyst's assumption of ongoing earnings power used, for example, in the capitalized earnings approach or a guideline company approach.

4. Adjustments to Earnings. Generally, earnings or cash flow is the most important input in determining value. Often, in establishing the earnings power, adjustments are made to the company's reported earnings to more accurately reflect its anticipated future performance. These adjustments should be scrutinized. For a start, check the math and make sure that the proper sign (+ or -) was attached to the adjustment. The adjustments themselves can be the main issue in the valuation analysis. All reference and supporting material should be examined for accuracy.

5. Large Swings in Cash Flow. Unusual financing situations, such as the sale of stock, incurring long-term debt or purchase of a new operating facility can imply large and unusual swings in cash flow in a given year. These variations can greatly impact a discounted cash flow model if the major changes in cash inflow are not properly matched against the major changes in cash outflow.

6. Guideline Companies. Guideline companies are often used to select valuation multiples to be applied to the subject company. Selecting the appropriate guideline companies is important. Some of the factors to be considered in the process include: Capital structure; Credit status; Depth of management; Personnel expertise; Nature of competition; Maturity of the business; Products; Markets; Management; Earnings; Dividend-paying capacity; Book value; and Position of the company in the industry.

7. Does the Answer Conform to Ownership Interests? There are various forms of security ownership, and the value determined by the appraisal should conform to the appropriate ownership interest: per share for a stock interest; per unit for certain Partnerships and Limited Liability Companies; percentage interests for certain other Partnerships and LLC's; or, Members' Interests of LLC's in general.

8. Dividends From Sub Chapter S Corporations. S Corporations combine the limited liability features of a corporate entity with the income pass-through attributes of a partnership. As such, S Corporation stockholders are liable for the taxes on the company's income, whether it is distributed or not. Dividend capacity is a key analytical factor to consider, but may be distorted due to the relatively large dividends paid by S Corporations. To make a fair comparison to the investment returns of C Corporations, the S

Corporation dividend must be converted to its C Corporation equivalent. This enables the appraiser to determine if there is a real, economic dividend, or if the dividend is only sufficient to cover the implicit tax liability.

9. Text and Worksheet Agreement. Most analysts will prepare and finalize the worksheets that accompany the text of an appraisal report before completing the text. Changes can occur during the writing process and the reviewer of the report should ensure that the text properly references key worksheet benchmarks in the development of the analytical story.

10. Analytical Replication. The reader of an appraisal report should be able to replicate the analysis presented in the worksheets, based on the numbers, averages, medians, adjustments and percentages provided. The analytical conclusion, typically selected from a range of indicated values, should provide the rationale for the selection process and the rationale should validate the risks and opportunities previously discussed in the report.

In summary, as the business appraisal profession has matured, analytical tools and techniques have mushroomed, supported by database and computer resources that can now make for a complex and challenging appraisal report. By following these few benchmark items, professional advisors, fiduciaries and clients can work with and challenge the appraiser to provide an accurate and comprehensive work product. If you would like to discuss a valuation project in confidence, feel free to call. "

Simplot Reversed

In a split decision (2 for, and 1 dissenting), the United States Court of Appeals for the Ninth Circuit reversed a controversial decision of the Tax Court in *Estate of Richard R. Simplot v. Commissioner* (112 T.C. No. 13 (1999)). In the appellate court's opinion, the Tax Court was found to have committed errors that related to the misapplication of the standard of fair market value to the Class A voting shares of J.R. Simplot Company ("Simplot"). (The Ninth Circuit decision can be found at the following link: [http://www.ce9.uscourts.gov/.](http://www.ce9.uscourts.gov/))

This decision follows two other Ninth Circuit reversals of Tax Court decisions since early this year (*Estate of Mitchell v. Commissioner* (T.C. Memo 1997-461) and *Estate of Kaufman v. Commissioner* (T.C. Memo 1999-119)), both of which also dealt with the meaning of fair market value.

There were four major valuation issues in Simplot.

1. What was the marketable minority value of J.R. Simplot Company? The value was concluded to be \$830 million after certain issues were clarified at trial.
2. What was the appropriate consideration of Simplot's investment in Micron Technology stock, which had a large imbedded capital gain? All the appraisers fully tax-affected the gain, and the Court accepted this treatment without comment.
3. What was the appropriate marketability discount applicable to Class A voting and Class B nonvoting shares? All the experts concluded in the range of 35% to 40%, which was the range held by the Tax Court.
4. Finally, what premium, if any, was appropriate for the minority interest Class A voting shares (which represented a 23.55% of all stock outstanding) relative to the minority interest Class B nonvoting shares owned (2.79% of all stock outstanding) in the determination of fair market value?

Regarding this last issue, the Tax Court concluded that it was appropriate to allocate 3% of the value of the enterprise (\$24.9 million) across the small number of Class A shares (76.45 of a total 141,365.029 shares outstanding). The result, after consideration of marketability discounts, was a conclusion that the fair market value of the Class A voting shares was \$215,539 per share, and that the fair market value of the Class B nonvoting shares was \$3,417 per share. The disparity in the concluded values of the voting and nonvoting shares resulting from the allocation of 3% of enterprise value to the Class A voting block was the issue on appeal to the Ninth Circuit.

In its reversal of Simplot, the Ninth Circuit found that the Tax Court had committed certain errors of law that, from our layman's perspective, relate to the application of the meaning of the term fair market value. The majority opinion concluded:

"Much of the Commissioner's argument is devoted to speculation as to what might happen after the valuation date - the Simplots might fall out with each other, the purchaser might find ways of making Simplot more profitable and persuade the company to adopt his strategy, the purchaser might be willing to wait fifteen years to get any return. The speculation is as easily made that the company would go downhill when its founder, J. R. Simplot, 84 at the valuation date, retired; or that McDonald's, Simplot's largest customer for its potatoes, would change its supplier; or that Micron would prove to be an unwise investment. Speculation is easy but not a proper way to value the transfer at the time of the decedent's death. *Olson v. United States*, 292 U.S. 246, 259 (A934). In Richard Simplot's hands at the time of transfer, his stock was worth what a willing buyer would have paid for the economic benefits presently attached to the stock. By this standard, a minority holding Class A share was worth no more than a Class B share."

In essence, the Ninth Circuit held that the Tax Court's conclusion was not consistent with the concept of fair market value.

The Tax Court's opinion in Simplot created a great deal of concern for business appraisers and for estate planning attorneys. However, appraisers should not rely upon such cases to provide precedent for use in appraisals. It is the job of business appraisers to advance economic arguments on valuation questions to the courts, and it is the job of the courts to decide, based on those economic arguments.

In Simplot, the taxpayer's experts held their ground and lost on the issue of the voting versus nonvoting premium in Tax Court. However, the taxpayer believed in their arguments sufficiently to take the unusual step of appealing the Tax Court's decision. In the appellate forum, the Tax Court's conclusion was found lacking and to be in error for its "speculation." "

Tax Considerations in the Structuring of a Transaction

Corporations generally grow in one of four ways: (1) internal growth where cash generated by the operations of the business are reinvested into the business (2) the raising of additional equity capital from current or additional equity investors (3) the raising of additional debt financing from current or additional lenders. (4) acquisitions.

In an acquisition, the buyer purchases an existing business in order either to diversify or to integrate vertically or horizontally. If the purchasing corporation and the target corporation are approximately the same size, the transaction is often referred to as a merger. Mergers are typically characterized by the presence of key managers from both the buyer and the target in the top layers of management of the combined entity. If the buyer is much larger than the target corporation, the transaction is typically referred to as an acquisition. In an acquisition transaction, the management team of the buyer will typically dominate the management of the combined entity.

From the point of view of the Internal Revenue Service, there are four basic transaction structures:

1. The taxable purchase of the target's stock.
2. The taxable purchase to the target's assets.
3. The tax-free acquisition of the target's stock.
4. The tax-free acquisition of the target's assets.

Presented below is a general overview of each of these four basic transaction structures.

1. **Taxable Stock Purchase.** In a taxable stock purchase, the target's shareholders realize gain or loss on the sale of their stock in the target entity. The buyer's basis in the acquired stock is generally equal to the purchase price paid plus the expenses associated with the acquisition.

2. **Taxable Asset Purchase.** In a taxable asset purchase, the target transfers some or all of its assets to the buyer in exchange for cash. The target will then typically complete its liquidation and distribute the proceeds of the liquidation to its shareholders. The target corporation realizes any applicable gain or loss on the assets transferred, and the buyer receives a basis in the acquired assets equal to the purchase price paid plus any liabilities assumed plus the amount of any expenses associated with the transaction.

The target shareholders realize gain or loss on their disposition of the stock of the target corporation in the liquidation.

In general, all acquisitions that do not qualify as reorganizations under Code §368 or as transfers to a controlled corporation under Code §351 will be taxable. If a deal is structured carefully, it may qualify as a 'tax-free' deal. Tax-free deals are really tax-deferred deals, but a structure that allows this treatment may significantly reduce the size of the tax 'wedge' between the purchase price paid by the buyer and the after-tax proceeds of the seller.

3. Tax-Free Stock Acquisition. In a tax-free stock deal, the buyer exchanges some of its voting stock for all of target's stock. Depending on the structure of the transaction, 'boot' may also be paid. Boot is defined generally as any consideration other than the voting stock of the buyer (such as cash and notes) although buyer securities of like kind can generally be exchanged for target securities such as debt, warrants, and options. In order to achieve tax-free status, the amount of boot paid is severely restricted and depends on the form of the transaction.

After a tax-free stock transaction, the buyer typically does not receive a step-up in basis for any gain recognized by the target's shareholders. The target shareholders realize a taxable gain on any boot received, but the target shareholders keep their same basis for any non-boot consideration received.

4. Tax-Free Asset Acquisition. In a tax-free asset transaction, the target's basis in the assets will carry over to the buyer, and the target does not recognize gain or loss on the receipt of the buyer's stock. The target entity will have a basis in the buyer's stock received equal to its basis in the assets transferred to the buyer. In addition, the target's shareholders typically will not realize gain or loss on the distribution of the stock of the buyer to the target's creditors or shareholders.

This discussion should by no means be considered exhaustive, nor does it constitute accounting, tax, or legal advice. This article is intended solely to make the reader aware of the major tax considerations involved in the structuring of transactions. Please call Andrew Wilusz, VMI's Director of Mergers & Acquisitions, at 215-598-9310 to discuss transaction issues. "

Value Management Inc.
758 Durham Road
Newtown, PA 18940

Telephone: (215) 598-9310
Fax: (215) 598-0589
E-mail: info@valuemanagementinc.com