
Client-Attorney-Business Appraiser

The Meeting of the Minds at the Start of a Business Valuation



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Business valuations are frequently required by attorneys in three broad areas--tax related matters, proposed purchase or sale transactions and in litigation. Since each business valuation is unique, it is important that the assignment be carefully defined and well understood by the principals, the attorney and the business appraiser. The following are five key elements to be addressed in a business valuation assignment.

1. Property To Be Valued. Simply put, exactly what property or interest is to be valued? Are individual assets to be valued or an equity interest? Intangible assets to be valued by a qualified business appraiser may include beneficial contracts, trade names, patents, copyrights, customer lists and goodwill.

Many owners of small businesses and

professional practices are directly responsible for the management and success of the firm. Transferring the owner's goodwill to a buyer may therefore include separate valuation and negotiation of covenants not to compete and employment agreements.

Will the entire business be valued or only a partial interest? In the case of a partial interest, the appraiser must consider minority and marketability discounts. In divorce cases, the state where the business is located is particularly important. Other considerations are the tax status and whether the business is a regular or an S corporation.

The class, rights and preferences associated with stock ownership must also be identified. Is there a buy/sell agreement which restricts ownership transfers? Does the agreement spell out a valuation formula?

2. Purpose and Use. What is the specific reason for the valuation? In tax-related and certain litigation matters, a mass of complex federal and state tax statutes and legal precedents must be followed.

Tax-related situations include valuations for estate, gift and charitable contribution purposes. In all IRS-related valuation matters, the appraiser must follow Revenue Ruling 59-60. The Ruling describes eight general, although not all inclusive, factors to consider when performing a fair market value appraisal. Valuation of Employee Stock Ownership Plans (ESOPs) must follow Revenue Ruling 59-60, Department of Labor regulations and specific case law. Allocation of the purchase price in proposed transactions must follow new IRS regulations.

Many times in litigation, court directives define the valuation problem, how the valuation reports will be prepared, rules for discovery and retention of experts. In other instances, the scope of the appraiser's work is influenced by case law and the particular facts and circumstances of the case.

In a proposed transaction, the principals

may seek further information in addition to a fair market valuation. A prospective purchaser may want the business appraiser to prepare pro forma financial statements and valuations under assumptions particular to the buyer either on a stand alone basis or in combination with existing business activities.

The seller may ask the business appraiser to assess the market for potential buyers and advise the seller on terms and other negotiating points.

Case law is important in - divorce valuations. New Mexico cases have addressed valuation issues such as the excess earnings method, buy/sell agreements, and computation of goodwill in a professional practice. State law is also involved in condemnations and dissenting shareholder suits.

3. Valuation Date. The valuation date is critical since changing circumstances can alter the value dramatically. Some dates are optional, others set by statute.

It is common in proposed transactions to value the business as of the normal fiscal year end closing of the business. This allows for the regular taking of physical inventory and other procedures done only at year end. However, because of a later closing date, particular valuation procedures may be performed to account for changes in certain balance sheet accounts.

The valuation date for an ESOP is the normal year end of the business; for estates it is the date of death or six months after; and for gifts or charitable contributions, the date is discretionary. In a divorce, the valuation date is often the effective date of the divorce. A critical date in damage cases is the date the damage occurred.

4. Standard of Value. It, is important to clearly define, if known, the standard of value which applies to the different purposes and uses discussed above. The most widely recognized standard of value is "fair market value" (FMV). FMV implies an objective assessment of the cash or cash equivalent price at which a given entity would change hands between a "hypothetical" willing buyer and seller. FMV applies to all federal and state tax matters including estate, gift, inheritance and income taxes and is also the legal standard for many other valuation situations.

Another common, although not universally recognized, standard of value is "investment value." Investment value is based on a particular owner's or prospective owner's subjective idea of the value of the business. Investment value may vary widely from FMV because of differing perceptions of future earning power, risk, tax status and synergy with other operating activities.

As in New Mexico, the term "fair value" is sometimes described in state statutes involving dissenting shareholder rights. In many instances the valuation standard is unclear, particularly in litigation. Value definitions are sometimes developed by reference to case law that follows the particular facts and circumstances.

5. Administrative Instructions. Three administrative points should be agreed upon--the form and extent of the report, the time schedule and the fee arrangement.

The form of the report can be either written, oral, or a combination of both. A written report can be as simple as a single page letter or a detailed fully documented report of many pages.

Depending upon the complexity of the assignment, the business appraiser may require up to sixty days to arrive at an appraisal conclusion and to prepare an appraisal report. Court times, transaction closing dates, and other deadlines enter into the time schedule. The best plan is to give the business appraiser as much lead time as possible and to have all parties agree on the schedule.

There are three general fee arrangements--fixed fee, fee range or hourly rate. The more clearly defined the assignment the more likely a fixed fee or fee range can be quoted. Professional business appraisers are legally and ethically prohibited from receiving contingency fees.

Conclusion. There are five key elements to a business valuation assignment that should be agreed upon, preferably in writing--the property to be valued, the purpose, the valuation date, the standard of value and the administrative instructions. Clearly defined valuation objectives and requirements can help eliminate confusion, misdirected efforts and invalid conclusions.