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VALUE ADDED™

ROUTE TO:

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IRS Issues Proposed Business Valuation Guidelines

The Internal Revenue Service issued their Business Valuation Guidelines in draft form in May 2001 as part of its ongoing effort to:

> *". . . provide guidelines applicable to IRS Valuation Engineers, Appraisers, Valuation Specialists and others engaged in valuation practice relating to the development, resolution and reporting of issues involving business valuations and similar valuation issues."* [IRS BV Guidelines - Introduction]

These Guidelines are not a series of suggested methods or approaches for preparing the valuation. Instead, they appear to be designed to improve the examination process. This article highlights several interesting portions of the Guidelines but is not meant to be an exhaustive overview. For a copy of the Guidelines, contact us. The Guidelines are organized as follows:

1. Introduction
2. Development Standards
   - 2.1 Planning
   - 2.2 Identifying
   - 2.3 Analyzing
   - 2.4 Workpapers
   - 2.5 Reviewing
3. Resolution Standards
   - 3.1 Objective
   - 3.2 Arriving at Conclusions
4. Reporting Standards
   - 4.1 Overview
   - 4.2 Report Contents
   - 4.3 Statement

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Highlights from the Guidelines

Entity to be Valued. The Guidelines are very specific in requiring the identification of the entity to be valued and the scope of work to be performed and this is a step forward from the IRS.

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Deals Still Get Done

Even in an Uncertain Marketplace

The economic expansion that has been ongoing since 1992 continues, but the pace has slowed significantly, and the outlook for the balance of the year is uncertain. As a result of the slowdown, the Federal Reserve has shifted monetary policy and reduced the Federal Funds rate seven times since the beginning of the year. There is mixed sentiment regarding whether we will have a quarter of negative growth, although the consensus is that the expansion will continue.

Given this backdrop, deal activity has slowed dramatically. According to *Mergerstat*, the value of all transactions announced year-to-date

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Level of Value. Of particular note is Guideline 2.2.1.7. that requires an explicit statement of the premise or level of value. This information is often missing in valuation reports and leads to great confusion as to whether the reader is actually looking at the appraisal of a minority interest or a controlling interest.

Developing Information. The Guidelines for developing information follow closely those of Revenue Ruling 59-60 in that they require a comprehensive look at the entity as well as its markets and the relevant markets in which similar companies may have publicly traded securities. Guideline 2.3.4. reads:

> *"The valuator should select the appropriate benefit stream, such as pre-tax or after-tax income and/or cash flows, and select appropriate projection models to be consistent with the valuation methodologies selected."*

One can clearly read this to mean that the selected income stream should be consistent with the multiple applied to it. Therefore, the idea of mixing pre-tax income and after-tax multiples and so forth, would, in fact, be inappropriate.

Fair Market Value vs. Synergistic Value. Guideline 2.3.6.3. states:

> *"Other levels of value considerations, such as the impact of strategic or synergistic contributions to value [should be considered]."*

This raises a number of interesting questions. For example, is this designed to be a departure from a more traditional understanding of fair market value that considers mostly financial buyers?

If synergistic or strategic considerations are taken into account, this would appear to provide some impetus for pushing up value. Conversely, it also creates the dilemma for those who are involved in transactions in that it may be more difficult to derive a strategic price for one company than for another. One must never forget that in a specific strategic deal, you have a successful buyer who looked at a candidate, found just the right match, whether rational or irrational, and was willing to pay a particular price. Some so-called strategic or synergistic benefits can be fairly straightforward, particularly in cost reduction. However, other benefits such as revenue growth or new markets could be highly speculative. As a practical matter, it would be clear that caution should be exercised in imputing strategic benefits to valuations in a tax environment.

Documentation. The Guidelines also call for workpapers to document the steps taken and techniques used. When there is a difference of opinion about the conclusion of value, the details of how each conclusion was derived can effectively communicate the underlying premise.

We note from Guideline 2.5.2.5. that the reviewer should:

> *"Form an opinion as to the apparent adequacy and relevance of the data and the propriety of any adjustments to the data."*

The Guidelines seem to be calling for the ability to replicate the critical information in either the taxpayer's report or the government's report. This is a critical element to having an appropriate exchange of information and a full understanding of each party's position.

Reasonableness of Conclusion. Standard 2.5.2.7. notes:

> *" . . . opinions and conclusions in the report under review are appropriate and reasonable . . . "*

Tests of reason and reasonableness should be found in every report. Tests of reason keep the appraiser in the ballpark, so to speak. Even though the individual assumptions may have seemed reasonable and the methods applied may have been reasonable, they may yield an unreasonable answer.

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Deals

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through June 29 was down almost 50% from the same period last year. The deal activity that is occurring is seemingly at lower valuations than realized in recent years. The average EBITDA multiple paid in deals announced in the first quarter was 5.49x, which compares with 6.19x for all of 2000 (S&P Portfolio Management Data, *M&A Today*, June 2001). Credit has tightened, requiring would be acquirers to contribute more equity to deals than in the recent past. Yet, despite uncertainty in the economy, opportunities exist for both buyers and sellers of businesses.

Private Equity Groups ("PEGs") have seen available deals diminish in number and quality with the economic slowdown. However, good deals continue to attract interest, as many funds are sitting on committed but unallocated dollars. PEGs are typically funded by institutional investors who allocate a portion of their investment dollars to private companies.

In recent years a large number of PEGs have focused on new economy companies. With the collapse in the public market for dot.com stocks, the private equity market has all but dried-up for new economy companies. At the same time, value investing has come back into vogue. Currently, private equity groups are seeking a history of strong operating cash flow, a defensible market position, and seasoned and capable management.

Investments can take several forms depending on the desire of the current owners and the objectives of a particular fund. A common form of investment is backing a management buyout. The PEG will take a majority stake in a company and offer the existing management team the opportunity to share in the ownership. This often occurs when the owners of the company are not involved in the day-to-day operations of the business.

Another form of investment is a partial recapitalization. In this situation, the PEG will provide an equity investment that will allow the company the opportunity to continue to grow, but provide some liquidity to the current owner(s). In these circumstances the owner will typically remain with the company, enjoying the upside investment potential in his or her company while creating a degree of personal liquidity. Again, a PEG will typically take a majority stake in the company, but some groups will offer to take minority positions.

Personal liquidity needs of business owners exist in both slow and robust economic times. While options may not be as plentiful in a slower economy, private equity can provide a potential avenue to liquidity.

What opportunities exist? Public companies that have been active acquirers in recent years are looking at shedding non-core operations obtained in larger acquisitions. This is creating opportunities for private and other public companies. Pricing may not be as important as the ability to monetize the investment and focus management attention on core operations. Private equity firms continue to seek "good deals." Well-funded PEGs are seeking opportunities with companies that offer strong growth potential, as well as existing positive cash flows. Companies with significant positions in their market segment, as well as a proven management track record can still find reasonable pricing. Good deals are being funded with an overweighting of equity relative to deals that were done in prior years. The underlying assumption is that PEGs will be able to refinance and withdraw excess equity in the foreseeable future. With smaller companies (revenues <$25MM), lenders are less apt to offer financing based on cash flow alone. Asset reliance is much greater in these cases. It should be noted that asset values do not necessarily equal the value that the accountants place on the assets, but more typically a fair market value of the assets. ◆

Using a Business Analyst When Litigating a Valuation Issue

In this newsletter, we have frequently explored the benefits of valuation advisory services, such as how they provide the peace of mind and the thoughtful documentation that is required to conduct those transactions that can be scrutinized by tax collectors, regulators, courts, and a myriad of other lurking adversaries.

Compliance issues (tax, regulatory, and legal/fiduciary compliance) probably trigger most needs for qualified, independent valuations of closely held securities. The familiar gift, estate and income tax issues relate to minority interests, discounts for lack of marketability, intangible assets and the like. Many regulatory considerations relate to transactions with employee stock ownership plans ("ESOPs") and certain (re)financings, mergers, and acquisitions. Legal and fiduciary compliance issues stem from ESOPs, transactions that affect minority shareholders, and practically any deal where a law requires "fair" treatment of parties who lack control. When it comes to addressing these compliance considerations, the benefits of valuation services are understood by practically all legal and financial advisors to business owners.

Moving beyond the typical compliance issues, valuation services can be extremely useful in the litigation arena. Undoubtedly, value is the centerpiece of much business and personal litigation. And the high-stakes, hard-to-quantify issues of litigation are always aggressively challenged.

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In essence, an expert analyst should do three things, whether in a litigation or compliance environment. These are essential to assessing any question of value.

1. Focus on relevant information;
2. Draw conclusions that have economic substance; and,
3. Articulate the reasonableness of conclusions in a manner that appeals to common sense.

A qualified expert has practical experience dealing with real problems of real companies and individuals. A business analyst should be able to define the valuation issues, assemble the relevant information, and quantify the financial aspects of a case. Moreover, an expert should be able to communicate the soundness of conclusions convincingly.

Litigated issues are as diverse as the people involved and the problems that haunt them. These areas of litigation are the ones most likely to require the type of support that a business valuation consultant can provide:

- **Dissenting Shareholder Actions.** "Fair value" as defined in the various states
- **Divorce.** Controlling interests, minority interests, professional practices, partnerships, valuation of publicly traded and restricted securities
- **Bankruptcy.** Post-mortem analysis, going-concern valuations, reorganization feasibility assessment, fraudulent conveyance, forecasting
- **Damages.** Breach of contract, lost earnings, antitrust, eminent domain, forecasting
- **Arbitration.** Review of opposing experts, negotiation assistance, range estimates of value
- **Trial Support.** Critique of opposing experts, cross examination assistance, expert testimony, economic research, public securities, market/ industry research

Having a qualified business valuation expert on a litigation team can be a wise asset-protection strategy. Please call to discuss a litigation issue in confidence. ◆

IRS Proposed Guidelines

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Dispute Resolution and Independence. According to Guideline 3.1.1.:

> *"The objective is to resolve the issue as early in the examination as possible . . ."*

A well documented, stand-alone report that is complete, factual and easy to understand is at the cornerstone of resolving these kinds of disputes. Early resolution is in the best interest of all of the parties.

Guideline 3.2.4. reads:

> *"Valuators will employ independent and objective judgment in reaching conclusions and will decide all matters on their merits, free from bias, advocacy and conflicts of interest."*

This is good advice to all.

Conclusion

These Guidelines are now out for comment by the major business appraisal associations. As mentioned previously, for a copy of the proposed Guidelines, contact us. ◆

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