

THE NEW MEXICO LAWYER

The Monthly Newspaper of Law and Business

Straight Answers to Business Appraisal Questions

By Darrell V. Arne, CPA

Part I - April 1993 Issue

From 1980 to 1987, the number of full-time and part-time practitioners valuing businesses grew from a few hundred to approximately 25,000. Business valuation continues to be the fastest growing appraisal discipline in the United States. Some reasons why follow:

- Investors, lenders and taxpayers bore the brunt of the economic collapse of the S&L industry in the 1980s, which was caused in part by faulty appraisal practices. Today business deals must make economic sense through realistic assessments of an enterprise's future prospects.

- The IRS is looking more closely at business valuations for estate and gift tax purposes as a way to possibly ferret out additional tax revenues. The IRS hires its own business appraisal experts and send agents to business valuation training courses.

- Some courts are beginning to examine the valuation expert more closely and are refusing to "split the difference" on business valuation issues. The Tax Court in the *Estate of Edgar A. Berg* (T.C. Memo 1991-279) ruled in favor of one expert, the one with the business valuation training and the better researched and documented valuation opinion.

- Business valuation issues continue to occur with regularity in domestic relations and civil litigation cases.

If you need a business appraised, what do you need to know? The following questions arise most frequently when a business valuation is contemplated.

- ***When does the need for business valuations arise?***

A formal business valuation normally is required when a third party will rely on the valuation conclusion.

This generally happens in two instances: tax related appraisals and litigation. In both circumstances, the appraiser must maintain his or her independence and objectivity.

Independent valuations are required for Employee Stock Ownership Plans (ESOPs), estate, gift and charitable donations.

The IRS, Department of Labor, trustees and fiduciaries, employer and plan participants, and the donor and donee rely on business valuations prepared for tax purposes.

The courts, the litigants and their attorneys seek business valuations in various litigation cases.

Common situations where a business valuation is required in litigation include domestic relations cases, dissenting shareholder suits, contract disputes, lost profits cases and other business litigation.

"Some courts are beginning to examine the valuation expert more closely and are refusing to split the difference on business valuation issues."

- ***Is a business appraisal necessary when a business is bought or sold?***

Unlike a business appraisal for tax or litigation purposes, buyers and sellers of businesses normally do not need a formal written business appraisal. This is because the appraiser's services are tailored to meet the specific needs of the buyer or seller.

An initial valuation assessment often is used in the negotiation of an agreed upon price and terms rather than to develop an opinion for third party reliance.

Accordingly, the business appraiser usually takes on the role of a consultant/advocate for one side or the other.

Buyers may ask a business appraiser to take part in the due diligence process of identifying and analyzing financial documents, prepare cash flow projections and provide assistance in structuring the deal.

Sellers sometimes have business appraisers assess the reasonableness of the asking price and also assist in deal structuring. If a business is being marketed for sale through a business broker, frequently the broker will make cash flow calculations to arrive at a listing price.

- ***How is a business appraised for tax purposes?***

A business appraised for estate or gift tax purposes must follow the IRS guidelines in Revenue Ruling 59-60. Proposed Department of Labor regulations give specific definitions and procedures plan trustees are to follow when valuing an interest in a business enterprise owned through a qualified plan such as an ESOP.

- ***How is a business appraised in litigation?***

The kind of business appraisal work done in litigation depends upon the desires of the litigants, their attorneys and sometimes the court. A business appraiser can be engaged as a consultant to the attorney or an independent expert.

The business appraisal expert can be court appointed under Rule 11-706. In that case, the scope of work to be performed by the appraiser is determined by court order.

If court testimony is anticipated, the business appraiser

generally follows the same process for valuations done for tax purposes. However, the appraiser may be asked to limit the amount of work because the parties want a preliminary estimate or range of values.

This may happen in the early stages of litigation where an attorney is assessing the merits of the case. (The levels of services a business appraiser performs are discussed below.)

- ***When can a business appraiser limit the amount of work done and still give a valuation opinion?***

The American Society of Appraisers has issued a standard describing three levels of business valuation services. Similar to the way CPAs render opinions for

audits, reviews and compilations, an appraiser following this ASA standard can offer three levels of business valuation services: *appraisal, limited appraisal and calculation.*

In an *appraisal*, the objective is to express an unambiguous opinion of the value of the business where the appraiser collects all relevant information and considers all relevant approaches. An appraisal is appropriate for third party reliance (a full narrative report) necessary for ESOPs, estate and gift, charitable donations and litigation with court testimony.

The objective of a *limited appraisal* is to express an estimate as to the value of a business where the appraiser collects limited relevant information and considers the most appropriate valuation approaches. A limited appraisal is appropriate for internal use only (a short form narrative report) in employee buy-in, buy-sell agreements, business planning and acquisition analyses. The scope of work can be reduced by limiting the internal and external research analysis, limiting the number of valuation methods used or shortening the narrative report.

The valuation objective in a *calculation* is to provide an approximate indication of the value of a business where the appraiser collects limited relevant information and applies valuation approaches agreed upon with the client. These are for one party use only (an oral or limited written report) to establish a valuation range at the start of litigation, a seller's negotiating range or a valuation for estate planning purposes. The work the appraiser performs could be limited to an overview of the business with calculations to arrive at a valuation range.

- ***Who values businesses?***

With passage of the S&L bailout legislation, real estate appraisers now must be licensed in every state. To date, this licensing requirement has not been imposed on business appraisers. The practitioner might be a fulltime or part-time business appraiser.

The majority of business appraisals are done by business appraisal firms, CPAs, business brokers, investment bankers and real estate appraisers. Most practitioners have specialty designations if a large part of their work is devoted to valuing businesses.

- ***What questions are commonly asked of business appraisers to assess their qualifications to testify as experts in court?***

Business appraisers who testify at depositions or in

"In an appraisal, the objective is to express an unambiguous opinion of the value of the business"

court usually are asked general questions about their background (e.g. education and work history). The following specific questions often are asked to determine a business appraiser's qualifications as an expert in business valuation:

- What percentage of your time is devoted to business valuations and how many businesses have you appraised?
 - What business valuation courses have you taken the past three to five years and do you hold any designations or certifications in business valuation'?
 - Have you written any articles or given any presentations on the subject of business valuation?
 - Have you appraised businesses in a variety of industries and for a variety of purposes?
 - Do your business appraisals follow the standards of the Uniform Standards of Professional Appraisal Practice and the American Society of Appraisers?
 - Have you been involved in actual transactions of businesses and business interests?
 - Have you ever defended your valuation opinion in court as an expert witness or before the IRS?
 - Have you ever been appointed as an expert witness by the court?
- ***How much does a business valuation cost?***

It is unethical for a business appraiser to be paid on a contingency basis. Each business appraiser determines his or her own fee schedule. However, fees normally are quoted three ways: on an hourly basis, fee range or fixed fee.

An hourly fee often is quoted for engagements involving litigation or for consulting with buyers or sellers in a business transaction. Appraisers quote on an hourly basis in these cases because the time requirements are normally not determinable at the start of the engagement.

A fee range or fixed fee are more likely to be quoted if the scope of work can be clearly defined, as in an

appraisal, limited appraisal or calculation described above.

A calculation may cost less than \$1,000. It would not be unusual for the initial appraisal of an ESOP to cost \$5,000 or more.

Part II - May 1993 Issue

Valuing businesses solely by rules of thumb and cursory reviews is obsolete. Business valuation is a profession.

Appraisal and professional societies are training practitioners to become valuation specialists who must adhere to valuation standards in the way they perform and report the results of a business valuation.

- ***What steps are involved in a business appraisal ?***

From the perspective of the business appraiser, a full scope business valuation normally is a four-step process.

The first step is to do internal and external research surrounding the business. This step consumes most of the appraiser's time. The internal analysis of the business would include documenting the history of the business and its operations, the products and services it offers, its customers, current and prior ownership and a three- to five-year historical trend analysis of balance sheets and income statements.

In doing the external analysis, the appraiser investigates local, regional, national and sometimes international economic conditions affecting the business. Industry trends and financial statistics for similar businesses are researched and comparisons are made with key competitors.

In the second step, the business appraiser makes adjustments to historical financial statements. In determining the earning capacity of a business, appraisers call this "normalizing" the income statement. Adjustments are made to normalize discretionary expenses such as owner/manager salaries and perks. Non-recurring income and expenses are eliminated.

On the balance sheet, tangible assets are adjusted to fair market values as of the valuation date. This process may require the assistance of an equipment or real estate appraiser.

The third step is to make valuation calculations. The three approaches to calculate a business value are the asset based, income and market approaches. The specific parts of the calculations, such as normalized earnings and capi-

talization rates, are justified by the appraisal work done in steps one and two.

Valuation methods and risk rates may be further supported by empirical research data in the particular

*"fees normally are
quoted three ways:
on an hourly basis,
fee range or fixed
fee"*

industry. When valuing partial interests, minority and marketability discounts are applied. Discount percentages are substantiated with data from internal company analysis and external studies on discounts.

The final step in a business appraisal is to arrive at a valuation conclusion. The appraiser places most weight on valuation approaches and methods having the greatest reliability as demonstrated in the work done in the prior three steps. A fully written appraisal report is often 30 to 50 pages long.

● **What "standards" do business appraisers follow?**

For more than 30 years, business appraisers relied on Revenue Ruling 59-60, an IRS publication originally issued for guidance when valuing businesses for estate or gift tax purposes. Today, two organizations - the Appraisal Foundation and the American Society of Appraisers - have issued business valuation standards that have expanded upon the IRS ruling.

In 1987, nine professional appraisal organizations formed the Appraisal Foundation and adopted a document titled "Uniform Standards of Professional Appraisal Practice" (USPAP).

Ten standards were released covering the following disciplines: real estate, personal property and business valuation. The business valuation standards established guidelines for developing and communicating a business appraisal.

The American Society of Appraisers (ASA) was one of the nine founding members of the Appraisal Foundation and the only member representing appraisal disciplines besides real estate (i.e., personal property and business valuation).

The business valuation committee of the ASA has issued nine of its own business valuation standards designed to clarify the USPAP standards and provide additional requirements for its members.

The ASA standards deal with business valuation terminology, the content of fully written appraisal reports, the scope of valuation services and various valuation methodologies and procedures.

Two other organizations are in the process of developing standards, the Institute of Business Appraisers and the American Institute of CPAs. The standards these groups eventually will issue are anticipated to follow in concept the standards already developed by USPAP and ASA.

● **What are the requirements to obtain a specialty designation as a business appraiser?**

The American Society of Appraisers (ASA) offers

two levels of professional credentials for business valuation. Individuals who have two years full-time business appraisal experience, who pass a series of examinations in four four-day courses of study (or a comprehensive examination) and who have approval of two appraisal reports by a Board

*"Valuing
businesses solely by
rules of thumb and
cursory reviews is
obsolete."*

of Examiners can earn an Accredited Member designation.

An Accredited Senior Appraiser designation is offered once an Accredited Member can demonstrate five years full-time experience. About 500

business appraisers in the United States and Canada are accredited through ASA.

The Institute of Business Appraisers (IBA) offers the designation Certified Business Appraiser. IBA's requirements for testing and approval of written reports are similar to ASA, except there is no experience requirement.

There are approximately 150 business appraisers certified through IBA.

The American Institute of CPAs (AICPA) is planning a business valuation designation for CPAs in late 1993.

The AICPA's requirements for a Business Valuation Specialist are anticipated to follow the ASA format for experience, testing and approval of appraisal reports.



Darrell V. Arne, CPA, specializes in business valuation and litigation services. He holds designations in business valuation from the American Society of Appraisers and the Institute of Business Appraisers.