VIEWPOINT ON VALUE

MARCH/APRIL 2018

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Avoid common pitfalls when applying the income approach

Valuing a business using projected earnings is a complex undertaking. Here are some common pitfalls that novice or untrained valuators tend to make when using the income approach — and experienced business valuation experts have learned to steer clear of.

Mismatching earnings and discount rates

Under the income approach, anticipated economic benefits are converted into a single present value. In other words, the value of a business interest is a function of a:

1. Projected earnings stream, and
2. Discount rate based on the risk of the investment.

Economic benefits can take many forms. Examples include earnings before tax; cash flow available to equity investors; and cash flow available to equity and debt investors.

Likewise, discount rates can take many forms. Examples include the cost of equity or the weighted average cost of capital (WACC).

Errors may occur when the subject company's projected earnings are matched to the incorrect discount rate. For example, *equity* cash flows should be matched with the cost of *equity*, not the WACC. The cost of equity will be higher than the WACC. So, if equity cash flows are discounted using the WACC, the business interest is likely to be *overvalued*. In addition, pretax earnings streams shouldn't be discounted using an after-tax cost of capital (and vice versa).

Adjusting (or not adjusting) historical earnings

The underlying assumptions for most earnings projections are based, to some extent, on historical earnings. Projections based on past performance sometimes need

Two methods, one valuation approach

Two popular methods that fall under the income approach are capitalization of earnings and discounted cash flow (DCF). Which is appropriate when valuing a particular business?

Under the capitalization of earnings method, economic benefits for a representative *single* period are converted to present value through division by a capitalization rate. The cap rate equals the discount rate minus a long-term sustainable growth rate. This method is generally most appropriate for mature businesses with predictable earnings and consistent capital structures.

Conversely, the DCF method derives value by discounting a *series* of expected cash flows. The "cash flow" at the end of the projection period is known as the terminal (or residual) value. Terminal value is typically calculated using the market approach or the capitalization of earnings method. It represents how much the company could be sold for at the end of the projection period, when the company's operations have, in theory, stabilized.

DCF models are generally more flexible than the capitalization of earnings method. For example, the DCF method is well suited for high growth companies and those that expect to alter their capital structure over the short run.

to be adjusted, for example, to reflect standard industry accounting practices, for non-recurring income or losses, or for related-party transactions. But the appropriate adjustments vary depending on the degree of control that the business interest possesses. For instance, adjustments for compensation or rent paid to related parties may not necessarily be appropriate when valuing a minority interest that lacks control to change these payments.

Adjustments also may be needed to align the subject company's earnings stream with the earnings streams generated by comparable public companies used to derive the discount rate. Errors typically occur when the person valuing the business interest 1) fails to consider control issues, or 2) overlooks adjustments needed to reflect how much earnings a hypothetical buyer would expect the business to generate in the future.

Making unrealistic assumptions

Typically, the income approach is based on the assumption that the subject company's earnings will grow indefinitely. At some point, however, the company's existing assets (such as a factory or piece of equipment) will be fully utilized, and the company will need to purchase additional assets to meet its earnings projections.

A common assumption is that annual depreciation expense will approximate the need to update fixed assets. This might not necessarily be true when the company is operating near or at its capacity limit.

The same principle applies to other fixed costs, such as managerial salaries and rent expense. At some point, all costs are at least step-variable (that is, they increase in steps, rather than on a per-unit basis). Management also may need to take on additional debt to achieve its projected earnings, which could alter the company's capital structure.

Likewise, when valuing a high-growth business, such as a start-up venture or a high-tech firm, management may expect to grow at 10% (or higher) each year. But no business can realistically expand at such a pace forever. Competitors and substitute products are likely to enter the marketplace and eventually slow down the pace of growth.

So, before discounting projected earnings, an expert needs to take a step back and evaluate whether projections seem reasonable over the long run. Oversimplified projections can lead to valuation errors.

Hire a business valuation expert

These pitfalls highlight the perils of do-it-yourself business valuations and the importance of hiring a credentialed business valuation expert. The pitfalls may also trigger questions as attorneys and business owners review valuation reports prepared by the opposing side in litigation. ■

3 ways valuation experts adjust financial statements

Business valuation experts can't always accept the subject company's financial statements at face value. Sometimes experts need to adjust the financial statements before using them to value the business. Here are descriptions of three common types of adjustments and explanations of when each one might be relevant.

1. Normalizing adjustments

Normalizing adjustments align the subject company's financial statements with U.S. Generally Accepted Accounting Principles (GAAP) or industry standards. For example, a company that uses the cash (rather than the accrual) method to report income and expenses would require several adjustments. On the balance sheet, receivables, prepaid expenses, payables, deferrals and accrued expenses would be estimated.

On the income statement, revenues would be increased for items invoiced but still outstanding. Expenses would be matched to the current period's revenues.

A subject company also may deviate from industry accounting practices. Normalizing adjustments can help make more meaningful comparables between the subject company and data drawn from others in its industry. These comparisons come into play when benchmarking performance, identifying guideline companies and gauging risk.

For instance, suppose the subject company reports inventory using the last in, first out (LIFO) method, but most other industry participants use the first in, first out (FIFO) method. LIFO companies tend to report higher cost of sales and lower inventory balances, assuming an inflationary economy and rising (or stable) inventory levels. Therefore, a subject company that uses LIFO will likely be undervalued because its accounting methods make it appear less profitable than FIFO companies — unless normalizing adjustments are made.

2. Nonrecurring and nonoperating items

Hypothetical investors buy shares based on how a company is expected to perform in the future. Historical financial results are relevant only as far as they provide insight into what's likely to occur later.

Discontinued operations and one-time events are typically eliminated unless management expects them to recur. Examples of nonrecurring items include settlement costs or proceeds related to a lawsuit, gains and losses from asset sales, and environmental cleanup costs. These items usually don't represent any value to a potential buyer and require an adjustment to reflect that they're unusual and nonrecurring.

In addition, when valuing an operating business, it's important to differentiate between operating assets (such as machinery and office equipment) and nonoperating assets (such as real estate and investments). Why? Because distinct capitalization rates and pricing multiples apply to each.

Nonoperating assets should be valued separately because they aren't integral to normal operations and may have more or less risk than a private business interest. In addition to separating these assets on the balance sheets, business valuation experts also adjust for any income generated and expenses incurred by the nonoperating assets.

3. Discretionary spending

This is the most subjective category of valuation adjustments and may not be appropriate in every case. For example, when experts value an interest on a minority, nonmarketable basis, they generally refrain from adjusting for items outside the minority shareholder's realm of control.

Owners' compensation is a common example of a discretionary adjustment. If the company's owners receive above- or below-market compensation, a business valuation expert would consider adjusting pretax income for the difference between actual compensation and the owners' replacement compensation.

Management's future plans also affect whether discretionary adjustments are made. Continuing with the compensation example above, if an overcompensated owner plans to retire soon and will be replaced by an unrelated party, an adjustment might be warranted, regardless of whether valuing a minority or a controlling interest. But if the owner has no plans to retire or alter his or her compensation, an adjustment is unlikely when valuing a minority interest.

Adjustments impact value

Valuation adjustments can affect how an expert applies the cost, market and income approaches — and disagreements about which adjustments are appropriate can lead to major discrepancies between expert opinions. So, it's important to understand how adjustments affect the valuation process and support them with objective market data. ■

Estate of Kollsman

The valuation of art . . . and the art of valuation

The U.S. Tax Court recently decided a high-profile estate tax case involving the valuation of two Old Master paintings from the 17th century. However, this case has implications that extend to valuations of other types of assets. Here are the details.

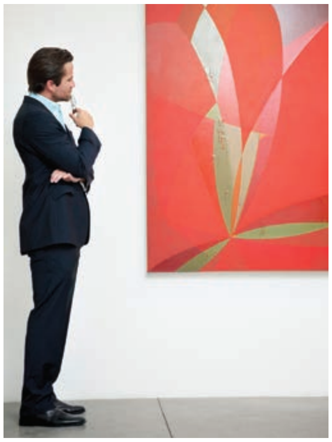
Conflicts of interest and subsequent events

The estate's expert had seen the decedent's paintings (known as Maypole and Orpheus) during visits to her residence prior to her death in August 2005. After the owner's death, the expert wrote a letter to the estate's executor, stating that the fair market values of Maypole and Orpheus were $500,000 and $100,000, respectively.

With the appraisal letter, the expert included a consignment rights agreement giving his employer (Sotheby's) exclusive rights for five years to auction the paintings. The estate attached the expert's letter to its estate tax return as evidence of fair market value of the paintings.

The executor also consulted a fine art restoration expert who recommended that the paintings, which were covered with a heavy layer of dirt and grime, be cleaned. Both paintings were cleaned without damage. And Maypole was sold by Sotheby's in January 2009 for about $2.4 million.

The IRS issued a notice of deficiency, determining the paintings' values on the valuation date to be $1.75 million and $300,000, respectively.



IRS victory

At trial, the expert for the IRS valued the paintings at $2.1 million and $500,000, respectively. The estate continued to use the values from the estate tax return. But the court found the estate's appraisals to be "unreliable and unpersuasive" for several reasons.

First, the expert provided appraised values while soliciting the executor for exclusive auction rights, a significant conflict of interest that gave him a financial incentive to "lowball" the estimates to reduce the estate's tax burden.

In addition, the expert exaggerated the dirtiness of the paintings and the risks involved in cleaning them, despite evidence to the contrary. Moreover, the conclusions regarding the impact of cleaning risks on value contradicted the principle that a hypothetical willing buyer and seller are presumed to have "reasonable knowledge of relevant facts." The court held that 1) this presumption applies even if the relevant facts were unknown to the owner, and 2) a reasonable investigation into the condition of the paintings would include an opinion from a restoration expert regarding the risks and likely outcome of a cleaning.

The expert provided no comparable sales to support his valuations, instead urging the court to accept them based solely on his "experience and expertise." The court said this was a "remarkable" omission, given the importance of comparable sales in determining art values.

The court also emphasized the sale of Maypole, less than four years after the valuation date, for nearly five times the appraised value set forth by the estate's expert. Fair market value generally must be determined without regard to post–valuation-date events. However, a subsequent sale price can be a relevant indicator of an asset's fair market value on the valuation date, provided the expert considers intervening market conditions.

The court generally accepted the valuations set forth by the IRS expert, who relied heavily on comparable sales data. Making some adjustments, the court valued Maypole and Orpheus at $1,995,000 and $375,000, respectively.

Beyond art

Although *Estate of Kollsman* involves the valuation of art, it provides useful insights into the Tax Court's views on conflicts of interest, the meaning of "reasonable knowledge of relevant facts," the importance of market comparables and the impact of postvaluation events. ■

Make business valuation experts a forethought, not an afterthought

Too often, business valuation experts are hired months after a case is filed or just before it goes to trial. This limits the documents and procedures they can use to perform their analysis. However, you can save significant money, time and frustration by hiring an expert early in the litigation process and asking for relevant information during discovery.

A preferred list of candidates

Do you have a list of experts who are qualified to value a business? Attorneys who deal with corporate litigation or marital dissolution cases need to have a list of credentialed business valuation candidates on hand, so they can act decisively when the need arises.

Meet with your preferred expert at the start of each case. The initial consultation gives attorneys and clients an opportunity to understand the business valuation process and discuss a timeline. This meeting also helps experts understand the nature of the lawsuit and scope of the engagement.

In turn, hiring an expert early helps attorneys draft discovery requests and allows experts sufficient time to analyze relevant data. Plus, naming a preferred expert upfront prevents the opposing side from hiring him or her.

Relevant documents and procedures

Before experts can value a business interest, they need help gathering relevant information, such as:

- Three to five years of financial statements,
- Three to five years of income tax returns,
- Marketing materials,
- Employment contracts for key employees,
- Lease agreements and other major contracts,
- Fixed asset listings,
- Shareholder agreements,
- Organizational charts and job descriptions,
- Information about related parties, and
- Prior valuations and narratives describing past stock transactions (for example, shareholder buy-ins or buyouts or offers to purchase the business from third parties).

Proactive attorneys include these items in their written discovery requests, especially in adversarial situations. They also may request that their business valuation experts be granted access to the company's facilities to conduct a site visit and perform a comprehensive management interview within a reasonable time period.

These are critical steps in the valuation process. To help facilitate these procedures and minimize potential disruptions, some attorneys provide a detailed questionnaire for management to complete prior to site visits.

Hiring an expert early helps the attorney draft discovery requests and allows the expert sufficient time to analyze the relevant data.

Think outside the box

The list provided here is just a starting point. Other possibilities exist, including information that's stored electronically or on social media. Comprehensive discovery ends with one final question: Is there anything else my expert should know that might be relevant to valuing this business? If you hire an expert early, you can brainstorm your discovery checklist together. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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