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Future outlook for business valuation professionals

By Shannon Pratt, DBA, CFA, FASA, MCBA, CM&A, MCBC

I see the business valuation profession growing significantly in the foreseeable future. New people are entering the profession every day. But perhaps more importantly, there is a trend toward more part-timers becoming full-timers and members of business appraisal professional organizations seeking the professional accreditations that those organizations offer.

For example, I see a growing number of names on the AM (Accredited Member) and ASA (Accredited Senior Appraiser) lists for the American Society of Appraisers. Also, many members of the Institute of Business Appraisers have been achieving their CBA (Certified Business Appraiser) designations, and 2004 saw a surge in ABV (Accredited in Business Valuation) designations among members of the American Institute of Certified Public Accountants.

Possible areas of decline

What types of business do I see going away and what types I see growing? Well, it depends a lot on Congress. If the estate tax is allowed to die, I see a lot of gift and estate tax work going away.

I called Will Frazier of Howard, Baker, Frazier & Elliott who met on February 16 with the staff of the Joint Committee on Taxation as a representative of the American Society of Appraisers. Of particular interest to business appraisers is Section XI.B of the draft proposal, which would eliminate valuation discounts in Family Limited Partnerships (FLPs).

Abuses minimized with qualified appraisers

Will told the Joint Committee staff that whatever abuses were prevalent in FLPs could be eliminated by using qualified appraisers. Will said that the staff seemed unaware of appraisal organizations and was genuinely unfamiliar with the Appraisal Foundation. I have found this in the past, that Senators and Representatives and their staffs are totally unaware that a business appraisal profession even exists.

The staff is assuming that elimination of valuation discounts will cause the recovery of $400 million a year in gift and estate taxes that the Treasury is not now receiving. Will explained to the staff that, if valuation discounts were banned, gifting currently being done through FLPs and LLC's would essentially cease. That means that the tax dollars that the government is now receiving (even after valuation discounts) would dry up.

Areas of prospective growth

I also called Bruce Bingham, of Trenwith Group, LLC, a BDO Seidman, LLP subsidiary, who is chair of the ASA Business Valuation Committee. He said that FASB 141 and 142 are generating a lot of work for appraisers and an enhanced need for expertise in intangibles and intellectual property.

He also said that the NASD is currently researching the conflict of interest involved with investment bankers rendering fairness opinions. He sees this as an area of potential for business appraisers who are willing to take the risks associated with rendering fairness opinions.

I have been amazed for many years that the SEC has not put a stop to the conflict of interest involved in investment bankers rendering fairness opinions. Maybe with the increased awareness of corporate governance and the NASD getting involved, we will see more independent committees of boards of directors hiring business appraisers for fairness opinions.

Need for independence

How is the role of the business appraiser changing? I see the role of the business appraiser changing very little, except for an increased recognition of the need for independence.

I still see appraisals that are tainted with the brush of advocacy, which has led a few judges to regard all appraisers as hired guns. However, I see fewer such appraisals now than a few years ago. It is very important that appraisers maintain their independence and resist pressures from clients and their attorneys to come up with values that are high or low in accordance with the clients' interests. Only by maintaining our independence will we maintain our credibility.

Appraisers' backgrounds then and now

What is the background of today's appraiser (versus qualifications and education for an appraiser who started five to ten years ago)? The majority of the entrants to the profession today have an accounting background, the same as entrants five to ten years ago. The difference is that most of them today realize that an accounting background is not sufficient to be qualified as an appraiser, and most of the entrants today are taking further education specifically in business appraisal.

When I started 35 years ago, most of the appraisers had a degree in finance, and that is still what I seek in hiring entry-level appraisers today. Accounting is a necessary tool, but two years including the intermediate theory sequence (the level of accounting knowledge required for the CFA) is enough for most business valuation engagements.

Templates and models not enough

I asked Bruce Bingham for his perspective on qualifications. He said the "young people like to cling to templates and models they like to get their hands around numbers and data, but some are not relevant, or, if relevant don't tell the whole story. Financial and analytical capabilities are important.

"Guys that have been in the profession a long time provide experience and common sense. The qualifications that courses provide is [are] a good first step, but the courses need to be followed up with on-the-job training."

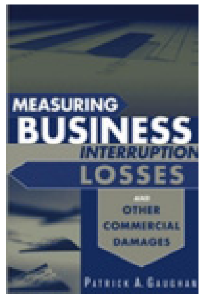
Continuing growth ahead

I believe that as the business appraisal profession continues the trend of becoming more recognized by attorneys and boards of directors, the demand for business appraisal services will continue to grow. A key step in this recognition is educating Congress and the regulatory bodies on what the profession has to offer.

Guide for valuing business interruption damages

Measuring Business Interruption Losses and Other Commercial Damages, **Patrick A. Gaughan,** 2004. John Wiley & Sons, Hoboken, New Jersey. (800) 762-2974, fax: (317) 572-4002, *www.wiley.com*. $90, 480 pp., 6" by 9", hardcover.

This book was written on the principle that commercial damages that result from business interruption or other corporate events are often difficult to measure. The book serves as a definitive guide to success in business interruption litigation and is designed to provide a basis for how lost profits should be measured. The author, Patrick A. Gaughan, PhD, is President of Econometrix Research Associates, Inc., and Professor of Economics and Finance at Fairleigh Dickinson University.



The first chapter is an introduction to finding a damages expert, the qualifications the court is looking for, the differences between the accounting, finance, and economics, and the need to form a team of experts.

Chapter two discusses the use of two broad methods for measuring damages: the before and after method and the yardstick approach. Gaughan discusses loss periods, economic loss analysis, and statistical methods needed to determine causality by linking the actions of the defendant to the alleged losses of the plaintiff. Analysis conducted for commercial damages may begin at a macroeconomic level, and then become more focused to a regional, industry, and firm-specific level. Lost profits are measured as the difference between the incremental lost revenues and their associated costs.

The third chapter delves deeper into the methods of conducting a macroeconomic analysis. The significance of this analysis-the first due diligence step-is to determine the extent to which the performance of the economy was responsible for the plaintiff's losses.

The following chapter details what is considered to be the second step: industry analysis. Here, the performance of the industry in which the plaintiff operates is analyzed, and is then compared to that of the macro-economy and to that of the firm. In a quickly growing industry, there may exist expectations that the plaintiff's firm would have followed this growth, and vice versa. Gaughan points out that industry data should always be checked for reliability.

Chapter five contains common methods for forecasting lost revenues. Simple methods use historical earnings and apply a growth level, taking into account prior analysis, to determine the "but for" revenues. Next, actual revenues are compared to the "but for" revenues projection. More advanced methods, although less frequently used, involve regression analysis to project "but for" revenues. Expertise is a must if using this method, as any errors can be made apparent during cross-examination.

The next chapter explores the steps involved in measuring lost profits that begin after the "but for" revenues have been forecasted. Here, one measures incremental costs associated with lost incremental revenues. The cost analysis is typically done by, and possibly best suited for, an accountant trained in measuring such costs.

Chapter seven discusses the application of the time value of money. Rates of return can be used to bring past damages up to an appropriate level at trial date, and discounts can be used to bring the future value of losses to present value.

Chapter eight looks at the various methods of business valuation. The next topic covered is intellectual propriety, and after that, Gaughan provides an in-depth examination of securities-related damages.

Chapter eleven highlights antitrust litigation, which can potentially require testimony on both the liability and damages side of the case.

The concluding chapter tackles the hotly debated issue of punitive damages, going over issues such as the purposes served by such damages, their interpretation by jurors, and their economic effects and reputation costs on operating entities.

A model to adjust the value of S corporation equity

The S Corporation Economic Adjustment Model, **Daniel R. Van Vleet,** *Business Valuation Review,* September 2004, pp. 167-180.

In this article, you will find discussions regarding general economic characteristics of business valuation approaches, various differences in the income tax treatment of both S corporations and C corporations, and the differences in the net economic benefit that are derived by S corporation and C corporation shareholders.

The author provides a mathematical framework to be used to adjust the indicated value of S corporation equity securities when empirical studies and analyses of C corporations are used to estimate value. The discussion and analyses in this article are only relevant to S corporation equity securities that lack ownership control.

Initially, the basic differences in the tax treatment of S corporations and C corporations, along with their shareholders, are discussed. These differences comprise the first premise of this article, while the second premise lies in the fact that capital markets are efficient over the long term.

When valuing S corporation equity securities, the value indications provided by the income approach can potentially be distorted when investment rates of return of publicly traded C corporations are used. This is due to the differences in the income, capital gains, and dividend income tax treatment of S corporations and C corporations and their respective shareholders.

Also, a further distortion may arise when public company market-derived pricing multiples are calculated, or acquisition price premiums paid for publicly traded companies are used in the analysis.

Due to the difficulty of constructing accurate empirical studies of equity security transactions that specifically isolate the economic differences solely attributable to the differing income tax treatment of C and S corporations, the article discusses the “S Corporation economic adjustment” (SEA).

Here, an S corporation equity adjustment multiple can be calculated (SEAM). The SEAM provides an estimate of the percentage premium an investor would be willing to pay for an S corporation share versus an otherwise identical C corporation share.

This is a mathematical model that may be used to adjust the appraised valued of equity of an S corporation when empirical studies and analyses of C corporations are used to estimate value.

Nevada condemnation valuation exception explained

***State of Nevada v. Cowan,* 2004 Nev. LEXIS 124 (December 17, 2004).** *Judge Shearing.*

This condemnation case presented the issue of valuing a business to which franchise licenses for the business could no longer be obtained. Stuart and Barbra Cowan operated a Texaco gas station in Nevada that was condemned by the state to make way for a new road. The Cowans could not move their business because the oil companies were not extending any more gas station franchise agreements in the Las Vegas area. The Cowans and the state could not agree as to a value of the business, so this action followed.

Valuation approach

The Cowans' argument was that the value of the business should be determined by the lost business goodwill and the lost business opportunity. The state disagreed and argued that neither goodwill nor lost business opportunity should be considered when valuing a business for condemnation purposes.

The state argued for Nevada's traditional approach:

> Traditionally, damage to a business (as opposed to the taking or damaging of its physical assets) has been treated as a noncompensable loss, even when the damage or destruction occurs because a condemning agency takes the land on which the business is conducted. Since the business is not taken for use as a going concern, the condemnor does not acquire the going-concern value of the business and should not be required to compensate for that which is not taken. In this case, NDOT is not getting any benefit from the business, as it is acquiring only the real property.

However the Cowans argued that the exception to the traditional approach should apply:

> [T]his court has recognized that under certain exceptional circumstances, the business owner may be compensated over and above the value of the real property. In National Advertising Co. v. State, Department of Transportation, this court recognized that when the condemnation of the real property results in the business being destroyed, the business owner should be compensated. …

The court agreed:

> The Cowans were unable to relocate their business because oil companies were not extending new leases for gas station franchises in the Las Vegas area. Consequently, the lease's value was inextricably tied to the unique location of the real estate that was condemned. In this situation, we conclude that the undivided-fee rule does not adequately compensate the lessee for what was taken. The Nevada Constitution mandates that "private property shall not be taken for public use without just compensation." Therefore, the State must compensate the Cowans for the destruction of their business.

Measure of damages

The Cowans argued that the court should allow evidence of lost business opportunity. The court rejected this argument, stating that measuring damages solely on the loss of goodwill was more appropriate.

The Cowans also disagreed with the trial court's decision to disallow comparables from California but allow the original purchase price as evidence of value. They argued that the California sales were appropriate comparables but that their purchase five years prior was too outdated to be accurate as to current value.

The court ruled that the California comparables were properly excluded due to the confusion they would likely cause. In addition, the court noted that the inclusion of the original purchase price was well within the lower court's discretion.

Holding and rationale

The Supreme Court upheld the trial court's use of the exception to the traditional approach in valuing the business, specifically the inclusion of goodwill value. The court also upheld the value arrived at by the jury of $260,000, despite the Cowans' assertions for a much higher amount.

Dissenting opinions

In his dissenting opinion, Judge Maupin argued that the case should have been remanded, given the lack of local comparative sales information, and would have allowed the Cowans to present evidence of comparable sales from other states. Judge Gibbons echoed that opinion, and also added that admitting the original purchase price into evidence was an abuse of discretion, as that price would have possibly introduced unfair prejudice, confusion of the issues, and the potential to mislead the jury.

Shaky market approach prevails over improper cost approach

***In re the Marriage of Helzer,* 2004 Mont. LEXIS 619 (December 14, 2004).** *Judge Regnier.*

In this marital dissolution, the issue was the value of Northwest Precision, Inc., a machine manufacturing company owned by husband.

Husband asserted that the trial court erred in following wife's expert's valuation, which relied on the market approach. Husband claimed that no genuine comparable sales existed at the time to accurately gauge his property's value and contended the cost approach used by his expert was more comprehensive in valuing the property at $145,000 at the time of the marriage.

Wife countered that the trial court correctly considered her expert's property valuation, as her appraiser reviewed some 400 sales in the time period in an attempt to find comparable sales and reach a fair market value. Further, wife argued that husband's expert's testimony was obtained in the form of a perpetuation deposition during which wife's counsel was unable to attend and participate in due to illness. Moreover, wife contended husband's expert's testimony was based exclusively on husband's estimates regarding improvements and labor on the property.

Holding and rationale

The Montana Supreme Court concluded that the trial court had not abused its discretion in its choice of valuation. The court found that the trial court could have relied on wife's expert, because although true comparable sales were hard to find, his comparison and analysis appeared to be justified. Moreover, the court found that the trial court was justified in finding that husband's expert's approach "appeared to be unrealistic" and that its reliance on husband's calculations was improper.

Court rejects DCF and uses comparable public company method

***Doft & Co. v. Travelocity.com Inc.,* 2004 Del. Ch. LEXIS 75 (May 20, 2004).** *Judge Lamb.*

(A minority shareholder of Travelocity.com Inc. (Travelocity) brought a dissenting shareholder action contesting the $28 per share it received in a short-form merger of Travelocity and seeking a determination of the fair value of its shares.

William H. Purcell was the shareholder's expert, and Paul A. Gompers was the expert for Travelocity. Both experts used essentially the same methods to value Travelocity's stock; i.e., a discounted cash flow (DCF) analysis and a comparable company analysis. In performing their comparable company analyses, both Purcell and Gompers used Expedia-one of Travelocity's main competitors-as the single comparable company. Despite the similar approaches taken, the results arrived at by the experts varied widely. Gompers' DCF analysis returned a value between $11.38 and $21.29 per share. Purcell's DCF yielded a value between $33.70 and $59.95 as of the merger date. The two experts' comparable company analyses also yielded significantly divergent results because they disagreed about the appropriate discount to apply to reflect Travelocity's competitive disadvantages.

Court rejects DCF, finding unreliable inputs

The Delaware Chancery court, quoting that "methods of valuation, including a discounted cash flow analysis, are only as good as the inputs to the model," found that the most fundamental input used by the experts-the projections of future revenues, expenses and cash flows contained in management's five-year plan-"were not shown to be reasonably reliable." The court criticized Gompers's selective use of management projections, and observed that its conclusion that no one was able to produce a reliable set of long-range projections for Travelocity was reinforced by the fact that "Gompers's DCF produced values ranging from $11.38 to $21.29 relative to a squeeze-out merger in which Travelocity's 70 percent parent agreed to pay $28 per share to acquire the minority interest."

Court relies on comparable company method

Having rejected the DCF method, the court turned to the comparable company method. Both experts used Expedia as the single comparable company in their analyses, but disagreed on the appropriate discount to be applied to the multiples derived from their analyses of Expedia. The court agreed that Expedia was clearly comparable to Travelocity. Gompers argued for a 40 percent discount, whereas Purcell argued for a 10 percent discount. After considering numerous factors, the court concluded that a 35 percent discount to the valuation multiples was appropriate, to reflect the competitive obstacles Travelocity faced. The court used EBITDA and price-to-earnings multiples, and applied a 30 percent control premium. After conducting its comparable company analysis, the court determined that the fair value of the dissenter's shares was $32.76 per share.

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