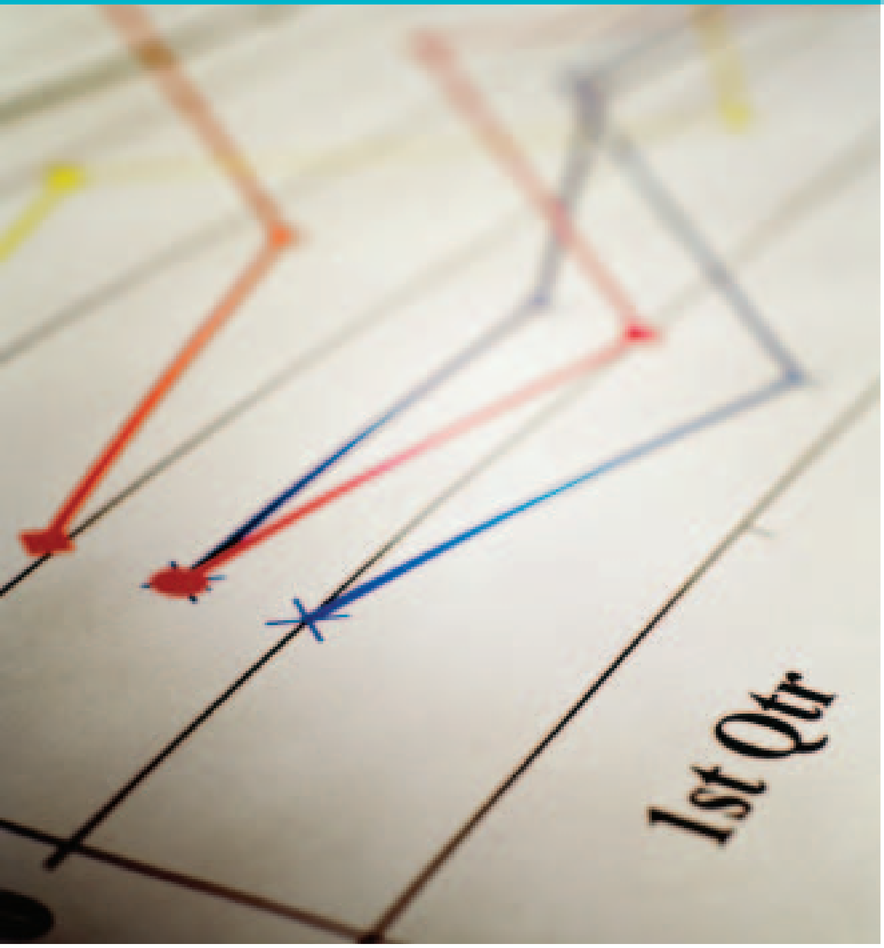
# Valuation Concepts

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# How valuation experts determine damages

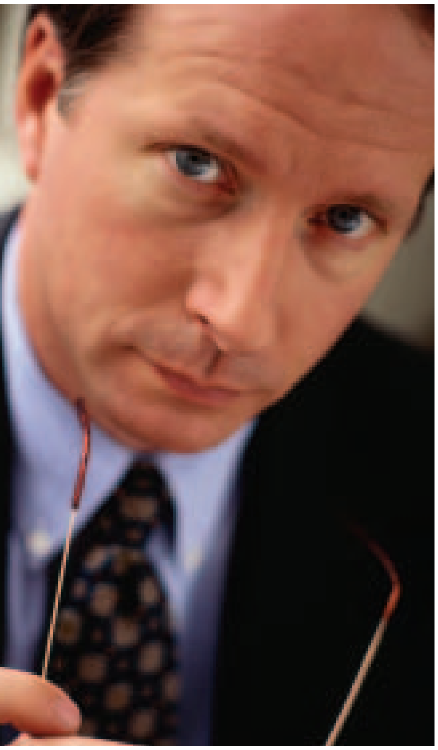
Valuation experts are often engaged to estimate monetary losses for a variety of parties, including individuals, corporations and partnerships. They may be hired by plaintiffs, defendants, and in some cases, both, in a joint engagement.

Damages for individuals in personal injury cases may include lost earnings and fringe benefits, household services, lost opportunity costs and medical expenses. Calculated damages for business operations include lost profits, additional costs or lost revenues.

To accurately calculate damages, experts rely on legal counsel to provide information about the legal theory — for example, restitution or benefit of the bargain — to be proven during trial. The damage expert can then determine damages which were proximately caused and reasonably foreseeable, to a reasonable degree of economic certainty.

### Projected loss periods

Calculating damages is essentially a projection of what would have happened if a damage incident hadn't occurred. When experts assess damages, they decide whether the available historical financial data can be relied on as a starting point for damage calculations.



For example, audited financial statements are generally considered more reliable than unaudited statements. Experts also consider the historical financial results of the damaged party to determine if its operating results have been affected.

Damages are calculated for a projected loss period. For injured individuals, the loss period is generally based on government statistics on work life expectancy, life expectancy and employment status. The individual's gender, education level and disability status will also affect loss period calculations.

When the injured party is a business, the loss period begins with the alleged damage incident and ends on some future date. For example, the damage incident might relate to a breach of contract for a contract with a set termination date in the future. Losses are, therefore, projected over the contract's life, and discounted to today's dollars using a present value calculation.

*To accurately calculate damages, experts rely on legal counsel to provide information about the legal theory — for example, restitution or benefit of the bargain.*

Damages are generally calculated as of the trial date. Pretrial losses and projected posttrial losses are separated. In some cases, an injured party may be entitled to some kind of interest on money lost (prejudgment interest or lost opportunity costs) in addition to the damages incurred. Future losses are computed to the end of the loss period and are discounted back to the trial date.

### Two common methods

An expert generally uses one of two primary methods to calculate damages: before and after or yardstick. Which is applied depends on the kind of damage incident, the parties involved and the type and reliability of the financial data.

When sufficient and reliable historical data exists, experts generally favor the before and after method. This approach examines the change resulting from the alleged damage incident.

To calculate this, experts might examine the effect of the damage incident on profit, focus on additional costs incurred as a result of the damage incident or examine the effect of the damage incident on sales volume.

An alternative version of the before and after method considers a change in the value of an entity. Say, for example, that a company had a value of $1 million before a damage incident, such as a breach of contract. After the incident, its value dropped to $500,000. In this situation, an expert would use $500,000 as a starting point to calculate damages.

"After" results, however, aren't always available — for example, when a company goes out of business. In this case, the reliability of the company's operating results prior to the damage incident becomes even more important.

When there is little historical data related to the injured party, experts typically use the yardstick method. This method compares information related to the injured party to relevant industry and competitor data.

### Experts require legal support

While there are other methods for determining economic damages, the before and after and yardstick methods are the two most common. Once attorneys have provided the relevant legal theory and established the credibility of supporting documentation, experts can choose the most appropriate approach.

### Before and after method vs. yardstick method

When calculating damages, experts generally use one of two methods: before and after or yardstick. Here's how they might be applied:

**Before and after method.** John Doe alleges that he has been wrongfully terminated during the second year of a five-year contract with the ABC Corp. The damage period could be considered the remaining three years of his contract. An expert's calculation of damages is based on a comparison of Doe's compensation prior to termination vs. what could have been earned if he hadn't been terminated.

If the damage period is projected based on work life expectancy, the expert examines Doe's entire work history, including the amount of time spent in each position, benefits, patterns of wage increases, reviews and promotions. These help determine the "after" damages, or how long it is likely to take Doe to find another position and what he is likely to earn.

**Yardstick method.** XYZ Company has a contract with a customer to produce 10,000 units per year. To meet the terms of this contract, the company needs to open a new division since it has not previously produced the product. After XYZ completes construction on the facility, the customer backs out of the contract.

Because the company has no history with this particular manufacturing process, the expert must find appropriate yardsticks outside the company. Fortunately, XYZ has several competitors that produce the product. An expert, therefore, calculates lost profits based on what these peers have earned.

# There's no substitute for a management interview

When preparing a business valuation, quantitative data — from tax returns, balance sheets, contracts and other sources — is crucial. But as any business owner will tell you, there's more to a company than numbers. Qualitative factors also contribute to a company's overall value.

It isn't always easy, however, to gain insight into the qualitative value of a business. Appraisers rarely glean adequate internal information from a company's Web site or its marketing materials. In fact, there's almost no substitute for conducting a one-on-one interview with a company's owner or management.

### Answering key questions

Depending on why a business valuation is being sought, appraisers will ask a variety of questions during the management interview. But management interviews can usually provide answers to the following key questions about a company's operations and outlook:

**Does the company have adequate management depth?** A company's financial direction and corporate policies may be decided by just one individual or by numerous executives. Companies generally benefit from the contributions and varying opinions of more than one person.

**Does the continued success of the company depend on any key personnel?** Operations that are dependent on one or a few key people risk suffering financial losses or even failure if these individuals die or leave the company. An adequate succession plan, therefore, is essential to any business's financial future.

**Are there plans to grow operations through acquisitions or capital investments?** The answer to this question indicates how management intends to gain further market share. Plans should produce growth without significantly compromising the company's core business or its liquidity.

**What are the company's competitive advantages and disadvantages?** This helps appraisers identify the company's value drivers and its less-successful products.

Knowing these advantages and disadvantages, appraisers can estimate future financial performance.

### Facilitating the meeting

As many attorneys know, performing a management interview can help enhance an appraiser's credibility in the eyes of a court. But interviews can sometimes be difficult to schedule and participants may not always be accommodating or forthright during the interview.

Attorneys can help valuators arrange meetings and ensure cooperation among participants. If necessary, attorneys may need to request depositions or file detailed interrogatories to obtain information from management.

### Getting the straight story

Appraisers tap a variety of resources to learn about the company they are valuing. But quantitative data can only tell part of the story. To get past the numbers and perform a well-rounded analysis of a company, appraisers need to get management's take, too.

# NAV method helps appraisers calculate fair market value

When determining the fair market value of a business, appraisers commonly employ several valuation methodologies broadly categorized as income, market and asset-based. One asset-based approach is the adjusted net asset value (NAV) method.

The NAV method is commonly used with nonoperating entities, such as investment holding companies, and with companies that have generated losses. But appraisers also use it for establishing the minimal, or floor, value of operating entities.

### Balance sheet challenges

The NAV method adjusts the book value of a company's assets to either its fair market, replacement or liquidation value, depending on the purpose of the valuation. It also reduces the adjusted value of assets by the fair market value of any liabilities.

This process starts with a company's historical balance sheet. Balance sheet accounting is generally pretty conservative; accountants record assets at their historical or original cost. Assets are never "written up," or increased, for changes in value or market conditions.

Sometimes, however, assets are "written down," or decreased. For example, investments, marketable securities and inventory might be decreased to reflect an impairment in their value. This impairment follows the accounting principle of lower of cost or market value —

a practice that records the asset's value as less than its historical acquisition cost.

Over time, the assets, as recorded on financial statements, become more and more disparate to their fair market value. This disparity is often further compounded by depreciation. For example, a building may be depreciated on the books while its real market value is appreciating.

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Another common disparity is caused when a company records inventory using the last-in-first-out method — a method in which items acquired last are treated as the first ones sold. This approach may cause the remaining inventory on the balance sheet to appear lower than its market value, especially during inflationary periods.

Due to such disparities, a company's net book value (the sum of all assets, less liabilities) rarely equals its fair market value. Using the NAV method, appraisers analyze each asset and liability to determine if it needs to be adjusted.

Once normalization adjustments are made, the balance sheet reflects the fair market value of the underlying recorded tangible assets. It may also reflect identifiable intangible assets, such as patents or trademarks.

## Unidentified intangible assets

Balance sheets, however, do not reflect the value of certain unidentified intangible assets, such as a trained workforce and office facilities. Therefore, valuators consider the additional costs associated with reproducing intangible assets if a buyer were to acquire them. These include the cost of:

- Finding an adequate office location,
- Hiring and training employees,
- Tooling and calibrating equipment,
- Integrating computer and inventory systems, and
- Writing policy and procedures manuals.

Valuation experts also consider factors such as the nature of the business, its competition and barriers to entering the marketplace.

## Treasury and other methods

One method appraisers use to calculate the intangible value of a going concern is through the capitalization of excess earnings or Treasury method. The approach considers two components of value: net assets and intangibles.

The company's excess earnings — or those attributable to intangibles — are calculated by subtracting its adjusted net earnings from a fair return on its net tangible assets. Once the excess earnings are determined, valuators add the adjusted net assets to reach a going concern value.

Another method used to calculate the intangible value of a going concern is to list intangibles and estimate the out-of-pocket cost to reproduce them. For example, if a company needs employees, what is it likely to cost to advertise or engage recruiters to fill the positions?

The expert often quantifies this value by considering several months of operating expenses, excluding owner's compensation. The resulting numbers should accurately estimate the cost a company would incur while new operations are being established.

## Not always appropriate

Using the NAV method to value an ongoing concern can be a complicated process. Appraisers often need to consider whether an additional amount should be added to a company's book value to capture intangible value. Because every company is different, the NAV method may not be appropriate in all circumstances.

# Gain valuable insight into your business with ratio analysis

Valuation experts regularly use financial ratio analysis to evaluate the financial health of a company. These financial ratios are calculated from line items in a company's financial statements and are useful in examining historical trends and gaining insight into how a business is likely to perform in the future.

A ratio analysis can help gauge a company's ability to meet its current liabilities and finance future growth, how well the company is using its assets, or how its profitability compares with that of its industry peers.

Valuation experts aren't the only ones who need to understand what financial ratios mean. Business owners — or anyone responsible for a company's financial performance — can also benefit from a basic understanding of these measurements.

## Four principal categories

Several ratios are used to assess a company's financial health and performance. These ratios are generally grouped into four principal categories.

**Liquidity ratios** measure the ability of a company to meet current obligations. Commonly used liquidity ratios include:

- Current ratio, or the ratio of current assets to current liabilities,
- Quick ratio, which only considers assets that can be readily liquidated, such as cash and accounts receivable, and
- Receivables turnover, which estimates the average collection period for credit sales.

Since current assets are generally used to pay short-term debt and make interest payments, it's essential that a company have adequate current assets. Liquidity ratios illustrate a company's need to improve liquidity or make more efficient use of its funds.

**Coverage ratios** measure a company's capacity to service its debt. One commonly used coverage ratio is times interest earned, which measures a firm's ability to meet interest payments and indicates its capacity to take on additional debt. Another is current debt coverage, which can be used to measure a company's ability to repay its current debt.

Before a company that already has significant bank debt seeks further financing, it should calculate its coverage ratios and consider what message they send to potential lenders.

**Leverage ratios** can indicate the long-term solvency of a company. The long-term debt-to-equity ratio represents how much debt financing is funding company assets.

For example, a ratio of one-to-one indicates that the company's operations may be meeting most of its capital requirements, and that debt financing is not a material source of capital. Because cash isn't necessarily needed to service debt, there may be more available for potential shareholder distributions.

On the other hand, a long-term debt-to-equity ratio of five-to-one indicates that the company requires significant debt financing to run operations. This may translate into lower returns for shareholders and higher default risk for creditors. And, because the company needs to make considerable interest payments, it has less cash to meet its current obligations.

**Operating ratios** help appraisers evaluate a number of things, including management's performance and the effects of economic and industry forces. Operating ratios can illustrate how efficiently a company is controlling costs, generating sales and profits, converting revenues to cash, and using its fixed assets.

## Benchmark company performance

Since ratio performance can vary from industry to industry, ratio results mean little without appropriate benchmarks. Benchmarking a company to its competitors, its industry averages and its own historical performance provides perspective on its current financial health.

Valuation experts find information on appropriate benchmarks from rating agencies like Dun & Bradstreet, government sources such as the Securities and Exchange Commission, and industry trade associations. They also apply current ratios to the company's historical financial statements. This helps identify positive trends to be maintained and negative trends that need to be addressed.

### Basic understanding goes a long way

Ratios provide valuators with valuable insight into a company's financial performance and health. A basic understanding of these ratios will also help owners and management make better, more-informed decisions about their company's financial future.

# Debate continues over built-in gains discount

In *Eisenberg v. Commissioner,* the Second Circuit Court of Appeals recognized the practice of adjusting or discounting the value of stock of a closely held C corporation for potential built-in gains taxes. The court decided that stock may be adjusted even when no liquidation or sale of the corporation or its assets is planned.

This reversed an earlier Tax Court ruling agreeing with the IRS' contention that there should be no reduction in the value of closely held stock to reflect capital gains tax liability when a sale is not planned. But even though the appeals court ruling supports a built-in gains discount, the actual amount of the adjustment remains under debate.

### Courts can guide adjustments

Each valuation is based on a specific set of facts and circumstances. So while court rulings can guide valuation discount practices, actual adjustments are difficult to quantify without similar facts.

In some cases, courts have ruled that a dollar-for-dollar built-in tax liability should be directly subtracted from a company's net asset value. For example, in *Simplot v. Commissioner,* the Tax Court allowed the net asset value of a holding company to be reduced by the full amount of built-in gains taxes (with a combined state and federal rate of 40%).

In *Dunn v. Commissioner,* the Appeals Court remanded the case back to the Tax Court, asking it to recalculate the company's asset-based value using a 34% reduction for built-in tax liability. And in the case of *Jameson v. Commissioner,* the Tax Court determined when the holding company would likely pay built-in gains taxes, by calculating the net present value of the future built-in gains taxes and reducing the net asset value of the holding company by that amount.

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Section 754 of the Internal Revenue Code may help determine adjustments for partnerships (or limited liability companies that elect to be taxed as partnerships) that sell, exchange or transfer a partnership interest. When the optional basis adjustment is elected, a partner's assigned basis of a partnership asset can be "stepped up" to its fair market value, therefore avoiding taxable gains.

### Uncertainty remains

Buyers generally consider the unavoidable future taxes on a closely held corporation's appreciated assets when determining fair market value. While the liability of built-in capital gains taxes is usually clear for C and S corporations subject to built-in gains tax, the calculation of the adjustment or discount allowed by courts still remains uncertain.

# Outstanding Valuation Services

J.L. Pierson is an Accredited Senior Appraiser designated by the American Society of Appraisers (ASA) in the Business Valuation discipline who specializes in business valuation for closely held businesses, family limited partnerships (FLPs), Limited Liability Companies (LLCs) and professional corporations.

We also provide valuation and litigation support services for a broad range of other purposes, including complex fractional real estate portfolio valuations, damage calculations, buy-sell agreements, shareholder suits, bankruptcies, marital dissolution and intellectual property matters.

## Typical projects include:

- Valuation of professional practices and interests in FLPs and LLCs holding marketable securities, real estate or other investments, including partnership interests.
- Succession planning, gift and estate planning, and asset protection for the closely held business in all industries.
- Determination of the appropriate corporate development strategy for enhanced business value including exit strategy.

*We would welcome the opportunity to serve you. Please call us at (203) 325-2703 or e-mail: info@NYNJCT-BV.com and let us know how we can be of assistance.*

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