VALUING THE CLOSELY HELD BUSINESS ENTITY:
A Lawyer's Guide to Business Valuation.

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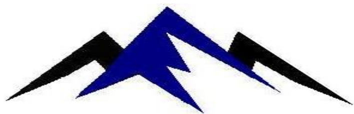

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Any attorney involved in litigation where the value of a closely held business is an issue is faced with the problem of ascertaining the value of that asset. Although the simple solution seems to be the hiring of an "expert" to provide the valuation testimony, the attorney must be aware of the methods and standards used by the expert in order to prepare the case.

The purpose of this article is to provide the attorney with a basic understanding of the valuation process. The focus of the article is more of an overview, not a how-to manual, allowing the attorney to understand the process and information used by the expert, and to be able to discuss these issues with the expert. It is important to point out that each valuation is unique, and many factors must be considered in arriving at the fair market value of an entity. There are no "formulas" or other shortcuts which can be used to arrive at a value; each matter must be analyzed using it's own unique factors.

Definition of Fair Market Value

One of the most universily accepted definition is:

"*the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothectical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property:* [1]

The U.S. Supreme Court opined that fair market value is "the amount (that) in all probability would have been arrived at by fair negotiations between an owner will to sell and a purchaser desiring to buy." [2]

However, the value must be predicated on actual conditions existing, not on an assumed market, [3] nor is it restricted to an immediate buyer. [4]

There are several very important points in that definition that need to be understood.

- The willing buyer and willing seller are *assumed to be hypothectical people dealing at arm's length.* The price is not representative if the buyer or seller has motivations unlike the typical buyer or seller. This would include synergistic purchasers, and sellers that have an outside influence causing the sale of the business.
- Actual conditions surrounding the valuation are important. The economy, competition, and industry conditions must be viewed as of the date of the valuation.
- Reasonable knowledge about the property is important. This would include issues such as leases, environmental issues, condition of the plant and equipment, and continuing management.

The Valuation Process

"A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance. [5] (Note that the Revenue Ruling discusses valuations for estate and gift tax matters. Over time, this revenue ruling has become a standard for most, if not all valuation matters.)

In the final analysis, the reasonableness of any valuation must take into account not only the judgment and experience of the appraiser, but also the accuracy of the underlying information which he relied on, as well as the methods used in arriving at the opinion. An early commentator on valuation discussed the process as follows:

> "It is almost never possible to measure value with exact, mathematical accuracy. Instead, the appraiser must exercise a certain amount of judgment, must make choisce, and must arrive at estimates.
>
> Some refer to appraising as an art rather than a science.
>
> However, the fact that the appraisal process in not exact does not necessarily mean that appraising is more artistic than scientific.
>
> In fact, sound appraisals are based on the scientific method, which is (1) to define the problem, (2) to gather the pertinent facts, (3) to analyze the facts, and (4) therefrom to arrive at a conclusion." [6]

It is important to realize that competent valuators, using the same information, can arrive at different conclusions as to value. This can be caused by the use of different assumptions (such as specific company risk, size, and discounts) It is said in the valuation industry that when two competent appraisers find values within 10% of each other they are both right, or both very wrong.

Another early commentator on value, James C. Bonbright, offered a comment on the meaning of value when he wrote;

> "One of the frequent sources of legal confusion between cost and value is the tendency of courts, in common with other persons, to think of value as something inherent in the thing valued, rather than as an attitude of persons toward that thing in view of its estimated capacity to perform a service. Whether or not, as a matter of abstract philosophy, a thing has value, is a question that need not be answered for the sake of appraisal theory. Certainly, for the purpose of a monetary valuation, property has no value unless there is a prospect that it can be exploited by human beings. [7]

In reality, the value of a closely held business entity revolves around either the physical assets of the entity, the earing capacity of the entity, or a combination of both. The seller must determine what he is giving up, and the buyer must determine what he is acquiring.

Reveune Ruling 59-60 is regarded as one of the most widely accepted guidelines to be used by a business valuator. It is important to point out that the ruling is just that, a guideline of issues to be addressed by the valuator in arriving at his opinion of value. Many Courts have held that Rev. Rul. 59-60 is a valid basis for determining the valuation of a closely held business. [8] The Illinois Appellate Court found that an expert who prepared a valuation opinion in contravention of Revenue Ruling was not acceptable, saying "from our review of the record, we cannot say that the methods used by petitioner's expert were proper." [9] It is impossible to open a treatise on business valuation without seeing a reference to Rev. Rul. 59-60.

It is important for the attorney to have an understanding of the eight factors that are listed in Rev. Rul. 59-60, and to be certain that the expert has considered those factors and addressed them in the valuation report. The eight factors are listed below. [10]

1. ***"The nature of the business and the history of the enterprise from its inception."*** The history of the business is an important part of the valuation process. How has the entity changes with changes in technology and the economy? How and why has the entity grown? How has the product line changed with time?
2. ***"The economic outlook in general, and the condition and outlook of the specific industry in particular."*** It is very important that the appraiser have an understanding of the general economic conditions as of the date of the valuation, as well as the economic outlook for the future. If the entity operates in a small geographical market, as opposed to having national activities, the understanding of the local economic conditions is also vital. This includes issues relating to the industry that the entity operates in. Is the industry as a whole growing? At what rate? What is the industry outlook 2 years to 5 years out? How is technology impacting the specific industry?

3. ***"The book value of the stock and the financial condition of the business."*** – It is somewhat of a mystery why the ruling discusses the book value of the entity, when it has been demonstrated that book value is rarely equal to fair market value. Many courts have found that asset or book value shall not be of prime importance unless special situations (such as imminent liquidation) provide it. [11] However, it is critical to a valuation that the evaluator fully understand the financial condition of the business and its relative relationship to industry information.
4. ***"The earning capacity of the entity"***- Not that the ruling talks about the "earning capacity" of the business, and not the tax or book earnings. Earnings have been called the most important criterion of value when valuaing a company engaged in selling a product or a service. The narrative of the ruling states in Section 5(a), "In general, the appraiser will accord primary considerations to earnings when valuing stocks of companies which sell products or services…" The Second Circuit stated, "the value of corporate shares is probably in the end determined more by what income they will fetch than by any other single consideration." [12] However, earnings need to be normalized to eliminate noneconomic reserves and contingencies, or to eliminate tax factors which may create distortion. [13] The use of a weighted average earnings calculation over a period of years is preferable to an arithmetical average. "A compny with earnings increasing from $100,000 to $500,000 over five years is radically different from one with earnings decreasing from $500,000 to $100,000, although the arithmetical average is the same." [14]
5. ***"The dividend paying capacity of the entity***." – Dividends are not a material element in valuation where actual or effective control is involved. In those cases, the "dividend paying capacity, rather than actual payments should be considered. [15] The courts tend to take a very practical approach to this area, realizing the substantial tax cost of removing earnings as dividends rather than through other methods such as salaries or other forms of tax deductible payments since no tax deduction is allowed to a corporation for dividends paid. [16]
6. ***"Whether or not the enterprise has goodwill or other intangible value***." – Intangible value, or "goodwill", is most properly defined as "transferred expectancy of earnings in excess of normal returns on tangibles. " [17] Black's Law Dictionary defines goodwill as "the ability of a business to generate income in excess of a normal rate on assets due to superior managerial skills, market position, new product technoloby, etc." [18] This is obviously one of the key questions in the valuation of a closely held entity: Is there goodwill, and what is the value of that goodwill? As stated above, one of the key indicators of goodwill is earning in excess of those considered normal. In most valuation this will be the area with the most controversy.
7. ***"Sales of the stock and the size of the block of stock to be valued***." – It is well agreed that the best indicator of value is an arm's length transaction covering the equity ownership of the entity. The key point to be emphasized here is the necessity that those transactions be truly "arm's length." Where those transactions are available, the evaluator should factor in that information in reaching the ultimate conclusion of value.

8. ***“The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over the counter***.” - This is more commonly known as the “comparable company” method in determining the value of the entity. One of the major problems in addressing this factor is finding truly comparable entities. The U.S. Tax Court in a 1967 decision succinctly described the closely held company as follows: “(A) publicly traded stock and a privately traded sotck are not…. the same animal, distinguished only bu the size, frequency, or color of its spots. The essential nature of the beast is different.” [19] Additionally, in 1974, the Tax Court again addressed the issue of comparability when it opined, “Moreover, in determining the fair market value of stock where no bid and asked prices and no relevant sales exist, a comparison with the values of securities of coporations engaged in the same or similar lines of business which are publicly traded is only one factor to consider.” [20] The issues of comparability will be further addressed later in this article.

The operative thread to the above discussion is that each of these points should be considered. The valuator can choose to place little or no reliance on any one item, if he or she can show the justification to do so. An evaluator cannot ignore a factor without reasonable basis to do so.

Valuation Methodologies

It has been said that the number of valuation methods available is limited only by the human imagination. Others would say that there are a finite number of methods. Most texts agree that there are a number of methods which are commonly accepted by the appraisal community and which the practitioner should be aware of. We will focus on some of these methods in the following discussion. However, it should be pointed out that this discussion is not a complete listing of all methods available, but covers some of the more frequently used methodologies. The choice of a method to be used is a function of the entity to be valued, as well as the experience and judgment of the appraiser. Barring the possible expectation of selling the investment at a higher price to a greater fool, companies values are driven by earning power or the liquidation of assets.

Book Value

This method appears to be the easiest method, as book value is a defined value found on the enitities financial statements. However, book value can be the most misleading method, unless proper analysis is made. Financial statements are dept on an historic basis and can contain certain accounting entries which are estimates, such as depreciation and amortization. The method also ignores appreciation of underlying assets, as well as the method of accounting-used (ie. Cash vs. Accrual) This method my be appropriate for very small, service oriented businesses (including professional practices) where the assets primarily consist of cash equivalents or are not material to the generation of income.

"Under any standard of value, the true economic value of a business enterprise equals the company's accounting book value only by coincidence. More likely than not, the true economic value of a company will be either higher or lower than its accounting book value. There is no theorectical support, conceptual reasoning, or empirical data to suggest that the value of a business enterprice (under any standard of value) will necessarily equal the company's accounting book value.
From a valuation perspective, the terms book value or net book value are merely accounting jargon. Bet book value (often called book value, in the vernacular(is synonymous with the amount of owners' equity recorded on the company's cost-basis balance sheet.
In fact, accounting book value is not a business valuation ethod at all, although it is popular in buy-sell agreement formulas. The values presented on the cost-based balance sheet are usually not representative of a current ecnonmic value for business valuation purposes. Also, there may be one or more intangible asset accounts or contingent liability accounts that should be considered in a business valuation – but that are not presented on the cost-basis balance sheet at all." [21]

Asset or Liquidation Method

This method is considered to be most appropriate for real estate or other holding entities which are asset based, rather than providing a product or service to the public. The method requires individual appraisal of all assets and liabilities to determine the net available to the owners in the event of a liquidation. Costs of the liquidation should also be taken into account by the appraiser in arriving at the final value. This method can be valuable in that it can set a "floor value" at which an owner would not sell his business to a third party but would liquidate it to achieve the greatest value.

This method will also indicate the cost to duplicate the entity. It is important to understand that this method does not recognize any goodwill to the entity but only establishes values for the tangible assets.

Income Methods

One of the primary pointes to be addressed in the use of an income method is whether the valuator will use historical or projected information. This is another area that is based on the judgment of the valuator. Theorectically a valuation made using future projections is the most proper, but the key question has to focus on the reliability of the projectsion, as well as the extent that the local court will rely on projected information rather than on historical data. "In general, approaches using current or historical data, if properly carried out, should yield a result that is reasonably reconcilable with what a well-implemented discounted economic income method would derive. This is an absolutely critical point that I see many "number crunchers"

miss. This is beause historical data, properly adjusted, represents an alternative method of predicting future income. This is important for the appraiser relying on historical income to realize, because an investor always bases his investment decision on the expectation of future returns, regardless of whether he relied on an estimate of future income to determine value, or used historical periods as a representative proxy for future returns." [22]

The difficulty with using projections in most valuations is the lack of previous projections, as well as the inability of management to create projections that are reliable. It is the client, not the appraiser, that must be responsible for the projections. In fact, another commentator, Jim Hitchner stated that "Projections are valuation's dirty little secret" and stressed that "appraisers must not simply accept the projections the client provides, plut them into a discounted cash flow analysis, slap on a discount rate, and be done with the analysis." [23] Put more succinctly, if the projections don't make sense, the ultimate valuation conclusion will not make sense.

Discounted Future Cash Flow (DCF) Method

Excess Earning Method

This is also sometimes referred to as the "formula method" and has it derivation in Appeals and Review Memorandum (ARM) 34 issued by the IRS during prohibition to determine the value lost to the liquor industry. Although the IRS has denounced this methodology, and it may be considered as the most widely used, and most widely misused methodology, it is a methodology used by many appraisers on small business entities. [24] In its most simple form, this method provides a formula to determine what the appropriate return from the tangible assets is, and to the extent that there are "excess" returns on those assets, capitalizes those returns and adds them to the market value of the assets.

Build Up Method

Capital Asset Pricing Method (CAPM)

Comparable or Guideline Methods

[1] Internal Revenue Service, Revenue Ruling 59-60, 1959-1 C.B. 237
[2] Olson v. United States, 292 U.S. 246, 257 (1934)
[3] Sidney L. Katz, 27 T.C.M. (CCH) 825 (1968)
[4] Katherine H. Daily Estate, 6 T.C.M. 114 (1947)
[5] Rev. Rul 59-60, section 3.01
[6] Raymond Miles, Basic Business Appraisal, pages 4, 5 (1984)
[7] James C. Bonbright, The Valuation of Property, pg 21 (1965)
[8] See Lavene v. Lavene, 162 NJ Super. 187 (1978), In re the marriage of Moffat, 279 N.W.2d at 15 (Iowa 1979), Muller v. Muller 116 Misc 2d 660 (New York 1982) Wahl v. Wahl, 159 N.W.2d 651 (Wisc 1968)
[9] In re the Marriage of Rossi, 113 Ill. App.3d 55 (1983)
[10] See Rev. Rul 59-60, Section 4 – "Factors to Consider"
[11] See Bader v. United States, 172 F.Supp 833 (Ill 1959); Central Trust Co. v. United States, 305 F.2d 393 (Ct. Cl. 1962); E. H. Skove, Trustee, 67-1 USTC 8474; Estate of Edw. Tully, Sr., 208 Ct. Cl. 596, 78-1 USTC 13228 (1978)
[12] Rogers v. Helvering, 107 F.2d 394 (2d Cir. 1939)
[13] Estate of Samuel Want, 29 T.C. 1223 (1958)
[14] Estate of J. L. Snyder v. United States, 61-1 U.S. Tax Court 11,987; see also E. H. Skove, supra note 11.
[15] Rev. Rul. 59-60, sec 4.02(e), see also Estate of Edw. Tully Sr. above note 11
[16] Driver v. United States, 76-2 USTC 13,155 (Wisc 1976)
[17] Samuel S. Schahet, 18 T.C.M. (CCH) 243 (1959)

[18] Black's Law Dictionary, 625 (5th Ed. 1979)
[19] Morris M. Messing, 48 T.C. 501 (1967)
[20] Tallichet v. Commissioner, 33 T.C.M. 1133 (1974)
[21] Valuing a Business – The Analysis and Appraisal of Closely Held Companies, 5th Ed., Shannon P. Pratt, McGraw Hill Company, 2008, page 351 – 352.
[22] Ibid, page 57
[23] See Business Valuation Review, Vol 23, No 5, May 2017, page 1
[24] See IRS Appellate Conferee Valuation Training Program, (Commerce Clearing House, Chicago) See also Rev. Rul 68-609, 1968-2 C.B. 327