

BDG Business Valuation Insight

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A good exit strategy
is worth applauding

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subsequent events



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Exit stage right

A good exit strategy is worth applauding

Overworked business owners often overlook the possibility of unexpected events such as market downturns or natural disasters. But operating a business without a contingency plan is like driving blindfolded: Things are fine as long as the road is straight and predictable. But when conditions change, the owner often runs into trouble.

In these uncertain economic times, having a sound exit strategy — including a plan for passing on responsibility for running the company, transferring ownership and extracting your money — can be a great help to those who will be taking over after you leave. Because a stable business is worth more than an unstable one, creating a seamless transition is essential to maximize your investment. This requires planning while the company is in good economic health.



Set realistic goals

A well-planned exit strategy addresses a variety of transfer scenarios. These may include voluntary transfers that apply to retirement, gifts to family members, donations to charities, stock compensation plans for managers, or mergers or acquisitions. They may also include involuntary transfers such as those involved with death or disability, divorce, partner/shareholder disputes, bankruptcy, or restructuring.

Exit planning starts with some number crunching and soul searching. The optimal exit strategy depends not only on the transfer scenario, but also on the owner's personal needs and objectives.

Determine the best strategy

Once goals are set, it's time to evaluate which alternatives meet the owner's short- and long-term needs. Here are some of the most common exit strategies for private businesses:

- When several individuals share ownership, a buy-sell agreement can provide liquidity upon retirement or an unexpected "triggering" event. In some cases, the company repurchases the departing owner's shares. In other cases, the remaining shareholders pitch in. Shareholder life and disability insurance policies can help fund company buybacks.
- For owners seeking to transfer ownership to relatives or a worthy charity, gifting interests in the business may fit the bill. Proactive gifting schedules that span several years can dramatically reduce transfer taxes. For instance, by transferring business interests to a family limited partnership (FLP), an entrepreneur can gift limited partner units to heirs at significant discounts from net asset value. FLPs also permit the donor — as a general partner — to retain control of the business.

- Rather than give away shares of the business, some business owners need cash and opt to sell the business to related parties. Numerous sale options exist. For instance, employee stock ownership plans (ESOPs) generate liquidity for the exiting owner while providing employees with a rare investment opportunity. But because valuation issues for an ESOP are unique, having a valuation done specifically for the ESOP is especially important before making a decision. Other potential buyers include suppliers, customers and competitors. They possess not only the requisite industry acumen to run the business, but also unique synergies that may warrant a premium price.
- In mergers or acquisitions with unrelated buyers, informed owners who can adapt to creative sales terms — including installment sales, seller financing and consulting contracts — often receive more than the asking price.

Introduce the experts

In all of these areas, valuation professionals can provide invaluable input. They can estimate preliminary business value — the cornerstone of any exit strategy. In addition, appraisers can quantify financial needs

upon retirement, disability or untimely death. They can also discuss insurance options to fund estate tax obligations or company buyouts.

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Valuators come in handy when weighing exit strategy alternatives as well. They can appraise assets for gift and estate tax returns or in conjunction with buy-sell provisions, evaluate the tax consequences of various exit strategies, consult on mergers and acquisitions, or prepare fairness opinions for high-profile transactions.

Bring down the house

It would be wonderful if the final act would just take care of itself. But without an exit plan, it's not nearly as easy to get off the stage! There's no time like the present to ensure that future succession plans will be successful. ●

No question: Onsite interviews provide value

Business owners love to talk about their success. But some are reluctant to have valuers interview them. Why? Some may be time-crunched and not fully appreciate the benefits of onsite interviews. Others may worry that a valuator on the premises might draw attention to a sensitive situation — such as a shareholder dispute or bankruptcy. Or they may be hiding assets or downplaying earnings during a divorce.

Whatever the reason for their reluctance, owners — and their legal counsel — need to understand the value and importance of onsite interviews. Those who know what to expect can facilitate the interview process by making it more efficient and effective.

Nuts and bolts

To value an investment, you must first understand it. Financial statements, tax returns and Web sites



provide some insight into a company's value. But a valuator gets the most complete picture by also physically touring the facilities and speaking with managers face-to-face.

An onsite interview is part of the data-gathering process. It helps clarify how the company operates, including its strengths and weaknesses. The more time a valuator invests in "getting to know" the business, the more reliable his or her opinion will be.

No subject is taboo in an interview. Among the areas frequently covered are:

- Operations and production,
- Corporate culture and strategy,
- Marketing and sales,
- Accounting and finance,
- Research and development,
- Internal controls and governance,
- Prior sales and offers,
- Related-party transactions,
- Human resources, training and employee turnover, and
- Industry trends.

Ideally, meeting with employees from several departments helps flesh out the valuator's perspective. The owner or CEO typically is the last person on the interviewer's agenda.

Beyond the numbers

Experienced interviewers try to explain the findings they have observed during their preliminary analyses. For example, suppose a valuator reviews financial statements and notices that the company's profits are significantly below the industry average. The interview provides the owner an opportunity to answer why profits are low. In turn, being able to explain *why* a company has more (or less) company-specific risk enhances a valuator's credibility.

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For this reason, interviews usually occur after the valuator has reviewed and analyzed the company's financial statements and other pertinent documents. Valutors want enough time to sift through all their data beforehand. After the interview, they still need time to process the information they have obtained during the site visit.

Adversarial scenarios

Litigation can stand in the way of a valuator's fact-finding mission. Controlling shareholders can be protective of financial information, dishonest — or simply disagreeable. In litigious situations, it may be prudent to request onsite interviews during the discovery phase, even if relations initially seem amicable.

Attorneys who understand the importance and scope of interview procedures are better equipped to persuade the court to mandate access to company facilities and personnel.

Case in point

Courts increasingly recognize the importance of onsite interviews. For example, in the divorce case *Gaskill v. Robbins*, the Supreme Court of Kentucky criticized the husband's valuator for relying exclusively on the client's data without independent verification, staff interviews or physical inspection. Such procedural flaws discredited the expert and persuaded the court to accept the opposing expert's value.

Similarly, in *Anzalone v. Anzalone*, the Superior Court of Pennsylvania agreed that onsite interviews add credibility.



A sharp eye can be a powerful weapon

Onsite interviews sometimes yield surprising results — especially in adversarial situations in which the controlling shareholder has a financial interest in downplaying value.

For example, in a dissenting shareholder case, the valuator read newspaper clippings displayed on the waiting room coffee table before the interview. One article announced the opening of a sister plant in a nearby town — a fact the controlling shareholder was hiding from the valuator's client (a minority shareholder).

The new facility was a separate legal entity owned exclusively by the controlling shareholder. During the previous year, the subject company had referred business and transferred assets at below-market prices to the sister plant. These underhanded activities materially affected the value of the client's minority interest.

As this fictitious story demonstrates, onsite interviews can add insight and perspective. Without them, you may be hearing only part of the story.

The U.S. Tax Court also prefers experts who conduct onsite interviews. For instance, the taxpayer's expert prevailed in the *Estate of Adams* because he had interviewed "persons in authority" — unlike the IRS's expert.

In *Kobler v. Commissioner*, the taxpayer's expert was praised for spending more than three days at the company and interviewing 12 employees. By contrast, the IRS's expert met with management only once for a couple of hours.

Essential element

Some business owners perceive onsite interviews as wastes of time and money, security breaches, or disruptions to normal business operations. But these interviews are truly a critical part of the valuation process. Owners and attorneys who overlook these fact-finding opportunities may compromise the credibility of their valutors and the quality of their valuation conclusions. ●

Solving the puzzle

How to find the right-size discount or premium

Valuing a business is like putting together a puzzle. Appraisers gather all the pieces through research and analysis. If properly assembled, a meaningful number appears. But valuation discounts and premiums are difficult pieces to fit into the picture. For one thing, they can be large — and somewhat subjective. For another, valuers may use methods that preclude the need to subtract discounts — or add premiums.

A controlling factor

Investors pay premiums to have majority control of businesses. Conversely, they expect discounts for being unable to assert control. Prerogatives of control include the rights to appoint management, pay dividends, direct business strategy, set compensation and divest assets.

The most common control adjustment is the discount for lack of control (DLOC). Valuers consider many factors when quantifying DLOC, such as ownership distribution, block size and state laws. To quantify DLOC, valuers sometimes use control premium studies of public company acquisition prices to compute implied minority discounts. Small interests with the power to block the prerogatives of control may warrant a swing vote premium. Alternatively, owners who lack voting rights may require an additional discount.

Marketability counts

Marketability refers to how quickly an investment can be liquidated at minimum cost and maximum certainty about price. Private business interests generally sell more slowly and unpredictably than publicly traded companies. Discounts for lack of marketability (DLOM) may apply when public data is used to value private firms.

Valuers support DLOM with empirical evidence, including:

Restricted stock studies. These studies compare public stock prices to private placements of restricted



stock. The restricted and unrestricted shares are identical, except that the former are subject to a minimum holding period of one year.

Pre-IPO studies. Valuers use these studies to compare companies' private transactions before going public to initial public offering (IPO) prices. In general, pre-IPO studies generate higher average (or median) discounts than do restricted stock studies.

Option pricing studies. To compare the cost of put options to the cost of publicly traded stock, valuers may look at option pricing studies. A major component of marketability is the risk that an investment will decrease in value over time. Put options hedge this risk.

An empirical study's average discount is just a starting point. Experienced valuers customize the underlying data — by date, size, SIC code and other factors — to support their DLOM estimates. They also analyze more than one type of DLOM study and reconcile conflicting evidence or case law.

All these empirical studies apply exclusively to *minority* interests. *Controlling* interests may warrant a discount for lack of liquidity. However, illiquidity discounts are highly subjective and may be difficult to support since there is little evidence available.

Levels of value

Discounts and premiums are meaningless unless the valuator clearly defines the basis of value that his or her preliminary analysis generates. The valuator also needs to define the desired basis of value.

For example, suppose an appraiser uses the guideline transaction method to value a business. He adjusts the company's earnings for discretionary items, such as above-market owner's compensation and related-party transactions. The appraiser concludes that his

preliminary analysis has generated a controlling basis of value. The desired basis of value is minority, nonmarketable.

To arrive at the appropriate basis of value, the appraiser subtracts discounts for lack of control (15%) and lack of marketability (25%). The effects of these discounts aren't additive (equaling 40%) but multiplicative (totaling 36.25%).

No sure fit

It's important to note that valuation discounts and premiums don't automatically fit into every business valuation assignment. Valuators take pains to determine discount applicability and size by carefully analyzing the facts and circumstances of each case. ●

Take control of subsequent events

How do valuers handle an event that occurs after the valuation date, but before the report is published? Catastrophic events, such as the 9/11 attacks or Hurricane Katrina, instantly and unexpectedly changed stock values. But internal events, such as the loss of a key person or a technological innovation, may also significantly alter future expectations.

Valuers consider "only circumstances existing at the valuation date and events occurring up to the valuation date," according to Statement on Standards for Valuation Services (SSVS) No. 1. The American Institute of Certified Public Accountants (AICPA) and several states have adopted this professional standard.

But subsequent events that were "known, knowable or foreseeable" on the valuation date are fair game. For example, suppose a business unexpectedly lost a major customer that accounted for 70% of revenues on June 30, 2010. Would an appraiser account for the customer loss in his or her report if valuing the business on Dec. 31, 2009?

Although the loss occurred after the valuation date, the *risk* of losing the key customer probably was known, knowable and foreseeable at year end. Thus, the valuator would factor the risk (but not the actual loss) into the discount rate or pricing multiple.

The courts, however, have sometimes extended the admissibility of subsequent events beyond "known, knowable or foreseeable." For example, in the Tax Court case *Estate of Noble*, Judge Laro admitted an unforeseeable subsequent event into evidence. A transaction that had occurred 14 months after the valuation date was deemed relevant, because it had "occurred within a reasonable time . . . and no intervening events drastically changed the value of the property."

This case draws an important distinction between subsequent events that affect value and those that provide evidence of value. Many federal courts will consider the latter category when deciding on business value.

Valuation of a Business, Interest, Security or Intangible

Becher, Della Torre, Gitto & Company, CPAs has been involved with business valuations for over two decades in connection with client acquisitions, estate and gift tax planning, litigation, and simply to keep buy-sell agreements up to date, cost effectively.

The American Institute of Certified Public Accountants (AICPA) has recently promulgated business valuation standards, effective 2008, under a pronouncement entitled: "Statement on Standards for Valuation Services - Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset", see summary below. You can be assured that our reports are prepared in accordance with top professional standards.

For 25 years Becher, Della Torre, Gitto & Company, CPAs has been committed to top quality tax and accounting services. Our attestation practice has been quality peer reviewed every three years since 1983. Our most recent quality control reviews under the guise of the AICPA and the Public Company Accounting Oversight Board (PCAOB) for SEC were both "no letter of comment", the highest achievement.

We rigorously employ the highest standards to all client engagements. Business Valuations are conducted for a variety of purposes, including:

- Gift and estate planning
- Business sales and purchases
- Buy-sell agreements
- Divorce proceedings
- Mergers and acquisitions
- Employee stock ownership plans
- Succession planning
- Family limited partnerships
- Goodwill and intangible assets
- Bankruptcy

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Neil Della Torre, CPA is Accredited in Business Valuation under the AICPA

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