

The Assumptions Underlying Business Appraisals

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Business appraisals are prepared for many purposes: divorce settlements, determining the value of a gift of an interest in a family owned business, or in shareholder actions. A valuation may be performed to value stock options of a closely held business or the purpose may be to determine what the value of the business would be if it had not entered bankruptcy. Whatever the purpose of the appraisal, there are key underlying assumptions that need

to be understood to grasp what a business appraisal does tell you and what it does not. This understanding is key to defending or attacking a business appraisal.

In his landmark book, *Basic Business Appraisal*, Raymond C. Miles lays out three principles of business valuation: Principle of Alternatives, Principle of Substitution, and the Principle of Future Benefits. These three principles and some additional ones are discussed below.

Assumption 1: The Principle of Alternatives. The Principle of alternatives is that for any contemplated transaction (deal) each party has alternatives to actually doing the deal. For example, if we are trying to buy a car and trade in our old car, we can go to different dealers to see who will give us the best deal. If we are trying to sell our house, we can choose whether to accept and offer or not. This does not mean however that business transactions are always free of one or the other party being compelled to do a deal.

Assumption 2: Investors will purchase investments of equal value interchangeably. This is known as substitution. This assumption is critical to the valuation of a privately owned business, debt or stock options. Implied by substitution is that there is some price at which an investor will purchase an investment. Investments are equalized by their rate of return. The riskier the investment the greater the rate of return an investor will require. Privately or closely-held businesses are generally considered riskier than publicly traded companies. The size of the business is important as well. An investment in US Treasury bonds is certainly less risky than an investment in Pete's Used Cars. The principle of substitution says that an investor will be indifferent between investments of the same value with similar risks.

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Assumption 3: All appraisals are based on future benefit. Whether it is an appraisal of jewelry, real estate, or a business, the value determined based on the expected future benefit. This benefit may be monetary, non-monetary or both. In business valuation, the future benefit is expected income. The income may be the proceeds received in a sale, the value of an income stream, or both. If I own a diamond ring, the value is whatever it will sell for. The appraiser bases the value on what comparable rings are currently selling for. On the other hand, if I own rental real estate I receive both an income stream (rent) and the potential for future appreciation of the property. The combination of the two determines the value of the property. This assumption sometimes gets confused in divorce when spouses are not to benefit from post marital efforts by the other spouse. Nevertheless, if an Appraiser concludes as to the value of something, this value is based on some expected future benefit.

Assumption 4: The sooner an investor receives his or her money the more value it has. This is known as the time value of money - \$100 today is worth more than \$100 in 5 years. From the perspective of investors, the longer it takes for them to recover their money from an investment the higher the return on investment they expect. The reason for this is that there are a number of risk factors impacting their ability to recover their investment: inflation, bankruptcy, natural catastrophes, and so forth, could cause investors to lose all of their investment. This is why the stock market fell after September 11th, 2001 and why it continues to fall in light of the expected decline in earnings by major corporations.

In addition to these assumptions, there are fundamental principles to understand about business appraisals in general.

Principle 1: Appraisals resulting in an opinion or conclusion of value require professional judgment. No matter how much empirical data is used or how scientific or precise the appraiser tries to make their appraisal look, in the end, they have to use professional judgment to determine the value. Areas in an appraisal that are subjective include the determination of the discount or capitalization rate and discounts. The two most common discounts are for lack of marketability and lack of control when valuing a minority interest in a business. Appraisers who use more than one method to value a business may weight these values depending on their confidence in the applicable methods and/or underlying data. On one appraisal I saw, the appraiser used two different market methods that were weighted to derive a combined market value. The appraiser next weighted the value from the market method with the values derived from discounted cash flows and an actual sale of company stock. This value looked very precise, but each weighting was subjective. Finding the hidden

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assumptions in a business valuation report requires expertise. You will best serve your client by having a qualified business appraiser review the report.

On occasion, an appraiser may give you an *estimate* or *calculation* of value. The appraiser will do this if they feel unable to reach a conclusion of value, or if they have not performed all the steps necessary to render a conclusion of value.

Principle 2: The *Valuation date* determines what information can be used when appraising a company. The valuation date, also known as the "as of" date, is the specific point in time as of which the valuator's opinion of value applies. Often this applies to the business' most recently completed fiscal year; however in the case of an appraisal for estate tax purposes, the value will be either the date of death or the alternative date. It is not unusual for judges and inexperienced business appraisers to misunderstand the implications of the valuation date. When appraising a business as of a particular date only the facts known or knowable as of that date may be referenced. For example, a business is appraised as of December 31, 2000 with a value of \$500,000. In June of 2001, the business receives an unsolicited offer and the owner sells his business for \$700,000. As of December 31, 2001, the appraiser cannot foresee the future and predict the sale of the business after receiving an unsolicited offer. If the appraiser's report is dated after June 2001, it is appropriate for the appraiser to reference the sale and the impact on value this has.

The Internal Revenue Service and the Tax Courts on certain cases have taken the position that a sale six months after the appraisal date is a factor to be considered when reaching an opinion of value. When doing appraisals for gift or estate taxes it is important to know what positions the IRS and Tax Court have taken in the district.

Principle 3: There are multiple types of value. Modern business appraisal practice might be said to begin with the issuance of Revenue Ruling 59-60 by the internal Revenue Service. Revenue ruling 59-60 established fair market value defined as "*the price at which the 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.*" While this is the most widely used definition of value, value is actually an economic concept and there are many different types of value. These include fair value, investment value, intrinsic value, value to holder, and so on. The applicable standard of value to be used depends on the purpose and venue of the valuation. For example, fair market value is required by the IRS for valuations prepared for estate tax, gift, and charitable donations. On the other hand, when performing a valuation for divorce purposes, the definition of value can vary widely by state. Some states use fair market value; others use fair value, which is defined by statute and case law; and still others might use

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investment value. Investment value is the value to a particular owner or buyer. For example, a larger company purchasing a smaller company may pay a premium over fair market value due to expected economies or sales growth. It is important to clarify with the appraiser what the applicable definition of value is.

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