BUILDING VALUE
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Volume 6, Issue 2

A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

Tom Keith & Associates, Inc.
Tom J. Keith, ASA, CBA
121 S. Cool Spring St. • Fayetteville, North Carolina 28301
Contact: Thomas Bell • (910) 323-3222
twb@keithvaluation.com • www.keithvaluation.com

OVERVIEW OF A VALUATION ENGAGEMENT

The Appraisal Process in 12 Steps

The process of developing a business valuation is not always well understood by the end users of the valuation report. Attorneys or business owners may not know exactly what to expect when they engage an appraiser to perform a business valuation.

The majority of valuation engagements generally follow these 12 steps, although not necessarily in the order presented. While a specific engagement may not include every step, this should give you a good overall understanding of the valuation process.

1. Engagement Definitions
The first step is to define the basic elements of the engagement. The appraiser will identify the client and describe the interest to be valued. The effective date of the appraisal should be confirmed, and this is the time to outline a delivery schedule and discuss fee arrangements with the client. The engagement definition should also specify the standard of value to be used. In many engagements, this will be Fair Market Value, but in some cases another standard will be more appropriate.

2. Document/Information Request
Once the engagement is defined, it is time to gather the data required for the valuation analysis. The business appraiser will typically request that the client provide information about the subject company to be valued. The information requested will cover financial

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CASE UPDATE — KOHLER V. COMMISSIONER

Herbert Kohler, Jr. et al. v. Commissioner, T.C. Memo 2006-152, July 25, 2006

Decedent died on March 4, 1998, owning a minority interest in Kohler Co. The fair market value of his shares was $47,009,625 utilizing the alternate valuation date. In its deficiency notice, the IRS asserted a $144,500,000 fair market value.

At trial the IRS valuation expert (who is not the same one that determined the fair market value for the notice of deficiency) calculated a $156 million fair market value. The Court first discussed this appraiser's background and certifications. The Court was troubled that this expert's report was not submitted in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP), including the customary USPAP certification.

The Court noted that the IRS expert only spent 2-1/2 hours meeting with Kohler management, yet "He decided the expense structure in the company's projections was wrong and decided to invent his own for the income approach analysis. He did not discuss his fabricated expense structure with management to test whether it was realistic."

The expert did not apply the dividend-based method under the income approach despite the history of dividends and the understanding by management that dividends were the primary means for shareholders to obtain an investment return on this closely held stock.

The Court concluded, "After carefully reviewing and considering all of the evidence, we continue to find [the IRS expert's] conclusions to be incredible. We therefore give no weight to respondent's expert's conclusions. Respondent has therefore not met his burden of proof."

Testifying for the taxpayer were both the expert who prepared the original valuation report for the estate tax return as well as an expert added for trial. Court found both taxpayer experts to be "thoughtful and credible." Both experts were published authors and held valuation credentials. Both experts spent significant time with management in order to understand the Kohler business. The experts did not fabricate their own projections, but relied on those prepared by management. They also used the dividend method that the Court clearly liked.

The court found their appraisals to be "more thorough and consistent with traditional appraisal methodologies for closely held companies." The valuation on the estate tax return was accepted as filed.

— John R. Gilbert, CPA/ABV, ASA

"Overview of a Valuation Engagement" continued from page 1

performance, products and markets, operations, facilities, personnel, and corporate documents and records. Failure to receive the requested data in a timely manner is typically the primary reason that reports are delayed.

3. Economic Analysis

Some business appraisers start the analysis process with a look at the economic and industry conditions in which the business operates. The geographic market for the company's services is identified and the demographic characteristics of the market as they relate to the company are considered. These characteristics may include population, income, housing, and labor rates, as well as other data points relevant to the nature of the subject company's business.

4. Industry Analysis

An industry analysis typically includes a review of the competitive landscape, including such items as the identity and market share of competitors. Appraisers may also identify the value drivers in this specific industry and look at the industry structure and rate of growth. Some appraisers use a model such as Porter's Five Forces Model to parse the industry information, while others apply other analytical tools.

5. Analysis of Subject Company Financial Statements (historical and forecast)

The foundation of a good valuation is the subject company financial analysis. The appraiser must thoroughly understand the financial condition of the subject company before those numbers can be used in the valuation analysis. Appraisers will measure the company against itself with a review of historical performance and against competitors and the market. This may involve a comparison of the company's performance with industry averages or a comparison to specific guideline companies. Then the appraiser may make appropriate adjustments and analyze the assumptions underlying forecasts.

6. On-site Visit and Management Interviews

The appraiser will typically make a site visit to the subject company and interview management. A facilities visit allows the appraiser to assess the quality of inventory and equipment and to interview senior management and other key personnel. This also provides an opportunity for the appraiser to follow-up on any questions that arose in the initial financial statement analysis and to get additional information from management on operational and competitive issues.

7. Valuation Approaches

The appraiser will consider all three valuation approaches (market, income, and asset) and then determine which ones are applicable for the subject company. If the appraiser is performing the market approach, the appraiser will typically identify guideline companies or guideline transactions, make financial statement adjustments, and develop relevant market multiples. The appraiser will also consider any prior transactions or offers to purchase the subject company's stock. Under the income approach, the appraiser will determine the current value of future cash flows, develop a required rate of return, and calculate free cash flow based on management's forecasts. If the asset approach is appropriate, the appraiser will review any appraisals of real property or other assets.

8. Consider Applicable Discounts

Depending on the type of engagement, the appraiser may decide that it is appropriate to apply certain discounts in the valuation analysis. These may include a minority interest discount (or the converse control premium), a lack of marketability discount, a key person discount, a blockage discount, or other applicable discounts.

9. Develop Valuation Conclusion

After consideration of all the elements in the prior steps, the appraiser will develop a valuation conclusion.

10. Develop Appraisal Report

Many engagements will result in a written valuation report. The report should adhere to applicable standards, cover all relevant issues, and thoroughly document and support the valuation.

11. Client/Fiduciary Review

At the end of the valuation process, the appraiser typically reviews the report with the client. During the process, any factual errors or missing information that could affect value can be identified.

12. Engagement Wrap-up

At the end of the engagement, the case file is closed, any electronic files are archived, and physical work papers are stored.

The amount of data to be considered and the analysis to be done in a valuation engagement is usually substantial. When all parties know the elements of the engagement and what to expect at each step, the process will go more smoothly and often more quickly.

— *Eva M. Lang, CPA/ABV, ASA*

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(910) 323-3222
twb@keithvaluation.com

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