Jim Hitchner's Valuation Products and Services

VPS Q&A

A free Q & A periodical to promote education, build consensus and answer your questions in the financial valuation and litigation services industry.

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Email your question to: jhitchner@valuationproducts.com

RECONCILIATION AND WEIGHTING OF VALUATION METHODS AND APPROACHES

Question 1: In preparing a valuation for a minority interest in a closely held company for estate tax purposes, is it okay to use a weighted average of several methods (Book Value, Liquidation Value and Capitalized Earning method) to determine fair market value for a going-concern business?

Answer 1: There are two main things going on in your question. First, can you mix a liquidation premise of value and a going- concern premise of value (capitalized earnings)? Second, what are the allowable choices for reconciling and weighting values from different methods and approaches?

While it is possible that a going-concern value and a liquidation value can be similar or the same, it is more often the case that it is one or the other. A company that has liquidation value equal to going-concern value means that the company is not earning a rate of return equal to the full going-concern value of the assets employed in the business. In other words, the assets employed in the business are not earning the rate of return they should. As such, there is probably very little cash flow being generated by the business for the liquidation and going-concern values to be the same. If the going-concern value on a control basis is higher than liquidation value, then the going-concern value is more likely to be the correct value and averaging this with the liquidation value will only give you the wrong answer.

Now, let's get to the other part of the question and let's assume going-concern value. I don't like to average the conclusions from different valuation methods unless I believe they all have equal relevance and reliability. More often, one or two methods are the primary methods and the other(s) have less reliability and may be used more as corroborating methods. This is often due to data limitations and support, which can happen when using the guideline company transaction method of the market approach where you know little about the underlying transactions and you only have a few transactions to rely upon. These are judgment calls that each analyst must make. Also, some analysts use numerical weightings whereas others use qualitative weightings.

As Mike Mard and I said in *Financial Valuation Workbook, second edition*, 2006, Wiley, "In correlating and reconciling values, many analysts simply average all of the indications of value. This implies that each method has equal weight, validity, and accuracy. This is seldom the case in a business valuation... Other analysts will assign weights to each of the methods, such as 0.5 to the income approach, 0.2 to the guideline public company method, 0.1 to transactions, and so on. However, this may again imply accuracy that does not exist. Also, if you are only putting a 10 percent weight on a method, you may be indicating that the method may not be very accurate."

Furthermore in *Financial Valuation and Litigation Expert* journal, Issue 10, Dec 07/Jan 08, the front-page article titled "BV Standards: The Positive Side" compares the *AICPA Statement on Standards for Valuation Services No. 1 (SSVS)* to relevant sections and language from the *Uniform Standards of Professional Appraisal Practice (USPAP)*. It addresses the reconciliation of valuation approaches and methods (with cites) as follows:

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- Reconcile the quality and quantity of data available and analyzed: *USPAP* p.U71; *SSVS* par. 30, 42, 44
- Reconcile the applicability and relevance of the approaches, methods and procedures used: USPAP p.U71; SSVS par. 42, 44
- Value conclusion is the result of appraiser's judgment and not necessarily the result of a mathematical process: USPAP p.U71; SSVS par. 4, 11, 42, 44. Note: There is no specific mention of a mathematical process in SSVS.

Last but by no means the least, remember the words from Revenue Ruling 59-60 under Section 7 titled "Average of Factors," "Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance."

Answer by: *Jim Hitchner, CPA/ABV, ASA, Valuation Products and Services and The Financial Valuation Group (Atlanta,GA) jhitchner@valuationproducts.com*

TIERED DISCOUNTS IN FLP VALUATIONS

Question 2: **I'm aware of numerous methodologies/empirical info used to help estimate discounts appropriate to ownership interests in FLPs holding marketable securities and real estate, but what is the best means with which to estimate discounts for FLPs holding closely held company equity interests (that may already be valued at a discounted level)?**

Answer 2: In this scenario, I would most likely use closed-end funds (CEFs) to support the discount for lack of control. The way I see this problem is that you have a family limited partnership that owns stock in a closely held operating company. To me, this is not substantially different from having a FLP that owns shares in a publicly traded company. Only the underlying asset is different, not the concept.

Which closed-end funds would I use? I would use a selection process similar to the one I use to match the CEFs with a portfolio of marketable securities. However, in this instance, I think that the selection of the funds would be more closely based on what the underlying company does. For example, if it is a real estate development company, I might use real estate CEFs. If it is a company in a financial industry, I would look for financial CEFs. If I could not find specific industry CEFs, I would most likely use domestic equity funds of some sort.

The reason for using CEFs is that the FLP owns shares in a company; why change the basic analysis that we would do with any FLP?

However, the valuation analyst needs to consider the differences between a publicly traded stock and a closely held stock and determine if this would affect the DLOC or the DLOM. However, care must be taken to not double count the privately held nature of the underlying shares.

[***Editor's Note:*** This is a timely question and answer given the recently released tax court opinion *Astleford v. Commissioner,* T.C. Memo. 2008-128, May 5, 2008. This case addressed "tiered" discounts in a family limited partnership. "We note that this Court, as well as respondent, has applied two layers of lack of control and lack of marketability discounts where a taxpayer held a minority interest in an entity that in turn held a minority interest in another entity... However, we also have rejected multiple discounts to tiered entities where the lower level interest constituted a significant portion of the parent entity's assets... or where the lower level interest was the parent entity's 'principal operating subsidiary.' The 50-percent Pine Bend [Second tier General Partnership] interest constituted less than 16 percent of AFLP's [Top tier FLP] NAV and was only 1 of 15 real estate investments that on Dec. 1, 1997, were held by AFLP, and lack of control and lack of marketability discounts at both the Pine Bend level and the AFLP parent level are appropriate." For a summary of the case, see The Financial Valuation Group's FVG E-Flash 10-1, 2008 www.fvginternational.com

Answer by: *Linda Trugman, CPA/ABV, MCBA, ASA, MBA, Trugman Valuation Associates, Inc. (Ft. Lauderdale, FL), Member, ASA Business Valuation Committee; Chair, ASA Business Valuation Education Committee; Member, AICPA Forensic and Valuation Services Executive Committee, Editor of the AICPA ABV E-Alert. Linda@trugmanvaluation.com*

PRACTICE MANAGEMENT AND LACK OF TESTIFIERS

Question 3: **There seems to be an aging of qualified testifiers. What are valuation and forensic services firms doing to address this problem?**

Answer 3: Forensic companies across the United States are facing an increasingly severe problem: namely, the shortage of experts with experience in testifying at deposition and trial. These companies include forensic accounting, computer, engineering, and valuation, as well as many other forensic specialties. The forensic companies face pressures from several sources:

CLIENTS

The clients of forensic companies/firms generally want the most experienced forensic experts to write and sign the reports and testify at deposition and trial. Some of these clients are not overly price sensitive (e.g., clients involved in intellectual property litigation).

When you are suing or being sued for tens of millions or hundreds of millions of dollars, the last thing you are concerned about is the cost of your expert witness. It is not uncommon for these expert witness assignments to run $250,000 - $500,000 or more. On the other hand, forensic engineering firms face more competition and price sensitivity, even in larger construction defect cases.

Obviously there can be some fee pressure in litigation matters where there is less at stake for the client or they are strained by the expert witness fees. These potential fee problems should be addressed up front with the client.

Clients may not be receptive to the use of an inexperienced expert to testify on their behalf. These clients do, however, accept and in some cases encourage experts without trial experience, who bill at lower rates, to "work-up" the files. This work typically involves reading documents, running numbers, on-site investigations, summarizing depositions, and other time consuming work.

FORENSIC FIRMS

Many forensic firms follow the pyramid approach (e.g., a few experienced partners who sign the reports and do all or most of the testifying for the firm). These experienced experts can face severe pressures, including:

- Signing off on reports where the bulk of the work is done by others,
- Testifying at deposition and trials numerous times per year, sometimes involving extensive travel, and
- Not spending enough time to gain the necessary knowledge of the case at hand, including the crucial nuances.

These experienced experts have been forced to justify their right to testify in the face of Daubert and other challenges. In addition, the more frequently they testify, the more they become a target to be eliminated or compromised by opposing counsel.

Additionally, the firms who have only a few experienced experts run into severe problems when these experts are conflicted out, busy with other cases, or become ill or retire.

EXPERTS AT FIRMS

The experts at the firms who have little or no testifying experience can become disillusioned with never seeing a case through to its completion. These experts may lack confidence, become frustrated, complacent, and may eventually leave the firm to seek greater opportunities at other firms.

SOLUTIONS

Forensic firms are now dealing with the above problems in several ways:

1) Mentoring the least experienced experts,
2) Gradually increasing the responsibilities of the least experienced experts,
3) Convincing clients that it is in their best interest to let the experts who have worked up the files and have intimate knowledge of the case to sign the reports, and in some cases, testify at deposition and trial, and
4) Training the experts in the art of report writing and testifying so they are ready, practically and psychologically, to assume more responsibility at their forensic firms.

Forensic firms that take the above four steps are well on their way to insure the long-term survival and success of their firms.

Answer by: *Steven Babitsky Esq. and James J. Mangraviti Jr., Esq., partners in SEAK, Inc. (www.seak.com), a professional education company.*

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BV STANDARDS UPDATE:
SIX MONTHS LATER

June 17, 2008 - 1:00 pm EDT

Ed Dupke, CPA/ABV,
Jim Alerding, CPA/ABV, ASA, CVA
Jim Hitchner, CPA/ABV, ASA

All three panelists were members of the AICPA BV Standards Writing Task Force for the entire six-year period leading up to their release.

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and Bob Duffy, CPA/ABV, ASA,CFA (Grant Thornton)
Moderated by Jim Hitchner, CPA/ABV, ASA

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Presented by Jim Hitchner, CPA/ABV, ASA
Assisted by Sam Wessinger (The Financial Valuation Group)

DISCOUNTS FOR LACK OF MARKETABILITY: QUANTITATIVE VS. QUALITATIVE MODELS
R. James Alerding, CPA/ABV, ASA, CVA, (Clifton Gunderson, LLP)
Neil Beaton, CPA/ABV, ASA, CFA, (Grant Thornton, LLP)
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- Compliance Checklist- SSVS Oral Report
- Compliance Checklist- USPAP Standard 9
- Compliance Checklist- USPAP Standard 10
- Compliance Checklist- USPAP Front Matter

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