

2007 and Beyond: What Are the Big Issues in Business Valuation?

The IRS's enhanced oversight of appraisals and appraisers is certainly a hot topic in 2007, along with the continued evolution of valuing pass-through (tax-affecting) entities. Fair value for financial reporting and related FASB pronouncements will continue to make news, as will efforts by the Business Valuation (BV) profession to create a convergence of practice standards.

Tax issues heating up

Last year was relatively quiet in the federal tax courts. The Fifth Circuit's holding in *McCord v. Commissioner* captured BV headlines, primarily for its reversal of the Tax Court's determination of marketability discounts. But the decision turned on the continued viability of the defined value gift clause, so it leaves open the question of the appropriate methodology and data for determining discounts, which is bound to be a big issue in 2007. Although estate planners may be tempted to use the defined value gift clause, it may still flag the attention of IRS examiners as much as any high-dollar transaction or significant discount.

In another high-impact Tax Court case last year, *Dallas v. Commissioner*, highlighted the continued uncertainty of valuing subchapter S Corporation earnings. In declining to tax affect in an estate/gift tax scenario, the *Dallas* court distinguished the recent decision by the Delaware Chancery Court in *Delaware Open MRI Radiology v. Kessler*, which applied tax affecting in an appraisal action. Rather than ending the debate, the distinction widened it, according to many BV analysts, so watch for tax affecting to remain a key issue in the coming year.

IRS gets tough on appraisers too

The passage of the Pension Protection Act of 2006 (PPA)—including its attendant penalties

for appraisers and appraisals—will continue to impact the profession. Many see the new legislation as part of a bigger trend toward the creation, issuance, and/or revisions of standards applicable to the providers and users of BV services. In addition to the PPA, last year also saw:

- Substantial changes to the BV provisions of the Uniform Standards of Professional Appraisal Practice (USPAP)
- Yet another exposure draft on BV Standards from the American Institute of Certified Public Accountants (AICPA)
- Updated BV guidelines from the IRS
- FASB's release of SFAS 157 on fair value measurements (along with updates on SFAS 123R, 141, and 142) and its continued work with the International Accounting Standards Board (IASB) toward a convergence of fair value standards
- A new task force formed by the International Valuation Standards Committee (IVSC), charged with drafting global valuation standards and fair value guidance
- A similar BV task force formed by the Appraisal Foundation

BV no longer a specialty

The rapid development and dissemination of new standards and new information has brought extraordinary change to the business valuation profession. While BV used to be a niche practice area, it's now considered by many to be a general practice area with various specialized niches, including fair value measurements but also valuations in health care, ESOPs', intangible assets, M&A, lost profits/economic damages, and the like.

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To practice competently in any one of these niches requires significant commitment to the work and to greater accountability and credibility within the BV profession. In facing the challenge to raise the bar, BV practitioners will be seeking more opportunities to better serve their community of clients in the financial, auditing, and legal professions.

SFAS 157: What You Need to Know About FASB's Fair Value Measurements

The Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements*, is the latest evidence that the FASB is indeed moving from rules-based to principle-based standards. Effective for fiscal years ending November 2007, SFAS 157 is now a fixture on the fair value landscape, and business appraisers as well as attorneys need to understand its implications and applications.

Parsing the new Statement

The best way to understand the new FASB pronouncement is to parse its elements. SFAS 157 defines fair value as:

...The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

- **Price.** The Statement does not contemplate a strict entry or exit price; rather, it seeks to include assumptions concerning market participants (see below) to realize the price they would pay on the measurement date.
- **Orderly transaction.** Although SFAS 157 specifies a valuation date, it assumes the asset's exposure to the market for a prior period to allow for customary marketing activities.
- **Market participants.** Closely aligned with the hypothetical willing buyer and seller, market participants in a fair value assessment are:
 - **Unrelated parties:** Independent of any specific entity, including the reporting entity
 - **Knowledgeable:** Having a reasonable understanding of the transaction, asset, or liability based on all available information, including due diligence
 - **Willing and able:** Under no compulsion to transact for the asset or liability

The reporting entity need not identify specific market participants, only the characteristics that

distinguish them generally, considering the specific asset or liability, its principal market, and the market participants with whom the entity would transact.

- **Application to assets.** Fair value measurement assumes the highest and best use of the asset that is: (1) physically possible; (2) legally permissible; and (3) financially feasible. The valuation premise is in use/in exchange, which seeks to maximize the value of the asset or group of assets in which the asset will be used. This bases value on the use by market participants—even if the reporting entity intends a different use. In this case, even if an acquiring company has a clear strategy for the deployment of an asset, conformity with SFAS 157 may require eliminating buyer-specific strategies.
- **Application to liabilities.** The Statement assumes that the liability is transferred to a market participant and that the non-performance risk is the same before the transfer as after. The liability continues; in other words, it is not settled.
- **Valuation approaches.** The Statement requires “techniques that are appropriate in the circumstances and for which sufficient data are available.” They should be consistently applied; a change is appropriate only if it is “a better representation of fair value.”

Fair value hierarchy

SFAS 157 prioritizes the valuation inputs according to whether they are observable (reflecting market assumptions based on independent data) or unobservable (reflecting reporting entity assumptions from its own data). This hierarchy allows the user of financial statements to assess the relative reliability of fair value measurements, ranked as follows:

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities, which the reporting entity can access at the measurement date.

Level 2 inputs are those other than Level 1 quoted prices, directly or indirectly observable, such as:

- Quoted prices for similar assets or liabilities in active markets;
- Quoted prices for identical or similar assets or liabilities in inactive markets; or in which there are few participants; or in which prices are not current or vary substantially among market makers (brokered markets); or in which little information is released publicly (principal-to-principal market);
- Observable inputs, other than quoted prices, such as interest rates, yield curves, volatilities, prepayment speeds, loss severities, credit risks, and default rates; and

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- Inputs that are derived principally from or can be corroborated by market data.

Level 3 inputs are unobservable inputs; i.e., inputs that reflect the reporting entity's own assumptions about what market participants would use to price the asset or liability (including risk), developed using the best information available without undue cost and effort. There is no verification requirement if the assumptions are in line with those of market participants.



Blockage discounts

SFAS 157 affirms the fair value of actively traded positions in a financial instrument (including a block) as the product of its quoted price times the quantity held ($p \times q$), without adjustment for a blockage factor and extends this requirement to broker-dealers and investment companies. But as for broader discounts, such as control premiums, swing votes, and non-financial assets (real estate), FASB will most likely examine these in future statements.

The Importance of Buy-Sell Agreements: Two Cases Spell Out What Can Go Wrong

Fausak's Tire Center, Inc. v. Blanchard, 2006 Ala. Civ. App. LEXIS 719 (December 8, 2006) and *Bullet Land, Inc. v. Thal*, 2006 U.S. Dist. LEXIS 88521 (December 7, 2006)

These two cases highlight the many problems associated with buy-sell agreements—and the ways attorneys and business appraisers can help clients avoid them.

Death of a shareholder

In the *Fausak* case, three brothers bought a company for \$1.1 million, or \$2,100 per share; the sole asset was a tire store on a piece of real property. For the next three years, they discussed the need for a buy-sell agreement, drafted at least four different versions, and purchased life insurance policies to fund a buy-sell—but failed to formalize the terms. Two years later, the shareholders modified the purchase price of the company stock to \$2,500 per share, which all agreed was fair. But it took another couple of years, after one of the brothers died, for the remaining shareholders to execute a buy-sell agreement fixing the stock at \$2,500 per share.

At the time of his death, the shareholder owned a 20 percent interest in the tire business, which the company valued at nearly \$17,000 (the record does not clarify how this value was reached). The company also valued the decedent's 125 shares at the \$2,500 price, for a total of \$312,500. Accordingly, the remaining shareholders offered the widow a total of just under \$333,000 to buy out her husband's interest, less a \$15,000 advance they had made to his estate.

Although the widow cashed the \$15,000 check (which was endorsed "for advancement buy/sell agreement") she apparently balked, perhaps believing that given the company's growth since her husband's death, its per-share value had risen as well.

The company tried to argue that the shareholders' agreement to modify the purchase price of the stock to \$2,500 was a "note or memorandum" sufficient to establish the terms of a buy-sell agreement at the time of the death—as further evidenced by the widow's cashing of the \$15,000 advance. The probate court disagreed, however, as did the Court of Appeals on review. To satisfy the applicable Statute of Frauds, any writing must contain the "essential terms" of the alleged agreement, including, in the case of a buy-sell, the "mutual assent" of the signing parties to its purpose:

[T]he problem with considering the stock-valuation document as a memorandum... is not that the document might have been intended for some purpose other than a buy-sell agreement, but, more fundamentally, that it is simply insufficient to evidence a buy-sell agreement at all.

Even written buy-sells cause problems

The *Fausak* case shows what can happen when parties delay too long in implementing a buy-sell agreement. The *Bullet Land* case illustrates what can happen when the terms aren't sufficiently spelled out,

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especially those concerning the binding effect of the appraisal(s) involved.

The Bullet Land partnership was formed to renovate and operate a historic hotel. In early 2006, the general partner received and consented to a written notice of removal. The partnership's buy-sell agreement involved five basic steps: 1) each party selects an appraiser; 2) those two appraisers select a neutral third appraiser; 3) the three appraisers collectively determine a fair market value; 4) if the three appraisals differ, the lowest value is disregarded and the two higher values are averaged; and 5) the average is submitted to a CPA to determine the final purchase price.

All of the steps took place. The general partner and the partnership each selected an MAI appraiser, who then selected a third, neutral appraiser. The appraised values for the entire partnership came back at \$17.1 million, \$13.4 million, and \$12 million, respectively. The latter (from the neutral appraiser) was tossed out, and the buyout price for the general partner's interest was calculated to be \$3.6 million, based on

the remaining two appraisals. An independent CPA confirmed the buyout price, and the deal appeared ready to close, per a letter from Bullet Land's counsel confirming the "agreement of the parties."

But then the neutral appraiser sent a report to Bullet Land's lawyer, stating that the \$17.1 million appraisal was "not credible" because it was based on inappropriate comparable data and projections that were not "supported by market evidence and...conditions." What followed was a lawsuit in which both parties disputed the facts as well as the claims—the partnership attacking the \$17.1 million appraisal and the general partner trying to enforce the buyout price as an arbitration award.

Buy-sell is not an arbitration agreement

In the end, the parties' only agreement was that the appraisal process had failed to bring about a purchase. Despite the near closure of the buy-sell process, the Court found it did not constitute an arbitrated settlement agreement and denied the general partner's motion to dismiss—leaving all parties exposed to further litigation and costs.

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Our business valuation group can help you in a number of areas, including:

- **Stockholder Disputes**
- **Shareholder Redemptions**
- **SFAS 141, 142, and 144**
- **Buy/Sell Agreements**
- **Condemnations**
- **Estate and Gift Tax Valuations**
- **Employee Stock Ownership Plans (ESOP)**
- **Marital Dissolution**
- **Intangible Asset Valuation**
- **Stock Options (SFAS 123R and Section 409A)**
- **Valuation Consulting**
- **Transfer Pricing (Section 482)**

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