

Anatomy of a Business Valuation Report and Common Errors Therein

L. Paul Hood, Jr., JD, LL.M., CFRE, FCEP

paul@paulhoodservices.com

www.paulhoodservices.com

Quotes of the Day

- First, an oldie but goodie from grad school:
- ***If you torture the numbers long enough, they'll confess to whatever you want them to say.***

Attributed to Gregg Easterbrook

Quotes of the Day

- ***Everything is worth what its purchaser will pay for it.*** Publilius Syrus, *Maxim* 847

A Sincere Word of Thanks

- To Chris Mercer, Barbara Walters Price and all of the good folks at Mercer Capital located in Memphis TN (www.mercercapital.com) and elsewhere for supplying the business appraisal report that we'll examine today.
- I have been friends and worked with these folks for over 25 years. They are among the very best business appraisers with whom I have ever worked.
- But they're just good people. I also appreciate them being generous enough to provide us with a true to life business appraisal report and for putting up with my badgering and follow-ups about it.
- I have learned lots of things about business valuation from them over the years.

Introduction

- Valuation is a critical determination in taxation.
- Valuation is *time-specific*. When property value must be determined is a critical question. The evidence of value generally is as of the valuation date, although courts have permitted leeway here either before or following the valuation date as evidence of value.

Why Should You Still Care about BV

- Things that don't have an established public market still have to be appraised for income tax basis purposes after death. IRC Sec. 1014.
- Basis determination still plays a role in determining estate tax DSUE Amount.
- **I am concerned that estate planners will fall into the trap of not securing the client's new basis at death in light of the doubling of the federal estate tax applicable exclusion amount.**
Don't be one of these people!!!

Why Should You Still Care about BV

- **Role reversal**-The issue will shift to the **income tax arena**, with the IRS arguing for a **low** adjusted basis and the taxpayer usually arguing for a **high** basis, just like in the **charitable space**.
- In the gift tax arena, if the donor doesn't provide a qualified appraisal report, the gift tax statute of limitations doesn't toll. IRC Sec. 2001(f).
- The valuation misstatement penalties apply if value is significantly **overstated** or **understated**. Quality valuation work remains **essential** to the practitioner.

Difficulty of the Task of the Taxpayer's Appraiser Too Often is Understated

- What is the taxpayer's appraiser asked to do?
Well, under the present tax compliance system, the taxpayer's appraiser gets the ***"FIRST CRACK"*** at establishing value, which is placed onto the estate or gift tax return or income tax return.
- If neither audited nor otherwise challenged (and the waiting period for the moment of truth could seem like an eternity), the appraiser's version stands.

Difficulty of the Task of the Taxpayer's Appraiser Too Often is Understated

- However, if IRS questions the appraiser's opinion of value and posits a higher or lower value, what then becomes the role of the taxpayer's appraiser?
- Is it not now a two-fold role -- prove a **negative** that is **unknown** at the time of the original valuation on audit, i.e., that the IRS appraisal is incorrect (which, in and of itself, is as difficult in its own right standing alone as any other attempt to prove a negative) **and** that his or her valuation opinion is **supportable**?

Appraiser as Storyteller

- But at his essence, the business appraiser is a **storyteller**. In my opinion, the best business appraisers who I've ever worked with are great storytellers. The story is centered around the subject company justifying and explaining the conclusion of value.
- Is the report physically appealing? Have pictures? A table of contents? Tabs? Is the font easy to read? Is the content well organized? Does it flow well? If a website is noted, does it reference the date of the examination of the website? These are all hallmarks of a well written business valuation report.

Hood's Rules of Business Valuation

- Actual value is *irrelevant*.
- Actual value is *unknown*.
- Perceived, defensible value is *everything!*
- The six most important words in Rev. Rul. 59-60 are “*common sense, informed judgment and reasonableness.*”

The Goal of Business Valuation

- Everything done in a business valuation engagement and report should be aimed at *supporting* the ultimate conclusion of value.
- A conclusion without *adequate* support is doomed-getting the *right* answer with inadequate supporting data *doesn't* count for much.

Always in Draft Form First

- In practice, I made it a policy to ***always*** review a business valuation report in ***draft*** form before I authorized its issuance in final: ***Never release any business valuation report before it is ready.***
- In business valuation, the likelihood of getting some facts wrong or making a mistake is just too great to run the risk of not reviewing the draft business valuation report.
- Chris Mercer always requires his analysts to first get command of the numbers, and then to get command of the business-what makes it successful, what are its risks and opportunities, etc.

Agenda

- In this presentation, I will endeavor to do two things:
 - Examine what dictates the contents of a BV report.
 - Examine an anatomy of a good business appraisal report.

What Dictates the Contents of a Good BV report?

- Some business appraisers voluntarily (through the American Society of Appraisers (“ASA”)) comply with the Uniform Standards of Professional Appraisal standards (“USPAP”).
- The fairly new regulations under Treas. Reg. Sec. 1.170A-17 now **mandate** following USPAP. This is a slight change. The IRS has preferred USPAP for a long time, but now adherence with USPAP is **required**.

What Dictates the contents of a good BV Report?

- USPAP Standards **3** (Appraisal review, development), **4** (Appraisal review, reporting), **9** (Business appraisal, development) and **10** (Business appraisal, reporting) apply to business valuations.
- USPAP Standard **10** contains some excellent suggestions for what should be included in a business valuation report.

Applicable standard of value

- Fair market value***, which is the standard used in tax valuations.
- Fair value-state law***, usually used in state court divorce and shareholder dispute situations.
- Fair Value-financial reporting***. SFAS 157.

Applicable standard of value

- ***Intrinsic value***, the actual value of a company or an asset based on an underlying perception of its true value including all aspects of the business, in terms of both tangible and intangible factors, which may or may not be the same as the current market value.
- ***Investment Value***, denotes value for a particular potential purchaser.

What Dictates the Contents of a Good BV Report?

- Each of the “Big 4” business appraisal organizations (**ASA**, American Society of Certified Public Accountants (“**AICPA**”), Canadian Institute of Certified Business Valuators (“**CICBV**”), and National Association of Certified Valuation Analysts (“**NACVA**”)) has business valuation standards with which its members must comply.

What Dictates the Contents of a Good BV Report?

- Some business appraisers belong to more than one business appraisal organization and must comply with the rules of *all* of the organizations in which they are members.
- Note that the subject appraisal was signed by an ASA certified analyst, but the footnote says that if the analyst is a CPA, then the appraisal report will comply with the AICPA valuation standards too. *See Master Page 12.*

What Dictates the Contents of a Good BV Report?

- Business appraisal standards-you can obtain a copy of each of these sets of standards for free on the websites of each organization.
- **NACVA**-Standards went into effect for business appraisal reports issued on or after June 1, 2017.

Business Valuation Standards

- **AICPA**-SSVS No. 1 went into effect for engagements entered into on or after January 1, 2008.
- **ASA**-the oldest set of business valuation standards, the ASA Business Valuation Standards first went into effect back in January 1992.
- **USPAP**-Current version in effect from January 1, 2024-December 31, 2025.

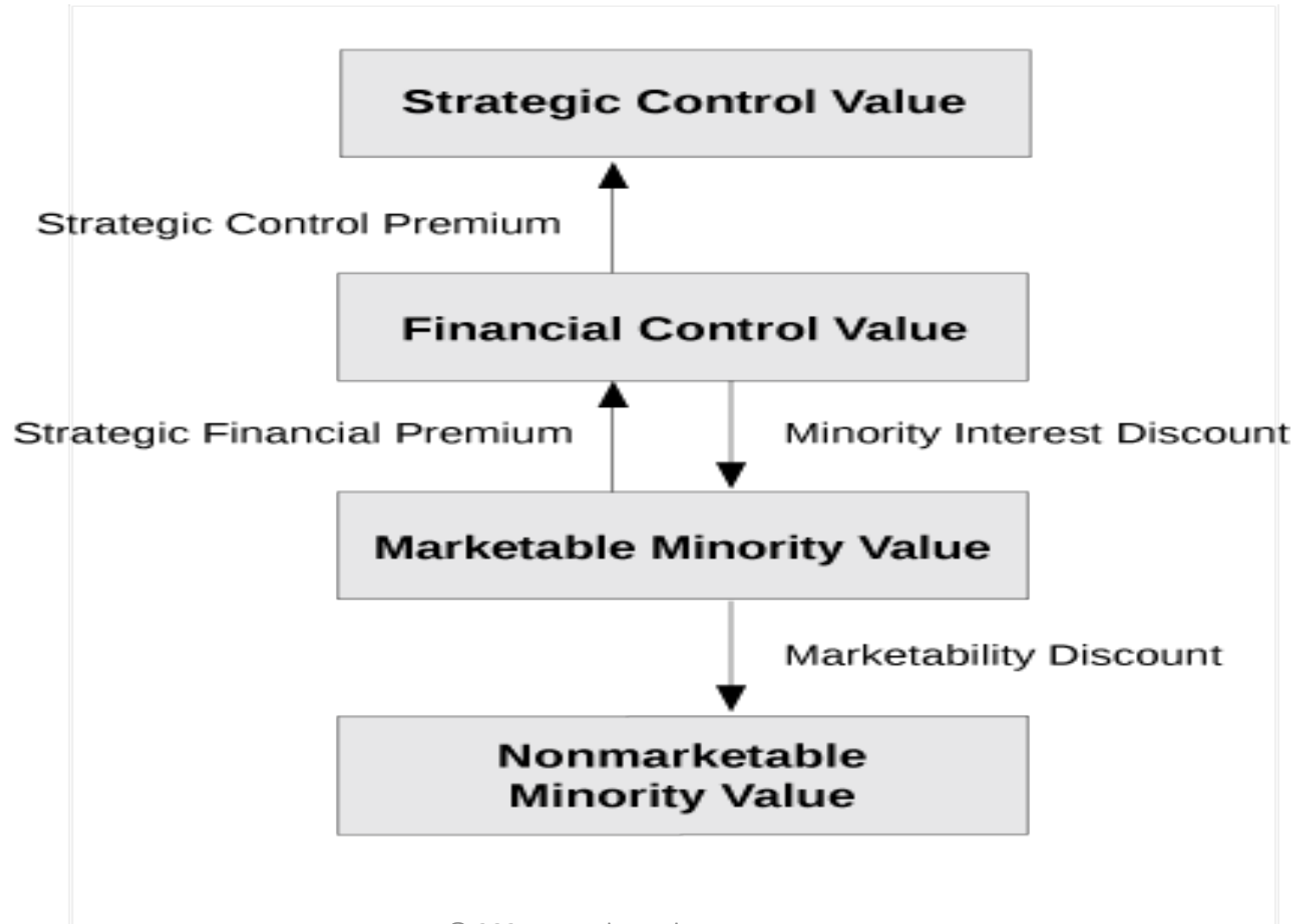
Business Valuation Standards

- It is important to be aware of these standards, even though *all* of them say that failure to comply is not a ground for liability.
- However, at a minimum, the business valuation standards set a *floor* of professional expectations.

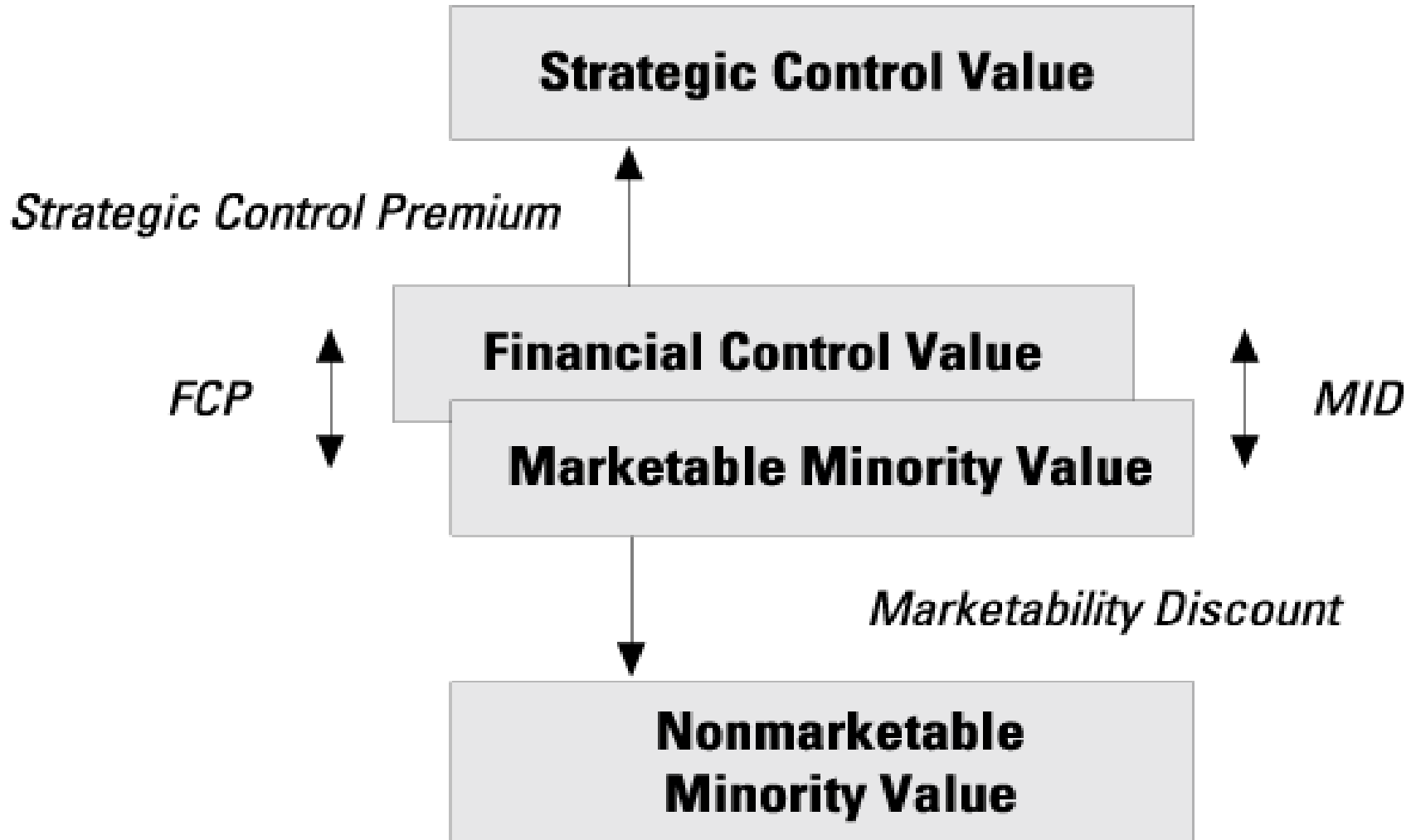
Applicable levels of value

- ***Synergistic*** control-Not a fair market value level.
- ***Financial*** control-top level in the fair market value standard of value.
- ***Marketable minority*** (generally thought where public company stocks usually trade).
- ***Non-marketable minority.***
- Other.
- The charts on the next two slides also were produced by Mercer Capital.

Classic Levels of Value



Another Depiction of the Levels of Value



Applicable Premise of Value

- Going concern.
- Liquidation.
- Assemblage of assets.
- Orderly disposition.
- Usually, the applicable premise of value will be *going concern*, which simply means that there is an assumption that the subject company will continue for the foreseeable future.

What dictates the contents of a good BV report?

- The IRS/Treasury Department has weighed in:
 - Rev. Rul. 59-60, as amplified and clarified by subsequent published rulings.
 - DLOM Job Aid, which contains an in-depth discussion of many of the approaches to determining the discount for lack of marketability (“DLOM”).

What Dictates the Contents of a Good BV Report?

- The IRS/Treasury Department has weighed in:
 - Treas. Reg. Sec. 301.6501(c)-1(f)(3), which contains some appraisal disclosure rules.
 - Treas. Reg. Sec. 1.170A-13 and -17, both of which contain definitions of “qualified appraiser” and “qualified appraisal.”
 - IRS Audit Manual has business valuation guidelines for IRS appraisers to follow.

BV Reports

- What is “suggested” (the business valuation standards issued by the various business appraisal professional organizations don’t *require* anything) to be included in an appraisal opinion of value?
 - AICPA SSVS No. 1, Par. 51-77
 - NACVA, PS V
 - ASA, BVS-VIII
 - USPAP Standard 10

Anatomy of a Real BV Report- Review Process

- I will be making reference to the *master page numbers* located at the center top of each page of the valuation report of *ABC Lumber Company, an S corporation*.
- Ignore the page numbers within the report.

BV Reports

- Statement of **scope** of the report and any **limitations** or applicable **extraordinary assumptions** must be set forth in the report. *Master Pages 7 and 12.*
- Most of the valuation standards issued by the various business appraisal professional organizations have different gradations of forms of reports but all allow for both written and oral business valuation reports.
- USPAP has two types of reports: the **appraisal report** and the **restricted appraisal report**. *The ABC report is a full-blown appraisal under the ASA Business Valuation Standards and USPAP. Master Pages 7 and 12.*

Anatomy of a Good Business Appraisal Report

- Definition of the business valuation **assignment**. *See Master Page 7.*
- **Opinion** letter or letter of transmittal that contains all of the language mandated by the applicable business valuation standards. *See Master Pages 2-3.*
- Applicable **premise** of value. *See Master Page 7.*

Anatomy of a Good Business Appraisal Report

- Applicable **standard** of value. *Master Page 8.*
- Applicable **level** of value. *Master Pages 10-11.*
- Statement of **scope of the work** and report as well as any limitations or applicable extraordinary assumptions. *Master Page 12.*

Anatomy of a Good Business Appraisal Report

- Economic outlook, both local and national. *Master Pages 13 and 102-122.*
- Industry analysis, including review of major competitors of the subject company. *Master Page 14.*
- Overview of the subject company. *Master Pages 15-18.*

Anatomy of a Good Business Appraisal Report

- Presentation of financial statements of subject company, together with ***normalizing adjustments***, for at least five years, as required by Rev. Rul. 59-60. *Master Pages 19-30, 32 and 59-79.*
- Book value and current financial condition of the subject company. *Master Pages 20-30.*

Elements of a Good Business Appraisal Report

- Presentation of financial statements, together with normalizing adjustments, of all **public company “comps”** (“guideline companies”). **No guideline public companies found.**
- Other valuation considerations of the subject company, including a discussion of management, classes of equity and debt and restrictions, if any, on the transfer of interests in the subject company. *Master Pages 15-18.*

Elements of a Good Business Appraisal Report

- Discussion of the **three** valuation approaches: asset-based, income/cash flow-based and market-based. *Master Pages 25-35.*
- Full description of the screening and selection process for guideline companies—the **process** is **critical**. *Master Page 33.*

Comment: Would have liked to have seen more detail here, but the report does reference the ASA valuation standard on screening for guideline companies.

Elements of a Good Business Appraisal Report

- Discussion of the applicability of valuation discounts and premiums. *Master Pages 43-90.*
- Reconciliation of indications of value and weighting of the various valuation approaches and methods. *Master Page 97.*
- Conclusion of value. *Master Pages 8, 57-58, 80 and 97.*

Elements of a Good Business Appraisal Report

- Contingent and limiting conditions. *Master Page 98.*
- Sources of information. *Master Page 101.*
- Table of Contents. *Master Pages 4-6.*
- Appendices of financial statements of subject company and selected guideline companies. *Master Pages 19-30, 61-79.*
- Qualifications of Appraiser. *Master Pages 99-101.*

Definition of the Business Valuation Assignment

- ***Definition of the business valuation assignment should include the following elements, which should be spelled out in the engagement letter:***
 - Name of client (might be a lawyer). *Master Page 7.*
 - Name of subject company. *Master Page 7.*
 - Type of entity (partnership/LLC, S corporation or C corporation). *Master Page 7.*

Definition of the Business Valuation Assignment

- ***Definition of the business valuation assignment should include the following elements, which should be spelled out in the engagement letter:***
 - The Appraisal Report sets forth all of the material parts of the Assignment on one page in a chart on *Master Page 7*. ***Comment: this is very good practice in my opinion.***
 - The definition of the assignment in the ***engagement letter*** should mirror that in the ***report*** unless it has been changed by mutual consent.

Definition of the Business Valuation Assignment

- Principal business location(s). *Master Page 7,*
- Subject interest being valued, e.g., common stock, assignee interest in an LLC, etc. *Master Page 7.*
- State of organization. *Master Page 7.*

Definition of the Business Valuation Assignment

- Standard of value. *Master Pages 7-10.*
- Premise of value. *Master Pages 7 and 11.*
- Level of value. *Master Page 7 and 10-11.*
- Effective date (“as of” date) of business valuation. *Master Page 7.*
- Date of Report Issuance. *Master Pages 1 and 7.*

Definition of the Business Valuation Assignment

- Purpose(s) and intended use(s).
Master Page 7.
- Scope of work-what type of engagement is it? A full-blown appraisal? Or something less, like a limited appraisal or even only calculations? *Master Page 7.*

BV Reports

- Most business valuation professional organizations have two types of business valuation engagements (appraisal and calculation).
- However, the ASA (the rules of which this appraisal report follows) has **three** types of business valuation engagements (appraisal, limited appraisal and calculation). ***This was a full-blown appraisal and a full-blown appraisal report, both of which I strongly recommend.***
- For tax purposes, I strongly recommend an appraisal and a completely self-contained business valuation report-***might effectively be your appraiser's only chance to testify on direct. This is a full-blown appraisal report, which is what I strongly recommend.***

BV Reports

- USPAP Standards Rule 10-3 contains some really good language for a business appraiser certification that should be included even if the overall report isn't subject to USPAP. Some of the highlights:
 - No bias.
 - Engagement and compensation not contingent on a pre-determined result.
- However, since the IRS recognizes USPAP, and since the new regulations **require** compliance with USPAP, I suggest that all tax appraisals comply with USPAP Standards 9 and 10.

ABC Lumber Company Report- Introductory Comments

- For starters, I insist on *footnotes*, like this report has, rather than endnotes because it's easier to review with footnotes.
- As I said earlier, a good business valuation report tells a story.
- As you can see, it's not all just text. There're cutout boxes and highlighted numbers, etc.

ABC Lumber Company Report- Introductory Comments

- The business appraisal report usually is lengthy, so it's imperative that it be easy to read because many readers, e.g., judges often have short attention spans.
- Note that the report has **schedules**, which relate to the financial statement spreads and review, **exhibits**, which relate to the determination of value, and **appendices**, which include the sources of information, contingent and limiting conditions (note that these are tied back to the Introduction), and the *National Economic Review* for the appropriate time period.

Anatomy-Transmittal Letter- Master Pages 2-3

- This Transmittal Letter for this report is drafted very carefully and thoughtfully (and understandably defensively) to minimize that to which the appraiser is opining.
- Note that everything is tied back to what was set forth in the Introduction on *Master Page 7*.
- It notes that the firm had done previous appraisals for the company and that testimony concerning the report is a separate engagement.

Table of Contents-

Master Pages 4-6

- This report has a table of contents. All full-blown appraisal reports should have a table of contents.
- The report Table of Contents includes subsections, which is very helpful during the review process.
- The Table of Contents of the report roughly mirrors the considerations in Rev. Rul. 59-60.

Introduction-Assignment Definition

Master Page 7

- I really like the clarity of setting forth all of the material elements of the assignment on one page.
- Note how the Assignment Definition on *Master Page 7* is specifically incorporated into the Transmittal Letter to minimize or even eliminate misunderstandings about the scope of the assignment.
- Some reports attempt to restate the assignment in the transmittal letter, but I worry about differences between what the Transmittal Letter in such an instance says and what the body of the report says. More confusion can be created if it differs from what the engagement letter provides. Caution is advised.

Introduction-Statement of Conclusion of Value-Master Page 8

- I like the conclusion of value stated and easy to find within the beginning of the report, as this one does.
- Note that the report states the value of the total common equity and the per share conclusion of value at the Assignment Definition Level of Value.

Statement of Scope and Limitations-

Master Page 12

- A critical inclusion in this section is the following conditional language:
- *We have relied upon the referenced information without independent verification. This report is therefore dependent upon the information provided. A material change in critical information relied upon in this report would be cause for a reassessment to determine the effect, if any, upon our conclusion.*

Economic Outlook-Master Page 13

- I like how the report breaks down the discussion between the national economy and the local economy, because there's often a disconnect between the two.
- I like how they attached their own proprietary economic outlook piece for the national economy as an appendix. I've seen reports not prepared by Mercer Capital that also contains that firm's national economic outlook, which they sell to appraisers and others.

Industry Outlook-Master Page 14

- In response to the occasional yet steady grouching about appraisal fees, I point out that a full-blown report is a 360-degree analysis of the subject company.
- I tell clients that a valuation report is a great ***management tool*** because it looks behind the financials and brings them to life while putting them in proper perspective. They're much more helpful than mere review of financial data.

Industry Outlook-Master Page 14

- To me, one of the most valuable and telling parts of a business valuation report for subject company executives is the depth of the industry analysis in the report.
- This part essentially does a SWOT analysis and not only summarizes the present state of the industry, but it looks for and identifies important trends about which to be aware for their future impact on the subject company.
- For ABC Lumber Company, it appears to me that the biggest risk to its business is the rapid increase of alternative products to build houses like steel, concrete and hemp.
- This is what is so valuable about a business appraisal report.

Overview of the Company-

Master Pages 15-18

- This too is a very important section for business owners and stakeholders. It can identify (and often does) a weak bench of management and points out management gaps too, but it also can highlight management strengths.
- It describes the company's organizational makeup, its divisions, if any, and it does a supplier analysis, which is very important.

Presentation of Financial Statements-

Master Pages 19-30 and 59-79

- This comprehensive, in-depth analysis looks behind the current financial statements and compares current results against the historical results, not only on the income statements, but on the balance sheets and statements of cash flow.
- The financial data is set forth on Schedules, while the valuation analysis is on Exhibits.
- The analysis breaks down ABC Company by division too, which unveils strengths and weaknesses.
- The analyst made notes to the financial statements, many of which source the data, which is important from the standpoint of replicability, which I think is crucial.

Determination of Value-

Master Pages 31-59 and 80-101

- The analyst goes through the exercise of valuing the company utilizing the three valuation approaches, as per Rev. Rul. 59-60.
- Even though the report also uses the Quantitative Marketability Discount Model (QMDM) that Mercer Capital invented, it diversifies its discount for lack of marketability (DLOM) analysis and considers not only the benchmark analysis, e.g., pre-IPO studies and Restricted Stock Studies, but effectively the *Mandelbaum* factors that late Judge Laro put down in that case, as well as QMDM. I think that diversifying the DLOM analysis is best, which is what this report does.

Common Errors Made in Business Valuation

- Every one of the errors discussed in the following slides has at least one reported decision where that error was made.
- These errors are chronicled in *A Reviewer's Handbook to Business Valuation*.

Quotes From Reported Decisions in Tax Valuation Cases

*“Too often in valuation disputes the parties have convinced themselves of the unalterable correctness of their positions and have consequently failed successfully to conclude settlement negotiations -- a process clearly more conducive to the proper disposition of disputes such as this. The result is an **overzealous effort, during the course of the ensuing litigation, to infuse a talismanic precision into an issue which should frankly be recognized as inherently imprecise** and capable of resolution only by a Solomon-like pronouncement.” Tax Court in **Messing v. Comr.**, 48 T.C. 502 (1967).*

Quotes From Reported Decisions in Tax Valuation Cases

*“In addition to our problems with the constituent elements, we question the **validity** of this equation as a valuation tool. We cannot imagine that any prospective buyer would use such an arbitrary, artificial, and subjective approach to formulate an initial offering price or to calculate a last best offer.” Tax Court in **Mueller Est. v. Comr., T.C. Memo 1992-284.***

Quotes From Reported Decisions in Tax Valuation Cases

“One expert admitted that his method of computation constituted ***"a highly theoretical exercise,"*** and indeed, ***this honest characterization applied equally well to the valuation methods utilized by the three other experts."*** Tax Court in ***Reynolds Est. v. Comr., 55 T.C. 172 (1970).***

Quotes From Reported Decisions in Tax Valuation Cases

“As the methodology we employ today may well be viewed...as unsophisticated, dogmatic, overly simplistic, or just plain wrong...on the end of the methodology opposite oversimplification lies **over-engineering.**” (emphasis by the court) **Fifth Circuit in *Dunn Est. v. Comr.*, 301 F. 3d 339 (5th Cir. 2002).**

1. Failure to Adequately Consider the Willing Seller

- Failure to adequately consider the willing seller is a common error when focusing too much on business valuation discounts and not enough on whether a willing seller would sell at that price.
- The *International Glossary of Business Valuation Terms* defines “fair market value” as encompassing an analysis of both willing buyer **and** willing seller.
- Rev. Rul. 59-60 and Treas. Reg. Sec. 20.2031-1(b) also focus on both willing buyer **and** willing seller.
- **Cites: *Branson Est. v. Comr.*, T.C. Memo 1999-231; *Mandelbaum Est. v. Comr.*, T.C. Memo 1995-255**

2. Failure to Consider the “Hypothetical” Nature of the Willing Buyer and Willing Seller

- Although it isn't in the formal definition of “fair market value” in either Treas. Reg. Sec. 20.2031-1(b) or in Rev. Rul. 59-60, the jurisprudence added the requirement that the willing buyer and willing seller be “hypothetical.”
- This mistake often is made when the business appraiser focuses too much attention on the universe of *likely* buyers instead of a *hypothetical* willing buyer.
- **Cites: *Simplot v. Comr.*, 243 F. 3d 1191 (9th Cir. 2001)**

3. Failure to Conduct Adequate Due Diligence

- USPAP Standards Rule 9-1(b); and NACVA PS II(C) contemplate that a BV appraiser must conduct sufficient due diligence in a BV engagement.
- The business appraiser must be **part blood hound** and root out even the most sensitive information that has a material impact on value, and the lawyer must be of assistance.
- **Cites: *Freeman Est. v. Comr.*, T.C. Memo 1996-372; *Bennett Est. v. Comr.*, T.C. Memo 1993-34**

4. Failure to Conduct Site Visit or Interview Sufficient Management

- AICPA SSVS Par. 53(a) and (c) and Appendix A (16) and NACVA PS V(C)(1)(e)(9) suggest that appraisers disclose in a BV report whether a site visit was conducted and the identification of the management personnel interviewed.
- Cost-over-conscious clients often lead to the error of the business appraiser not making a site visit.
- **Cites: *Gloeckner Est. v. Comr.*, T.C. Memo 1996-148; *Kohler v. Comr.*, T.C. Memo 2006-152; and *Polack v. Comr.*, T.C. Memo 2002-145.**

5. Failure to Provide Sufficient Explanation

- Former IBA PS Sec. 1.8 suggested a standard of replicability of results in a business valuation report.
- Tax Court Rule 143(g) provides in pertinent part that a BV report is the business appraiser's direct testimony, so no further explanation may be sought—this is a common government litigation tactic.
- Tell your clients ***not to be cheap-get a full-blown report when it is likely to matter.***
- Cites: ***Winkler Est. v. Comr.***, T.C. Memo 1989-231.

6. Failure to Sufficiently Explain Assumptions Made in Business Valuation Report

- USPAP Standards Rules 3-4(c) and 10-1(c); ASA BVS-VIII Section (III); and AICPA SSVS Par. 18, 52(l), 68(g) and 71(m) require or suggest that assumptions be identified and explained.
- **Cites: *Costanza Est. v. Comr.*, T.C. Memo 2001-128, rev'd, 320 F. 3d 595 (6th Cir. 2003); *Bailey Est. v. Comr.*, T.C. Memo 2002-152.**

7. Failure to Apply Discussion of Economic Factors to the Subject Company

- AICPA SSVS Par. 53(h), ASA BVS-I(III)(F) and NACVA PS IV(H)(2) suggests that business valuation appraisers gather economic information concerning the subject company and the economy surrounding the industry of the subject company, as does Rev. Rul. 59-60.
- That gathering has little or no meaning unless it is actually applied to the subject company and the industry of the subject company.
- **Cites: *Anderson Est. v. Comr.*, T.C. Memo 1988-511.**

8. Using a Valuation Method Without Establishing Legitimacy, e.g., Rules Of Thumb

- AICPA SSVS Pars. 39 and 62, ASA BVS-V(V) and NACVA PS IV(F) all caution against the use of rules of thumb alone as stand-alone valuation methods.
- There is always a *Daubert* risk in using unproven methodology.
- **Cites: *Renier Est. v. Comr.*, T.C. Memo 2000-298.**

9. Failure to Make Inquiries With Significant Third Parties

- AICPA SSVS Appendix A(17) suggests that a BV appraiser should make inquiry of significant third parties in the course of a BV appraisal and disclose and explain those inquiries.
- **Citations: *Adams Est. v. Comr.*, T.C. Memo 2002-80.**

10. Failure to Accurately Define Capital Structure of Subject Company

- USPAP Standards Rule 9-2(e); AICPA SSVS Par. 52(e); ASA BVS-VIII(IV)(A); and NACVA PS V(C)(1)(c)(3) and (4) suggest or require that a BV appraiser accurately describe the capital structure of the subject company for purposes of defining the subject interest.
- The business appraiser has to put what he or she is valuing in the proper context.
- **Cites: *Kaufman v. Comr.*, T.C. Memo 199-119, rev'd sub nom. *Morrissey v. Comr.*, 243 F. 3d 1145 (9th Cir. 2001).**

11. Failure to Set Forth Adjustments to Financial Statements in the Business Appraisal Report

- AICPA SSVS Par. 40, 51 and 58; ASA BVS-II(III) and VIII(VI)(B); and NACVA PS V(C)(1)(e)(2) provide that a BV appraiser should set forth adjustments made to financial statements in the BV report.
- This applies to both the subject company and any guideline companies.
- **Cites: *Gallagher Est. v. Comr.*, T.C. Memo 2011-148; *True Est. v. Comr.*, T.C. Memo 2001-167, aff'd., 390 F. 3d 1210 (10th Cir. 2004).**

12. Relying Upon Guideline Companies that Were Not Comparable Enough to The Subject Company

- What constitutes a guideline or comparable company to the subject company has been the subject of both BV standards and reported decisions.
- Rev. Rul. 59-60 is not that helpful in this regard, merely giving two examples of what would not be considered a comparable company.
- ASA BVS-V(III)(A) requires a “reasonable basis for comparison.”

13. Relying Upon Guideline Companies that Were Not Comparable Enough to The Subject Company

- AICPA SSVS Par. 61 suggests that a BV appraiser include a description of the **process** used for selecting and evaluating guideline companies.
- ASA SBVS-1 provides the following guidance: *“Ideal guideline companies are in the same industry as the subject company; however, if there is insufficient market evidence available in that industry, it may be necessary to select other companies having an underlying similarity to the subject company in terms of relevant investment characteristics such as markets, products, growth, cyclical variability, and other relevant factors.”*

14. Relying Upon Guideline Companies that Were Not Comparable Enough to The Subject Company

- Courts have disregarded appraisers' selections of guideline companies due to:
 - **Size**: *Knight v. Comr.*, 115 T.C. 506 (2000); *Hendrickson Est. v. Comr.*, T.C. Memo 1999-278; *Gallagher Est. v. Comr.*, T.C. Memo 2011-148, supp., T.C. Memo 2011-244.
 - **Profitability and asset makeup**: *Luton Est. v. Comr.*, T.C. Memo 1994-539; *Knight v. Comr.*, 115 T.C. 506 (2000).
 - **Operating characteristics**: *Hendrickson Est. v. Comr.*, T.C. Memo 1999-278.

12. Relying Upon Guideline Companies that Were Not Comparable Enough to The Subject Company

- Courts have disregarded appraisers' selections of guideline companies due to:
 - **Product mix**: *Zaiger Est. v. Comr.*, 64 T.C. 927 (1975); *Gallagher Est. v. Comr.*, T.C. Memo 2011-148, supp., T.C. Memo 2011-244.
 - **Significant sales in markets other than that engaged in by the subject company**: *Brookshire Est. v. Comr.*, T.C. Memo 1998-365.
 - **Consistent use of multiples on the low end of the range of possible multiples**: *True Est. v. Comr.*, T.C. Memo 2001-167, aff'd, 390 F. 3d 1210 (10th Cir. 2004).

13. “Cherry Picking” Valuation Multiples

- If the old adage “made as instructed” has any truth at all, then the selection of only those valuation multiples that support the business appraiser’s conclusion of value while disregarding other valuation multiples that throw the conclusion into doubt is an invitation to disaster.
- **Cites: *Wall v. Comr.*, T.C. Memo 2001-75; *Gallo Est. v. Comr.*, T.C. Memo 1985-363.**

14. Inconsistent Use of Data

- A cousin of the cherry-picking error, if the business appraiser is inconsistent in the use of data, e.g., using a market-based method to construct a discount or capitalization rate after rejecting the market approach, without carefully explaining the subtle distinction, the business appraiser's conclusions may be subject to challenge.
- **Cites: *Klauss Est. v. Comr.*, T.C. Memo 2000-191.**

15. Misapplication of Pre- and Post-Tax Figures

- ASA BVS-IV(IV)(D) suggests that a BV appraiser **consistently** apply capitalization factors or discount rates should be consistent with the types of anticipated benefits used.
- Failure to keep pre-tax and post-tax figures straight is sloppy.
- **Cites: *Dockery v. Comr.*, T.C. Memo 1998-114.**

16. Bias and Lack of Objectivity

- USPAP Ethics Rule (Conduct); AICPA SSVS Para. 14 and 15; ASA BVS-VIII(III); NACVA PS II(A) require a BV appraiser acting in that capacity to be objective and independent and free from bias.
- **Cites: *Hearst Corp. v. U.S.*, 28 Fed. Cl. 202 (Cl. Ct. 1993), vacated, 36 F. 3d 1116 (Fed. Cir. 1994); *Mueller Est. v. Comr.*, T.C. Memo 1992-284.**

17. Failure to Use Common Sense

- The six most important words in Rev. Rul. 59-60 are **“common sense, informed judgment and reasonableness.”**
- Yet, one consistent theme in the jurisprudence is the losing appraiser neglected to consider one of those three maxims.
- **Cites: *O’Keeffe Est. v. Comr.*, T.C. Memo 1992-210.**

18. Math Errors in a BV Report

- In today's world of Excel spreadsheets with embedded calculations and rows of data, nothing looks worse than to find a glaring math error such as double counting or a transposition error.
- Columnar errors in spreadsheets are easy to make and sometimes hard to find until the other side finds them.
- **Cites: *Bell Est. v. Comr.*, T.C. Memo 1987-576; *Magnin Est. v. Comr.*, T.C. Memo 2001-31; *Renier Est. v. Comr.*, T.C. Memo 2000-98.**

19. Inconsistency with Previous Appraisals of the Same Subject Company

- Where an appraiser values the same or a similar interest in the subject company and that appraiser arrives at significantly different conclusions of value or uses significantly different valuation methodology, the appraiser probably cannot explain too much.
- And this applies if the same or a similar interest was appraised by another business appraiser where the subsequent appraiser has access to that report, which can happen if the client gets a new business appraiser.

20. Inconsistency with Previous Appraisals of the Same Subject Company

- Any significant changes either in conclusion of value or in methodology should be very well documented and explained in the subsequent report.
- **Cites: *Freeman Est. v. Comr.*, T.C. Memo 1996-372.**

21. Failure to Carefully Proofread Business Valuation Report Prior to its Issuance

- This can be a real problem for business appraisers who are in small firms because sometimes it just takes a second set of eyes to catch errors or inconsistencies that aren't obvious if you are too close to the document.
- One solution is to let the draft report get “old and cold” before you review it in final form prior to issuance.
- **Cites: *Hinz Est. v. Comr.*, T.C. Memo 2000-6.**

22. Failure to Write for the Ultimate Audience

- In a tax appraisal, the business appraiser should be writing as if the matter will get litigated and brought before the U.S. Tax Court, where most of the judges have read numerous business valuation reports but who aren't business appraisers and who generally detest valuation cases.
- The business appraiser who can convey complex concepts in easy to read prose and in simple terms often carries the day.

23. Use of Different Valuation Methods in Valuing the Same Interest in BV Reports Without Adequate Explanation

- Even though there may be legitimate bases for valuing the same interests utilizing different methods in sequentially issued reports, there is a risk that the second method will be perceived as a result-oriented report that is merely offered to support the conclusion of value in the first report.
- **Cites: *True Est. v. Comr.*, T.C. Memo 2001-167, aff'd, 390 F. 3d 1210 (10th Cir. 2004).**

24. Inconsistency Across BV Approaches in the Same BV Report

- Where a BV appraiser is inconsistent across BV approaches, a red flag should immediately go up.
- **Cites: *Gallagher Est. v. Comr.*, T.C. Memo 2011-148, modified T.C. Memo 2011-244.**

25. Improper Reliance Upon a Draft Appraisal by a Third Party

- “As a point of fact, one of the appraisals on which [the appraiser] purported to rely **was merely a draft of an appraisal**, and [the appraiser] never spoke to the author concerning the author’s completion of that draft or about any of the information contained therein.” [emphasis added] **Tax Court in *Cloutier Est. v. Comr.*, T.C. Memo 1996-49.**
- “On the record before us, we cannot say that the estate acted with reasonable cause and in good faith in using an unsigned draft report prepared by its accountant as its basis for reporting the value of the decedent’s interest in PHC on the estate tax return. **Mr. Winnington is not a certified appraiser.**” [emphasis added] **Tax Court in *Richmond Est. v. Comr.*, TC. Memo 2014-26.**

26. Use of Past Writings Against BV Appraiser

- A BV appraiser should try to be consistent with his or her published positions unless there is a real good explanation in the BV report.
- **Cites: *Caracci v. Comr.*, 118 T.C. 379 (2002), rev'd 456 F 3d 444 (5th Cir. 2006).**

27. Reliance Upon Benchmark Analysis for Determination of DLOM for a Controlling Interest

- *“We also find that the restricted shares and pre-IPO studies referenced by [the appraiser] are not useful in determining marketability discounts applicable to controlling interests, because those studies analyzed marketability of noncontrolling interests.”* Tax Court in *True Est. v. Comr.*, T.C. Memo 2001-167, aff’d., 390 F. 3d 1210 (10th Cir. 2004).
- But there are reported cases where courts have expressed preferences for one study over the other, and they go both ways.

27. Reliance Upon Benchmark Analysis for Determination of DLOM for a Controlling Interest

- There are many ways to factor in a DLOM. However, they essentially break down to benchmark market methods (including the restricted stock studies (pre-IPO) and the pre-IPO studies), qualitative methods, income methods and real options-based methods.
- In my opinion, it's best to use several different DLOM methodologies in the different categories and weight them accordingly and not put all of your DLOM eggs in one method basket.

28. Utilizing an Assumed Income Tax Rate that Differed from the Actual Tax Rates of the Subject Company

- *“Finally, we question [the appraiser’s] use of a 40-percent marginal tax rate in computing WACC, when the marginal tax rates derived from FLC’s income statements for FY 1979, FY 1980, and FY 1981 are 4.96 percent, 1.25 percent, and 31.69 percent, respectively.” Tax Court in **Furman v. Comr.**, T.C. Memo 1998-157.*

29. Discounting an Income/Cash Flow Stream Only at or Close to the Risk-Free Rate

- *“First, [the appraiser] modified the WACC formula by weighting FIC’s debt and equity based on book value, rather than market value, to arrive at a WACC of 11.0 percent. Considering that the parties have stipulated risk-free rates of 11.86 percent and 14.4 percent in 1980 and 1981, respectively, it is obvious that [the appraiser’s] result is incorrect.” Tax Court in **Furman v. Comr.**, T.C. Memo 1998-157.*
- *“The mean average of U.S. Treasury bonds and notes at the time was 12.33 percent according to the expert. This represents the rate of return an investor would expect on risk-free, intermediate and long-term investments generating taxable income. **The expert gave no explanation for why the rates applied in his excess earnings method were lower than the U.S. Treasury bond and note rates despite the comparatively higher** risk that investment in Bell companies’ stock presented.” [emphasis added] Tax Court in **Bell Est. v. Comr.**, T.C. Memo 1987-576.*

30. Double Counting

*“Although [the appraiser] recognized he had double counted a liability of \$137,038, he did not modify his computations to correct for this error. Had he done so, Renier's nonoperating assets would have increased by \$137,038, and its total value would have equaled \$1,984,736.” Tax Court in **Renier Est. v. Comr.**, T.C. Memo 2000-98.*

*“Based on [the appraiser's] formula, as adjusted to account for the double counted liability of \$137,038, we conclude that \$104,584 should be subtracted from Renier's reported net income as a normalizing adjustment to account for the interest generated by its excess working capital.” Tax Court in **Renier Est. v. Comr.**, T.C. Memo 2000-98.*

Lagniappe: Inconsistent Cap Rates Across Valuation Methods

*“Furthermore, the rates of return applied by [the appraiser] in the excess earnings method bore no relationship to the capitalization rate [the appraiser] used in the capitalization of income stream method. **We believe his choice of varying rates indicates a result-oriented analysis.** An appropriate capitalization rate is determined by the comparable investment yield in the market not by the choice of a valuation method. [The appraiser] made little effort to identify comparable investments.” [emphasis added] Tax Court in **Bell Est. v. Comr.**, T.C. Memo 1987-576.*

Lagniappe: Thoughts on Dual Role as Direct and Rebuttal BV Expert

- **Against:** Cast in both roles, an expert will lose face in the eyes of the trier of fact (good cop + bad cop = compromised objectivity).
- Bias is an inclination to present or hold a partial perspective at the expense of (possibly equally valid) alternatives. Anything biased generally is one-sided, and therefore lacks a neutral point of view. Bias can come in many forms. BV seems to suffer from many biases and presumptions derived of heuristic convenience.

Lagniappe: Thoughts on Dual Role as Direct and Rebuttal BV Expert

- **For:** Even in non-controversy work, we attempt to communicate balance and proactively anticipate devil's advocacy of our work, thus a preemptive rebuttal against contrary positions and treatments is often contained in our original/direct work product.
- Appraisers acting in both roles can either fail miserably, contradicting their own direct work and bullying the other side's work, or can skillfully demonstrate a disinterest in "setting" the number while establishing a real goal for reporting a reasonable number among a range of potentially diverse outcomes. Unfortunately, there often is no middle ground.

Concluding Thoughts

- It is just as important to explain and to justify what a business valuation appraiser did **not** do in the course and scope of an engagement and **why** he or she didn't do it as it is to explain what the BV appraiser **did**.
- Just about every error made by a business appraiser could have been prevented with a truly objective review - if the business appraiser is a sole practitioner, it really helps to either get an independent review or let the business valuation report get "old and cold" before reviewing it and letting it be released in final form.

Concluding Thoughts

- Have a goal of creating a justifiable trail on which a third-party business valuation appraiser could *replicate* the work and conclusion of value. See former IBA PS 1.8.
- Pay close attention to all of the business valuation standards, including those to which the business appraiser *isn't* subject.
- Encourage the use of templates, peer reviews and checklists.

Concluding Thoughts

- As a reviewer of business valuation reports and a purchaser of business valuation services, you should have a review checklist that is similar to the one included in these materials.
- There also is a good business valuation review checklist in *Shannon Pratt's Valuing a Business* Sixth Edition.

Conclusion

- Thank you for your attendance and attention!!!
- Once again, thanks to Mercer Capital!!!
- If you have any questions or comments, please e-mail me at paul@paulhoodservices.com.
- Have a great day!!!