ADVANCED MARKETING
ACTIVATOR
SEPTEMBER 2003

VALUING A CLOSELY-HELD BUSINESS

INTRODUCTION

There are many reasons why an owner might need or want to value his or her closely-held business. These include planning for estate liquidity, making a gift to a family member, a friend or charity, properly recognizing the business worth in a pre- or post nuptial agreement or a marital dissolution, ascertaining worth for loan collateral purposes, performing a "fiscal checkup" to test the financial health of, or trends in, the business, or should a buy-out be necessitated by death or disability, at retirement, or the sale of an interest in the business to a third party. This commentary assumes the valuation is needed for buy-sell purposes.

CLOSELY-HELD STOCK DEFINED

Closely-held stock is stock in which there are a limited number of shareholders, where restrictions are imposed on a shareholder's ability to transfer the stock, where there is no listing of the stock in an exchange or regular quotation in the "over the counter" market, or where the company has an irregular, limited history of sales or exchanges. All or any one of these factors not only helps define a closely-held business, they significantly impact on its valuation. The mere facts that such stock is seldom, if ever, traded and there is little, if any, market for it will be a major determinant of value..

Time to Set Price: The proper time for setting the price (or establishing a price-setting formula) where the triggering event occurs at a shareholder's death or disability is when the buy-sell agreement is drafted by the client's attorney. Otherwise, the buy-sell agreement guarantees only uncertainty and increases the likelihood of litigation with both the IRS and the other parties to the agreement.

Three Criteria: Whatever the price the parties agree upon (directly or by formula), it should meet three criteria. It should be (1) reasonable, (2) fair, and (3) workable.

There is no "right" valuation formula or method; the method or combination of methods which should be used depends on the specific facts and circumstances of the case. The more thorough, objective, and rational the process, the more likely it will be respected by the IRS and the courts for both tax and other purposes. Obviously, the taxpayer's burden of proof that the value meets these tests will be less onerous when the parties are unrelated and dealing at arms' length.

The Four Basic Methods: There are four basic methods for setting a price in a buy-sell agreement. These are based on: (1) book value, (2) agreed value, (3) appraised value, and (4) formula value.

BOOK VALUE

Book value (stated assets less liabilities) is a particularly good place to begin the price setting process where (1) the business in question is primarily an asset holding company - such as an investment company, (2) the company is in the real estate development business, and assets, rather than earnings, are the key to valuation, (3) a one-person corporation is involved - since such a business is often worth only its liquidation value, (4) the liquidation of the corporation is in process or imminent at the valuation date - and the true value of the business is the amount actually available to the stockholders after a sale or liquidation, (5) the business is highly competitive but only marginally profitable and the firm's past earnings history is unreliable as a tool to measure potential future profits, (6) the business is relatively new, (7) a merger or consolidation is likely to occur, or (8) the business is experiencing large deficits.

Need for Adjusting Book Value: Unadjusted book value, per se, is rarely appropriate as a measure for determining price. In almost all cases, certain adjustments to book value should be made. This adjusted book value method involves adjusting the asset components of a business (which are carried at some figure other than fair market value) to an approximate fair market for each such component. The balance sheet is then re-computed, using these adjusted figures to arrive at the "adjusted" book value. It is important that the buy-sell agreement defines what the parties mean by "book value" since there is no universally accepted definition. Also, the agreement should state the accounting method used to compute book value.

Adjustments are necessary to reflect the difference between true market value and book figures where assets are valued at cost. For example, in the case of a closely-held investment company, the primary assets of the business consist of marketable securities are generally carried on the company's books at cost. Likewise, land is an asset generally carried at cost on a company's balance sheet, but in many cases is worth considerably more on the open market. The result is a book value which bears little or no relationship to the present worth of the business.

Adjustment is also necessary when assets have been depreciated at a rate in excess of their true decline in value. For example, the typical operating company which produces or sells products or services to the public may have purchased equipment originally costing $500,000 but which, on the company's books, has been depreciated to $200,000. The equipment may actually be worth a lot more or a lot less than its - $500,000 cost - or the $200,000 figure at which it may be presently carried. This same principle applies to real estate which is often depreciated much more rapidly for tax purposes than its actual drop in value. In many cases the fair market value of depreciable real estate may be substantially above (or below) its original cost.

Common indicators of a need to make an adjustment to book value also include items such as probable future lawsuits or unfavorable long-term leases which may or may not have been disclosed in the footnotes of a firm's financial statements, assets which have been written off, or assets such as franchises and goodwill which are carried on the books at a nominal value.
Other indicators of a need to make adjustments include situations where the business is experiencing difficulty in collecting its accounts receivable, where inventory includes goods that have become obsolete or are not readily marketable, or where inventory may be significantly understated.

When life insurance proceeds are received by a corporation under an entity or stock redemption arrangement, the proceeds would increase the value of the corporation and must be addressed in determining the purchase price -- particularly if the death proceeds might trigger an AMT (alternative minimum tax). Likewise, adjustments to book value are indicated where the liquidity position of the business is poor, or the business has a low amount of current assets in comparison to its current liabilities, or when the firm is experiencing a shortage of adequate working capital, or it is burdened with substantial long-term indebtedness.

Where the firm has more than one class of stock outstanding, a second class of stock may have preference to the class of stock in question as to dividends, preference as to assets in the event of a sale or liquidation, or in voting powers. For example, the true value of the assets cannot be realized as readily by the owner of common stock if there is a voting participating cumulative preferred issue outstanding.

A further factor that often indicates the need for adjusting book value is "retained earnings." The book value of a business might in fact be high because earnings have been retained over a long period of time, whereas the true value of the company might be lower than it appears – especially if its current earnings are low and the outlook for increased earnings in the future are dim. Obviously, the parties should understand that book value does not recognize the importance of intangible factors, such as the strategic location of the business, the effect of long- term advertising, or a hard-earned, well respected and easily recognized reputation.

After these adjustments are made to book value, the adjusted book value is then divided by the number of shares outstanding to determine the per share value. An agreement using the book value method should be drafted to state precisely the terms and accounting method utilized in determining stockholders' equity, and the date as of which the valuation will be determined.

Impact of Life Insurance on Book Value: It is extremely important, if book value is used, to specify the date upon which the valuation will be made. For instance, consider the different results that could occur if a life insurance funded agreement provided that the company's book value would be measured on the:

A. Date of death,
B. End of the month prior to death,
C. End of the last accounting period, or
D. End of accounting period nearest date of death.

Many authorities feel that book value as of the end of the regular accounting period nearest the date of death (with appropriate adjustments for the period of time between the date of death and the end of the regular accounting period nearest that date) is the most workable arrangement. But consider again the impact of the business receiving - say - $1,000,000 of life insurance and the fairness upon each of the parties (not to mention the difficulty of paying for the stock of a corporation with a value inflated by the insurance proceeds).

Who is the Client? Here are some approaches that the planning team may want to consider from the basis of who is to be favored in a stock redemption plan which uses book value in its price setting formula. From the viewpoint of surviving shareholders, it is most advantageous to set the measuring date prior to the insured shareholder's death (e.g. the end of the last accounting period prior to death), or to set the measuring date as sometime prior to the insured shareholder's death but provide that book value will be increased by the excess of (a) premiums paid for all key employee life insurance, over (b) the cash values of all such policies as of the date of the insured's death.

Of course, for the heirs and estate of the insured decedent-shareholder, it would be most beneficial to set the measuring date as sometime prior to the insured shareholder's death but add to that value the excess of (a) the death proceeds over (b) the premiums paid on the policy. Or, set the measuring date as of the date immediately after the insured shareholder's death and provide in the agreement that in no event will the price paid for the decedent's stock be less than the amount of insurance on his or her life. Planners, advisors and clients must be aware of the implications of each and attempt to achieve the appropriate balance.

"AGREED" VALUE

Under this method, the parties agree upon an amount and specify a per-share value. A certificate to that effect is attached to the agreement on a periodic basis as the value changes. This method is simple and easily understood. The certainty of price minimizes disputes among the parties, keeps accounting and appraisal fees to a minimum, and makes it easier for the parties to plan their estates because they know how much their heirs can expect for their business interests. A stated price is also helpful in funding the agreement - at least initially - since everyone knows how much life insurance is needed.

Unfortunately, the parties will often neglect to amend the amount or may be unable to agree upon a new price. As a result, the agreement is likely to become outdated after a number of years, probably will not take into account changes which the parties couldn't anticipate at the time the price was first agreed upon. Furthermore, for a family-owned business, that amount is unlikely to be persuasive as to its value for estate or gift tax purposes - especially if it has not been determined under some objective and reasonable criteria, or updated within a short time prior to the valuation date for transfer tax purposes.

A possible solution to the problem of updating is to provide a pre-determined schedule or mechanism for periodic reevaluations and specific guidelines if a reevaluation is not accomplished. For example, if the parties fail to get a revaluation or if one shareholder refuses to accept the revalued price, the value may be automatically increased by an inflation mechanism such as the Consumer Price Index. Often a sample "certificate of value" is attached to the agreement to be revisited upon from time to time.

APPRAISED VALUE

This method requires that an appraisal will be made at, or within a specified time after, the valuation date by a qualified and independent third party. There are two ways this is typically accomplished, the independent appraiser approach and the federal estate tax value approach.

In the independent appraiser approach the estate hires an appraiser, the buyers hire an appraiser, and the two appraisers, if they can not come to terms within a given period of time, hire yet a third appraiser. Alternatively, the price to be paid might be set by the average value found by all three appraisers. The cost, aggravation, and loss of time generated by this method are obvious.

If federal estate tax or state death tax valuation as filed on the estate's return is used as the measure of the amount payable under the agreement, a dual ethical and practical conflict is created for the

estate's executor: On the one hand, the estate's executor wants to keep the value of the stock down in order to lower federal and state death tax costs to a minimum. At the same time, the executor has great incentive to set as high as possible a value for estate tax purposes in order to "swell" the amount that will be received by the estate under the buy-sell. (If an unlimited marital deduction and/or high unified credit equivalent is available to the decedent-shareholder's estate, the executor will have even greater reason to claim the highest possible value since increasing the value will not increase estate taxes but will increase the amount the heirs receive.)

Taken to its extreme, this could result in the estate's executor aiding and encouraging the IRS examiner to increase the valuation of the closely held stock. This, of course, would be diametrically opposed to the interests of the surviving shareholders. Think of the conflict of interest implications this would create if the estate's executor were also the decedent-shareholder's co-shareholder and good family friend or close relative.

Uncertainty of outcome is another reason that generally, neither the independent appraiser nor the estate tax value of the stock should be used as the price setting mechanism. From the buyers' viewpoint, it is impossible to plan how much money will be needed to fund the agreement. From the decedent's family's perspective, it is impossible to predict how much liquidity the estate will have or need. In fact, with an appraisal method that depends on a final estate tax value, the buyer and the seller (not knowing the extent of the financial burden or how much will be received, respectively, until the estate is finally settled) are faced with the prospect of waiting for a process that can take at least nine months or, in many cases, years to complete.

Some planners, however, encourage the outside appraisal approach, fearing an IRS challenge to the agreement price may result in a tax value in excess of the purchase price. They are also concerned about possible unfairness in the apportionment of taxes among estate beneficiaries if, for example, the interest of a beneficiary was related to the sum to be received from the sale of stock.

At first glance, it would seem that a simple and inexpensive alternative is to have a financial adviser such as an accountant or financial analyst set the price. But should the firm's regular (or in-house) accountant be used - or should provisions be made for an independent accounting firm to do the job? The trade off - at the very least - will be potential conflict of interest vs. expenses. The probability is that the only highly probable result will be misunderstanding and a certainty that, as far as one party is concerned, the price paid was not fair. (Before opting to use this technique, the parties involved should obtain estimates of the cost of a business valuation so that they can have an idea of how very expensive this price setting method can be.)

FORMULA VALUATION

There are many variations to this valuation method. Optimally, the overall process in arriving at the formula will take into consideration these factors (assigning more weight as appropriate to the factors that most influence the future financial success of the business being valued):

- **Nature and history of the business**: How risky or stable is it? How strong is its management? How diverse is its operations? Is it growing or shrinking? What significant events have shaped or could shape its future?

- **Economic outlook in general and for specific industry**: What's happening in the general economy? What's happening in the specific industry?

- **Book value**: To what extent is book value misleading? What adjustments need to be made to properly bring the asset components to fair market value?

- **Earnings capacity**: What is the businesses future income potential? What adjustments need to be made for salaries, travel and entertainment expenses, non-recurring items, potential legal or tax liabilities? Are there shareholder loans that are disguised dividends because they are really equity rather than debt?

- **Dividend paying capacity**: What do cash flow projections show?

- **Goodwill**: What level of earnings over normal expected return can be reasonably projected?

- **Sales of stock**: Have there been recent sales? At what price? Under what conditions and to whom was the stock sold? Have there been events since the sale that significantly affect the value of the business?

Capitalization of Earnings: A typical method of obtaining a rough approximation of value is called "capitalization of earnings." It works like this: Consider three "magic money machines." When their cranks are turned, all three churn out $100,000 of U.S. currency per year. Are they all worth the same?

Assume the first machine was built strongly and had been cranking out money for years - and everyone liked and admired its rugged appearance and fully expected it to continue to crank out $100,000 a

year indefinitely into the future. The risk, in other words, was low and, therefore, investors in that machine (spelled B U S I N E S S) were willing to accept a modest (say 13 percent) return on their investments. At 13 percent, what value does an asset have if it steadily produces $100,000 per year?

Assume the second machine was sturdy - but not as well built as the first machine. It breaks down - not often but sometimes - and needs a special skill to make it run just right. It too will crank out $100,000 a year for the foreseeable future. The risk, however, is higher. Therefore, investors in that machine were not willing to accept a mere 13 percent return (perhaps only a few percent more than they could have received on their money had they invested it in very safe government securities for which they would have to do no cranking whatsoever). They wanted at least a 16 percent return. Yet if the machine produces only $100,000 a year, how much should they invest to purchase the machine?

Now, the third magic money machine could only be operated by one person. She alone had the skill and the patience to make it run and keep it going. And she was old. Very old. Therefore, if they were to invest in that machine, investors wanted to recoup their investment much more quickly – before the operator retires. They wanted at least a 19 percent return for their higher risk. Since this third machine produced $100,000 a year, just like the other two, how much should they invest?

CAPITALIZATION OF INCOME

Capitalization Rate..... 0.16
Adjusted Earnings..... $100,000

Expected Rate of Return	Value of Business
0.13	$769,231
0.14	$714,286
0.15	$666,667
0.16	**$625,000**
0.17	$588,235
0.18	$555,556
0.19	$526,316

(Illustration courtesy of NumberCruncher Software)

At a 16 percent assumption, the business would have a worth to the investor of $625,000. At 13 percent, the business would have a much greater worth, $769,231 while at 19 percent, a hypothetical purchaser would pay only $526,316. That, of course, was a very simplified example. In real life the valuation of the machines which produce money, whether in the form of business or otherwise, is much more complex and less susceptible to an easy mathematical solution.

Capitalization of Adjusted Earnings: Although the principles are the same, the capitalization of adjusted earnings concept adds one layer of sophistication. Under the "capitalization of adjusted earnings method," adjusted earnings are multiplied by a factor appropriate for the specific industry at the determined valuation date. The capitalization rate varies inversely with the degree of risk and rate of return. The higher the risk, the lower the earnings multiplier (i.e., the capitalization rate) will be.

A comparison of two companies, both earning $100,000 a year after taxes, might be helpful in illustrating the concept.

Assume company "A" is relatively small and is in a highly competitive industry. It's growing but hasn't yet established itself. A buyer, to take the risk of purchasing this company, might require a return of 20% per year on his or her money. In other words, for this level of risk, he or she wants to recover his or her capital in five years or less. If the firm earned, after taxes, $100,000 a year, this buyer would be willing to pay no more than five times $100,000, or $500,000. In other words, we've multiplied the firm's after-tax earnings by an appropriate capitalization rate.

Assume company "B" is older, has a proven record of profits, possesses a strong backup management, a substantial annual earnings growth rate, and has highly favorable prospects for the future. The same investor might be willing to settle for only a 12% return given this lower level of risk. In other words, using this method, you might project - say - eight years after-tax earnings as the value of the business, or roughly $800,000.

Obviously, the earnings multiplier (capitalization rate) selected will have a strong effect on the ultimate estimation of value. The rate of return demanded by a potential buyer (given a specified level of risk) will vary from time to time depending on the earnings rates of comparable alternative investments. Likewise, there are no "correct" capitalization rates - even the IRS uses different rates at different times and under different circumstances.

Need for Adjusting Earning Power: After-tax earnings, to which the selected capitalization rate is applied, should be adjusted in order to reflect a realistic appraisal of the earning power of the company by:

- adding back excessive salaries or reducing earnings if salaries paid were too low;
- adding back bonuses paid to stockholders or their families;
- adding back or subtracting, respectively, excessive or nominal rents paid to stockholders;
- eliminating nonrecurring income or expense items;
- adjusting for excessive depreciation; and
- adjusting earnings to take into consideration nonrecurring expenses, a major change in accounting procedures, widely fluctuating or cyclical profits, abnormally inflated or deflated earnings, or strong upward or downward earnings trends. Earnings are usually averaged over a five-year period and sometimes the average is "weighted" so that an upward earnings trend is given greater weight.

Per share value is then determined by dividing the total capitalization result by the number of shares outstanding. Appropriate discounts are then taken for lack of marketability or lack of control.

A.R.M. 34 Method: A variation of the adjusted capitalization method is known as the A.R.M. 34 (Appeals and Review Memorandum 34) method. Technically, this device is outmoded and no longer used by IRS agents officially. In reality, it is quite often used to check the reasonableness of the result obtained by a simple capitalization and is sometimes used in establishing the price or price setting formula in a buy-sell arrangement. The method essentially combines tangible and intangible values to arrive at an overall worth.

Basically, under A.R.M. 34, which combines the adjusted net asset value and capitalization approaches, a five-step process is used:

- Figure a reasonable return on tangible assets;
- Deduct the result of computation (1) from the annual earnings figure used. This difference should be the portion of earnings and profits generated by intangibles;
- Capitalize profits generated by the intangibles to determine what the intangibles are worth;

- Add the result of computation (3) to the net worth of tangibles. This sum will be the total value of the corporation; and

- Divide the step (4) result by the number of shares outstanding to determine the per share value of the corporation.

Example: Suppose your client's company had average annual adjusted earnings of $100,000, the average annual asset value producing those earnings was $500,000, and the client expected a 13 percent rate of return on that $500,000 investment. He or she would expect $65,000 ($500,000 x .13). The difference between what was actually generated ($100,000) and what could be expected from the tangible assets of the firm ($65,000) is the amount (i.e., $35,000) assumed to be generated by intangible factors.

If that $35,000 is then divided by the 0.16 estimated capitalization rate, the total "goodwill" of the firm can be estimated at $218,750. Adding the tangible assets of $500,000 to the $218,750 of goodwill results in an overall going concern value of $718,750. But if the return on tangible assets was projected at 17 percent, this would increase the expected return on the $500,000 to $85,000 (from $65,000), and correspondingly lower the earnings on intangible assets to $15,000. Using the same estimated capitalization rate of 16 percent, this would lower goodwill to $93,750 ($15,000 divided by 0.16) and drop total value to $593,750.

The buy-sell agreement should first provide for an adjustment of book value. Then it should provide for an adjustment of earnings. The agreement should then state the rate of return to be used (or based on an independent standard such as Moody's Bond Rate or the Section 7520 rate) and the capitalization rate.

CONSIDERATIONS IN SETTING THE PRICE (OR CREATING THE FORMULA)

A high valuation means that the heirs receive more cash and the buyers must pay more for the stock (and in return receive a higher income tax basis where a cross purchase plan is used.) This seems to lead to higher federal estate taxes. But planners should keep in mind the impact of an unlimited federal estate tax marital deduction and the increases in the applicable exclusion amount available under the current transfer tax system. A lower valuation means less cash is payable to the heirs of a deceased shareholder. The corresponding advantage is that the corporation or surviving shareholders are required to make a lower outlay.

Here's a quick "reality check": Let's assume your clients, all co-owners, have knowledge of the relevant facts about the finances of the business. Put two slips of paper in front of each and ask each co-owner to answer two questions:

- What is the most you would pay for the stock - if I owned it?

- What is the least you would take for the stock - if I wanted to purchase it?

This "bid and asked" price technique will help establish an acceptable price range, or assist the parties in coming to a realistic figure which may be the average of the hypothetical "bid and asked" prices.

Some commentators have claimed that estate tax returns with unlimited marital deductions will not be audited since the IRS has no incentive to increase or decrease the valuation for estate tax purposes, and no estate tax is payable in either event. That reasoning sometimes leads - dangerously in my opinion -- to a suggestion that the estate be intentionally overvalued. Planners should keep in mind that:

- estate tax values are not conclusive evidence of the fair market value of property, and

- there is a very substantial penalty that the IRS can impose for either under or over valuation.

CONCLUSION

As you have seen, valuation of a business is a difficult and uncertain process. Yet, for many purposes, it will be necessary for a client's business to be valued. In some situations it will be sufficient to obtain a mere ball-park guesstimate. For others, particularly where income, estate, or gift tax returns are concerned, a much more defensible and thorough process must be used. Purposes must be weighed against costs.

Value is a variable upon which reasonable minds can and will differ. But value must not be determined by a mere flip of the coin or a flippant attitude. The use of careful and thorough appraisals by qualified, independent professionals, documentation, and well drafted arm's length restrictive and binding agreements will be effective tools in establishing and substantiating values that are fair and equitable to the parties involved, and acceptable to federal and state taxing authorities.

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