VALUATION REPORT

BUSINESS VALUATION TRENDS AND STRATEGIES SUMMER 2008

WHAT'S IT WORTH?

Family Heirloom … or National Treasure?

In September 2007, designer Marc Ecko paid $752,467 to buy Barry Bonds' record-breaking 756th home-run baseball. The white disco suit worn by John Travolta in *Saturday Night Fever* recently sold for $145,000. A letter signed by President Theodore Roosevelt just brought in $5,500 at auction.

How does one arrive at a price for these treasures? And what is the standard of value?

INTRINSIC OR INVESTMENT VALUE?

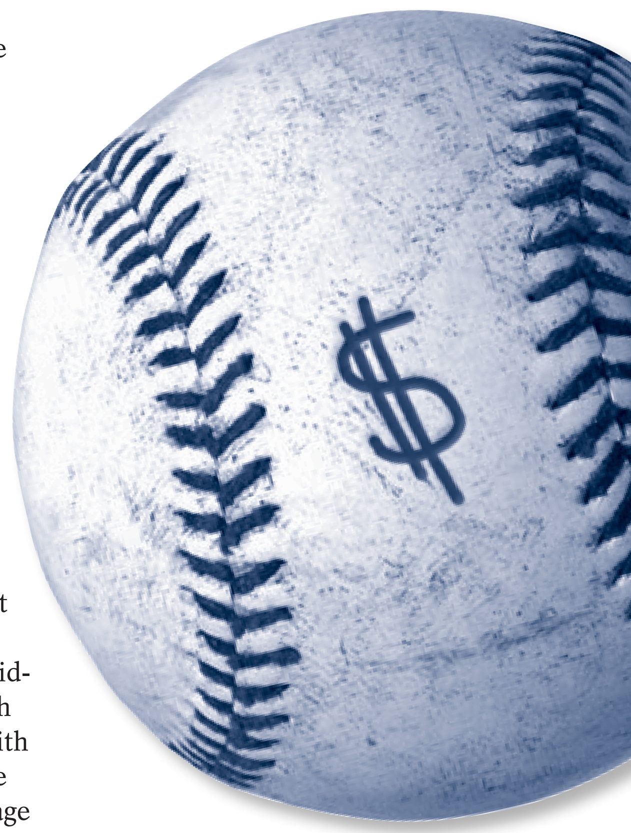
In business valuation, fair market value is generally the standard, based on cash flow generated by the company. When it comes to unique objects, replacement value is necessary for insurance purposes, but either intrinsic or investment value is the standard for sale or auction.

Intrinsic value is the value that an investor perceives others will pay for the piece because it is desirable. Your grandmother's ring may have high intrinsic value if it is truly a piece of fine jewelry. It has lower intrinsic value if it is merely valuable to your family as a sentimental heirloom.

Investment value is the value to one particular investor. If a collector has all but one of a certain item, he or she may be willing to pay more than any other collector to complete the set.

WHAT DRIVES VALUE?

There are several factors that drive the value of unique objects:



Authenticity: Several methods are available to authenticate objects, ranging from scientific analysis of paint, ink or paper, to comparison to similar items. For artwork, antiques and autographs, appraisers typically perform authentication services for a fee.

Condition: Fans of PBS's *Antiques Road Show* know that the condition of the item in question can enhance or detract from its value. Vintage toys in the original packaging are worth considerably more than their played-with counterparts. Antique furniture with its original finish is generally more valuable than pieces of the same age that have been touched up.

Rarity: Limited supply increases value. In the 1950s, The Topps Company printed fewer baseball cards than it does today. For this reason, baseball cards from the 1950s are generally worth more than baseball cards from more recent eras.

Ownership History: Previous ownership, or provenance, can have a major impact on value. For example, the sale of Princess Diana's gowns raised millions for charity, while other 1980s fashions continue to

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IRS INSIGHT

The Impact of R&E Tax Credits on Valuation

The Research and Experimentation (R&E) tax credit has evolved dramatically since the early 1980s. More companies now qualify for this wage-based credit, which is governed by Internal Revenue Code §41.

WHAT QUALIFIES?

To qualify for the credit, R&E activities must meet four criteria:

1. The research activity must be designed to discover information relating to a new or improved product or process, formula, technique, invention or software.
2. The research must be technological in nature.
3. Activities must be intended to eliminate uncertainty by discovering information that is currently unknown to the company.
4. Activities must include a process of experimentation to evaluate alternatives.

WHAT'S THE VALUE?

The R&E tax credit is a Tier 1 tax issue, which means it is among the greatest compliance risk tax issues as determined by the IRS. The IRS audits a large percentage of requested R&E tax credits.

These credits may impact a valuation determination, depending on whether the potentially significant amount of income attributed to credits is accepted or denied by the IRS. To include or not include the R&E refunds in a valuation is an important judgment that should be made by a valuation expert.

The crux of the issue is the determination of whether the credits are deemed valid by the IRS and are likely to continue. Analysts must ask many questions to arrive at that determination:

- When did the client first claim the credit?
- What amount of refund did the client receive and when?
- Is the business eligible for the R&E credit in the future?
- Did the IRS audit the R&E claim in the past? If so, were there significant adjustments?
- Is there a current IRS audit taking place?
- Did the business receive a 60-day letter from the IRS regarding the tax credit?
- Has the client received a Mandatory Information Document Request?
- How large is the credit? Is it material and recurring?
- What is the true effect on earnings per share?
- Did an outside firm prepare the R&E claim or was it prepared in-house?

The answers to these questions will identify the status of the existing credits and whether they, or the potential for other future credits, should be included in the valuation, and if so, to what extent.

Another factor to consider is that the R&E tax credit is currently expired. While it is likely that Congress will renew it for at least another year, nothing is certain. (However, the credit is retroactive, so companies can go back to any open year and amend tax returns to recapture unclaimed credits.)

Along with the renewal, many CPAs and valuation analysts would like to see R&E reform, including adding more definitive wording to the code, clarifying documentation requirements so that companies can be more secure in their claims, and making the entire process more simple and permanent. ❖

If you would like to discuss how the R&E tax credit may impact the value of your company, please contact our firm.

What's It Worth? *(Continued from page 1)*

languish at thrift shops. JFK's golf clubs sold for $770,000 in 1996, while other late-1950s sets were junked ages ago.

Market Interest: Current events and fads can sway the market. Memorabilia from the Olympic Games rises in price every few years as interest piques and wanes. The value of certain political paraphernalia changes as elections come and go.

TRASH OR TREASURE?

Thanks to the Internet, sellers and buyers of historical treasures and pop culture gems have an easy way to find each other. And eBay has redefined the marketplace, even for rare objects.

One man's trash is indeed another man's treasure, so don't make assumptions about the value of unique items. As always, it is wise to rely on a specialized valuation analyst. ❖

OWNERSHIP SPOTLIGHT

Clarifying Compensation: What's Reasonable?

The value of a business hinges on its income. In theory, more income and fewer expenses mean more value in the company.

Of course, part of a business valuation analyst's job is to closely examine a company's income and expense figures to arrive at a clear picture of what's really going on in the business. When assessing the value of closely held businesses, owner compensation is an expense category that's always under scrutiny.

Why? Because it's difficult to separate an owner's return on investment from his or her compensation for services rendered. To determine an accurate value, one must first determine what a non-owner employee would require in terms of compensation for the same job, and use that figure as a more reasonable expense against earnings.

Figuring out what's "reasonable" can be complicated, so valuation professionals turn to a variety of sources for help.

COMPENSATION BENCHMARKS

When undertaking a compensation study, a valuation expert typically starts with an organization chart and job description outlining the position's responsibilities. The analyst will also look at variables such as the size of the business, its profitability relative to its peer group, employee benefits and cost-of-living differentials.

Armed with a true picture of the job and its responsibilities, the valuation professional can then compare the position to others like it using a variety of compensation information resources, from industry association salary surveys to proxy statements for publicly traded companies. Valuation experts also rely on sophisticated, subscription-based compensation studies, which assess companies by industry code and screen them using specific variables.

CORRELATING PUBLIC AND PRIVATE

One of the more popular subscription sources, Economic Research Institute (ERI), uses regression analysis to correlate data from publicly traded companies with data from a subject company. By "translating" this data, ERI allows valid compar ison between, say, a $2 billion public company and a $2 million closely held company.

Other databases are specific to various jobs — physicians, architects and other professional services, for example. Some studies even indicate a base salary range as well as incentives.

Additional services, such as those provided by Risk Management Associates and Integra, provide financial benchmarks by industry code. Using this type of information, valuation professionals can look at average shareholder compensation as a percentage of sales. This approach is somewhat limited, however, because the data is shown "as reported" by the company. In an owner-managed business, the number reported is the actual expense, which may not reflect reasonable compensation in the marketplace.

PUTTING IT ALL TOGETHER

As is often the case in the valuation arena, arriving at a final number for reasonable compensation involves a fair amount of judgment. The challenge for valuation analysts is to merge the more generic compensation study data with the specifics of the company involved.

Because this requires specialized expertise, it is prudent to work with an experienced valuation expert who can not only find the relevant data but also interpret it correctly. Backing out the "extras" included in owner compensation is key to arriving at a reasonable compensation number and a more accurate business value. ❖

If you would like to find out more about reasonable compensation, please contact our firm.

ERP: Two Sources Better Than One

Investors usually want to balance risk with reward. Thus, a higher return may pique their interest even if greater risk is involved.

This concept is at the heart of the equity risk premium (ERP), a percentage indicating the "extra" return a stock theoretically provides over a risk-free investment, such as a treasury bond. In business valuation, the ERP is used to calculate the discount rate applied to future cash flows using the income approach.

While there is no universally accepted standard for estimating ERP, analysts have often turned to a highly regarded study of U.S. capital markets called Ibbotson Associates' *Stocks, Bonds, Bills, and Inflation Yearbook*. Known simply as Ibbotson's, this study contains summaries of returns on U.S. stocks and bonds since 1926. Using these realized return rates, Ibbotson's ERP average is 7.15 percent, which some observers believe is too high.

A newer study developed in 2005, the Duff & Phelps *Risk Premium Report,* offers an alternative ERP measure that's in the 5 percent range. Duff & Phelps presents historical ERPs and size premiums for 25 size-ranked portfolios using eight alternative measures of company size. Because of the increased number of measures, some analysts believe Duff & Phelps provides a more accurate ERP, particularly for smaller companies.

Of course, the strengths and weaknesses of these two sources are the subject of much debate. Courts and auditors also continue to be increasingly demanding regarding valuation calculations. As more data becomes available, the expectation for objective, supportable numbers increases.

For these reasons, many valuation analysts are now using both Ibbotson's and Duff & Phelps to support their ERP calculations. In fact, in its analyst training, the American Society of Appraisers now suggests incorporating data from both sources for market analyses. ❖

For more information about ERP calculations, please contact our firm.