

Valuations Plus

The problem with transaction multiples

SUMMER 2010

Business owners, appraisers and their jurors – auditors, judges, other parties affected by the appraisals – tend to have a serious “Goldilocks” problem when considering “comps,” guideline companies that have published valuation multiples.

Any measurable differences between a subject company and its comps can be – and typically are – used to exclude transactions that would otherwise provide useful information. Owners say, “They aren’t as profitable as we are,” or “I know the owner and he’s an idiot. I would never run my business that way.”

Business owners often will think that a basket of transactions from their business sector are not relevant (“That comp doesn’t do what my business does”), but they will hang their hat on one or two transactions they’ve heard about businesses that are similar to theirs.

These same owners will, however, listen to their broker’s advice and diversify their own retirement portfolio by buying a handful of mutual funds that invariably track the S&P 500 or other broad index. Their view of their marketable equities portfolios is completely different from their view of their equity investment in their own company.

What are appropriate benchmarks for managing a private company and determining its value? If owners ran their retirement portfolios the same way they view comps, they would have difficulty finding a meaningful benchmark.

Compare, for a moment, a typical brokerage statement. Data on industry sectors and broad market indices are provided, comparing any investment to one or more peer groups. That type of comparison is just as useful and valid for a private company.

Where does data for comps come from?

Two main sources of data for market multiples are trading in shares of public companies (public comps), and

acquisitions or mergers of whole businesses (transactions or deal comps).

The market as a whole provides just as much, or more, useful information as does a small selection of comps, whether public comps or deal comps. There is an overwhelming amount of information published on public companies. And there is a much smaller but constantly growing amount of information published on transactions of private businesses.

Private business transaction reporting is, for the most part, voluntary, and the veracity of the data is subject to the degree of verification that database providers undertake in publishing it. That said, commercially available data of deal comps is generally taken to be about as reliable as that for public comps, which means you have to take it with some skepticism – and that is before applying any judgment on how applicable the data is to a subject company.

So why is this important?

Knowing that each company is as unique as each of its owners and employees and all the personal influences they bring, and yet also knowing that value is derived from the assets a company has and how it uses them to create future earnings, we continue to search for the comps that are just right and ignore the power of the data available to us if we step back and consider the bigger picture.

Ignoring the available data is as foolish as an astronomer trying to study the motion of the stars only by looking through a telescope. How can you get a sense of what’s going on if you focus on only one pinpoint at a time? Zoom out a little, and learn a lot more.

Too often, a valuation report will dismiss the market approach for lack of “truly comparable” guideline

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Methods & Measures

By CPAAmerica guest columnist
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Matrimonial case study: The value of a valuation

Editor's Note: Our firm is a member of CPAmerica International, one of the world's largest associations of CPA firms. This article was written by Laura Ewart, a CPA with member firm Cowan, Guteski & Co., P.A., in Toms River, N.J.

A real life case can provide valuable insights into valuation issues and how to resolve them.

Each case requires thoughtful analysis and the creation of a work program designed specifically for the situation at hand.

The situation

Our CPA firm was recently retained by the wife in a matrimonial matter. Her husband owned a business in the transportation sector.

In accordance with New Jersey case law for matrimonial cases, we typically value the business as of the date the complaint for divorce was filed. Depending on when we are brought into the case, we may be preparing reports a year or more after the complaint has been filed. This delay can lead to a lack of records or, at times, a lack of recollections.

Our starting point for a business valuation is the company's prior five years of tax returns and financial statements.

We research the industry, acquire benchmarking and market data on the industry for comparison and analyze the company's financial performance, as well as its assets and debt structure. These, along with our forensic analyses, help to identify, examine and, if necessary, make adjustments to the reported income stream upon which our valuation is based.

Our findings

Unreported income. There are frequently allegations of unreported or "cash" income and/or personal expenditures being paid by the business. In looking at closely held companies, these allegations often prove true.

When considering an allegation of unreported income, you must look at the company's income sources and determine if there is an opportunity for this to occur.

Certain industries lend themselves to a greater possibility of this situation. If opportunity is there, it is often difficult to quantify the exact amount. An analysis of the company's bank records and the business owner's personal bank accounts, personal assets and lifestyle should be performed to ascertain if the reported income is consistent with these items.

Our investigation into the company's income sources, which were mainly insurance carriers, indicated that the opportunity for unreported income was negligible. As further support for this conclusion, the husband's reported salary and shareholder distributions were compared to the marital lifestyle reported by both spouses. The reported income was sufficient to meet the needs of their lifestyle.

Nonoperating asset. Although additional cash income was ruled out, the cash balance reported on the company's balance sheet had been steadily increasing over the last two years. An examination of the detail revealed that \$450,000 had been transferred from the operating account of the business into a business savings account. The working capital ratio indicated the additional cash in savings was not needed for current operations.

An inquiry determined that the money was not reserved for capital purchases. Based on these findings, we concluded that the savings account was a nonoperating asset of the business, and it was added to value.

Change of company accountant. The business offers statewide, 24-hour medical transport services. An analysis of the tax returns showed a steady growth in annual gross sales. The company's net income from the years 2004-2005 was vastly different than that reported in 2006-2008.

Further investigation led to the discovery that, in the earlier years, there were little or no shareholder distributions reported. However, in the later years, several hundred thousand dollars were distributed.

Also discovered was a change in accountants in 2006. The current accountant provided detailed financial records. The allocation for shareholder distributions properly included checks paid to the husband and personal expenditures paid through the company, including loan payments on the husband's personal boat.

Further analysis indicated that the previous accountant improperly expensed these items through the company.

Nonbusiness expenses. When analyzing the company's expenses from a forensic viewpoint, there are some common nonbusiness or personal expense categories that lend themselves to abuse possibilities.

We found adjustments for personal use were needed for auto expenses, entertainment, travel, telephone, utilities, as well as legal and professional fees associated with the litigation. It is important to determine how these types of expenses are being categorized in the company's financial records. If these expenses are incorrectly categorized as business expenses, the true earnings stream of the business is being distorted, and therefore expenses must be "normalized" to prepare a proper valuation.

We also found nonbusiness expenses commingled in business-related categories. The repair and maintenance account included expenses for the husband's personal boat. One account particularly drew our interest because it included veterinary and pet supply expenses.

Our first assumption was that these were personal expenditures, but further analysis revealed that the business has a registered search-and-rescue dog that lives at the facility and works for the business. To our surprise, the dog turned out to be a valid business expense.

Each case has nuances that require the keen analytical skills of the business valuation analyst. Careful planning and procedures can help assure that you have captured all the relevant data needed to issue a proper business valuation report. ■

**WORDS
on
WORTH**

*By CPAmerica guest columnist
Laura Ewart, CPA*

Tax Court revisits case on LLCs as estate planning tools

The Tax Court has rendered a second decision on the same set of facts in a single case.

The Tax Court decisions involved Suzanne Pierre, a New York businesswoman. The first decision is referred to in this article as *Pierre 1*, and the second decision on the same set of facts is referred to as *Pierre 2*.

The facts in the Pierre decisions were not disputed.

In 2000, Suzanne J. Pierre created a single-member LLC under New York law. She also created two trusts for her son and granddaughter, respectively.

She then transferred \$4.5 million in cash and marketable securities to the LLC. Afterward, she gifted a 9.5 percent interest in the LLC to each trust. She also sold a 40.5 percent interest in the LLC to each trust in exchange for a promissory note.

Based on an independent appraisal, she valued the interests in the LLC at a 10 percent discount for lack of control and a 30 percent discount for lack of marketability, for a 36.55 percent cumulative discount.

In *Pierre 1*, the IRS lost its argument that, since no election was made to treat the LLC as a corporation for federal tax purposes, the entity should be disregarded. As such, Pierre should be treated as if she transferred the cash and marketable securities to the trusts, and no discount is appropriate.

In *Pierre 2*, the IRS argued that the gift and sale transactions should be collapsed and treated as disguised gifts of 50-percent LLC interests to each trust to the extent their value exceeds the value of the trust's promissory notes. Accordingly, the IRS contended that the gifts should be valued as two 50-percent undivided interests in the LLC, rather than two 9.5 percent interests.

The court agreed with the IRS, applying the step-transaction doctrine.

The transfers all occurred on the same day. Pierre transferred her entire interest in the LLC within the time it took for four documents to be signed.

The court found that nothing of tax-independent significance occurred in the moments between the gift transactions and the sale transactions. The court also found that the gift transactions and the sale transactions were planned as a single transaction and that the multiple steps were used solely for tax purposes.

It is at this point that *Pierre 2* takes a curious turn.

The IRS chose not to offer its own expert witness to challenge the valuation of the LLC interests. Apparently, the IRS expected to prevail on its position in *Pierre 1* that the gifts were of the underlying assets of the LLC and not the LLC interests themselves.

Suzanne Pierre hired a new appraiser for the Tax Court case. This second appraiser agreed with the original appraisal of a 10 percent discount for lack of control. However, the new appraiser used a 35 percent discount for lack of marketability, higher than the 30 percent discount used in the original appraisal.

Since the second appraiser had initially valued a 9.5 percent LLC interest, the court asked him to reconsider his calculations for a 50 percent interest in the LLC. The appraiser testified that the discount for lack of control would be reduced to 8 percent, and the court accepted the 8 percent discount.

Although the second appraiser used a 35 percent discount for lack of marketability, Suzanne Pierre was asking for only the 30 percent discount used by the first appraiser.

The IRS directed its challenge against the 35 percent used by the expert in court and did not offer an objection to the original appraisal. Without a legal challenge from the IRS, the court let stand the 30 percent discount for lack of marketability.

Because the IRS appears to have mishandled its case to some extent, advisers should be careful about the lessons taken from the *Pierre* cases. *Pierre 1* (*Pierre v. Commissioner*, 133 T.C. No. 2) stands for the proposition that a single-member LLC is not disregarded when valuing gifts of interest in the LLC.

And *Pierre 2* (*Pierre v. Commissioner*, T.C. Memo 2010-106) shows that the step-transaction doctrine can be applied to multiple gifts and sales that are part of a prearranged plan.

The failure by the IRS to offer expert valuation testimony could mean that the discounts used were not fully reviewed by the court.



By CPAmerica guest columnist
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Transaction multiples *continued from front*

companies, and often without further explanation of what was considered and excluded. Common excuses include “Public companies are too big and too different,” “No meaningful transactions were identified,” or “All the selected transactions analyzed were too different from the subject to derive an appropriate valuation multiple.”

Users of valuation reports should not accept these excuses, especially without understanding what efforts were made to reach such conclusions. If some public or transaction comps were initially identified and subsequently excluded, ask what information was gleaned from the analysis and judge for yourself how useful that is to you.

The current generally accepted (and taught) valuation practice is to “drill down” from the universe of available data until only a small handful remains. It is not unusual to see a market approach rely on a dozen transactions or a few public companies – or less.

It is typical to see one median multiple from the data set applied, if any. Frequently, no time is devoted to comparing and contrasting the results from the whole universe against the sector and further still against the industry or peer group of companies that have similarities to a subject company.

Consider that, for public comps, there are 15,000 plus public companies listed in the United States or, more narrowly, all

500 companies in the S&P 500 index or 2,000 companies in the Russell 2000 index. For deal comps, several thousand transactions involving U.S. companies are published each year. To say that none of the data can be applied in valuing a subject company is as disingenuous as the statement that a company is so unique that it has no competition.

So what is the better alternative?

If you need to understand the value of a company, look in the valuation report for an explanation of steps taken to identify and analyze market comps data.

You are paying for good information and analysis – ask for it and use it with a critical mindset. Ask, “What are the general market trends” and “What are good companies in the industry or sector trading for, and what is the range of multiples?” No matter how unique you believe your business to be, do not accept that it cannot be analyzed by comparison to other businesses that have been traded or are publicly traded.

If the valuation report determined the value of the company using a capitalization rate or discount rate, you have already accepted the premise that the company is valued using information from capital markets.

The value of your company isn’t determined from just one or two limited data points. Obtain the bigger picture from market comps so you can understand where the conclusion that is applied to your company lies within that broader spectrum. ■

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation. Please be advised that, based on current IRS rules and standards, the advice contained herein is not intended to be used, nor can it be used, for the avoidance of any tax penalty assessed by the IRS.

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