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Selecting a Business Appraiser

*Excerpted from Mercer Capital's recent book,
Revenue Ruling 59-60 at 50: Rediscover Fair Market Value*

Business appraisal is both an art and a science, and Revenue Ruling 59-60 reinforces this point upon a full reading of the complete document. The concepts of the willing buyer and the willing seller, as well as the basic eight factors to consider requiring careful analysis in each case, are broadly recognized. However, Revenue Ruling 59-60 needs to be properly recognized as setting forth the theory for the appraisal of closely held corporations, and appropriately highlights the difficulty in applying that theory in practice.

In Section 3, Approach to Valuation, the Ruling states:

Often, an appraiser will find wide difference of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation that issued the stock, but that judgment must be related to all of the other factors affecting value.

In Section 6, Capitalization Rates, the Ruling goes on to say:

A determination of the proper capitalization rate presents one of the most difficult problems in valuation.... Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated.

The thoughtful concepts of reasonableness, judgment, and consideration resonate throughout Revenue Ruling 59-60. Indeed, some form of the word "consider" appears approximately 31 times. The body of knowledge that allows for that thoughtful consideration can be found in the certifications and professional designations that relate to business valuation.

PROFESSIONAL CREDENTIALS

There are several credentials or professional designations that are applicable to business valuation and related subjects. Professional credentials include the following designations:

- » **Accredited Senior Appraiser (ASA).** This designation is granted by the American Society of Appraisers ("ASA"). The American Society of Appraisers is a multi-disciplinary organization (including members in real estate, business valuation, fine arts, machinery and equipment and gemology), and the Accredited Senior Appraiser designation initially requires passing an ethics exam and a course and

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examination on the Uniform Standards of Professional Appraisal Practice. Once those two requirements are met, the applicant must pass or demonstrate acceptable equivalency for a series of principles of valuation courses. Upon successful completion of the courses, an individual must have a minimum of five years of full-time equivalent appraisal experience. Additionally, candidates must submit a representative appraisal report for review by the organization. (www.appraisers.org)

- » **Accredited in Business Valuation (ABV)**. This designation is granted by the American Institute of Certified Public Accountants (“AICPA”). The AICPA is the national professional association for Certified Public Accountants in the United States. The additional designation of ABV requires that members hold a valid CPA certificate, and pass a comprehensive business valuation examination. Also, substantial involvement in at least six business valuation engagements or evidence of 150 hours is required. (<http://fvs.aicpa.org>)
- » **Certified Business Appraiser (CBA)**. This designation is granted by the Institute of Business Appraisers (“IBA”). The CBA designation requires members to hold a 4-year college degree or equivalent, successfully complete at least 24 hours of coursework offered by the IBA, and complete a 6-hour, proctored, CBA written examination covering the theory and practice of business appraisal. In addition, designation candidates are required to submit two examples of their work to the IBA for review before being granted the designation. (www.go-iba.com)
- » **Certified Valuation Analyst (CVA)**. This designation is granted by the National Association of Certified Valuation Analysts (“NACVA”). The CVA designation requires the successful completion of a 5-day Business Valuation and Certification course, a proctored exam, and a case study, and two years experience as a CPA. (www.navca.com)
- » **Chartered Financial Analyst (CFA)**. This designation is granted by the CFA Institute. To earn the CFA Charter, you must pass through the CFA Program, a graduate-level, self-study program that provides a broad curriculum with professional conduct requirements, culminating in a series of three sequential exams. The CFA program is not structured as an appraisal program. Rather, charter holders are typically employed as securities analysts, portfolio managers or investment bankers and consultants. The securities analyst approach to the body of knowledge includes ethical and professional standards, quantitative methods, economics, financial reporting and analysis, corporate finance, equity investments, fixed income analysis, derivatives, alternative investments and portfolio management and wealth planning. (www.cfainstitute.org)
- » **Chartered Business Valuator (CBV)**. This designation is granted by The Canadian Institute of Chartered Business Valuators (“CICBV”). In order to achieve the CBV designation, an individual must complete six courses offered by the CICBV, accumulate at least 1,500 hours of business and securities valuation work experience, and successfully pass the membership entrance exam. (www.cicbv.ca)

EXPERIENCE

Experience counts, and the professional credentialing requirements highlight that important aspect of training. However, while a 5-year time-in-grade may be sufficient to grant a professional credential, long-term experience really shows up upon examination of the appraiser’s depth and breadth of assignments undertaken. Experience is also evident in a more subtle way: the interaction of the appraiser with other professionals in his own firm. Since it is difficult to build a business appraisal practice around a limited number of industries, the larger appraisal firms provide the benefit of experience at the firm level, which helps ensure the necessary quality control.

Experience also counts in answering the question: Should we hire an industry expert for this engagement, or is it preferable to hire a valuation expert? Given valuation expertise and broad industry perspective, specific industry expertise provides an element of comfort. However, in most independent valuation situations, industry expertise alone is an inadequate level of qualification unless supplemented by valuation knowledge and breadth of industry experience.

THE TOP 5 THINGS AN ATTORNEY SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

- 1. Define the project.** In order for the appraiser to schedule the work, set the fee, and understand the client's specific needs, the attorney needs to provide some basic benchmark information, such as: a description of the specific ownership interest to be appraised (number of shares, units, bonds); an understanding of the level of value for the interest being appraised; a specification of the valuation date, which may be current, or may be a specific historical date; a description of the purpose of the appraisal (informing the appraiser why the client needs an appraisal and how the report will be used).
- 2. Insist on an appraiser with experience and credentials.** Each business appraisal is unique and experience counts. Most business valuation firms are generalists rather than industry specialists, but the experience gained in discussing operating results and industry constraints with a broad client base gives the appraisal firm substantial ability to understand the client's special situation. Credentials do not guarantee performance, but they do indicate a level of professionalism for having achieved and maintained them. Attorneys should insist upon them.
- 3. Involve the appraiser early on.** Even in straightforward buy-sell agreements, family limited partnerships, or corporate reorganizations, it is helpful to seek the advice of the appraiser before the deal is set, to see if there are key elements of the contract document that could be modified to provide a more meaningful appraisal to the client.
- 4. Ensure that your expert's report can withstand a *Daubert* challenge.** In *Daubert (Daubert v. Merrell Dow Pharmaceuticals, Inc.* 113 S.Ct. 2786 (1993)), the Supreme Court noted several factors that might be considered by trial judges when faced with a proffer of expert (scientific) testimony. Several factors were mentioned in *Daubert* which can assist triers of fact in determining the admissibility of evidence under Rule 702, including:
 - a) Whether the theory or technique in question can be (and has been) tested
 - b) Whether it has been subjected to peer review and publication
 - c) The known or potential error rate of the method or technique
 - d) The existence and maintenance of standards controlling its operation
 - e) The underlying question: Is the method generally accepted in the technical community?
- 5. Expect the best.** In most cases, the fee for appraisal services is nominal compared to the dollars at risk. The marginal cost of getting the best is negligible. Attorneys can help their appraiser do the best job possible by ensuring full disclosure and expecting an independent opinion of value. The best appraisers have the experience and credentials described above, but recognize the delicate balance between art and science that enables them to interpret the qualitative responses to due-diligence interviews and put them in a stylized format that quantifies the results.

“Experience also counts in answering the question: Should we hire an industry expert for this engagement, or is it preferable to hire a valuation expert? Given valuation expertise and broad industry perspective, specific industry expertise provides an element of comfort. However, in most independent valuation situations, industry expertise alone is an inadequate level of qualification unless supplemented by valuation knowledge and breadth of industry experience.”

THE TOP 3 THINGS A BUSINESS OWNER SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

1. Understand the levels of value. There is no such thing as “the value” of a closely held business. That is an implicit assumption in the field of business appraisal. Yet, business appraisers are engaged to develop a reasonable range of value for client companies. Confusion over an appraiser’s basis of value, either by appraisers or by users of appraisal reports, can lead to the placing of inappropriately high or low values on a subject equity interest. The unfortunate result of such errors can include the overpayment of estate taxes, contested estate tax returns, and ESOP transactions that prove uneconomical or unlawful. Therefore, it is essential that both business appraisers and the parties using appraisals be aware of the correct basis of value and that appropriate methodologies be followed in deriving the conclusion of value for any interest being appraised.

The levels of value chart is a conceptual model used by many appraisers to describe the complexities of behavior of individuals and businesses in the process of buying and selling businesses and business interests. It attempts to cut through the detailed maze of facts that give rise to each individual transaction involving a particular business interest and to describe, generally, the valuation relationships that seem to emerge from observing thousands upon thousands of individual transactions.

Basic valuation theory suggests that there are three levels of value applicable to a business or business ownership interest:¹

- » *Controlling interest basis* refers to the value of the enterprise as a whole
- » *Marketable minority interest basis* refers to the value of a minority interest, lacking control, but enjoying the benefit of liquidity as if it were freely tradable in an active market
- » *Nonmarketable minority interest basis* refers to the value of a minority interest, lacking both control and market liquidity

The relationship between these three levels of value is depicted in Figure 1.

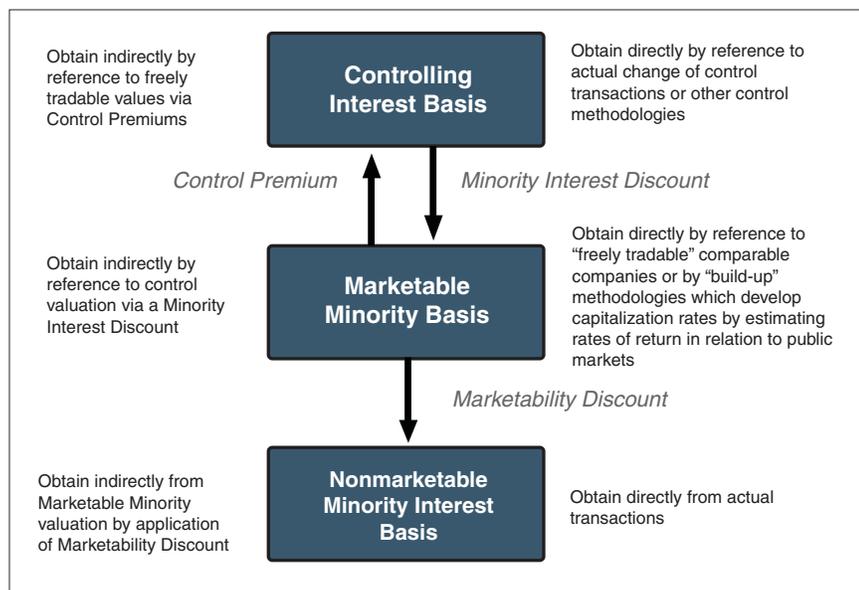


FIGURE 1

¹ For a more complete discussion of the levels of value, see Chapter 3, *Business Valuation: An Integrated Theory, Second Edition* (John Wiley & Sons, Inc., 2008)

Levels of value can co-exist, with one shareholder owning a controlling interest, one a marketable minority interest, and one a nonmarketable minority interest. Clearly, the appropriate level of value depends upon the purpose of the valuation. Nevertheless, understanding the three primary levels of value is critical to the valuation process both from the standpoint of the appraiser and the client.

2. Understand the difference between your compensation rate of return and your investment rate of return. Business owners will often combine these two concepts into one return, typically in the form of compensation. Since it all comes from the same pot (the company), why does this matter? Your business appraiser will help you segregate these two concepts, since the appraisal will be dependent upon a proper investment rate of return, after consideration of a proper compensation rate of return (i.e., compensation expense). The business owner/operator is due both returns, but there is a clear distinction between the two.

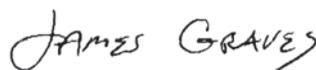
3. The business appraiser is not your advocate. Your attorney is your advocate, and your appraiser must be independent of the consequences of the conclusion of value. If litigated, opposing counsel is certain to ask the appraiser if he received any guidance with regard to a suggested conclusion or range of values that was expected.

THE TOP 3 THINGS AN ACCOUNTANT SHOULD KNOW WHEN SELECTING A BUSINESS APPRAISER

1. Avoid the conflict of interest trap. Your tax and audit clients will appreciate the fact that you consider your relationship too important to jeopardize by performing a business valuation that almost certainly would be challenged as having at least a perceived conflict of interest. The one time appraisal assignment will be thought of as a relatively minor fee-income generating project in context with on-going annual tax and audit work. Locate an independent business appraiser with whom you can work, and you will feel comfortable in providing a referral to a professional who does not also provide the tax and audit services.

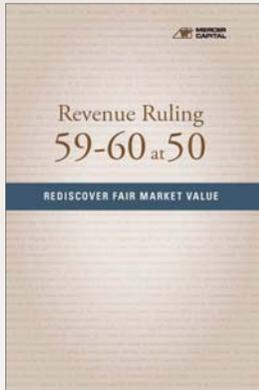
2. Avoid the lack of experience trap. Business appraisals have become increasingly detailed and sophisticated as the profession has grown. Accounting firms typically build their book of business on tax and audit work. If your internal staff does not include professionals dedicated solely to business valuation, the part-time nature of generating marginal additional fees by business appraisal may come back to haunt you and your client, typically in court.

3. Help your client distinguish between a business appraisal and a real estate appraisal. Many of the corporate entities appraised either own or rent the real estate where the business is operated. For a successful operating business, the most meaningful valuation is typically based on some measure of capitalized earnings, rather than the value of the underlying real estate. However, the accountant will recognize that some businesses, due to the nature of their operations, are characterized more by their underlying assets, and less so by their earnings power. This is true for asset-holding entities, and for some older family businesses with marginal earnings but with appreciated real estate on the books. Many business appraisers are not asset appraisers, but may need to consider a qualified real estate appraisal in the business valuation process.



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Click here to order your copy of *Revenue Ruling 59-60 at 50: Rediscover Fair Market Value*, or complete the order form on the following page and fax it to 901.685.2199



Revenue Ruling 59-60 at 50

REDISCOVER FAIR MARKET VALUE

Tagging a text with the label “classic” should not be done carelessly. But 50 years after its initial release, few would disagree that Revenue Ruling 59-60 deserves the title. Written in the spare, unadorned style of a government publication, the Ruling is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports.

Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

Published in January 2009, this 120+ page book is written for attorneys and other users of business appraisal reports. Order your copy today.

Chapter List

Chapter 1	A Summary of Revenue Ruling 59-60 from a Business Appraiser’s Perspective
Chapter 2	Fair Market Value Versus The Real World
Chapter 3	What Revenue Ruling 59-60 Means for Operating Companies
Chapter 4	Revenue Ruling 59-60’s Application to Asset-Holding Entities
Chapter 5	The Growing Influence of Intangible Assets
Chapter 6	Selecting a Business Appraiser
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Appendix B	Court Case Bibliography
Appendix C	The National Economy in 1959

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	Revenue Ruling 59-60 at 50	\$50	\$45	

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What's New on Mercer Capital's Web Site

Mercer Capital's website is updated frequently and contains information of interest to attorneys, business owners, bankers, and other professional advisors to business. Please visit often at www.mercercapital.com.

NEW ARTICLE

How ESOPs Work

ESOPs are a recognized exit planning tool for business owners, as well as a vehicle for employees to own stock in their employer company. However, most business owners and their advisors are unfamiliar with how an ESOP works. The mechanics of an ESOP can vary somewhat, but there is a basic common functionality to all ESOPs. This article discusses the mechanics of leveraged and non-leveraged ESOPs.

NEW ARTICLE

Some (Unsolicited) Advice for CFOs and Controllers of Public Companies

Even if you are a veteran when it comes to goodwill impairment testing under SFAS 142, it's important to understand that things are different in 2009. Most of us have never experienced a business climate like this before (and hopefully won't again for a long time). The fair value standard is new, auditors are no longer content with some of the old answers, and reasonable fair value estimates are simply harder to make. We've mined our experience helping clients like you meet the new challenges of goodwill impairment testing for a few tips in advance of your annual goodwill impairment test.



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FINANCIAL INSTITUTIONS GROUP

Bank Watch - April 2009 Issues Posted

These complimentary monthly email newsletters cover bank activity in five U.S. regions, including the Atlantic Coast, Midwest, Northeast, Southeast, and West. Each regional edition of Bank Watch highlights various banking metrics, including public market indicators, M&A market indicators, and key indices of the top financial institutions, providing insight into financial institution valuation issues.

SELECTED LIST OF UPCOMING SPEAKING ENGAGEMENTS

April 23, 2009

"Discounts and Premiums in Valuations for Financial Statement Reporting"

ASA Business Valuation Discipline Meeting

Washington, D.C.

Travis W. Harms, CFA, CPA/ABV

April 29, 2009

"Buy-Sell Agreements"

Hoosier Hills Estate Planning Conference

Bloomington, Indiana

Z. Christopher Mercer, ASA, CFA

May 8, 2009

"Bank Valuation in Today's Environment"

New York ASA Chapter Meeting

New York City, New York

Andrew K. Gibbs, CFA, CPA/ABV

May 27, 2009

"Discounts for Lack of Marketability" and "Subsequent Events"

2009 NACVA Annual Conference

Boston, Massachusetts

Z. Christopher Mercer, ASA, CFA

June 9, 2009

"Lack of Marketability and Lack of Control"

AICPA Fair Value Measurements Conference

Chicago, Illinois

Travis W. Harms, CFA, CPA/ABV

September 3, 2009

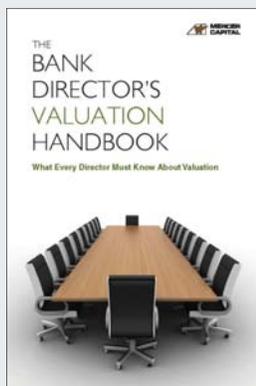
"Valuation for Gift and Estate Tax Purposes"

Birmingham Estate Planning Council

Birmingham, Alabama

Timothy R. Lee, ASA

To see a complete list, visit the Speaker's Bureau section of our website at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.



THE BANK DIRECTOR'S VALUATION HANDBOOK

What Every Director Must Know About Valuation

Valuation issues intersect with a bank's affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.

SECTION ONE: INTRODUCTION TO VALUATION

- Chapter 1: The Valuation Process
- Chapter 2: Core Valuation Concepts
- Chapter 3: Financial Management & Performance Measurement

SECTION TWO: COMPENSATION & EMPLOYEE BENEFIT PLANS

- Chapter 4: Employee Benefit Plans
- Chapter 5: Stock Options, Restricted Stock, & Stock Appreciation Rights

SECTION THREE: STOCK TRANSACTIONS

- Chapter 6: Estate & Gift Tax Issues
- Chapter 7: Raising Capital
- Chapter 8: Buy-Sell Agreements

SECTION FOUR: STRATEGIC ALTERNATIVES

- Chapter 9: Mergers & Acquisitions
- Chapter 10: Fairness Opinions
- Chapter 11: Capital Gains & Dividends
- Chapter 12: Sub-Chapter S Conversions

SECTION FIVE: FINANCIAL REPORTING

- Chapter 13: Fair Value Accounting
- Chapter 14: Fair Value Accounting In Business Combinations
- Chapter 15: Share-Based Compensation

SECTION SIX: STATUTORY & LEGAL CONCEPTS

- Chapter 16: A Primer on Litigation
- Chapter 17: Statutory Fair Value
- Chapter 18: Divorce of a Key Shareholder

SECTION SEVEN: CONCLUSION

- Addendum: The Capital Purchase Program (CPP)
- Addendum: IRS Provides New Tax Incentive for Banks

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TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
NEW E-BOOK			
The Capital Purchase Program Handbook	This 33-page handbook covers a number of topics related to the CPP, including the activity to date in the program, the advantages and disadvantages of participating, accounting issues raised, and the actual cost of the preferred stock after factoring in the warrants. Mercer Capital will endeavor to provide appropriate updates to this handbook as conditions warrant.	Complimentary	<i>Currently Available</i>
The QMDM Companion, Version 4.0 (2008)	The Quantitative Marketability Discount Model (QMDM) presents a practical model to assist business appraisers in developing, quantifying and defending marketability discounts under the income approach. The very latest version of the QMDM now includes a revised and expanded explanatory manual. The model and manual are delivered as a .zip file electronically via email.	\$125.00	<i>Currently Available</i>
Valuing Financial Institutions	We are responding to requests to put this 1992 book back into print and we are doing so as an E-Book	\$65.00	<i>Currently Available</i>
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corp vs. C Corp debate.	\$19.95	<i>Currently Available</i>
Embedded Capital Gains	A closer look at the Embedded Capital Gains issue.	\$19.95	<i>Currently Available</i>
Rate & Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions	In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution.	Complimentary	<i>Currently Available</i>
QMDM Fact Sheet	The latest information about the QMDM in a pdf format	Complimentary	<i>Currently Available</i>

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NEW WHITEPAPER SERIES: "UNDERSTAND THE VALUE OF ..."

TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
Understand the Value of Your Local Exchange Carrier	Over the past decade, the telecommunications industry has been characterized both by rapid innovation and obsolescence. Whether through selling, acquiring, divesting, or any other major strategic change, it is important to realize the value of your telecommunications company as it stands today.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Electrical Distributorship	Electrical equipment wholesalers operate in a highly fragmented industry, consisting largely of family-owned business with a few locations within a relatively close proximity. This article provides insight into the situational (when and why) and analytical (how) aspects of valuing electrical distributors.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Start-Up Business	Valuation for start-up enterprises can be a tricky proposition. Regardless of industry, start-ups generally share a common set of operational characteristics and valuation needs that are distinct from mature firms. This article discusses specific valuation considerations relevant to start-up companies.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Independent Trust Company	Due to their variance in size, there is no one-size-fits-all definition of an independent trust company, and recognition of the particular attributes of independent trust companies is significant to understanding their value.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Brick Business	This article provides an informative overview regarding the valuation of businesses operating in the brick industry, including a discussion of value as it relates generally to both manufacturers and wholesalers, as understanding how brick businesses are valued may help you understand how to grow the value of your business.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Insurance Brokerage	For the past several years, insurance brokerages have been in a period of consolidation, and the current soft market is expected to persist for at least the near term. As such, it is an opportune time for business owners to have an idea of what their brokerage business is worth.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Physician Practice	The event that triggers ownership transfer can be categorized as either voluntary or involuntary. It is important for physicians to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved.	Complimentary	<i>Currently Available</i>
Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.	Complimentary	<i>Currently Available</i>

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MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- » Dispute Analysis Services and Expert Testimony
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- » Valuation for Corporate Income Tax Issues
- » Valuation for ESOPs
- » Purchase Price Allocations
- » Valuation of Employee Options
- » Goodwill Impairment Testing
- » Valuation of Intangible Assets
- » Fairness Opinions

Mercer Capital's investment banking professionals specialize in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

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