Viewpoint on Value

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Questions IRS wants answered about marketability discounts

The *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals* helps IRS field agents better understand the theory underlying this complicated discount. But the relevance of the job aid extends beyond discounts applied in a federal tax context. Anyone who relies on an appraisal that includes a discount for lack of marketability (DLOM) may benefit from reviewing this 116-page publication.

The basics

The job aid defines marketability as "the ability to quickly convert property to cash at minimal cost… with a high degree of certainty of realizing the anticipated amount of proceeds."

A marketability discount is taken to reflect the lesser price that's expected from a private business interest that can't be quickly sold and converted to cash. It's appropriate when the subject interest is nonmarketable, but the prior steps in the valuation process result in a marketable value.

The job aid recognizes that the process of quantifying a DLOM is "factually intensive" and "heavily dependent upon the experience and capability of the valuator." In other words, professional judgment guides a valuator's approach to quantifying a DLOM.

DLOM questionnaire

Generally, empirical research — such as restricted stock and pre–initial public offering studies — suggests a range of median discounts from 30% to 60%. But, depending on the facts at hand, the "right" discount for a particular interest can vary significantly from the median. Empirical studies provide a useful starting point. From there, valuators weigh various factors that may warrant a higher or lower DLOM than the median range.

The job aid summarizes questions valuators address when selecting a DLOM for a subject interest:

What are the company's prospects for selling? The more likely it is for the business to sell in the near future, the lower its DLOM.

Could the company realistically file for a public offering? Large businesses with lower registration costs tend to warrant a DLOM below empirical studies medians.

Who owns the rest of the company's stock? Valuators consider the relationships of the other shareholders — including related parties, institutional investors and controlling owners. A business owned by bickering family members or a stingy, autocratic controlling shareholder may warrant an above-median DLOM, for example.

What's the relative size of the ownership interest? Smaller blocks of stock are generally less desirable, unless they possess swing vote rights. These rights occur when a small owner has the power to side with another owner to sway business decisions. Conversely, large blocks of stock may possess elements of control. But they also may "flood" the market, which may warrant a higher discount (or a separate "blockage" discount).

Is the interest subject to transfer restrictions? If so, what's the length and severity of the restrictions? The right of first refusal to shareholders or the company, for example, may extend an investor's expected holding period — making it harder to sell the subject interest quickly.

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Do investors have access to reliable financial information about the subject company? A lack of reliable, transparent information could make an investment less attractive in the marketplace and, therefore, warrant a higher DLOM.

How strong is the company's financial performance and management? Healthy companies with positive financial results, low leverage, predictable earnings and professional management teams are more salable than their weaker counterparts.

What's the company's dividend-paying history (and ability)? Companies that distribute cash to shareholders provide a return on investment other than liquidating their interests. Both real and potential dividends make an investment more attractive and, therefore, warrant a lower DLOM.

Are there outside influences in play? External factors that impact a DLOM include the industry's outlook, state laws and general economic conditions. Many of these factors were outlined by the Tax Court in the landmark *Mandelbaum v. Commissioner* case.

Bottom line

The job aid urges IRS agents to judge each DLOM based on its reasonableness and adherence to the company's circumstances. Above all, a valuator's methodology must be generally accepted within the valuation community — and it must consider the perspectives of *both* buyers and sellers. Appraisal reports that provide detailed written support for discounts help the IRS make these critical determinations. ●

Common DLOM approaches

In total, the *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals* published by the IRS (see main article) describes 23 different DLOM approaches. Two of the most common studies cited are:

1. Restricted stock studies. The Securities and Exchange Commission restricted stock rules before 1997 required investors to hold such stock for at least two years (and after 1997 to the present for at least one year). The differences between prices at which restricted stocks are issued relative to freely traded stocks of the same company are considered a proxy for a DLOM. These studies typically show medians around 35%.

2. Pre-initial public offering (pre-IPO) studies. These studies compare sales of the same company's stock before and after its IPO. Initial measurement points range from several *days* before the IPO to several *years* before the IPO. The median discounts reported in pre-IPO studies tend to range between 30% and 60%. So, a DLOM based on pre-IPO studies will generally tend to be higher than one based on restricted stock studies.

Some valuators turn to bid-ask spreads, option pricing models and various analytical methods when quantifying a DLOM. The job aid covers these newer methods in detail, as well.

Recycle paper and plastic, not appraisal reports

It may seem economical and time-effective to reuse an old business appraisal for a new purpose. But recycling an appraisal without your valuator's approval could prove costly over the long run for a few simple reasons.

Value evolves over time

Think of value as a moving target. Internal and external factors — such as employee turnover, equipment condition, competition levels and government regulations — affect a company's value over time. It's also relevant to consider how active the industry's current merger and acquisition market is.

To illustrate, suppose Al bought 5% of ABC Co. for $10 per share in 2004, based on a formal appraisal. Today, Bob wants a piece of the action, and ABC's controlling owner offers to sell him shares based on the 2004 appraisal. Is it fair to use a 10-year-old appraisal?

The answer depends, in part, on how internal and external factors have affected the company's value over time. The 2004 appraisal may overstate ABC's current value, for example, if the company has lost 25% of its market share because of increased competition and several key employees have left to work for competitors.

Value has many definitions

Value also depends on how you define it. Different standards — such as investment value, fair value or fair market value — may apply. Or the basis of value — such as controlling or minority, nonmarketable — may differ.

Discounts for lack of control and marketability can have a significant impact on value. But valuation discounts don't always apply and may differ depending on the size of the block. Adjustments to the company's income stream also depend on the size of the block and the valuation purpose.

Continuing with the previous example, suppose Bob wants to buy 75% of ABC from the controlling shareholder. But Al bought only a minority interest in 2004. Valuing a large block of stock requires different adjustments and analyses than valuing a minority interest in a private firm with limited marketability.

An appraisal is valid only for the dates and purposes listed in the report.

Value is case-sensitive

An appraisal is valid only for the purposes listed in the report. Valuators face different considerations depending on *why* a business is being appraised. Shareholder disputes, mergers and acquisitions, and tax purposes are just a few common reasons for an appraisal.

It's important to disclose *all* intended uses of a valuation report. In some cases, recycling may work out. But often the appraiser will need to update — or even redo — the appraisal, depending on how much the two assignments differ.

Continuing with our previous example, suppose ABC's controlling owner is currently getting divorced. Should she (or her spouse) rely exclusively on the 2004 appraisal when divvying up the marital estate? Although the valuator might mention the previous appraisal in his or her report, there are many reasons it's not valid — especially in a divorce context.

Suppose the divorce occurred in a jurisdiction that excludes all goodwill, or just the personal goodwill component, from the marital estate. If so, the valuator might need to value all or part of ABC's goodwill to determine the interest that's includable in the marital estate.

One size doesn't fit all

An appraisal provides a snapshot of a company's value on a specific date and for a specific purpose. Never assume an old appraisal still fits today — particularly when in a high-stakes litigation setting. ●

How do private and public companies differ?

Private company appraisals are often derived from public stock data, because it's more relevant and plentiful. But private and public companies can markedly differ in terms of risk, expected return and liquidity. Appraisals that fail to account for these differences could be making "apples-to-oranges" comparisons.

Searching for relevant data

Private companies tend to keep the details of their ownership transfers close to the cuff. But there are some exceptions. For a fee, some private firms and business brokers disclose deal terms to proprietary databases. In turn, valuators may use these databases to value private companies.

Unfortunately, private transaction databases may lack an adequate sample of comparables or may not provide enough detail about each transaction to offer meaningful comparisons. There's also the merger and acquisition method, which generates value on a controlling basis. But it may be less relevant when valuing a minority interest in the subject company.

While private deal data is hard to find, public data is plentiful. Public companies are required to report transaction details to the Securities and Exchange Commission (SEC). Their current public stock prices and market capitalizations are also readily available. So, valuators often turn to public stock data when valuing private companies.

For instance, the guideline public company method derives value from pricing multiples based on comparable public companies' stock prices relative to fundamental financial variables (such as price-to-earnings or price-to-cash-flow).

The income approach also relies on public stock data. A subject company's rate of return is typically based on public stock market returns. Rates of return are used to discount the subject company's expected income stream to its net present value. Riskier investments typically warrant higher rates of return, which generates a lower value.

Understanding what's different

Here are some key differences between private and public companies — though there may be exceptions to these generalizations:

Size. A company must be fairly large to justify public registration costs and ongoing regulatory compliance costs. So, public companies tend to be larger than their private counterparts.

Diversification. Similarly, private companies tend to have fewer lines of business and operate within a smaller geographic radius. They're more likely to rely on key customers or provide niche products and solutions.

Management quality. Public companies tend to be professionally managed, because they have greater access to financial resources that enable them to pay salaries that top managers expect. Small private firms tend to be run by entrepreneurs and their families. They also may have less access to debt and equity capital than large public corporations.

Financial reporting. Investors want insight into the financial performance of their investments. The SEC requires public companies to issue audited financial statements on a quarterly basis. In contrast, private companies are less likely to provide similar levels of assurance and often provide only year end reports.

> Smaller private firms tend to be riskier — and generally warrant higher rates of return or lower pricing multiples — than larger public companies.

Internal controls. Investors and the SEC expect public companies to implement strong internal control systems that include whistleblower hotlines, corporate codes of conduct and internal audit functions. At small private companies, it may not even be feasible to effectively segregate duties, mandate vacations or rotate jobs, for example.

Factoring in differences

Most of these differences boil down to risk. Smaller private firms tend to be riskier than larger public companies. Therefore, they generally warrant higher rates of return or lower pricing multiples. Those are two ways valuators account for the differences between private and public companies in their analyses.

Another key difference relates to marketability. A minority interest in a public company — such as shares of Disney or Microsoft — sells faster and at a more certain price than a minority interest in a small private business. Valuators reflect this difference by taking discounts for lack of marketability, which are often 30% or greater, depending on the nature of the business interest.

Getting it right

Private and public companies differ in many ways, so comparisons between the two types of entities aren't perfect. Experienced valuators understand how to adjust for these differences, taking care not to double-count the effects when quantifying their discount rates, pricing multiples and marketability discounts. ●

Methodologies on trial

Keys to surviving a *Daubert* challenge

Valuators often serve as expert witnesses if the parties to a lawsuit can't agree on the value of a private business interest or economic losses that have been incurred. Before valuators take the stand, they should be prepared to defend their valuation methodologies from what's commonly referred to as a *Daubert* challenge.

Techniques and theories

The accuracy of an expert's conclusion isn't the primary focus of a *Daubert* challenge — that's left to the court during trial. Instead, judges consider four factors related to the expert's methodology in accordance with the landmark *Daubert v. Merrell Dow Pharmaceuticals, Inc.* decision:

1. Testing. A technique or theory that stands up under technical scrutiny is generally perceived to be relevant and reliable. Laypeople should be able to understand your appraiser's methodology, and other experts should be able to replicate his or her work.

2. Peer review. Reliable methods have been published in trade journals to give other practitioners the opportunity to reveal potential flaws and weaknesses. Novel techniques are less likely to pass muster.

3. Error rate. No method is perfect. Valuators admit the shortcomings of their techniques, using more than one method whenever possible and reconciling differences between valuation methodologies. Valuators also must adhere to professional standards.

4. Acceptability. Reliable methods are generally accepted by the valuation community as appropriate for the case at hand. All valuation techniques won't apply in every case — relevance to the case in question is key.

Qualifications

Courts also want to know that an expert is truly qualified to value a business in the subject company's industry. Today, business valuation is a separate, established discipline within an accounting or a consulting practice. A CPA license or an economics degree generally

isn't enough to prove an expert is qualified to value a business or calculate economic damages.

Instead, hire a valuator who has earned business valuation credentials from one of the following organizations:

- American Institute of Certified Public Accountants (AICPA),
- American Society of Appraisers (ASA),
- Canadian Institute of Chartered Business Valuators (CICBV),
- Institute of Business Appraisers (IBA), or
- National Association of Certified Valuation Analysts (NACVA).

Also check whether the expert is current on his or her professional dues and continuing professional education requirements. Failure to stay atop of these requirements can be an embarrassing revelation during a *Daubert* challenge.

High stakes

So-called "experts" who fail *Daubert* challenges never make it to trial. Instead, their reports and testimony are excluded from evidence. Always review the techniques, theories and qualifications of both sides' valuators to gauge the admissibility of their reports and testimony. ●

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

*To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at **203 - 255 - 3805.***
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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.