FOCUS ON FUN

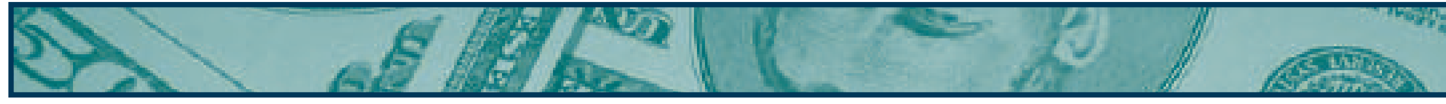
Accountants & Humor
– A Sociological Fable

1. Tax shelters, and the proper method of valuing them, has caused a fair amount of IRS litigation. In successfully challenging the taxpayer's calculated value of $4 million (that value then used for write offs) for the German film version of Jack London's "Sea Wolf", the IRS pointed out that the film's North American premier was a three day run in Escanaba, Michigan, with a total box office take of $144. Further, the film's distributor projected that the national gross box office take would approximate $576.

2. It is well known that various parts of the tax code and regulations are difficult to understand and often confusing. However, there are few examples as on point as the following excerpt taken from instructions for the preparation of tax forms:

"For purposes of paragraph 3, an organization described in paragraph 2 shall be deemed to include an organization described in Section 501(c) 4, 5 or 6 which would be described in paragraph 2 if it were an organization described in Section 501 (c) 3."

3. Ruth Gillings was employed as an independent contractor therapist at a health systems company, and earned $55,000. She did not file a tax return or pay any estimated taxes. She got caught, the IRS assessed her the tax deficiency as well as penalties for failure to file a return and failure to make estimated tax payments (yes, those are two separate penalties, and they do assess both). She paid the tax liability but not the penalties. Believe it or not, she took this all the way to Tax Court, where she argued that the penalties should not apply because her parents raised her to believe that the IRS is an illegal organization and taught her not to file tax returns or pay taxes. She was a very dutiful daughter. As a result – now get ready for this one – she believed that if she ever did file tax returns or pay taxes, she would be disowned by her parents. Justice, not family honor, triumphed and the Court determined that her fear she would be disowned by her parents if she filed or paid taxes, did not excuse her failure to file. The penalties were enforced.



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Our Sometimes Friend, The Market Approach

Overview

The market approach is a way of determining the value of a business by comparing it to actual transactions, as contrasted with the application of theory. However, it is not quite that simple or straightforward – numerous subjective determinations must be made. There are, in the broad sense, two types of sources for market data. There are proprietary databases providing information as to transactions involving privately held companies – these sources are used for the transactional method. These databases get their information typically from accountants, business brokers and various business industry sources. In limited circumstances, information from these sources can prove very useful – however, there are numerous potential shortcomings that cannot be ignored. The other broad source is the public market – using transactions from the various stock markets, determining public companies that are similar enough to the subject company being valued to use as a basis for valuation. This constitutes the guideline public companies method. In limited circumstances, and generally only for larger companies, this can prove to be a useful tool. It is usually not suitable for the truly small closely held business.

Transactional Data

As referenced above, proprietary databases may be able to provide information useful in the valuation of the subject entity. In order to make effective use of same, a few issues need to be recognized/addressed:

• We need to have data on companies that are relatively similar to the subject entity. This is a critical issue, and often one which prevents the use of these databases. By way of example, if the subject entity is a manufacturer of automobile tires, and the database that you have is for all manufacturers, it is questionable as to whether that is suitable. If that database dealt with manufacturers selling to the automobile industry, it would clearly be better, but not necessarily good enough. Just how finely correlated it needs to be is a case by case determination;

• Assuming that we have been able to determine a sufficient similarity as to the nature of the company – is there a sufficient volume of transactions to constitute a comparable base? This is especially the case with private databases, as contrasted with information from publicly traded companies. A concern here is that if the database has only a few transactions, it may not be a sufficient pool or universe of data to constitute a foundation for comparison purposes. There is no hard and fast rule, but at least several transactions is generally considered the minimum desirable number;

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Calendar
Recent & Upcoming Events

Speeches:

April 2008

14 - Reasonable Compensation – Family Law Section retreat (South Beach, Miami, Florida)

May 2008

21 - Unreported Income & Business Valuation – Institute of Management Accountants (East Hanover NJ)

September 2008

9 - Divorce Issues – Shenkman Seminar Series (Teaneck NJ)

26 - Divorce Taxation – NJ Society of CPAs (Iselin NJ)

* * *

Articles:

Fall 2007 issue of the American Journal of Family Law – Generating Liquidity to Settle a Case

Spring 2008 issue of the American Journal of Family Law – Civil Unions – Uncivil Taxes

Janet Barson & Laura Johnson
(Editorial, Design & Layout)

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• Even if the first two steps above have been met, there remain a slew of other issues that need to be addressed. For instance, when did the transactions occur – the more stale they are, the less useful the information. Also, what about location – these databases generally draw information from throughout the country, and that may not be useful, especially for businesses which are location sensitive. There is also the concern over size (which is more of a concern for some people than for others). If the company being valued is doing $10 million a year in sales, and the database of companies which we have accessed reflects companies doing a sales volume ranging from $100,000 to $5 million, and let us say only five of them are doing in excess of $2 million, are these truly comparable enough;

• Assuming we have passed all the preceding obstacles, there is at least one more left – do we have sufficiently useful data points for comparison purposes? Perhaps the two most common comparisons are based on a multiple of net income and a multiple of sales revenue. Especially with the closely held companies that are in these databases, a multiple of net income can be a dangerous multiple to use, because there are so many potential variations in how businesses report their net income. This is often clearly illustrated when we review the information in these databases, and find that the multiple of the sales price compared to the income is all over the place. The other multiple, comparing the sales price to the gross revenues of the company, can be a much better benchmark, because it is less susceptible to the net income game that closely held companies tend to play. However, since this base for comparison relies on sales, the top line, and not net income, one needs to be very careful in applying this, making sure that the subject company being valued is truly sufficiently comparable so that the multiples of such a big number (sales) are meaningful and relevant to the business at hand.

• Assuming all of that has been addressed, we are now faced with the fundamental issue of how useful are the data points. This is often a direct function of the dispersion in the multiples evidenced by those data points. To illustrate, assume there are twenty companies in our database, and the range of ratios of sales price (the acquisition transaction) to sales revenue is between 20% and 200% (the selling price was anywhere from 1/5 of sales revenue to 2 times sales revenue). If that wide range has no clear norm (there is no bunching of these ratios, but rather they are fairly spread out), then on what basis can any multiple be chosen? The mere use of some form of average or median is probably incorrect because there is no basis for knowing whether the subject entity is an average company in respect to the pool to which it is being compared. Thus, barring a close bunching of ratios (i.e. out of the twenty companies involved, twelve of them have a purchase price to sales revenue ratio of between 42% and 48%), there is no valid way to come up with a fair, appropriate and supportable average.

Once we are satisfied we can use the transactional method, the valuation process can proceed. Assume you have determined that the norm based on transactions is 40% of one year's revenues – based on $5 million in revenue, the company is therefore worth $2 million.

Another big issue that needs to be addressed is what is, and what is not, included in the referenced sales price. That is, most transactions involving closely held businesses are asset acquisitions rather than stock acquisitions – the buyer is buying the pieces of the business but not the entity shell. Further, buyers typically buy only some of the pieces – depending on many issues, they typically do not buy cash, they sometimes do not buy receivables, they usually buy the inventory and the machinery and equipment, they sometimes buy trade payables and accruals, they usually do not buy notes payable. If you do not know how the data source came about its numbers, there is the potential for substantial error in the value conclusion.

Guideline Company

This method within the market approach involves the use of publicly traded companies, and applying the appropriate multiples to the subject entity. On one level, this is a potentially excellent approach because it involves companies where a lot of information tends to be available in the public domain. On the other hand, there are potentially numerous problems with the use of public company comparables (along some of the same conceptual lines as the problems in using the private databases):

• Size – most of the time, the public companies to which the subject entity is being compared are considerably larger than the entity being valued. Assume we are valuing a manufacturing operation with sales of $10 million and stockholders' equity of $2 million, and in our search for comparables we have come across three publicly traded manufacturers in the same field. How truly comparable are these companies when their sales range between $500 million and $5 billion, and their stockholders' equity between $100 million and $1 billion? Are these really comparable, or are they too large to make valid comparisons?;

• Diversification – in general, publicly traded companies tend to have considerably greater product or service diversity than comparable privately held companies. For example, assume the subject company is a manufacturer of children's clothing, and the publicly traded comparables also have divisions that manufacture cloth, draperies, women's clothing and cardboard boxes. Further, the children's manufacturing portion of the comparable represents only 30% of its total sales volume. How comparable are these companies? Greater diversification, as a general rule, makes a company less risky in that it is not tied into

the fortunes of just one narrow segment of the economy;

• Geography – in a sense, this goes back to the cliché of "location, location, location". Generally, closely held companies operate in a limited geographical area. Further, even if they sell on a national level, they typically manufacture or distribute, or do what they do out of one or perhaps two locations. Thus, either what they sell or how they manufacture/make it, or both, tend to be tied into one geographic area. Publicly traded companies tend to have multiple locations, and tend to sell on a wider scale. As a result, they also tend to be less risky because they have a greater diversification. This again goes to the question of just how comparable are these entities.

Valuation using guideline public companies proceeds along many of the same lines as does the process described above for private company transaction. That is, we look to find the appropriate multiples. The most common with publicly traded companies is the price to earnings ratio (P/E). While this presents an issue with most privately held companies because of the definition of earnings, with public companies how they arrive at earnings tends to be more understandable and more usable than with privately held companies. Other commonly used benchmarks include multiple of sales, and less often (and typically in more capital intensive situations) a multiple of book value.

A major conceptual difference in using public company information for valuation purposes is that the value, which is derived from the trading price on the market, is an all-inclusive value for the company. That is, if the public company has 100 million shares outstanding, and is trading for $5 a share, putting aside issues involving control, that company is worth $500 million. Unlike with the use of databases of private companies, this does not involve an asset purchase, and the value concluded is for all of the assets and all of the liabilities of the company. Another important concern is that when determining the value based on how these public companies are trading (typically on a daily basis), the price being considered, and therefore the foundation for the valuation multiple being considered, is that of a minority position. The trading price is what the typical 100 share or 1,000 share block is getting on the market. That is clearly a minority position. Many times when we are valuing a privately held company, we are looking at the entire company, or a large minority interest.

Rules of Thumb

Kind of a variation on the market approach (transactional based on private company data), but one with much less credibility and reliability, is what is often referred to as the Rule of Thumb method (notably, the initials are ROT). In the simplest sense, a ROT is an elementary market approach with relatively little sophistication or analysis. The concept is along the lines of "in this industry/profession businesses typically trade for between 50% of and 150% of annual revenues, or between 1 times and 4 times owner's discretionary income, or…"

ROTs are generally established by data compiled, often by business brokers, sometimes by accountants, using very limited information about various businesses that have been sold. Typically, the information available is limited to such key data as sales and owner's discretionary income (which is a polite way of saying "what did the owner really take out of the business?"). These two critical benchmarks are then compared to the sales price, and the appropriate relationships expressed. Very little other information is available, and little else is ever accumulated in terms of understanding the underlying processes. The merit of the use of these is only in the crudest sense, and rarely as the sole or stand-alone method of valuing a business. Generally, ROTs are used only for a rough sanity test or comparison basis, and sometimes when a real valuation is not wanted but a sense for where values might be. Even then, the crudeness of the method leaves a wide margin for error.

By way of example of how dangerous the ROT method can be, consider that in the accounting profession, accounting firms typically trade for between 50% and 150% of annual fees. For an accounting firm grossing one million dollars a year, that would suggest the value is somewhere between $500,000 and $1,500,000. That is an extremely wide range, and of course gives no recognition to the particularities of that firm, the nature of its clients, how well it's run, etc, etc.

Conclusion

The Market Approach has the potential, in limited circumstances, of being the best approach to achieving a realistic determination of value. However, as with so much else in our professional lives, if not used correctly, it has the potential to be worse than useless.

Still available - our previous books: **Financial Issues in Divorce Practice; Business Valuation – The Basics** – complimentary copies for the asking. Contact us if you haven't received your copy.