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VALUATION ISSUES™

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FAMILY BUSINESSES AND THE NEED FOR STRATEGIC PLANNING

Luke A. Waller, ASA

When family members work together in, or share ownership, of a business, it is almost impossible for the business or for that matter the family to function independently. Many times the failure to separate the two can be the downfall of the business.

Although a significant number of businesses in the United States are family owned or controlled, a much smaller number survive the generational transfer of ownership from the first generation to the second generation and an even smaller number survive the generational transfer of ownership from the second generation to the third generation.

In order to survive from one generation to the next, family businesses need to be diligent in a strategic planning process. This process entails establishing clear goals and objectives for both the business and the family members. A strategic plan entails making decisions today that will affect the future.

> **"In order to survive from one generation to the next, family businesses need to be diligent in a strategic planning process."**

The first step in developing a successful strategic plan is to schedule a meeting with the critical stakeholders. The first meeting might best be accomplished through the scheduling of a family business retreat. A retreat offers participants an opportunity to discuss personal and business concerns, set policies and goals, and plan for the future. A retreat should be held away from the office and should cover a couple of days.

The retreat should begin with an introduction reviewing the history of the business and current operations as well as reminding individuals of the business' vision. The introduction should also establish the ground rules for the meetings as well as set timetables for the meetings.

The retreat is also a good time to prepare a mission statement. A good mission statement will address establishing realistic and measurable goals and objectives for the business, such as revenue, profits, growth, expansion or contraction, and new products or services.

A retreat is the first step in what might be a series of meetings needed to develop a successful strategic plan.

A strategic plan should address the following questions:

- What are our goals?
- Where are we going?
- Who is responsible for what?
- What are the time lines involved?
- How do we measure and evaluate our progress or lack there of?
- What do we do when the "unexpected" happens?
- How does this fit with our vision for the family and the business?
- Is the information used to develop the plan accurate and reliable?
- Is the business diversified?
- Are there any opportunities or threats on the horizon that will affect the business?
- Does the plan take into consideration the needs of the family and the business?

There are no right or wrong answers to the above questions. The most important aspect may be getting everyone's involvement in the process. This should lead to fewer surprises in the future when unforeseen circumstances arise, such as the death or disability of a key person in the business.

Again, getting everyone's involvement in developing policies and procedures should help to minimize surprises in the future even if there is no overall consensus at the initial meetings. At least the parties should know where each other stands before a potential crisis hits the Company. A time of crisis is not the time to find out that a family member has totally different ideas and opinions of how and who should run the company than what others thought they had.

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Family Businesses...Strategic Planning (Cont.)

Many times the valuation of the company will assist in establishing a strategic plan. Knowing the value of the company can help in making many decisions, such as under what circumstances would we sell, how much insurance do we need and what impact might estate taxes have.

Part of the strategic planning process involves developing policies and procedures that take into account the needs of the family and business. Among the issues that family businesses are often confronted with include:

- Who is allowed to participate in the business and in what capacity
- What should the compensation be for family members
- Which family members will be the next generation for leadership and ownership
- How to minimize estate taxes

The process of developing a successful strategic plan is an evolving process and a process that continually needs to be re-evaluated. By developing a successful strategic plan, family owned businesses position themselves to allow for the successful transition of the family business from one generation to the next.

Use Proper Due Diligence When Selecting A Business Valuation Expert

By Luke A. Waller, ASA

The demand for experts to value businesses has increased in recent years due to an increase in corporate restructurings and recapitalizations, the proliferation of Employee Stock Ownership Plans (ESOP), new accounting standards issued by the Financial Accounting Standards Board (FASB), the use of more sophisticated estate planning procedures, buy/sell agreements, and a general increase in the number of owners of closely held businesses. However, the increase in demand for business valuation experts appears to be creating a growing number of unqualified practitioners who claim to be experts in business valuation.

In the 1970s and 1980s many financial institutions got into trouble for lending on the basis of overvalued property. Real estate appraisers were blamed for either incompetence or lack of independence. Now the danger is that the fair market values being placed on businesses and their stock could be equally inaccurate and could also suffer from lack of independence.

The large deals involving publicly traded companies may get all the attention, but most transactions involve closely held companies. Because there is no publicly traded market price for their stock, appraisers are needed to make an important judgment as to the value of closely held stock.

When the closely held business needs to be valued it is usually due to a very important event for the owner. Hiring an appraiser should be given the proper due diligence to insure that a full-time professional is doing the appraisal.

> **"Hiring a big firm with a well known name doesn't guarantee that you will get a qualified appraiser."**

Hiring a big firm with a well known name doesn't guarantee that you will get a qualified appraiser. Make sure you talk with the appraiser who will actually be doing the appraisal. Also make sure that the appraiser is qualified and that you have confidence in him or her.

Noting that there appears to be a growing number of unqualified business appraisers as there was real estate appraisers in the late 1970s and 1980s, what lessons can we learn from the previously mentioned trouble that the financial institutions got into in the 1970s and 1980s?

The reason cited most often for the faulty real estate appraisals were either incompetence of the appraiser or lack of independence of the appraiser. Therefore, for a closely held business valuation one should hire a competent appraiser who is truly independent and who can be completely objective. This is of course much easier said than done.

For many years, one of the bigger questions surrounding independency involved the question of auditor independence, especially regarding the effect when the same firm provides consulting services (including business valuations). However, the collapse of Enron Corporation in 2001 brought the debate to the forefront.

For years, accounting firms, especially the Big Four, have evolved into multi-disciplinary businesses beyond their traditional tax and auditing work. Allegations abound that audit fees are often set unprofitably low to establish client relationships and to sell their other consulting services (including business valuations). The quest for higher paying fee based work involving other aspects of their client's business is where the accountant's professional independence comes into question.

In 2001, the Securities and Exchange Commission (SEC), concerned with the public's perception, issued a modernized set of rules for auditor independence. The SEC indicated that the prior independence standards were outdated and ineffective in maintaining independence in fact and appearance.

In regards to valuation and appraisal services, the rules state that: "We are adopting a rule that, with some exceptions, provides that an accountant is not independent if the accountant provides appraisal or valuation services or any service involving a fairness opinion. Appraisal and valuation services include any process of valuing assets, both tangible and intangible or liabilities."

Many times, poorly prepared, incompetent or advocacy valuations lack

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Use Proper Due Diligence... (Cont.)

detail and support. The following are some of the most common types of report errors/omissions found in the review of valuation reports:

1. Failure to adequately identify pertinent issues related to the valuation engagement such as:
   - The client (e.g., business owner, attorney, executor of an estate, etc.)
   - The standard of value (e.g., fair market value, fair value, strategic value)
   - The premise of value (e.g., controlling interest or minority interest)
   - The valuation date
   - The purpose of the valuation
   - The various sources of data relied upon in the valuation report
   - The proper identification of the authors of the valuation report
   - A signed certification page
   - Professional qualifications of the appraisers.

2. Failure to adequately discuss company specific factors impacting the valuation such as:
   - A review of the company's history and operations
   - Identification of the company's key management and each key manager's individual skills and responsibilities
   - A description of the company's ownership and any factors affecting the valuation of its ownership interest (e.g., ownership compositions, buy/sell agreements, membership or partnership agreements, prior transactions, recent offers to acquire or sell the company).

3. Failure to understand the dynamics of the industry in which the company operates.

4. Failure to understand the company's competition (e.g., major competitors, strengths, weaknesses, opportunities and threats (SWOT) analysis).

5. Failure to understand the dynamics of the local, regional, or national economy in which the company operates.

6. Failure to perform a thorough and detailed financial analysis of the company, including a comparison of the company to its peers via a benchmark analysis.

7. Failure to apply appropriate premiums or discounts (e.g., premium for control, discount for minority interest, discount for lack of marketability) to the appropriate premise of value (e.g., controlling interest or minority interest).

To ensure that a competent appraiser is hired, a thorough review of an appraiser's qualifications and experience should be performed. The American Society of Appraisers, a professional appraisal organization whose senior members have earned the designation of Accredited Senior Appraiser (ASA) must have five years of full time experience, pass a rigorous examination, and submit a series of reports to a review committee. Therefore, a good starting point to determine the competency of the appraiser is to ask if the appraiser is a senior member in good standing with the American Society of Appraisers. Another good question to ask, in trying to determine the competency of an appraiser, is to ask if the appraiser has any expert testimony experience especially if litigation is anticipated. If taxes are involved, either now or in the future, it is a good idea to hire an appraiser who has been hired by the Internal Revenue Service (IRS). Other considerations to help determine the competency might include the number of years the appraiser has been valuing businesses full time, the types of businesses the appraiser has valued, the number of articles the appraiser has written and published on valuation matters and whether the appraiser is active in the American Society of Appraisers either as an officer or committee member.

"Many times, poorly prepared, incompetent or advocacy valuations lack detail and support."

Another consideration to help determine the competency of the appraiser is to ask the appraiser what valuation courses or seminars they have attended recently. If the appraiser is an instructor of such courses, it is a strong sign that they are highly regarded in the appraisal community.

Once you have determined that an appraiser is competent, the appraiser should also be independent of the company or transaction. The mere perception that an appraiser may not be a disinterested party could be damaging if the values were ever disputed in court or by the Internal Revenue Service.

In conclusion, the valuation of a business is usually performed for a very important reason, (e.g., estate planning, a change in ownership, gifting of stock, Employee Stock Ownership Plans (ESOPs), estate tax, marital dissolution, compliance with financial accounting standards, etc.) and it could result in litigation or in a review by the Internal Revenue Service. Therefore, it makes sense to take the time to determine if the appraiser is (1) competent to handle the assignment and defend his/her work in a court later, if needed (2) going to be perceived as being truly independent of the company and/or transaction.

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KTS CALENDAR

RECENT AND UPCOMING SEMINARS AND SPEAKING ENGAGEMENTS

2/1/05 Presentation—Bluegrass Estate Planning Council, Lexington, KY.—"Current Topics in Valuation."

5/19/05 Presentation—Quad City Estate Planning Council, Davenport, IA.

5/19/05 Presentation—Estate Planning and Trust Council of Long Beach, Long Beach, CA.—"Current Valuation Issues in Estate Planning & Estate Tax."

5/24/05 Presentation—Lorman, Long Beach, CA.—"Partnerships, LLCs and LLPs: Organization and Operation."

6/17/05 Presentation—Lorman, Santa Ana, CA.—"Partnerships, LLCs and LLPs: Organization and Operation."

KTS RECENT ENGAGEMENTS

* Valuation of a steel service center for estate tax purposes.
* Valuation of certain publication royalty rights pertaining to various law textbooks for estate tax purposes.
* Valuation of tangible and intangible assets of a contract electronics manufacturer for financial reporting purposes.
* Valuation of plastic surgeon practice for divorce purposes.
* Valuation of an interest in an Agreement pertaining to a popular cartoon strip for estate tax purposes.
* Valuation of a company involved in the scuba diving industry for estate tax purposes.
* Valuation of a manufacturer of frozen dough for estate planning purposes.

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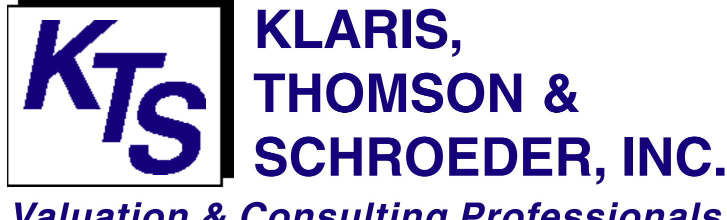

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Quarterly Quote:

"The wise man doesn't give the right answers, he poses the right questions."
- Claude Levi-Strauss