KTS
VALUATION ISSUES™
KLARIS, THOMSON & SCHROEDER, INC. 2008-1

# Andersen Case Review

*By John A. Thomson, ASA, MAI*

The Andersen case involved four LLC's each with various assets (oil and gas, royalty interests, and working interests). Two of the LLC's were relatively large, $25 million to $42 million in net asset value ("NAV"). The other two were much smaller, $2 million to $5 million in NAV. These oil and gas interests were primarily in Texas and Louisiana. The size of the subject interest in each of the LLC's varied from 25 percent to 37.5 percent. The valuation date was February 3, 1997. Each LLC had four members including the decedent and two of her sons. The two sons essentially managed the LLC's through a separate "operating company" (Andersen Oil & Gas Company). All services were essentially out sourced from the LLC's to Andersen Oil & Gas Company.

The taxpayer filed its 706 tax return using appraisals by Chaffee and Associates ("Chaffee") out of Shreveport, Louisiana. The IRS took issue with the appraisals and believed that the interests were significantly undervalued. The taxpayer then retained a second valuation expert, BDO Seidman ("Stryker"), out of New York. The second opinions were somewhat higher than the first by Chaffee, but still believed too low by the IRS. There was no resolution. The taxpayer paid the additional tax (based on a higher valuation by the IRS) and then filed for a refund in U.S. District Court. This transferred jurisdiction of the case to the Department of Justice ("DOJ".)

The DOJ then retained Klaris, Thomson & Schroeder, Inc. ("KTS"). KTS's appraisal opinions, although greater than the taxpayer's second appraisal opinions (Stryker), were lower than the IRS's original opinions. After the taxpayer received and reviewed the KTS appraisals, they retained Shannon Pratt, an independent practitioner, to act as the rebuttal witness to the KTS appraisals.

**When accepting an assignment as an expert witness for the government, try to remember that you will always be out numbered by the taxpayer's experts, think of it as a challenge!**

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There were essentially four valuation issues in the case, the application of the guideline approach to these oil and gas LLC's, the application of the NAV, the weight given to each approach and lastly the discounts taken. Whether the LLC's were operating companies or asset holding companies, all four appraisers, three for the taxpayer and one for the government, used the guideline or market approach. This indicates that none of the appraisers believed that the LLC's were solely asset holding companies which would generally call for only the NAV approach. The real issue then became how much weight to give to each approach.

We should state that Chaffee's complicated reports along with KTS's rebuttal of the Chaffee reports at trial essentially eliminated any consideration of the Chaffee reports. Stryker and KTS (Thomson) used the same approaches (market approach and the NAV approach.)

The underlying assets (oil and gas, royalty interests and working interests) were appraised by the taxpayer's oil and gas expert and were accepted by both sides. The oil and gas expert appraised these assets, utilizing the discounted cash flow ("DCF") approach, which is standard for these type of assets. The main sub issues within the market approach were which variations of the approach (market indicators) should be utilized and which market multiple from the guideline companies should be applied to the market indicators. Stryker, on behalf of the taxpayer, used a price to pre-tax cash flow (last twelve months,"LTM") indicator and a price to PV10 equity indicator (PV10 is an issue within itself peculiar to oil and gas that even Shannon Pratt was unfamiliar with at his deposition). Thomson used price to pre-tax cash flow, LTM, LFY (last five years, "LFY") and a three year average. Note that the current year was a very profitable year compared to the prior two years, and, therefore, a three year average

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***"The way to get started is to quit talking and begin doing."*** ***– Walt Disney***

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indicator was more conservative. Chaffee used five market indicators which provided a very significant swing in value. Another reason that the Chaffee reports were not given any consideration.

The price to PV10 equity indicator is essentially a price to an adjusted equity. The adjusted equity is based on valuation of the oil and gas assets utilizing the SEC required 10 percent discount rate in the discounted cash flow approach. The 10 percent discount rate may or may not be the appropriate market rate but it is required for financial reporting consistency among oil and gas companies by the SEC. KTS did not use this market indicator, as we believe that the NAV approach gave significant consideration to the underlying assets and the PV10 market indicator was confusing not only to Shannon Pratt but to the court. The court was very confused with the many variations presented in the guideline approach. However, they believed that the three indicators used by KTS and the two indicators used by Stryker (one of which was used by KTS) should be used. (Price to pre-tax cash flow LTM, LFY, a three year average, and price to PV10 equity.)

The choice of the comparable companies was never really an issue as several of the comparable companies were used by all the experts.

The next sub issue was which market multiple within the range of the multiples was appropriate as presented by the experts. Chaffee in their first reports, filed with the tax return (706), selected the median multiple, however, in their second (revised) reports for trial they adjusted the median multiple downward by 24 to 28 percent for size. We should also point out that Chaffee used a price to after tax cash flow (40 percent tax rate) where as Stryker and KTS used pretax cash flow (the LLC's did not pay any corporate income tax). KTS selected market multiples, 20 to 25 percent below the median. On the larger two companies, KTS used an adjusted multiple of 20 percent below the median and on the smaller two companies, KTS adjusted the median downward by 25 percent. Stryker used market multiples at the low end of their range which was approximately 45 percent below their median multiple. KTS considered the superior financial performance of the subject LLC's, their superior financial condition (no debt), their inferior (smaller) size, and the fact that they were private versus public companies. Stryker appeared to only consider the last two factors. KTS attempted to support their adjustment factor by comparing what public companies were acquired for (price to earnings multiple) on an average, versus private companies, as reported in the 1997 Mergerstat (as of the valuation date). Private companies in 1997 were acquired for approximately 20 percent less than public companies. The court liked the concept but thought that the data (as presented) was to generalized and not specific enough to the subject LLC's. Stryker selected a multiple at the low end of their multiple range giving significant weight to size differences. They appeared to give little or no weight to the subject LLC's superior financial condition or performance. The court accepted Stryker's selection. We believe that this decision by the court was heavily swayed by Pratt's rebuttal testimony and not necessarily by anything in the Stryker report.

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The next issue was the weight to give the market or a guideline approach versus the NAV approach. KTS weighted the NAV two to one compared to the market approach. Stryker weighted the market approach more heavily. The court agreed with KTS and weighted the NAV two to one versus the market approach. The primary factor here was how complicated the market approach appeared to the court. For example, one taxpayer appraiser used post-tax cash flow, the other used pre-tax cash flow. Chaffee used five different market indicators [price to earnings, after tax cash flow, PV10 Equity, revenue, and earnings before depreciation, interest, taxes, and amortization, (EBDITA)] with a very significant range of value. Also, the PV10 equity multiple and its application was complex, even Shannon Pratt was confused here. He did not realize that PV10 equity was not necessarily fair market value.[1]

The last issue was the marketability discount (the minority discounts among Stryker & KTS were very close, eight percent versus ten percent). Stryker used a 40 percent discount (lack of marketability) on his NAV approach for all four LLC's and 30 to 40 percent in his market approach. KTS used 28 to 31 percent depending on which LLC was being considered. The higher, 31 percent, was for the LLC with the lowest yield. Two factors helped the court conclude 40 percent. First, when Thomson of KTS was asked by the judge if 40 percent was within a reasonable range albeit at the upper end, Thomson replied yes, but at the very upper end for these LLC's. Secondly, Pratt (who impressed the judge with his credentials) testified, he believed the discount to be 45 percent. The judge thought because Pratt "wrote the book" he would be in "the middle of the road." However, 45 percent was not the middle of 30 to 40 percent. Pratt's 45 percent "unbias opinion" swayed the judge to conclude 40 percent as reasonable. It should be pointed out that the judge also allowed a 10 percent liquidation (transaction cost) discount, even thought liquidation was not required or contemplated.

In summary, the judge was new to the bench and appeared to be unfamiliar with valuation. Although he referred to Shannon Pratt as Carl Pratt, in his opinion, he was swayed by Pratt's credentials. The judge essentially disregarded (very politely) the taxpayer's original appraiser (Chaffee).

Their reports were difficult to follow and presented very significant swings in value. Also Chaffee's revised trial reports concluded the same answer, however, they made significant changes to their calculations. Lastly, Chaffee used after-tax cash flow versus pre-tax cash flow.

The range of cash flow multiples for Stryker and Thomson were not significantly different (4-11, when eliminating Stryker's outlier). Stryker selected his market multiple (5) from the low end of the range (approximately 40 percent below the median). Thomson selected his market multiple (6.6) 20 to 25 percent below the median depending on which LLC was being considered. The court accepted the low end swayed by Pratt. The marketability discounts by the three experts were 30 to 40 percent. Pratt's middle of the road discount was 45 percent and again the judge was swayed by Pratt to conclude at 40 percent. ❒

[1] *This occurred in Mr. Pratt's deposition prior to the trial.*

# What Is Your Practice Worth?

***By Luke Waller, ASA***

Have you ever wondered or maybe even needed to know what your practice is worth?

There are many reasons why the owner of a practice would want to have their practice valued. Some of the more common reasons for wanting the practice valued include:

- Gift and estate planning
- Business and succession planning
- Potential purchase or sale of a practice
- Merger
- Charitable contribution
- Marital dissolution
- Employee stock ownership plan (ESOP)
- Partner buy-out
- Financing

In order to determine the value or worth of a practice, one must first understand the meaning of value. Value can be defined in many different ways, but this article will focus on the process involved in determining the fair market value of a practice. According to the American Society of Appraisers, a long standing multi-disciplinary appraisal organization, fair market value is defined as "the price, expressed in cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." [1]

In the course of trying to ascertain what the fair market value of a practice is in a valuation engagement, the owner of a practice will be exposed to a due diligence process. The purpose of the due diligence process is to identify the potential risks associated with the ownership of the practice. During the course of due diligence, the owner of a practice may be asked to provide the following information to the appraiser:

- Financial statements
- Tax returns
- Leases on equipment or property
- Articles of incorporation/organization, bylaws, partnership agreements
- Marketing practices
- Overview of personnel and key management
- Strategic plans
- Description of operations (i.e., major customers, geographic region, etc.)
- Legal information regarding any current, past, or potential litigation involving the practice

After the appraiser has conducted the proper due diligence and received the information noted above, the appraisal process can begin.

Closely-held businesses, whether it be a furniture manufacturer, a beer distributor or even a practice, all have one thing in common. The ownership of the business is concentrated in the hands of only a few shareholders in which there is no publicly traded market for the shares. Therefore, in appraising a practice whose ownership is closely-held, it is advisable that the appraiser consider the following factors:

1. The nature of the practice and its history since inception;
2. The economic outlook in general and the outlook of the subject industry in particular;
3. The book value of the stock in the practice and the financial condition of the practice;
4. The earning capacity of the practice;
5. The dividend-paying capacity of the practice;
6. Whether or not the practice has goodwill or some other intangible value;
7. Prior sales of the practice's stock and size of the stock being valued;
8. The market price of stocks of corporations engaged in the same or similar line of business.

In appraising the value of a practice, there are three general approaches that could be used. These three approaches include the market approach, the income approach and the cost approach. The most commonly used of the three approaches are the market and income approaches. The cost approach is typically the least utilized approach in the valuation of a closely-held practice because it excludes the value of intangible assets which normally are the most valuable assets of a practice. Therefore, we will focus our discussion on the market and income approaches as it pertains to determining the value of a practice.

The first approach, the market approach, is a general way to determine a value indication of a practice ownership interest using one or more methods that compare the ownership interest in the practice being valued to similar interests that have been sold. Example methods employed under the market approach include the Guideline Company method and the Merger and Acquisition method.

The Guideline Company method, under the market approach, is predicated on the theory that the market value of a closely-held company, like a practice, can be estimated based on the prices investors are willing to pay for the stocks of similar, publicly traded companies. This estimation is made through the use of price ratios that relate the public companies' stock prices or invested capital (market value of stockholders' equity plus interest-bearing debt) to their sales, earnings, cash flows, or other financial measures. By comparing the financial performance of similar, publicly traded companies with that of the practice being valued, the appraiser can estimate the appropriate price multiples to use in estimating the market value of the subject practice.

The Merger and Acquisition method involves deriving indications of value for a practice from prices at which entire companies in similar lines of business have been sold or the prices at which significant interests in similar companies changed hands. The Merger and Acquisition method is predicated on the theory that the market value of a closely held business, like a practice, can be estimated based on prices that purchasers of closely-held businesses are paying for the stock or assets of similar closely-held businesses.

Another common approach employed in valuing a practice is the income approach, which requires that the earning capacity, whether it is derived from past, current, or projected earnings, be capitalized at a rate sufficient to satisfy the investment and business risk requirements of ownership. The application of this approach usually requires a sufficient earnings history to help give a clear indication of expected future performance. One of the more common methods used under the income approach is the Discounted Cash Flow ("DCF") method.

In valuing a practice using the DCF method, a practice's future revenue and its earning potential along with its estimated net capital requirements are projected typically five (5) years into the future in order

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to determine the net cash flows of the practice. These projected net cash flows are then brought to a present value (i.e., what is the value of these cash flows in today's dollars) at a discount rate reflecting the perceived risk of an investment of this type. In addition, a residual net cash flow is projected and capitalized in order to account for net cash flows earned by the practice beyond the fifth year of the projection. This residual capitalized value is then also discounted and brought to present value. The present value of the residual net cash flow and the sum of present values of the five one-year projected net cash flows are then summed to give an indication of the value of a practice under the DCF method.

The correlation of results is the final step in the valuation process in which the appraiser considers and selects from the various value indications to arrive at a final value estimate. The appraiser weighs the relative significance, applicability, and defensibility of each value indication and relies on the most appropriate. Although the correlation necessarily involves personal judgment, the appraiser's conclusions follow a careful, logical analysis of the procedures leading to a final indication of value.

In conclusion, the process of determining the worth of a practice can involve a number of complex issues. Having a good understanding of the due diligence process and the purpose for the appraisal are key in understanding what your practice is worth. Another key factor to having a successful appraisal performed of your practice is to make sure the appraiser has the proper qualifications and experience necessary to understand the dynamics of your practice as well as the dynamics of the particular industry. ❒

[1] The American Society of Appraisers, Retrieved October 14, 2004 from the American Society of Appraisers web site: http://www.bvappraisers.org/glossary/

## NEWS & NOTES

**Klaris, Thomson & Schroeder, Inc. is celebrating 15 years in business: 1993 - 2008!**

**KTS RECENT STAFF ADDITIONS:**

**Nancy J. Matheny**, CPA/ABV, ASA is a Senior Valuation Consultant in the St. Louis office.

**Robert C. Schultz**, CPA, is a Financial Consultant in the St. Louis office.

**Douglas E. Braunstein**, J.D., is a Valuation Consultant in the Washington, D.C. office.

In addition, our Los Angeles office welcomes our newest team member, **Krystle Taniguchi!**

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is a full service valuation and consulting company specializing in business valuations, intangible asset valuations, financial consulting, expert testimony and litigation support. In addition, we also perform real estate valuations, machinery and equipment valuations, and international transfer pricing analyses.

*For more information or a free valuation seminar for your firm or professional group, please call Anita Thomson at (877) 587-7008, or e-mail your request to ktsinc@verizon.net.*

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