

SMALL BUSINESS STRATEGIES

Can your appraisal beat an audit?

By ANTHONY F. MOLLICA

Appraising a closely held corporation poses a variety of intricate problems.

Here are just two potentially tricky areas: determining consumer demand for the company's products or services and determining the industry's and company's stage in the business "life cycle."

Further complicating the process can be the purpose of the appraisal. Among the reasons for business appraisals are estate planning, gifting, divorce, merger, sale or employee stock option plans (ESOPs).

The appraisal process becomes more involved when the assignment is not only to estimate the value of the closely held corporation, but to allocate this value into minority shares, majority shares, voting shares, non-voting shares, participating shares, non-participating shares, preferred shares and other classes of shares that may get preferential treatment for dividends or distributions from sale.

Document your findings

After determining the assignment's scope, the next step is to find out what documentation is required. For IRS purposes, the stock valuation in a closely held corporation must be supported by an appraisal report that meets the requirements of Revenue Ruling 59-60 and its amendments. To meet these requirements, the appraisal must cover 13 separate categories, including a description of the business, its products, number of employees, management profiles, wage rates and trends.

After determining value, the appraiser must show in detail all financial calculations. Further, if a fractional interest is being appraised, the tax cases or other data relied upon for discounts must be presented and explained.

The Department of Labor (DOL) regulates ESOPs and, because they are

statutorily defined as Employee Benefit Pension Plans, the appraisals come under close scrutiny. The DOL considers its regulations to be consistent with the IRS, however, they have additional requirements. The DOL is continually updating the requirements and the most recent update added "adequate consideration."

Adequate consideration is defined as "the fair market value determined in good faith. Good faith requirements set an objective standard of conduct for the fiduciary."

Good faith is defined as "applying sound business principles of valuation and conducting a prudent investigation of all



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circumstances prevailing at the time of the valuation."

Preparing for legal challenges

Divorce or other litigation requires the appraiser to prepare an appraisal report that can be easily understood by lawyers, judges and juries. When preparing an appraisal report for litigation with juries involved, consideration must be given to

the sequence in which the evidence will be presented and the evidence that will be offered by opposing witnesses.

Professional appraisers are objective witnesses, however, they must be concerned with making an understandable presentation to support their opinion.

The value of a closely held corporation must be allocated among the tangibles and intangibles. The intangibles can include goodwill and patents.

Goodwill can be defined as the value that exists in addition to the value of the tangible assets (furniture, fixtures, equipment, inventory, etc.) which is created by the synergy between management, products, location, merchandising and continuing customer satisfaction.

Patents are special licenses issued by the U.S. government for the manufacture and exclusive right to make, sell or lease a certain product.

Common mistakes

Some common mistakes include relying upon unadjusted financial statements and using unadjusted book values as a basis for valuation. Book value is the historical cost less depreciation of the tangible assets and generally has little relationship to economic reality.

Financial statements (including audited statements) accurately reflect the results of the company's operations for tax purposes, but they are not designed to reflect market value or economic reality.

When employing an appraiser, be sure to find one with experience in valuing companies in the line of business being appraised. Always ask for details about the appraiser's background, professional designations and related appraisal experience.

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