Will Your Business Valuation Stand Up to Scrutiny?

There are many reasons a dealership may require a business valuation; buy-sell agreements, shareholder disputes, employee stock ownership plans (ESOPs) and estate planning and gifting strategies.

In many instances, there will be an opposing party who questions the validity of the final value, whether it be a dissenting stockholder or the Internal Revenue Service (IRS). It is imperative that the dealer be aware of the basic characteristics of a valuation so he is able to make sure that the valuation analyst is using sound judgments and that, if challenged, the value will be defensible.

The Basics

Uniform Standards of Professional Appraisal Practice (USPAP) were developed by the Appraisal Standards Board (ASB) of the Appraisal Foundation to provide guidelines to be adhered to in performing a valuation. Most professional valuation analysts will conform to these standards.

In addition, the IRS issued Revenue Ruling 59-60 to document relevant factors to be considered when performing a business valuation, which are:

- The history and nature of the business
- The economic outlook of the United States and that of the specific industry in particular
- The book value of the subject company's stock and the financial condition of the business
- The earnings capacity of the company
- The dividend paying capacity of the company
- Whether or not the firm has goodwill or other intangible value
- Sales of the stock and size of the block of stock to be valued
- The market price of publicly-traded stock or corporations engaged in similar industries or lines of business

Adhering to the above standards and addressing all relevant factors are the first elements that will be scrutinized by someone questioning the valuation. But what other elements will be examined?

Normalization Adjustments

Adjustments may have to be made to historical financial statements to present them in "realistic" terms. For example, abnormal officer compensation or unreasonable rent paid on self-rented property would have to be adjusted to an amount typical in the industry. These adjustments are called normalization adjustments.
Other normalization adjustments that are common when valuing a dealership might be:

**LIFO Inventory Valuation Adjustments:** Favorable tax treatment is afforded to dealerships that utilize the LIFO (last-in first-out) method of inventory valuation. However, for valuation purposes, the effect of changes in the LIFO reserve does not present a true picture of the dealership’s earning potential. Therefore, a normalization adjustment must be made to reflect income as if the specific identification inventory valuation method was used.

**Uniform Capitalization (Section 263A) Adjustments:** The IRS also requires that costs associated with carrying inventory be capitalized (Section 263A—Capitalization Period of Direct and Indirect Costs). A portion of expenses such as salaries, employee benefits, rent, telephone, insurance and data processing must be reclassified and reflected as an additional asset on the balance sheet. If not for the IRS requirement, one hundred percent of these expenses would be reflected and a reduction of economic income would result. Again, where the books are kept on an income tax basis, normalization adjustment is needed to reverse this entry.

**Unusual Commission Structure Adjustments:** Commission structures can vary greatly from dealership to dealership. Unconventional and uncommon structures may be used as a way of pacifying salespeople or to create additional selling incentives. Whatever the reason, if the commission expense is not considered within the parameter of the industry norm, a normalization adjustment must be made to reflect this.

**Non-operating Income and Expenses:** When a dealership has non-operating items of income and/or expense, they should be removed to reflect a normalized income statement. For example, if a dealership owns real estate from which it is deriving net income that is unrelated to the operation of the business, such net income should not be included on the normalized income statement. Then the dealership can be valued on an operating basis. The fair market value of the non-operating assets can be added to the operating value.

**Related Party Rent Adjustments:** In many cases, dealership property is owned by related real estate entities. It is common that rent paid by the dealership is tax-motivated and is not comparable to the going rate of the real estate market. If this is the case, a normalization adjustment will be made to adjust this expense to the rent charged in the market area.

These are just some of the normalization adjustments that may be required. Each valuation must be analyzed independently.

It can be expected that the adequacy of these types of adjustments will be examined.

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**Capitalization Rate**

One of the most subjective areas of the business valuation is the formation of the capitalization rate. The dealership’s financial position must be analyzed to identify strengths and weaknesses. The valuation analyst must assess the risk associated with an investment in the company. This risk assessment must then be converted into a capitalization rate. This is another area that could be challenged if scrutinized. It is important to have detailed backup for all conclusions reached in formulating this rate.

**Intangible Value of Goodwill**

In every valuation of a dealership, consideration should be given to the intangible value of goodwill. Franchise agreements, customer contracts, customer lists and customer relationships all have an intangible worth that must be translated into a goodwill or blue sky value.

The capitalized excess earnings method is the most commonly used method for estimating a company’s goodwill. Utilizing this method will determine what portion of the total value of the company is attributable to goodwill.

An important part of the computation when using this method is the selection of an excess earnings, capitalization rate. This is the rate which is used to convert excess earnings into a goodwill value. Again, this is a very subjective judgment that will be a prime area of scrutiny.

Many dealers have an unrealistic expectation of their dealership’s goodwill value. Public companies, such as Penske and Lithia, have been paying very high multiples of earnings for dealerships around the country. But is this an indication of the true value of the dealership or a reflection of the premium the public companies are willing to pay to enhance their entire organization for such items as increased overall revenues or the addition of a particular franchise?
The standard of value in a valuation report is usually fair market value, which is defined in the IRS Revenue Ruling 59-60 as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

A dealer should want his valuation report to adhere to this concept. Using high multiples of earnings based on transactions of public companies for most dealerships' valuations would be inappropriate. The financial data of the dealerships involved in public company transactions must be comparable to the dealership being valued. This is usually not the case.

**Premiums and Discounts**

An important part of any valuation is the selection of appropriate premiums or discounts. The marketability of the dealership, or the lack thereof, and the interest being valued (either controlling or minority) would have to be determined. A proficient valuation analyst will use a number of resources including prior court cases to help in determining what premiums or discounts are applicable.

The purpose of a valuation is to value some portion of the stock of the company. Valuing less than fifty-one percent of the stock is considered a minority interest value. A purchaser would not be willing to pay the same amount for stock if they are unable to exercise control. Therefore, a minority interest discount would be appropriate. The reverse of this is true when valuing an interest of more than fifty percent. This person would be expected to pay a premium for control of the company. Therefore, a control premium would be appropriate.

The stock of a dealership, other than a public company, is not equivalent to stock of, say, IBM. It cannot be bought and sold on the open market. Because of this restriction, a discount would be appropriate to account for the lack of marketability.

The application of these premiums and discounts are contingent upon what valuation methods are being used. The valuation analyst must guard against inappropriate usage.

If an unreasonable or unsubstantiated percentage is used, the entire valuation is in jeopardy of being deemed worthless.

**Conclusion**

Much of the planning and strategies developed by the dealer to minimize taxes and maximize wealth will revolve around the value of the business. Once the decision is made to have a business valuation performed, the dealer must make certain that the valuation analyst is going to adhere to the professional standards established and that reasonable judgments will be used so that the valuation work product will stand up to tough scrutiny.