

# ADVOCATE'S **EDGE**



*Bohac v. Benes Service Co.*  
Is the asset-based approach relevant for going concerns?

Factors to consider when selecting guideline companies

Appellate court overturns ruling based on “incompetent” valuation

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## *Bohac v. Benes Service Co.*

# Is the asset-based approach relevant for going concerns?

The appropriate technique for valuing a business depends on a variety of factors, including the type of business, its plans for the future and the valuation's purpose. In a recent dissenting shareholder case, the Nebraska Supreme Court found that the circumstances called for an asset-based (or cost) approach to value a business that's a viable going concern.

### **Dissolution dispute**

The case involved a family-owned farming operation that included a farm implement division. The business was founded by a married couple in 1966. When the husband died in 2011, four of their five sons took over the company's management. When the wife died in 2017, she held approximately 15% of the outstanding stock, and the four sons who were actively involved in the business each owned 20% to 21% of the stock.

The personal representative for the wife's estate discovered some business practices that troubled her. She filed a petition for dissolution of the

company, alleging the four sons acted in an "illegal, oppressive and/or fraudulent manner" in multiple circumstances. For example, they didn't hold required meetings, obtain director and stockholder approval for major transactions, or properly report income.

The asset-based approach isn't used *exclusively* for companies facing liquidation.

The company denied the allegations and filed an election to purchase the estate's interest. The personal representative was obligated to sell the estate's interest in lieu of judicial dissolution pending a determination of the fair value of the interest.

The district court valued the interest at about \$2.9 million. The company appealed, arguing that the court should have applied the income approach to value the company, rather than the asset-based approach put forth by the estate's expert.

### **Asset-based vs. income approach**

Under the asset-based approach, each asset is assigned a fair market value (FMV) based on its value if the business were sold.



## Fair value vs. fair market value

The opinion in *Bohac* (see main article) used two common valuation terms — fair value (FV) and fair market value (FMV). The terms sometimes are confused.

IRS Revenue Ruling 59-60 defines FMV as “[T]he price at which the 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.” This standard of value is typically used to value business interests for estate and gift tax purposes. It may be subject to discounts for lack of control and/or marketability.

In dissenting shareholder cases in most states, FV usually is more relevant. FV for these cases may be defined by state statute or case law. For example, in *Bohac*, state law dictated that FV be determined using “customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal.” As in many other states, Nebraska generally doesn’t allow discounts for lack of control or marketability when calculating FV.

Liabilities are deducted from the total value to reach the FMV of the company’s equity. Often, the asset-based approach sets a floor for a company’s value.

The income approach reflects the anticipated benefits of owning a business. It’s based on the company’s projected cash flow and considers historical data in making projections.

### Rejected premise

The estate held that the company’s expert mistakenly confused use of the asset-based approach with a liquidation premise of value. Under the liquidation premise, the company’s assets are assumed to be sold piecemeal, and the business is terminated. In contrast, the going concern premise assumes the business will continue operating into the future.

The Nebraska Supreme Court agreed with the estate. It held that the principle of “highest and best use” didn’t require it to apply a liquidation premise of value when the company was clearly a going concern.

In terms of the appropriate valuation method, the asset-based approach isn’t used *exclusively* for companies facing liquidation. Going concern

entities can also be valued using the asset-based approach, along with the market and income approaches.

In *Bohac*, both valuation experts agreed that the market approach was inapplicable, because there were insufficient comparable corporations or prior sales that could be used to draw a comparison. Of the two remaining valuation methods, the asset-based approach yielded higher valuation amounts than the income approach from both sides’ experts at trial.

The Nebraska Supreme Court concluded that, due to many factors, the asset-based approach was the proper method to value the company. In particular, the company relied heavily on its significant fixed assets, such as equipment and parts inventory.

### Special circumstances

The asset-based approach isn’t appropriate for every business. For instance, it can be difficult to use for companies with significant earnings capacity and/or intangible assets. But, as the court found in *Bohac*, it can prove a good choice for going concern companies with considerable tangible assets. This case also highlights the importance of discussing the appropriate standard and premise of value with your expert at the start of the valuation process. ■

# Factors to consider when selecting guideline companies

**W**hen valuing businesses, experts often rely on the guideline transaction method. This technique, also called the guideline merger and acquisition (M&A) method, derives pricing multiples from the market prices of controlling interests in companies engaged in the same or similar lines of business as the subject company. Is this method right for your situation?

## Selection criteria

Business valuation experts can only use the guideline transaction method when relevant comparable transactions are available. In assessing potential guideline companies for selection, experts may consider the following factors:

- Industries served and market share within them,
- Size, in terms of revenue and assets,
- Type and diversity of operations, markets, and products or services,
- Quality and depth of management,
- Capital structure,
- Geographic location and demographics,
- Historical and future revenue and earnings growth,
- Years of operation,
- Technological development, and
- Intellectual property protection such as copyrights and patents.

An expert's written report usually identifies the criteria used to select guideline companies. Should you wind up in court, those criteria, and those that were ignored, can prove useful when examining expert witnesses.

Beware: Although courts and the IRS may gravitate toward the guideline transaction method for its perceived objectivity, it should be used with caution. Many of the details and terms of a sales transaction, as well as the underlying motives of the buyer and seller, may not be known. Buyer-specific considerations may not be universal to the hypothetical universe of buyers and sellers that is assumed to exist under the fair market value standard.

## Sample size

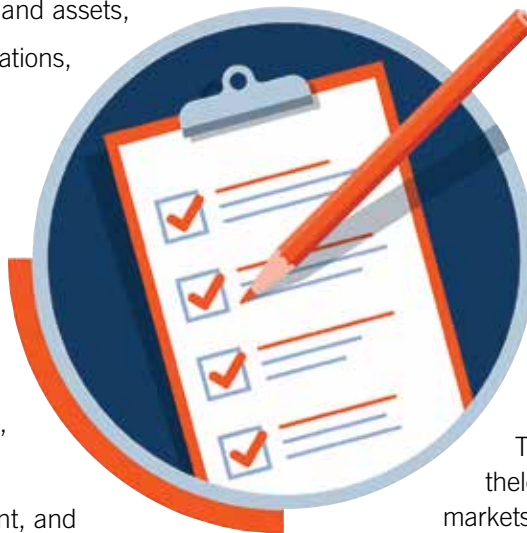
There are no rules regarding the number of guideline companies that are needed to provide a meaningful data set. However, experts typically use at least three guideline companies. The more similar data points that exist between the guideline and subject companies, the fewer the number of guideline companies needed.

Guideline companies should provide a reasonable basis for comparison to the investment characteristics of the company being valued. Ideal guideline companies operate in the same industry. But if sufficient data isn't available from within the industry, a valuation professional could select companies in other industries.

These companies should nonetheless share characteristics such as markets, products, growth and cyclical variability with the subject company.

## Pricing multiples

Once a valuation expert selects guideline companies, it's time to compute pricing multiples that compare the purchase price to various financial metrics, such as price-to-earnings or price-to-revenue. The



appropriate metric depends on the characteristics of the subject company.

For example, price-to-book value may be appropriate when valuing asset holding companies. Alternatively, price-to-revenue may be appropriate when valuing a subject company that has a different cost structure or tax planning objectives than the guideline companies have. And price-to-revenue also may make sense when the subject company uses the tax or cash-basis of accounting and guideline companies use the accrual-basis accounting method.

Often, pricing multiples for operating companies are based on some form of earnings, such as net income, operating cash flow, seller's discretionary cash flow, or earnings before interest, taxes, depreciation and amortization expenses (EBITDA). When using earnings-based multiples, it's important for experts to analyze guideline companies' financial

data and adjust as needed so that the guideline companies might adequately be compared to the subject company.

In general, valuation experts should know how each private transaction database defines financial terms. Failure to understand key terms, such as earnings, or what's in (or excluded from) the purchase price could result in apples-to-oranges comparisons.

### Word of caution

The guideline transaction method is used when it's the most appropriate based on the facts and circumstances. When other methods are available, it's generally not appropriate to use this method alone. Instead, use it with alternative valuation methods and reconcile why the results of this method may differ from other methods. Contact a business valuation professional for more information. ■

## Appellate court overturns ruling based on “incompetent” valuation

**W**weak valuation testimony may sometimes satisfy a jury. But it can come back to haunt you on appeal. A government agency learned that lesson the hard way in a recent Pennsylvania eminent domain case (*State Route 00700, Section 21H v. Bentleyville Garden Inn, Inc.*).

### Highway construction leads to litigation

In 2015, the Pennsylvania Department of Transportation (PennDOT) paid a hotel owner (“the condemnee”) \$286,915 as “just compensation” for the partial taking of his 5.902-acre property. The taking included a permanent acquisition of 1.140 acres for a new exit ramp from Interstate 70 and a temporary acquisition of 0.856 acres for use during construction. PennDOT broke ground in March 2016 and completed the project in November 2018.

In 2017, in response to a filing by the condemnee, the state Board of Viewers awarded the property owner \$2.9 million as just compensation. PennDOT appealed, leading to a jury trial. The jury awarded \$355,000 in damages for the taking of two acres to construct the exit ramp — the amount proposed by PennDOT's certified real estate appraiser.

It awarded no damages for the effect of the partial taking on the remaining property. Evidence indicated that the hotel's occupancy rate had dropped to less than half of its pre-construction level. Its revenues remained depressed post-construction, while those of competitors in the area had improved.

The condemnee appealed. Among other things, it argued that the PennDOT appraiser's testimony was incompetent.

## Appellate court checks in

The Commonwealth Court of Pennsylvania agreed with the condemnee when it came to PennDOT's expert. The appellate court began its analysis of his testimony by noting that the appraiser didn't consider "damages related to business loss" caused by the highway project when calculating the after-taking value of the property.

The appraiser wrongly believed that the state eminent domain law didn't allow him to consider the hotel's depressed revenue related to the construction project. To the contrary, the court said, the statute expressly authorizes a valuation based on a "capitalization of the net rental or reasonable net rental of

the condemned property." The appraiser also didn't understand the distinction between this type of capitalization and the capitalization of income or profits of a business conducted by a tenant — only the latter is prohibited by statute. As long as income is capitalized to value real property, opposed to a leasehold interest, it's expressly authorized by statute.

The "incompetence" didn't stop there. The appraiser further failed to consider the "damages or benefits specially affecting the remaining property due to the proximity" of the new ramp, as required by the eminent domain code. Instead, he wrongly assumed such damages couldn't be considered because the construction project was temporary.

The ramp itself, however, was permanent, and the disruption created by the lengthy project "was lasting in its effect." The court determined that the loss of revenue before, during and after construction is relevant when establishing the damages for remaining property put to a hotel use.

## Return visit

The appellate court held that the only competent expert testimony on the value of the property came from the condemnee's expert. He properly capitalized the property's revenue to establish an after-taking value and factored in the injury to the remaining property. The jury relied solely on PennDOT's appraiser's valuation, though, so the verdict was reversed and remanded for a new trial. ■

# Don't let fraud disrupt your M&A deal

**D**ue diligence is key when buying or merging with another business. Today, many M&A deals involve companies that were disrupted by the pandemic, as well as those that have been adversely affected by recent supply

chain shortages and geopolitical issues. Not only is it important to vet the seller's financial statements, projections and representations for errors and exaggerations, but buyers need to look for potential signs of fraud.

## Reviewing the financials

In today's volatile marketplace, a seller who's under duress may be tempted to make a distressed company appear healthier than it truly is. For example, the seller could:

- Report revenue prematurely (or fictitiously),
- Postpone expense recognition,
- Project unrealistic post-pandemic growth rates, and
- Fail to write off uncollectible receivables, obsolete inventory or impaired goodwill.

Creative accounting tactics, errors and other anomalies are especially common in smaller companies that don't have their statements audited by outside experts or that may not have adequate internal financial expertise. A forensic accounting expert can help evaluate the seller's financial statements for warning signs of fraud and review the assumptions underlying projections to determine whether they're supported by historical trends and current market data.

## Evaluating management

In addition to evaluating the target company's control environment for opportunities to commit fraud, due diligence procedures should include background checks on the company's principals. It's also important to watch for *behavioral* warning signs of fraud. People who exaggerate results or commit fraud may exhibit control issues, such as an unwillingness to share duties, files or billing records. They also may become irritable or defensive when confronted about irregularities or potential conflicts of interest.

Although it's better to detect fraud before a deal closes, a buyer might consider having an indemnification clause written into the purchase agreement. This measure can help protect the buyer against any lies that affect the purchase.

## Researching external sources

During due diligence, buyers should look beyond the information provided by sellers. For example, regulatory disapproval, pending lawsuits, customer complaints and suspicious supplier relationships could forewarn of potential issues.

Due diligence procedures should include background checks on the company's principals.

This information may be found through online searches of the company and members of its management team. A forensic accountant might suggest additional procedures — similar to those done during an audit — to help validate account balances and search for unreported liabilities and risk factors.

## What's a deal breaker?

Evidence of fraud and other anomalies cause some potential buyers to rescind their offers — but not always. In less-serious situations, it may be appropriate to adjust the purchase price or change the deal's structure. A forensic expert can help determine what's appropriate based on the circumstances. ■





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