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Valuation Of Closely Held Corporate Stock

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VALUATION OF CLOSELY HELD CORPORATE STOCK

by

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This independent study is submitted by Steven M. Haines in partial fulfillment of the requirements for the Degree of Master of Business Administration from the University of North Dakota and is hereby approved by the Faculty Advisor under whom the work has been done.

R A Bertsch

Advisor

PERMISSION

Title: Valuation of Closely Held Corporate Stock

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CHAPTER 1

INTRODUCTION

There are approximately 1.7 million corporations filing reports with the United States Treasury. Only 43,200 of these corporations are traded on the exchanges or over-the-counter.[1] The remaining corporations are not actively traded and can be classified as closely held stocks. For the purpose of this study, a closely held stock is defined as stock not being traded on a national securities exchange or in a regularly quoted over-the-counter market.

Most American businessmen are unaware of the tremendous amount of litigation arising out of shareholder disputes, particularly in closely held corporations.[2] The central issue in the majority of these disputes is the fair market value of the corporate stock.

The determination of fair market value of stock is required for a variety of reasons. Upon the death of a shareholder, the stock must be valued for Federal Estate and State Inheritance Tax Returns. For estate planning the stockholder will need to know the value of his stock in order to estimate the size of his estate. Then he can project the estate tax bill in order to assure the heirs will have

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[1]Harry H. Ness, "Valuing Closely Held Company Shares," _Textile World_, December 1974, p. 87.

[2]Michael S. Megna, "Appraising Closely-Held Share Capital," _Trusts & Estates_, September 1978, p. 561.

adequate asset liquidity to pay the tax. In gifting stock, the shareholder will need to know the fair market value in order to file a gift tax return.

In major refinancing, the stockholders must offer to creditors or security purchasers a realistic appraisal of the value of the business.

Acquisition of or merger with another company will also require valuation of the business. If the stockholders wish to tax advantage offered by creation of an employee stock purchase, they will have to know the value of the business in order to fix the price on stock acquired by the employees. Finally, the Internal Revenue Service sometimes challenges the size of salaries and fringe benefits of closely held corporate stockholders. The IRS views excessive compensation as dividends which should be taxed at the corporate level and the stockholder level. Such charges can be defended if the value of the business is known.[3] Whatever the reason, stockholders will eventually need to have their shares evaluated.

Normally, the fair market value of stock is the amount at which shares would exchange between a willing buyer and a willing seller, with neither being under any compulsion to buy or sell and with both parties being fully informed of all facts at hand.[4] The mere definition of closely held stock excludes this type of valuation. Other valuation factors must be applied to closely held corporate stock. Since most

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[3]Donald Moffitt, "Why You Should Set Value on Your Business: Professionals Tell How to Make an Appraisal," The Wall Street Journal, July 25, 1977, p. 24

[4]U.S. Treasury Regulation, Section 20.2031-1(b).

valuation disputes pertain to the tax consequences, it is important to be familiar with the valuation guidelines provided by the Internal Revenue Service. Revenue Ruling 59-60 outlines the factors to consider in valuing the stock of closely held corporations or the stock of corporations where market quotations are not available. The ruling states that the following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise from its inception.

(b) The economic outlook in general and the condition and outlook of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Whether or not the enterprise has goodwill or other intangible value.

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in free and open market, either on an exchange or over-the-counter.

In addition to the above factors, Revenue Ruling 59-60 addresses other issues such as the weight to be accorded various factors, capitalization rates, averaging of factors and restrictive agreements.

Revenue Ruling 69-609 reaffirmed the procedures set forth in 59-60, but also updated the formula approach in the determination of fair market value of intangible assets of a business. The gist of the ruling is that the formula approach may be used only if there is no better basis available for making the determination. The ruling gives suggested rates of return on investment and capitalization of earnings in excess of a fair rate of return on net tangible assets.

It should be noted that Revenue Ruling 59-60 is written in very general terms. The factors outlined are merely guideposts used by the Internal Revenue Service in valuing closely held stock. The Internal Revenue Service concedes that there is no single formula that can be applied to all valuation cases.[5] Hence, the value of a closely held corporation interest will be determined by the ability of the appraiser to convince the Service, the court, or concerned party of the value applied.

It is the objective of this paper to expand upon the above factors through interpretations of tax practitioners, appraisers, estate planners and the tax courts. These factors will then be utilized in evaluating the fair market value of closely held stock in a case study. This presentation will hopefully outline logical and useful guidelines that will minimize wasted time, undue expense and possible litigation in future appraisals.

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[5]Revenue Ruling 59-60, 1959-1, C.B. 237.

CHAPTER 2

VALUATION METHODS USED

The following chapter is a discussion of the valuation factors outlined in Revenue Ruling 59-60. From these factors evolve expanded applications and techniques used by attorneys, accountants and appraisers.

The Nature and History of the Business

In determining the appropriate valuation method, the evaluator should initially become familiar with the company's basic operation, which may dictate the valuation method. The goal should be to develop a clear understanding of the company's business, how its operations are carried out, the method or organization, key management personnel, and the general level of development reached by the company.[6]

The evaluator should investigate the legal and financial structure of the firm. This can be accomplished by collecting and reviewing past financial statements, articles of incorporation, by-laws, minutes of board meetings, contracts and insurance policies.

If a business has a substantial portion of its assets in equipment and real property, these assets lend themselves to valuation by appraisal. However, if the company tends to have higher or unusual earnings as compared to competitors, it may lend itself to an evaluation

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[6] D. Michael Connellan, "Appraising Closely Held Companies," Bankers Monthly Magazine, December 1976, p. 20.

method related to earnings.

Legal considerations may uncover liens against the assets which will impair the value of the assets. Further analysis of the nature of the business may unfold valuable patents, exclusive contract rights, or know-how that is not adequately covered in the financial statements.

One owner may clearly dominate the company by virtue of the force of his personality, talents or special knowledge. The loss of this key man may have a devastating effect upon the value of the corporate stock. Review of insurance policies will indicate if there is sufficient coverage against such a loss as the death of key personnel in order to sustain the company until replacement or recovery can be made.

The environment and attitude of the community will also indicate the future success of the company. The product or service furnished by the company must also be scrutinized to insure there is a demand present and to give evidence that there does exist a going concern.

Giving attention to the business's history will give a picture of the company's stability, growth, diversity and other factors that help to determine the degree of risk inherent in the business.[7]

Economic Outlook

A knowledge of the general economic conditions and conditions within the specific industry are essential to any appraisal. Forecasts of general business conditions make possible forecasts of the sales of particular industries or individual firms.[8] Unemployment, inflation, monetary

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[7] "How to Value Closely Held Stock for Estate Tax Purposes," Institute for Business Planning, June 1976, p. ii.

[8] W.W. Haynes, Managerial Economics (Georgetown, Ontario: The Dorsey Press, 1963; revised ed., Dallas: Business Publications, Inc., 1969), p. 121.

policy, international trade, etc. all have an effect on the general business conditions and the specific firm. These macro considerations effect the future potential earnings and costs of the firm. Market structure, elasticities of demand and supply, company and product life cycles also serve as a basis for an understanding of the competitive standing of the company and its industry. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy.[9]

Book Value

Book value is the excess of the value of the corporation's assets over its liabilities. In valuing stock by this method the appraiser should obtain the balance sheet dated nearest the valuation date. Assets shown on the balance sheet have been acquired over a period of time spanning different price levels and economic circumstances. The prices paid for the various assets at the time of purchase may differ drastically from the current market value of these assets.[10] Therefore adjustments need to be made to the assets and liabilities in order to reflect the true net asset value.

Accounts receivable should be discounted based upon past collection success. Investments and marketable securities are usually reported in financial statements at the lower of cost or market, however, for evaluation purposes these investments should be listed at their realizable amounts at the date of valuation. This is of considerable importance

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[9] Revenue Ruling 59-60.

[10] Richard C. Scott, "Pricing the Going Concern," Journal of Small Business Management, July 1977, p. 37.

for a company whose assets are predominately investments.

Inventories are another area of concern in the valuation process. Different industries value their inventories in several different methods. Some firms may expense large quantities of supplies rather than showing them as an asset on the books. In some instances, obsolete inventories may remain on the books as an asset, thus requiring an adjustment. Land, buildings and equipment should be adjusted to current market value.

Intangible assets such as goodwill are normally recorded on the books only when they are acquired by purchase or otherwise established through a business transaction. Because goodwill is associated with the earnings that cannot be attributed to a normal return on identifiable assets, the ultimate evaluation of goodwill depends upon the valuation of those business properties that can be identified.[11] The IRS sets forth in Revenue Ruling 68-609 that a reasonable return on tangible assets would be either an industry average or 8 percent for lower risk businesses to 10 percent for high risk businesses. The capitalization rate on intangibles would than be 15 percent in low risk business and 20 percent on high risk business. This higher rate recognizes the degree of risk that characterizes goodwill.

Reserves for contingent liabilities should be eliminated. These reserves should be added back to retained earnings unless the liability is imminent and can be reasonably calculated.

If the corporation has more than one class of stock outstanding, the explicit rights of each class of stock as to voting power and

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[11] Harry Simons, Intermediate Accounting, 5th ed. (Cincinnati: South-Western Publishing Company, 1972), p. 558.

dividend preference should be noted.

In general, the entire balance sheet should be scrutinized and each asset and liability should be given proper weight. In this process the appraiser would be wise in soliciting the advice of outside professionals. The expert opinion of an outside third party carries considerable weight.

This balance sheet approach to stock valuation problems can give additional insight into the company's financial condition. Numerous financial ratios can be calculated from balance sheet amounts, thus enabling the appraiser to compare the firm's financial structure against similar companies within the industry.

The adjusted book value per share is nothing more than the total net asset value divided by the number of shares outstanding.

There is a difference of opinion among the professional appraisers as to the validity of this approach in valuation problems. James W. Jenkins, financial consultant, feels that net book value rarely provides a useful guide to business valuation and is only valid when stock values are low relative to earnings. Its usefulness than is that it might form a lower limit for a proper stock value.[12] Mr. Jenkins' opinion is founded on the premise that the net asset value is based around liquidation of the business. The approach given in this study is based on the concept that the business is a going concern. Therefore, values are not derived from distress sales.

An article in Financial World stresses that the book value approach

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[12] James W. Jenkins, "The Valuation of a Business: An Overview," The Appraisal Journal, January 1980, p. 77.

to stock valuations is an overlooked tool. This approach gives an indication of the value of the underlying assets. Companies showing a high working capital per share are attractive to acquisition minded corporations.[13] The highlights surfaced by this approach may have a large effect upon the ultimate value of the stock.

Earning Capacity

Unlike the preceding book value method, which concentrated upon the balance sheet, the earning capacity approach utilizes the income statement for the determination of stock value.

In making an evaluation by reference to earnings it must be kept in mind that a prospective buyer of corporate stock assumes the corporation is a going concern and that he will earn a reasonable return on his investment. The price he pays will depend upon the risk involved and the earnings record of the corporation.

This approach requires that the past earning record of the firm must be analyzed in order to identify trends and possible adjustments. Revenue Ruling 59-60 suggests that five or more year's earnings should be taken into account. Each year's income statement should be analyzed for proper adjustments such as was done in the book value approach concerning the balance sheet.

If one of the year's income statements shows a loss, the reason behind the loss should be sought. If it is a result of an accounting adjustment or similar non-recurring item, then the income figure should be adjusted.

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[13]"Net Asset Value," Financial World, December 15, 1975, p. 31.

If some of the prior years include earnings which were inflated or deflated due to unusual economic conditions affecting the economy generally or the specific industry, suitable adjustments should be made or the years earnings should be omitted entirely.

Capital gains and losses distort the earnings trends and should be eliminated. Excess depreciation should be added back to net earnings if fixed assets are depreciated on an accelerated basis.

Sometimes in a closely held company officer-stockholders receive compensation in excess of the value of services rendered. Also, loans to officer-stockholders may be at an unusually low interest rate distorting the earnings. In both cases, adjustments may be deemed necessary.

After all the years income statements have been adjusted an average yearly earnings figure can be calculated. This figure should be net earnings after Federal and State income taxes, but before reduction of any dividends paid.

A capitalization rate or a price earnings ratio must than be applied to the earnings figure to arrive at an estimate of market value under this approach. The price earnings ratio is the inverse of the capitalization rate. To capital earnings either divide the yearly earnings figure by the capitalization rate or multiply it by the price earnings ratio.[14]

The problem with these approaches is that it is difficult to determine an accurate capitalization rate or comparable price earnings ratio.

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[14] Jeffrey E. Lamson, "Factors That Will Substantiate the Valuation of a Closely Held Corporation," The Journal of Taxation, April 1971, p. 227.

The capitalization of indicated earnings must be consistent with the buyer's expectation of a reasonable return on investment based on relative risk and to a lesser extent, current interest rates.[15] The problem with the price earnings method is the ability to find a truly comparable company with the industry. The size of the comparable company and the earnings trend should be similar.

After applying the capitalization rate to the adjusted net income figure, this amount is then divided by the number of shares outstanding. The calculated amount represents the fair market value per share using the income approach.

Another application emphasizing the income statement is the discounted future earnings approach. This approach focuses on two important factors: the amounts of the expected future earnings stream and an appropriate discount rate. Earnings in future years are forecasted by determining suitable growth rates and capitalizing the net income estimates. These estimates are then discounted to the present value. The difference in use between the discounting process and the straight capitalization process is mainly dependent on the assumed future life of the investment. If the life of the operation is limited, the discounting method may be preferred.[16]

Dividend-Paying Capacity

Dividend-paying capacity rather than actual dividends paid should

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[15] David T. Vass, "Factors That Are Presently Being Emphasized in Valuing a Closely-Held Corpoartion," The Journal of Taxation, June 1973, p. 357.

[16] Ernest J. Lawinger, "Appraising Closely-Held Stock--Valuation Methods and Concepts," Trusts & Estates, October 1971, p. 818.

be the criteria for stock evaluations, especially those of closely held corporations. The dividend-paying capacity and the actual dividends may not have any relation to each other. This is because stockholders may want to avoid taxes on dividends and are already sufficiently compensated by inflated salaries and bonuses.

Valuation of shares by the use of dividends paid or paying capacity is similar to that based upon earnings. A projected dividend rate is found and this is then multiplied by an appropriate multiplier (the reciprocal of the capitalization rate) to produce a value.[17]

Another valuable tool in determining the divident capacity is to analyze the typical pay out percentages within the industry.[18]

The fact that the dividend-paying capacity method essentially duplicates the earnings method and that in the last few years controls have been imposed by the federal government on payments of dividends by closely held corporations has minimized the usefulness of the dividend capacity as an evaluation tool.

Size of Block to be Valued and Sales of Stock

The size of the block of stock to be sold can have an effect on the value. A controlling interest may justify a higher value per share than a minority interest which is more difficult to sell. The "blockage" theory of discounting the fair market value is inappropriate for closely

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[17]Johannes R. Krahmer and Thomas D. Henderer, Estates, Gifts, and Trusts Portfolios, vol. 221: Valuation of Shares of Closely Held Corporations (Washington, D.C.: Tax Management Inc., 1969), p. A-42.

[18]William A. McClellan, "Valuation of Closely Held Securities: Accounting Know-How is the Key," The Journal of Accountancy, March 1966, p. 47.

held stocks because of the lack of a prevailing market. It seems appropriate to value any large block of stock at less than its fair market value because of the difficulty in disposing of it.[19] Discounts for lack of marketability have varied a great deal in past valuation cases because it has been based historically upon the judgment of the appraiser. One helpful aid in determining the size of a discount is the utilization of cost of flotation statistics of registered equity issues. These statistics present data on the relationship between the costs associated with registering an equity issue and the size of the issue.[20]

Closely held stock is seldom sold, but when there has been a recent sale, the sales price will usually be upheld as the fair market value. However, the sales transaction must be at arm's length. Sales transactions between "insiders" will be subject to close scrutiny by the IRS and the tax courts.

Stock Values of Similar Corporations

Another method of valuation is to find comparable securities that are being traded on the public market. Exact comparability is unattainable, but reasonable similarities can be found. Similar characteristics to look for are size, growth, product line, market area, profitability and financial condition. When such firms are found and their stock is publicly traded, the prices for which shares are traded can help to form a basis for valuation.[21]

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[19] George D. McCarthy and Robert E. Healy, Valuing a Company (New York: The Ronald Press Company, 1971), p. 123.

[20] Vass, p. 358.

[21] Lawinger, p. 818.

Restrictive Agreements

A well drawn up stock purchase agreement can help assure a harmonious relationship among shareholders and provide for the retention of control within an ownership group. Such an agreement will aid in fixing the valuation of stock in an estate and provide a source of liquidity where stock is not otherwise marketable.

In order to fix the Estate Tax value, the agreement must serve a proper business purpose and show that it was not intended to function as a bequest of the business interest. The first test is easily satisfied because of the desire to secure continuity and experience in management of the business. The second test is best approached by ensuring the purchase price provided in the agreement which was reached as a result of arms-length.[22] Another important determinate is the agreement must be binding during the lifetime as well as at the death of the stockholder.

Stock purchase agreements can be a stock redemption agreement which obligates the corporation to redeem the shareholders stock or a cross purchase agreement which obligates the other shareholders to redeem the stock. Also, agreement can specify a specific price or provide an evaluation formula based upon sound appraisal methods. This approach is a time saver and affords smoother transition of stock, but is only valid as a valuation factor for Estate Taxes.

Relationship of Factors

The application of the various evaluation factors to the same company will undoubtedly produce as many different values. Every valuation

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[22]Ira Stechel, "Restrictive Buy-Sell Agreements Can Limit Estate Tax Value of a Business Interest," The Journal of Taxation, June 1976, p. 360-1.

should begin with familiarization of the company's history and its future outlook, as well as that of the industry. This basic information provides the basis as to what valuation method or combination of methods should be used in valuing the specific closely held stock. Two predominant methods are the book value method which emphasizes the balance sheet and the earnings approach which emphasizes the income statement. Normally, operating companies, those which sell products and services, lend themselves to the earnings approach. Investment companies, those whose primary assets are investments, lend themselves to the book value method. The other valuation factors are just as important, but appear to be additional adjustments to the two predominant methods. These factors are not all inclusive, but fairly represent the primary methods used by the Internal Revenue Service and outside professionals in valuing closely held stock.

The next chapter is a brief review of some tax court decisions regarding closely held stock valuations.

CHAPTER 3

TAX COURT CASES

Standard Research Consultants, Inc. published the abstracts of tax court decisions involving 156 valuation cases covering a period from January 1949 to June 1970. From this information Spencer J. Martin and Gerald P. Votta produced a list of thirty-one factors considered by the court.[23] These factors were separated into three different categories: conventional accounting data, other financial factors and miscellaneous factors. The following tables are summaries of these factors.

TABLE 1

Accounting Data Utilized in 156 Tax Cases

Factor	Times Used	Percent of Cases
Historical earnings*	57	37
Book value*	54	35
Dividends paid or yield	30	19
Net working capital	13	8
Growth of net worth	8	5

*Indicates factors recommended in Revenue Ruling 59-60.

Table 1 indicates that both earnings and book value are predominantly used by the courts in stock valuation cases. The term historical earnings does not include instances where the court has used the capitalization approach. Based upon these results, the appraiser may be able to

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[23] Spencer J. Martin and Gerald Votta, "Accounting and Nonaccounting Factors in Valuing Stock of Closed Corporations," The CPA Journal, November 1972, pp. 902-5.

justify a value based on data easily obtained from normal accounting records. In rendering a decision, the court may have used a variety of factors. Unfortunately, the courts normally do not assign weights to the factors used.

TABLE 2

Other Financial Factors Utilized in 156 Tax Cases

Factor	Times Used	Percent of Cases
Earning power*	35	22
Stock being valued represented a minority interest*	22	14
Dividend paying capacity*	11	9
Capitalization of average earnings	9	6

*Indicates factors recommended in Revenue Ruling 59-60.

Table 2 is also proof that earnings of a corporation are a large determinant in valuing corporate stock. Earning power means the estimation of potential earnings, which also rely on past accounting data. Capitalization of average earnings was probably overlooked in a majority of the cases because reasonable capitalization rates could not be obtained. In closely held corporations it is very difficult to find similar companies whose stocks are actively traded.

Table 3 represents miscellaneous factors used by the courts which do not necessarily come from the financial statements but also represent other economic and non-quantifiable factors. Expert testimony refers to the use of outside professionals such as real estate appraisers and investment brokers in order to substantiate valuations. The high usage of this factor indicates that courts do heavily rely on the expert opinion of outside third parties.

TABLE 3

Miscellaneous Factors Utilized in 156 Tax Cases

Factor	Times Used	Percent of Cases
Expert testimony	71	45
Prior sales of stock*	66	42
Nature and history of business*	38	24
Tangible assets (value of underlying assets)	33	21
Size of block being valued*	27	17
Lack of evidence offered by taxpayer	27	17
Restrictions on stock	25	16
Marketability	18	11
Character and quality of management	16	10
General economic condition*	16	10
Position in the industry*	11	7
Market value of stock of comparable companies	11	7
General stock market condition	9	6

*Indicates factors considered in Revenue Ruling 59-60.

Prior sale of stock are given high priority in valuation cases if they are at arms-length and have recently been transacted.

Expert testimony, prior sales of stock and the nature and history of the business are three factors that do not necessarily require analysis of the accounting records and are frequently cited by the tax courts.

In an attempt to update these findings a brief review of current court case decisions was conducted. The review disclosed nothing to alter conclusions based on the 1949 to July 1970 data.

Current court case decisions seem to be giving greater allowances in discounting stock values due to lack of marketability. Outside expert testimony continues to be a highly used factor by the courts. It is also interesting to note that in several cases the court appeared to act as an arbitrator by ruling the value to be somewhere between the high and low values presented.

Presented in the next chapter is a hypothetical case study which attempts to illustrate how different valuation methods can be applied to a specific problem.

CHAPTER 4

HERITAGE MARKETS INC. - A CASE STUDY

Heritage Markets Inc. is a small supermarket chain located in the Midwest. The company began operations in 1952 when two brothers, Robert and Richard Clark, built their first retail grocery store. Since that time, two additional stores have been built and sales have increased from \$475,000 to \$2,674,000. Both men are the only stockholders with equal amount of shares owned. The organization consists of Robert Clark, president; Richard Clark, vice president; three store managers and a manager of finance. Store operations include approximately 90 employees and administrative employees totaling 15.

Recently a large regional supermarket chain has made an offer to purchase Heritage Markets Inc. In order to assess the offer, Robert and Richard Clark need to establish a fair market value for the shares they own. The following is a summary of their analysis.

History of the Business

Heritage Markets Inc. has shown a steadily increasing trend of profits. Excellent personnel relations and community support have attributed to its profitability. No one man dominates the operations as indicated by the organization structure. There are no unusual factors that would abnormally affect stock value such as large legal suits, patents, or binding contracts. Competition within the community of 200,000 consists of three large supermarket chains with an average of six stores each. There are also approximately twenty smaller independent supermarkets and a variety of convenience stores.

General Economic and Industry Outlook

Grocery chain earnings prospect for 1980 and 1981 will vary greatly from one operator to the next. Sales should hold up because of the consistency of food demand, but profitability is being pressured by the recession and more cautious purchasing of general merchandise. The industry's sales are noncyclical, but its profitability is vulnerable to consumers trading down to lower margined food products. Retail food price increases have trailed the general economy's inflation rate this year. The food price inflation rate is expected to climb to fourteen percent in 1981.[24]

Strong government pressure to decrease the farm to retail spread has had a conservative effect on pricing strategies.

Industry growth is ultimately linked to population trends. While total U.S. population growth has averaged less than one percent in recent years, certain regions have fared somewhat better. Alternative means of growth have been achieved through acquisitions. The older, smaller units have a greater difficulty remaining profitable.

Competition within the grocery industry has historically been severe because of demand elasticities. However, firms possessing modern facilities, captured shares within markets, ability to expand and sound management will continue to prosper.

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[24] The Value Line Investment Survey (New York: Arnold Bernhard & Company, Inc., 1980), p. 2111.

Book Value

The balance sheet for Heritage Markets Inc. as of June 30, 1980, is presented at Table 4 on the following page. The first column, labelled "Per Books", are the amounts on the corporate ledgers computed in accordance with generally accepted accounting principles. In order to determine the fair market value per share based upon net asset value, these amounts were adjusted to reflect current market values. These adjusted amounts are reflected in the second column headed "Per Adjustments."

Inventories are normally carried on the statements at the lower of cost or market. In this instance inventories have been restated at their higher value of market. The same situation applies to the value given to other assets. The other asset account consists of long term investments held by the company which were restated at market instead of cost. Land, buildings and equipment were appraised at actual market value instead of the cost amounts reflected on the corporate books. The liability section of the balance sheet appeared to be adequately stated and no adjustments were necessary. Retained earnings were increased to reflect the increase in total assets. Total equity is $438,500 and adjusted book value per share is $438.50.

Earning Capacity

The income statement for Heritage Markets Inc. for the last five fiscal years is presented at Table 5. Similar to the book value approach, these statements have been adjusted in order to eliminate any distortions to the normal earning trends of the corporation. All five years' income statements were adjusted because of accelerated depreciation taken on the fixed assets. The operating and administrative expense section now

TABLE 4

HERITAGE MARKETS INC.
Balance Sheet
June 30, 1980

	Per Books	Per Adjustments
CURRENT ASSETS:		
Cash and short term investments	$ 55,000	$ 55,000
Accounts receivable	14,000	14,000
Inventories	165,000	170,000
Other current assets	21,000	21,000
TOTAL CURRENT ASSETS	$255,000	$ 260,000
OTHER ASSETS	$ 15,000	$ 16,500
LAND BUILDING AND EQUIPMENT:		
Land and buildings	586,000	600,000
Fixtures and equipment	180,000	126,000
Less accumulated depreciation	(230,000)	-0-
	$536,000	$ 726,000
TOTAL ASSETS	$806,000	$1,002,500

	Per Books	Per Adjustments
CURRENT LIABILITIES:		
Accounts payable	$135,000	$ 135,000
Other short term debt	34,000	34,000
TOTAL CURRENT LIABILITIES	$169,000	$ 169,000
MORTGAGE PAYABLE	210,000	210,000
OTHER LONG TERM DEBT	185,000	185,000
TOTAL LIABILITIES	$564,000	$ 564,000
STOCKHOLDERS EQUITY:		
Common stock (1000 shares)	$ 20,000	$ 20,000
Retained earnings	$222,000	$ 418,500
TOTAL STOCKHOLDERS EQUITY	$242,000	$ 438,500
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$806,000	$1,002,500

TABLE 5

HERITAGE MARKETS INC.
Adjusted Income Statements
Fiscal Year 1976 through Fiscal Year 1980

	June 30, 1980	June 30, 1979	June 30, 1978	June 30, 1977	June 30, 1976
Sales	$2,674,000	$2,269,000	$1,817,000	$1,491,000	$1,271,000
Other revenue	8,500	8,700	6,600	4,100	2,800
	2,682,500	2,277,700	1,823,600	1,495,100	1,273,800
Cost of sales	2,089,000	1,752,007	1,415,000	1,177,000	1,003,000
Operating and administrative expenses	521,000	455,000	359,000	283,000	240,000
	2,610,000	2,207,007	1,774,000	1,460,000	1,243,000
Earnings before taxes	72,500	70,693	49,600	35,100	30,800
Federal and state taxes	34,000	34,500	24,122	16,619	15,005
Net earnings	$ 38,500	$ 36,193	$ 24,478	$ 18,481	$ 15,795

reflects straight line depreciation instead of the accelerated method used. In addition, the June 30, 1979 income statement has been reduced by the $6,000 capital gain on the sale of equipment. Since the corporation is not normally in the business of selling assets, this adjustment was necessary.

In order to determine the average earnings per share giving emphasis to the most current years, the following calculation was made:

Fiscal Year 1976	$15,795 x 1 =	$ 15,795
Fiscal Year 1977	$18,481 x 2 =	$ 36,962
Fiscal Year 1978	$24,478 x 3 =	$ 73,434
Fiscal Year 1979	$36,193 x 4 =	$144,772
Fiscal Year 1980	$38,500 x 5 =	$192,500
		$463,463 ÷ 15 = $30,898

With 1000 shares outstanding, the weighted average earnings per share is $30.90. In arriving at an estimate of market value per share under this approach a capitalization rate or a price-earnings ratio must be applied to the weighted average earnings amount.

The price earnings ratio or capitalization rate is directly related to the amount of risk associated with the company. The average price earnings ratio for Grocery Store Corporations listed on the exchange averaged 11.4 during 1979. This ratio is expected to increase to 12 in the near future.[25] Based upon above average growth and earnings record, this price earnings ratio would appear to be reasonable for valuation purposes. Multiplying 12 times the weighted average earnings per

[25] Ibid.

share of $30.90 equates to a fair market value of $370.80 per share based upon the income capitalization method.

Miscellaneous Factors

Since there has never been Heritage corporate stock sold in the past, the prior sales of stock method could not be used. Stock sales of comparable companies could not be used because of the inability in obtaining such information. Restrictive agreements are not a factor in this valuation since Heritage Markets Inc. have none.

Heritage Markets Inc. is an operating company selling products as opposed to investment type companies. Therefore, the tendency is to put more emphasis upon the earnings approaches to their stock valuation. However, in light of the possible acquisition by a larger supermarket chain, consideration should be given to the book value approach. A company with a high net asset value is a prime candidate for acquisition purposes. The discount for lack of marketability was deemed inappropriate for this valuation because of the acquisition offer. Based upon these factors, the fair market value per share of Heritage Markets Inc. stock should approximate $400.

CHAPTER 5

SUMMARY AND RECOMMENDATIONS

At some point in time, a value must be placed on almost every small business. The majority of the time these valuations are a result of some tax consequence. Since stock in most small businesses are not actively traded, alternative methods must be used in determining their value.

Revenue Ruling 59-60 was used as an outline in providing the valuation approaches which have long been recognized by the courts and practiced by the investing public and the appraisal profession. The initial approach to any valuation should be a thorough investigation into the company's history. This type of analysis will provide guidance as to which approach or combination of approaches should be pursued.

Two basic approaches used in stock valuations are the book value approach and the earnings capacity approach. The book value approach concentrates on the balance sheet and the earnings approach concentrates upon the income statement. There are a variety of investment analysis techniques stemming from these two basic approaches. Further refinement to these methods is obtained by analyzing other general economic considerations.

By reviewing court case decisions and the case study provided in Chapter 4, it becomes obvious in valuation problems that there is no one right answer. There is an infinite variety of circumstances which can affect the ultimate value. There will always be differences of opinion among appraisers.

The objective of this paper was to disclose to future appraisers of closely held stock the essential elements needed to properly develop a valuation approach and recognize defective approaches or errors of omission in such approaches. Time and expense involved in valuation problems will be minimized if the value presented is based upon relevant factual information given in an orderly way.

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