

Navigating the Complexities of the Market Approach: Common Challenges and Pitfalls to Avoid

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Overview of Key Concepts

When it comes to valuing a privately held business, IRS Revenue Ruling 59-60 establishes the framework of approaches, methods, and factors to be considered when estimating the fair market value (“FMV”) for estate tax, gift tax, and other purposes under federal tax laws.

Outlined within this guidance is the key requirement that, in addition to the asset (or cost) and income approaches, the market approach must also be considered in determining the value of a company, requiring practitioners to consider “the market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.”¹



The most common variations of the market approach include the guideline public company method and the guideline transaction method. With the **guideline public company method**, implied valuation multiples associated with reasonably comparable publicly traded companies are utilized as benchmarks to estimate the value of the subject company. In contrast, the **guideline transaction method** utilizes implied valuation multiples from arms’ length transactions in a similar fashion.

Each method can be used as a primary valuation method under the appropriate circumstances, or as a reasonableness test of the value determined using another approach (such as the income approach). The following section outlines some of the most common errors practitioners fall victim to when applying the market approach as a valuation methodology.

Market Approach: Common Pitfalls

Some common examples of situations through which the market approach can be incorrectly applied are as follows:

- **Not Accounting for Differences in Size, Diversification and Other Company Specific Considerations:**
While two companies may compete in the same industry, significant differences in size, risk profile, and growth can lead to situations where a direct comparison of two entities may be misleading. For example, material customer and supplier concentration, key person risk, and geographic concentration are all significant risk factors that may result in a company trading at a lower multiple than industry competitors.

One notable example of a tax court ruling where the use of the market approach was scrutinized is **Estate of Heck v. Commissioner (T.C. Memo 2002-34)**.² In this case, the estate included shares of common stock in F. Korbel & Bros., Inc., a producer of champagne. The valuation expert witness relied on two guideline companies for use of the market approach, which were ultimately rejected due to differences in products sold, with the Tax Court citing the following:

‘As similarity to the company to be valued decreases, the number of required comparables increases in order to minimize the risk that the results will be distorted by attributes unique to each of the guideline companies. In this case, we find that Mondavi and Canandaigua were not sufficiently similar to Korbel to permit the use of a market approach based upon those two companies alone.’

- **Selective Bias in Determining Valuation Multiples:**

In the context of the market approach, confirmation bias (which is the tendency to search for, interpret, favor, and recall information in a way that confirms or supports one’s prior beliefs or values), can occur when only transactions or guideline companies that support a desired valuation outcome are considered. This can result in a market approach sample that is not representative of the broader market, increasing the risk of an inaccurate valuation of the subject company if a valuation professional fails to recognize the behavioral biases.



In **Wall v. Commissioner (2001)**,³ the petitioner’s expert reasoned that seven publicly traded companies were sufficiently similar to the subject company to serve as guideline companies, however, when selecting an appropriate multiple for the subject company, the expert only referenced some of the guideline companies identified (which happened to have the lowest multiples). The tax court took issue with the valuator’s selective use of multiples, citing that the valuator did not use all the guideline company multiples but instead picked and chose among the lowest, resulting in an understatement of the value of the subject company’s stock.

- **Ignoring Differences in Level of Value:**

It is important to note that the guideline transaction method may yield valuation information at either a controlling or non-controlling level of value. It is critical that practitioners understand and take this into consideration when comparing controlling to non-controlling interest transactions as, holding all else held constant, a non-controlling interest holder would pay a lower price for a fractional interest in a company than a controlling interest holder due to limited operational influence.

- **Failure to Recognize Evolving Market Conditions:**

When using historical transactions, it is crucial to consider any changes to economic conditions and market sentiments between the date of the transaction and the valuation date. For example, consider a company that owns and manages office properties. Due to significant changes in remote work trends, reduced demand for office space, and changes in how office space is utilized, the market for these companies has changed in recent years such that in some cases pre-pandemic transactions may no longer be indicative of current market conditions or value.

Determining When (and How) to Apply the Market Approach:

Although IRS Revenue Ruling 59-60 requires the market approach to be considered in determining value of a company, ultimate use of the market approach is not required in situations where sufficient comparable data is not available. The market approach may be used as the primary valuation methodology in cases where there is a sufficient sample of guideline companies and/or transactions where comparability is high (i.e., similar customers, products, end markets, growth rates, etc.) with meaningful pricing multiples. Conversely, in situations where operational and financial comparisons between guideline companies and/or transactions and the subject are meaningful but not as directly comparable, the market approach may be used as a reasonableness test in order to validate and corroborate the value of the subject company derived using the income or the asset-based approach(s).

Summary:

When used appropriately, the market approach can provide a reliable FMV estimate using market pricing which is reflective of current market conditions through objective, readily available, and verifiable data. However, the market approach also comes with challenges and risks that, if not properly addressed, can result in inaccurate valuation conclusions or greater IRS scrutiny.

In order to mitigate the previously discussed risks that can undermine the market approach, it is important that valuation professionals conduct sufficient diligence to obtain proper understanding of the company's business model, key products and services offered, end markets served, lifecycle stage, and growth opportunities, among others. These qualitative considerations should be supplemented with quantitative financial analysis and independent market research.

To ensure that the valuation complies with applicable laws and guidelines, such as those set by the IRS, it is important to engage a qualified, independent valuation professional that has the technical knowledge to apply these methods accurately and appropriately.

¹ Internal Revenue Service. Revenue Ruling 59-60, 1959-1.

² Estate of Heck v. Commissioner, T.C. Memo 2002-34.

³ Wall v. Commissioner, T.C. Memo 2001-75; 2001 Tax Ct. Memo LEXIS 97.

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