

LEGAL CASE COMMENTARY

The Other Side of Kohler: IRS Expert Offers Insights

By **CBIZ Valuation Group***

In light of recent public discussion of the Tax Court's decision in *Kohler v. Commissioner*, we think it important to further explain some of the facts and findings. We also believe that valuation specialists will benefit from a healthy debate on the salient issues, and gain further insights by reviewing both sides of the case and, in effect, being the judge. (For details on the court opinion, see the September 2006 *BVU*).

The focus of the trial was the valuation of the estate's shares in the Kohler Company as of September 4, 1998 (the alternative valuation date, six months after the date of death). In between the two dates, in May 1998, Kohler underwent a reorganization that included the involuntary purchase of outsiders' shares. For comparison purposes, the valuation conclusions here are expressed as price per Kohler share prior to the reorganization. Additionally, we refer to the two experts for the taxpayer as "Taxpayer Expert 1" and "Taxpayer Expert 2." (For reference, the Tax Court adopted the valuation conclusions by Taxpayer Expert 1.) Figure 1 summarizes the experts' conclusions:

Figure 1	
Appraiser	Non-marketable, per share value September 4, 1998
Taxpayer Expert 1	\$48,215
Taxpayer Expert 2	\$65,010
CBIZ	\$160,000 (adjusted)

* CBIZ Valuation Group, LLC, a wholly owned subsidiary of CBIZ, Inc. (NYSE: CBZ), is a national practice with principal offices located across the U.S.. The firm provides valuation, financial advisory and litigation support services; www.cbizvaluation.com.

First up for debate: Dividend Discount Model

Taxpayer Expert 1 prepared a discounted cash flow (DCF) model and a dividend discount model (DDM). Taxpayer Expert 2 prepared a DCF model and two DDMs. CBIZ prepared a DCF model. CBIZ did not use a DDM because, if applied correctly, the DDM is equivalent to the DCF model,¹ and many authorities recommend avoiding the redundancy by applying the DCF accurately.²

Taxpayer Expert 1's conclusion was significantly below that of Taxpayer Expert 2, based on their respective DDMs. The reasons for the difference:

- In analyzing dividends, Taxpayer Expert 1 did not consider planned share repurchases, which are generally accretive to the remaining shareholders and can disguise dividends as well as increase liquidity.³
- Taxpayer Expert 1 ignored Kohler's retirement of debt over time, assuming that the excess cash flows would not create value or be reinvested.

Correcting these errors would have increased Taxpayer Expert 1's DDM-indicated value from \$47,317 to more than \$70,000 per Kohler share.

Reliance on overly conservative management plan

1. *Revenue assumptions.* Kohler's historical revenue growth rate averaged about 9.0% over the five-years immediately prior to the valuation date. In their depositions during a dissenters' case, Kohler management had pointed to a target "real" growth rate of 7.0% or a nominal growth rate of 9.8% with inflation. But the estimated growth rate in Kohler's 1998-2003 management plan (Management Plan) equaled 3.9%.

In its DCF model, CBIZ used a growth rate of 4.8% between 1998 and 2003. Kohler management, CBIZ and Taxpayer Expert 1 used a residual nominal growth rate of 4.0% in their respective cash flow projections.

Continued to next page...

The Other Side of Kohler

...continued from front page

Taxpayer Expert 2 deviated from management's long-term growth assumptions to reduce the nominal rate of growth of Kohler's revenues from 4.0% in 2003 to 2.7% in 2008, which effectively lowered the valuation by about 16%.

2. *Cost and expense assumptions relating to non-recurring events.* Kohler's net income was depressed in the early and mid-1990s due to underperforming acquisitions. It reported net income of almost \$88.0 million (4.0% of revenue) during 1997 and \$88.7 million during the 12 months ending August 31, 1998. This historical net income was understated due to substantial, one-time business enterprise system (BES) investments, which were expensed instead of

capitalized; and also because of losses from operating units that were held to be sold, closed or disposed of by the end of 1998.

CBIZ rejected the Management Plan because: (a) its cost and expense assumptions were inconsistent with Kohler's fixed and variable cost and expense structure as indicated by management interviews; (b) it was "top-down" with no detailed underlying support; and (c) it overstated costs and expenses, relative to revenue, by \$60 million to \$100 million (pretax) and by \$36 million to \$60 million (post-tax) for 1999.

In retrospect, as of December 22, 1998 (about three months after the alternate valuation date), a new management plan (December Plan) was in place that supported net income of \$115.5 million. The substantial increase in this December Plan net income was not tied to revenue growth (which showed only a slight increase), change in interest rates or change in housing starts. An expected decline in the latter supported, in part, the lower revenues in the Management Plan. The actual net income during 1999 equaled \$120 million. CBIZ projected net income, on an apples-to-apples basis, of \$115 million for 1999.

3. *Capex.* The capital expenditure levels in the Management Plan were greater than necessary to support Kohler's assumed growth rates. While both Taxpayer's Experts relied on Management Plan for estimated capital expenditures, CBIZ cut capital expenditures to match the forecast growth rates in the Management Plan.

By correcting Taxpayer Expert 1's analysis for DDM-based errors and by eliminating nonrecurring expenses, his value conclusions increase from \$48,200 to \$155,000 per Kohler share.

By correcting Taxpayer Expert 2's analysis for revenue deviation from the Management Plan, eliminating nonrecurring expenses and adjusting capital expenditures to match revenue growth, his value conclusion increases from \$65,000 to \$163,800 per Kohler share.

By comparison, CBIZ concluded a value per share of \$166,000 (see Figure 2).

Continued to next page...

Reprinted with permission from Business Valuation Resources, LLC

BUSINESS VALUATION UPDATE

Managing Editor:	Sherry Henry
Associate Editors:	Paul Heidt & Adam Manson
Publisher:	Doug Twitchell
Production Manager:	Laurie Morrissey
President:	David Foster
Customer Service:	Pam Pittock
Sales:	Joseph Bettencourt & Linda Mendenhall
Publisher Emeritus:	Shannon Pratt

EDITORIAL ADVISORY BOARD

RONALD D. AUCUTT, Esq. McGuireWoods LLP—McLean, Va.	LYNNE Z. GOLD-BIKIN, Esq. Wolf, Block, Schorr & Solis-Cohen, LLP—Norristown, Pa.	JAMES S. RIGBY, ASA, CPA/ABV Financial Valuation Group—Los Angeles, Calif.
JOHN A. BOGDANSKI, JD Lewis & Clark Law School—Portland, Ore.	LANCE S. HALL, ASA FMV Opinions, Inc.—Irvine, Calif.	ARTHUR D. SEDERBAUM, Esq. Patterson, Belknap, Webb & Tyler—New York, N.Y.
HON. WILLIAM A. CHRISTIAN N.C. 11th Judicial District Court—Sanford, N.C.	JAMES R. HITCHNER, CPA/ABV, ASA The Financial Valuation Group—Atlanta, Ga.	RONALD L. SEIGNEUR, MBA CPA/ABV CVA Seigneur Gustafson Knight LLP—Lakewood, Colo.
BARNES H. ELLIS, Esq. Stoel Rives LLP—Portland, Ore.	JARED KAPLAN, Esq. McDermott, Will & Emery—Chicago, Ill.	DONALD S. SHANNON, Ph.D., CPA School of Accountancy, DePaul University—Chicago, Ill.
NANCY J. FANNON, ASA, CPA/ABV, MCBA Fannon Valuation Group—Portland, Me.	MAURICE KUTNER, Esq. Maurice Jay Kutner & Associates, P.A.—Miami, Fla.	BRUCE SILVERSTEIN, Esq. Young, Conaway, Stargatt & Taylor, LLP—Wilmington, Del.
JAY E. FISHMAN, ASA, CBA Financial Research Associates— Philadelphia, Pa.	GILBERT E. MATTHEWS, CFA Sutter Securities Incorporated—San Francisco, Calif.	
LARRY WELDON GIBBS, JD Gibbs Professional Corporation—San Antonio, Texas	JOHN W. PORTER Baker & Botts, LLP—Houston, Texas	

Business Valuation Update™ (ISSN 1088-4882) is published monthly by Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to *Business Valuation Update™*, Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035.

The annual subscription price for the *Business Valuation Update™* is \$329. Low cost site licenses are available for those wishing to distribute the *BVU* to their colleagues at the same address. Contact our sales department for details. Please feel free to contact us via email at customerservice@BVResources.com, via phone at 503-291-7963, via fax at 503-291-7955 or visit our website at www.BVResources.com. Editorial and subscription requests may be made via email, mail, fax or phone.

Please note that by submitting material to *BVU*, you are granting permission for the newsletter to republish your material in electronic form.

Although the information in this newsletter has been obtained from sources that BVR believes to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This newsletter is intended for information purposes only, and it is not intended as financial, investment, legal, or consulting advice.

Copyright 2007, Business Valuation Resources, LLC, (BVR). All rights reserved. No part of this newsletter may be reproduced without express written consent from BVR.

The Other Side of Kohler

...continued

Unsupported working capital assumptions

None of the appraisers followed the Management Plan in their respective estimated working capital calculations. Taxpayer Expert 1, allegedly without giving consideration to process improvements, increased working capital from August 31, 1998, to December 31, 1998, by \$46 million more than in the Management Plan, which decreased Kohler stock value by 7.1%.

Taxpayer Expert 2 assumed an increase of approximately \$88.5 million greater in working capital than that contained in the Management Plan, between August 31, 1998, and December 31, 1998. This decreased the valuation conclusion by 11.9%.

CBIZ considered the process improvements (BES expenses) and working capital trends observed in 1997 and 1998 in estimating future levels; its working capital assumptions were consistent with the December Management Plan.

Discount for lack of control applied to minority cash flows

Taxpayer Expert 1's DCF-based value was lower than Taxpayer Expert 2's DCF conclusion because Taxpayer Expert 1 applied a 26% discount for lack of control to a DCF analysis that was already on a minority interest basis. As pointed out during cross-examination, this contradicted language in *Valuing a Business*, Fourth Edition (by Pratt, Reilly and

Schweih's). (At one point, the Court, referencing this contradiction, told the witness, "You are going to regret writing that book.")

Prior transactions evidence of value

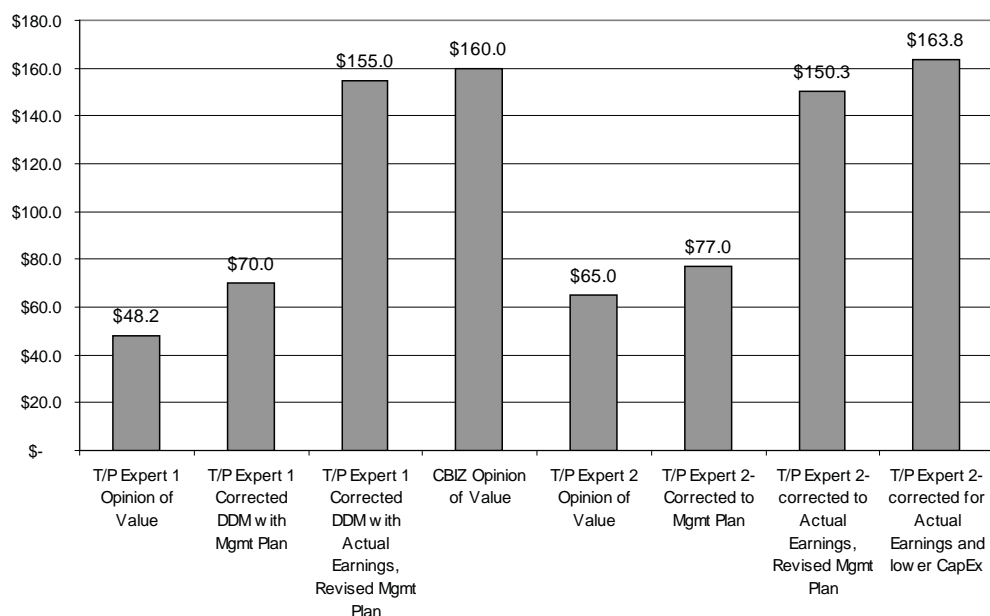
Over Kohler's history, shares had been sold by unrelated third parties with negotiated prices in the 1990s ranging from \$80,000 to \$134,000 per share. Kohler had made lower offers to purchase shares and attempted to discourage such sales to preserve the company's private status. The last arm's-length trade before Kohler's announced reorganization was for \$126,250 per share in January 1998. The standing asking price for Kohler shares was \$185,000 per share in March 1998. The lowest arm's length price exceeded the Taxpayer Expert 1's by more than 100% (see Figure 3).

Furthermore, in connection with dissenting shareholder litigation, six experts provided opinions of value for Kohler shares, as of May 11, 1998, which ranged from \$100,000 to \$191,000, with the lowest value more than 80% greater than Taxpayer Expert 1's conclusion of \$55,400 per share.

CBIZ report fully compliant, including final adjustment

The CBIZ appraisal report complied with generally accepted appraisal practices in all material respects:

Figure 2



Reprinted with permission from Business Valuation Resources, LLC

- Our site visit and level of due diligence was longer than represented by the Court and in public discussion, especially the tour of facilities and operations. However, Kohler management was unable to answer many specific questions and provided answers that were inconsistent with documents we reviewed.
- Our opinion letter incorporated the standard limiting conditions and statement of independence and objectivity, instead of

Continued to next page...

The Other Side of Kohler

...continued from previous page

providing separate pages for the limiting conditions and appraisal certification.

- The USPAP issue, referenced by the Court and in public discussion, was a “red herring” that ignored the explicit assurances provided in our written expert report, our level of due diligence and our inclusion of all substantive analyses.

Finally, based on the rebuttal reports that set capital expenditures equal to depreciation, the only change CBIZ made at trial was to increase the capital expenditure assumption in terminal value, which reduced the valuation conclusion from \$171,280 per share to \$160,000 per share. This was neither a math error nor a conceptual mistake, but a professional concession to illustrate the valuation range based on the capital expenditure assumption.

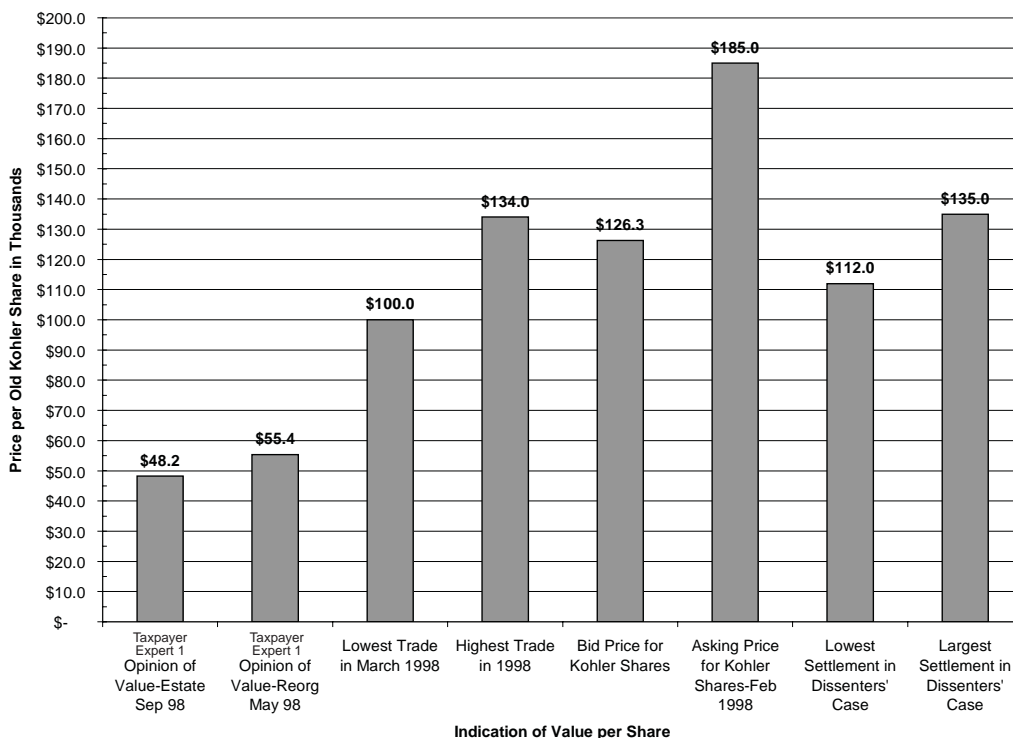
Space limitations preclude our discussion of further issues, such as the experts’ different conclusions as to discounts for lack of marketability and valuations under the market approach. What’s important to note is that during the *Kohler* case, CBIZ developed and delivered its ultimate opinion of value supported by independent

evidence, rigorous analysis, and the opinions of other appraisers in a related matter (experts testifying in a dissenters’ litigation involving Kohler).

However—as in so many valuation cases, due to the evidence and arguments advanced by the opposing party—ultimately the Tax Court did not agree with CBIZ’s expert opinion. We believe the Court was persuaded by simple but conceptually incorrect methods and testimony, which failed to reconcile discrepancies between the assumptions and methods of the two Taxpayer’s experts.

Additionally, the Court discounted evidence from prior transactions in Kohler’s shares and did not consider the valuation testimony in a dissenter’s case and subsequent evidence as to Kohler’s actual earnings, such that its final holding reflects assumptions which we believe are conceptually and mathematically in error. We offer this analysis not only for the “other side of the story,” but also to illustrate the issues that often arise in these complex cases, and to provide an example of the problems that can occur when presenting an expert valuation opinion in an adversarial proceeding.

Figure 3



Note: CBIZ has made copies of its valuation report on Kohler available to BVR, which has also received a copy of the report from one of the taxpayer’s experts. We are currently working to gather copies of all reports in a “bundle” for subscribers, and will announce their availability in an upcoming issue of the BVU as well as the BVWire™.

¹ Dr. Shannon Pratt testified in a dissenters’ case that the dividend discount and discounted cash flow models were consistent and the same (if properly executed).

² For example, Lundholm & Sloan, *Equity Valuation & Analysis*, (McGraw-Hill/Irwin, 2004), p. 11; Damodaran, *Investment Valuation*, (Wiley, 2002), pp. 373-379.

³ Brealey & Myers, *Principles of Corporate Finance*, (McGraw, 1991), p. 148.

Reprinted with permission from Business Valuation Resources, LLC