Viewpoint on Value

January/February 2015

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Think of valuation first when writing buy-sell agreements

Buy-sell agreements protect business owners from unexpected events, such as a shareholder's death, disability or divorce. They're also useful when owners disagree and want to sell their interests — or buy out a difficult partner. Too often valuation issues take the backseat to legal issues, leading to irreconcilable differences when the agreement comes into play.

Whether owners are deciding on a current buyout price, purchasing insurance coverage for key shareholders or planning future buyout terms, an accurate valuation is imperative. Here are a few valuation issues to flesh out *completely* while shareholder relations remain amicable and no one is under duress to buy or sell.

Definition of value

"Value" means different things to different people. So, it's important to fully define value in the context of the buy-sell agreement. Usually, shareholders want to measure the "fair market value" of their interests — that is, the price that the universe of hypothetical buyers and sellers would agree to pay for a business interest.

But that's not always the appropriate standard of value. For example, noncontrolling owners may feel entitled to their pro rata share of the entire company's value on a controlling basis in a buyout.

The definition of value may even vary depending on what event triggers the buy-sell agreement or the size of the ownership interest. A well-thought-out agreement will identify these nuances. For example, under the agreement's terms, a shareholder who loses his or her professional license due to unethical behavior may be entitled to less than one who's retiring. Or the owner of a controlling interest may receive a smaller discount for lack of marketability than a minority shareholder.

The parties also may disagree about the appropriate valuation date. Valuations are valid as of a specific point in time, and conclusions can vary significantly in a volatile economy or if major business decisions made by a controlling owner alter the value of the business.

Methodology

Valuators use three methods to value a closely held business. The *asset-based (or cost)* approach estimates the value of equity by subtracting liabilities from the combined fair market value of assets. The *market* approach compares the subject company to similar businesses sold on the public markets and in private deals. The *income* approach determines value from expected future economic benefits.

Buy-sell agreements that require the company to obtain regular appraisals help the owners to understand which methods are the most appropriate for their business. That way, no one is surprised when it's time for a buyout — and fewer disagreements are likely to ensue. Regular appraisals also give owners a general idea of what their interest is worth, which may narrow the gap between the buyer's and seller's expectations.

Some detailed buy-sell agreements address which adjustments to the company's cash flow and its preliminary value are appropriate. For instance, an agreement may specify that owners compensation will be adjusted to match a predetermined industry benchmark. Or it may prescribe a discount for lack of marketability of, say, 15% or 30%.

Appraisals

Generally, the company and the exiting shareholder each hire separate experts to value the business. Or sometimes the buy-sell agreement names a specific joint appraiser who the owners agree is competent and unbiased. This strategy can help minimize costs and disputes later on. (See "Can joint appraisers *really* work?" on page 7.)

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Other important considerations include who will pay appraisal fees, how long the appraisal process will take and which documents the controlling shareholder will provide to the appraisers. The buy-sell agreement may even include a provision that allows valuators to perform site visits and interview management to help with discovery, if the parties wind up in court.

Terms

A valuation generates a cash-equivalent price in today's dollars. But sometimes owners prefer installment payments for tax or cash flow purposes. A buy-sell agreement should address whether shareholders will receive a lump-sum or a series of installment payments over a prescribed time period. In installment sales, the parties also may stipulate an interest rate to apply over the buyout term.

When drafting the buy-sell agreement, many owners wonder how they'll finance future buyouts. Often insurance is a smart answer, but some businesses maintain reserves to finance buyouts from operating cash flow. Borrowing funds when the agreement is executed can slow down the buyout process — which can cause stress for family members when a business owner dies without an adequate amount of liquid assets.

Updates

A buy-sell agreement is a living document that should change as the business evolves — if not, the agreement may become obsolete over time. Owners also may inadvertently invalidate their own agreement by failing to update it or adhere to its terms.

For example, a buy-sell agreement needs to be updated if shares are sold to a new owner or an existing owner leaves the company, either voluntarily or involuntarily. If buyouts are funded by life insurance, policies need to be periodically reviewed to determine whether more (or less) coverage is needed.

Center stage

As owners write and revisit their buy-sell agreements, the value of the business needs to take center stage. Often management chooses to have regular valuations to ensure that everyone knows what their interests are worth — and to avoid surprises in stressful times. ●

Factoring fraud into the valuation equation

Fraud is a risk for virtually every business. But some companies are better at deterring and preventing fraud than others. On average, businesses lose 5% of their annual revenues to fraud, according to the biennial *Report to the Nations on Occupational Fraud and Abuse* issued in 2014 by the Association of Certified Fraud Examiners (ACFE). The median loss was $145,000 — but 22% of victim organizations in the study incurred losses of $1 million or more.

Clearly, fraud can devastate a closely held business. Although testing for and investigating fraud isn't normally part of the valuation process, valuators do take fraud risks into account when appraising a private business interest.

Who's most at risk for fraud?

The ACFE defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets."

Examples include corruption, asset misappropriation and financial misstatement.

Some businesses are more vulnerable to fraud than others. When assessing fraud risks valuators consider issues such as:

Size. High-profile fraud cases — such as Enron or WorldCom — make front-page news. But the ACFE reports that companies with fewer than 100 employees are "disproportionately victimized by fraud and notably under-protected by anti-fraud controls." Because private businesses also typically possess fewer fiscal and human resources than their public counterparts, they often struggle to rebound from fraud losses.

Industry. Some industries tend to be more fraud-prone than others. The top five most represented sectors in the 2014 ACFE study include:

1. Banking and financial services,
2. Government and public administration,
3. Manufacturing,
4. Health care, and
5. Education.

Industry research is a critical part of the appraisal process. Valuators need to understand which schemes the subject company may be prone to based on the industries in which it participates. For example, manufacturers are at high risk for billing scams and corruption, such as purchasing schemes, bid rigging and kickbacks, according to the ACFE.

Internal (or antifraud) controls. These are the policies and procedures companies use to protect assets, improve operating efficiency and ensure reliable financial statements. A strong system of internal controls, including fraud training programs and whistle-blower hotlines, is a company's first line of defense against fraud.

The 2014 ACFE study reports that the most effective controls at reducing fraud losses are:

- Proactive data monitoring and analysis,
- Employee support programs,
- Management review, and
- Formal codes of conduct.

Victim organizations that had these internal controls in place experienced losses that were at least 50% smaller than companies that didn't.

How do fraud risks affect value?

High fraud risk equates with lower values. For example, when applying the income approach, valuators might increase their company-specific risk premiums, a component of the cost of equity, to account for significant fraud risks.

Similarly, under the market approach, fraud risk may come into play when choosing criteria for picking guideline companies — or when adjusting median (or average) pricing multiples for differences between the subject company and the comparables.

A subject company with significant fraud risk — or that has fallen victim to fraud in the past — might be less marketable to potential buyers or less desirable to potential minority interest owners. Accordingly, valuators might factor fraud risk into their valuation discounts.

Only part of the story

The ACFE study exposes only the tip of the iceberg. Fraud is a far more pervasive problem that often goes undetected or unreported. It also carries indirect costs, such as lost productivity, reputational damage and lost revenues — not to mention the costs of investigating fraud and pursuing fraud claims. Experienced valuators understand these potential costs and factor fraud risks into the valuation equation. ●

Estate of Adell

Business value excludes son's personal goodwill

The issue of personal goodwill is most often associated with business valuations prepared for marital dissolutions. But it can also become a key issue in estate tax valuations, as this recent U.S. Tax Court decision demonstrates.

Background

In 1999, a father and son created STN, a satellite uplinking company. The father owned 100% of STN, and the son managed its daily operations. The father, before his death, transferred his interest in STN to a trust for the benefit of his three children.

STN received programming fees from only one customer, The Word, a 24-hour religious station created by the son. Under the service agreement between STN and The Word, in exchange for providing technical and administrative services, STN was supposed to receive the lesser of:

- Its actual costs, or
- 95% of The Word's net programming revenues.

In every year of its 10-year service agreement, The Word paid STN 95% of its net revenues, which ranged from about $7.6 million in 2002 to

$16.8 million in 2006. STN used these funds to pay operating expenses, including salaries to the father and the son that, combined, ranged from about $3.2 million in 2002 to about $8.6 million in 2006.

Rejection of the asset-based approach

The father died in 2006, and in 2007 his estate filed an estate tax return, which it amended twice. After the second amended return was filed, the IRS issued a deficiency notice, which the estate challenged. Both sides hired valuation experts to determine the date-of-death value of STN. The original estate tax return reported a value of $9.3 million, using the discounted cash flow method.

When the case went to trial, the estate brought forth two experts, including the valuator who provided the appraisal for the original estate tax return. Both experts independently valued STN at $4.3 million using the asset-based approach. They argued that the service agreement prevented STN from making a profit, because it limited programming fees to its actual operating costs.

The Tax Court rejected this argument, because STN had an established history of profitability, despite its service agreement, and, therefore, the discounted cash flow method was an appropriate valuation method. The estate's expert originally accounted for the risk inherent in the relationship between The Word and STN by including a 3% company risk adjustment in his cost of equity.

Personal goodwill exclusion

Between the issuance of its deficiency notice and the trial date, the IRS also revised its original appraisal from $92.2 million to approximately $26.3 million. For trial purposes, the IRS's expert used a discounted cash flow analysis that was similar to the estate's original appraisal but made some different adjustments.

Most notably, the estate's expert adjusted management compensation to $480,000 per year for the father and son (combined) to reflect market rates. He also included economic charges for the son's personal goodwill that ranged from $8 million to $12 million per year over the projection period.

Conversely, the IRS's expert believed that a hypothetical buyer could persuade the son to continue his employment at STN by offering him a salary equal to 8.1% of annual revenue. In 2006, that percentage would have resulted in a salary of $1.6 million.

The Tax Court ruled that the adjustments made by the IRS's expert to account for the son's personal goodwill were inadequate. Compared to the actual salary that the father and son earned in 2006 ($8.6 million, combined), the expert's $1.6 million payout seemed extremely low.

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The court ruled that personal goodwill is owned by the individual, not the corporation. Because the son hadn't signed any employment or noncompete agreements, he was free to leave at any time and use his personal business relationships to compete with STN. Therefore, his personal goodwill should be excluded from the value of the business in the gross estate.

Lessons learned

Private business owners who gradually transfer business relationships to the next generation and relinquish control may create personal goodwill, thereby reducing business value for estate planning purposes. But personal goodwill is a personal asset only if the company refrains from executing employment and noncompete agreements with its owners. ●

Can joint appraisers *really* work?

Many courts and attorneys encourage the use of a joint valuation expert, rather than two dueling valuators. This can save time and money. It can also eliminate the perception that each side's expert is a hired gun, advocating for his or her client's financial interests.

Establish a solid foundation

Consider three sisters who took over their father's creative agency when he retired. After a few years, the youngest wanted to sell her one-third interest, but the sisters couldn't agree on its value. So their attorney recommended that they hire a joint appraiser to come up with a fair, objective buyout price.

The parties stipulated to certain facts and scope limitations in the valuator's engagement letter. First, the interest's value would be based on the last three years' financial statements, which the parties agreed accurately reflected the firm's earnings capacity and financial standing.

In addition, they agreed that these reports required no adjustments for discretionary, contingent or nonoperating items. In terms of the interest's relative lack of control and marketability, the parties agreed to apply a 15% combined discount from the preliminary value of the business.

These initial steps helped foster an atmosphere of trust and collaboration. They also minimized surprises when the valuator shared his conclusion. Thanks to the effective use of a joint appraiser, this buyout was completed within a month of signing the engagement letter — and the parties avoided the arguments and acrimony that tend to accompany shareholder buyouts, especially among family members.

Understand the limitations and pitfalls

Joint appraisers don't work in every situation. Sometimes the parties can't overcome deep-seated feelings of animosity and distrust, no matter how many details they stipulate to in advance. These feelings may be intensified by the disproportionate amount of time valuators inevitably spend with controlling shareholders as they gather data about the company.

Some litigants also worry about the fact that, unlike communications between expert witnesses and attorneys, communications with joint appraisers aren't entitled to attorney-client privilege. Parties also might be concerned that, if a joint appraiser doesn't work out, they'll need to start over with new experts.

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Rebuild trust for the future

Always consider the unique facts and circumstances of the case *before* using a joint appraiser. If the parties seem capable of working together and openly sharing information, a joint appraiser can save time and money — and rebuild trust. The last component can be especially beneficial if the parties hope to, after the dust settles, have an ongoing relationship, such as family business owners who will spend the holidays together or divorcing spouses who will co-parent their children. ●

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John M. Leask II (Mac), CPA/ABV, CVA, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuators.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuators' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at www.LeaskBV.com.

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at ***203 - 255 - 3805.***
The fax is ***203 - 380 - 1289****, and e-mail is* ***Mac@LeaskBV.Com****.*

If you have a business valuation problem, Mac is always available to discuss your options — at no charge.