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Firm Values

A Business Appraisal Publication

Presented By:

GRW APPRAISAL SERVICES

BUSINESS APPRAISAL AND LITIGATION SUPPORT SERVICES

I offer this newsletter to provide insight into current information and trends in business and the appraisal industry. I hope you find it enriching and welcome any questions or comments. If there is a topic you'd like to discuss with me or report upon please let me know.

We provide services including business valuation, divorce consulting, litigation support, forensic accounting, account tracing, and transaction due diligence, and operations consulting. For further information about our practice please visit GRWAppraisalServices.com. You may email me at GRWAppraisal@Gmail.com or call me directly at 512-574-3444.

Greg Weichbrodt
Principal

This writing presents a discussion of valuation discounts relevant to minority shareholders, thoughts on the Tax Cuts and Jobs Act, and a discussion about potentially under reported business revenues.

Valuation Discounts Relevant to Minority Shareholder Interests - Part 1 - Discount for Lack of Control

In our Fall 2017 issue of *Firm Values* I provided a primer on shareholder buy-sell agreements. In this issue, I will further expand on a potentially critical component in these agreements - a discount for lack of control ("DLOC"). In the determination of value of a less than 100%, or minority interest in a company, a valuation analyst considers the shareholder's rights and benefits that come with such an ownership interest. Rights and benefits can vary among shareholders and are explicitly stated in a well-written operating or buy-sell agreement.

Having or lacking certain rights can have a considerable impact on the value of a shareholder's interest because a majority shareholder's ability to control company decisions can effect a minority shareholder's return on investment or ROI. After all, the primary reason most people invest in a company is because of the expected monetary return on their investment. Accordingly, a minority investor likely will perceive less value in an interest without control than for an otherwise equal controlling interest in a company. Examples of actions a controlling shareholder may take that can reduce the ROI to other shareholders include:

- Paying excess compensation or perquisites to majority shareholders without providing a proportionate benefit to others. Perquisites may include paying for non-business trips, meals, autos, retirement plans, medical care, education, etc.

- Paying non-working family members.
- Paying vendors related to the controlling shareholder at greater than market rates.
- Leasing a building owned by the controlling shareholder at greater than market rates.
- Borrowing funds from the company at no interest or at a rate less than market.
- Forcing a minority shareholder out of their investment in the company.
- Liquidating or dissolving the company.

With little power to limit such actions aside from costly litigation, a minority shareholder may be forced to accept the decisions of a controlling shareholder. Many times when setting up a business entity, prospective shareholders do so without the necessary consideration of how specific shares are to be valued. Often, this occurs because prospective owners do not understand the potential consequences of their decision at the time, or when a buy-sell agreement is silent on the issue, the lack of decision. Are differences in rights to be ignored and shares to be valued on a pro-rata basis of total company value? For example, should a 25% controlling interest be equal in value to a 25% non-controlling interest, or should a non-controlling interest be valued at something less than an otherwise equal controlling interest?

More often than not, such consideration is left to a time when shareholders are at odds and are looking to part ways. Naturally, the departing shareholder will want the to be paid as much as possible for his/her shares and the remaining shareholders will want to pay as little as possible to redeem the shares. Without prior agreement, a pending transaction may be quite contentious. In order to reduce disagreement among shareholders over share value, be sure an operating or buy-sell agreement contains explicit language that defines the parties' intentions and how shares with differing rights are to be valued. This can be accomplished by stating that discounts such as that for lack of control, or otherwise, are or are not to be considered in a determination of share value.

Know that the Fair Market Value standard of value implicitly includes consideration of a DLOC. So, when reading that shares are to be valued based on fair market value, an appraiser assumes that when appropriate, such a discount is to be applied. Keep in mind that it may be important to include exceptions to an agreed rule or standard of value. If a circumstance arises such as when a shareholder is to be expelled for wrongdoing, perhaps some discount to share value is appropriate, when otherwise it is not. Alternatively, when fair market value is the selected standard of value, perhaps under the circumstance of divorce when shares are to be divided between spouses, a DLOC may not be appropriate.

Understand that consistency in action is important. If a shareholder gained his/her interest in a company on a pro-rata basis of total ownership, such a precedent may dictate how an interest will be redeemed. To avoid future differences in understanding, come to and record in writing an agreement among shareholders on how to value a minority interest and do so under differing circumstances such as shareholder death, divorce, expulsion, withdrawal, etc.

In a following issue of *Fair Values*, I will present a review of the mechanics of considering a DLOC within certain valuation methodologies.

Will the new Tax Cuts and Jobs Act Cause a Conversion to C Corp. from Pass Through Status?

A new study by Penn Wharton predicts a "mass conversion" of pass-through businesses to C corporation under the Tax Cuts and Jobs Act. Likely converts are those professional services businesses that don't qualify for the new 20% qualified business income deduction (QBID). These firms are attracted to the lower corporate tax rate of 21%, as opposed to the pass-through rate of around 40%, particularly if they have the ability to defer paying out dividends, the study says. Researchers forecast that 235,780 U.S. business owners will switch from pass-through entity owners to C corporations.

Excerpted From BV Wire

Valuing Cash Heavy Businesses in Divorce

In a recent appraisal assignment, a primary concern of my client was that she did not believe the reported revenues in her husband's business were accurate. There are many small businesses that receive a substantial portion of their receipts in cash. Such businesses include nail or beauty salons, food trucks, restaurants, laundromats, etc. When one spouse operates a business and the other is not involved and does not have any familiarity with business operations, oftentimes there is concern that the company's reported financials are not representative of operations. Due to the rise of credit and debit cards, as well as digital payment systems such as Square Cash and PayPal the use of cash is declining but it still may represent a material portion of a company's revenues. However, short of a confession from the spouse who operates the business, it may be exceedingly difficult to directly quantify unreported receipts. Though, there are several ways to perform a "smell test" for its existence.

Ratio Comparison - Given competition, businesses within the same industry tend to operate at similar margins. Prices for services or products are competitive. The cost of supplies is similar. The employee bases and required wages likely are similar. There are many sources of company financial data such as in industry trade publications and that published by BizMiner.com or the Risk Management Association, RMA. These two data companies publish expense types by dollar amounts and as percentages of revenue by industry or NAICS code. If the subject company reports an expense that is substantially out of line with that of the average company in the industry, then this apparent discrepancy may be an indication of false reporting. First however, an analyst will try to rule out the reasons for any difference such as that for locational wage variations, or otherwise.

Bank Statement Review - It may seem obvious that if a business receives cash and does not report it in their financial reports that the cash will not be deposited either. However, sometimes it is deposited. So by looking at total deposits and removing any transfers or non-revenue additions to an account, an analyst can compare total deposits to reported revenues to look for unreported income. Further, with today's accounting programs, it is generally easy to identify the amount in reported cash transactions. Compare this amount for a given time period to deposits amounts too. More importantly, if it is known that a business receives some portion of their revenues in cash or that in general, companies in the industry that are similar to the subject company do so, then the lack of any cash deposits may need to be questioned.

Lifestyle Analysis - An analyst can review the manner in which the divorcing couple lives and interview his/her client about regular monthly expenditures. A list of total expenditures such as those for a mortgage, utilities, groceries, dining out, or otherwise can be compiled. If the amount spent on all items regularly surpasses the couple's reported income, then this may be an indication of under reported income.

By performing the above inspections, an analyst may be able to document enough circumstantial evidence to either coax a confession from the working spouse or to base his/her findings on adjusted amounts that correlate to the research performed. In my recent assignment, we decided to base the business appraisal analysis on the adjusted findings as I was unable to interview the opposing spouse, and it was believed the evidence was strong enough to suggest under reported income. The case is pending.

We invite you to contact us. Count on GRW Appraisal Services for the experience you need and to provide the personal attention you want. Call or email us today.

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