Firm Values

A Business Appraisal Publication

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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 you may have. If there is a topic you'd like me to discuss or report upon let me know.

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

Happy 2017! This writing presents an update of an emerging tax position taken by the IRS, a discussion of two widely used standards of value, and a look at the importance of the quality of earnings in an appraisal analysis.

Update to proposed IRC Section 2704 regulations

By now, surely you've heard about regulation 2704's possible effect on business valuation and taxpayers. If enacted as written it appears the regulations would make sweeping and very significant changes to the valuation of interests in many family-controlled entities for estate, gift, and generation-skipping transfer tax purposes.

December 1, 2016 Hearing

An amazing number of speakers descended on the IRS in Washington, D.C., to fight the controversial proposed Section 2704 regulations designed to curb estate valuation discounts for minority interests. Speakers testifying at the December 1 hearing said the rules are so broad and convoluted that they should be withdrawn permanently. If that's out of the question, the regs should be revised, but they're so far gone that they are beyond repair, speakers said. The IRS should go back to the drawing board and come out with a new version-and allow for another comment period.

In total, there were 37 witnesses-an "unprecedented" number, said the IRS-more than any other hearing in at least 30 years, an IRS attorney told BVWire. While the format of these hearings is simply for speakers to present their 10 minutes of comments, IRS and Treasury

officials on the panel felt compelled to make some remarks in response to the strong concerns of valuation experts, attorneys, wealth planners, and family business owners who testified.

A common issue speakers brought up was the so-called "implied put right" that exists in the proposed regs. This is the ability of each member of the entity to force the company to buy back his or her interest for cash equal to a minimum value within six months of exercising the right. No such right exists in the real world, speakers told the panel, and it should be removed from the regs.

No put right: "It is not our intention for the regs to contain a put right," said Charlotte Chyr, IRS Special Counsel. This appeared to put this matter to rest and short-circuited some comments by subsequent speakers.

Another recurring theme was the three-year rule, which would nullify discounts taken for certain transfers that occurred within three years of the transferor's death. Speakers were concerned that the rule would apply to transfers that occurred prior to the regs being finalized. As written, the regs are unclear on this.

Not retroactive: The three-year lookback rule "will not be retroactive," Chyr told the audience. It would only affect transfers made after the date the final regs are published.

Further, it was indicated that discounts will not be eliminated from consideration in valuation analyses: "We will make it clear that these regs will not eliminate minority discounts," said Catherine Hughes, attorney-advisor at the Treasury. Audience members were happy to hear that, to some extent. Of course, this doesn't mean that discounts won't be significantly reduced, which they will be under the regs as written.

While the panel addressed a few issues, many more remain, such as how the regs have redefined long-accepted definitions of fair market value, marketability, and control. For example, the regs remove the hypothetical willing buyer and willing seller assumption from the definition of fair market value-and also the notion of an arm's-length transaction.

Not all of the witnesses were against the regs. A speaker from Americans for Tax Fairness fully supports the regs, saying they will close loopholes the wealthy use to avoid estate taxes. Everyone agrees that some abuses are going on that should be stopped, but why not focus the regs on those egregious cases without hurting the family business that was formed for legitimate reasons?

What's next: The IRS will "seriously consider" the comments made at the hearing-and those about 10,000 people submitted on the IRS website. It is highly unlikely the IRS will finalize the proposed regs as written because of remarks officials made at the hearing. Some observers think the regs will be tweaked and rushed through before the Trump administration moves in, otherwise they will have little chance to see the light of day. Stay tuned!

Portions of this article are copied from BVWire, a publication of Business Valuation Resources, LLC

Fair value vs. fair market value in shareholder disputes

The applied standard of value is an important determinant in the ultimate conclusion of value when a business valuation expert performs an appraisal. A standard of value is a defined term that provides direction to the appraiser on how certain factors are to be considered. Two such standards are: 1) fair value, and 2) fair market value. The difference in definition between these two standards can lead an appraiser to render a meaningfully different conclusion of value, had the other standard been selected.

Fair market value is defined by the Internal Revenue Service (IRS) in its Revenue Ruling 59-60 as: "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge or relevant facts".

There is not unified definition of fair value. This standard of value has been defined by court jurisdiction and can vary from state to state. A generally recognized definition from Section

13.01(4) of the Revised Model Business Corporation Act ("RMBCA") issued by The Committee on Corporate Laws of the American Bar Association Section of Business Law and reads: "'Fair value' means the value of a corporation's shares determined: (i) immediately before the effectuation of the corporate action to which the shareholder objects; (ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and (iii) without discounting for lack of marketability or shareholder minority status except, if appropriate, for amendments to the articles pursuant to section 13.02(a)(5)".

The primary difference between these two standards is the treatment of shareholder level discounts. Subsection (iii) above states that under the fair value standard such discounts are to be disregarded. In instances when the subject of an appraisal is less than 100 percent of the equity in a company, it is important to understand the effect of the applied standard of value, as the application of shareholder level discounts can result in a considerably reduced conclusion of value.

The RMBCA contains an official comment section that provides clarity on the definition of fair value and addresses applications of the standard, as defined. It states: "Subsection (iii) of the definition of "fair value" establishes that valuation discounts for lack of marketability or minority status are inappropriate in most appraisal actions, both because most transactions that trigger appraisal rights affect the corporation as a whole and because such discounts give the majority the opportunity to take advantage of minority shareholders who have been forced against their will to accept the appraisal-triggering transaction. Subsection (iii), in conjunction with the lead-in language to the definition, is also designed to adopt the more modern view that appraisal should generally award a shareholder his or her proportional interest in the corporation after valuing the corporation as a whole, rather than the value of the shareholder's shares when valued alone."

While the RMBCA cites appropriate uses for the fair value standard, many state courts have adopted this standard for use in actions that call for an equitable division of company shares. Listed below are four cases that address the application of shareholder level discounts in shareholder disputes.

1) TriContinental Corp. v. Battye, 74 A.2d 71 (Del. 1950)
2) Cavalier Oil Corp. v. Harnett, 564 A.2d 1137 (Del. 1989)
3) Swope v. Siegel-Robert, Inc., 243 F.3d 486, 492 (8th Cir. 2001)
4) Pueblo Bancorporation v. Lindoe, Inc., 63 P.3d 353 (Colo. 2003)

The opinions in the above cases regarding the application of discounts are consistent. It was determined in each of the cases that the use of the fair value standard and thus, disregarding shareholder level discounts, was appropriate under the given circumstances.

Shareholder disputes can arise for a variety of reasons. Parties to these disputes should be aware of the nuances that may be involved in the valuation of a partial interest in a closely held business, including the appropriate standard of value to be applied. Further, careful consideration should be given to relevant statutes and case law when determining whether or not valuation discounts are applicable when valuing an ownership interest. Selection and interpretation of the appropriate standard of value in a disputed case is a legal issue which is to be argued by counsel and ultimately decided by the court.

Quality of earnings

Company earnings are not always objective and business valuation experts regularly apply a multiple to earnings to determine a company's value. A primary element in valuing a company is the determination of "normalized" earnings.

In most business sales, the buyer is acquiring a business for its cash flows, and weighs the predictability of such income. Cash flow is related to reported earnings, but considers other elements such as non-cash receipts or expenditures reported on the financial statements, changes in working capital, and other balance sheet components. An appraiser generally begins with reported earnings and then must convert it to cash flow to understand what an

investor may actually expect as a return on his or her investment. The normalization of earnings process is a critical step in arriving at this expectation.

Generally, the act of normalizing earnings not only consists of the conversion of income to cash flow but also includes consideration of items that do not affect the profit or loss. A careful analysis of earnings and the dynamics of a company's operations will result in a useful tool - normalized cash flow.

EBITDA and other measures of income

Earnings Before Interest, Tax, Depreciation, and Amortization ("EBITDA") is a commonly used basis of earnings. EBITDA generally represents the amount of cash flow from a business' operations that is available to be reinvested in the business, service debt by paying interest and repaying principal, pay taxes, and provide a return on investment to the owners. One important issue not considered in determining EBITDA is the recurring need of the business to add to its fixed assets or equipment. Accordingly, a review of EBITDA does not appropriately represent available cash flow or investor return. Other bases of company earnings may include Earnings Before Interest and Tax ("EBIT"), Pretax Income or Earnings Before Tax ("EBT"). Each of which exclude critical components of normalized cash flow.

Expected earnings

Potential future income is a primary factor in the valuation of a closely-held interest, and all information concerning past income which may be helpful in charting or predicting future operations should be considered. The use of prior earnings records is a good starting point to future expectancy. Determining earnings and its quality is an important first step. In addition to considering the company's reported earnings, it is usual and necessary to normalize such earnings for discretionary ownership payments, nonrecurring items, costs not chargeable to operations, and asset and liability adjustments that would affect operating results and returns to investors.

Regardless of a company's earnings reporting method, adjustments usually need to be made to the selected earnings basis to arrive at a normalized level of income. Four categories of adjustments are presented below.

(1) Owners discretionary payments

Though not a complete list, optional, excessive, or unnecessary payments that should be added back to reported income include the following:

- Owners' salaries in excess of the amount required of non-owners performing the same functions
- Owners' family members receiving payroll or consulting fees in excess of the amount typically paid for such services
- Excess fringe benefits for owners and their families
- Insurance premiums for personal or excessive coverage compared to what is normally offered to employees
- Life, disability, and long term care insurance premium payments when the company is not the beneficiary
- Health care expenses for owners
- Expenses for vehicles not used primarily in the business
- Travel, entertaining, sports, and ticket expenses not for direct or actual business purposes
- Rent paid for owner owned property in excess of market rent
- Repairs, maintenance, utilities, supplies, and any other payments that can be attributed to the personal use of or benefit to the owners
- Temporary occupancy costs or rent primarily for personal use
- Contributions made to the owners' favorite and personal charities
- Any other items not necessary for operating the business

This is a representative list and that listed may not apply. The object is to inspect all expenses to include only those that are necessary for business operations, and eliminate all others, to arrive at a normalized income basis.

(2) Nonrecurring costs

A second category of expense that may be adjusted out consists of one-time or nonrecurring costs or expenses. A representative list follows.

- Bonuses or incentive payments to employees for specific extraordinary performance if not repeated annually
- Consulting fees for special one-time projects
- Higher than market salaries for certain key and unrelated people performing services that are beyond the scope of their usual responsibilities and that an owner/officer usually would be expected to do
- Extraordinary revenues from customers that previously cut back and now restocked their inventory to bring it to more regular or prior levels
- Income or losses resulting from a one-time sale of obsolete inventory or fixed assets
- Product recall costs
- Water or storm damage repairs or insurance proceeds
- Moving costs
- Write off of a product line or a business development project
- Buy-out of a long-term contract

(3) Costs not chargeable to operations

Depending on the selected basis another group of adjustments includes actual and regular costs that may not belong in the calculation of normalized earnings, such as:

- Interest payments
- Interest income
- Expenses not representing cash expenditures such as depreciation and amortization
- Income not representing cash infusions such as accrued contingent revenue expected to be received in later periods
- Income taxes

Additionally, those that may not be included in reported earnings and may belong in the calculation of normalized earnings, such as:

- expected expenditures for capital assets - to appropriately capture this, the use of a multiple year projection may be necessary instead of using a single period representative income basis.

(4) Additional adjustments

A further category to be considered is the adjustment of asset values and payments that would affect earnings, such as:

- Accounts receivable adjustment for uncollectible accounts
- Inventory adjustment to one that is more aligned with market value - resulting in a potential cost of goods sold adjustment
- Reserves for sales returns, allowances, warranties, customer complaints, advertising credits, and similar items based on representations to customers
- Excessive upfront contractual payments for periods extending over successive years
- Annual payment items for periods stretching into the following year
- Equipment or fixed asset purchases, additions, renovations, or major maintenance projects that should be capitalized rather than expensed

Income taxes

An adjustment for corporate income taxes must be considered. This is a hotly contested area of valuation. Some businesses operate as pass-through companies such as those electing Subchapter S-corporation status, partnerships, or limited liability companies where income is not taxed at the corporate level but rather passes through to the individual ownership level when it is taxed, whether or not distributed. When a business operates as a C corporation, taxes are payable by the company on the reported income. Whether or not to tax income primarily is based on the selected valuation methodology and source data used to convert income to value. Further reading on the subject of taxation in valuation should be done outside of this article.

Capital structure and asset base

While capital activity may not factor into a determination of earnings, it should be considered in calculating a representative cash flow. There should be a review of the company's capital structure, the company's need for regular or permanent borrowing, and the need for one-time or continuous fixed asset acquisition. A consideration of such items that effect cash flow likely will affect the resulting valuation. Depending on the selected valuation methodology, these items may need to be factored into cash flow either by including interest costs, loan principal repayments, or regular and periodic capital expenditures.

For a growing business, it is important to consider the draw on cash to fund current liabilities, increasing accounts receivable, and growing inventory levels. While not part of an earnings calculation, these issues cannot be disregarded. Again, it may not be possible to model all factors within a single period of representative earnings. It may be necessary to model several years of cash flows and account for expected sources and uses of cash over a longer projection period.

Sustainability of earnings

The sustainability of earnings needs to be considered based upon the company's history and projected operations; whether there have been any changes in operations, major customers gained or lost, change in location, loss of or need for essential employees, and outside elements that would affect the continuance of the company's trends. Outside factors include items such as:

- economic or industry trends
- commodity prices and availability
- susceptibility to disruptive activities
- the continuance of strength in the marketplace of the company brand or product
- ease or difficulty of competitors entering the market

Conclusion

Any determination of expected earnings involves many judgments, and each of the many steps in determining such earnings has to be done carefully and deliberately with a focus on the magnitude of its effect on the final conclusion. A trained appraiser will consider and document any adjustments made in order for the user of the appraisal to apply their judgment to the process. The quality of the process used to determine a representative normalized earnings level is a key starting point to arriving at a reasonable conclusion of company value.

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