Valuation Concepts

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Adding up the little stuff

Normalization adjustments under the income approach

Along with generating (one hopes) healthy earnings, a business may provide its owners with a variety of perquisites, such as vehicles and travel opportunities. Under the income approach, a valuator will likely make adjustments for many, if not most, of these perquisites, as they can significantly affect how much the business is worth.

Getting back to normal

The income approach calculates the expected economic benefits of a company into a single amount by converting some level of earnings into a value using a capitalization rate or discount rate. But, when valuing the business, an appraiser must analyze and, if appropriate, adjust or "normalize" the financial statements.

A valuator should make adjustments only if the hypothetical buyer could implement the necessary changes.

These normalization adjustments modify reported financial data relevant to the appraisal process. A valuator may use them to:

- Remove nonrecurring, unusual or unnecessary expenses from the business's income statement that decrease its true economic earnings,
- Identify items that artificially inflate (one-time or unusual income items) or reduce (abnormally low items) income,
- Present consistent financial data regarding the subject and guideline companies,
- Adjust from reported values to current values,
- Amend revenues and expenses to levels that are reasonably representative of continuing results, and
- Revise for nonoperating assets and liabilities as well as any related revenues and expenses.

The ultimate objective of normalization adjustments is to convert the cash flow of the business, its ownership interests or securities to a stream of cash flows that reflects what the hypothetical buyer would have access to. Adjustments would also be made to reflect the actual value of each *asset* a hypothetical buyer would have access to. This generally results in a better estimate of fair market value, though a valuator should

make the adjustments only if the hypothetical buyer could implement the necessary changes.

Recognizing the typical items

Normalization adjustments can arise from many sources. Typical items may include:

Owner compensation. Some business owners may deplete earnings through compensation, leaving little within the company for distributions. When developing a value opinion, an appraiser would consult salary surveys, industry studies or other sources to determine reasonable compensation.

The results of this research may lead the appraiser to add back income to the business if compensation was excessive or to subtract income if compensation was below industry standards. Other compensation-related adjustments, for items such as payroll taxes, benefits and other amounts that fluctuate based on wages, may also be warranted.

Rent. If the company pays rent to a related party, the payments may be above or below market rates. The appraiser may investigate rental rates for similar neighboring facilities, consult with realtors and even obtain a real estate appraisal.

Other factors may complicate the analysis, including the term of the lease agreement and capacity issues (such as when a company is paying rent on a

Accounting plays a role, too

Items that qualify as a normalization adjustment aren't always as obvious as a lengthy "corporate retreat" to the Bahamas or a "business vehicle" for a young employee who happens to share a last name with the owner. Many normalization adjustments spring directly from a company's books, including:

Inventory. There are several methods to account for inventory. When the "last in, first out" (LIFO) method is used, ending inventory figures may not reflect those assets' economic value. Further, higher purchase expenses are typically charged against revenues under the LIFO method, lowering net income. In these situations, a valuator often must make a normalization adjustment.

Depreciation. Depreciation is an accounting mechanism that allocates asset costs over a "useful life." Some businesses use tax-driven methods that accelerate depreciation, while others use a "straight-line" method.

The decision on the type of depreciation method to use can be based on factors such as a company's basis of accounting or tax planning initiatives. In either case, net asset values may be understated on the company's balance sheet. After considering commonly used industry methods, a valuator may adjust asset values and depreciation expense. In some cases, he or she might also obtain an appraisal of the fixed assets.

Miscellaneous entries. The books of many businesses contain a wide variety of entries that, though relatively small, could affect the company's value if the appraiser doesn't properly recognize them. Adjustments may be warranted for items such as bad debt expense, installment sales, capital vs. operating leases, notes receivable and payable, and contingent liabilities.

10,000 square foot warehouse but historically uses only 5,000 — it may not need the extra capacity and the rent on this unused footage may be a potential add-back to earnings).

Perquisites. Often, certain expenses occur solely at the owner's discretion. For example, he or she might decide to contribute large amounts to a favorite charity, attend an expensive "business-related" golf vacation or pay country club dues through the business. Such costs may not be ordinary or necessary for the business and call for adjustment.

Nonrecurring expenses. These may include legal fees related to a lawsuit, one-time computer consulting fees, or large and unusual purchases. The appraiser may need to add back such costs to the company's income.

Nonrecurring revenue. Businesses sometimes garner funds from one-time sources such as discontinued operations and vendor refunds. Although each of these amounts may be relatively small, when aggregated, they can add up and affect the company's value, requiring adjustments.

Depicting the true condition

The normalization adjustments we've discussed here are just a few of the more common ones. Each appraisal, having unique circumstances, may warrant different adjustments. In any case, revising an income statement with normalization adjustments allows a valuator to accurately depict the entity's true economic condition to a company's owners, as well as current or prospective investors and buyers.

Lack of control discounts don't always apply to minority interests

One critical factor in any business valuation is control. Precisely who's in charge of the company and who isn't? For valuation purposes, the concept of control relates to a shareholder's ability to influence the company's affairs. And his or her ability to do so isn't always related to percentage of ownership interest.

For example, a shareholder may own only a small percentage of the company's outstanding shares but own all of the voting shares. In this instance, the shareholder would effectively have control of the company despite the larger ownership percentages of the other shareholders.

Yet this distinction is often unclear to business owners — particularly minority owners, who may assume things about their ownership status that, ultimately, don't hold up in court.

Perks of ownership

Someone with a controlling ownership interest in a business enjoys certain perquisites that represent his or her rights as a "control owner." Some of the more common benefits afforded to control owners include the ability to:

- Select management,
- Set management compensation and perquisites,
- Enter into contracts,
- Sell the company or its assets, and
- Change the articles of incorporation or company bylaws.

These benefits are generally unavailable to minority interest holders. Therefore, the value of a minority interest can be subject to a lack of control discount because of these shareholders' inability to control officer compensation or other company policies — an inability that could positively or negatively affect the shareholder's capacity to sell that minority interest.

The court defined "intrinsic value" as "the worth of the property to the parties."

The valuation approach may, however, affect minority discounts. For example, if a valuator uses the income approach and adjusts for officers' compensation, the level of value might move toward a controlling interest rather than a minority one. This is because a minority shareholder normally would not have the ability to change an owner's compensation.

An interesting example

One recent case provides an interesting example. In *Owens v. Owens*, a marital dissolution, the husband argued that the trial court had abused its discretion by failing to apply a lack of control discount in valuing his interest in the business in question. The husband and his brother each owned 50% of the company, so the husband's expert applied a one-third lack of control discount because the husband owned less than 51% of the business and didn't effectively have control.

The trial court, however, refused to take into account any discounts. It stated that the company was "being valued for equitable distribution and not for sale." The husband appealed, but the appellate court affirmed the trial court's opinion, asserting that the concept of intrinsic value was the appropriate standard of value in equitable distributions. The court defined "intrinsic value" as "the worth of the property to the parties."

Dubious assumptions

Business owners need to know exactly what type of control they have over their companies and how a valuator, or indeed a court, may define that control under various circumstances. Otherwise, they may make dubious assumptions and learn — too late — that a critical discount, or some other valuation factor, doesn't always apply.

Are S corporations worth more than C corporations?

Consensus develops regarding whether to tax-affect earnings

It's a storied valuation debate: Is an S corporation worth more than a C corporation? And is there value to the S election? The answer at least partly relates to the practice of "tax-affecting" S corporation earnings.

When performing a valuation, if an appraiser tax-affects an S corporation's earnings, the resulting value will be the same as it would be for a C corporation, assuming the exact same circumstances. If he or she *doesn't* tax-affect the earnings, the resulting value will be higher than that of an identical C corporation under the same circumstances.

Whether it's appropriate to tax-affect S corporation earnings has been widely argued — including in the courtroom. Slowly, a consensus seems to be developing.

3 advantages of S corporations

For tax purposes, the difference between C corporations and S corporations is clear. C corporations are taxed as legal entities separate from their shareholders; whereas, if a company elects S corporation status, its taxable income passes through to the shareholders and is exempt from federal and, sometimes, state corporate income taxes.

Although the tax differences between S corporations and C corporations are clear, whether valuators should tax-affect S corporation earnings is decidedly less so.

Instead, its shareholders are taxed on income from their proportional ownership in the business at their respective individual tax rates. Consequently, there are three major advantages to electing S corporation status:

1. No double taxation. Unlike C corporations, the company can distribute its dividends without incurring income taxes twice.

2. A boost in basis. Shareholders receive an increase in their basis to the extent that taxable income exceeds distributions to them.

3. A tax-saving opportunity. In the event of a sale, S corporation owners may receive more proceeds if the buyer can realize increased tax savings by allocating the purchase price down to the underlying assets and getting a step-up in basis.

A step-up in basis increases the buyer's basis to the amount of the purchase price, thereby reducing the buyer's income taxes in future years through increased depreciation and amortization or lessening the buyer's future capital gains on the sale of the entity's assets.

What the courts have said

Although the tax differences between S corporations and C corporations are clear, whether valuators should tax-affect S corporation earnings is decidedly less so. Several legal rulings have addressed the subject, including:

Walter L. Gross v. Commissioner. This case involved a small minority interest, with shareholders receiving distributions approximately equal to taxable net income. The shareholder agreement limited potential willing buyers of the subject interest to persons who met the legal requirement for the corporation to retain its S corporation status, and none of the shareholders expressed an interest in selling their respective shares.

The Tax Court determined that the S corporation's earnings should not be tax-affected, noting that it

would create a "fictitious tax burden" that reduces earnings by 40% and thereby diminishes the value. The Sixth U.S. Circuit Court of Appeals affirmed this decision in a two-to-one vote.

A variety of factors may be pertinent to deciding whether tax-affecting is warranted.

Estate of Adams v. Commissioner. Similar logic prevailed here. The Tax Court suggested, while citing *Gross,* that S corporation earnings shouldn't be tax-affected because S corporations essentially have a 0% tax rate.

Estate of Heck v. Commissioner. In this case, neither expert tax-affected their clients' minority cash flows in valuing the minority interest. But both experts took discounts for the risk the minority interest shareholder takes on from electing S corporation status (that risk being that S corporation status could be lost). The Tax Court agreed that a 10% discount was appropriate for such additional risks, in addition to a 15% marketability discount.

Estate of Wall v. Commissioner. Here the taxpayer's expert presented a traditional tax-affected valuation. The Tax Court again rejected this approach, stating:

"We believe it is likely to result in an undervaluation of [the subject S corporation] stock …We also note that both experts' income-based analyses probably underestimated value, because they determined cash flows on hypothetical after-tax bases and then used market rates of return on taxable investments to determine the present value of those cash flows."

Overall, these cases point out a repeated rejection of the traditional valuation practice of automatically tax-affecting S corporation pretax income when valuing interests in S corporations and, presumably, other pass-through entities.

Valuation considerations

The larger lesson to be learned here is that, when valuing S corporations, tax-affecting the business's earnings may not always be appropriate. There are a variety of factors that may be pertinent to deciding whether doing so is warranted, including:

- Whether the subject interest is a minority or control interest,
- Whether the history of distributions (that is, the dividends S corporations pay shareholders) reflects future expectations,
- The hypothetical buyer's likely exit strategy (What is the expected holding period? Is there a reasonable chance that retained net income will be realized and that the buyer will pay for the ability to use the increased basis? If so, when?), and
- Whether it's reasonable to believe that an opportunity exists for a step-up in the basis of the assets for the hypothetical buyer. And if so, how is that measured and when?

As you can see, making this choice is hardly simple, so the uncertainty surrounding tax-affecting isn't surprising.

Facts and circumstances

The legal decisions we've mentioned reflect that it's no longer appropriate for valuators to automatically tax-affect S corporation earnings. Courts will likely support only strongly substantiated decisions to tax-affect. Thus, ultimately, valuators must base that decision — and each appraisal as a whole — on the specific facts and circumstances of the case.

The value of voting vs. nonvoting stock

In drafting various company agreements, attorneys commonly use voting and nonvoting stock classes, as well as other vehicles (such as general partner and limited partner interests), to segregate a company's voting rights. Yet is there truly a value difference between voting and nonvoting shares?

Good question

Possession of a controlling interest in a business usually allows a shareholder to enjoy certain rights over other shareholders. State statutes, however, may affect these rights. In some states, for instance, a simple majority is sufficient for most critical decisions, such as mergers, sales, liquidations and acquisitions. Other states may require a two-thirds or greater majority to approve such actions.

When valuing voting vs. nonvoting stock, an appraiser must determine whether the owner of the voting shares is able to derive additional economic benefits from them.

Naturally, these variations in state law regarding the rights of minority shareholders can significantly affect the worth of an ownership interest. And when valuing voting vs. nonvoting stock, an appraiser must first and foremost determine whether the owner of the voting shares is able to, in fact, derive additional economic benefits from them.

If the answer is yes, then clearly the voting shares are worth more than the nonvoting ones. This situation is more common in controlling ownership positions; but each situation is unique, so valuators carefully assess all of the relevant facts to be sure.

If the answer is no, then the matter isn't as clear. And the best way to calculate the value differential between voting and nonvoting shares remains a widely discussed issue in the valuation community, and, again, each case brings its own distinctive factors into play.

Various texts and journals have discussed the price differential between voting and nonvoting shares, the most notable being *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, by Pratt, Reilly and Schweihs. It states that the differential for voting shares usually doesn't exceed 10%. Other studies performed in the 1980s and 1990s calculated the median premiums for voting shares as ranging from 1.3% to 6.37%.

Estate planning relevancy

The issue of voting vs. nonvoting share value is especially relevant in the context of estate planning. Historically, the IRS has suggested that a company's voting shares are worth significantly more than its nonvoting shares.

In an important case, *Estate of Richard R. Simplot v. Commissioner*, the Tax Court assigned a substantial premium to the decedent's minority voting stock in J.R. Simplot Co. over his nonvoting stock. In its analysis, the court considered who would be the most likely buyer, the investment holding period and the potential control ownership implications, among other things.

The Ninth U.S. Circuit Court of Appeals reversed the Tax Court's decision, which it asserted was based on "speculation" and "imaginary scenarios." The Ninth Circuit went on to say that, "in violation of law, the Tax Court constructed particular possible purchases." Doing so clearly violates the definition of fair market value, as a hypothetical willing buyer and a hypothetical willing seller aren't "specific individuals or entities."

In the Tax Court's ruling, two of the three judges of the Ninth Circuit ruled that the IRS hadn't convincingly shown that the minority interest in the voting shares was of more value than the interest in the nonvoting shares. Essentially, the Ninth Circuit valued the voting shares as economically equal to the nonvoting ones.

Differing situations

The *Simplot* case serves as a reminder to revisit the definition of fair market value and its related implications more often. Ultimately, it appears most appraisers would probably agree with the notion that minority voting shares have some incremental value above nonvoting shares. But just how much more valuable voting shares are than nonvoting ones depends on each situation.