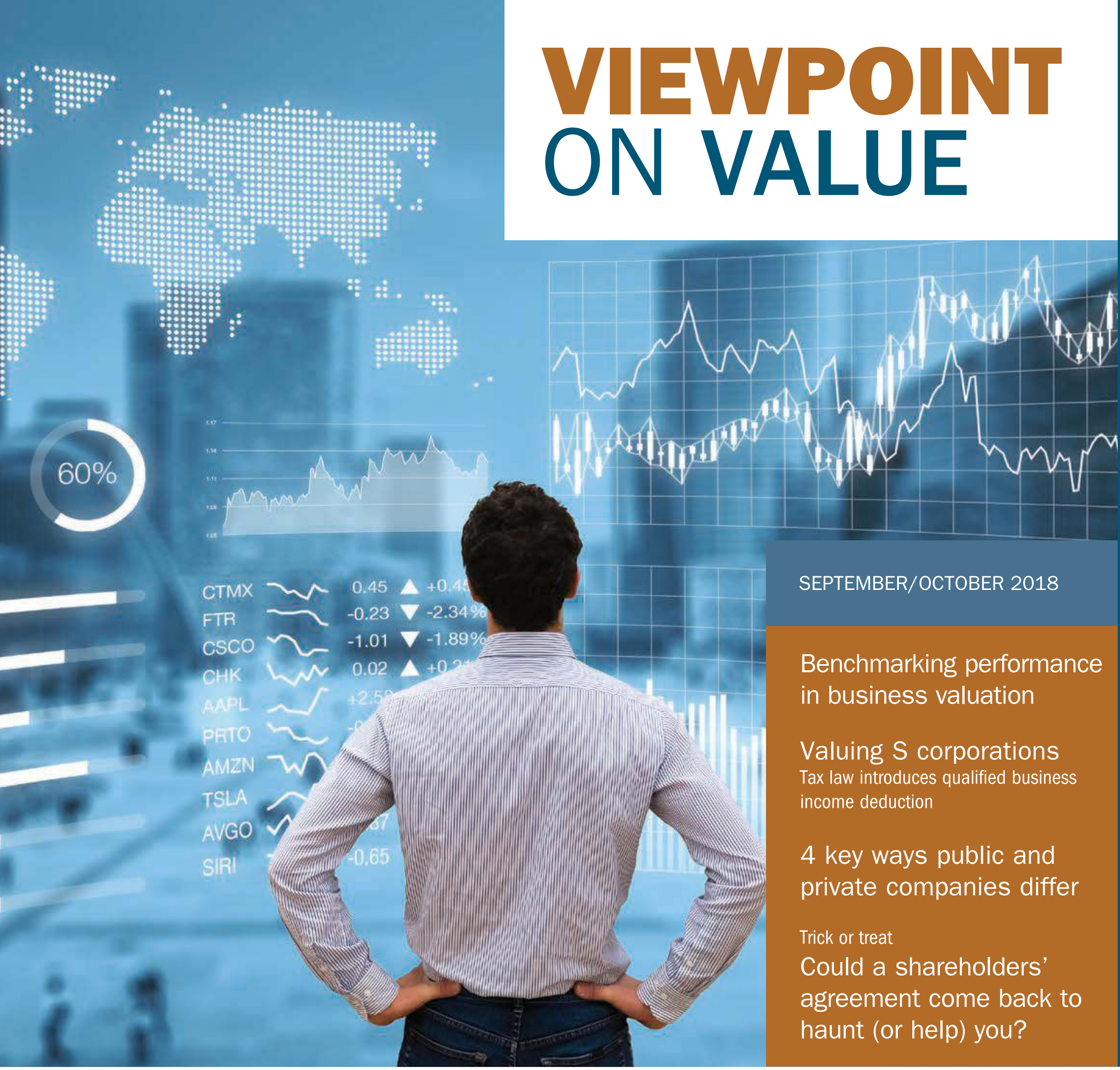
VIEWPOINT ON VALUE



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Benchmarking performance in business valuation

Valuing S corporations
Tax law introduces qualified business income deduction

4 key ways public and private companies differ

Trick or treat
Could a shareholders' agreement come back to haunt (or help) you?

Do you have a **Question?** or want to speak to
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Benchmarking performance in business valuation

One way to gauge company-specific risk is to benchmark financial performance over time and against competitors. In turn, the risk assessment helps an expert estimate the subject company's expected return. Here are critical benchmarks that business valuation experts monitor when valuing a private business.

Profitability

Profitability metrics evaluate how much money the subject company earns from each dollar in revenue. For-profit companies need to earn enough to cover fixed and variable costs, but some may accept a loss on certain products to gain market share or lure customers.

For example, a consumer product manufacturer might not make much money from selling a razor base — in fact, these may be given away for free or for a nominal amount. But the manufacturer makes up for the loss when it sells replacement blades and complementary products with a hefty margin.

Common profitability metrics include:

- Gross margin [(revenue – costs of sales) / revenue], and
- EBITDA margin (earnings before interest, taxes, depreciation and amortization / revenue).

Profit margin (net income / revenue) may be less relevant when benchmarking private firms, because it's hard to compare companies with different tax structures. So, EBITDA may be used instead. This also eliminates from the analysis the effects of accelerated first-year depreciation deductions for private companies that have recently acquired major fixed assets — as well as the effects of differing interest rates between the subject company and its comparables.

Liquidity

The income statement tells only part of the story. Business valuation experts also spend significant time dissecting the balance sheet, starting with working capital metrics. To the extent that current assets exceed current liabilities, the subject company has extra cushion (or liquidity) to weather short-term cash shortfalls and adverse events.

Conversely, when a company's current ratio (current assets / current liabilities) is less than 1, a line of credit might be needed in case of emergency. A business with above- or below-average liquidity may warrant an adjustment for excess or deficit working capital. It's also important to evaluate the composition of working capital for bad debts, obsolete inventory and shrinkage.

Asset management

Business valuation experts also consider how much revenue is generated for each dollar invested in assets (revenue / total assets). This analysis can be broken down by different categories of assets and evaluated in terms of days (rather than the number of times an account turns over). For example, an expert might compute:

- Days in receivables [(average receivables / annual revenue) × 365 days], or
- Days in inventory [(average inventory / annual cost of sales) × 365 days].

Productivity metrics also can be industry specific. For example, a hospital might be evaluated based on revenue per bed or a hotel based on revenue per room. A labor-intensive manufacturer might be evaluated in terms of output per worker. Human capital isn't reported on the balance sheet, but it can be a valuable asset.

Pay attention to accounting methods

Before benchmarking financial performance, it's important to consider the accounting methods used by the subject company and its comparables. Adjustments may be needed to the extent that the subject company deviates from accounting norms; otherwise, inaccurate "apples-to-oranges" comparisons may result.

Some differences may not be obvious. For example, suppose a private company follows U.S. Generally Accepted Accounting Principles (GAAP). However, GAAP allows certain private company reporting alternatives. One alternative permits a private company to amortize goodwill from a business combination over 10 years, rather than test it annually for impairment.

Annual amortization charges reduce the fair value of goodwill (an asset) and lower profits. Plus, the charges are incurred regardless of whether the merger is successful (unlike impairment charges). Subtle differences in financial reporting methods could affect an expert's financial analysis, if no adjustments are made.

Leverage

Debt can be an inexpensive alternative to equity financing that helps the business grow and lowers the cost of capital. Typically, the cost of debt is less than the cost of equity. That's because debtholders are paid before equity investors in a liquidation. Plus, interest expense is generally tax deductible. (Dividends paid to equity investors aren't tax deductible.) However, the cost of debt may become prohibitive as the debt-to-equity ratio increases.

For tax years that begin in 2018 or later, the Tax Cuts and Jobs Act generally imposes new limits on interest expense deductions for businesses with annual gross receipts over $25 million. Additional rules and restrictions apply, and there are some exceptions. For certain businesses above this threshold, the change could increase the cost of debt capital.

Borrowing money can be a cost-effective way to grow a business. But there are limits. At some point, the cost of debt capital becomes prohibitive, and creditors may be unwilling to lend additional funds.

It's all relative

When benchmarking financial performance, what's "normal" varies depending on the company's size, industry and geographic location. Business valuation professionals understand these nuances and how they affect a company's perceived risk and expected return. Contact a trained specialist for more information on how financial benchmarking is used to value a business. ■

Valuing S corporations

Tax law introduces qualified business income deduction

Are S corporations worth more (or less) than otherwise equal C corporations? The Tax Cuts and Jobs Act (TCJA) introduces a new twist in the tax-affecting debate for S corporations — a tax deduction equal to as much as 20% of qualified business income (QBI) that attempts to level the tax playing field between C corporations and pass-through entities, including S corporations.

What is the "tax-affecting" debate?

Under prior law, net taxable income from S corporations (and other pass-through business entities) was simply taxed at the owners' level at the ordinary-income rates for individuals. In general, no tax was paid at the entity level on S corporation earnings. C corporation income, on the other hand, is taxed at the entity level, and any dividends are taxed again at the shareholder level.

Often, operating as an S corporation was a smart tax-saving strategy under prior law for entities that qualified. But this favorable tax treatment was less advantageous if a business didn't distribute enough cash to cover the owners' tax obligations related to the business — or if the business no longer qualified (or planned) to operate as an S corporation.

Today, experts and courts generally concede that avoiding entity-level taxes is an important *benefit* to consider when valuing an S corporation. But experts also must consider the *downsides* to owning a minority interest in an S corporation, such as how much the company distributes to shareholders, and whether there's a differential between tax rates at the corporate level and the investor level.

What's changing?

Under the TCJA, C corporations will permanently be taxed at a flat 21% for tax years beginning in 2018. This rate is significantly lower than the top individual tax rate of 37% for 2018 through 2025 (unless Congress extends it). To help achieve some parity between different types of businesses, Congress devised the QBI deduction. But the TCJA made the break temporary and not every S corporation will be eligible — and it isn't always 20% of QBI.

Available for tax years beginning in 2018 through 2025 (unless Congress extends it), the new deduction generally equals:

- 20% of QBI from a partnership, limited liability company (LLC), S corporation or sole proprietorship, plus
- 20% of aggregate qualified dividends from REITs, cooperatives and qualified publicly traded partnerships.

What are the limitations?

The deduction is limited to 20% of an owner's taxable income, which is calculated before the QBI deduction and before any net long-term capital gains and qualified dividends that are eligible for preferential federal income tax rates. In addition, if an owner's taxable income exceeds certain limits, the QBI deduction is subject to two other limitations:

1. **W-2 wage limitation.** The QBI deduction can't exceed the greater of the noncorporate owner's share of: 1) 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or 2) the sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

2. **Service business limitation.** Income from specified service businesses generally doesn't count as QBI. This limitation affects any business where the principal asset is the reputation or skill of one or more of its employees, including doctors, attorneys, actuaries and financial advisors. Engineers and architects, however, are specifically excluded from this limitation.

The limitations for both W-2 wages and service businesses don't apply until an owner's taxable income exceeds $157,500, or $315,000 for a married couple filing jointly. Above those income levels, the limitations are phased in over a $50,000 taxable income range, or over a $100,000 range for joint filers.

The debate continues

When it comes to tax-affecting pass-through entities, there's no clear-cut guidance that prescribes a specific tax rate — or denies tax-affecting altogether. Rather, tax-affecting may be permitted on a case-by-case basis, depending on the facts and circumstances.

Business valuation experts must understand this new tax law provision when they value an S corporation using public (C corporation) data. In addition, case law decided under prior law may not be as relevant under the TCJA. For more information, contact a business valuation professional. ■

4 key ways public and private companies differ

Public company data often serves as the basis for valuing privately held businesses, because it's readily obtained from a public stock exchange. But there are four important differences between these types of businesses that valuation experts need to consider.

1. Size

Public companies must achieve a certain "critical mass" to justify the costs of going public and complying with the ongoing reporting requirements of the Securities and Exchange Commission (SEC). The largest public companies are multibillion dollar conglomerates with global business operations.

By comparison, there are many small private companies with under $10 million in annual revenue and fewer than 10 employees. They often operate as pass-through entities — that are taxed at the owners' individual tax rates — rather than as C corporations. Smaller entities also tend to be domiciled in the United States and have limited market reach. They typically operate in one industry or geographic region.

professional management teams. Or they may receive financing at premium rates to compensate creditors for their incremental risk. In turn, capital constraints can impair the growth prospects of a small business.

Small business owners tend to rely on their personal savings — or friends and family — to finance business operations. Are these forms of financing considered debt or equity? Informal loans may be unrecorded or stay on the balance sheet for years without incurring interest charges.

2. Level of sophistication

Public companies typically have many shareholders who expect the company to be professionally managed and profitable. The SEC requires public companies to issue audited financial statements that conform to U.S. Generally Accepted Accounting Principles (GAAP).

Private companies vary in terms of management quality. Some are run like public companies with an emphasis on maximizing earnings per share. However, many closely held businesses strive to minimize their tax obligations — or they may focus on the owner's philanthropic or personal objectives. Private businesses also tend to engage in related-party transactions, such as below-market rental agreements or relatives on the payroll.

The quality of financial reporting also varies among private companies. It's common for smaller businesses to issue reviewed or compiled financials — or to follow a non-GAAP method of accounting.

3. Access to capital

Banks and private equity (PE) investors may be hesitant to finance private companies, especially those without formal business plans, audited financial statements and

4. Internal controls

Private businesses are often managed by individuals who play multiple roles. As a result, they tend to have fewer internal controls to prevent fraud and cyberattacks than public companies do.

For example, private companies may not have enough employees to duplicate or rotate jobs. Or they may not have enough resources to implement a fraud reporting hotline or conduct internal audits — or even to perform a physical inventory count.

The *Report to the Nations on Occupational Fraud and Abuse* by the Association of Certified Fraud Examiners (ACFE) confirms that weaker internal controls often contribute to bigger fraud losses among private businesses. The 2018 ACFE study found that the median fraud loss among private businesses was $164,000, compared to $117,000 for public ones.

Ready, set, adjust

There's a wealth of public company transaction data that often serves as the starting point when valuing a private business under the income or market approach. But adjustments may be needed when using public stock data to reflect the differences of operating a smaller, less sophisticated private entity. ■

Trick or treat

Could a shareholders’ agreement come back to haunt (or help) you?

Shareholders’ agreements often include buyout provisions, governing transfers of stock if an owner leaves the business. These provisions may, for example, prescribe a fixed price, valuation discounts for lack of control or marketability, and procedures for valuing the business during a shareholder buyout. Even if an agreement doesn’t specifically address marital dissolutions, courts sometimes consider buyout provisions when partitioning marital estates that include closely held stock, as this Louisiana appellate court case demonstrates.

Value Rx

In *Baumbouree v. Baumbouree*, the husband owned a share of his medical practice’s outstanding stock. In a motion for judicial partition of community property, the trial court valued the stock at $1,000 a share pursuant to a shareholders’ agreement.

The agreement’s buyout provision required shareholders to sell their stock to the practice for $1,000 per share upon a shareholder’s death, inability to practice medicine or termination of employment. The trial court ruled that the buyout provision governed the value of “the use and enjoyment of ownership,” not just stock transfers.

Second opinion

On appeal, the wife asked the Third Circuit Court of Appeal of Louisiana to require the medical practice to produce various financial documents to determine the stock’s value. Her business valuation expert claimed such documents were essential to determining going concern value.

Her expert objected to the use of the buyout provision. He contended that the “subjective and static stated value contained in the shareholders’ agreement excludes all of the necessary elements which must be considered in quantifying either the ‘fair market value’ or ‘fair value’ of the community property.”

However, the appellate court affirmed the trial court decision, reasoning that the husband would receive the price prescribed by the buyout provision ($1,000 per share) if any of the triggering events occurred. So, the value of the husband’s interest stood at $1,000, and the medical practice wasn’t required to produce any financial or compensation records.

Also noteworthy was the dissenting opinion. Judge Saunders opined that, while the shareholders’ agreement sets the value upon *disposition* of the stock, it doesn’t set the value of the continued use and enjoyment of the stock.

Stock ownership gives shareholders voting rights, a right to receive dividends or distributions, and a right to receive a share of the proceeds upon liquidation. Each of these rights provides benefits to the shareholder — and generates value that must be considered when partitioning assets in a divorce, according to the dissent.

Lesson learned

Always keep marital dissolution in mind when drafting a buyout provision. When partitioning assets for a divorce, there are no clear-cut rules on when a shareholders’ agreement may be considered. So, it’s critical to consider how these provisions might be perceived in a court of equity. ■

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Michael has more than 30 years of experience with a focus on valuation, litigation support, and taxation issues. He has additional expertise in auditing, financial statement analysis and consulting. His traditional accounting experience, includes taxation and financial statement reporting for closely held businesses, with a concentration on professional practitioners, real estate developers, construction contractors, retailers, manufacturers, and computer hardware and software providers.

Michael earned his Bachelor of Science Degree from the University of Delaware. He holds accounting certifications in both New Jersey and New York. Michael is a member of the American Institute of Certified Public Accountants (AICPA), a recipient of the AICPA's Accredited in Business Valuation (ABV), and Certified in Financial Forensics (CFF) designations. Michael is a member of the New Jersey Society of Certified Public Accountants (NJSCPA), where he was the Group Leader of the Business Valuation, Forensic & Litigation Services Interest Group, and is currently on the Steering Work Group. He is certified by the National Association of Certified Valuation Analysts (NACVA), and holds that organization's highest designation as a Certified Valuation Analyst (CVA). He is accredited as a Certified Fraud Examiner (CFE). In addition, Michael is an Accredited Senior Appraiser of the American Society of Appraisers (ASA).

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