Mueller Prost PC
CPAs + Business Advisors

VALUATION REPORT

BEST PRACTICES

Valuation Provisions Critical to Buy-Sell Agreements

When is the last time you reviewed your company's buy-sell agreement? If you can't remember — or worse, you don't have a buy-sell agreement in place — it's time to take action.

A buy-sell agreement is designed to dictate what will happen when a partner retires, dies, becomes disabled or leaves the company for some other reason. The agreement describes the arrangements of a shareholder buyout, including purchase pricing, funding and payment terms.

The goal is to alleviate what might be an emotional negotiation or lawsuit when a partner departs, and minimize the possibility that shares could be sold outside the company or left to a spouse or children, creating an unworkable partnership.

Formula vs. Appraisal

One of the most critical aspects of a buy-sell agreement is the valuation provision, which describes how the shares of the company will be valued and which mechanism will be used to arrive at a price. Two of the most common valuation mechanisms are the formula process and the valuation process.

A formula process dictates the type of formula to be used — for example, a multiple of book value or earnings, or an average of several different formula calculations. A valuation process requires an appraisal by one or more valuation professionals to determine value. If valuation professionals are involved, the agreement should also dictate several additional components:

Standard of value: While fair market value is the typical standard of value used in buy-sell agreements, the company's specific circumstances may demand another standard, such as fair value, for instance.

Discounts: Do you want the valuation to assess the business as a whole, or a specific shareholder's interest in the business? Due to discounts for marketability and minority interest, an overall business value — such as would be used in the sale of a business — will be very different from the value of a minority shareholder's interest.

Valuation date: The value of the company and its shares might vary dramatically depending on the date of the valuation. Do you want the valuation date to be the same as the date of a triggering event? Or do you want the date to be independent of any event and occur according to a schedule dictated in the buy-sell agreement?

Appraisers: How many valuation professionals should be hired and what should their qualifications be? Who should pay for the valuation — the company or the individual shareholders? You could hire one independent professional everyone agrees on, or hire one for the company and one for the departing partner. Using a single appraiser is clearly more cost efficient.

Appraisal standards: All CPAs are required to follow the AICPA's standards for valuation services. Other valuation-related bodies, such as the National Association of Certified Valuation Analysts and the American Society of Appraisers, have their own standards. You and your partners should agree about which standards to follow.

With so many variables involved, it's crucial that you have an experienced valuation professional guide you and your partners, and review your buy-sell agreement to identify any potential problems. And remember, a valuation is useless if it's not updated regularly.

We can help you evaluate your existing buy-sell agreement or work with your attorney to draft a new one. Call us at 314.862.2070 to discuss this further.

COMPENSATION MATTERS

Salaries vs. Dividends: What's Reasonable?

Business owners and their accountants spend a fair amount of time considering compensation — because "reasonable" compensation is a big issue in terms of taxes and business value. For S corporation owners, the more money they take in salary (rather than as dividends), the higher their tax liability. Since the IRS is interested in maximizing tax revenue, the agency has a vested interest in making sure owners take a reasonable salary that's not too high based on their actual duties and in comparison with their peers.

Owner compensation also varies according to circumstances and the owner's potential interest in manipulating business value. For example, if the owner is getting divorced, he or she might take more in compensation in order to lower the value of the business — thereby lowering the value of the asset to be divided between spouses. Conversely, if the owner is selling the business, he or she might take less in compensation so the company's cash flow looks better.

Normalizing Compensation

Reasonable compensation is of interest to valuation analysts because their job involves "normalizing" the owner's compensation to reflect the salary and benefits a non-owner would be paid to do the same job.

Determining reasonable compensation is not as straightforward as it might seem. The difficulty (and resulting litigation) often stems from the many factors that influence what's "reasonable" and the assumptions made by valuation analysts as they attempt to normalize compensation. Analysts typically use several tactics to determine what's reasonable:

1. Job description – What is the owner actually doing in his or her job? The analyst looks at job duties, education, experience, knowledge, skills, responsibilities and the time and effort the owner puts into running the business. The analyst also considers standard industry practices, the company's performance, historical compensation practices, the competence of others on the management team, and the owner's benefits. Looking at all of these factors together usually gives the analyst a general idea of the reasonableness of the owner's compensation.

2. Compensation databases – Valuation analysts also dig into various compensation databases to determine reasonable comp. There are many databases to choose from, depending on the target company's industry, size and other characteristics. For example, the U.S. Department of Labor maintains a free online database, "America's Career Infonet" (http://www.acinet.org) that's searchable by occupation and location. Aon Consulting's "Executive Compensation Database" covers publicly traded companies, while Aspen Publishers' "Officer Compensation Report" focuses on compensation for small to midsize businesses in eight different industry groups. The Economic Research Institute's "Salary Assessor" covers 2,000 industries, multiple cities and nearly 5,000 positions.

3. Human resources analysis – Even more data points are available via customized human resources studies. Conducted by independent compensation experts, these studies provide valuation analysts with highly targeted research related to the company's specific profile and unique circumstances.

Credibility Counts

The point of this data gathering is to determine a reasonable compensation number that will withstand scrutiny by the IRS or an opposing attorney or expert witness in a court case. The valuation analyst's numbers must be based on reliable data, calculated in a reasonable way, and documented thoroughly.

Because this is one of the most litigated areas of taxation, it's important to work with analysts experienced in determining reasonable compensation. They must be able to clearly explain calculations and assumptions, and defend their conclusions in court.

Our experienced valuation professionals are ready to assist you. Contact us today at 314.862.2070 to discuss your reasonable compensation questions.

VALUATION TREND

A(nother) Look at Tax Affecting S Corporations

Valuation analysts love a good debate. An especially interesting one regards the valuation of S corporations relative to C corporations.

To derive the cost of capital for S corps, valuation analysts rely on a variety of inputs, many of which are based on C corp data. But because C corps are subject to double taxation, valuation analysts often “tax affect” S corps to create a C corp equivalent, and then add a premium for S corp status when estimating fair market value. This calculation can significantly impact value for gift and estate tax purposes and for charitable contributions.

For years, the question at the center of this debate was about how to measure that premium. More recently, the premise was shifted by valuation experts Keith Sellers and Nancy Fannon. In a paper published late in 2011, “Valuation of Pass-Through Entities: Looking at the Bigger Picture,” Sellers and Fannon assert that some of the valuation industry’s most basic assumptions about tax affecting may be wrong.

Their argument centers on the various taxes paid by shareholders and how they affect the cost of capital. According to Sellers and Fannon, “to the extent that shareholder-level taxes impact the stock prices of publicly traded companies, they are also impounded in the cost of capital estimates derived from public company returns.”

In other words, the returns on public companies already reflect the effect of various taxes on the entity and its shareholders. Therefore, the tax effect is already included to some extent in the data used by valuation analysts. To analysts, this is a thought-provoking idea that begs big questions about the extent of the effect and how to account for it.

Taxes Impact Value

Sellers and Fannon describe five issues that affect shareholder taxes and their impact on value:

1. Shareholder-level taxes are capitalized in market prices and therefore are observed in market returns.

2. Market participants — individuals vs. institutions, etc. — affect the magnitude of a firm’s tax capitalization.

3. The composition of market participants and tax clienteles has changed over time, which has affected corporate capitalization strategies and behavior.

4. Firms respond to changing tax policies by trying to minimize shareholder taxes.

5. Investors respond to tax policies by maximizing after-shareholder-level returns.

A Purer Cost of Capital

Sellers and Fannon discuss several different approaches to removing the imbedded effects of shareholder-level taxes to arrive at a “purer” cost of capital. While the approaches differ in complexity and methodology, they support the idea that shareholder taxes are correlated to the equity risk premium. They also suggest that the impact is significant and varies by type of investor.

For example, they cite a regression analysis by Dhaliwal, Krull, Li and Moser showing that while “tax-penalized dividends increase the cost of capital, tax-advantaged marginal investors reduce the positive correlation.” In fact, they say, the presence of institutional investors in a company reduces the shareholder dividend tax premium by 57.21 percent.*

Where does this leave the valuation analyst? Sellers and Fannon don’t offer a specific solution, reminding observers that “researchers have spent decades working on a solution and still report that the extent of tax capitalization is ‘mixed and controversial.’”

In light of this lack of clarity, Sellers and Fannon encourage analysts, tax courts and the IRS to consider the issue further. They advise private market analysts to consider offsets and other associated risks when their valuation subject assumes tax regimes that are different from those reflected in public market returns.

Interested in the fine points of valuation calculations? Our valuation analysts are happy discuss them with you.

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*“Dividend Taxes and the Implied Cost of Equity Capital,” Journal of Accounting Research, Vol. 43, No. 5

How to Make the Most of Your Expert Witness

Attorneys rely on valuation professionals as expert witnesses in a variety of litigation settings. Hiring the right expert and understanding how best to work with him or her can make a big difference in your case.

Get your expert involved early. Include your valuation expert as early as possible in the trial preparation process. He or she can point out strengths or weaknesses in a valuation report or suggest areas for further investigation.

Share details. The valuation date and circumstances of the company can change a valuation conclusion substantially, so be sure to share everything that may impact valuation-related testimony.

Also, if there's anything weak or questionable about your case that your witness should know, it's better to tell him or her upfront — before you get to the courtroom. If you don't share potentially damaging information, your expert may be surprised in front of a judge or jury.

Look for expertise. Experience, credentials and personality all play a role in choosing a valuation expert witness. Just because you've worked with a specific expert in the past doesn't mean he or she is right for every case. In specialized fields, industry expertise may be required.

The expert's ability to calmly and clearly present information will be key in a trial. Pay attention to experts used by the other side. If you've watched them on the stand and think they're good, consider hiring them yourself next time.

Understand boundaries. While they may be hired by one side or the other, valuation expert witnesses are required to render objective, unbiased opinions. This neutrality is key to their credibility, both in your case and in future litigation. Your expert's opinion will be severely discounted by any appearance of bias.

Call our experienced valuation professionals at 314.862.2070 to assist your litigation team as needed.

Mueller Prost PC offers practical solutions and insightful advice to individuals, businesses and non-profit organizations, providing a full range of audit, tax, accounting and business advisory services. The experience of our more than 80 accountants, engineers, operations leaders and former business owners gives us a unique and comprehensive perspective to address the needs of growing organizations. In addition, we leverage our membership in PKF North America (an association of more than 100 legally independent accounting and consulting firms) to enhance our national and international capabilities. For more information, visit **www.muellerprost.com**.

The firm offers a full range of professional tax, audit, accounting and management advisory services to businesses and individuals, including a team of highly qualified business valuation experts.

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