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Avoiding Common Pitfalls in Business Valuation and Ownership Transition

Presented by:
Deborah E. Finch, CPA/ABV, CVA, CDA, Partner
Samuel M. Lyon, CPA, Senior Tax Manager

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Introduction to Ownership Transition

Introduction to Ownership Transition

- "Baby Boomers" - 78 million people in the U.S. born between January 1, 1946, and December 31, 1964.
- Approximately 9% of the "Baby Boomer" generation are business owners.
- As a result, approximately 7 million "Baby Boomer" companies in the United States are estimated to be transitioned during this period.
- The Exit Planning Institute has projected that over the next 12-15 years, more than 8 million closely-held U.S. companies will be sold.

Introduction to Ownership Transition

- In 2019, PWC updated its *Family Business Survey* which surveyed nearly 3,000 closely-held owners and managers.
  - The survey indicated that only 18% of the businesses surveyed have a robust succession plan – a documented and communicated leadership transition strategy – formally in place.
  - The survey also indicated that 39% of respondents expect to buy or merge with other companies in the next two years
  - And 47% plan to bring in outside expertise to help run the company

Introduction to Ownership Transition

Consequences of not having a clearly-defined ownership transition plan:

- **<u>Leads to confusion and disputes</u>** among key employees
- Can cause **<u>disruptions in operations</u>**
- Often results in the **<u>dissipation of the Company's value</u>**

Introduction to Ownership Transition

Challenges in Ownership Transition Planning:

- Economic Challenges
  - Devalued or depleted retirement assets have delayed retirements and have stalled transition planning
  - More stringent lending environment reduces available financial resources to implement ownership transition
- Demographic Challenges
  - 78 million "Baby Boomers" are being replaced by 20% less "Generation Xers"
  - Younger generations are generally more cautious, more life-balanced, and have fewer financial resources
  - Demand for talent has exceeded supply

Business Valuation Pitfalls

Business Valuation Pitfalls – Standard of Value

- The proper **Standard of Value** for valuing a closely-held business is an assumption or set of assumptions regarding the specific characteristics of the buyer and seller (either hypothetical or actual) in a given set of circumstances surrounding a particular transaction
- There are **three** principal **Standards of Value** for valuing a closely-held business:
    - Fair Market Value
    - Fair Value
    - Investment Value

Business Valuation Pitfalls – Standard of Value

Strategic Value of Closely-Held Business Sold to Outsider ⟷ **Synergistic Value**
(Investment Value or Acquisition Value)

Premium 10% - 40%

"Deal Zone" – sales price to outsider

Internal Transfer Price
- No premium for control
- No discount for minority interest ⟷ **Fair Value of Closely-Held Business**
(Stockholder's Value)

25% - 50% Discount

Value for Income, Estate, and Gift Tax
-Premium for Control and Discount for Minority Interest
-Marketability Discount ⟷ **Fair Market Value**
(IRS Value)

Business Valuation Pitfalls – Premise of Value

- **Premise of Value** is an assumption regarding the most likely set of transactional circumstances that me be applicable to the subject valuation
- There are **three primary Premises of Value** for valuing a closely-held business:
  - Going Concern Value
  - Orderly Liquidation Value
  - Forced Liquidation Value

Business Valuation Pitfalls – Valuation Formulas

- Reliance on industry rules of thumb can produce an unreliable measure of value
- Fixed price agreements should be avoided, as they do not appropriately measure current value
- Fixed formulas need to be understood and tempered with an objective analysis of underlying factors
  - Consider the ability of a formula to be manipulated, particularly those based on a multiple of book value

Business Valuation Pitfalls – Valuation Formulas

- Consider the following example:
  - GHI Associates, Inc. is owned by a single shareholder and has a net book value on January 1, 2022, of $500,000
  - The Company earns $200,000 per year for the next 5 years and the Company's sole shareholder sells their stock after 5 years (January 1, 2027)
  - The Company's buy/sell agreement with the new shareholders calls for the stock to be sold based on a multiple of 2 times book value

Business Valuation Pitfalls – Valuation Formulas

	Option 1	Option 2
Book Value @ 1/1/2022	$500,000	$500,000
Accumulated Earnings ($200,000 x 5 years)	1,000,000	1,000,000
Salary or Distributions to Shareholder	(1,000,000)	-
Projected Book Value @ 1/1/2027	500,000	1,500,000
Valuation Multiple	2.00	2.00
Sale Price	1,000,000	3,000,000
Less: Shareholder Loan Repayment	N/A	(1,000,000)
Net Proceeds to Shareholder	$1,000,000	$2,000,000

- By making loans to the shareholder instead of salary or dividend distributions, the shareholder made an additional $1,000,000 under Option 2 using the same valuation formula for the same Company

Internal Ownership Transition Pitfalls

Internal Ownership Transition Pitfalls – Blueprint for Ownership Transition FAILURE

- Secrecy is the best philosophy
- All owners must pay for the price of success
- Controlled growth philosophy
- Never give up control

Internal Ownership Transition Pitfalls – Blueprint for Ownership Transition FAILURE

- Those who own the business should run the business
- All owners must be exactly like the prior owners
- Every decision must be approved by senior owners
- All owners are not created equal

Internal Ownership Transition Pitfalls – Buy/Sell Agreement

- A comprehensive buy/sell agreement should be adopted among the owners that provides for the sale of an owner's interest in the Company upon the occurrence of a specified event
- Examples of specified events would be retirement, death, disability or separation from service of an owner
- Should be reviewed periodically to ensure relevance and compatibility with current tax environment

Internal Ownership Transition Pitfalls – Buy/Sell Agreement

- A buy/sell agreement should be self-executing and should accomplish the following objectives:
  - Provide for orderly transfer of ownership
  - Restrict transferability of the ownership interest
  - Create a market for the ownership interest
  - Permit retention of control by existing owners
  - Reasonably assure the continuance of the business and reduce the risk of dissolution and loss of value

Internal Ownership Transition Pitfalls – Realistic Expectations

- The biggest pitfall in internal ownership transition is waiting too late
- Need to allow adequate time to transition value to buyers
- Unrealistic estimates of value are also problematic, as cash flows from earnings won’t support process in excess of true value

External Ownership Transition Pitfalls

External Ownership Transition Pitfalls – Financial Reporting

- Must get internal financial reporting process in good order
  - Evaluate quality of internal financial statements and make improvements as needed
  - Budgets, forecasts, and projected financial may play a key role
  - Consider other financial analysis that will be useful in evaluating potential sale
  - Eliminate comingling of business and personal expenses
- Consider type of financial statement and reliability of information
  - Audit
  - Review
  - Compilation
- Annual tax returns will also be reviewed by a potential acquirer

External Ownership Transition Pitfalls – Due Diligence

- Potential buyer should thoroughly investigate target company
  - Due diligence should be a comprehensive process from the initial contact through consummation of a transaction
  - A detailed checklist should be utilized
  - Focus should be both on internal operations of the target company as well as external factors including the market in which it operates and its reputation and relationships
  - Consider obtaining support from outside experts including CPA firm as part of investigation of financial records
- Seller should also perform due diligence on potential buyer
  - Ability to consummate transaction
  - Ability to pay future amounts due in installment sales
  - Maintain employment and fulfill promises to employees
  - Protect and enhance reputation of business

External Ownership Transition Pitfalls – Structure of Sale

- Should the Transaction be structured as an Asset Sale or Stock Sale?
- Seller prefers a stock sale
  - One level of taxation at favorable long-term capital gains rate
  - No retention of liabilities
- Purchaser prefers an asset sale
  - Limitation of assumed liabilities
  - Step up basis of purchased assets
- Work together and think creatively to structure a deal that works best for both parties!
- Under certain circumstances, the buyer and seller may jointly elect under IRC Section 338(h)(10) to treat the stock sale as a sale of assets for tax purposes

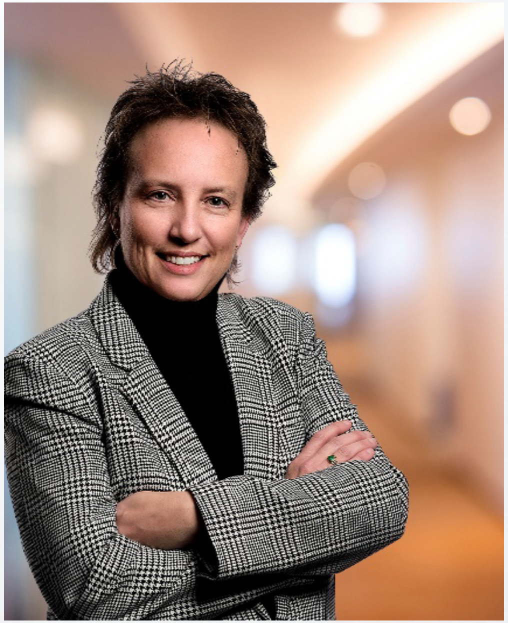
External Ownership Transition Pitfalls – Other Considerations

- Earn-Out or Contingency Agreements
  - Need to ensure proper incentives are in place
  - Specific accounting provisions should be carefully analyzed (revenue billed vs. revenue collected; from which clients?)
- Noncompete Agreements
- Employment Agreements

Questions

Deborah E. Finch, CPA/ABV, CVA, CDA

Tax Partner



Email: dfinch@dmcpas.com

Web: www.dmcpas.com

Address:

DM Financial Plaza
221 South Warren Street
Syracuse, NY 13202

Phone: (315) 472-9127, ext. 160

Samuel M. Lyon, CPA

Senior Tax Manager

Email: slyon@dmcpas.com

Web: www.dmcpas.com

Address:

DM Financial Plaza
221 South Warren Street
Syracuse, NY 13202

Phone: (315) 472-9127, ext. 187

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