

SVG's Viewpoint on Value



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Long-term strategies to boost cash flow — and value

Value is driven by a business's ability to generate cash flow in the future. Companies that maximize cash flow, therefore, are worth more to investors. But it may be unrealistic to focus on the obvious cash flow improvement targets — revenue and costs — when demand is flat and many businesses have cut back their overhead.

Here are some cash flow management techniques that may help businesses squeeze more out of existing operations.

Working capital

Obviously, businesses need to spend money to make money. Retailers must purchase inventory, pay salaries and rent, and advertise before they can sell anything to customers. Manufacturers must purchase materials, build products, ship finished goods and send out invoices before they receive payments from customers.

Working capital is the difference between a company's current assets and its current liabilities. Businesses increasingly need working capital as they grow. But the more cash that's tied up in working capital, the less a business may be worth.

You can more effectively manage cash flow by focusing on these key areas:

Accounts receivable. Having accounts receivable in order is key to maintaining cash flow. The CFO should calculate the average number of days it takes to collect money from customers and compare the average collection period to the company's historic collection period as well as industry averages. Then management should review

policies and procedures regarding invoicing, collections, dispute resolution and deposits. Finally, the financial team needs to brainstorm ways to streamline the collections process.

For example, one manufacturer discovered that the average collection period had risen from 33 days to 40 days over the last year. Upon further investigation, the owner discovered that a large customer was nearly bankrupt, causing it to delay payment and dispute bills. In response, the manufacturer changed to cash-on-delivery terms for this customer.

To expedite collections overall, the manufacturer began offering early payment discounts and charging interest on late payments. The owner also withheld half of its salespeople's commissions until payment was received in full.

Inventory. For many businesses, raw materials, work-in-progress and finished goods inventory drains cash. Companies should keep just enough inventory on hand to meet imminent customer needs. In fact, some manufacturers have requested access to their



key customers' three-month forecasts in order to facilitate lean ordering practices.

It's important to measure the days-in-inventory ratio as well as inventory composition. Don't tie up cash in slow-moving or special order items. Instead, make sure the bulk of inventory is high-demand, fast-turning items. Consider returning slow-moving items or writing off obsolete inventory.

Remember that cash flow management is a continuous improvement process.

Accounts payable. Unlike receivables and inventory, payables are a liability. So, the goal should be to slow down payables payments without jeopardizing supplier relations or missing out on valuable early payment discounts. The slower that companies pay suppliers, the longer cash stays in the bank, earning interest.

Often owners can comparison shop among suppliers online. Competitors might offer better prices, scheduling and terms — especially in today's volatile marketplace.

Fixed assets

Fixed assets also can affect a company's cash flow. Businesses need equipment, computers, vehicles and real estate to operate. Purchases use up cash, but divestitures generate cash. Companies can generate cash flow by selling off underused or nonoperating fixed assets. Divestitures can lower insurance and storage costs, too.

Plant, property and equipment (PPE) purchases require prudence, particularly in a tight credit market. Rather than buying on gut instinct, owners should conduct accounting payback or net present value analyses to ensure capital expenditures make financial sense. Creative alternatives — such as adding a second work shift or leasing — may be more efficient than expanding or buying new equipment.

Ongoing diligence

Effective cash flow management builds shareholder value, which is important even if a business isn't for sale. Many business owners focus on the income statement — targeting revenues and expenses — but those who forget the balance sheet may miss valuable opportunities. It's important to remember that cash flow management is a continuous improvement process. A one-time exercise — or an effort that fails to engage all levels of employees — won't have a long-lasting impact on value. ●

Look beyond cash flow to build value

Risk is another factor in the valuation equation (see main article). A value-minded owner should search for ways to lower the company's perceived risks to potential buyers by:

- ➔ **Creating a formal business plan.** Forecasts and projections facilitate due diligence and demonstrate management depth. But buyers might critique a seller's business plans and modify them with their own assumptions. Budgeted and actual results should be constantly monitored to prevent "budget creep" and cost overruns.
- ➔ **Minimizing reliance on key people.** Because most private businesses rely on a few key individuals, it's critical to have formal succession plans and signed noncompete agreements to reduce the strain on business operations if a key person dies or otherwise leaves the business.
- ➔ **Diversifying the customer (and supplier) base.** Customer concentration is one of the biggest risks facing small and midsize businesses. Typically, buyers are concerned if one or more customers' sales each represent a large percentage of the company's total sales (for example, 10% or more), especially if the relationships aren't protected by a long-term contract.

How valuers approach value

A valuation primer

Determining the value of a business is a complex endeavor. Here's a primer on the most commonly used valuation approaches and methods to help you gain a better grasp of the ins and outs of business valuation and be better able to evaluate your expert's work.

3 approaches to value

Typically, a valuator chooses one primary approach or method to derive an asset's value, and uses one or two others to serve as checks or supports of that value. The choice depends on several factors, including the valuation's purpose (for example, merger and acquisition, tax, or shareholder disputes), the type of interest being valued (for example, controlling or minority) and the relevant standard of value (for example, fair market value or FMV, fair value or investment value). The three most common valuation approaches are:

1. The income approach. When a valuator uses the income approach to value a company, he or she projects the subject company's future cash flow and discounts it back to net present value using a discount rate commensurate with the company's risk.



This method capitalizes or discounts the company's expected income stream. The valuator may use discounted cash flow analysis to estimate the present value of the future stream of net cash flows generated by the business.

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2. The market approach. Under this approach, valuers derive pricing multiples from public or private comparable transactions. These pricing multiples are then applied to the subject company's earnings to derive its value. The valuator adjusts the data to account for the differences between the subject company and comparable firms. This method requires an adequate number of comparable companies to produce credible results.

3. The cost, or asset-based, approach. Usually reserved for a company whose earnings (and expected earnings) aren't sufficient to contribute to its value, or asset-intensive companies with little intangible value — such as traditional manufacturing and investment-holding businesses — this approach requires the valuator to establish the value of all assets and liabilities as a method of valuing the entire business. The identification and valuation of intangible assets is the most troublesome aspect of this method.

Other valuation methods

In addition to the three approaches above, a valuator might use one of several valuation methods to further refine his or her analysis:



Adjusted book value method. Under this method, the valuator converts each asset and liability to FMV. The company's value is the sum of the FMVs of its tangible assets and liabilities. This method works best for asset-holding companies, such as family limited partnerships (FLPs) that are holding real estate or marketable securities. It's also useful in valuing distressed companies, such as those facing bankruptcy. But this technique is more difficult to apply to going-concern entities with intangible value or synergies among the assets.

Public guideline company. A subset of the market approach, the public guideline company method uses the prices paid for shares of similar publicly traded companies to estimate a business's value. Although the courts favor this method for its perceived objectivity, two factors often prevent appraisers from applying this method: 1) a public company's typically larger size and 2) the public market's limited number of pure players.

Private transaction. Similar to the public guideline company approach, the private transaction formula uses sales of entire comparable companies to estimate a business's value. Although the courts also appreciate this method's perceived objectivity, it's often difficult to apply because many industries lack a sufficient number of meaningful comparables. Further, courts sometimes criticize this method because private company transaction databases seldom contain enough information to truly understand the comparables' operations or the deals' terms.

Discounted cash flow. Arguably the most complex and subjective technique, the discounted cash flow method is used to estimate a company's value through computation of the net present value of a company's future income stream. Despite its drawbacks, most experts believe it's the most technically sound method, frequently used by investors in real-life decision-making and transactions. And it's usually the best choice in high-growth industries or for startup companies.

Excess earnings. This method combines elements of the asset-based and income approaches. The valuator uses the adjusted book value approach to estimate net tangible value. Then he or she calculates the company's intangible value by capitalizing above-market earnings. This option is a popular choice for small professional practices. Although many courts recognize this technique, some don't like it because no empirical evidence supports the capitalization rates used on excess earnings.

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The ABCs of valuation

When determining a company's value, solid earnings are important. But other factors, based on a business's individual characteristics, are also significant. If you understand the methodology that appraisers apply to evaluate how these elements — and others — affect your company's value, you'll be in a better position to make the right strategic moves. ●

Who owns goodwill?

The case of *Howard v. Commissioner*

Goodwill is an intangible asset that arises from a business's name, reputation, customer loyalty, location, products and other similar factors. It represents the likelihood that customers will return to the business in the future without contractual obligations.

Goodwill can be owned by a business or by an individual practitioner. Personal goodwill is frequently associated with professional firms that rely on the owners' skills, training and reputation. The classification of goodwill has important tax and legal consequences, as observed in a recent case.



Background

In *Howard v. Commissioner*, the main issue was the proper classification of goodwill from the sale of a dental practice that had a noncompete agreement in effect on the closing date.

Larry Howard began practicing dentistry in 1972 and incorporated his practice in 1980. A sole

practitioner, he entered into an employment contract and noncompete agreement with Howard Corp. upon incorporation. The noncompete agreement prevented Dr. Howard from participating in a similar business within three years of selling his stock within a 50-mile radius of Spokane, Wash.

In 2002, Dr. Howard retired and sold his practice to Dr. Finn. The parties agreed to allocate \$47,100 to business assets, \$16,000 to the noncompete agreement, and \$549,900 to Dr. Howard as personal goodwill.

Findings

The IRS audited Dr. Howard's 2002 federal tax return, which included a long-term capital gain of \$320,358 for personal goodwill from the sale of his dental practice. The IRS reclassified this amount from personal goodwill to a noncompete agreement, a corporate asset. Because of the difference between long-term capital gains rates and dividend income rates, Dr. Howard was charged a deficiency of \$60,129 and interest of \$14,792.

Dr. Howard paid the IRS charges, but filed a claim for a refund. In court, Dr. Howard used state divorce case law to support his personal goodwill classification. (In Washington, personal goodwill is a marital asset, not a business asset.)

To counter this, the IRS cited *Norwalk v. C.I.R.*, which states "there is no [business] goodwill where ... the business of a corporation is dependent upon its key employees, unless they enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become property of the corporation."

The federal district court of the Eastern District of Washington agreed with the IRS. It held that Dr. Howard was an employee of Howard Corp. with a noncompete agreement valid from 1980 through 2003, plus three years, or to 2006. The noncompete

prohibitions would likely discourage patients from following Dr. Howard to a new location. Therefore, any goodwill generated during that time period was Howard Corp. goodwill, not a personal asset of the dentist.

Lessons

This case teaches many interesting lessons. First, it shows how noncompete agreements may get in the way of taxpayer attempts to claim personal goodwill when they retire. After all, the difference between long-term capital gains rates and dividend income rates can be significant. The case also highlights the need to modify (or terminate) noncompete and employment agreements as practitioners approach retirement.

A tricky situation

Divorce attorneys might want to review the arguments made in this case when dealing with marital estates that include private business interests. Although tax precedent may not be binding in family courts, *Howard* might persuade a judge to reconsider how goodwill is classified. When a non-compete agreement exists, a professional service firm's goodwill could be a corporate asset.

Whether for tax, divorce or financial reporting purposes, purchase price allocations can be tricky and often necessitate the use of appraisal professionals. ●

Need to know: FAQs about key person discounts

Virtually every small business has centralized management and relies on the talents of a few managers. The risk of centralized management typically is taken into account in the company's future earnings or discount rate.

In some cases, however, one person is a linchpin — if he or she leaves, the organization will come undone. This key person typically has unique skills, technical knowledge, experience or relationships that would be difficult to replace or replicate.

For example, one partner in an advertising firm might be the "rainmaker," accounting for 75% of annual revenues. Or an entrepreneurial scientist might be the only person who understands a startup's proprietary formulas and complex manufacturing processes. In such instances, a separate key person discount may be appropriate.

There's little empirical evidence to support key person discounts, but they tend to range from 5% to 25%. Factors that affect the discount include the key person's age, health, medical history and day-to-day responsibilities.

Some appraisers quantify a key person discount as the difference between the subject company's projected value before and after the loss of a key person. Others estimate the cost to replace the key person, including recruiting and training costs, replacement compensation, and the temporary decrease in cash flow caused by the person's departure. Other appraisers include the key person discount as part of the discount for lack of marketability.

Once quantified, the key person discount is an entity-level discount. So, it's applied to the company's controlling value *before* shareholder-level discounts, such as discounts for lack of control and marketability.





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