



**PERKINS & CO**

*Let's get there*

# BUILDING VALUE

A Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

## Valuing “Mom and Pop” Businesses A PRIMER

### Contacts:

Keith H. Meyers, CPA, ABV, CFF  
Shareholder  
503.221.7579  
kmeyers@perkinsaccounting.com

Peter Kwong, CPA, ABV, CFF  
Shareholder  
503.221.7541  
pkwong@perkinsaccounting.com

Lisa J. Goecke, CPA, ABV, CFF  
Shareholder  
503.221.7510  
lgoecke@perkinsaccounting.com

Paris Powell, CPA, ABV, CFF  
Business Valuation Manager  
503.221.7564  
ppowell@perkinsaccounting.com

Is there really a difference between valuing the “mom and pop” Main Street business versus the larger, closely held business that has several owners and appears to be run more like a business? The answer is “yes and no.”

Valuation is valuation – in other words, the valuation analyst attempts to use all three approaches to valuation and tests the various methods that fall under these approaches. They may not all apply, but the valuation analyst who is performing a thorough job looks at the various approaches and methods for all valuation assignments (assuming that it is not a limited valuation or calculation engagement). This does not change, no matter what the size of the business being valued. However, when valuing the very small business, the valuation analyst is often faced with limited records and information that sometimes makes the assignment appear to be more difficult.

So, how does the valuation analyst approach the valuation of one of these smaller businesses? To simplify this article, assume that the valuation assignment is to value 100 percent of the equity of the company. The analyst’s document request will vary depending on the type of entity it is (corporation, LLC, partnership or sole proprietorship). Most valuation textbooks contain sample document requests that should be tailored to the specific assignment, but the financial documents that are requested are generally the same and include:

1. Financial statements and/or tax returns for a representative number of years to reflect a business cycle
2. A balance sheet as of the valuation date
3. List of cash accounts and any significant cash investments
4. Aged accounts receivable listing
5. List of items comprising inventory (quantity, description and cost)
6. Fixed asset register and/or depreciation schedule including real estate and equipment lists, date of acquisition, cost, depreciation method, useful life and accumulated depreciation
7. List of items comprising significant other asset balances

8. Accounts payable listing
9. Analyses of significant accrued liabilities
10. List of notes payable and other interest-bearing debt, along with the current balances
11. List of items comprising significant other liability balances<sup>1</sup>

What will you get? If you are lucky, number one. The problem with many of these smaller businesses is that they do not maintain detailed accounting records. If the business is the type that requires a balance sheet on its tax return, then you might have something you can work with. However, many of these businesses are sole proprietorships that report their earnings on Form 1040, Schedule C, based on a summary of the transactions that are recorded in their checkbooks. As a result, these businesses have no idea what a balance sheet is. Therefore, part of your assignment may be the analysis of underlying documents to create a set of financial statements that can be utilized in the valuation analysis.<sup>2</sup>



However, if this becomes part of your assignment, it is above and beyond the valuation exercise. Think about getting a separate retainer agreement for this portion of the assignment, because there will be additional fees incurred in order to carry out this exercise.

A second issue that comes up when valuing the smaller business is, what is “buried” in the income statement? In other words, what “perqs” are being paid for? Many smaller businesses use their company checkbooks as personal checkbooks and then deduct these expenses as business expenses. Examples are things like personal

*continued on next page*

*continued from page 1*

telephone and utility bills, and personal credit card statements. In addition, personal assets like cars and vacation properties are recorded on the books of the company and all associated expenses are paid for as though they are ordinary and necessary business expenses. And then you will find family members who are receiving salaries and benefits, although they have nothing to do with the operations of the business.

Very often, the only way to discover these types of payments is to engage in a forensic evaluation of the books and records. These types of investigations can become time consuming and expensive. Depending on the purpose of the valuation, you may have no choice (for example, if the valuation is for a litigation assignment, you want to be able to show the trier-of-fact that you can support the adjustments you made

valuation analyst uses the pricing information to determine multiples (price to revenues or earnings) that are applied to the normalized income stream of the valuation subject. There are advantages and disadvantages to these databases and the valuation analyst must understand what is contained in each of these databases and how to use the data. Unfortunately, it is not as simple as multiplying the revenues of the valuation subject by the price to revenues multiple.

Under the capitalization of benefits method, the valuation analyst uses historical information as a guide to what the future financial situation of the subject company will look like. The benefit stream that is often used is net income; this is true for several reasons. Many smaller companies will not have GAAP-based historical balance

sheets and the analyst cannot get the information needed to create them, so the calculation of net cash flow is impossible to do. Also, for many of these companies, there is little change in the working capital from year to year and little in the way of capital expenditures and debt. As a result, net cash flow and net income approximate one another. There may be circumstances where this might not be the case, so be wary about making too many generalizations when valuing a specific company.

The excess earnings method is not the most favored of the valuation methodologies, but it is used to value small companies, especially in the divorce arena. Since it is a combination of an adjusted book value method, along with a capitalization of benefits method, the analyst must have enough information available to apply all of the necessary procedures. For the analyst who cannot locate transaction data to apply a market approach, this can be used as a secondary method to support the capitalization of benefits method. The results from the capitalization of benefits method and the excess earnings method should approximate one another if they are done properly.

What tends to be very important when valuing the small company is showing the reader some type of “sanity check” that supports your valuation conclusion. One way of doing this is by using a rule of thumb. The analyst does not want to rely on these rules of thumb as a primary indication of value. Instead, test your value against rules of thumb for the industry of your subject company to show the reasonableness of your conclusion.

At the end of the day, valuation is valuation. Valuing the “mom and pop” business often requires additional work to be done so the analyst has a

reasonable set of financial data from which to draw conclusions. However, this does not alleviate the analyst’s responsibility to follow standards and provide a competent job for his or her client.

*By Linda B. Trugman, CPA/ABV, MCBA, ASA, MBA  
Trugman Valuation Associates, Plantation, FL*

<sup>1</sup> Numbers 3 through 11 are suggested if you have to attempt to create a balance sheet. Adjust your document request to reflect those items that will help you in your analysis. Overwhelming the client with an unreasonable demand will not get you what you need; it will get you push back from your client.

<sup>2</sup> A discussion of this area is beyond the scope of this article. However, CPAs should be aware that if they compile financial statements, they may be subject to accounting pronouncements and might have to attach a compilation letter to these financial statements.



## EXPERT TIP

Valuing the “mom and pop” business often requires additional work to be done so the analyst has a reasonable set of financial data from which to draw conclusions.

with backup documentation). However, this is another instance where you may need to have a separate retainer agreement laying out what you will be doing and the fees involved with this separate engagement.

Once the analyst has a reasonable set of figures with which to perform the valuation assignment, what is the next step? The methods most likely to be applicable in this type of engagement are the transaction method, capitalization of benefits and excess earnings.

There is a large amount of transaction data available that includes sales of privately held companies. The main databases containing this transaction data are the Institute of Business Appraisers’ transaction database, BizComps® and Pratt’s Stats®. These databases can be searched by SIC code to find transactions of companies that are in the same industry as your subject company. Sometimes the analyst will find a lot of relevant transactions (restaurants, dental practices) and for some SIC codes, there is no data.

The concept behind the transaction method is that the

# A Closer Look at Small Businesses and the S Corp Premium:

## WHERE'S THE VALUE?

**Consider this:** In terms of numbers, the vast majority of businesses in the United States are small businesses and businesses in the lower-middle market (the subject markets). These comprise most of a valuation firm's present and potential client base. The overwhelming majority of these businesses are closely held which over the last 30 years have increasingly elected S corporation status or have chosen to conduct business as non-taxable entities such as limited liability companies or limited liability partnerships. This shift in the chosen form of entity is a result of business owners opting for more flexibility in their business and financial strategies as well as to avoid double taxation. Further, most business sales transactions between buyers and sellers for businesses in the subject markets are consummated on an asset sale basis. Most of these types of transactions are sales of controlling interests.

While S corporations or similar non-taxable target entities may have additional benefits to buyers in certain circumstances, it is necessary to further examine controlling interests of businesses in the subject markets (and assuming an asset sale transaction basis) to further consider whether additional value may exist when the seller's entity is an S corporation. This is important to consider since, again, these types of business transactions occur frequently.

### From the Buyer's Side: A New Broom Sweeps Clean

Sales transactions of businesses in the subject markets have mostly been via asset sales. This, of course, is usually due to the buyers' desire to pick and choose the assets that they need, to avoid any assumption of liabilities (actual, unknown, or contingent), and to reallocate a new basis to the purchased assets. Another consideration inherent in an asset sale transaction is that buyers are not purchasing the seller's entity, regardless of its form. As this is the case, it would seem that a buyer would likely assign value to the above benefits achieved via an asset sale rather than to the seller's S corporation entity, regardless of its legal form. Many buyers have elected to form their own entity, a great many of which are non-taxable entities.

A potential buyer in the subject markets would not likely assign any value to the seller's S corporation entity for four reasons:

1. Buyer can usually choose their own form of entity including incorporating and electing S corporation status; the costs for such would be minimal, frequently under \$1,000; the cost of establishing other types of non-taxable entities is also generally inexpensive;
2. The other benefits achieved in an asset sale (as enumerated above) would likely outweigh any benefit of purchasing an entity with S corporation status;
3. Buyers seem to have a certain level of comfort with choosing and utilizing their own entity;
4. Based on the author's experience, negotiations for businesses in this type of scenario center around other asset sale considerations as discussed above rather than whether or not the seller's S corporation entity would provide benefits to a potential buyer.

Further, since asset sale transactions do not involve the acquisition of the seller's legal entity, it logically follows that a potential buyer would not attribute any value nor be willing to pay for an entity that he or she is not purchasing. Also, in such negotiations, potential additional value in regards to the seller's non-taxable entity is frequently not discussed.

### From the Seller's Side: Yes, but . . .

Owners of profitable businesses that have elected S corporation status have enjoyed some of the potential tax benefits available to their entity, and if a buyer purchased that particular business including the S corporation entity, the same potential tax benefits would be available to the buyer. A seller, of course, would perceive S corporation status as being beneficial to a potential buyer and thus would attempt to assign value to their S corporation status and would incorporate this value into its asking price. Also, a valuation usually includes the usage of empirical data based on studies of returns of publicly held companies that are C corporations. This being the case, a seller would utilize this methodology to determine a company's value and would likely attempt to add a premium for perceived benefits available due to the S corporation status.

However, an S corporation election, or conducting business as another form of non-taxable entity, does not alter the nature of a business nor does it alter the amount of net operating cash flows that would be realized if it were a C corporation. It is also likely that the seller would realize that the buyer does have the flexibility of viable alternatives in choosing their own entity and that many times the buyer would insist on an asset sale for these types of businesses anyway. As such, sellers in many cases would probably acquiesce, agree on an asset sale, and in the process would back off from the inclusion of an S corporation premium in their asking price. Past sales transactions in controlling interests of businesses in the subject markets seem to indicate that a potential buyer is willing to pay an equivalent C corporation value plus an additional price due to the benefits inherent in an asset sale (stepped-up basis, no liabilities assumed, etc.)

### Buyers: Hypothetical, Real, or Synergistic

Whether a hypothetical buyer is assumed under the fair market value standard or whether an actual or synergistic buyer is involved in a business sales transaction, it is likely that any of these types of buyers would analyze and view perceived benefits from an S corporation in the same manner. Thus, each of these types of potential buyers would utilize a similar approach as described above.

### Summary

In essence, potential buyers in the subject markets considering the purchase of a controlling interest in an S corporation and utilizing an asset transaction basis could easily realize the benefits of an S corporation by establishing a new S corporation rather than purchasing the seller's S corporation entity. Past sales transactions demonstrate that many deals have been made on this basis, indicating that sellers have agreed to such terms. While there are theoretical arguments (based on the utilization of empirical data of publicly held corporations) in support of additional value attributable to potential benefits attributable to an S corporation entity, these would be most appropriate to minority interest transactions and/or stock sales transactions. Therefore, from a practical standpoint, it is difficult to assign any additional value attributable to the seller's S corporation entity in regards to sales transactions of controlling interests in the subject markets.

*By Marvin T. Brown, CPA/ABV, CVA  
Brown Valuation Group, Athens, GA*

## FEATURED CASE

### R.V.J. Cezar Corporation vs. Commissioner

#### CITATION

*R.V.J. CEZAR CORPORATION, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent, and RESTITUTO T. AND VIRGENCITA P. CEZAR, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent*

T.C. Memo 2010-173, Docket Nos. 30125-08, 30144-08  
Filed August 4, 2010

#### AT ISSUE FOR THE COURT:

- Whether the transfer of a lot and improvements thereon constituted a taxable constructive dividend to the taxpayers,
- Whether the dividend should have caused the Corporation distributing the property to recognize income, and
- Whether the Taxpayers and Corporation were liable for accuracy-related penalties related to their failure to recognize the dividend.

#### LOT AND HOUSE TRANSFERRED TO TAXPAYERS

Restituto Cezar owned R.V.J. Cezar Corporation (“Corporation”) which built houses on a speculative basis. The Corporation built a spec home which was transferred to Mr. Cezar and his wife, Virgencita, (“Taxpayers”) via quitclaim deed. During audit, Mr. Cezar maintained that the lot and improvements were corporate assets. The lot and improvements had a fair market value of \$920,000, construction costs were \$502,000, and the Taxpayers assumed the Corporation’s mortgage of \$57,227 on the date of transfer.

The IRS determined that the distribution of the lot and improvements from the Corporation was a constructive dividend. Accordingly, the Cezars received a qualified dividend and long-term capital gains as a result of the dividend, and their failure to report these made them liable for accuracy-related penalty.

Additionally, the Corporation failed to report gross income from the distribution of lot and improvements. The IRS assessed an additional accuracy-related penalty as a result of the understated gross income.

#### CONSTRUCTIVE DIVIDEND DETERMINATION

The Cezars conceded they received the lot as a constructive dividend. However, they argued the improvements were not constructive dividends because they owned the improvements. Their argument was that they paid for the construction materials and did all the work to construct the improvements, so they owned the improvements.

The Tax Court disagreed, citing the Taxpayers’ inability to produce supporting documents indicating the Corporation owned the improvements, inability to produce the agreement between the Taxpayers individually and the Corporation allowing the Cezars to construct improvements on the Corporation’s lot, and Mr. Cezar’s statements during audit that the lot and improvements were corporate assets. Finally, the court noted that the Corporation had never sold lots and improvements separately and that it was unlikely a buyer would want to buy a lot but not the improvements (or vice versa).

#### CORPORATION’S RECOGNITION OF INCOME

The Cezars conceded that the constructive dividend caused the Corporation to recognize taxable income, insofar as the fair market value of the property received exceeded the Corporation’s basis in the property. Because the Cezars and the Corporation were unable to document the Corporation’s basis, the Tax Court determined the Corporation recognized additional unreported income.

#### ACCURACY-RELATED PENALTIES

The Tax Court determined that both the Cezars and the Corporation were liable for an accuracy-related penalty under § 6662 for failure to keep accurate financial records and substantial understatement of income tax, respectively. Accordingly, the Taxpayers were required to pay the additional penalty.

#### CONCLUSION

The court’s ruling in *Cezar* demonstrates the importance of accurate record keeping and professional tax advice, both for corporations and individuals. Tax practitioners can use the ruling as a marketing tool for small business owners who believe they can or should do it themselves.

*By Chris D. Treharne, ASA, MCBA, BVAL and John Walker  
Gibraltar Business Appraisals, Inc., Longmont, CO*