Valuation & Litigation Briefing

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Questions to gauge marketability — or lack thereof

The discount for lack of marketability (DLOM) is often a contentious issue. Why? First, the DLOM can have a significant impact on the value of a business interest, reducing it by, say, 15%, 30% or more. Moreover, quantifying the appropriate discount for a specific business interest requires subjectivity and an in-depth understanding of key empirical studies. Here's more on the art and science underlying the DLOM.

What is marketability?

The *International Glossary of Business Valuation Terms* defines marketability as "the ability to quickly convert property to cash at minimal cost, with a high degree of certainty of realizing the anticipated amount of proceeds." It defines the DLOM as "an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability."

Business interests that are expected to take a long time to sell and/or incur high transaction costs may warrant a higher DLOM.

Investments in shares of closely held companies are considered to have an indefinite holding period (a long-term illiquid investment) and thus are inherently less marketable. And business interests that are expected to take a long time to sell and/or incur high transaction costs may warrant a higher DLOM. When quantifying this discount, experts also factor in the risk that investors might not receive their expected returns.

What factors affect the DLOM?

Empirical studies (see "Quantifying the DLOM" on page 3) are typically the starting point for quantifying a DLOM. From there, experts gauge a business interest's marketability using these factors:

- Expected holding period,
- Level of risk or volatility, and
- Expected dividend payments.

Experts consider a mental checklist of questions when quantifying the DLOM for a specific business interest. Here are some examples:

Does the interest include "put" rights? The right to sell an interest back to the company, if certain conditions are met, creates a limited market for the interest. However, an expert must evaluate whether the company will have the financial ability to redeem these interests. If not, the liquidity associated with put rights may be illusory.

What are the prospects of an initial public offering (IPO) or sale? The higher the likelihood the company will conduct an IPO or sale — and the sooner such an event is likely to occur — the lower the DLOM. An expert must consider whether the company is a strong candidate for an IPO or sale, based on its performance and conditions in its industry, as well as the intentions of its controlling owners.

Quantifying the DLOM

Valuation experts use various empirical studies when estimating the discount for lack of marketability (DLOM) for a business interest. Common sources of empirical data include:

Restricted stock studies. These studies quantify the DLOM by comparing trading prices of public company stocks with prices paid in private transactions involving restricted stock of the same company. Restricted shares are generally identical to their publicly traded counterparts, except that they're subject to a minimum holding period. Because the restriction will eventually be lifted, restricted stocks tend to be more marketable than comparable closely held stocks. Average discounts from restricted stock studies generally range from 20% to 45%.

Initial public offering (IPO) studies. These studies compare IPO prices with prices of the same stock in private transactions before the IPO. The increase in stock price before an IPO and at the time of the IPO represents the stock's relative lack of marketability. These studies may be adjusted to exclude non-arm's-length transactions, such as sales to insiders or exercises of stock options. Average discounts from IPO studies generally range from 30% to 60%.

The mean or median discounts from these studies may serve as a starting point that needs to be adjusted up or down, based on the characteristics of the specific business interest. Experts also use other methods to quantify the DLOM, including discounted cash flow models and stock option pricing models.

Do shareholder or partner agreements restrict transfers of shares? Contractual transfer restrictions typically warrant a higher DLOM to reflect the increased time and cost associated with selling the business interest.

How large is the business or business interest? Generally, investors perceive large businesses as less risky than small ones. Moreover, as the size of an interest increases, the pool of potential buyers eventually decreases and the likelihood that a sale will "flood" the market increases. This could make a sale more challenging.

How solid is the company's historical performance and what are expectations for the future? Strong performance — in terms of profitability, earnings stability and revenue growth — along with stable historical and expected returns translates into lower risk and higher marketability.

Are there any company-specific risk factors? The existence of these risks — such as lack of geographic or product diversification, heavy dependence on key customers or suppliers, poor management quality and pending litigation — generally adds to the DLOM.

Does the company have a history of paying generous dividends? Higher historical dividends may be associated with lower DLOMs.

How much in dividends is the company expected to pay out in the future? A company may cut back on expected dividends if performance is likely to decline — or if shares in a family business are transferred to nonfamily members.

Need help?

Marketability is a complex issue. Experienced valuation professionals ask the right questions to customize a DLOM that fits a particular business interest. ■

Owners' compensation: What's reasonable for C corporations?

The IRS and C corporations often disagree about the reasonableness of shareholder-employee compensation. C corporations usually prefer to classify payments as tax-deductible wages because it lowers corporate taxes. But, if the IRS believes that an owner's compensation is excessive, it may claim that payments are disguised dividends, which aren't tax deductible.

Reasonableness is decided on a case-by-case basis. In *H.W. Johnson, Inc. v. Commissioner*, the U.S. Tax Court found that a corporation was entitled to deduct more than $11 million paid to two shareholder-employees over two years.

A solid business

H.W. Johnson involved a successful Arizona concrete contractor owned 51% by the founder's wife, and 24.5% each by her two sons, who served as co-vice presidents. H.W. Johnson didn't produce its own concrete, so it was affected by a statewide concrete shortage starting in late 2002.

In 2003, the sons partnered with other investors to form a concrete supply business. The partnership helped ensure that H.W. Johnson would receive a steady supply of concrete, even when other contractors couldn't procure what they needed.

During 2003 and 2004, H.W. Johnson paid the sons, combined, more than $11 million in salary, bonuses and directors' fees. The company computed bonuses according to a formula adopted in 1991 and amended in 1999. The IRS determined that the sons had received more than $8 million in excessive compensation and argued that this amount should be reclassified as nondeductible dividend payments.

Factors to consider

The Tax Court, based on legal precedent set forth by the Ninth U.S. Circuit Court of Appeals, considered the following factors to estimate a reasonable level of compensation:

The employees' role in the company. Given their expertise, management skills, relationships, reputations and personal guarantees of corporate indebtedness, the sons were integral to the company's success.

Compensation paid by comparable companies for similar services. The company's performance significantly surpassed that of any benchmark companies identified by the parties' experts, making meaningful comparisons difficult.

The company's character and condition. H.W. Johnson's remarkable revenue, profits and asset growth during 2003 and 2004 warranted above-market compensation for the sons' contributions to the company's day-to-day operations.

Internal consistency of compensation arrangements. Bonuses were paid pursuant to a "structured, formal, and consistently applied program" that was applied equally to all of the company's employees.

The IRS challenged another critical factor: potential conflicts of interest. It argued that family ownership of the company's stock permitted the business to disguise nondeductible dividends as deductible compensation.

Independent investor test

In evaluating the reasonableness of owners' compensation, the Ninth Circuit traditionally examines potential conflicts of interest from a hypothetical independent investor's perspective. If such an investor would be satisfied by his or her return on equity (ROE), then arguably shareholder-employees "are providing compensable services and … profits are not being siphoned out of the company disguised as salary."

H.W. Johnson provided investors with a pretax ROE of 10.2% in 2003 and 9% in 2004. The court found that these numbers aligned with industry averages for similar concrete contractors and, therefore, would satisfy an independent investor. In light of this test, the court decided that the amounts paid to the sons were reasonable and deductible as compensation expense.

Venue-specific factors

Tests for evaluating what level of shareholder-employee compensation is reasonable vary depending on the case's venue, as well as the facts and circumstances surrounding a company's compensation. Be sure your financial expert understands the factors used in a case's jurisdiction and incorporates them into his or her analysis. ■

Close-up on fair value

FASB simplifies the test for goodwill impairment

In January 2017, the Financial Accounting Standards Board (FASB) published Accounting Standards Update (ASU) No. 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. Here's how financial reporting will change under the updated guidance — and why three of seven FASB members dissented from the decision.

Reviewing the old rules

Typically, goodwill arises when one company acquires another. After the purchase price has been allocated among tangible assets and identifiable intangible assets — such as intellectual property and covenants not to compete — any remaining value is attributed to goodwill.

At one time, the FASB required companies to capitalize goodwill and amortize its cost over its estimated life (up to 40 years). In 2001, however, the FASB, recognizing that goodwill doesn't necessarily lose value, adopted new rules for reporting goodwill.

The rules require companies to evaluate the carrying value of goodwill annually and write it down if it's impaired — that is, if the goodwill's fair value has dropped below its carrying (or book) value. Under certain circumstances, companies must conduct impairment testing in between annual tests. For example, interim testing may be required if certain "triggering events," such as unanticipated competition or loss of a major customer or key employee, signal a potential loss of value.

Under the existing rules, testing goodwill for impairment is a two-step process, applied separately to each of a company's reporting units. First, determine a reporting unit's fair value and compare it to the unit's book value. If the fair value is higher, no further testing is required. If fair value has dropped below book value, proceed to step two.

The second step is to calculate the "implied fair value" of goodwill — that is, the fair value of the reporting unit as a whole minus the fair value of its identifiable net assets. If the implied fair value of goodwill is less than its carrying amount, goodwill has been impaired.

Impairment testing can be somewhat complex. So, in 2011, the FASB offered a simpler, "qualitative" option that allows some companies to avoid quantitative impairment testing. This option allows management to evaluate certain qualitative factors and then determine whether it's more likely than not that a reporting unit's fair value has fallen below its carrying amount. If management determines that the chances of impairment are 50% or less, no further testing is required.

In 2014, the FASB decided to allow private companies to elect to amortize goodwill acquired in business combinations over a period of up to 10 years instead of testing it for impairment annually. But some private companies — especially those that are large enough to consider going public someday — continue to test for impairment, similar to public entities.

Focusing on public companies

Despite the FASB simplification efforts, many companies continued to complain about the complexity of the goodwill impairment test. So, the FASB recently issued ASU 2017-04 to further simplify postacquisition accounting for goodwill. Under the updated guidance, an impairment loss will equal the difference between the reporting unit's carrying amount and its fair value.

But some companies wanted the FASB to retain the option to apply the second step of the impairment test, because it would offer a more precise measurement of goodwill impairment in some cases. In fact, three FASB members dissented from issuing the update. In their view, goodwill could be misstated in a one-step test.

> ***Under the updated guidance, an impairment loss will equal the difference between the reporting unit's carrying amount and its fair value.***

"I would emphasize the fact that I don't think it's a simplification or an improvement when you run into situations where you could actually misidentify an impairment," FASB member Harold Schroeder said during a FASB meeting. "By eliminating Step 2 you actually increase the cost, collectively to the system, by having misinformation in the marketplace."

Valuing goodwill

Although the FASB has made the goodwill impairment test easier, valuation expertise remains critical. Business valuation experts can help conduct qualitative assessment, determine appropriate reporting units and measure the fair value of those reporting units.

CPAs are specifically prohibited from providing valuation services for their public audit clients. The use of outside valuators helps maintain the auditor's independence and gives stakeholders greater confidence in postacquisition financial results. ■

Uncovering hidden assets and income in divorce cases

In divorce cases, spouses may have an incentive to hide assets and income to minimize support payments or skew marital asset distributions. Here are some ways spouses may attempt to conceal their wealth and techniques financial experts use to uncover it.

Common schemes

How might dishonest spouses attempt to hide assets or income? Consider these scenarios:

Hidden bank accounts. A spouse may divert cash into a new, undisclosed bank account in his or her own name.

Undervalued assets. A spouse uses cash to purchase expensive assets — such as artwork, jewelry or antiques — and downplays their value.

Understated or unreported business income. A spouse might, say, collude with his or her employer or business partners to delay the payment of bonuses, commissions, stock options or other compensation until after the divorce. Spouses who own a private business also might delay sending customer invoices or signing business contracts to make the company appear less valuable.

Fraudulent transfers. A spouse could temporarily transfer the title to an asset to a friend or family member who returns it after the divorce.

Phony expenses or debts. Another ploy is to funnel cash to a friend or family member and disguise it as payments on fake invoices for nonexistent products or services, or as repayment of a phony debt.

Methods of detection

The first step to revealing hidden wealth is to establish a baseline — typically, the point in time when the marriage began to deteriorate. Major changes after that date — such as declining income or shrinking bank balances — may indicate that a spouse is manipulating finances.

To identify unreported income, experts examine sales, payroll, tax and other financial records. They also may interview employers and customers or clients to determine whether income has been delayed or misdirected. Hidden assets are often revealed by a review of tax returns, invoices and receipts. For example, interest, dividends or itemized deductions reported on a tax return might lead to hidden accounts or assets. A document review may expose invoices for repairs, maintenance, professional fees or other expenses related to previously unreported assets.

Lifestyle analysis is another powerful tool for revealing hidden assets and income. The expert determines whether a couple's income and assets are sufficient to cover its expenses and liabilities. A shortfall may indicate hidden sources of funds.

Fill in the blanks

Need help compiling a list of documents to request during discovery or conducting a forensic analysis to reveal hidden assets and income? Contact a financial expert to develop a clear picture of a couple's financial condition and arrive at a fair divorce settlement. ■