A newsletter from NIFA
APPROVED EXPERT FINANCIAL WITNESSES

NIFA NEWS

ISSUE 14 - Part 1

NIFA WELCOMES THREE NEW MEMBERS

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NIFA VALUING PRIVATE COMPANIES - PART 1

Valuing businesses is more of an art than a science because value is a matter of opinion. Indeed, it has been said that the value of a share is what it can be argued to be. This is especially true when valuing shares for tax purposes, where the valuer adopts the "hypothetical open market" basis. So it is often more appropriate to state the value of a share as falling within a range of values, rather than to specify a precise figure. After all, the valuer is not normally one of the transacting parties and is in no position to strike a deal, thereby determining the price. So the valuer should aim to give the transacting parties a range of values within which, in his professional opinion, a deal is likely to be concluded.

This is all very well, but if you are to rely on a valuation, you want to be assured that it is an opinion that has been reached rationally, with some careful thought and on the basis of fact.

Let's first consider some concepts of value.

Joe has been driving the same car for eleven years. He averages 11,000 miles per year and has maintained it in good working order. He paid £15,000 for it. If he were to replace it with the same model today, he would expect to pay £24,000. Glass's Guide suggests a current sales value of £1,000.

What's the value of the car?

The value of the car to Joe is a lot more than £1,000 but less than the £15,000 he paid for it - its cost. Joe will have to find £24,000 to replace it - its replacement cost. He'll have the inconvenience of finding a buyer, choosing and arranging a replacement, and altering the insurance. He does not intend to sell just yet. As far as Joe is concerned, the car's value to him is higher than the £1,000 suggested by Glass's Guide. The value that Joe has placed on his car is known as the "owner value". If it were a company owned vehicle, it would have a "book" or "net book" value - more of that later.

Glass's Guide may be a fair indication of the "market value" of the car because that value is based on a number of transactions for that specific model over the past 3 months or more.

Sadly, Joe's situation changed when he wrote off his car. Now he cannot sell the car, he cannot use it and he has to negotiate with his insurer. His insurer tells him that its value is £800 and pays him. Is that the market value or is it a discounted market value - discounted because he is in a weak negotiating position? If he had sold before the accident would he have got more than £800? Well, undamaged he might have found a buyer for £1000 - £1200. He knows this because he used to drive past a garage where they had a similar car on display for that amount - but it did take 6 months to sell.

NIFA, THE NATIONAL NETWORK OF INDEPENDENT FORENSIC ACCOUNTANTS, SETS AND APPLIES HIGH STANDARDS TO BE DELIVERED BY OUR APPROVED EXPERT FINANCIAL WITNESSES

NIFA Concepts of value continued...

Finally, there is the concept of "fair value" – fair to both parties. More on this later by reference to private company shares.

This tale illustrates that there is more than one way to look at value and that the value of anything is dependent upon time, the buyer's and seller's respective needs and the condition of the asset being sold. In every commercial deal each side places its own value on the property to be exchanged. Where the seller's price equals the buyer's price, a deal is struck. The skill in valuation is to find that common ground.

If there is a ready market for the item, then the price can usually be determined without too much difficulty. If I don't like the price being demanded, I can search for a cheaper supplier. Market forces will regulate the price so that any price differences are usually small or occur in different time periods. If I cannot find a cheaper price I am forced to buy at the seller's asking price. If I do find a cheaper price, the first seller will find that he is selling less and will have to reduce his price to boost sales. Such are the mechanics of an open market.

But what if there is no market? What if we are asked to value a business where there is no intention to sell and there is no buyer knocking on the door? Such situations often happen – in divorce, where a spouse's private company or business has to be valued, in tax, where a 1982 valuation of shares is required.

In such circumstances the valuer is forced to assume that there is an open market and that buyer and seller will bring to the deal the knowledge and rationale that might be expected of reasonable people trying to clinch a deal. This is the hypothetical open market value – a concept that has grown out of case law, much of which involved valuations for taxation purposes.

The hypothetical open market value is a concept that is adopted for most business valuations where matrimonial proceedings for divorce have been commenced.

NIFA Private company valuations

When valuing a private company limited by shares, it is essential to bear in mind just what a share is. A share is a "bundle of rights" and the more shares you have in a particular company, the more rights you have. The more rights you have, the more control you have over what the company does, how it is run and what dividends it declares.

Let's say a company has issued 100 Ordinary Shares. If I own 75 or more of those shares I have absolute control of the company. I can appoint and dismiss directors, set the dividend and, most importantly, I can pass a resolution to wind up the company without fear of being challenged, subject, of course, to a petition under section 459 of the Companies Act 1985.

> *If I have more than 50 shares I have control but I cannot pass a special resolution without the support of other shareholders.*
> *If I have between 25 and 50 shares, I am known as an* ***influential minority*** *shareholder. I could block a special resolution.*
> *If I have fewer than 25 shares I am known as an* ***un-influential minority*** *shareholder.*

The concept of control is central to share valuations – the more control you have, the greater the relative value of your shares. Or to put it the other way, if you do not have absolute control, expect to suffer a discount on the value of your shares. Having said that, some recent divorce cases have shown that the court is prepared to apply the law of equity to the valuation of a spouse's minority shareholding by ignoring discounts.

Now is a convenient time to look at the concept of "Fair Value". This is often seen in shareholders' agreements and in a company's articles of association – "The auditors shall compute a fair value for the shares.....".

Take the example of a company with an issued share capital of 90 ordinary shares of £1 each, held as follows: Fred Smith 30, Joe Bloggs 30, John Doe 30. None of the shareholders actually works in the business - they are simply investors. John Doe decides he wants to sell his shares. If he sells 15 to Fred and 15 to Joe, there is a "Mexican Stand-off" - no-one has control. But if John sells only to Fred, then Fred will have 60 shares and control. To understand the impact of the options on the value of John Doe's shares, let's put some figures for possible values.

Say the company as a whole is valued at £120,000. If a buyer were found for all 90 shares, then the company would be sold for £120,000. The pro-rata value of each block of 30 shares - £120,000 divided by 30 - is £40,000. This value is of little practical importance.

If only John wants to sell, he will suffer a discount on the pro rata value of the shares because no individual has control. Assume that a discount of 60% would be applied - not unusual for a shareholding of that size in a small company. John might hope to receive £40,000, but it is more likely that he would receive only £16,000 (£40,000 less 60%). And it would be the same for each of them - as an individual minority shareholder they are unlikely to get more than £16,000 on the hypothetical open market basis. An outsider is not going to pay par value for a minority interest in a private company.

If John Doe sells to Fred and if Joe does not wish to acquire any of John's shares, then Fred will gain control. A controlling shareholding in the company would carry a smaller discount - say 25%. So the value of Fred's new shareholding will be £60,000 (£120,000 X 66% less 25%). So, by acquiring John's 30 shares, Fred will have doubled his shareholding and gained control of the company and the value of his increased shareholding will have risen from £16,000 to £60,000. He will have doubled the number of shares he owns and more than trebled the worth of his investment.

The concept of Fair Value seeks to apportion some of Fred's disproportionate increase in value to John, the selling shareholder. After all, John is assumed to be a reasonable and rational individual. He will be aware of the fact that by selling his shares to Fred, Fred gains control and control carries a premium.

We'll come back to control and discounts later but for now let's get down to the nitty-gritty of valuing shares in an unquoted private company. First, let me explain some accounting jargon!

The accounts or financial statements consist of a balance sheet and a profit and loss account. For companies that are not small (as defined by section 246 of The Companies Act 1985), the accounts will also include a cash flow statement. These documents will be augmented by notes and an explanation of the accounting policies adopted by the company. More about accounting policies later.

NIFA The balance sheet

A balance sheet is a statement showing the company's assets and liabilities at one moment in time – usually midnight on the last day of the company's accounting period – 31st December 2004, for example.

The assets can consist of "Fixed Assets" – those that are permanently used in the business. Fixed Assets can be "tangible" – property, plant and machinery, vehicles, office equipment or "intangible" – goodwill, intellectual property, patent rights and trade marks. The value of Fixed Assets is usually written off (reduced) over a number of years by means of depreciation, or in the case of intangible assets, by amortisation. Thus, a company may write off the cost of its vehicles over four years. This means that if a company purchases a vehicle for £12,000, that vehicle will be shown in the accounts at a net book value of £9,000 after one year, £6,000 after two years, £3,000 after three years and zero after four years. Profits will have been reduced by £3,000 in each year. This is ***not*** an attempt to record any reduction in the market value of the car (although it may well come close), rather it is a charge against profits to reflect the usage, consumption, wear and tear of the asset in the course of its use in the business.

Other assets shown in a balance sheet are "Current Assets" – those that arise from transactions in the company's trade – its stock, its debtors (customers who owe money) and its positive cash and bank balances. Current assets are expected to be turned into cash within twelve months of the balance sheet date. So, we would expect to sell all the stock, which would give rise to customers who owe us money (debtors), who, when they pay up, will increase the company's cash balances.

The balance sheet also shows creditors – people or other businesses to whom the company owes money for its supplies and overheads. Creditors are separated on the face of the balance sheet between "Amounts falling due within one year" and "Amounts falling due after more than one year". Trade creditors (the amounts owed to businesses who have supplied goods and services to the company) are an example of amounts falling due within one year. They will usually be paid within 90 days. Amounts falling due after more than one year consist of that portion of loans, Hire Purchase agreements and Finance Lease agreements that will fall due for payment after twelve months.

NIFA The balance sheet continued...

If we add Fixed Assets to Current Assets and deduct Amounts falling due within one year and Amounts falling due after more than one year, we arrive at a figure known as "Total net assets".

The above items appear in what is colloquially referred to as the "Top half" of the balance sheet. The bottom half records the company's issued share capital, its accumulated profits retained in the business and any reserves it may have, such as an asset revaluation reserve as a result of an uplift in the value of its properties or a Capital Redemption Reserve, as a result of a purchase of its own shares out of retained profits. The total of this section of the balance sheet is often captioned "shareholders' funds".

The total of the top half of the balance sheet – the total net assets – should equal the total of the bottom half – shareholders funds. It "balances"!

It is important to note that the balance sheet does not reflect the market value of a company's assets. You will frequently hear business owners alluding to the "net worth" of the company by reference to its total net assets as shown in the balance sheet. This can be misleading because the balance sheet is a statement that results from accounting entries, not from a valuation of the business. Sometimes assets are disclosed in the balance sheet at a valuation – freehold properties, for example. Their market value may be higher than what appears in the accounts because the revalued amount may have suffered depreciation between the date of the valuation and the balance sheet date.

When looking at a balance sheet in a company valuation you need to be aware of what might not be included – freehold properties that were acquired many years ago and which are stated at a net book value after depreciation but whose market value may be considerably higher. There may be goodwill which has not been included in the balance sheet. Goodwill is the excess of the value of a business over the fair value of its underlying assets. A buyer may be prepared to pay more than the market value of the assets of a business because he / she believes that the future profit streams will exceed the value of the assets. Think of the "dot com" boom when people were paying huge sums for companies that consisted of little more than whiz-kids with bright ideas about internet selling and a few laptops. Those who bought paid a high price for goodwill – both literally and metaphorically!

So that's the balance sheet. It gives a financial snapshot of the assets and liabilities at one moment in time - more of an accounting document than a statement of value. The figures will have changed by one minute past midnight as interest is earned or paid, depreciation charged etc.

TO BE CONTINUED IN ISSUE 14 - Part 2...

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