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NIFA NEWS

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NIFA VALUING PRIVATE COMPANIES - PART 2

The profit and loss account

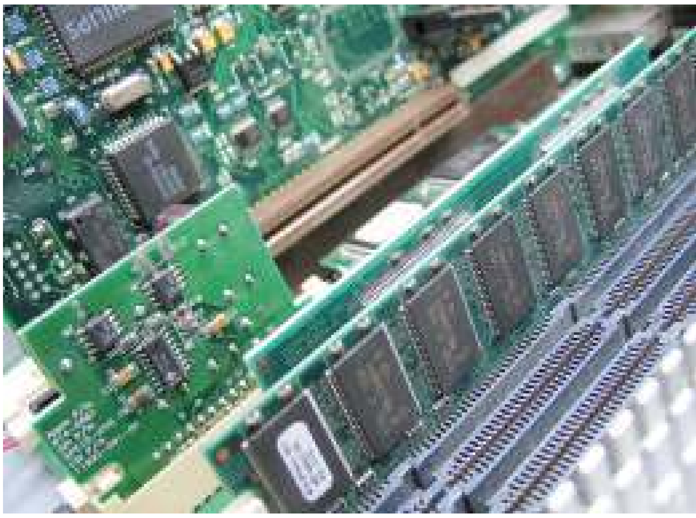
The profit and loss account is the history book or log of the company's transactions for a particular period. So, when you see the words "Profit and loss account for the year ended 31st December 2004" it means exactly what it says on the tin. It means all the sales made, less all the costs incurred in the year to that date. Or could it mean something else?

Here beginneth your first lesson in creative accounting. Some might call it deception! This is important. The valuer must get to grips with the true level of profits being generated by the business and this may not be what is shown in the Profit and Loss Account – the P&L.

Chips Limited is a private company that sells computer hardware. It also develops and sells software, which is run on its hardware, to IT professionals. The software is usually diagnostics tools or error/catastrophe mitigation tools. A licence to use the software is sold and it is valid for one year. The hardware sales consist of two elements: the sales value of the hardware itself and an annual maintenance charge. Chips Limited draws up its accounts to 31st December.

On 21st December it sells hardware with a sales value of £20,000 to a customer. The customer signs up to an annual maintenance agreement and pays a further £3,000 for the forthcoming year's maintenance. The customer also buys a 50 user licence for virus protection software for £24,000 payable monthly in advance.

Chips Limited records sales of £20,000 plus £3000 plus £24,000 - £47,000 in total. Is this correct? Is it correct to take full credit for a maintenance agreement in this current year when most of the maintenance work will be carried out next year? And is it wise to assume that the customer will continue to pay for virus protection throughout the next twelve months? Would it not be prudent to defer some of the sales value of the maintenance agreement until next year when it will be earned? Would it not be a good idea to account for the virus protection sale on a monthly basis?



Instead of recording sales of £47,000, sales of only £20,000 might be more realistic. Believe it or not, it is only within the last year that the UK has had an accounting standard on how to recognise and record income – Application Note G to Financial Reporting Standard 5.

The recognition and recording of income is an example of an accounting policy. Chips Limited's policy was to recognise income (and hence the profit) when the sales invoice for £47,000 was raised but it has the effect of overstating profits.

Other policies need to be critically appraised: how is stock valued, are stock write downs valid or are they simply a means of hiding profits? Are bad and doubtful debts identified and is adequate provision made? These matters affect profitability and it is usually the profitability of a business that determines its value. So a critical review of accounting policies and their application is essential when valuing a company's shares.

NIFA Valuation Methods

There are several methods used to value companies. The most common are:-

- the future maintainable earnings method,
- the net assets method,
- the dividend yield method.

The first two methods are normally applied when valuing a controlling interest or the entire share capital of a company.

Where an individual shareholding has to be valued, the valuer needs to consider the rights which the shareholding brings to the owner before choosing one, or a combination of more than one, of the above methods.

In the case of minority shareholdings, the dividend yield valuation method can be adopted, if there is a history of dividend payments. However, the dividend yield method is not often employed because many private companies do not pay regular dividends and the directors are not obliged to satisfy "City" demands for a constantly increasing dividend stream, as are public limited companies – "PLCs".

Future maintainable earnings method

The earnings method seeks to establish the amount of earnings, in the form of after tax profits, which the company can sustain for the foreseeable future. This sum is then multiplied by a factor representing the number of future years' earnings which a purchaser might consider acquiring. Put another way, the purchaser will be looking at the period over which profits will pay back his original investment. This factor is often referred to as the P/E ratio (Price/Earnings) or the "Capitalisation Factor".

A more recent adaptation of the earnings method is the use of "EBITDA" – earnings before interest, tax, depreciation and amortisation - as an attempt to identify the core trading profits of a business. Often referred to as the Enterprise Valuation method, it is not, in the author's opinion, an appropriate method for valuing private companies because buyers of private companies are interested in distributable profits after tax. However, there is a case to be made for its application to larger companies, especially those being acquired by other companies, where the concept of pre-tax trading profits is more important.

It is common when using the earnings method to make adjustments to reported after tax profits so as to smooth out any unusual transactions and to recognise the fact that, in private family companies, management and staff remuneration may not equate with what would be paid if the company were managed and run by non-family members. Furthermore, the director/shareholders of private companies may also take remuneration by way of dividends in order to save Employer's National Insurance contributions. Such variations need to be identified and brought into account when computing earnings.

As a rule of thumb, the earnings method should receive preference where:

1. the company is, and is likely to continue to be, a going concern,
2. there is a record of profits over the past 3 years,
3. the company is not asset rich in the sense that it has assets, which if valued on the open market, would exceed the present value of future cash flows from trading profits,
4. the shareholding to be valued is a controlling interest.

Adjusted past profits, particularly those of the most recent year, are often considered to be a reasonable basis from which future profitability can be estimated. However, I would stress that the past is not necessarily a reliable basis upon which to predict the future, if indeed any prediction is possible. This is particularly true where the results vary from losses to profits.

The golden rule in share valuation is to estimate the price that would be paid for benefit received in the future. A buyer buys the potential future profits of a business and past profits may not reflect what the future might bring. Too often valuers rely on an arithmetic derivation of future earnings from past profits, without adequate consideration of what is likely to happen in the future. Profit forecasts can be of help but not many private companies prepare them on a regular basis. Forecasts need to be critically appraised – are they prepared using the same accounting policies as are used in the accounts, have past forecasts been reliable?

Net assets method

By contrast, the net assets method ignores the future cash flows which the business may generate. Instead, this method values the assets less the liabilities of the business at a given date on one of two bases:

a break-up or forced sale basis, which assumes that the assets must be sold,
a going concern basis, which assumes that the assets will not be sold but are to be valued on an open market basis between a willing buyer and a willing seller.

The net assets method is normally appropriate where:

the company is not a going concern and is likely to be wound up and its assets sold piecemeal,
or the company is a going concern but is asset rich - the current value of its net assets outstrips the present value of the future cash flows from its trading. Property investment or development companies are examples of where this method may be particularly relevant;
or losses have been incurred, with the result that future maintainable earnings cannot be quantified with sufficient reliability.

The dividend yield method

The dividend yield method is commonly used to value minority shareholdings. A minority shareholder is not usually in a position to direct the affairs of the business by virtue of his lack of control. He can only rely on dividends for his return. Dividends are, however, at the discretion of the directors and a minority shareholder does not usually have the power to appoint directors or to influence their decisions.

The difficulty with the dividend yield method is that private companies do not have to strive to maintain an upward trend in dividends. Often no dividend has been paid for many years. More recently, dividends have been favoured, mainly for tax reasons, as a form of remuneration by owner managers. The dividend paid is not so much a return on investment as a form of tax efficient remuneration for managerial services to the company. It would be wrong to assume that a dividend will be paid every year.

Let's now look at an example of how a company might be valued:

Wenger Limited

Wenger Limited manufactures football shirts and shorts. It was established 15 years ago by Freddie Adams, who owns all of the shares. Freddie is the only director and his wife is Company Secretary. The company has secured contracts with several league clubs to produce shirts and shorts for players and fans. The company trades from premises owned by Freddie's Self Invested Pension Plan. Turnover and profits have shown good growth over the past few years but competition from the far east is beginning to be felt and the company is coming under pressure to trim its prices.

A summary of results is set out below:

	2004 £000s	2003 £000s	2002 £000s
Sales	2,000	1,400	1,500
Cost of sales	1,400	840	975
Gross Profit	600	560	525
Overheads	500	480	450
Net profit before tax	100	80	75
Tax	24	15	16
Profit after tax	76	65	59
Dividends	40	40	40
Retained profits for year	36	15	19
Director's emoluments	20	25	25

The 2004 results are stated after an exceptional write down of stock amounting to £50,000.

The first matter to be ascertained is the level of future maintainable profits.

Note that the emoluments paid to Freddie are below what one would expect for a company of this size. Freddie is clearly taking dividends as a form of remuneration because they avoid a charge for Employer's National Insurance contributions. If Freddie were to be bought out, a full time manager would be needed. It is unlikely that a suitable candidate would accept a total remuneration package of less than £80,000. Post tax profits are overstated - we need to increase director's remuneration. The reason for the stock write down needs to be ascertained. Was it justified and is it likely to be repeated? If it is a one-off, exceptional item, then future maintainable profits are likely to be £50,000 higher than those of 2004.

NIFA The dividend yield method continued...

Assuming that there are no further adjustments to taxable profits, future maintainable earnings are likely to be as follows:

		£000s
Profits before tax as per 2004 accounts		100
Add back:	stock write down	50
	Freddie's emoluments	20
		170
Less:	Manager's remuneration	80
Revised profits before tax		90
Taxation		22
Future maintainable earnings		**68**

The next step is to decide upon a capitalisation factor. The following issues need to be considered:

The company is small and must be very dependent upon Freddie. Constant pressure on margins from the far east could spell the end of lucrative sales agreements. There is nothing special about the company and its products - no niche, no innovation, no management succession. The Company's product range is narrow and not diversified. The sales and profit trends are upwards. Asset backing is minimal. In the above circumstances it is unlikely that a capitalisation factor greater than 4 will be achieved - it is more likely to fall between 2 and 3.

The value of the whole of the issued share capital is, therefore, between £136,000 and £204,000. If that seems low, think of it this way: rather than pay Freddie £200,000, a buyer could set up his own similar business for that amount and probably do just as well by outsourcing production to the far east .

If Freddie was one of two shareholders each owning 50% of the shares, no discount would normally be applied. Depending on the number of other shareholders and the spread of their holdings, Freddie's 50% could be discounted by as much as 40% - it really depends on the circumstances. The smaller the shareholding, the greater the discount. Of course, reference should always be made to the Articles of Association and to any Shareholders' Agreement to see whether any mention is made of the valuation method to be adopted and whether a discount is to be applied.

Finally, check the net asset value before deciding upon the value – if the net asset value is greater than the earnings valuation, then further consideration is needed. Make sure that assets are stated at proper values – properties may be understated and stock may be overstated – and that all assets have been identified – goodwill and intellectual property can often be overlooked.

So there we have it – the final value for Freddie's company! Or is it? Who's to say that Alex won't come along tomorrow and view Wenger Limited as a ready-made route to fulfilling his boyhood dream of owning a sports manufacturing business and be prepared to offer Freddie £300,000? It could happen, but it's unlikely. On the balance of probability, taking into account all that we know about Wenger Limited's past and its likely future, we have arrived at a reasoned hypothetical value for the company.

But it is only an opinion, albeit a professional opinion. Without doubt another accountant or valuer will challenge the valuation. Challenges between accounting experts on share valuations most commonly address:

(a) **the computation of future earnings**
(b) **the capitalisation (P/E) factor**
(c) **the discount.**

Reason and compromise usually resolve the impasse.

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