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Business Owners' Choice of Organizational Form to Appraisers' Determination of Value: An Agency

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ABSTRACT:- Determining the value of a privately held firms confound those in academia as well as practitioners in the fields of appraisal, forensic accounting, and law. Divergent parties to the transfer look to apply the valuation technique to serve their own best interests. This paper seeks to explore how agency theory induces owners to choose the form of their businesses at inception and how this choice will affect the appraisers' valuation of the firm at the transfer of ownership.

KEYWORDS: Organizational form; Agency theory; Value

I. INTRODUCTION

A determination of the value of a privately held firm is no easy matter, and doing so has continued to confound those in academia and practitioners in the fields of appraisal, forensic accounting, and law. The methodology that provides an accurate assessment of what the value of a firm will be at the transfer of business ownership may be contentious. Divergent parties to the transfer look to apply the valuation technique to serve their own best interests. This paper seeks to explore how owners decide to choose the form of their businesses and how this choice will affect the appraisers' valuation of the firm.

Rational business owners will seek to extract the most value from their firms at transfer, while those acquiring the firm will attempt to justify a lower valuation. Moreover, government entities will often intervene to ensure compliance with tax requirements. When there are disputes, appraiser practitioners are called upon to render opinions on the value of the business using the methodology that will be the most advantageous for their clients. When legal recourse is sought to settle a contested value, forensic accountants are able to provide expert opinions so that the courts are able to render a decision as to the ultimate value to be placed on the business entity.

When entrepreneurs establish their businesses, they explicitly or implicitly elect the organizational form under which they will commence operations. Some of the same factors that influence the choice of the type of organizational form at creation will affect the value of the business enterprise. This paper will not only use agency theory to investigate how owners choose the organizational form of their businesses, but will also evaluate how practitioners will interpret this form when valuation is ultimately required. This link between owners' decisions and practitioners' perceptions is an important consideration that has been here to fore under explored in management literature.

Agency factors that can be considered by owners in determining the organization classification include levels of uncertainty of continuing levels of cash flow, capability of oversight of managers, and uncertain span of control that will be retained by the owner [1]. Owners will seek to extract rents from the organization, usually in a self-interested manner that would detriment other interested parties. Appraisers are cognizant of owners' propensity to maximize personal benefits. The practitioners and forensic accountants will lower the valuation of the organization when it is clear that the owner has chosen a form that decreases potential profit that can be derived from the business after transfer.

Existing literature indicates that the legal and tax consequences of the choice of organizational form [2] ((analyzing consequences of organizational form choice when merging firms); Langstraat and Jackson [3] (discussing tax and liability consequences of organizational form choice)). More recently, the effect, if any, of organizational form on valuation of a business has been studied and debated among valuation practitioners [4] (summarizing the valuation issues in dispute and proposing valuation methodology for pass-through entities); Van Vleet [5] (describing valuation adjustments for S corporations and pass-through entities). The choice of organizational form has been discussed in the agency context [6-8]. However, the effect on the calculated value of the firm has not been fully explored.

The choice of organizational form and resulting valuation of businesses through the lens of agency theory has been considered in existing literature. The agency theory and organizational form relationship has been recognized by Berle and Means as early as 1932.

However, a structured integrated approach has not been thoroughly presented. This deficiency has left the valuation literature devoid of a discussion of the significance of agency issues on valuation. This paper specifies the agency considerations that influence the choice of organizational form and ties them to their valuation consequences, thereby bridging the gap that currently exists in the literature.

In this paper, we propose that the future perceived value of a given firm by its owners will result in the of business form elected. That is, the anticipated future valuation of a firm influences the choice of organizational form by the business owners. This proposition is contrary to the existing literature which primarily takes the organizational form of a firm as a given, analyzes the benefits and costs associated with this presupposed entity classification, and then determines the value of the firm as the result [7-10]. As with prior literature regarding the implications of organizational classification on the valuation of non-public firms, we consider only those entities that are sole proprietorships, partnerships, or closely held corporations not listed on stock exchanges. Each entity classification bears benefits and risks to the owner(s) of the firm.

For example, it may be more effective for a business owner to control all facets of the firm and reap all of the profits while it is in operation, but find that the firm has very little value when the owner seeks to retire. Conversely, owners that share profits with partners and/or shareholders may not maximize personal cash inflows while the firm is in business, and will likely have increased costs of running the business due to agency costs. The signal of a firm that generates when it selects a business form that is not a sole proprietorship is that agency costs are less than the benefits derived from separating ownership and control [6]. The calculated value of a given owner's interest at divesture will comparatively be greater when future cash flows from the business are more ascertainable and reliable.

We have found that owners select an entity form that will result in the greatest value at some estimated point in the future, including transfer of interest due to sale, divorce, gift, retirement, or death. In order to maximize this desired future value, the owners must seek to maximize the positive cash flow stemming from the business while minimizing the costs in doing so. Owners of a firm will choose the organizational form that maximizes the benefits and minimizes the costs associated with the agency problem. This signal is shown in the type of entity that is elected. A stronger signal that the agency costs will be minimized by the optimal choice of organizational form will generate a higher calculated value of the firm than a mere present valuation of future cash flow. If those who are charged with valuing a firm determine that the entity form will reduce the costs encompassed within agency theory most effectively, the calculated future value will be higher than if the business entity signals a sub-optimal entity choice that will maximize resiliency of future cash flows.

The remainder of the paper proceeds as follows. Section one presents literature review of existing agency theory with respect to organizational form. Section 2 presents the framework of our model of analysis. Section 3 presents our propositions regarding agency theory influence on perceived future value of a firm resulting in a choice of business entity. Section 4 presents the procedure traditionally used to measure the value of the firm (i.e., the estimated present value of anticipated future cash flow). Section 5 present practical implications of this novel relationship, and section 6 presents opportunities for further research.

II. LITERATURE REVIEW, VALUATION METHODOLOGY AND PROPOSITIONS

Agency theory represents the consensual relationship between two parties, where two parties agree that one will work under the control of, and on behalf of, the other [6] (Restatement 2nd of Agency, § 1 (providing a definition of the legal relationship between owners and their employees)). The agent is the party that agrees to work for the other. The principal agrees to have the agent work on his behalf.

Principals, as owners of the firm, will seek to gain as much benefit from their agents with the least amount of incentive payment. Further, where there is more than one principal or owner of the firms, each will seek to gain the maximum benefit from the ownership stake, even if it is at the expense of the other principals. Additionally, agents will seek to attain as much value from the firm with the least amount of effort.

Such is the crux of the agency problem when there is a division of any degree of ownership and control [1,6].

In order to verify that agents are not usurping its power to inappropriately benefit from their relationship with the firm, the principals must engage in some degree of monitoring. This monitoring encompasses a set of contracts and bonding that create organizational costs. Additional costs of monitoring include: (1)

Engaging accountants and attorneys to verify and enforce the principals' interests. (2) Time spent in engaging in monitoring activities rather than revenue production, (3) dissemination of information throughout the firm regarding business practices that will reduce the agency problem, and (4) coordination among the owners of the firm to supervise agents' activities [11] ((discussing legal cost of enforcing ownership interests)). If the cost of full enforcement of the relationship among principals and agents exceeds the benefits, then a "residual loss" to the firm results in decreased profits [6].

Agency factors that can be considered by owners in determining the organization classification include levels of uncertainty of continuing levels of cash flow, capability of oversight of managers, and uncertain span of control that will be retained by the owner. Owners will seek to extract rents from the organization, usually in a self-interested manner that detriment other interested parties. Information asymmetry is inherent in any transaction, and the owner of that which is subject of a transaction has the advantage of greater knowledge regarding the viability of the firm. Appraisers are cognizant of owners' propensity to maximize personal benefits based on this unequal distribution of information. The practitioners and forensic accountants will lower the valuation of the organization when it is clear that the owner has chosen a form that decreases potential profit that can be derived from the business after transfer.

It is important to note that the choice of business entity by the owners of firms may not be primarily influenced by the goal of value maximization. For example, owners may seek to limit personal liability, avoid taxation, accommodate family responsibilities, adjust control of and/or responsibilities for running the business, achieve amore preferable work/family balance, and any number of additional factors that may cause owners to choose a business form that is suboptimal in terms of future value [12]. Owners may be willing to make suboptimal business entity selections in order to maximize the utility resulting from satisfying family values and obligations.

Principals may seek to fund "pet projects" that will not maximize revenue or will retain agents based on personal relationships irrespective of competency [10]. Further, owners may lack sufficient confidence in the perceived likelihood of success in expanding of the business, which again may result in a choice of business entity that will not maximize future value and reduce current or future costs.

Rational business owners will seek to choose a business entity that will most effectively maximize the benefits of ownership and control structure while mitigating the associated agency costs [13]. In order to determine the ideal choice, the owner must consider the means by which business is transacted. Principals and agents are more likely to behave with similar motivations when: (1) the net profits areaccurately determined, (2) agents' behavior can be easily verified, and (3) contracts are not based solely on the activity of the agents [1].

Principals can anticipate and control in advance the agents' behavior and actions; this "task programmability" allows for an alignment of principal and agent motives even when the behavior of agents is the means of determining incentive-based compensation [1]. Finally, when principals determine that the business will increase in value, the choice of business entity will reflect a desire for a greater ownership stake, even if agency costs are not minimized [8].

A sole proprietorship business entity engenders all of the profits, liabilities, control, and responsibilities in one person: the owner of the firm. A rational owner will seek to relinquish the benefits (and burdens) of sole ownership if the personal benefit of doing so is increased. Once the firm is no longer a sole proprietorship, the ownership and/or control no longer rests with one person. With this division, there will unavoidably be competing interests among all stakeholders in the firm. These stakeholders include not only the owners of the firm, but also the agents of the firm. This separation of ownership and control creates costs associated with the agency problem.

Sole proprietorships, partnerships, and closely held corporationsseek to control agency costs by restricting the residual claims of these costs implicitly (or explicitly) to the owners. Costs of controlling agency problems are reduced, but there can be inefficiency in the maximization of firm assets. Underinvestment in revenue-producing activities may result, such that the organizational form that reduces agency costs is less than the overall benefits of separating ownership and control. Reduction of costs does not necessarily result in higher calculated value. Instead, the signal that a firm has found the optimal organizational form that takes into account agency costs generates a more advantageous value calculation than the firm solely seeking to minimize costs [7].

There are several advantages to the separation of ownership and control, despite the unavoidable associated agency costs. First, the one most relevant for this analysis relates to the opportunity for ownership diversification. Where ownership can be separated from management, the risk of ownership can be borne by any willing person, not just those that manage the business. This allows for investor diversification and a lower cost of capital. Second, greater need for capital, either for purposes of business growth, or to bond promised payments, corresponds to increased benefits from diversification and, therefore, greater benefits from separation of management and control [13].

Third, when there is separation of ownership and control is that managerial talent can be acquired from a pool of labor that is not limited to those with sufficient capital to invest in a business. Ceteris paribus, managerial ability should therefore, on average, be greater in businesses with separation of ownership and control.

Effective processes that separate the functions of management and control of important decisions at all levels of the organization minimize the costs associated with the agency problem. A combination of principal-agent relationships may manage agency costs: (1) actions of agents may be vetted through a hierarchy of decision makers up to the ownership level, (2) separate entities such as boards of directors may independently oversee the activities of the firm, (3) incentive structures may align motives of principals and agents, or (4) ownership interests may be shared among all parties [13,14].

All of these efforts are costly. A business owner will achieve the highest calculated value when the choice of business entity demonstrates that the benefits of expanding beyond the sole proprietorship are greater than the costs associated with the agency problem. The choice of business entity signals the realization that the agency costs are less than the benefits of separating ownership and control, resulting in a higher calculated value in the future.

The purely rational owner will therefore seek to create an organizational form that will maximize the value of the firm by minimizing the residual risk. Those who contract for the rights to net cash flows in this case are those who negotiate a contract to receive not only the payments resulting from the business, but also the administration of the business as a whole. The purchasers are not just buying a piece of the income, but rather the generator of the income.

Accordingly, a buyer will consider a business that has chosen the form that enables the new owner to maintain the cash flow stream that is used to calculate the value of the firm.

III. METHODOLOGY OF BUSINESS VALUATION

The owner of a business may seek an appraisal of the value of his business for a multitude of reasons. In its early stages, he may require an appraisal for raising start-up capital. At this stage, the owner is selling a portion of the business and the appraisal provides assurance that the funding received is fair compensation for the ownership interest transferred. As the business grows and employees are hired, an appraisal may be used to determine the value of shares contributed to an employee stock ownership plan, or for stock or options granted to employees or directors. Such transfers are usually made to reward employees for past service and to provide an incentive for future efforts. If an owner of the business dies or is divorced, an appraisal may be necessary for estate tax purposes or the distribution of marital assets, respectively. An appraisal of the business might be required to obtain commercial loans where the owner's business interest is offered as collateral. Appraisals are often sought if the business is sold, merged, gifted, or "taken public," to assure that the appropriate taxes are paid, to determine the tax basis for the acquired assets, or to determine the appropriate consideration for the transferred ownership interest. Commercial damage lawsuits may require appraisals to determine the economic losses suffered from actions that diminish the value of a business, such as a breach of contract, or tortuous interference.

Accounting standards require valuation of acquired businesses to test for impairment. Appraisals are often necessary in the event of a partnership dissolution or expulsion, and in dissenting shareholder lawsuits to determine compensation for the separating owner. Given the numerous reasons that an appraisal may be required for a business, business valuation is likely an issue that every business owner will encounter.

IV. VALUATION APPROACHES

Ultimately, the value of any financial asset, such as a business, depends upon the cash flow that it will provide to its owner. The cash flow may be periodic, as with businesses that generate monthly income or quarterly dividends for owners. Alternatively, the cash flow may be back-ended, as when the business generates no, or even negative, cash flow until it is sold. One or more of three approaches can determine the value of a business. These approaches are referred to as the asset approach, the income approach and the market approach.

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