

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

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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

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 divestiture 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.

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 a more 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 are accurately 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 corporations seek 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.

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 tortious 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.

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.

Asset approach

The asset approach is seemingly the most straightforward approach to valuing a business. Under this approach, a value is assigned to each individual asset of the business, as well as to the individual liabilities of the business, based on their respective fair market values. Many of the

asset values are readily obtained, such as cash balances. However, the asset approach does require more than a simple duplication of a business' balance sheet. Certain assets might require adjustments from their stated value. For example, the reported balance of accounts receivable might have to be adjusted to reflect uncollectible accounts. Some assets will require independent appraisals, such as real estate that is carried on the books at historical cost, net of depreciation. The appraiser would adjust the reported value of the real estate to reflect its current market value. Finally, some assets of the business, such as goodwill, patents, or other intangible assets might require independent appraisal because their values are typically omitted from a business' balance sheet, unless the assets have been previously purchased. Even then, the assets may require appraisals to test for impairment. The liabilities of the business are also analyzed individually to determine whether adjustments are necessary to their reported values.

Income approach

The income approach is based on an expectation of the future income that the business will provide for its owner. The term "income" is often more precisely described as free cash flow, i.e., the amount of money that the business will generate for its owner after allowing for expenses, business income taxes, and any amounts that must remain in the business for purposes of providing working capital or funds for capital expenditures. The expected future income of a business entity is discounted to reflect its present value calculation. Publicly traded share prices generally reflect the present value of all future streams of cash flows from the corporation within the investors' anticipated time horizon of ownership of the shares [15-17].

The discount rate represents the required rate of return that an investor would demand to invest in the business. It also reflects the rate at which future income is discounted to determine its present value. The discount rate that the appraiser applies is based on the risk inherent in the business being appraised. In a publicly traded company, the discount rate (r) is traditionally calculated by application of the capital asset pricing model (CAPM). By expression, $r = r_f + \beta (r_m - r_f)$.

The CAPM specifies that the discount rate will equal the risk-free interest rate (r_f) plus the product of the equity risk premium ($r_m - r_f$) and the business' "beta" (β). Beta measures the covariance of the business' returns (r_b) with the return on the equity markets as a whole. Thus, $\beta = \text{cov}(r_b, r_m) / \text{var}(r_m)$. The equity risk premium reflects the rate of return that investors require above the risk free rate to compensate them for bearing the risk of an equity investment. The CAPM is premised on the concept that an investor will only be rewarded for investment risks that cannot be eliminated through diversification, i.e., by holding wealth in many different types of investments [15].

For closely held businesses, beta cannot be directly determined because the returns on their stock investments are not directly observable. However, a discount rate, or required rate of return, can be determined with the certainty-equivalent form of the capital asset pricing model (CE-CAPM) and observable cash flows. The CE-CAPM is of interest for valuing a closely held business because it can account for the lack of diversification that often exists for owners of closely held businesses. It does so by substituting the ratio of the standard deviation of the business' returns ($\text{stdev}(r_b)$) to the standard deviation of market returns ($\text{stdev}(r_m)$) for beta in the traditional CAPM equation, such that

$$r = r_f + [\text{stdev}(r_b) / \text{stdev}(r_m)] * (r_m - r_f).$$

This approach assumes that the owners of closely held businesses have substantially all of their wealth invested in the business, and therefore are undiversified, which is generally referred to as the "total beta" approach (Damodaran, 2005).

Whenever r_b and r_m are not perfectly correlated, it can be shown that $\text{stdev}(r_b) / \text{stdev}(r_m) > \beta = \text{cov}(r_b, r_m) / \text{var}(r_m)$. The squared coefficient of correlation, ρ^2 , measures the extent to which random variables move together. Thus, $\rho^2 = \text{cov}(r_b, r_m)^2 / \text{var}(r_m) \text{var}(r_b) \leq 1$ and $\text{cov}(r_b, r_m)^2 \leq \text{var}(r_m) \text{var}(r_b)$. Using $\beta = \text{cov}(r_b, r_m) / \text{var}(r_m)$, this inequality can be rewritten as $\beta \text{cov}(r_b, r_m) \leq \text{var}(r_b)$. Then, by dividing each side of the equation by $\text{var}(r_m)$, we obtain $\beta^2 \leq \text{var}(r_b) / \text{var}(r_m)$. Taking the square root of both sides of the equation produces the desired result, $\beta \leq \text{stdev}(r_b) / \text{stdev}(r_m)$. As a result, the discount rate (r) will be greater when the nature of the business does not allow for owner diversification.

For a given level of expected future cash flow (CF), the present value (PV) of a business can be expressed as $PV = CF / (r - g)$, where r is the discount rate, and g is the expected rate of growth in future cash flows. This model was developed in 1938 by J.B. Williams, but is often referred to as the Gordon Growth Model [15]. If the expected future cash flow of the business is known, the value of the business may be obtained by dividing future cash flow by $(r - g)$. The value of the business may also be expressed as a multiple of future cash flow, where the multiple is $1 / (r - g)$. Using the multiple approach, it is apparent that the valuation multiple will be lower when r is greater or when g is smaller. This concept will be useful when considering the market approach to valuation.

Market approach

The market approach can be considered a "shortcut" of the income approach. Under the market approach, rather than independently determining the appropriate discount rate for the business being valued, the appraiser relies upon the prices of companies that are deemed to be similar to the business being appraised to determine its value. Under this approach, the appraiser will consider the pricing "multiples" that are paid for the similar companies. For example, the appraiser might observe that the stock of publicly traded companies similar to the subject company sell for a multiple of fifteen times earnings. The market approach can also make use of pricing multiples obtained from acquisitions or purchases of entire companies, and apply those multiples to the company being valued. In this situation, the analyst might observe that similar closely held businesses have sold for a multiple of five times earnings. Valuation multiples are the mathematical equivalent of determining a discount rate and growth rate. Therefore, the theoretical basis for using the market approach rests on sound financial principles.

When applying the market approach, the appraiser must not only locate companies similar to the one they are valuing, but they may also have to adjust the pricing multiples to reflect attributes of the subject company that might make it more or less desirable than the companies from which they obtain the market pricing multiples. Factors that may require the appraiser to adjust the observed market multiples include all those that influence risk or expected cash flows. More specifically, this includes any factors that might influence the discount rate (r) or the expected growth of future cash flows (g) as defined under the income approach section of this paper.

In sum, the survival of a business is incumbent to the anticipated future cash flows, and is ultimately valued using these cash flows, the book value, or market comparisons as single considerations or in some combination. It is this likelihood of survival as signaled by the choice of business entity that generates a higher calculated value. The owner that has chosen the ideal form of business to mitigate the costs of agency while maximizing the benefits of separation of ownership of control will enjoy the best opportunity for calculated value when it's time to sell. It follows that rational owners will take into consideration the amount of value they can derive from their business ownership at divestiture when the organizational form is chosen.

Propositions

In developing our propositions, we necessarily assume that owners of a firm are rational and not influenced by factors other than those encompassed in profit maximization. Additionally, we assume that avoidance of income taxation is not the sole (or at least primary) determinant of organizational choice. While it is clear that taxes paid to the government will decrease the net cash flow to the owners of the firm, the calculated value of the firm is not achieved through tax minimization, but rather by net revenue maximization.

They key consideration in this analysis is that the perceived value calculation is the determinant of entity choice. In a pragmatic sense, business owners will eventually divest their ownership of the firm by sale, gift, or their death. Assuming they are rational, they will naturally want the actual dollar value of this interest to be maximized and will seek to structure their business organization to achieve this goal. In general, our propositions relate first to what influences the decision of owners to choose an organizational form for their business. Secondly, we propose that the calculated value of the firm will be directly influenced by the agency costs that appraisal practitioners will impute based on the chosen organizational form. Minimizing these agency costs perceived by practitioners by selecting the most appropriate entity choice will generate a higher calculated value.

Owners that perceive that levels of uncertainty in the continuation of cash flow and the risks of failure are high, then they are more likely to choose an S Corporation organizational form. The capability of oversight of managers and a greater likelihood of business continuity are incumbent to the corporate form. Accordingly,

Proposition 1a: An owner will select the S Corporation organizational form when the present value of short-term cash flow is greater than present book value.

Uncertainty is mitigated by higher levels of assets (i.e., book value). In addition, barring bankruptcy, there is a guaranteed continuation of the entity even if owners die or otherwise divested of ownership. Thus,

Proposition 1b: An owner will select the sole proprietorship or partnership organizational form when the firm's book value is greater than the present value of short-term cash flow.

Practitioners whose specialty encompasses the appraisal of firm valuation are well aware of the implicit agency theory influences on the selection of organizational form by owners. The value of a firm, net of agency costs, must be sufficiently large so that external investors will be induced to provide funding. Of course, rational investors will anticipate that the investment will not result in a net loss of value over time. Therefore, investors will expect that at the time of divestiture of the investment interest, the value of the portion of ownership will have increased. In order to make this determination of a future increase in

value, the investor will need to verify that the firm has: (1) a sound business plan, (2) adequate assets and/or cash flow to remain in operation, (3) competent management, and (4) sufficient processes to manage the costs of any separation of ownership and control of the business [10]. Liquidation of ownership requires a potential purchaser to be confident that the ownership interest will generate future positive cash flow. Otherwise, the investor's ownership stake will be illiquid and devoid of any value. If the liquidation is not voluntary, is the subject of disagreement between the transferring parties, or there are valuation disputes involving the calculation of taxes, forensic accountants can be called upon to determine value. Again, these practitioners take into consideration subjective factors associated with organizational form that will alter the ultimate valuation of the firm.

Holding all other factors constant, the organizational form should be irrelevant for appraisers to determine value. Discounted present value of future cash flows, book value, and/or market comparability can be calculated in a completely disinterested methodology. However, when the owners' choice of organizational form is contrary to what would be expected by the appraisers, the value of the transferred firm will be decreased. Accordingly,

Proposition 2a: When the discounted present value of future, cash flows are greater than book value, and the organizational form is not an S Corporation, then there will be a downward adjustment of calculated value made by the appraisers.

Failure to select an S Corporation organizational form when cash flow exceeds book value extends a signal that there are factors that induced the owner to choose a sub-optimal organizational form. This information is not intrinsically known to those seeking to acquire the firm, and it is appropriately assumed that the owner is seeking to extract additional value. This effect of agency decreases the firm value.

The risk protections that are encompassed with the S Corporation category represent a signal that the book value is not an accurate indicator of the likelihood of continuing favorable cash flow. Accordingly, the firm will be appraised at a lower value. Hence,

Proposition 2b: When the discounted present value of future cash flows are less than book value, and the organizational form is an S Corporation, then there will be a downward adjustment of calculated value made by the appraisers.

Agency costs and valuation

Appraisers and forensic accountant practitioners should recognize the signal that the chosen form of organization sends regarding the risk, growth prospects, and managerial talent of the business. The choice is relevant to the appraisal because the very same factors that influence the selection of organizational form also have significance for the valuation of the business. Under the income and market approaches, the appraiser has to consider the risk borne by investors in the business that they are appraising and the business' growth prospects. Under the income approach, risk and growth are incorporated into the appraiser's selection of a discount rate, expectation of future earnings, and assessment of future earnings growth. With the market approach, appraisers consider these same factors: risk, future earnings, and future earnings growth, for both the company being valued and for the companies from which they obtain their market data.

In the past, some appraisers considered the choice of company form to be irrelevant to the valuation process. The appraisal community has

generally recognized the difference in value that can be created by the choice of organizational form. However, most of this literature appears to focus on the income tax benefits of pass-through entities including sole proprietorships, partnerships, and S Corporations [4,5]. To understand the relationship between company form and company value, appraisers should also consider the forces that shape the choice of corporate form. The tax consequences of company form are widely recognized, as are the legal liability consequences. What is frequently overlooked is the influence of agency costs on the choice of company form, and how these agency problems affect the value of the company and signal other factors that will influence value.

Consider first the income approach to valuation. As described above, this approach requires a forecast of future cash flow and its growth, and the selection of a discount rate that reflects the risk of the cash flows. To the extent that growth in future cash flows can be generated with minimal capital investment, the value of a business would be independent of form. However, if growth in cash flows requires additional capital for fixed assets or working capital, the open C corporation will have an advantage over proprietorships, partnerships, and closely held corporations. The selection of an open C corporation as the organizational form allows the business to raise capital from diversified investors, who will be concerned only with non-diversifiable risk. The discount rate for a publicly traded C corporation, with diversified ownership, would be based on the covariance of its future returns with the market. The discount rate for future cash flows of proprietorships, partnerships, and closely held corporations will be based on the total risk to the non-diversified investor. This risk is measured by the standard deviation of returns. In any instance where the covariance of the businesses' financial returns are less than perfectly correlated with the market, the discount rate for publicly traded C corporations will be lower than for the other forms of business where owners are non-diversified.

If the business has chosen an organizational form such as a sole proprietorship, partnership, or closely held corporation, it is a signal that its operations are subject to significant agency costs that render the separation of ownership and control inefficient in economic terms. If ownership and control must be united, the opportunity to raise capital from financially diversified investors is reduced or eliminated. As indicated above, the required rate of return, or the discount rate, applied to future cash flows will be higher when investors cannot diversify. A higher discount rate will reduce the value of the business.

A second factor that will tend to generate lower values for businesses organized as sole proprietorships, partnerships, and closely held corporations is a lower expectation of growth in future cash flows. The effect of a reduced growth rate can be seen from the Gordon Growth Model. Based on a projection of next period's cash flow (CF), the value of a business with constant future growth is represented by the formula: $CF / (r - g)$, where r represents the chosen discount rate and g represents the expected future growth in cash flows. Since the growth rate is in the denominator of the equation, a reduced growth expectation translates into a reduced value of the business, even if current cash flows are comparable.

What factors would suggest that the sole proprietorships, partnerships, and closely held corporations would expect lower growth in future cash flows? First, growth in cash flows typically will require organizational growth. This is likely to require additional physical capital, or at least additional working capital. The anticipated need for future capital would favor the open C corporation as an organizational form. The choice of other organizational forms suggests lower

expected growth. Additionally, the talent of management is also a factor affecting future growth expectations. As mentioned earlier, because the closely held organizational forms tend to preclude separation of ownership and management and limit the pool of potential managers, managerial talent capable of generating higher growth is less likely in the closed organizational forms. The existence of these factors suggesting lower growth expectations will lower the value of the business.

Under a market approach, the factors listed above suggest that the appraiser must exercise caution when attempting to apply market pricing multiples obtained from publicly traded businesses to the other forms of business. The very fact that the publicly traded companies chose that organizational form is a signal that the anticipated need for additional capital was substantial enough to balance the increased agency costs. This need for additional capital may be a sign of higher expected future growth. The ability to separate ownership and control allows for financially diversified investors and a lower cost of capital. If valuation multiples are obtained from the publicly traded companies and applied to the closely held organizational forms, adjustments will have to be made to reflect the lower anticipated growth rates and lack of diversification in ownership.

Even in instances where market data are obtained from the sale of closely held businesses, if these businesses had chosen different business forms, then the appraiser should attempt to ascertain whether the choice of form signals some underlying difference in the fundamentals of the business. Is a professional practice organized as a sole proprietorship comparable to one organized as a partnership in terms of management? Would a restaurant organized as a partnership have the same growth expectations as one organized as a corporation? Rather than assuming that the organizational form has no bearing, the appraiser should consider whether there were, in fact, significant factors relevant to the valuation process that led to the chosen organizational form. The results of these considerations can be incorporated into the valuation process.

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 [10,11] ((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].

Conclusion

Business entities have a number of organizational forms that they may elect. When valuing businesses, the appraiser should not ignore the organizational form or acknowledge it only for its tax or legal consequences. The choice of organizational form is shaped by agency principles that signal the investment risk and growth prospects of the business. The information communicated by the choice of organizational form can be explicitly incorporated into the income and market valuation approaches that the appraiser will apply through the selection of discount rates and growth forecasts. While there is no generally accepted adjustment that can be applied based on the organizational form, agency theory suggests that the non-corporate forms are likely to have lower valuation multiples due to higher discount rates and lower growth expectations.

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