



## CONSIDERATIONS WHEN ESTABLISHING A MINORITY DISCOUNT



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**I** remember in college preferring accounting to economics because the answers were always “black and white” with no gray or theoretical issues. Then I started preparing business valuations!

One of the most difficult areas to justify in the valuation of a business is the discount for a minority interest in a business. A discount for a minority interest is defined as the decrease in the degree of control in the entity that the minority owner has as a result of the extent of his ownership.

This can manifest in a variety of limitations on the powers of that minority owner. Among the most common are a lack of ability to:

- Set compensation and benefits
- Appoint officers and management
- Set company policies
- Issue or buy back stock in the company
- Take on debt
- Merge or acquire
- Liquidate
- Declare dividends

Several factors must be considered when establishing the discount for minority interest.

### **Who owns the other shares?**

The valuation expert must not consider his or her block of minority shares in a vacuum. The minority shares may be owned by those whose block of shares can change a vote or stop a vote. A key person in the company may own a minority interest and this would impact the lack of control.

Possibly there are several minority owners and not one majority owner, so that having a minority interest is not as limiting. You must be certain to inquire as to the overall ownership of the company before proceeding with the valuation of your particular minority shares.

### **What do the corporate documents say?**

Power in a company can be vested through a shareholder agreement, articles of incorporation, corporate resolutions, employment agreements or other corporate documents.

These can all influence the shareholders’ abilities to effect changes in the company. An integral part of the valuation would be the review of these documents to determine if any powers exist beyond the minority percentage being valued.

### **Do state statutes control?**

Each state has laws that impact upon the rights of minority shareholders. These statutes vary from state to state. Being knowledgeable or obtaining proper legal counsel as to the protections provided by the governing state can have a bearing on the minority shareholders' rights.

State laws vary as to what percent vote is needed on specific issues. Many states have protections in the statutes for shareholders who dissent on specific acts of a company, such as a merger or acquisition. The statutes can alter the valuation.

### **What method are you using to value the company?**

Inherent in the different valuation methodologies is whether the shares being valued are on a minority basis or not. If you are using the guideline public company method to value shares, remember that the guideline companies will already be on a minority basis and further discounting for the minority interest would be incorrect.

On the other hand, if you are using capitalization of excess earnings method to first value the whole entity and then discount, the minority discount could be significant. Always be aware of the impact of the valuation methodology.

There are numerous other factors that influence the amount of the minority discount. These include the standard of value (e.g., fair market value, fair value), stock voting rights, regulatory agencies and the overall financial health of the company.

There are also various methods for determining the minority interest. These include discounting of the future income stream generated by the stock ownership; comparing to transactional data of other sales of minority interest; and taking a pro rata share of the total value of the company and subjecting it to a determined minority interest discount factor. These are beyond the scope of this article.

It is imperative that a prudent appraiser makes sure to understand the overall picture before concentrating on determining the minority interest being valued. For more information on the Business Valuation Services offered by Cowan, Guteski & Co., P.A contact Lynne Broza, CPA, ABV, CFF, Director at 732-676-4100.

### **About the Author**

Lynne Broza, CPA, ABV, CFF, Director is an expert in the financial aspects of matrimonial litigation and the valuation of closely-held businesses. With 30 years of experience in public accounting, Ms. Broza has been retained as an expert witness in litigation matters including divorce proceedings, personal injury claims, shareholder disputes and estate valuations. She has testified in cases in both New Jersey and New York.