

**Valuation in the Context of Divorce:
Goodwill and Professional Practices**

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VALUATION PRINCIPLES—START WITH THE BASICS

A. OVERVIEW

It has often been said that valuing a business can be both incredibly simple, and at the same time absurdly complex. On the surface, the analysis that is done to value a business is really nothing more than organized common sense—gathering a bunch of data, putting it through some calculations, and coming up with that magical number.

But obviously, valuing a business is not nearly as simple as that. One of the things that make it so complex is clearly the amount of details involved--and therein lies the devil--but the other reason they're so “absurdly complex” is the degree of subjectivity involved in the process.

Fortunately, there are more and more tools being made available that lend a degree of objectivity to this process, which is by its nature a very subjective exercise.

B. WHAT FACTORS ARE CONSIDERED?

Many of the issues that need to be addressed in a valuation for any purpose are spelled out in Internal Revenue Ruling 59-60. Although this ruling is meant to provide guidance for valuation for estate and gift taxes, it is relevant to this discussion because these same factors are equally relevant for valuations for almost any purpose, including divorce which has the same standard of value.

Revenue Ruling 59-60 enumerates eight factors to be taken into consideration in the valuation process, as follows:

- (1) Nature and history of the business: simply, tell the business's story. What does it do; what is its capital structure; form of entity; has it been growing; how diverse is its product base?
- (2) Economic condition generally and outlook for the industry specifically: this is an absolutely crucial step in the valuation, because it provides the key to predicting where a company will go in the future—and it is critical to understand that value is based on the anticipation of FUTURE results, as opposed to its past history.
- (3) Book value of the stock and financial condition of the company: The Ruling directs you to look at the past five years of financial history of the company. Part of the reason the financial history is important is to be able to compare the company to others in its industry. For example, if the company is more sound financially than its competitors, that would tend to indicate it is perhaps less risky than its competitors, and would therefore command a higher relative value. The other reason to consider the financial history of the company is as an indicator of the future. So, although the appraiser gathers a great deal of information about the financial history of the company, what they are really trying to do is predict the financial future of that company.
- (4) The earnings capacity of the company, for the reasons just described.
- (5) The dividend paying capacity of the company--and note it says capacity, not dividends actually paid.

- (6) It directs you to consider intangibles, and specifically goodwill. This portion is expanded on significantly in a separate revenue ruling, which lays out a way to calculate goodwill as a separate component of value.
- (7) Prior sales of stock of the company, as they likely have relevance to the value; and finally
- (8) Sales prices of stocks of comparable companies that are traded in the active market.

C. STANDARDS OF VALUE

Before one approaches a valuation, one also must consider the circumstances for which the valuation is being done. “Value” under one set of circumstances may not be the same as value under a different set of circumstances. When most people think of value, they typically think of “fair market value”, which is defined as follows:

Fair Market Value: “The price that a hypothetical willing buyer will pay a hypothetical willing seller, neither being under any compulsion to act and both being knowledgeable of all relevant facts.”

Some definitions add that the buyer not only be willing, but also able to consummate the transaction. A financial buyer will pay no more for a company than that which can be supported by the cash flow.

Some buyers are willing to pay a premium for a business, however. Those buyers are “strategic buyers.” Strategic value is defined as:

Strategic Value: The price that a specific willing buyer will pay a specific willing seller, based on an expectation of benefits that will inure to the buyer beyond that which an average hypothetical buyer would enjoy.

A strategic buyer will often pay more and sometimes far more, than that which a financial buyer would pay. Such a willingness to pay more than would otherwise be indicated is usually due to the buyer's perception (right or wrong) that the acquisition will result in some combination of:

- ∞ Financial synergies;
- ∞ Economies of scale;
- ∞ Increased market share;
- ∞ Vertical integration;
- ∞ Greater efficiency;

or any other reason that the combination will benefit the buyer.

D. VALUATION APPROACHES

There are three general approaches used to value a business, and each general approach has within it numerous "methods". These approaches include the Asset approach, the Market Data approach; and the Income approach.

E. ASSET APPROACH

This approach includes methods such as book value, adjusted book value, and liquidation value.

This approach is best suited for non-operating businesses, such as real estate operators and holding companies, and for asset-intensive businesses, such as manufacturing companies. It is also suitable for a company that is about to be liquidated or any company that generates losses.

Asset based methods rely on the fair market value of the individual assets of the company. There are many variations on this theme, for example, a going concern asset value as opposed to a liquidation value. Usually the circumstances of the valuation dictate which type of asset based method would be used.

F. INCOME APPROACH

Income based methods, sometimes referred to as capitalization methods, tend to be the methods that are most widely used and accepted for business appraisals, because they are the methods that make the most sense to an investor.

The basic premise of the income approach is that value of the business depends on its probably future earnings. This method is often used to value profitable companies of any type. Essentially, it answers the hypothetical question, “What rate of return would an investor require to invest in this particular business?”

Mechanically, value is determined by applying a capitalization rate to the earnings of the business. The values of all operating assets are excluded from separate consideration as they are deemed to be included in the value under this method. Non-operating assets, however, are added to the indicated value.

There are two primary factors to take into consideration when using this method:

- ☞ What level of income is to be capitalized; and
- ☞ What capitalization rate (rate of return) is to be used?

We will first address the level of income to be capitalized.

Income to be Capitalized: There are many different “levels” of income that could be determined appropriate for capitalization, including:

- ☞ Operating profit;
- ☞ Earnings before interest and taxes;
- ☞ Earnings before interest, taxes, and owners’ compensation;
- ☞ Net profit, which generally means after tax;
- ☞ Net free cash flow to owners;
- ☞ And others

There is no “right” or “wrong” level of income to capitalize. Rather, the important issue is to make sure that the capitalization rate correlates to whatever income level the appraiser has selected.

Normalized Income: We start by determining what is usually called either “normalized income”, or “economic income”. This income is that level of income that is most likely to be reflected in the annual operating results of the company for some period of time into the future. Certain items are adjusted out of (or into, as the case may be) the company’s actual financial results, to arrive at what would be a level of income that would be obtained if certain “non-arm’s-length” items, such as owner perquisites, were removed from the statements.

There are three basic types of adjustments that are made:

- ☞ Removal of one-time, extraordinary, or non-operating income or expenses;
- ☞ Accounting adjustments; and
- ☞ Removal of owner perquisites.

An example of a one-time expense might be the payment of a lump bonus to an employee.

An example of non-operating income might be a gain on the sale of some of the company's fixed assets.

Adjustments to owner perquisites generally involve removing excess compensation or other benefits that a non-owner doing the same job would not receive in an arms-length negotiated compensation package. It also includes related-party transactions, such as rent for a facility that is being paid to a related party at a rate other than fair market value.

Note for Use of Income Approach for Professional Service Firms:

With respect to the use of the Income Approach to value professional service firms, in considering the cash generated by the ongoing operations of the business, an investor would consider the amount and likelihood of cash flow available for a return on his investment *after* all reasonable and necessary expenses of running the business were paid. "Reasonable and necessary expenses" include such things as cost of goods sold, wages, and general and administrative expenses. In the case of professional service companies, very often there is little or nothing left over for a return to an investor in the business after all reasonable and necessary expenses of the business have been paid. This is because the professionals who run the business *are* the business, and much of what the business earns is paid to them as compensation that they have earned for their services rendered to the business. To the extent that there is excess cash flow available for distribution to the investor, the likelihood of such cash flow then being available for a return (i.e. dividend) after these business expenses are met involves an examination of the risk characteristics of the investment.

For a professional services firm, one of the most significant risks would be that the current owner would not compete, once he sold the business. Thus, it is likely a significant portion of any value would be attributed to a covenant not to compete with the professional, as opposed to the value of the business itself.

Selection of Appropriate Capitalization Rate: There are several different ways you can go about arriving at an appropriate capitalization rate. In effect, that is what is done in the market data analysis, by use of a multiplier (rate of return) obtained from comparable sales data.

The capitalization rate for a particular business needs to take into consideration the risks associated with the business and be based on facts relating to that business. A typical rate of return analysis begins with the minimum rate of return an investor would expect on an investment that is considered a “safe” investment, usually measured by the current market rate on long-term U.S. Government bonds.

To that safe rate, further points are added to compensate the investor for the added risk of investing in something other than a safe investment. Such additional risk factors include:

- ☞ The risk associated with investing in public markets;
- ☞ The risk associated with the size of the investment;
- ☞ Risk associated with the particular industry; and
- ☞ Risk associated with the particular business under examination, such as financial risk, business risk, and management risk.

There is a great body of empirical data available to assist in the rate of return analysis, but ultimately it is the subjective interpretation of that data, and of the company, that determines the appropriate rate of return.

Once the normalized earnings and the capitalization rate have both been determined, it is simply a matter of applying the capitalization rate to the income to come up with the value.

To illustrate how the level of income and the capitalization rate relate to value, let's assume that we've determined that the appropriate level of income is \$100,000, and the appropriate rate of return, based on our risk analysis, is 20%. The mechanics of getting from income to value is simply to divide the income by the rate of return, or to multiply the income by the earnings multiple:

Income	\$100,000	Same	\$100,000
Rate of return	<u>.1. 20%</u>	as	<u> x 5</u>
Value	<u>\$500,000</u>		<u>\$500,000</u>

So a 20% rate of return is the same as a multiple of 5 times earnings.

Again, there is no “right or wrong” level of income to use, and there is no hard and fast rule for determining the appropriate capitalization rate. It is, however, extremely important to make sure that the capitalization rate is applied to a corresponding level of income; for example, one of the most common errors in business appraisals is to apply a capitalization rate appropriate for post-tax earnings, to a level of income that is pre-tax.

G. MARKET DATA APPROACH

The concept behind this approach is that you can get a sense of what buyers might pay for your business, by looking at what buyers have paid for other similar businesses.

The market data approach can be suitable for any type of business, if you can find sufficient data. Some industries are characterized by lots of activity, and it's fairly easy to find good data. Other industries, however, may have very few or even no transactions.

To explain how this approach works, you are probably familiar to some extent with real estate valuations, where the valuation is usually based on sales of comparable property.

The market data approach is much the same for business appraisals. There is lots of data out there that can be used as “comparable business transactions” to compare your company to. This data essentially comes from two sources--publicly traded securities, and data on transactions of closely held businesses.

With regard to data on closely held companies, there are several major databases that provide information on closely held business transactions. These organizations gather data from business appraisers, bankers, and business brokers. Between them, they have data on thousands of actual transactions of closely held businesses.

The data is typically organized by industry code and includes, among other things, the date of the transaction, the location of the seller and buyer, the sales price, and the seller’s relevant financial information. You can use this data to create valuation multiples, that are then applied against your company’s data to arrive at an estimate of value.

It is important to have a complete understanding of exactly what assets were sold and what liabilities were assumed in the comparable transactions because such issues can obviously have a profound impact on value.

Some industries are characterized by lots of acquisition activity while others have little information available. Ideally, there should be at least several transactions that are reasonably comparable to the subject company in order to rely on this method in a valuation conclusion.

The other source of comparable sales data comes from the public markets. This data can be less relevant for sales of closely held businesses, UNLESS that business is the target of a public company, or a fairly large company itself. We also TEND to look more closely at public comparables when we’re doing a strategic buyer analysis, because it can be indicative of what a strategic buyer might pay.

Note for Market Data Approach for Professional Service Firms:

With respect to the use of the Market Data Approach to value professional service firms, one first must be able to find comparable sales with quality data, a task that is often nearly impossible in professional service businesses. In the case of such companies, the appraiser must consider the likelihood of cash flow continuing if the stock were to be sold, what a buyer would need to do to ensure the continuation of cash flow, and how the purchase price would likely be allocated. In a professional services firm, it would surely mean that a significant portion of any acquisition price would need to be allocated to either an employment contract for future services, or to a covenant not to compete with the former owner.

H. HOW DO YOU KNOW WHICH METHOD TO USE?

In the end, what determines which methodology to base the valuation conclusion on? It depends; for each valuation, there will typically be one method that makes the most sense for that particular company, and for the particular purpose of the valuation.

- Acquisitions of closely held companies by an individual who intends to own and operate the business tend to be based on an income method because an individual owner is looking to pay only that which the cash flow as a stand-alone entity can support.
- Acquisitions of closely held companies by a strategic (often synergistic) buyer tend to be based on a market data method.
- Acquisitions of capital intensive businesses or businesses with low or no profitability tend to be based upon an asset method.

However, these are far from hard and fast rules but rather mere guidelines. Again, the individual circumstances of the valuation at hand determine the methodology selected.

WHAT TO LOOK FOR WHEN REVIEWING A BUSINESS VALUATION

A. OVERVIEW

So, you or your client has hired an appraiser to value your client's business for their impending divorce. The appraiser provides his opinion, but unless you happen to be well versed in valuation yourself or you've worked extensively with the appraiser in the past and know their work, chances are you have no idea how the conclusion was arrived at or if it's even a reasonable conclusion. In this section, we will give you some quick tips for doing an initial review of a business valuation in order to help you identify some key areas of discussion with the appraiser.

B. STANDARD OF VALUE; PURPOSE OF THE VALUATION; VALUATION DATE

Probably the very first thing to look at is the first paragraph of the report, which will usually give the date of the valuation, the purpose for the valuation, and the standard of value. Make sure that each item is appropriate for the particular circumstances. (More importantly, better to have made sure you had these understandings with the appraiser *before* they undertook the engagement!)

Fair market value, fair value, strategic value, and intrinsic value will all result in different value conclusions.

The standard of value will also help determine whether it is appropriate to take discounts. If the standard is *fair market value* and the valuation is of a minority interest, the report should include discounts for lack of control and lack of marketability. However, if the standard of value is *fair value*, the value of a minority interest will likely be a pro-rata portion of the whole, without regard to discounts.

With regard to purpose, note that valuations prepared for different purposes can result in different value conclusions. For example, a valuation prepared for divorce purposes may result in a different conclusion than one prepared for a potential sale. This is why you should not necessarily use an appraisal that was done for a different purpose for the divorce valuation.

We often run into the situation where a company was valued one or more years ago for purposes of obtaining bank financing, for example, and the owner would like to use that appraisal for purposes of a divorce. It is generally best in that situation to obtain a new appraisal as of the appropriate date and for the specific intended use.

C. IS THE FORECASTED CASH FLOW REASONABLE?

When reviewing a business valuation that has relied on an income approach, the fastest check for reasonableness is usually a look at the forecasted cash flow.

While financial statements are historical and represent the company's past performance, business valuations are forward looking and attempt to predict the company's future performance (because the value of an investment is a function of what it will do for an owner in the future, not what it has done for an owner in the past). Future performance is typically based only in part on the company's historical performance; the appraisal should demonstrate an understanding of the qualitative factors that will impact its future performance, such as the outlook for the industry, the competitive environment, and forecasted economic conditions. The company may have also undergone internal changes that will impact its future performance, such as the acquisition of new, state-of-the-art machinery, or new leadership. Given all of these factors, does the forecasted cash flow appear reasonable? Things to look for include:

Use of historical averages- when the company's financial outlook is expected to be different from its historical performance, using historical averages is unlikely to result in accurate cash

flow projections. Also, the use of a formulaic weighting of the last five years results almost never results in a reasonable proxy for forecasted profitability—yet you will see it all the time. Check the results of such a formula, as ask if it makes sense, given the trends of the company’s results, the outlook for the company and the industry, and any changes that have taken place at the Company.

Projections that look like a hockey stick – when a company has had relatively stable historical results that resemble the flat part of a hockey stick, and then the projections shoot up like the handle of a hockey stick, we call these “hockey stick” projections. It is generally unreasonable, except perhaps in the situation of a start-up company, and then only one with strong backing market plan. Usually, it is highly unlikely that a company’s performance would change so drastically in such a short period of time. If a company is expecting such drastic improvement, this should be supported by explanation in the valuation report. Note also that if there is a forecasted dramatic improvement in sales, it should be accompanied by appropriate working capital needs and capital expenditures needed to accomplish the forecasted sales.

Reverse hockey stick – Likewise, the valuation may project that the company’s earnings are going to decline drastically. This may make sense if there is some significant change in the industry or because of the impact of new competition into the market. It is important to try to predict whether the forces that are driving the downturn are completely out of the control of the company, or whether they might seek to develop new products or sell in new markets, in order to prevent such a downturn.

As you can well imagine, the typical scenario is that the non-owner spouse presents the “hockey stick” projection, and the owner spouse presents the “reverse hockey stick” projection; this is a pattern that we have seen repeated over and over.

The appraiser's job is not to simply accept the forecasts, but rather, to attempt to ground them in economic reality and independent industry research. Too often, this critical component is left undone by the expert. The forecasted cash flow is a critical component of a valuation that relies on the income approach. Double check it for reasonableness and look for supporting explanations within the valuation report itself.

D. DOES THE DISCOUNT/CAPITALIZATION RATE MATCH THE FORECASTED CASH FLOW?

It is essential that the economic income stream that is projected be clearly defined and that the discount or capitalization rate used is appropriate for that definition of economic income being used in the analysis.

The capitalization rate (for capitalized cash flow method) and the discount rate (for discounted cash flow method) should also reflect the riskiness of achieving the projected cash flow. For example, if there is a great degree of risk of achieving the projected cash flow, one would expect the rate of return to be relatively high. Likewise, if there is more certainty of achieving the projected cash flow, you might expect a relatively low rate of return.

E. ARE THE COMPANIES CHOSEN FOR THE MARKET DATA APPROACH COMPARABLE TO THE SUBJECT COMPANY?

If the market approach was used in the valuation, take a look at the companies selected to see whether they are in fact, reasonably comparable to your client.

A good place to start is to see whether the business descriptions of the selected companies match your client's business description. The wording of the business descriptions may not be an exact match, but the industry, economic, and competitive forces that impact your client should be the same forces that impact the comparable companies.

We once reviewed an opposing appraisers' valuation report in which he had used transactions of regular grocery stores as comparable to the subject company, which was a whole foods/natural foods store. In fact, these two types of business are extremely different in terms of profit margins, customer demographics, sensitivity to shifts in the economy, etc. As would be expected, the pricing multiples for these two distinct types of business were vastly different, and as such, application of market pricing multiples of grocery stores to the financial results of a whole foods store results in an inaccurate value.

Another check is to see whether the companies selected are comparable to your client in terms of sales size, profit margins, and asset base. A company generating \$100 million of revenue with ten locations across the United States is probably going to command different pricing multiples than your \$3 million client in Sanford, Maine, or vice versa. There are many transactions of very small companies out there, which will also not be comparable to your \$3 million client. A range of sizes of companies is fine, but the range should not be too extreme in either direction.

We refer you to the attached article from CCH BV-Alert for more information on the appropriate use of the market databases. We note that extreme caution should be used when using this data—but unfortunately, it rarely is.

WHAT ADJUSTMENTS HAVE BEEN MADE TO THE CASH FLOW AND ARE THEY REASONABLE?

During the valuation process, there are several adjustments that may be made to a company's financial statements in order to present the financial results in terms of current economic reality. In this section we will review items that may require adjustment and how to spot them.

Owner compensation: As noted above, owner compensation may not be at market levels. This adjustment can sometimes have a significant impact on value and should be checked for reasonableness.

Working Capital: If the company is being valued using the income approach, and the measure of economic income is cash flow, the appraiser should give consideration to additional working capital needs if growth is forecasted. Likewise, a reduction in working capital needs may result if a downturn is forecasted for the company.

Other: Double check other adjustments to cash flow, such as adjusting related party transactions to fair market value, adjustments to owner perquisites, and others, to see that they appear reasonable.

F. NON-OPERATING ITEMS

If the company has non-operating assets or liabilities, such as excess cash or marketable securities, non-operating real estate, or equipment not necessary to operate the business, these items must be added back to the value of the business as determined under all three valuation approaches. Double check to see that these add-backs have not been overlooked.

H. UNREPORTED INCOME

Another common, and difficult, adjustment to financial statements is the case where the non-participating spouse tells you that the family business really produced more money than that which was reported on the company tax returns. Here, a difficult conundrum is raised: if you don't include the under-reported income, you undervalue the company; if you do include it, the spouse (who no doubt signed the tax return) risks retribution from the IRS. This is obviously an issue you should discuss with your client and carefully consider whether and how to pursue this in the value determination.

I. TREATMENT OF “PRACTICE” AND “PERSONAL” GOODWILL

States vary widely on their treatment of goodwill. Some states include it only if it would be “saleable” in an actual transaction; some courts look for the existence of “practice” goodwill, separate and distinct from the goodwill associated with a particular owner; and still other states include all goodwill. The predominance of states include practice goodwill, but are split on the inclusion of personal goodwill. Because Maine is a classic “fair market value” state, only saleable goodwill—that is, practice goodwill, is included in the value of the business.

The factors that influence the existence of each of these types of goodwill are as follows:

- Practice goodwill is that which is associated with the entity itself. It takes into consideration issues such as location, qualified workforce, required licenses (separate from the individual owner);
- Personal goodwill is that which is associated with the individual. It takes into consideration the practitioner’s age, health, personal reputation, and effort.

Generally, practice goodwill is considered to be “saleable”, but personal goodwill is not unless there is also the existence of an enforceable agreement that either requires the owner to continue working for the practice and/or prevents him from competing with the practice; very often, these agreements are combined.

Covenants Not To Compete

It is very important to consider the issue of covenants not to compete in arriving at value. Covenants not to compete are generally not marital property. If a considerable part of the value is predicated or would be allocated to a covenant not to compete with the spouse retaining the business, you need to be aware that part of the value may not be part of the marital estate.