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2014 Advanced Family law: Issues in Equitable Distribution

Valuation Basics and Methodologies

July 24, 2014

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Introduction

In many family law matters, determining the value of a business or professional practice is one of the most contentious issues to resolve. The value determination for the business creates significant tension and the parties are rarely willing to compromise on their respective position without thoughtful and careful analysis.

From the outset, it is important to understand that valuation, by definition, is a prophecy to the future; based on consideration of the potential future performance of a business. In order to properly develop an opinion of value, an analyst must develop a detailed understanding of the business, its history, the quality of management, its financial reporting and prospects for the future. The valuation analysis is both a quantitative and a qualitative effort that is guided by independent thought and experience, which requires significant time and attention to detail by the analyst. Each valuation assignment involves unique facts and circumstances that require different types of analysis. Additionally, the availability of information and willingness of management to participate in the process directly impacts the expert's ability to reach a determination of value. The basics of business valuation are founded on two primary elements:

1. The ability of a business to generate ongoing economic benefits (cash flow) in the future; more specifically, the value of those future cash flows in present value terms.
2. The risks associated with generating the aforementioned economic benefits (cash flows) both systematic and company specific.

Shannon Pratt thoughtfully summarized valuation in noting that "In the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner."[1] Valuations conducted for family law matters in North Carolina are prepared using the Fair Market Value standard of value. Fair market value is defined in the *International Glossary of Business Valuation Terms* as:[2]

> "… the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

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[1] Pratt, Shannon, P., Reilly, Robert, P., Schweihs, Robert, P., *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* (McGraw Hill, 2000).

[2] Internal Revenue Service, Revenue Ruling 59-60; The International Glossary was developed jointly by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and The Institute of Business Appraisers.

There are additional elements generally considered implicit in the Fair Market Value Standard of Value:

- The prospective purchaser is motivated by the profit opportunity implicit in the subject on a stand-alone basis, without considering possible synergistic benefits arising from the combination of the subject's operations or assets with existing or future holdings.

- The subject is evaluated on the basis that it will remain a going concern unless it is determined that the value in orderly liquidation exceeds the returns available as a going concern.

- The subject would be exposed to the market for a reasonable length of time to fairly expose it to a practical number of prospective purchasers.

Gary Trugman notes that the distinction between price and value is critical. Businesses are bought and sold for a price; however, the analysis involved in a business valuation is focused on determining value.[3] Trugman also makes note of the fact that there are often forces or conditions in the real word that impact a transaction price, but do not affect value.[4] Three key elements of the definition of fair market value include the following:[5]

1. The consideration is paid in cash or cash equivalents and is equitable to both parties
2. There is exposure for sale on the open market for a reasonable period of time
3. The parties are under no compulsion to act and are exchanging in an arm's length transaction.

These elements distinguish fair market value from the investment value of a business. This is an important distinction as the investment value of a business is the value of the business to a single or specific buyer based on their investment requirements and expectations.

Although simple concepts, the definition of value serves as the foundation upon which valuation analysis is performed. Without careful attention, it is possible to develop a value determination that is not fair market value because the fundamental principals were lost along the way.

Valuation Methodologies

There are three generally accepted business valuation approaches: the market approach, the income approach and the asset approach. Within each approach, there are various methods used to determine the value of a business. The following paragraphs contain a brief description of each approach, as well as a discussion of the various methods that may be used under each approach.

[3] Trugman, Gary R., *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium Sized Businesses,* Third Edition, American Institute of Certified Public Accountants, 2008.
[4] Ibid.
[5] Ibid.

Market Approach: The market approach determines the value of a business based upon what investors are paying for similar interests in comparable businesses. There are two methods generally considered when applying the market approach, the Comparable Transaction Method and the Guideline Public Company Method.

The Comparable Transaction Method determines the value of a business from the price at which entire companies in the same or similar lines of business were previously sold. Comparable transactions are generally selected by identifying transactions involving companies that share similarities with the subject business. This may include companies with similar lines of business, similar revenue levels, or common economic drivers. The method relates the price at which a transaction took place to certain financial variables that affect value (Such as price to revenue or price to earnings). Typically, the initial value determined from application of this method, prior to giving consideration to adjustment for factors such as the marketability of the ownership interest, represents a controlling interest value.

The Guideline Public Company Method is used to calculate value based on prices at which stocks of similar companies are trading on an organized public exchange. The methodology relates the stock price to certain financial variables that affect value (Such as price to revenue or price to earnings). Generally, the initial value determined from application of this method, prior to giving consideration to adjustment for factors such as marketability of the ownership interest, represents a minority interest value.

It is important to analyze the underlying details of selected transactions and guideline public companies. In some industries there are significant transactions and it is much simpler to use comparable transactions. Alternatively, there are many cases where it is difficult to identify a set of comparable transactions. Additionally, it is often difficult to separate any synergistic premium or distressed sales associated with the transactions due to the limited information provided in the various transaction databases. It is also necessary to take care when using the guideline public company method. The information related to guideline public companies is much easier to obtain; however, it is generally not advisable to compare a small software engineering practice to a publicly traded company.

Income Approach: The income approach is based upon the premise that the value of a business is the present value of the future earning capacity that is available for distribution to investors in the business. Although the market approach is widely used and familiar to most people because of their experience with the stock market or real estate appraisals, the income approach is a direct way of indicating the connection between the anticipated performance of a business and the resulting value.

Two methods are frequently considered under the income approach. These methods are the Capitalization of Future Economic Income Method and the Discounted Future Economic Income Method. Economic income is defined by Shannon P. Pratt as "any inflow into an economic unit in exchange for goods, services, or capital."[6] Pratt goes on to list various measures of economic income:

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[6] Pratt, Shannon, P., Reilly, Robert, P., Schweihs, Robert, P., *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* (McGraw Hill, 2000).

"..economic income could mean, among other things, gross revenues, gross profits, net operating profits, net income before tax, net income after tax, operating cash flow, net cash flow before taxes, net cash flow after taxes or net cash flow available for distribution to owners (e.g., dividends)."[7]

A key aspect of understanding the income approach is the ability to differentiate net income and cash flow. Net cash flow is the cash available for distribution to an owner after considering the cash needs to keep the business functioning. Pre-tax net income is converted to net cash flow available to the owner based on the following formula:

	Pre-tax net income
-	State income taxes
-	Federal income taxes
+	Noncash charges (e.g., depreciation, amortization, etc.)
-	Capital expenditures
+/-	Changes in working capital
+/-	Changes in long-term debt (add cash from borrowing, subtract payments)
	Net cash flow to owner

The capital expenditures and working capital noted above represent the amounts necessary to support projected operations. This would be the stabilized level of capital expenditures and working capital necessary for the expected level of growth.

The Capitalization of Future Economic Income Method is applied by determining the current earning capacity of the business by some chosen measure of economic income. The income stream chosen is then divided by a capitalization rate to estimate value. The capitalization rate is a market-based rate of return that should reflect the expected rate of return on an investment with a comparable level of risk, adjusted for long term growth expectations. The capitalization rate includes a company-specific risk component that reflects risks specific to the subject company (Such as customer concentration, geographic concentration, management depth, etc.). This method is appropriate when the operations of the Company are not expected to change significantly or where future earnings are expected to grow at a reasonably predictable and consistent rate.

The Discounted Future Economic Income method values a business based on its future economic income discounted back to present value using an appropriate discount rate. It requires forecasting the business's future revenues, operating expenses, taxes, working capital requirements and capital expenditures for a number of periods until the business reaches a stabilized level of operations. In order to account for the company operating into perpetuity, a terminal period is used to determine a terminal value once the business has reached a stabilized level of operations. The final step in the method is to discount the business's future earnings, including the terminal period, to a present value using an appropriate discount rate. This method is used often for early stage companies which do not have an operating history or when the future operations are expected to differ significantly or grow at different rates in the future. Given the requirement to project future operations until a level of stabilized operations is

[7] Ibid.

reached, the Discounted Future Economic Income method is used less frequently than the Capitalized Earnings approach in family law matters.

Asset Based Approach: This approach determines the value of a business's assets and/or equity using one or more methods based directly on the market value of the business assets less its liabilities. The asset-based approach is generally utilized in the valuation of companies that have significant tangible assets in relation to the intangible assets or in situations where liquidation is a consideration. There are three methods generally considered under the asset-based approach. The first two methods are the Adjusted Net Asset Value Method and the Liquidation Value Method. The third method is the Capitalized Excess Earnings Method. The Capitalized Excess Earnings Method is generally considered a hybrid of the asset based approach and the income approach.

The Net Asset Value Method requires an appraisal of each individual asset of a business on a going concern basis. The Liquidation Value method estimates the net proceeds from a hypothetical liquidation of the business's assets.

The Capitalized Excess Earnings Method determines the value of the business based on the appraised value of the tangible assets and an additional amount for the intangible assets. The normalized or adjusted earnings of the business are determined, and from these earnings a fair return on the tangible assets is subtracted. The residual is referred to as the excess earnings. These earnings are capitalized at an appropriate capitalization rate to estimate the value of the intangible assets. This value is added to the tangible asset value to estimate the value of the business as a whole. This method requires the use of subjective rates to determine both the rate of return on tangible assets and intangible assets. There are substantial criticisms of the use of this method to determine the value of a business. These criticisms have come from well-respected business valuation professionals and from the IRS. In the 1978 edition of the IRS Valuation Training for Appeals Officers Course book, the IRS made the following statement regarding the arbitrary rates of return used in the method:

> "To attempt to segregate value based on earnings as between normal income and that induced by whatever goodwill or other intangible assets the business may possess, is to aspire to a higher degree of clairvoyance than has yet been demonstrated as obtainable by mere man."

Selection of Methods

Valuation analysts should consider each of the approaches and present those approaches and methodologies that are most relevant for valuing the subject interest based on the specific facts and circumstances related to the case.

Performing a Business Valuation

The summary below and the associated presentation is intended to be a very high level overview of the primary steps in performing a valuation analysis. This is certainly not intended to be a full discussion of the efforts involved in conducting a valuation analysis but is intended to provide some insights that may be useful in working alongside a valuation expert and understanding the work necessary for a valuation assignment.

1) Identification of the North Star

The first step in performing a valuation analysis involves confirming the subject of the analysis, the interest being valued and the relevant valuation date(s) with the Attorney. This will impact the initial data request and the analysis performed. An important item to discern is whether the level of the interest being valued is a minority interest or a controlling interest. An engagement letter documents this information and it should be carefully reviewed by the attorney as it will serve as the foundational element of the valuation analysis. A sample of language in the engagement letter for a business valuation is included below:

> This letter outlines our understanding of the terms and objectives of the valuation engagement.
>
> The objective of our valuation will be to estimate the fair market value of a 100% controlling, non-marketable interest in Single, Inc. as of April 1, 2013. The term *fair market value* is defined by Revenue Ruling 59-60 as follows:
>
> "The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Generally, this is the initial paragraph of our engagement letter which is indicative of the importance of this information. The paragraph clearly identifies that this is a valuation engagement. Further, we are valuing a controlling interest under the fair market value standard of value. As soon as you receive an engagement letter, you should carefully review it to make sure that the expert properly understands the interest to be valued.

2) Gathering the necessary Data

The necessary documents and data requested for a valuation analysis is largely dependent on two variables:[8]

(a) The nature of the business and its business cycle; and
(b) Whether the resulting report will be a valuation report or a calculation report.

Valuation professionals customize the data requested for each engagement but there is certain financial information that is generally requested regardless of the nature of the business or the report type issued. Certain critical items are listed below:

[8] Trugman, Gary R., *Understanding Business Valuation, A Practical Guide to Valuing Small to Medium Sized Businesses,* Third Edition, American Institute of Certified Public Accountants, 2008.

Financial Information

1. Annual financial statements for 4-7 years prior to the date of valuation.

2. An Income statement for the trailing 12 month period immediately preceding the valuation date(s).

3. Federal income tax returns (and state returns) for 4-7 years prior to the date of valuation, including all supporting statements.

4. Copies of any forecasts or projections prepared by the Company for the most recent three years and for any future periods beyond the date of valuation.

5. Details of accounts receivable for the 4-7 years prior to the date of valuation, including an aged receivables listing at each date.

6. Fixed asset register and/or depreciation schedules for 4-7 years prior to the date of valuation and a listing as of the date of valuation.

7. List of notes payable and other interest-bearing debt along with dates of origination, term and interest rates as of the date of valuation.

8. Information related to the company rent expense for each annual period including information related to the lessor and whether or not there is any common ownership among the lessor and the subject company

9. Copies of sales, capital, or operating budgets.

10. Schedule of officers' and directors' compensation for 4-7 years prior to the date of valuation and a listing as of the date of valuation. If the compensation is not equally earned throughout the year, then provide the monthly compensation for each annual period

The above items are fundamental requirements to get started in most valuation engagements. Sometimes your client may become frustrated by the amount of financial data requested. However, it is important in performing the valuation analysis to develop a strong understanding of the history of the business and the changes in financial performance and operations over a complete business cycle. Business cycles vary from industry to industry, but analysts look at an extended period of financial performance that allows them to better understand the financial issues affecting the business. Occasionally, analysts are asked to look at a few years of tax returns and provide some indication of value regarding a business. Unfortunately, it is difficult if not impossible to perform the necessary analysis and develop a thorough understanding of the business without significant financial statement information. Beyond the obvious financial information, there is significant non-financial information necessary to properly develop an opinion of value.

The documentation request for a business valuation is a dynamic process. Once the valuation analyst has had the opportunity to review tax returns for a period of years, it may be necessary to request detailed information related to one or more specific expense accounts. Please also remember that a business valuation is not designed to ascertain fraudulent or other unscrupulous activity. In the general course of a typical business valuation, the valuation expert does not perform forensic analysis designed to identify fraudulent activities. In the event that you feel the financial reporting is fictitious or completely inaccurate, it may be necessary to engage a forensic expert prior to having a valuation performed.

As noted earlier, there is additional operational data, legal documents and other company data necessary to perform the valuation analysis. Some of the items requested may include the following:

1. Copies of any business plans
2. A written explanation of how compensation is determined for each owner
3. Schedule of key person life insurance
4. Details of transactions in the company's stock during the last 5 years
5. Copies of stockholder agreements
6. Minutes of board of directors meetings for the most recent year
7. Copies of key managers' employment contracts or ex-key employee termination
8. Resumes or a summary of the background and experience of all key personnel
9. Copies of any other value indicators, such as property tax appraisals
10. Reports of other professionals including appraisal of buildings and/or equipment and any reports completed by other consultants

In reality, the documents request for a valuation engagement is several pages long. Most analysts make every effort in the initial request to ask for all of the information that will be useful in completing the valuation. Inevitably, there is additional information requested as we develop our analysis of the subject company and compare it to the industry. In many cases, the non-financial or qualitative data request is just as important as the financial information. The qualitative data often points to what led to the reported financial results. In some cases you may receive a request for information that is not relevant for your client's business. There are some experts that have a standard list of items they request in every valuation and do not change them for the subject business. We recommend indicating on the document request that the requested data is not relevant for the given business.

The attorney plays a crucial role in helping the expert obtain the subject Company information in order to complete the report. It many cases properly identifying and acquiring the necessary information is based as much on effective communication as financial knowledge or expertise. One key source of financial information related to any business is that company's CPA.[9] To the extent possible, involving the CPA in putting together the requested documents will make the data collection process much smoother. In some cases, your client will be heavily involved in the financial aspects and management of the business. In this circumstance, the client can be valuable in providing the necessary information to complete the valuation. When the subject business is large, it is important to establish a good rapport with the CFO and/or Controller of the business. It is not uncommon for the attorney to authorize the CFO or Controller to communicate directly with the valuation expert. There are certainly circumstances in which the opposing party makes the information gathering process difficult or provides significant data that has no relevance to the documents requested. Fortunately, valuation analysts are skilled at combing through the information to identify those documents that are relevant. Many analysts are also helpful in providing the attorney with a document request that can be incorporated by the attorney in a request for production. Again, communication is the most important element in properly locating and identifying the necessary information for a valuation. Do not hesitate to pick up the phone and contact your valuation expert when you need to clarify a document request or you are unsure of the additional information that is needed to complete the valuation.

3) Analyzing the Business

After the analyst has gathered enough data to start work, the analysis of the subject business begins. Often, the expert will receive information or data from the attorney in waves. Generally, the expert will start work as quickly as possible to avoid delays in report issuance.

We previously discussed the common information necessary to value a business, and while important, it is only one part of the required data to perform the valuation engagement. It is also necessary to have a basis to compare the business, understand the impact of the local and national economies on the business and conduct a detailed management interview(s). The management interview assists the expert in better understanding and assessing the role of management in the business and their outlook compared with overall industry insights.[10] Typically valuation analysts subscribe to industry benchmark data services and subscription services that provide national economic analysis. In many cases, the analyst is required to perform some research related to the local economy as well as local factors that may have a direct impact on the subject business. Once an analyst has good industry and economic information for the period under analysis, it is useful in recognizing issues that are specific to the subject business as well as industry or macro-economic events.

Properly analyzing the subject business involves normalizing the financial statements by adjusting certain elements. The adjustments are designed to restate the financial statements for elements of owner control, nonrecurring income or expenses, or fix improper accounting. Owner control items include transactions entered to avoid or reduce income taxes or to hold assets within a business that are not actually part of the operations.

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[9] Ibid.
[10] Ibid.

Transactions or practices which are tax-motivated, or simply decisions of management, are not normally adjusted in the valuation of a minority interest, because the holder of a minority interest would have no power to effect a change in these policies. The purchaser of a controlling interest could, in theory, change these practices at will. The following are commonly considered for normalization.

- Contributions or donations
- Depreciation and amortization as determined on the income tax return
- The officers' salary expense
- The reported rent expense
- Inventory and cost of sales
- Non-operating assets or liabilities

The normalization of financial statements is critical and time consuming. In many cases it requires detailed financial information and in some cases discussions with third parties including vendors or professional service providers of the company being valued.

Business analysis is best described as a multi-step process used in of developing a conclusion of value based on company-specific consideration and industry and economic factors. With several years of financial and other operating data it, is possible to analyze financial trends and ratios and evaluate a company's financial performance.[11] In many cases it is possible to compare common size company financials to industry data and evaluate performance relative to industry norms.

Many in the valuation field refer to Revenue Ruling 59-60 as the authority on those items that should be considered in determining the fair market value of a business interest. The eight factors included in Revenue Ruling 59-60 are listed below and are included in most business valuation reports:

REVENUE RULING 59-60 Factors[12]

i) The nature of the business and history of the enterprise since its inception
ii) The economic outlook in general and the condition and outlook of the specific industry in particular
iii) The book value of the stock and the financial condition of the business
iv) The earning capacity of the future
v) The dividend paying capacity of the company
vi) Whether the enterprise has goodwill or other intangible value

[11] Ibid.
[12] Internal Revenue Service, Revenue Ruling 59-60.

vii) Sales of the stock and the size of the block of stock to be valued
viii) The market price of stocks of corporations in a similar business

Although it was issued over fifty years ago, Revenue Ruling 59-60 still serves as a guidepost for the analysis required in completing a valuation. These factors highlight the importance of understanding the risk and performance of the subject company in the context of its industry as well as the general economy.

Shannon Pratt provided one of the most succinct and useful summaries of valuation principles at the conclusion of Chapter 3 of his book Valuing a Business. [13] We have summarized Pratt's nine key principles below as they are a timeless reference for both valuation novices as well as experienced professionals.

1. The value of a business or an interest in a business is the sum of the anticipated future benefits to the owner, discounted back to the present value at a relevant interest rate.

2. The capital markets drive the relevant interest rate. The discount rate is the rate of return necessary to draw capital to a particular investment. The discount rate includes the required rates of return on investments with similar risk characteristics.

3. Projecting future income streams and estimating the relevant discount rate is challenging. There are recognized methods for determining value using the past financial data or current information. In this case, the historical or current financial date will require adjustments to reflect anticipated changes in the future including industry conditions, the macroeconomic environment and anticipated future growth. The analyst should be able to reconcile this estimate of value with an appraisal of value determined under the discounted future economic income method.

4. If an analyst uses specific transactions under the market approach, the associated investor's detailed expectations related to underlying risk, anticipated returns, capitalization rates or other valuation metrics are unknown to the analyst. Care must be taken to define financial variables similarly among the chosen guideline transactions and the subject company. It is also necessary to compare these measurements of value as of the same point in time.

5. Stockholders or members do not have a direct claim on the assets of a company given that the legal corporate (or partnership) entity separates the entity and its respective shareholders. As a result, the value of an interest in a corporation or a partnership can be more than or less than that stockholder's proportional interest of the underlying net assets of the business.

6. Although related, lack of control and lack of marketability are distinct concepts. Minority and controlling interests can be subject to a discount for lack of marketability.

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[13] Pratt, Shannon, P., Reilly, Robert, P., Schweihs, Robert, P., *Valuing a Business, The Analysis and Appraisal of Closely Held Companies* (McGraw Hill, 2000).

Marketability is the ability to convert an interest to cash quickly with a high degree of certainty in realizing the anticipated proceeds. Internal and external factors at the date of valuation impact both the discount for lack of marketability and the discount for lack of control.

7. There are numerous decisions which impact the business that non-controlling shareholders have no control over. As a result, a minority interest in a business may be worth significantly less than a pro-rata portion of the appraised value of a 100% interest in the subject business.

8. The market provides a premium for liquid assets as compared to those assets or interests that lack liquidity. Likewise, if a business interest lacks liquidity market participants seek an illiquidity discount. Consequently, if two businesses are similar in operational respects but one is not readily marketable, that illiquid business generally will be worth less.

9. The total appraised value of all individual minority interests in a business is not usually the equal to the value of a 100% controlling interest in the business.

4) Completing the Valuation Report or Calculation Report

The valuation report is a culmination of the analysis performed related to the subject business. Analysts carefully develop reports to communicate the research and analysis performed for the subject business, including the related industry and economic outlook. The report stands alone in defense of the analyst's opinion of value.