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Cracking the C-O-D-E

Understanding the Report

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Whether the business valuation report is your first or your fiftieth, two very important factors must be considered before starting your review. The expert who submits it must be sufficiently qualified to value the subject company, and the expert's procedures and report must be in compliance with appropriate business valuation standards. The absence of either could disqualify the expert from testifying and keep the report from being admitted, which could help your case tremendously if the opposing expert has failed to meet the requirements or be devastating if the expert in question is your own.

To qualify as an expert, a business valuator must have specialized training, expertise, knowledge, and experience. Various credentials differentiate experts in this field, and each has different requirements to achieve and maintain it. Following are the most common credentials with web addresses, which list underlying requirements:

Certified Public Accountant Accredited in Business Valuation (CPA/ABV)—American Institute of Certified Public Accountants (www.aicpa.org)

Accredited Senior Appraiser (ASA)—American Society of Appraisers (www.appraisers.org)

Certified Valuation Analyst (CVA)—National Association of Certified Valuation Analysts (www.nacva.com)

Certified Business Appraiser (CBA)—Institute of Business Appraisers (www.go-iba.org)

Business Valuator Accredited for Litigation (BVAL)—Institute of Business Appraisers (www.go-iba.org)

Review your expert's curriculum vitae to determine his or her credentials, specialized training, experience, and knowledge. Each credentialing organization sets the professional standards of their members. Standards are the guiding principles to ensure that valuation procedures are proper and the report is sufficient. Once you have reviewed the expert's credentials and professional standards, thoroughly review the valuation report.

Common sections & terms

The valuation report often is the only tangible product of the expert's work and conclusions. In some cases, the expert may provide a detailed written report, and in

others a summary or letter. Other acceptable forms include calculation reports, oral reports, and internal reports. Regardless of type, valuation reports should include:

A definition of the valuation assignment. The business valuation report should begin with the name of the company, the number of shares or percentage being valued, the valuation date, and the purpose of the valuation. This basic data may seem unimportant, but provides the foundation for the valuation methods and standards of value, which may differ depending on the purpose of the valuation or the size of the subject interest.

Standard of value. The word “value” means different things to different people. Before the actual process begins, the valuation expert and attorney must carefully define the “value” being sought. In family law, the standard of value varies by state. Most states use fair market value, fair value, holders’ interest value, or some combination. The report should clearly disclose which standard of value the expert will use and provide a clear definition of the standard. This standard often drives the valuation methods and factors to be considered. It also is an area for potential cross-examination if the standard of value does not comply with the state’s mandated standard.

History and nature of the business. A full understanding of the subject company’s business operations and industry is imperative for a proper determination of value. This section of the report can provide a plethora of important disclosures, such as vital company information, key customers, suppliers and competitors, changes in ownership, expectations for the future, and many other factors about the company or subject interest that may impact the valuation. Information regarding the history of the company and its future outlook is typically obtained from a series of management interviews, a site visit (when possible), third-party verifications, and industry research.

Data obtained/data relied upon. The information obtained by a valuation expert and what was actually relied upon in rendering the opinion may not always be the same. Typically, the report will disclose the list of information relied upon in performing the valuation and rendering the opinion. All information obtained may not be disclosed in the report. Always ask the expert what, if anything, was obtained and not relied upon, and more important, why it was not relied upon. Review the entire report as offered and admitted into evidence and ensure that underlying documents also have been admitted. The following information is commonly obtained and relied upon:

- Financial data (tax returns, financial statements, banks statements, etc.)
- Industry data (current, trends, outlook, etc.)
- Economic outlook (national, state, local, etc.)
- Mergers and acquisitions of comparable companies
- Comparable publicly traded companies
- Annual financial statement studies and ratio analyses within the industry

- Compensation studies and databases
- Legal documents and agreements to which the company is a party
- Mortgage or promissory note documents, guarantees, etc.
- Organizing documents, bylaws, operating agreements, etc.

This is a sampling of the information that may be in the report. Thoroughly review these items because typically they are the foundation of the expert's opinion.

Financial position. As part of a business valuation engagement, the expert must thoroughly assess the financial position of the company. This typically involves an in-depth review of the company's historical financial results as well as outlook for the future. A review of industry data and benchmarks also is performed to assess the subject company compared to its peers. This section of the report provides a narrative of the valuation expert's findings related to the financial condition of the company. A historical summary of financial statements or tax returns is usually provided in the appendix of the report and is commonly referred to in this section of the narrative. Projections of future financial results, as well as other financial schedules, also may be provided in the appendix.

Valuation approaches & methods. The three generally accepted approaches in valuing a business include:

- Asset approach
- Income approach
- Market approach

Within each approach are specific valuation methods.

Asset approach and methods: The asset approach, using the net asset value or NAV Method, involves determining the fair market value of a company's assets, then subtracting the liabilities from the assets to arrive at the fair market value of the equity. This approach is most appropriate when valuing an investment holding company or a company that is incurring losses or is only marginally profitable.

Another method under the asset approach is the Excess Earnings Method. The model for the excess earnings method computes the value of a company based on the value of tangible assets, plus an additional amount for intangible assets. The intangible value is determined by first computing the excess or incremental earnings of the company and/or subject owner(s). The incremental earnings reflect the owner's earning capacity in excess of the level of income generally earned by a nonowner and a reasonable return on the company assets. Incremental earnings are assumed to reflect the value of an ownership interest in a business, as opposed to the value of the services of the owner-professional, and are generally attributable to reputation, location, recurring referral sources, and other

aspects of goodwill. Once determined, the incremental earnings are then capitalized using an appropriate capitalization rate (or multiple) to arrive at an indicated intangible value. The excess earnings method is commonly used in business valuations for divorce.

Income approach and methods: The income approach determines the value of an asset based on the value of benefits to be derived from ownership of that asset. The income approach focuses on a company's ability to generate earnings or cash flow. There are two primary methods under the income approach, the Capitalized Earnings Method (CEM) and the Discounted Cash Flow (DCF) Method.

The capitalized earnings method is commonly used to value companies that have reached a stable level of sales and earnings. This method is based on the historical financial results of the company adjusted for nonrecurring items and items that are at the sole discretion of the owner. This adjustment process is called "normalizing earnings." Once the normalized earnings are determined, they are capitalized using an appropriate capitalization rate (or multiple) to arrive at the value of the company. (See Traps for the Unwary on page 37 for more on normalizing earnings and determining capitalization rates.)

The DCF method typically is used to value companies whose operations have not stabilized or a company whose historical results are not considered representative of anticipated future results. This method involves projecting future cash-flows until a time when the company is expected to stabilize. The projected cash-flows and the value at the end of the projected period are then discounted to present value using an appropriate discount rate that takes into account the risks associated with realizing the projected results. (See Traps for the Unwary for more on determining discount rates.) To utilize this method, the valuation expert must be able to estimate future operating results with a reasonable degree of predictability.

Income approaches are the most common in business valuations for divorce purposes and involve a number of assumptions and professional judgments. Thoroughly review and cross-examine the expert on his or her assumptions and professional judgments.

Market approach and method: The market approach involves identifying and selecting exchanges in the marketplace of interests with characteristics similar to the interest being valued. There are two primary methods under the market approach, the Guideline company method and the transaction method.

The guideline company method involves: (1) selecting an appropriate sample of entities whose shares are traded on public stock exchanges; (2) calculating the stock price as a multiple of an appropriate measure, such as earnings; (3) adjusting the multiple to recognize differences between the public company or companies and the subject company in size, expected growth, and other factors; and (4) applying the adjusted multiple to the operating results of the subject entity to determine the value of the shares of the subject entity.

The transaction method involves: (1) selecting an appropriate sample of companies that were acquired or merged with characteristics similar to the subject company; (2) analyzing the purchase price and calculating various price multiples; (3) adjusting the multiples to recognize differences between the comparable company or companies and the subject company in size, expected growth, and other factors; and (4) applying the adjusted multiple to the operating results of the subject entity to determine the value of the shares of the subject entity.

Another market-based approach is the prior transactions method. If the subject company has exchanged ownership interests with arm's-length terms and prices, the price established by these prior transactions should be reviewed and considered.

In business valuations for divorce, market approach methods are typically not utilized as primary methods of valuation. However, it is not uncommon for market approach methods to be used as reasonableness tests to support other approach(es). For most companies, it is too difficult to find comparables in the market that are similar enough to the subject company to make any meaningful conclusions. If the valuation expert in a divorce heavily relies on a market approach, thoroughly review his or her basis for doing so.

Conclusion and reconciliation of valuation methods. In most cases, multiple valuation methods are utilized, resulting in differing values. The valuation expert must then reconcile the values and determine which, if any, provide a more meaningful indication of value. A full explanation of the expert's reasoning for the concluded value or range of value should be included in this section of the report.

Addenda. Information included in the addenda of the report may vary and be called by different names, but generally is information required by the various profession's standards and includes:

- Assumptions and limiting conditions
- Representations/certifications
- Qualifications of the valuation expert

Assumptions and limiting conditions: This addenda contains a list of the major caveats and limitations associated with the valuation engagement. Although the list can be voluminous, it is well worth a read to identify possible weaknesses in the valuation. Examples include reliance on information provided by management or others not independently verified, restrictions or limitations in the scope of the work performed or data available for analysis, and disclosure of any hypothetical condition or assumption used in the valuation engagement.

Representation/certification: Most professional standards require the valuation expert to provide a signed statement, representing or certifying the work performed, and a list of factors that guided the work.

Qualifications of the expert: A statement of qualifications or curriculum vitae should be included for anyone who signed the valuation report or provided significant professional assistance. If others have signed the report or are noted as providing significant professional assistance, it may be necessary to depose those individuals to find out their level of knowledge and involvement.

Traps for the unwary

Business valuation experts will tell you that valuing a business is more art than science. This is because much of the assignment involves assumptions, professional judgment, and general knowledge and experience in valuing closely held businesses. As such, many areas can be vulnerable to attack if the valuation expert has not adequately substantiated the work. In addition to those mentioned above, others may include:

Normalizing the income stream. When applying an income approach method, the valuation expert must determine what the “normalized” level of income or cash flow is for the company. Some refer to this as “cleansing the income stream.” This is important because the determination of value under the income approach is based on two factors: (1) a normalized income stream, and (2) a discount or capitalization rate (i.e., valuation multiple). A slight change in either can affect the value significantly, so examine carefully each of these factors.

Normalizing adjustments are typically categorized as either a nonrecurring item or a discretionary item of the owner(s). Nonrecurring items include one-time expense or revenue entries, or items that are not expected to continue in the future. Discretionary items are those things the owner(s) has control over and that a hypothetical owner may or may not choose to incur. Typical discretionary items include owner/officer compensation, rent or other payments to related parties, travel, meals, entertainment, etc. If the subject interest being valued constitutes a minority interest or one that cannot control decisions related to discretionary items, such items are typically not adjusted for in the normalizing process.

The valuation expert usually identifies normalizing adjustments after a thorough review of the historical financial data of the company, as well as management and third-party interviews.

Discount/capitalization rates. This is the second and equally important factor that drives the determination of value under the income approach (a normalized income stream being the first, as stated above). A discount or capitalization rate is a reflection of the equity rate of return required by the owner/investor on the expected normalized income stream, taking into consideration the various business, financial, and other risks associated with such an income stream.

Although discount/capitalization rates can be developed in different ways, the most commonly used is the build-up method (BUM). A valuation expert will “build-up” the rate starting with a risk-free rate, such as a 20-year Treasury bond, and add to this such risk factors as an equity risk premium, a small stock premium required by small stock

investors, and company and industry-specific risk factors. Most of the BUM components are available from public sources, although there is some disagreement on which are best. The company-specific risk factors, however, are at the complete discretion of the valuation expert and should be reviewed carefully.

Specific company risk factors. Each company is unique and carries with it various strengths and weaknesses that impact the risks associated with owning/investing in such a company. These risks impact the required rate of return an owner/investor would require to invest in the business, and ultimately the value of the company. For a list of specific company factors that may be considered in determining the discount/capitalization rate under the build-up method, see “Specific Company Risk Factors” on page 37.

Once the valuation expert analyzes these and other factors of the subject company, he or she applies professional judgment and experience in selecting a specific company risk factor in calculating the discount/capitalization rate. Clearly a lawyer should focus carefully on the subjectivity of the expert and ask questions about this analysis.

Assumptions, assumptions, assumptions. Although the valuation expert provides a list of assumptions and limiting conditions in the report (typically as an addendum), the lawyer should carefully review and make inquiries regarding all major assumptions. Without a reasonable basis for an assumption, an expert can be discredited and the valuation report could be disallowed.

“According to management.” During the course of any valuation engagement, the expert will obtain verbal and written representations from management. When possible, the expert will corroborate the information with independent or third-party verification. However, sometimes, the information cannot be verified. In such circumstances, the expert may rely solely on management’s word. Depending on the nature of the information and its impact on the valuation, carefully consider whether this may make the report vulnerable to attack.

Unreported income or assets. If a company has unreported income or assets, the calculation of value under any of the three approaches could be grossly understated. If there is reason to believe the company is hiding or under-reporting income or assets, retain a forensic accountant in addition to the valuation expert. The valuation expert also may discover other factors considered “red flags” during a thorough review of the company’s financial data and/or comparison to industry benchmarks. In either case, an experienced forensic accountant can investigate the records and report any findings that may impact the valuation assignment.

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Sidebar:

Specific Company Risk Factors

- Access to capital
- Availability of labor
- Competition
- Customer concentration
- Customer loyalty and stability
- Customer pricing leverage
- Demographics
- Distribution channels
- Economic factors
- Employee stability
- Environmental factors
- Expected cash flow
- Fixed assets' age and condition
- Fixed vs. variable costs
- Geographical distribution
- Industry and government regulations
- Internal and external culture
- Internal controls
- IT systems
- Lack of diversification
- Legal/litigation issues

- Leverage
- Life cycle of current products or services
- Location
- Management depth
- Management expertise
- Potential new competitors
- Product or service diversification
- Small company
- Strength of intangible assets
- Supplier concentration
- Supplier pricing leverage
- Technology life cycle
- Volatility of earnings or cash flow