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Thought Leadership in Family Law Financial and Valuation Issues

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Thought Leadership

Insights

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Insights is intended to provide a thought leadership forum for issues related to the Willamette Management Associates business valuation, forensic analysis, and financial opinion services.

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from lawyers, accountants, bankers, and other thought leaders of the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Insights Editors and Staff

Robert Schweihs
Managing Editor
rpschweihs@willamette.com

Charlene Blalock
Editor
cmblalock@willamette.com

Mary McCallister
Production Editor
mmccallister@willamette.com

Mark Abbey
Business Manager
mfabbey@willamette.com

Debi Quinlivan
Accountant
dlquinlivan@willamette.com

Michael Amoroso
Financial Analyst
mcamoroso@willamette.com

Editorial Board

Business Valuation Services—*valuations of businesses, business interests, securities, and intangible assets*

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tgwhitehead@willamette.com

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Thought Leadership in Family Law Financial and Valuation Issues

Editor for This Issue: Charles Wilhoite, CPA

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Forethoughts

This *Insights* issue provides thought leadership on family law considerations related to financial, economic, forensic analysis, and valuation issues. The family law field represents a complicated environment that requires a wide array of professional services and expertise. The resolution of complex issues regarding the division of assets deemed includable within a marital estate, and the estimation of reasonable alimony/spousal maintenance, typically is exacerbated by intense emotion, often on the part of both the divorcing parties and their respective legal counsel. Because divorce statutes and judicial precedents vary from state to state, the professional services provided should be consistent with established judicial and regulatory guidelines and regional practice.

The consideration and understanding of property distribution laws governing the formation of a marital community are important when providing professional services in the family law field. While a myriad of issues may arise during the dissolution of a marital estate, issues regarding property distribution and alimony/spousal maintenance typically are among the most significant. As a result, legal counsel and court systems depend on the guidance provided by qualified and informed financial and forensic advisers familiar with the delivery of professional services in the contentious and complex family law field. As the divorce rate for married couples in the United States continues to range from 40 to 50 percent, the demand for such services likely will continue.

Each discussion presented in this issue of *Insights* was developed by legal and/or valuation professionals with significant experience in the family law field. Willamette Management Associates regularly provides independent financial, economic, forensic analysis, and valuation consulting services throughout the country relating to family law matters. Our valuation services include the development and issuance of independent fair value and fair market value opinions, the independent review and rebuttal of expert reports, and forensic analysis. We also provide expert testimony and related litigation support services.

About the Editor

Charles Wilhoite

Charles Wilhoite is a managing director of the firm, and he is resident in our Portland office. In addition to his work on all types of valuation engagements for the firm, he leads our tax-exempt entities and health care valuation services practice.

Charles joined the firm in 1990. Prior to joining the firm, Charles was a senior auditor for KPMG in Phoenix, Arizona, with a diverse client list that covered numerous industries, including health care, insurance, banking and financial institutions, government, manufacturing and distribution, construction and development, forest products, automobile dealerships, retail, real estate, and others.

Charles has extensive experience providing valuation, financial advisory, and forensic services in a family law setting. Charles has significant litigation support experience, and has been qualified as an expert witness in numerous county, state, and federal courts throughout the country, including the U.S. Tax Court.

Charles received bachelor of science degrees in accounting and in finance from Arizona State University. He is a certified public accountant (CPA), accredited in business valuation (ABV), and certified in financial forensics (CFF) by the American Institute of Certified Public Accountants; certified as a management accountant (CMA) and certified in financial management (CFM) by the Institute of Management Accountants; an accredited senior appraiser (ASA) in business valuation as designated by the American Society of Appraisers; a certified business appraiser (CBA) as designated by the Institute of Business Appraisers; a certified valuation analyst (CVA) as designated by the National Association of Certified Valuators and Analysts; and a certified fraud examiner (CFE) as designated by the Association of Certified Fraud Examiners.

Charles serves on the following boards of directors: the Federal Reserve Bank of San Francisco—Portland Branch; Meyer Memorial Trust; the Portland Business Alliance (Portland's Chamber of Commerce); Legacy Health; PacificSource Health Plans; U.S. Bank of Oregon, the Nature Conservancy; and Metal Toad Media.

Thought Leadership

Evaluating Key Person Risk When Valuing a Closely Held Company for Marital Dissolution Purposes

Michael A. Harter, Ph.D.

The operations, and the underlying value, of many closely held companies may be affected disproportionately by dependence on one or two key individuals. This dependence, typically referred to as "key person risk," is recognized within the valuation profession. This key person risk is often accounted for in the form of a valuation discount applied to the company's overall business value. Valuation analysts providing services in a marital dissolution setting often face the challenge of performing the necessary diligence to (1) identify whether a company is exposed to key person risk and (2) assess the impact of key person risk on the closely held business valuation.

Introduction

When valuing closely held companies for marital dissolution purposes, valuation analysts ("analysts") consider that some closely held companies rely on one individual for the company's success. Companies that rely heavily on one person for the success of the company suffer from key person risk. In these circumstances, it is important for the analyst to (1) evaluate whether key person risk exists and (2) adequately incorporate key person risk considerations into the valuation of the subject company.

If a closely held company has key person risk that is not adequately considered in the valuation, the subject company business value may be overstated. This discussion addresses how to evaluate whether key person risk exists in a closely held company. This discussion describes several methods for incorporating key person risk considerations in the business valuation process.

Key Person Risk in Closely Held Companies

When valuing closely held companies for marital dissolution purposes, the subject company is often relatively small and may rely on one person for its success. In such circumstances, it is important for the analyst to take into consideration the importance of the key person.

Typically, in smaller companies, upper-level management is comprised of relatively few employees. In such circumstances, it is not unusual for a company's future success and viability to hinge on the continued health, success, and contributions of an owner or founder. When a company is highly dependent on one individual for its continuing success, it suffers from key person risk.

The definition of a key-person discount is "an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise."[1] When valuing closely held companies for marital dissolution purposes, the analyst should understand key person risk and be able to evaluate whether or not it exists.

For federal gift and estate tax purposes, the U.S. Tax Court has allowed for a discount when concluding the value of companies when the existence of key person risk has been established. The value adjustment is often presented in the form of a key

person discount—reflected as a percentage discount to arrive at the estimated company value, or as an implicit adjustment to an estimated company value in the form of a higher discount rate or capitalization rate.

When valuing closely held companies for marital dissolution purposes, the analyst may (1) complete sufficient diligence procedures to establish whether a company has a key person dependency and (2) identify the key person risk and incorporate elements in the valuation process that adequately address the economic impact of identified key person dependency on the value conclusion.

This discussion focuses on evaluating whether key person risk exists in a company and how to adequately address key person risk issues when valuing a closely held company for marital dissolution purposes.

Key Person Considerations

Simply being an owner of a business does not automatically qualify an individual as a key person. Similarly, just because a company is "small" does not necessarily indicate that the company operates with key person risk.

A company may suffer little to no economic harm upon the departure of a member of upper-level management if the company operating structure includes (1) adequately trained employees that can effectively assume the duties and responsibilities of the departing manager and (2) diversified revenue, supplier, and distribution sources that do not depend on the departing manager. Even small companies operating with a well-diversified management team capable of fulfilling the role of a departing key person are positioned to mitigate key person risk.

When evaluating whether a company has key person risk, the following six areas may be analyzed:[4]

1. Management and leadership skill
2. Suppliers
3. Customers
4. Innovation
5. Obtain debt or equity
6. Employee loyalty

Each of the areas is discussed below.

Management and Leadership Skill

Does a person have management and/or leadership skills that are important for the company's operations? In some closely held companies, one individual may have the leadership ability to grow the company and navigate the landscape of a changing industry. Similarly, one person may be important for defining short-term and long-term goals. This individual may have the administrative and management leadership skills required to enable the company to realize its goals. If a company is highly dependent on one individual to lead and manage the company, and this person "cannot" be replaced, then the company suffers from key person risk.

To establish the existence and significance of the level of key person risk, an analyst typically interviews the key person, as well as other employees. This type of 360 degree diligence review enables an analyst to estimate the impact that key person's departure may have on the company.

If the key person has unique skills, talents, and qualities, but it is determined that an external hire could assume the key person's role at a comparable cost, then key person risk may not be present.

Suppliers

Are relationships with suppliers largely dependent on one person? A key person may be able to obtain better prices or more exclusive products from suppliers. More favorable supplier terms provide a company with lower input costs, which positively affect the profitability of a company.

A company that can realize lower input costs can then use its higher profitability to:

1. make further profitable investments in capital equipment,
2. offer higher compensation and draw more skilled employees into the organization, and
3. increase the marketing and/or advertising budget to reach more consumers.

Typically, an analyst may perform diligence procedures to determine whether company suppliers are providing favorable terms based on a relationship with a specific individual within the company. Such a circumstance likely may support a conclusion of the presence of key person risk.

Customers

Are relationships with customers largely dependent on one person? Customers may purchase goods or services from a company because they have a personal relationship with a particular person in the

company. A company or person may purchase goods or services from another company because the seller or provider produces or provides a high quality product or service. However, if the product or service is not noticeably different from comparable products or services offered by alternative providers, purchases may be attributable to a personal relationship.

In such a circumstance, the key person's relationships increase the switching costs to purchase goods or services from another provider. If a significant number of customer relationships can be attributed to one person at a company, or if a significant percentage of company revenue is generated by the relationships of one person, then key person risk may exist. The analyst may estimate what percentage of revenue is likely due to the relationships of the key person.

Innovation

Does one person in the company have a unique ability to innovate products? For companies in the technology sector, or other sectors demonstrating significant technological disruption or innovation, a key person may be important for understanding the direction the industry or products are moving.

Typically, an analyst performs diligence procedures aimed at understanding to what extent one individual enables a company to stay ahead of changing trends or innovations in the industry. If one person has been responsible for identifying changes or important trends in the industry, and the company has performed well as a result of the early identification of these shifts, the company may be exposed to key person risk.

Obtain Debt or Equity

Does one person have a unique ability to obtain debt or equity capital? In some cases, one person within a company may have an ability to raise additional equity capital through a large network of potential investors. Similarly, if one person has been responsible for raising debt, and this person cannot be replaced, then the company may be exposed to key person risk in the form of a threat to the company's continuing ability to raise additional capital on favorable terms.

Many closely held companies borrow through commercial banks, which rely more on the fundamental position of the company. Typically, an analyst performs diligence procedures aimed at understanding the key terms and conditions regarding equity and debt issuances.

If such diligence indicates that a single individual at the company has a history of achieving favorable financing terms based on relationships in the capital markets, the company may be exposed to key person risk.

Employee Loyalty

Are employees who are important to the company's operations loyal to a specific person? And, would the loyal employees leave if the key person left? In some smaller, closely held companies, strong loyalty may exist between a company founder or leader and other employees. Such loyalty could result in the departure of a number of employees should the founder or leader leave the company.

In such a circumstance, the key person may not even have unique skills or talents that the company relies on for its success. However, the company could still experience significant disruption and harm if the "charismatic" leader left, resulting in a group of other, important employees following. Generally, this is not a significant problem in larger companies with more diversified management teams.

However, in smaller companies, the departure of "everyone's favorite manager" could result in the loss of a number of employees, some of whom may have special knowledge or training and would be difficult to replace. Such a loss may be harmful to the continuing success of a small company.

When valuing a closely held company, an analyst typically performs diligence procedures to evaluate whether the company is exposed to employee defection as a result of loyalty to a particular individual or leader. Such potential losses are mitigated significantly by legally enforceable noncompetition agreements. The absence of a noncompetition agreement in such a circumstance may result in a conclusion that key person risk exists, possibly resulting in a reduction in the value of the subject company.

Compensation adjustments can be considered as a form of mitigating key person risk, but such adjustments typically have the impact of increasing operating costs, thereby reducing expected earnings and value.

An assessment of key person risk involves a diligence process and appropriate documentation. If the diligence process indicates that a company is exposed to key person risk, adjustments incorporated in the valuation process to address the risk may be deemed inappropriate absent sufficient evidence supporting the key person risk conclusions.

The presence and significance of key person risk at a company can exist in many forms. Before discussing how the analyst can incorporate key person risk in the valuation process, a review of several court cases is presented. This review is intended to (1) explain the rationale courts have used to identify the presence of key person risk and (2) present a range of key person discounts accepted by certain courts.

Representative Key Person Court Cases

When attempting to analyze whether key person risk exists and to estimate a reasonable level of adjustment to reflect the impact of key person risk, it may be instructive to review court decisions that have addressed the issue of key person risk. Several judicial decisions addressing the issue of key person risk and related discounts are discussed in the following paragraphs.

In *Kohl v. Kohl*,[5] the analysts were in general agreement about how to assess the equity risk premium including the risk-free rate and small capitalization premium. However, discrepancies arose when determining the risk factors for the specific business being valued. These risk factors included key person risk, customer concentration, and lack of marketability.

The court found that a 32 percent risk factor for dependence on a key person (Tod Kohl, the owner/operator) was not warranted. For example, a high risk was assigned to the stability of the businesses' earnings, and it was suggested that company earnings were highly dependent on the husband and the real estate industry.

However, earnings increased each year throughout the valuation period and the company was able to obtain new clients without much difficulty. Therefore, the court found that such a high risk factor did not reflect the reality during the period subject to valuation.

In *Miller v. Miller*,[6] the wife's analyst testified that a key person discount was not applicable to the husband's practice because he could be replaced by another internal medicine doctor. Furthermore, the fact that some patients might not return was taken into account by use of the market approach and by the use of a higher capitalization rate. In the income approach, the court found that the adjustment of the capitalization rate by the wife's analyst was an appropriate method to capture the risk that some patients would not return.[7]

In the court case of *In re Marriage of Frett*,[8] the analyst determined that the husband was a key person in TechniCom, Inc., a telephone equipment installation company. In addition to a 15 percent discount for lack of marketability, the husband's analyst included a 20 percent key person discount to reflect the risk of a potential loss of the key person to the company. However, the court determined that both discounts were excessive under the facts of the case.

The previous court cases provide an idea of how key person risk has been addressed for marital dissolution purposes. The following Tax Court decisions relate to federal gift and estate tax matters. However, these decisions relate to the measurement of the key person dependence valuation discount.

In *Estate of Mitchell v. Commissioner*,[9] the court decided that the death of Paul Mitchell exerted a materially significant, detrimental impact on the future of John Paul Mitchell Systems (JPMS). The court considered John Mitchell to be "vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry."

Since the court considered him a key person, and efforts to acquire JPMS prior to Paul Mitchell's death were contingent upon his continued service at JPMS, the court reasoned that there was inadequate management depth at JPMS after Paul Mitchell's death. The court opined that a key person discount of 10 percent should be applied after estimating the enterprise value and prior to additional discounts for lack of control and lack of marketability.[10]

In *Estate of Furman*,[11] the court was asked to determine the fair market value of a decedent's 27 Burger King restaurants. The living son, Robert, ran the company and was thought to be important to the company's success. Therefore, the taxpayer's analyst applied a 10 percent discount to reflect the reliance the company had on Robert as a key person. In considering the basis for the key person discount, the court stated:

> Where a corporation is substantially dependent upon the services of one person, and where that person would no longer be able to perform service for the corporation by reason of death or incapacity, an investor would expect some form of discount below fair market value when purchasing stock in the corporation to compensate for the loss of that key employee.

The court reasoned that a professional manager could have been hired to replace Robert. However, the court opined that the basis for the 10 percent key person discount included consideration of several additional risks the company was subject to, including the following:

1. Lack of management until a replacement was hired
2. Risk that a professional manager would require higher compensation than Robert had received
3. Risk that a professional manager would not perform as well as Robert

These decisions indicate that key person risk may have a significant influence on the value of a company. In the two Tax Court decisions discussed, the court accepted a discount for key person risk of 10 percent. However, the key person discount in any particular case will be based on consideration of the facts and circumstances specific to the case.

Adjusting for Key Person Risk

After assessing whether key person risk is present in a subject company, the analyst is faced with the task of quantifying the significance of key person risk and incorporating the impact of the key person risk in the valuation. There are three generally accepted business valuation approaches to valuing closely held companies for marital dissolution purposes: (1) the income approach, (2) the market approach, and (3) the asset approach.

Each of these approaches is discussed below. A discussion then follows regarding how to address the issue of key person risk in the valuation approaches.

Income Approach

Common income approach valuation methods include the discounted cash flow method and the direct capitalization method. The discounted cash flow method involves a projection of the subject company results of operations for a discrete, multiyear period. The discounted cash flow projection is then converted to a present value using a market-based, risk adjusted discount rate. The discounted cash flow method also involves a terminal value analysis at the end of the projection period.

The direct capitalization method involves dividing a market-derived, risk-adjusted direct capitalization rate into a normalized estimate of expected, long-term income (e.g., cash flow) for the subject company.

Market Approach

The market approach methods rely on the premise that prices of securities of companies in the same or similar lines of business provide informational value to investors. The market approach methods incorporate some form of relational analysis between a sample of guideline company security trading prices, or transaction prices, and selected financial/operating fundamentals in order to create a range of relevant pricing multiples.

These pricing multiples are used as a basis for selecting the particular pricing multiple to apply to the subject company's same fundamental value measures. The information sources considered for the purpose of completing the market approach can include data regarding privately held companies, publicly traded companies, or merged and acquired companies.

Asset-Based Approach

The asset-based approach methods consider the value of company assets (both tangible and intangible) and the value of company liabilities (both recorded and contingent).

The asset-based approach encompasses a valuation (either discrete or collective) of company assets, including current assets, tangible personal property, real estate, and intangible assets. This valuation approach also encompasses a valuation of company liabilities, including current liabilities, notes payable; and contingent liabilities.

All three valuation approaches may be considered, initially, when valuing a closely held company. However, the facts and circumstances and analyst judgment dictate which approaches will be applied.

The following discussion relates to incorporating key person risk in the income approach and market approach methods.

Key Person Risk and the Income Approach

Within the income approach, generally, there are two ways to apply a key person discount. First, the analyst can increase the discount/capitalization rate used to capitalize normalized income. The increase in the capitalization rate is intended to reflect the incremental risk the key person dependency exerts on the company's operations.

Second, the analyst can estimate the detrimental effect that the loss of the key person would exert on company revenue and profit. The estimated effect would then be used to:

1. normalize company earnings and net cash flow incorporated in the capitalization of net cash flow method or
2. develop adjusted company financial projections incorporated in the discounted cash flow method.

When developing a discount rate, an analyst typically begins with a risk-free rate and adds incremental risk components. Based on the facts and circumstances regarding the subject company, additional risk components could include an equity risk premium, a size premium, and an industry risk premium.

If an analyst determines that company-specific risk exists that is not addressed by the premiums previously identified, the analyst can then add an additional company-specific risk premium. Often, key person risk is incorporated in the development of a discount rate as a component of company-specific risk.

Due diligence procedures performed by an analyst during the valuation process should result in a solid, documented foundation for company-specific risk, including key person risk.

The second method to incorporate key person risk into an income approach business valuation involves normalizing company income or future cash flow to reflect company operations as if the key person were no longer present. A reasoned estimate regarding how company revenue would change and how operations would change on a day-to-day basis if the key person were no longer present is necessary. Typically, the impact of the loss of a key person is estimated based on due diligence interviews with the key person and management at the subject company.

Though not an exhaustive list, the six areas previously identified provide a reasonable interview foundation for the purpose of establishing whether a company is subject to key person risk and the nature of the risk. Through the interview process, an analyst may learn that a suitable replacement for a key person exists, mitigating, or potentially eliminating, the key person exposure identified.

To the extent that key person risk is identified, and the exposure cannot be eliminated effectively, revenue and earnings expected for the subject company may be lower.

Key Person Risk and the Market Approach

Key person risk can be incorporated in the market approach by adjusting the pricing multiples selected from the range of potential pricing multiples resulting from the analysis of the identified group of guideline companies.

When adjusting the selected multiples, it is important for the analyst to provide evidence in support of adjustments to the pricing multiples that reasonably corresponds with the estimated significance of the key person risk exposure.

Key Person Discount at the Company Level

Lastly, an analyst can apply a key person discount at the total company equity level. In other words, an analyst can apply a key person discount after the company's total equity value has been estimated. The advantage of applying the key person discount at the total equity level is that it does not involve any reliance on management projections or attempts at estimating normalized income based on the assumed loss of the key person.

Applying a key person discount at the total equity value level enables an analyst to avoid making multiple assumptions regarding the following:

1. Operating measures, such as future revenue and operating margins, and related growth rates

2. Customer/employee retention and supplier relationships

As a result, applying a key person discount as a percentage of total equity value represents a viable option when key person risk is identified in the valuation of a company for marital dissolution purposes.

Conclusion

An assessment of key person risk is important when valuing a company for marital dissolution purposes. This is particularly true when the subject company is relatively small. Areas an analyst can focus on in due diligence interviews to determine the existence and significance of key person risk include the following:

1. Management and leadership skill
2. Suppliers
3. Customers
4. Innovation
5. Obtaining debt or equity
6. Employee loyalty

There are several ways that the analyst can incorporate the impact of identified key person risk in the valuation process. Within the income approach methods, three alternatives were identified:

1. Adjusting company earnings and cash flow incorporated in the direct capitalization method
2. Adjusting company financial projections incorporated in the discounted cash flow method
3. Adjusting the discount rate/capitalization rate incorporated in the discounted cash flow method or the direct capitalization method

Within the market approach methods, an analyst can adjust selected pricing multiples or apply a key person risk discount at the enterprise level.

Regardless of the method(s) used to reflect the impact of identified key person risk in the valuation process, adequate rationale and documented support are necessary to support the conclusions presented.

Because key person risk may have a significant impact on the value of a company, the analyst completing a thorough and well-documented valuation that adequately considers and addresses key person risk issues can provide valuable assistance to legal counsel and the court in a marital dissolution setting.

"[A]pplying a key person discount as a percentage of total equity value represents a viable option when key person risk is identified in the valuation of a company for marital dissolution purposes."

Notes:

1. *International Glossary of Business Valuation Terms* (as adopted by the American Society of Appraisers, 2009).
2. Internal Revenue Service, Revenue Ruling 59-60, Section 4.02.
3. *IRS Valuation Training for Appeals Officers Course Book*, Business Valuation Resources, LLC, 101.
4. Shannon P. Pratt, *Discounts and Premiums*, 2nd ed. (Hoboken, NJ: John Wiley & Sons, Inc.), 260–1.
5. Kohl v. Kohl, 800 N.Y.S.2d 348 (2004).
6. Miller v. Miller, 288 Ga. 274, 705 S.E.2d 839 (2010).
7. In the case Miller v. Miller, the key person risk discount used by the wife's business valuation expert was not provided.
8. In re Marriage of Frett, 686 N.W.2d 235 (Iowa Ct. App. 2004).
9. Estate of Mitchell v. Commissioner, T.C. Memo 1997-461 (Oct. 9, 1997).
10. After determining an enterprise value and deduction for key person risk, the estate appealed the Tax Court's conclusion. On May 2, 2001, the Ninth Circuit Court of Appeals reversed and remanded Mitchell. The Ninth Circuit decision held that the Tax Court was internally inconsistent in its ruling on noncontrolling and marketability issues and failed to adequately explain its conclusion. On remand, the Tax Court again determined the same acquisition value and a 10 percent key person discount. See T.C. Memo 2002-98 (April 9, 2002).
11. Furman v. Commissioner, T.C. Memo 1998-157, (April 30, 1998).

Michael A. Harter is an associate in our Portland, Oregon, practice office. Mike can be reached at (503) 243-7501 or at maharter@willamette.com.

Personal Goodwill and Corporate Goodwill within the Family Law Context

Frank "Chip" Brown, CPA

The valuation of "personal" goodwill and "corporate" goodwill is often a disputed issue in a marital dissolution matter. Depending on the prevailing state statute, the distinction between these two types of goodwill may play an important role in determining which assets are marital property and which assets are separate property. Valuation analysts can provide significant guidance and support to family law counsel with regard to identifying and quantifying professional goodwill and business goodwill within a family law context. Similarly, family law counsel can provide invaluable legal guidance to the analyst regarding the relevant statutory authority and judicial precedent within the subject family law jurisdiction.

Introduction[1]

Valuation analysts ("analysts") are often called on to value goodwill as part of a family law controversy. Goodwill is defined as an intangible asset arising as the result of name, reputation, customer loyalty, location, products, and similar factors not separately identified. In many states, goodwill (or a portion thereof) has long been recognized as "property" in family law cases. Therefore, goodwill typically is subject to equitable distribution.

However, many courts have failed to draw a clear distinction between the two possible components of goodwill—namely, "professional goodwill" (often referred to as "personal" or "individual" goodwill) and "business goodwill" (often referred to as "corporate," "institutional," or "enterprise" goodwill). Hereafter, this discussion will refer, generally, to goodwill attributable to a person as personal goodwill and goodwill attributable to a company as enterprise goodwill. Depending on the statutory authority and judicial precedent in the subject state, this distinction may be important to the equitable distribution of marital estate property.

The distinction between personal goodwill and enterprise goodwill may be important to the segregation and quantification of separate and marital property. This is particularly the case if the personal goodwill of the spouse was acquired or accumulated prior to the marriage.

In many jurisdictions, the question of when property is acquired by the spouse may be important in a marital dissolution. This is because property obtained prior to the marriage (separate property) is usually returned to its owner, while the marital estate property typically is divided between the spouses.

This discussion includes the following:

1. An overview of the nature and quantification of enterprise and personal goodwill as it applies to marital dissolution cases
2. A summary of the different procedures implemented by various state courts to determine the enterprise or personal components of goodwill

Distinction between Personal and Enterprise Goodwill[2,3]

Within a family law context, goodwill historically has proven to be difficult to precisely define. The challenge relates to the fact that goodwill typically is generated by so many different factors and

combinations of factors that it is nearly impossible to list them all.

Exhibit 1 lists some of the characteristics, or indicators, regarding the existence of goodwill in a business or professional practice that the analyst may consider when identifying and quantifying the amount of personal goodwill and enterprise goodwill.

Personal goodwill, which is also called individual or celebrity goodwill, relates to an individual person. Typically, personal goodwill is not an asset that is owned by the business enterprise that employs the individual person.

Enterprise goodwill, which is also called company or institutional goodwill, is associated with the subject business enterprise. Typically, it is owned by the subject business enterprise (whether a corporation, personal services company, or professional practice).

It is often important to separately identify and individually value these two categories of goodwill. Such an approach is often required because there may be different legal, economic, and taxation consequences for each category or type of goodwill.

Some of the variables that affect whether personal goodwill exists include the following:

1. The type of service or product offered by the subject business enterprise
2. The subject individual's personal relationships with the customers or clients
3. The subject individual's direct impact on the operating focus, management, and key decisions of the subject business enterprise

Typically, more goodwill is allocated to the personal category if:

1. the individual makes essentially all significant management decisions regarding the subject business enterprise,

Exhibit 1
Goodwill Indicators

Personal Goodwill Indicators	Enterprise Goodwill Indicators
Small entrepreneurial business highly dependent on employee-owner's personal skills and relationships	Larger business, which has formalized its organizational structures and institutionalized its systems and control
No pre-existing covenant not to compete and/or employment agreement between selling company and employee-owner	Owner-employee has pre-existing covenant not to compete and/or employment agreement with the selling company
Personal service is an important selling feature in the company's product or services	The business is not heavily dependent on personal services
No significant capital investment in either tangible or identifiable intangible assets	The business has significant capital investments in either tangible or intangible assets
Only employee-owners own the company	The company has more than one owner, some of whom are not employees
Sales largely depend on the employee-owner's personal relationships with customers	Company sales result from name recognition, sales force, sales contracts, and other company-owned intangibles
Product and/or services know-how, and supplier relationships, rest primarily with the employee-owner	Company has supplier contracts and formalized production methods, patents, copyrights, business systems, etc.

"As a business enterprise increases in size and complexity, goodwill typically shifts from the personal goodwill category to the enterprise goodwill category."

2. the operations of the subject business enterprise are not functionally or economically separate from the individual, and
3. the success of the subject business enterprise ultimately is directly interrelated with the activities of the individual.

In the early stages of a business enterprise's operations, most internally created goodwill is personal goodwill. As a business enterprise increases in size and complexity, goodwill typically shifts from the personal goodwill category to the enterprise goodwill category.

Goodwill through the Eyes of the Courts[4]

While many family law courts acknowledge that both personal goodwill and enterprise goodwill exist in a professional practice, other courts recognize only enterprise goodwill. Still other courts have declined to recognize either professional goodwill or enterprise goodwill as a marital asset.

According to *BVR's Guide to Personal v. Enterprise Goodwill*,[5] the state family law court decisions to date fall into the following four general categories:

1. Category A – The court considers both personal and enterprise goodwill to be marital property—approximately one-third of the family law courts
2. Category B – The court considers enterprise goodwill to be marital property while personal goodwill is separate property—approximately one-half of the family law courts
3. Category C – The court considers neither personal nor enterprise goodwill as marital property—less than 10 percent of the family law courts
4. Category D – No decision or no clear decision—less than 10 percent of the family law courts

Category A—Person Goodwill and Enterprise Goodwill Are Marital Property[6]

There are 13 states that currently fall into Category A—that is, states that recognize both enterprise goodwill and personal goodwill as marital property subject to distribution in a divorce. The Category A states are Arizona, California, Colorado, Kentucky, Michigan, Montana, Nevada, New Jersey, New York, North Carolina, New Mexico, North Dakota, and Washington are included in this group of states.[7]

In 1974, in the case of *Golden v. Golden*, a California court held that the husband's professional (i.e., personal) goodwill in his professional practice as a sole medical practitioner should be considered in the marital property subject to division. The husband argued that, since his goodwill was dependent on his personal reputation and his personal skill, it should not be considered a marital asset.

The California court ruled against the husband. The court concluded that in a matrimonial matter, "the practice of the sole practitioner husband will continue, with the same intangible value as it had during the marriage. Under the principles of community property law, the wife, by virtue of her position of wife, made to that value the same contribution as does a wife to any of the husband's earnings and accumulations during marriage. She is as much entitled to be recompensed for that contribution as if it were represented by the increased value of stock in a family business."[8]

In 1974, the focus of goodwill began to shift from the business enterprise to the individual employee/practitioner.

An analyst witness in *Foster v. Foster*[9] was asked to estimate the fair value of goodwill of a medical practitioner, and not of his medical practice business. Family law courts in both Washington and New Mexico furthered this change in the perception of goodwill by including reputation as a key identifier in valuing professional practice goodwill.

As in the *In re Marriage of Lopez* decision,[10] in the 1976 decision *In re the Marriage of Lukens*,[11] the Washington trial court held that factors contributing to the professional goodwill of an osteopathic practice included the practitioner's age; health; past earning power; reputation in the community for judgment, skill, and knowledge; and his comparative professional success.[12]

Similarly, a Colorado appellate court ruled that a professional, like other entrepreneurs, could expect returning customers based on his established reputation for skill and expertise. That court held that these expectations were part of goodwill.

And, that Colorado court concluded that this goodwill "can be as unfair and inequitable as those states that exclude both personal and enterprise goodwill. For instance, this group disregards the legitimate double-dipping concerns of counting the goodwill—especially the goodwill attaching personally to the professional—both as a marital asset subject to division and as a source of future earnings to pay alimony and support."

The family law court cases in this category shifted emphasis to the individual professional in the business and away from the actual business goodwill. The *Lopez* decision was instrumental in identifying the factors that were relevant in determining the individual professional's goodwill.

The factors listed in the *Lopez* decision related to consideration of the individual professional's:

1. demonstrated earnings power;
2. reputation in the community for judgment, skill, and knowledge;
3. comparative professional success; and
4. nature and duration of the professional's practice.

Category B—Personal Goodwill Is Not Marital Property[13]

On the other hand, 25 states/jurisdictions fall into Category B. This category includes only the enterprise component of goodwill in the calculation of marital assets. In these jurisdictions, the professional or personal goodwill of a spouse is considered separate property. The Category B states include Alaska, Arkansas, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Indiana, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, Texas, Utah, Virginia, West Virginia, Wisconsin, and Wyoming.[14]

For example, in *Nail v. Nail*, a Texas court held that the accrued goodwill of a medical practice based on the personal skill, experience, and reputation of the individual physician, as well as on the expectation that the individual physician would continue to practice, did not constitute property that was subject to division.[15]

Also, in the 1981 case of *Nehorayoff v. Nehorayoff*, a New York court considered the issue of goodwill associated with a professional corporation that performed abortions. In finding a lack of professional goodwill, the New York court reasoned that the patients in the abortion practice did not develop a personal relationship with the physician. As a result, there was no expectation that a change in physicians would lead to a significant decline in business as it may in a private practice.[16]

Likewise, the Indiana Supreme Court stated that if goodwill is "attributable to the individual, it is not a divisible asset and is properly considered only as future earning capacity that may affect the relative property division."[17]

In *Hanson v. Hanson*, the Missouri Supreme Court concluded "[g]oodwill has no separate existence; it has value only as an incident of a continuing business. . . . We define goodwill within a professional setting to mean the value of the practice which exceeds its tangible assets and which is the result of the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the individual practitioner."[18]

In some family law judicial precedent, the courts take the position that if goodwill is to be recognized and divisible at all, then it should be completely separate and distinct from the professional's reputation.

In *Thompson v. Thompson*, the Florida Supreme Court held that "clients come to an individual professional to receive services from that specific person. Even so, if a party can produce evidence demonstrating goodwill as an asset separate and distinct from the other party's reputation, it should be considered in distributing marital property."[19]

Category C—Personal Goodwill and Enterprise Goodwill Are Not Marital Property

Category C states—including Kansas, Louisiana, Mississippi, South Carolina, and Tennessee—

consider neither personal goodwill nor enterprise goodwill as marital property subject to distribution.[20]

In *Singley v. Singley*, the Mississippi Supreme Court held that it was "join[ing] the jurisdictions that adhere to the principle that goodwill should not be used in determining the fair market value of a business, subject to equitable division in divorce cases."[21]

The Mississippi court stated that it is "increasingly difficult for experts to place a value on goodwill because it is such a nebulous term subject to change on a moment's notice."[22]

Furthermore, the Mississippi court noted that "It is also difficult to attribute the goodwill of the individual personally to the business. The difficulty is resolved, however, when we recognize that goodwill is simply not property; thus it cannot be deemed a divisible marital asset in a divorce action."[23]

Category D—No Clear Decision as to Whether Personal Goodwill or Enterprise Goodwill Are Marital Property

Category D states—including courts in Alabama, Georgia, Idaho, Iowa, Maine, Ohio, South Dakota, and Vermont—either (1) have yet to clarify their judicial position on the subject of goodwill or (2) have conflicting judicial decisions on the books.[24]

Conclusion

While there seems to be a consensus that personal goodwill may exist in a professional practice, there is no consensus regarding how to treat personal goodwill when distributing the property includable in a marital estate.

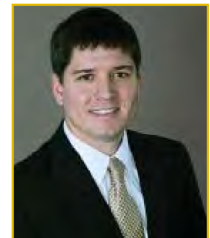
Family law counsel can benefit from valuation guidance provided by a qualified analyst with regard to identifying and quantifying personal goodwill and enterprise goodwill within a family law context.

In order to provide the highest level of service and relevant conclusions, analysts should seek legal guidance from family law counsel regarding the relevant statutory authority and judicial precedent that addresses the inclusion of goodwill as marital property within the subject family law jurisdiction.

Notes:

1. Alexis A. Dawicki and Richa Prakash, "Personal Goodwill and Business Goodwill—Are They Marital Assets?" Willamette Management Associates *Insights* (Special Issue 2008).
2. Ibid.
3. Robert F. Reilly, "Valuation of Goodwill within the Family Law Context," Willamette Management Associates *Insights* (Special Issue 2008).
4. Dawicki and Prakash, "Personal Goodwill and Business Goodwill—Are They Marital Assets?"
5. Adam Manson, ed., *BVR's Guide to Personal v. Enterprise Goodwill,* 5th ed. (Portland, OR: Business Valuation Resources, 2012).
6. Dawicki and Prakash, "Personal Goodwill and Business Goodwill—Are They Marital Assets?"
7. Christopher A. Tiso, "Present Positions on Professional Goodwill," *BVR's Guide to Personal v. Enterprise Goodwill,* 5th ed..
8. Golden v. Golden, 75 Cal. Rptr. 737-738 (Cal. App. 1969).
9. Foster v. Foster, 42 Cal. App. 3d 578 (Cal. App. 1974).
10. In re Marriage of Lopez, 558 P.2nd 279, 281 (Wash. App. 1976).
11. In re Marriage of Lukens, 16 Wash. App. 481, 558 P.2d 279 (1976).
12. Mary Kay Kisthardt, "Professional Goodwill in Marital Dissolution Cases," in Ronald L. Brown, ed., *Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner*, 4th ed. (Englewood Cliffs, NJ: Prentice Hall, 1998).
13. Allen M. Parkman, "A Systematic Approach," in Ronald L. Brown (ed.) *Valuing Professional Practices & Licenses: A Guide for the Matrimonial Practitioner*, 3rd ed. (New York: Wolters Kluwer, 2015).
14. Tiso, "Present Positions on Professional Goodwill."
15. Nail v. Nail, 486 S.W.2d 761 (Tex. 1972).
16. Nehorayoff v. Nehorayoff, 437 N.Y.S.2d 584 at 591 (N.Y. Sup. Ct., 1981).
17. Yoon v. Yoon, 711 N.E.2d. 1265, 1269 (Ind. 1999).
18. Hanson v. Hanson, 738 S.W.2d 429 (Mo. 1987).
19. Thompson v. Thompson, 576 So.2d 637 (Fla. Dist. Ct. App. 2005).
20. Tiso, "Present Positions on Professional Goodwill."
21. Singley v. Singley, 846 So.2d 1004 (Miss. 2002).
22. Ibid.
23. Ibid.
24. Tiso, "Present Positions on Professional Goodwill."

Frank "Chip" Brown is a managing director in our Atlanta practice office. Chip can be reached at (404) 475-2306 or at cbrown@willamette.com.



A Reminder from the Bench: Reasonableness Matters

Charles A. Wilhoite, CPA

There are many capable and qualified financial analysts throughout the country who are able to serve effectively as financial experts in a marital dissolution setting. Regularly, courts issue decisions that serve as a reminder that qualifications and experience are necessary for financial experts to produce supportable expert opinions. However, such expert opinions still may not persuade the court if they fail, in any respect, the test of reasonableness.

Introduction

Legal counsel frequently retain the services of valuation analysts ("analysts") to serve as financial experts to assist with the property settlement and property division aspects of marital dissolutions. Typically, the analyst will be retained to provide an independent opinion regarding the value—as defined by the relevant jurisdiction—of a business or business interest included within a marital estate.

When legal counsel selects the analyst, the selection typically is based on consideration of numerous factors regarding an analyst, including the following:

1. Education and training
2. Relevant professional certifications
3. Experience valuing companies comparable to the company(ies) subject to property division
4. Testimony experience

One characteristic or trait that qualified and experienced analysts who serve in the expert witness role are assumed to possess is reasonableness. Education, training, certifications, and experience may provide the technical foundation required for an analyst to produce and deliver opinions that are technically correct and consistent with relevant standards. However, the demonstrated application of reasonable judgment when applying generally accepted valuation procedures in an engagement setting often is the key factor in determining which opinion offered to the court will be given the greatest weight in the court's ultimate decision.

The following discussion summarizes two recent court decisions that clearly emphasize the fact that judges attribute great weight to the simple concept of reasonableness when forming opinions.

In *Bowe v. Vogel* (*Vogel*), the court determined that it was unreasonable to rely on the opinion of value of the wife's expert resulting from the direct capitalization method because the normalized earnings level placed too much emphasis on the subject company's projected earnings for the coming year.

In *Noble v. Noble* (*Noble*), the court ruled that it was unreasonable to value the subject political consulting firm based on a long-term projection, developed by the wife's expert. The projection included a significant increase in revenue and earnings every presidential election year over a 20-year projection period.

The court's decisions in *Vogel* and *Noble*, and the concept of reasonableness, are discussed in the following sections.

Summary of Vogel

Vogel was a dissolution of marriage action in which the parties maintained significant ownership interests in real estate and real-estate-related businesses. The husband and wife had been married

for approximately 19 years at the time of the dissolution—initiated January 2014. During the course of the marriage, the husband developed significant expertise, and achieved significant success, in the real estate field.

At the time of the dissolution, the husband and wife had amassed significant assets and wealth. Included within the asset base of the marital estate were numerous business ownership interests. Of particular interest, and the focus of the following discussion, was the marital estate's ownership of a combined 58.32 percent ownership interest in the equity of Land Advisors Organization, LLC (LAO).

In rendering her decision, the Honorable Ronee F. Korbin Steiner stated:

> The selection of an appropriate valuation date is at issue in this matter, along with the identified value of the business including whether discounts should be applied and/or whether the Court should apply a fair value or fair market value standard to the business. For the purpose of the dissolution, the parties have a 58.2% interest in Land Advisors Organization (LAO), the land brokerage firm. . . .

With regard to business valuation considerations, certain issues were addressed in the decision that often exert a significant impact on property settlement and property division in a marital dissolution. After providing a brief summary regarding LAO and the company's operating history, the subsequent sections discuss the issues identified by the court.

LAO

LAO represented a national land brokerage company that was established in 1987. LAO had offices in 10 states, which enabled the company to serve approximately 22 markets. With a focus solely on the brokerage of raw land, LAO operated as a highly ranked business in the industry, and reportedly was unlike any other business of its type in the country.

In addition to maintaining ownership in LAO, the husband also served as a commissioned broker at LAO.

In the years leading to the trial, LAO experienced significant volatility in revenue and earnings. Exhibit 1 summarizes the LAO reported revenue for calendar years 2010 through 2015, and management's projected revenue level for 2016 (as of year-end 2015).

Earnings demonstrated volatility comparable to that reflected in reported revenue for LAO over the period identified. The court's decision recognizes and acknowledges the cyclical, volatile nature of the real estate industry, and the expectation that such volatility would necessarily exert an impact on the value of LAO at different points in time.

The Appropriate Valuation Date

The impact of expected volatility in operating results for LAO was an important consideration of the court. Recognizing the nature of LAO operations, the husband and wife jointly retained Kotzin Valuation Partners (KVP) to estimate the value of LAO to facilitate the property division. The engagement completed by KVP ultimately resulted in KVP providing opinions of value regarding LAO effective as of December 31, 2013, December 31, 2014, and December 31, 2015.

Specifically, KVP rendered (1) a "valuation" opinion effective as of December 31, 2013 (the "2013 Valuation"), (2) a "calculation" opinion effective as of December 2014 (the "2014 Calculation"), and (3) a "calculation" opinion effective as of December 31, 2015 (the "2015 Calculation").

Because the dissolution was initiated in January 2014, and due to the extended term of the divorce, KVP received multiple requests to "update" the 2013 Valuation. The fact that multiple opinions of value regarding LAO were provided to the Court by a jointly retained valuation analyst forced the Court to render an opinion regarding the most appropriate valuation date.

In arriving at a final opinion regarding the appropriate valuation date, the Court considered the "cyclical and volatile nature of the industry,"

Exhibit 1
LAO Reported and Projected Revenue
Calendar Years 2010 to 2016

($mil.)	2010	2011	2012	2013	2014	2015	Average	Projected 2016
Revenue	6.8	9.8	16.5	20.1	18.2	13.1	14.1	19.0

determining that the valuation date of December 31, 2014, was appropriate. The court also cited the following factors as considerations in forming an opinion regarding the appropriate valuation date:

1. Because the original trial date was set for November 23 and 24, 2015, there was no reason for the husband to believe that the court could be presented a valuation opinion based on a December 31, 2015, valuation date.
2. The projections of the LAO were significantly higher than the company was performing.
3. Evidence reflected that homebuilders overbought in 2012 and 2013.
4. There was no evidence presented that the husband purposefully curtailed his work efforts in 2015 to drive down the value conclusion of LAO.
5. Under cross-examination, KVP admitted that 2015 income assessments resulted in the overstatement of the value of LAO in the 2014 Calculation.

Fair Value or Fair Market Value

In arriving at an opinion regarding whether the fair value or fair market value standard was relevant with regard to the marital estate's 58.32 percent equity interest in LAO, the court cited numerous factors in arriving at the conclusion that fair market value was appropriate:

1. Testimony provided by independent legal counsel who helped develop the LLC operating agreement established that a 58.32 percent equity interest in LAO did not confer control to the marital estate. The operating agreement clearly established that a 60 percent "supermajority interest" was required for control.

   While the husband served as the manager, but not the managing member, of a related LLC that owned an interest in LAO, it was determined that the husband did not control the ownership of the related LLC. Therefore, contrary to the position posited by the wife's analyst, it would be inappropriate to aggregate the related LLC ownership interest in LAO with the marital estate's ownership interest, which would have resulted in a supermajority interest.
2. The operating agreement of LAO, and testimony provided by independent legal counsel, established that there were significant limitations on the ability to transfer an interest in LAO, including the required approval of a majority interest of the nontransferring members and the written consent from all members to the transfer of all rights. The only transferable rights included the right to receive distributions, profits and losses if the supermajority agreed to the transfers.
3. The effective transfer of the LAO interest would not enable the husband to provide any assurance that the purchaser would become the manager of LAO, and the husband has no legal ability to confer such a right.
4. A sale of LAO in its entirety would require all members to consent.
5. The husband is effectively purchasing his wife's interest currently, tax-free to the wife. Uncertainty exists regarding whether the husband will ever realize cash in exchange for the 58.32 percent interest in LAO, although it is likely he will "continue to earn significant funds through commissions and/or distributions."

   Even if the husband is included in a sales transaction (a transaction that requires the consent of all the owners of LAO), "a buyer of his interest is only going to be willing to pay him a discounted amount for it because it is not a controlling interest."

Based on consideration of the factors identified, the court concluded that fair market value was the appropriate standard. Further, the court accepted discounts for lack of control and lack of marketability of 15 percent and 25 percent, respectively.

Reasonableness

While issues regarding the relevant valuation date and the relevant standard of value were significant in the court's decision, possibly of equal significance was the court's opinion regarding an important assumption incorporated in the valuation process. This assumption relates to the development of a reasonable level of normalized earnings in the direct capitalization method.

In summary, the opinions of value KVP presented regarding LAO as of each valuation date were based on the direct capitalization method. To complete the direct capitalization method as of each of the three valuation dates, KVP applied differing levels of weight to projected LAO operating results for the year immediately following each valuation date.

Willamette Management Associates was retained as the valuation analyst for the husband to provide a critique and rebuttal calculation, and this author served as the testifying expert. We argued that the KVP value conclusions as of each valuation date were overstated based on the fact that KVP had attributed excessive weight to management's projected operating results.

KVP applied 40 percent weight to the LAO management projections and 60 percent weight to historical (average) results for the purpose of estimating normalized earnings included in the direct capitalization analysis.

During the course of trial, the following points were established:

1. LAO operated in a cyclical industry, resulting in earnings expectations that are highly variable and difficult to project on an annual basis.
2. LAO "likely case" management projections were viewed internally as a "motivational tool" for commissioned agents.
3. LAO projected revenue for 2014 and 2015 was 40 percent higher and 27 percent higher, respectively, than actual revenue.

As stated by the court:

> The Court finds that relying on the 2015 "likely case" projection—representing a one-year, single period projection of revenue—to estimate the value of a highly cyclical business, without considering a normal operating period to develop a reasonable estimate of sustainable, long-term earnings for LAO, renders the Kotzin Calculation for 2014 flawed and unreliable as to the ultimate value.

While the court acknowledged that there was subjectivity involved in the process of estimating normalized earnings for LAO, the court favored our weighting—25 percent to management projections and 75 percent to historical average earnings—citing the fact that we considered a longer operating history for the purpose of developing the weights applied.

In essence, the court took notice of the fact that LAO had achieved the 2016 management projected revenue level only once in the prior five-year operating period. While this would translate into a weight (i.e., "probability") of 20 percent, the court appears to have taken notice of the fact that applying a 25 percent weight, rather than a 20 percent weight, to management projections was not in favor of the husband, who had retained us.

Exhibit 2 presents a summary of the fair value and fair market value conclusions regarding LAO as of December 31, 2014, presented to the court.

Based on the considerations previously described and related testimony and evidence presented, the court concluded that the appropriate indication of the value of LAO as of December 31, 2014, was our estimate of the fair market value of $5,518,000.

Summary of Noble

Noble represented a dissolution of marriage action in which the parties maintained a 100 percent ownership interest in Noble Associates, LLC (NALLC) and a 60 percent ownership interest in DC London, Inc. (DC London). The parties stipulated to a December 31, 2014, valuation date.

In rendering his decision, the Honorable Joseph Kreamer stated:

> Although the parties' experts have multiple areas of disagreement, the two critical ones are (1) whether it is proper to combine the two entities in order to properly value the community interest, and (2) how to view DC London's performance in 2012. . . .

The two areas of disagreement identified by the court resulted in a significant difference in value opinions offered. The wife's analyst, Dwight Duncan

Exhibit 1
LAO Reported and Projected Revenue
Calendar Years 2010 to 2016

	Fair Value Low Indication	Fair Value High Indication	Fair Value	Fair Market Value Low Indication	Fair Market Value High Indication	Fair Market Value
KVP	$11,740,000	$15,094,000		$7,484,000	$10,139,000	
WMA			$8,655,000			$5,518,000

(Duncan), opined that valuing the two entities on a combined basis, and assuming that DC London's 2012 performance would be repeated on a regular basis was appropriate. As a result, and based on a 20-year projection, Duncan concluded that the fair market value of the community interest was $12.5 million.

Willamette Management Associates was retained as the valuation analyst for the husband. As the testifying expert for the husband, it was our opinion that the two entities should be valued separately, and that DC London's 2012 performance was an anomaly that would not repeat. As a result, our combined opinion of the fair market value of the community interest was approximately $1 million.

After providing a brief summary regarding NALLC and DC London, the subsequent sections discuss the issues identified by the court.

NALLC

NALLC represented a sole proprietor political consulting firm established by the husband in 2008. In 2009 and 2010, the firm experienced considerable growth when it was retained to develop strategy to challenge President Obama's proposed health care reform. The health care strategy evolved into a strategy to win Republican seats in the U.S. House of Representatives.

In calendar year 2010, the firm managed nearly $60 million in expenditures and activity in more than 100 Congressional districts. However, the husband remained the sole employee of NALLC, with all operating activity implemented through the efforts of subcontractors.

NALLC continued to operate in 2011 and 2012, although activity was limited to managing an agreement with a media vendor for ads related to the health care issue. The agreement expired at the end of 2012, and NALLC effectively became a dormant entity, although it retained ownership of a condominium unit in Washington, DC.

DC London

DC London was established in 2010 as a national, full-service political consulting firm. According to the husband, DC London was formed in direct response to demands placed on the husband by a key client relationship to establish a more formal organization (relative to the sole proprietorship structure of NALLC). The goal was to develop a political consulting company that could take on larger projects and clients that required more individual attention. Additionally, such an organization would be able to offer a full-service suite of capabilities rather than offering only project management and the introduction of clients to vendors.

In 2012, and as a result of being selected to manage more than $300 million in funding provided by the Koch seminar with regard to the presidential election, DC London recognized gross revenue in excess of $47 million. The level of revenue recognized in 2012 was six times higher than any other year and over $20 million more than the combined revenue for 2011, 2013, 2014 and 2015.

Should NALLC and DC London Be Valued on a Combined Basis?

At trial, the wife's analyst testified that NALLC and DC London should be valued on a combined basis. The wife's analyst testified that DC London essentially was a continuation of NALLC, created by the husband to reduce the community's interest in his business. Further, the wife's analyst testified that the husband fraudulently conveyed the clients and goodwill of NALLC to DC London for no consideration, and "gave" a portion of DC London to two individuals for no consideration.

In arriving at the opinion that NALLC and DC London should be valued as two separate entities, the court offered the following:

1. DC London was formed well before the husband filed for divorce, and if the husband wanted to defraud his wife or otherwise keep DC London's revenue away from her, he would have filed earlier, before DC London's revenues exploded in the 2011-2012 timeframe.
2. The husband testified that the Koch network wanted him to form a more formal organization to continue his work with them, and he was advised by legal counsel to create a new entity.
3. Testimony provided by one of two other owners indicated that the two other owners

in DC London were an important part of DC London's ability to expand from NALLC's one-man business model, and they would not have continued without having some stake in the business.

4. Finally, all of the evidence points to a conclusion that the formation of DC London actually benefited the community. DC London was able to seize on the opportunities with the Koch network following the 2010 election, and this resulted in a significant increase in revenue to the community.

As a result of the factors identified, the court concluded that (1) DC London was not created to defraud the wife and (2) the husband's actions did not constitute a breach of fiduciary duty. Therefore, the court concluded, contrary to the position posited by the wife's analyst, that there was no basis to combine the two entities for valuation purposes, stating that to do so "would essentially value a company that does not exist."

How Should DC London's Performance in 2012 Be Viewed for Valuation Purposes?

In arriving at the opinion that DC London's 2012 operating results represented an anomaly, and should not be incorporated in the valuation of DC London, the court offered the following:

1. The testimony established that DC London's exploding revenue in 2012 was due almost entirely to its relationship with the Koch network.
2. The husband's testimony that DC London was essentially scapegoated after the 2012 election and that the Koch network quickly shifted its resources elsewhere was uncontroverted.
3. Adding to DC London's challenges, the husband was publicly identified as "the dark money man" in a February 14, 2014, article published by Pro Publica. The article was not only critical of the husband's role in funneling millions of dollars of the Koch network money through the Center to Protect Patient Rights, but also suggested that he excessively profited from his role with the Koch network.
4. It appears that there are no "cash cows" on the horizon that will ever provide anywhere near the level of revenue that the Koch network provided in 2012.

In summary, the court agreed with the husband's position that the circumstances indicated that DC London's 2012 success should be considered a nonrecurring event.

As stated in the decision:

> The Court is not particularly fond of the absolute nature of either approach, but under the circumstances, the court believes that Mr. Wilhoite's approach provides the most accurate analysis. . . . The Court finds that Mr. Wilhoite's characterization of 2012 as the year that DC London bought a winning Powerball ticket to be for the most part fair.

The court did go on to state that while it believed that Willamette Management Associates had the better position regarding how to treat 2012, it was uneasy with an analysis that simply ignores a presidential election year. That having been stated, the court emphasized that it did not have a sound analytical basis to disagree with both analysts and simply insert its own 2012 revenue number, then attempt to utilize that number to create its own value for DC London. As a result, the court concluded it was appropriate to adopt our opinion regarding the value of NALLC and DC London.

Conclusion

In both the *Vogel* and *Noble* matters, the decisions rendered by the court were affected significantly by the concept of reasonableness. In *Vogel*, the court concluded that the value opinion based on the direct capitalization method completed by a jointly retained analyst was overstated based on the fact that the analyst attributed unreasonable weight to company projections.

In *Noble*, the court concluded that the value opinion based on the discounted cash flow method completed by the wife's analyst was overstated. In that matter, the wife's analyst developed a projection for the subject company that incorporated the assumption that the operating results for the subject political consulting firm would increase dramatically every four years as a result of the anticipated impact of the presidential election.

In summary, courts frequently remind legal counsel and financial experts that while education, training, qualifications and experience are necessary to develop and render supportable opinions, such opinions may not persuade the court if they fail the test of reasonableness.

Charles Wilhoite is a managing director at Willamette Management Associates, based in the firm's Portland, Oregon, practice office. Charles can be reached at (503) 243-7500, or at cawilhoite@willamette.com.

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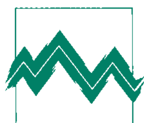

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773 • 399 • 4310 (fax)

1355 Peachtree Street, NE
Suite 1470
Atlanta, GA 30309
404 • 475 • 2300
404 • 475 • 2310 (fax)

Relevance of Discounts for Lack of Control and Lack of Marketability in Marital Dissolution Matters

Natasha M. Perssico, CPA

A discussion of the application of valuation discounts for lack of control and for lack of marketability in marital dissolution cases is predicated upon an understanding of (1) the standards of value commonly applicable in marital dissolution cases, (2) the valuation methods used and the resulting value level to which discounts are applied, (3) the specific control and liquidity facts and circumstances relevant with regard to the subject business interest, and (4) the relevant statutes and case law applicable in the jurisdiction in which the marital dissolution proceedings are taking place.

Introduction

Business ownership interests includable in marital estates can range from a small, fractional equity interest in a partnership, limited liability company, or corporation, to the total equity value of an entity. Further, the subject interest could be fully liquid, represented by stock in a publicly traded corporation, or relatively illiquid, represented by an equity interest in a private company.

Typically, valuation analysts ("analysts") are retained in a marital dissolution context to estimate the "value" of an ownership interest in a closely held company, based on the fact that the value of publicly traded equity is readily determinable in the marketplace. In such engagements, analysts are often faced with the challenge of determining the relevance, applicability, and level of a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM) when the subject interest represents a noncontrolling equity interest in a privately held company.

The following discussion identifies DLOC and DLOM considerations that analysts typically consider when rendering opinions in a marital dissolution context involving the valuation of a noncontrolling equity interest in a privately held company. Such considerations include the following:

- Standards of value
- Value estimates provided by different valuation approaches
- Rationale for a DLOC
- Rationale for a DLOM
- Diversity in the application of a DLOC and a DLOM

Standards of Value in Marital Dissolution Matters

Analysts define a standard of value as part of the valuation process. Two common standards of value used in business valuations of closely held businesses for marital dissolution cases are fair market value and fair value. Other less commonly used standards of value are book value, adjusted book value, going-concern value, investment value, and liquidation value.[1]

Because the standards of value applicable to marital dissolution matters vary on a state-by-state

basis, legal counsel and analysts refer to a particular jurisdiction's statutes and case law to determine the appropriate standard of value that should be used.

Some jurisdictions use fair market value, while others reference the terms "fair value" or simply "value" in marital dissolution statutes. The full meaning of fair value depends on the context of its use. It may be dictated by the court with jurisdiction over the case. Typically, fair value as a standard of value precludes the application of noncontrolling discounts. However, in some cases, no further definition of these terms is provided.

For all federal and state tax matters, including estate taxes, gift taxes, inheritance taxes, income taxes, and ad valorem taxes, the applicable standard of value is fair market value.[2] The Internal Revenue Service (the "Service") defines fair market value as follows:

> The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts.[3]

Fair value, though statutorily defined in most cases, is generally understood within the valuation profession to represent the pro rata, or allocated, portion of the total value of a company established on a controlling basis. Generally, the fair value of a subject interest is understood to be established absent the impact of a DLOC or a DLOM.

Based on the fair market value standard, many analysts apply discounts, such as a DLOC and a DLOM, to estimate the value of noncontrolling equity interests in marital dissolution settings. Based on the prevalence of the fair market value standard in the marital dissolution context, the focus of this discussion will be on fair market value and the relevance and application of a DLOC and a DLOM.

Even if a certain jurisdiction's applicable standard of value is fair market value, attorneys and analysts should still refer to relevant case law for guidance on the characteristics that comprise a particular standard of value. In reviewing past cases in a jurisdiction, an analyst may find that certain procedures, such as applying a DLOC or a DLOM, are disallowed in marital disputes in that particular jurisdiction.[4]

Value Estimates Provided by Different Valuation Approaches

In order to understand the economics principle behind applying a valuation discount to the equity value of an entity, consider that equity value is often estimated from the perspective of an investor who can directly buy or sell the underlying asset(s)— that is, from a controlling, marketable ownership perspective.

Depending on the specific valuation method applied, the generally accepted business valuation approaches will produce a value indication(s) with certain assumed ownership characteristics (e.g., controlling versus noncontrolling, marketable versus nonmarketable).

Ignoring any specific jurisdictional guidance relevant in a specific marital dissolution context, the appropriateness of applying a DLOC or DLOM is, in part, contingent upon the selected valuation method, as well as the ownership characteristics inherent in the subject interest.

For example, assume the subject interest in a business valuation engagement represents a noncontrolling, nonmarketable ownership interest. Further, assume the valuation approaches and methods relied on initially produce a value indication on a controlling, marketable basis. If the objective of the engagement is to estimate the fair market value of the subject interest on a noncontrolling, nonmarketable basis, typically it would be appropriate to consider the specific application of a DLOC and a DLOM—or an aggregate discount representing a combination of the two discounts—to the initial, indicated controlling, marketable equity value to achieve the engagement objective.

"A noncontrolling ownership interest in a company typically is subject to restrictions and to other limitations that are not reflected in the market value of the underlying assets owned by the entity."

Applying the subject interest ownership percentage to the total noncontrolling, nonmarketable equity value results in the fair market value of the subject interest on a noncontrolling, nonmarketable ownership interest basis.

Rationale for a Discount for Lack of Control

An ownership interest in a company that represents 100 percent of the equity value of the company usually provides the holder of the interest absolute, or total, control. Such a position typically affords the owner unilateral decision-making authority over the company, including valuable prerogatives of control that typically are not available to the owner of an interest representing less than a controlling ownership.

A noncontrolling ownership interest in a company typically is subject to restrictions and to other limitations that are not reflected in the market value of the underlying assets owned by the entity.

Some common prerogatives of control that are not available to the holder of a noncontrolling ownership interest include the ability to perform the following:

1. Select the management of the company
2. Determine management compensation and perquisites
3. Set investment policy and change the course of company business
4. Acquire and/or liquidate company assets
5. Borrow funds on the behalf of the company
6. Liquidate, dissolve, sell, or recapitalize the company
7. Declare and pay distributions

A noncontrolling ownership interest, in general, typically lacks these prerogatives of control. As a result, a noncontrolling ownership interest in the subject company is usually worth less, on a per-share or a per-ownership-unit basis, than an ownership interest that has unilateral control.

For example, the asset-based approach asset accumulation method generally produces a controlling ownership interest level of value. This is based on the premise that, typically, only a controlling-level owner has the prerogative to make decisions regarding the assets of the subject company. These decisions may include, for example, whether to replace or liquidate the subject assets or whether to put the subject assets to their highest and best use on a going-concern basis.

Noncontrolling shares that do not confer the authority to make such controlling-level decisions typically would sell at a discount relative to controlling shares due to lack of control. "If the application of the asset accumulation method encompasses (1) the value of all the financial assets, (2) the value of all of the tangible assets (at their highest and best use), and (3) the value of all the intangible assets, then a lack of control discount normally may be applied in order to indicate a noncontrolling equity ownership interest level of value."[5]

Rationale for a Discount for Lack of Marketability

The difference in price that an investor will pay for a liquid asset (i.e., stock in a publicly traded company) compared to an otherwise comparable, illiquid asset (i.e., stock in a nonpublic company) may be substantial. This difference in price is commonly referred to as the DLOM.

The DLOM measures the difference in the price of (1) a liquid asset (the benchmark price measure) and (2) an otherwise comparable, illiquid asset (the valuation subject).

In *Mandelbaum v. Commissioner*,[6] U.S. Tax Court Judge David Laro cited nine specific (but nonexclusive) factors to consider in developing a DLOM:

1. Financial statement analysis
2. Dividend history and policy
3. Nature of the company, its history, its position in the industry, and its economic outlook
4. Company management
5. Amount of control in the transferred shares
6. Restrictions on transferability
7. Holding period for the stock
8. Subject company's redemption policy
9. Costs associated with a public offering

The liquidity inherent in a particular subject interest typically does not reflect either a marketable or nonmarketable circumstance. Rather, marketability generally occurs on a continuum. Analyst judgment, based on consideration of the facts and circumstances in each case and relevant empirical data, typically serves as the foundation for the applicability and appropriate level of a DLOM.

Diversity in the Application of DLOC and DLOM

The application and acceptance of a DLOC and DLOM in a marital dissolution context varies in court systems from state to state. In *Montisano v. Montisano*,[7] an Ohio case, the appeals court affirmed the lower court's decision to disallow a DLOC or DLOM for the husband's noncontrolling position in a closely held travel company, despite the fact that the noncontrolling position was subject to a restrictive buy-sell agreement.

In a separate Ohio case, *Caldas v. Caldas*,[8] the appellate court upheld the trial court's decision to accept the husband's expert's report, which applied a 75 percent DLOM to a subject interest in a closely held company on the grounds that (1) the company had section 8A preference due to the husband's noncontrolling status and (2) the company relied upon the husband's security clearance in obtaining government contracts. The appellate court affirmed that the decision to discount the subject interest for lack of marketability was reasonable considering the risky nature of the business.

After the valuation date, but prior to trial, the husband's security clearance was revoked. The appellate court noted that the fact that the security clearance was lost indicates that the business did involve a high degree of risk.

In re the Marriage of Mann,[9] an Iowa case, the court of appeals upheld the trial court's valuation of husband's insurance sales and financial planning business on a hypothetical investor standard. Further, the court determined that the application of a DLOM was appropriate to account for the fact that the husband's business was a "small, sole proprietorship dependent upon its relationship with a single, large corporate entity."

In *Kussatz-Jakobson v. Jakobson*,[10] a Minnesota case, the trial court accepted the husband's expert's application of a lower DLOM based on the husband's testimony that he had no current intent to sell the business. The court of appeals upheld the trail court's valuation.

In *Berenberg v. Berenberg*,[11] another Minnesota case, the trial court disregarded the price set by an extant buy-sell agreement. The court opted to uphold a higher value with the rationalization for doing so being that another family member in the business had sold shares at a value above the specified buy-sell price. The court also applied a 35 percent combined DLOC and DLOM to account for restrictions on the ability to sell the subject interest. The court of appeals upheld the trail court's decision.

In re the M*arriage of Tofte*,[12] an Oregon case, the wife's expert argued that a 35 percent DLOM was inappropriate for the following reasons:

1. The annual return to the business, in the form of a yearly bonus to the husband, was sufficient to compensate for lack of marketability.

2. The discount was inappropriate since the husband had no intent to sell the business.

The appeals court affirmed that the application of the 35 percent discount was appropriate citing the following:

1. Oregon courts have applied noncontrolling and marketability discounts without regard to whether there is an intent to sell the subject interest or not.
2. The husband's bonus was not related to the number of shares held and, therefore, had no bearing on the discount.

In another Oregon case, *In re the Marriage of Batt*,[13] the wife appealed the application of a 25 percent DLOM in determining the value of the husband's interest in the family farming business. The wife argued that the husband had no intent to sell the business, and if the farming business interest was sold, it would be to family members or there would be a sale of the entire property by all of the co-owners of the farming operation. Based on these assumed circumstances, a DLOM was inappropriate.

The appeals court referred to *Tofte v. Tofte* in considering the lower court decision, citing that Oregon courts previously have held that the absence of an intent to sell the subject interest does not necessarily render a DLOM to be inappropriate.

However, the court also referred to *Barlow v. Barlow*,[14] another case involving a family farming business. The court stated that the underlying assumption for discounting is that only part of the stock (or interest) will be sold and that the remainder will be held by other shareholders (or members). The court quoted *Barlow* stating, "when that assumption is not supported by the evidence, a discount my not be proper." The court considered the similarities and differences between the *Barlow* facts and the *Tofte* facts and concluded that a DLOM was not appropriate based on the facts in the *Batt* matter.

Conclusion

Based on the small sampling of marital dissolution cases discussed, it is clear that business valuations completed in a marital dissolution context are situation-specific engagements. Such engagements require customized evaluation by legal counsel and analysts. Furthermore, the applicability of a DLOC and a DLOM in a marital dissolution context will vary depending on the state.

Application of such discounts requires consideration of factors such as (1) the applicable standard of value and (2) the valuation methods allowed and the resulting value basis to which discounts are applied.

Analysts should develop an understanding of the control and liquidity facts and circumstances regarding the subject interest that serve as the foundation for a particular DLOC and DLOM. Additionally, analysts may confer with legal counsel and refer to relevant statues and case law for guidance regarding the application of a DLOC and DLOM on a jurisdiction-by-jurisdiction basis.

Notes:

1. Robert E. Kleeman Jr., R. James Alerding, and Benjamin D. Miller, *The Handbook for Divorce Valuations* (New York: John Wiley & Sons, 1999), 7.
2. Shannon P. Pratt, "Defining Standards of Value," *Valuation* 34, no. 2 (June 1989).
3. Treasury Regulation Section 25.2512-1.
4. Allied Business Group, "Business Valuation Issues in Divorce" (February 2014).
5. Robert P. Schweihs, "Levels of Control," Willamette Management Associates *Insights* (Autumn 2011).
6. Mandelbaum v. Commissioner, T.C. Memo 1995-255 (June 13, 1995).
7. Montisano v. Montisano, No. 15915, 1993 WL 208324 (Ohio Ct. App. June 16, 1993).
8. Caldas v. Caldas, No. 20691, 2005 WL 2077783 (Ohio Ct. App. Aug. 19, 2005).
9. In re the Marriage of Mann, No. 01–1514, 2002 WL 31310022 (Iowa Ct. App. Oct. 16, 2002).
10. Kussatz-Jakobson v. Jakobson, No. C5-03-143, 2003 WL 22289924 (Minn. Ct. App. Oct. 7, 2003).
11. Berenberg v. Berenberg 474 N.W.2d 843 (Minn. Ct. App. 1991).
12. In re the Marriage of Tofte, 134 Or. App. 449, 895 P.2d 1387 (1995).
13. In re the Marriage of Batt, 149 Or. App. 517, 945 P.2d 517 (1997).
14. Barlow v. Barlow, 111 Or. App. 179, 826 P.2d 18 (1992).

Natasha Perssico is a senior associate in the Chicago office. Natasha can be reached at (773) 399-4313 or at nmperssico@willamette.com.

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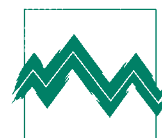

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Integrity

(The author wishes to remain anonymous)

*"If you have integrity, nothing else matters.
If you do not have integrity, nothing else matters."*[1]

Introduction

Whether a legal professional or a valuation analyst, providers of professional services in a marital dissolution context have the responsibility, and the fiduciary obligation, to provide services in a professional manner at the highest level of integrity. Though retained by clients, professional service providers are serving the court.

This discussion addresses the following traits from the perspective of a professional service provider:

- Character
- Honor
- Serving the public interest while honoring the public's trust
- Integrity

Case Fact Set

"Mom, who are we? Are we who we say we are?"[2] And so the family meeting ended with the decision made to divide very valuable community property assets equally with the mom's ex-husband. The following story is a personification of integrity that exemplifies the honesty, ethics, and trustworthiness that expert witnesses and lawyers alike should demonstrate in every aspect of their professional and personal lives.

Lindsay (the mom) was packing the personal belongings of her ex-husband for his retrieval. Lindsay went through a grueling divorce trial against her ex-husband, who some said had absolutely no regard for his obligation to tell the truth under oath, and his lawyer, whose zealousness to prevail, some said, seemed unbounded by the Rules of Professional Conduct. Lindsay, on the other hand, told the truth under oath, even when it hurt her case and even when she could have lied without detection. I failed to prevail on Lindsay's behalf and the ruling against her was devastating.

After trial, Lindsay's ex-husband and his lawyer were adamant in their demands that Lindsay return the ex-husband's personal belongings, including one-half of a collection of community property valuables that remained in the safe at Lindsay's home. They repeatedly reminded Lindsay of their careful pre-trial inventory of the collection, and that their accounting of the number due to the ex-husband was precise. The consequences of her failure to comply with their demands were unstated but, given their trial tactics, were an unpleasant prospect.

Lindsay and her children from a previous marriage were gathering the ex-husband's property and carefully packaging it, as would be expected of a woman of her character. Lindsay finally opened the home safe to get the collection of valuables for division and packaging. To her astonishment, the collection did not match the oft-stated inventory—there were *far more* valuable collectibles than were on the inventory.

The disposition of thousands of dollars' worth of unaccounted-for collectibles was now in the hands of the one who had told the truth, been subject to needless ridicule, and who felt she had unfairly lost. Neither the ex-husband, his lawyer, nor I would have ever known of the existence of the unaccounted-for assets. Like finding a wallet full of cash on a remote hiking trail, no one would have ever known what

happened to it. No one, that is, except the one who found it.

"The Measure of a Man's Real Character Is What He Would Do if He Never Would Be Found Out"[3]

Lindsay and her family did not need to audibly answer her son's questions: "Who are we?" and "Are we who we say we are?" They equally divided the overlooked collectibles, packaged them up with her ex-husband's personal belongings, and returned everything to him, including his share of the unexpected bounty of collectibles.

As professionals whose livelihoods depend on our reputations for truthfulness, character, and integrity, we must be ever mindful of "Who we are" and "Are we who we say we are?"

We must be ever vigilant to guard our positions of trust and be true to our fiduciary duties. Lawyers and expert witnesses enjoy positions of trust that can easily be violated with little risk of discovery. Hiding a fact here, shading a fact there, or taking advantage of the opposition's unintended mistake are the collectibles in the safe and the wallet on the remote trail for lawyers and expert witnesses.

Fortunately, lawyers and expert witnesses have at their disposal various Rules of Professionalism and Codes of Conduct that serve as the foundation to their efforts to be professionals with integrity.

"Lawyers Should Conduct Themselves Honorably"[4]

The Rules of Professional Conduct governing lawyers include extensive and explicit references to truthfulness, character, and, by direct extension, integrity. The Preamble to Arizona's Ethical Rules (ERs) admonishes lawyers that they have a "special responsibility for the quality of justice. Whether or not engaging in the practice of law, lawyers should conduct themselves honorably."[5]

Lawyers have a duty of candor towards the tribunal.[6] Lawyers cannot make false statements of fact or law to the court, nor may they knowingly permit false statements to be made.[7] If a lawyer discovers that she, or even her witness, has proffered false testimony, she has an affirmative duty to "take reasonable remedial measures, including, if necessary, disclosure to the tribunal."[8]

This duty applies "even if compliance requires disclosure of information otherwise protected by ER 1.6 [client confidentiality]."[9] Thus, the duty of candor towards the tribunal is so demanding that, in some circumstances, lawyers must breach the otherwise sacrosanct duty of keeping client communications confidential.

Lawyers have duties of fairness to opposing parties and counsel.[10] Lawyers must not alter, conceal, or destroy any information of potential evidentiary value.[11] They must not permit or counsel anyone else to do so either, including expert witnesses.[12] Lawyers may not falsify evidence, nor assist anyone else to do so.[13] Thus, lawyers must pursue their cases fairly and they cannot encourage witness misconduct; nor can they tolerate or overlook it.

Lawyers must always be truthful in their statements to others.[14] They may not make false statements of material facts or law, nor may they fail to disclose material facts when "disclosure is necessary to avoid assisting a criminal or fraudulent act by a client, unless disclosure is prohibited by ER 1.6 [client confidentiality]."[15] Thus, even when doing so is painful, lawyers must ensure that they tell the truth.

Lawyers must always show respect for the rights of others, including opposing expert witnesses.[16] Lawyers may not use litigation tactics "that have no substantial purpose other than to embarrass,

delay, or burden any other person, or use methods of obtaining evidence that violate the legal rights of such person."[17]

In my practice, I have been fortunate enough to engage, and to oppose, the best of the best of expert witnesses, primarily valuation and forensic accounting experts. I commence every engagement with an express notice that all of my communications with my experts are discoverable, which is a reminder that "the world may see" the level of our professionalism, or lack thereof. And I tell my experts that I expect from them only "the truth." The facts are what they are; we can handle anything so long as it is the truth.

Showing respect for an opposing expert does not equate with a soft touch or even gentleness. The very best experts sincerely believe in their work and opinions; they will not be swayed easily by vigorous cross-examination, nor should they be. The best experts expect the opposing lawyer to confront them with the lawyer's best cross-examination.

When I cross-examine an exceptional expert, I enjoy sometimes seeing that wry smile on the face of the witness—a clear indication that we are both giving it our best. After one trial, I called an expert whom I felt I had blistered rather harshly under cross-examination, perhaps unfairly so. His response? "Oh no, Jeffrey, you did exactly what I expected of you. You brought your best and so did I. When are we having lunch?" This gentleman is among the best in my jurisdiction and he understands that vigorous cross-examination is a respectful search for the truth and, if done professionally, permits the fact-finder to discern the facts (and, when done with professionalism, enjoy a lively battle).

It is professional misconduct for lawyers to "engage in conduct involving dishonesty, fraud, deceit or misrepresentation," or to "engage in conduct that is prejudicial to the administration of justice."[18] From an expert witness's perspective, this includes any attempt by your hiring lawyer to ask you, expressly or impliedly, to do anything that would compromise your duty, as the Uniform Standards of Professional Appraisal Practice (USPAP) put it, to "promote and preserve the public trust inherent in appraisal practice by observing the highest standards of professional ethics."[19]

"Serve the Public Interest, Honor the Public Trust"[20]

Like the Rules governing the conduct of lawyers, the Codes governing the conduct of appraisers, accountants, and examiners include extensive and explicit references to truthfulness, character, and integrity as well, perhaps even more references than lawyers' Rules.

Consider the American Institute of Certified Public Accountants' (AICPA) professional code of conduct that "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism."[21] Or, the American Society of Appraisers' admonition that "The appraiser's primary obligation to his/her client is to reach complete, accurate, and credible conclusions and numerical results regardless of the client's wishes or instructions in this regard."[22] Or, the Association of Certified Fraud Examiners' principle that "Certified Fraud Examiners shall conduct themselves with integrity, knowing that public trust is founded on integrity."[23] And, the Institute of Business Appraisers' guidance that "A member shall remain objective, maintain professional integrity, shall not knowingly misrepresent facts, or subrogate judgment to others. The member must not act in a manner that is misleading or fraudulent."[24]

Most codes governing the conduct of expert witnesses illustrate with great detail the lengths to which experts must go to "preserve the public trust" and to "maintain the integrity" of the profession and of the professional. Experts are required to always be impartial, unbiased, and independent.[25] Experts are not to "advocate the cause or interest of any party or issue."[26] And valuation experts may not "communicate a report that is known by the appraiser to be misleading or fraudulent."[27] Much like the Rules of Professional Conduct for lawyers, the Codes of Professional Conduct for valuation expert witnesses simply reflect how our character is to be measured, even "if [we] knew [we] would never be found out."[28]

"Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions."[29] What a wonderfully well-articulated standard of conduct promulgated by the AICPA.

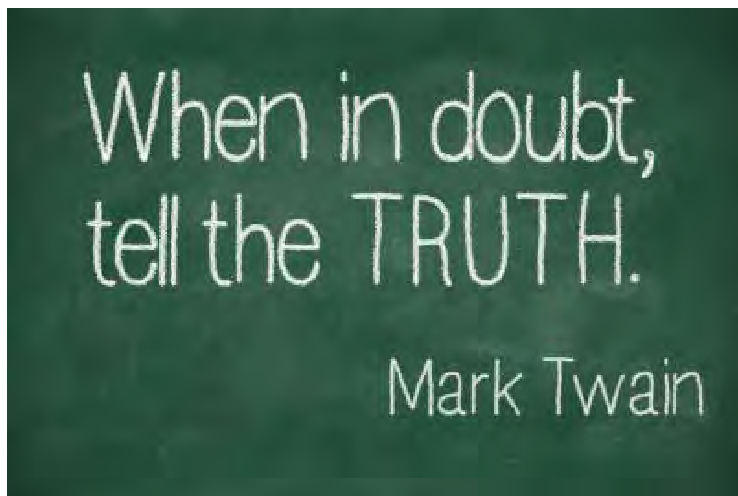
"Am I Doing What a Person of Integrity Would Do?"[30]

We are professionals, serving the public, seeking to earn the public trust and striving to maintain the highest standards of our respective crafts. Our livelihoods depend on our reputations, and our character and integrity are the foundation upon which our reputations rise, or fall. The AICPA, again, articulates a measurement for integrity exceedingly well:

> Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.[31]

When I was a child, my father took me to a store and, upon leaving, he noticed that the cashier had over changed him by a quarter. I was overjoyed at our good fortune. My father immediately took me back to the cashier to tell her of the mistake and return the quarter. He admonished me for having any thoughts of keeping the quarter, even though no one would have ever known. "Son," he gently but firmly said to me, "Our integrity is worth more to us than any amount of money." So, too, as professionals, our integrity is worth more to us than any client, any project, and any express or implied suggestion to do anything except that which "a person of integrity would do."[32]

Let your conscience be your guide in your professional endeavors. Let your Rules of Professional Conduct be your sword and shield against anyone who would ask you to sacrifice your integrity, even "just a little" or "just this once." When you take the oath on the witness stand, let lawyers and judges alike say, "This expert's reputation for integrity is unblemished; I trust what he or she has to say."[33]



Notes:

1. Alan Simpson, former U.S. Senator from Wyoming.
2. Quote from the son of one of my former clients during a family meeting to decide the disposition of valuables overlooked by her ex-husband. Shared with permission by my former client, whom I shall refer to as "Lindsay."
3. Thomas Babington Macaulay, British poet.
4. Arizona Rules of Professional Conduct, Preamble at ¶ 1.
5. Id.
6. Arizona Rules of Professional Conduct, ER 3.3. (The Arizona Rules are substantially similar to the American Bar Association's Model Rules of Professional Conduct.)
7. Id. at ER 3.3(a)(1)
8. Id. at ER 3.3(a)(3).
9. Id. at ER 3.3(c).
10. Id. at ER 3.4.
11. Id. at ER 3.4(a).
12. Id. at ER 3.4(b).
13. Id.
14. Id. at ER 4.1.
15. Id. at ER 4.1(b); but cf. ER 3.4(b).
16. Id. at ER 4.4.
17. Id. at ER 4.4(a).
18. Id. at ER 8.4(c) and (d).
19. Uniform Standards of Professional Appraisal Practice (USPAP) Ethics Rule, 2014-15 Edition.
20. American Institute of Certified Public Accountants (AICPA), Code of Professional Conduct, The Public Interest, ¶ 01.
21. Id.
22. American Society of Appraisers (ASA), Principles of Appraisal Practice and Code of Ethics, June 2015, at § 4.
23. Association of Certified Fraud Examiners (ACFE), Code of Professional Standards, 2014, at § III (A) (1).
24. Institute of Business Appraisers (IBA), Professional Standards, 2011, at § II (A).
25. USPAP Ethics Rule, Conduct.
26. Id.
27. Id.
28. See endnote 3, supra.
29. AICPA "Integrity," ¶ 02.
30. Id. at ¶ 04.
31. Id.
32. See endnote 28, supra.
33. My thanks to the following experts who generously contributed the professional association materials from which I gained invaluable insights and research for this discussion: Don Bays, Marc Fleischman, Mark Hughes, Lynton Kotzin, Frank Pankow, and Charles Wilhoite.

This discussion was written by a prominent attorney in the State of Arizona who is a Fellow of the American Academy of Matrimonial Lawyers™. Please direct any questions to the editor of this Insights *issue.*

Income Taxes and Value Considerations

Robert P. Schweihs

Typically, income taxes result in a reduction in the net earnings and cash flow resulting from business operations. Further, income taxes typically reduce the net proceeds realized from the sale of a business or a business interest. Currently, an entity can be legally structured in a variety of ways, with the various structures resulting in different income tax treatment. The recognition and understanding by a valuation analyst of the variety of legal operating structures available to companies, and related income tax implications, will enable the analyst to develop more complete valuation analyses and conclusions. Such considerations are relevant when providing valuation services in a marital dissolution context.

Introduction

Some observers have argued that income taxes don't matter with regard to investment decisions. For example, Warren Buffet has said that he has never seen an investment the merits of which depended on income taxes. Apparently, Warren Buffet hasn't seen any of the situations that valuation analysts ("analysts") regularly encounter in which income taxes do matter.

Analysts often encounter many types of situations in which the decision about how to treat income taxes is of material consequence, including in a marital dissolution context.

In many situations, analysts are asked to render an opinion regarding the value of the ownership of (1) a business entity, (2) a fractional ownership interest in a business entity, or (3) a business interest such as an intangible asset. In many of these situations, the analyst is applying the fair market value standard of value, and the analyst is focused on the income tax consequences facing the hypothetical buyer and seller of that subject ownership interest.

That is, the analyst is focused on the entity level after-tax cash flow that is attributable to that subject ownership interest. With regard to the measurement of after-tax cash flow, income taxes obviously matter.

In most business and security analyses, the income tax consequences at the owner's personal tax level are not analyzed. Tax consequences at the owner's personal tax level are usually not considered by the analyst because personal income tax attributes can be very different from one individual investor to the next.[1] However, in some situations, personal income tax consequences may be factored into the financial analysis.

In a marital dissolution context, regardless of the standard of value relevant in a particular jurisdiction, income tax consequences typically come into play when an analyst estimates earnings and cash flow relied upon to estimate the value of family-owned business interests included in a marital estate.

Examples

The observable price paid for certain types of assets is generally recognized to be the fair market value of those assets. For example, the observable price of a share of common stock that is actively traded in an efficient market is recognized as the fair market value of that share of stock. Generally, (1) the seller's tax basis in that share and (2) the broker fees paid to execute that transaction are not considered when estimating the fair market value of that share. Depending on how a transaction is structured, these transaction costs will differ relative to the various actual or potential transaction participants.

This same perspective is usually adopted when estimating the fair market value of many types of

assets. For example, when estimating the fair market value of a real estate or personal property (such as a machine or a piece of artwork), the appraiser does not consider (1) the seller's personal tax basis in the property or (2) the brokerage fees that might be involved in executing a sale transaction involving the asset.

The legal form of the business may affect its value, and diligent analysts will consider the relevant facts and circumstances regarding the ownership interest that is the subject of the analysis. For example, when analyzing a C corporation, a description of the characteristics of the hypothetical willing buyer and seller is less critical than when analyzing a tax pass-through entity. Almost any person or entity can be the owner of a C corporation.

In contrast, to maintain the tax pass-through entity status, the hypothetical willing buyer and seller of a pass-through entity will usually have to have certain characteristics. For example, the hypothetical buyer of an S corporation, in order to maintain the S corporation status, must be an eligible S corporation shareholder or else the S corporation status for the corporation (and for all of its other shareholders) may be lost.

Partnership agreements usually contain stringent restrictions regarding who is an eligible partner. Similarly, the organization documents of a limited liability company usually do not permit just anybody to become a member. The hypothetical buyer and seller referred to in the typical definition of fair market value, while not specifically identified, are presumed to be knowledgeable of all relevant information about the subject ownership interest.

A business that is organized as a tax pass-through entity may confer certain tax-related economic benefits to its owners. The taxable income earned by a pass-through entity is taxed only once—on the owner's personal income tax return.

A C corporation, in contrast, pays federal income tax on its taxable income first. The remaining taxable income (net of the company's income tax expense) will be taxable to the C corporation owner—but not until the after-tax income is distributed to the shareholder in the form of dividends. In this way, shareholders of a C corporation are subject to a so-called double taxation that does not affect owners of tax pass-through entities.

Assigning a value premium (or incremental adjustment) to a tax pass-through entity (compared to the value of an otherwise identical C corporation) may be a mistake for a variety of reasons, especially if there is a high risk that the tax pass-through entity status might be revoked. Additionally, an entity may have a history of failing to make sufficient distributions to cover the income taxes accrued on earnings allocated to pass-through owners. Such a circumstance, if expected to continue, would eliminate the need for a value premium.

Data on required rates of return are almost always based on the after-corporate tax return on an investment in a C corporation. That is because those after-tax returns are the data that are publicly available and most easily accessible.[2] Accordingly, valuation methods relying on earnings and cash flow developed on an after-tax basis should contemplate the impact of any perceived income tax rate differences.

Definition of the Valuation Assignment

To arrive at a meaningful valuation of a business or business ownership interest, an important early step is to clearly define the valuation assignment. Defining the valuation assignment is the logical beginning of the valuation process, providing focus for all the valuation considerations and efforts to be undertaken.

The definition of the valuation assignment typically will include a written identification of the assignment's objective and purpose. A clear definition of the valuation assignment will help explain the proper treatment of the income tax attributes that affect the value of the subject business or subject business ownership interest.

A typical objective of a valuation assignment in a marital dissolution matter may be to express an opinion of the fair market value of the ownership interest on a going-concern basis as of a specific valuation date.

A common standard of value that may be applied is fair market value. Fair market value is based on the price that the hypothetical buyer and seller would reach and does not concern itself with the proceeds that the seller will enjoy after paying the income taxes that would be due (and other transaction costs such as broker fees) if the proposed hypothetical purchase/sale transaction took place.

Often, a valuation assignment in a marital dissolution will be based on the premise that the business will continue to operate as a going concern at its highest and best use. The highest and best use is the reasonably probable and legal use of the ownership interest that is physically possible, appropriately supported, and financially feasible.

Based on the business valuation income approach, the fair market value of the investment is often measured as the present value of the future economic benefits that an investor would expect to receive. When applying the income approach,

the income tax attributes associated with owning the investment may be an important part of the analysis.

The definition of the assignment should spell out the intended use of the analysis and the intended users. The results of the assignment may not be relevant for any other purpose.

Purpose of the Analysis

The purpose of the analysis is the use to which the valuation result is expected to be put. Different statutory, regulatory, and judicial precedent standards govern valuations of businesses and business interests under various jurisdictions for different purposes.

The valuation analyses may fail to reach a meaningful result if the analyst failed to match the valuation methods to the purpose for which the analysis was being performed. The conclusion of a valuation analysis prepared for one purpose may not be the appropriate value conclusion for another purpose. The value conclusion of a particular analysis may be inappropriate, and an unfortunate business decision could be the result if the reader attempts to use the valuation conclusion for some purpose other than the intended one.

Most business valuation purposes can be grouped into one of the following categories:

1. Transaction pricing and structuring
2. Financing securitization and collateralization
3. Gift, estate, income, or property taxation planning and compliance
4. Owner/operator information and strategic planning
5. Bankruptcy and reorganization analyses
6. Forensic analysis and dispute resolution, including marital dissolutions
7. Financial accounting compliance and reporting
8. Regulatory compliance

Valuations performed for federal estate tax compliance purposes typically do not include the insurance proceeds that would be triggered by the death of the business owner even if the death of the owner is imminent and predictable. Depending on the structure of the policies and their ownership, life insurance proceeds may not be taxable. However, the cash value of a life insurance policy may be taxable if redeemed before the death benefits are paid. This consideration may not be appropriate if the purpose of the business valuation is different than estate tax compliance.

Fiduciaries such as trustees have a duty to make decisions that are in the best interests of the beneficiary of their efforts. A fiduciary viewpoint may also affect an analyst's decision about how to treat certain risk factors facing a business. For example, it may not be reasonable for an analyst to assign a valuation adjustment (i.e., a discount) that results in a lower value due to an avoidable built-in gains tax by assuming the sale of an asset of the marital estate if a party who can avoid incurring the built-in gains tax has a fiduciary duty to maximize the value of the marital estate.

When analyzing either an offer price or the structure of a transaction—depending on the circumstances—a fiduciary may decide to not enter into a transaction even when the terms of the transaction are fair from a financial point of view.

When property that is being analyzed is going to be transferred incident to a divorce, Internal Revenue Code Section 1041 allows the parties in a divorce to defer recognition of any gain on the value of the property until the property is sold. In other words, the transfer of ownership of assets in a divorce is generally not considered to be a taxable transaction. The Internal Revenue Code does not totally exempt the gain from taxation. Rather, it allows the marital dissolution parties to defer the income tax recognition.

Failure to consider the income taxes that will be paid, and to adjust the value of the property to reflect the embedded income taxes, may result in an overvaluation of low tax basis property. For example, if 100 shares of corporation X have an observable price of $100,000, but were acquired for $20,000, and if the party to the divorce who will retain the shares plans to sell them within the next few months in a taxable transaction, the value of the shares to that party is obviously not the same as receiving $100,000 in cash. Instead, the value of the shares is $100,000 less the estimated built-in gain tax liability that will be incurred with the stock sale.

In either tort or breach of contract litigation matters, the measurement of economic damages generally is recognized to be the amount necessary to put the plaintiff in the economic position the plaintiff occupied before suffering the consequences of the defendant's alleged misbehavior. If the economic damages have been measured based on an after-tax lost profits analysis, and the damages award is a taxable event for the plaintiff, then it may be appropriate to adjust upward the award of the economic damages so that, after paying the income taxes on the award, the plaintiff occupies the same position the plaintiff would have occupied before the alleged misbehavior took place.

The analysis of fair market value is based on the assumptions that hypothetical buyers and sellers

would use in pricing the subject ownership interest. The definition of the ownership interest involves a decision of which financial items should be aggregated (or bundled). The definition of the ownership interest should describe the entire bundle of legal rights that are being analyzed. The bundle of rights may include properties and attributes that are so closely related that, effectively, they are parts of a single ownership interest with tax attributes, an overall profit margin, expected remaining life, amortization period, and highest and best use.

In these examples of different valuation assignment purposes, the subject business income tax attributes can affect the value indications.

Legal Form of the Subject Entity

Depending on the legal form of the subject entity, different income tax laws govern the recognition of income and losses at the entity and owner level.

C corporations are subject to the Internal Revenue Code of 1986, as amended, subchapter C. C corporations are subject to federal income tax on the income recognized by the entity, regardless of whether that income is distributed to the shareholders. When the after-tax income of a C corporation is distributed to the shareholders, then there is a second level of income tax due (on the dividend income) at the shareholder level.

Most companies with shares that are publicly traded are C corporations. The financial performance of companies with shares that are publicly traded should be reported (in accordance with generally accepted accounting principles) so that investors can confidently make their investment decisions.

By comparing the financial performance of companies with shares that are publicly traded with the pricing of their publicly traded securities, analysts estimate required rates of return on investment. Those comparative relationships are used by analysts to estimate the value of securities that are not publicly traded.

Partnerships are subject to Internal Revenue Code subchapter K. S corporations are subject to subchapter S of chapter 1 of the Internal Revenue Code. Usually, partnerships, S corporations, limited liability companies (LLCs), and sole proprietorships do not pay income taxes at the entity level. These entities are commonly referred to as "pass-through entities." This is because the taxable income (and loss) is passed through to the owners of those entities who pay the taxes only at the owners' level (and not at the entity level).

Most of the companies with shares that are publicly traded are C corporations. These types of entities have important attributes other than income tax attributes. C corporations can have an unlimited number of and types of owners. The liabilities associated with operating C corporations do not pass through to the owners of the business. C corporations can issue many different types of equity and debt securities to attract investors.

Prior to 1958, there were only three types of entities available. C corporations protected owners from liabilities but subjected the owners to the two layers of income tax. Partnerships had multiple owners and one layer of income tax, but partnerships did not limit the business liability. Sole proprietorships had one owner and one layer of income tax, but they did not limit the business liability.

To aid in the creation of small business, Congress enacted Subchapter S of the Code in 1958. S corporations offer limited liability and one layer of income tax. Availability of S corporation status is limited to domestic enterprises and owners. There must be 100 or fewer owners who are individuals or certain types of entities (trusts, employee stock ownership plans, qualifying S corporations) owning one class of common stock (although voting and nonvoting shares may be issued). Today, more S corporation income tax returns are filed than C corporation income tax returns.

The law providing for REITs was enacted by the U.S. Congress in 1960. A REIT is a company that owns income-producing real estate. To avoid incurring liability or U.S. federal income tax, REITs generally must pay out an amount equal to at least 90 percent of their taxable income in the form of dividends to shareholders. REITs can be publicly traded.

A master limited partnership (MLP) is a limited partnership that qualifies under Section 7704. It combines the income tax benefits of being a limited partnership with the liquidity of publicly traded securities. MLPs began appearing in the early 1980s. An MLP must receive at least 90 percent of its income from qualifying sources such as energy exploration, mining, extraction, refining of oil and gas, and the transportation of alternative fuels like biodiesel.

By 1996, nearly every state had enacted an LLC statute. LLCs are very similar to partnerships. However, the liability of operating the subject business does not pass through to the business owners. There are no restrictions on the number of owners. LLCs can have partnerships or S corporations as a member, but S corporations cannot have an LLC or a partnership as a shareholder.

The organization documents of an LLC can be drafted to specifically favor certain membership interests with regard to economic returns and income tax treatment. An LLC agreement can assign income streams and tax consequences differently among its members.

Tax pass-through entities such as REITs and MLPs, as a result of their favorable income tax status, may have a competitive advantage when bidding to acquire a business (that would qualify for pass-through entity status) over entities that are not structured as tax pass-through entities.

If a C corporation yields after-tax investor returns that are different from the returns yielded by pass-through entities, how can an analyst justify applying unadjusted valuation pricing multiples derived from C corporations to tax pass-through entities?

Let's look at how the structure of a transaction involving a C corporation can affect the value of that transaction and, hence, the business value of a C corporation.

Transaction Structure

Generally there are four ways to structure a transaction involving the sale of an entity.

1. The buyer may pay cash to the seller for the equity of the subject entity.
2. The buyer may pay cash to the seller for the assets of the subject entity.
3. The entity buyer may exchange its equity for the subject equity owned by the seller.
4. The entity buyer may exchange its equity for the assets of the subject entity.

Simple Illustration for a 100 Percent Ownership Interest in a C Corporation

This illustration discusses the effect of income taxes on transaction value. The example may not necessarily be indicative of actual income tax liabilities that would arise in the sale of the entity or the relationship of those tax liabilities (that is, some tax expenses are deductible and can offset other tax liabilities) in any particular transaction.

Cash for Stock

When a C corporation's equity is exchanged for cash, if the purchase price is greater than the price the seller paid for the equity, the seller recognizes a gain on the sale of the shares on his or her personal income tax return. This is referred to as a gain on the "outside" basis. A taxable gain on the outside basis is recognized at the personal tax level and is not recognized at the corporate level.

To illustrate, the owner paid $100,000 to buy all of the shares of Candy, a C corporation, five years ago. That owner sells his or her shares of Candy today for $500,000. The seller has a capital gain on his or her personal tax return of $400,000 for the sale of the shares and pays a 20 percent capital gains tax of $80,000. The seller nets $420,000 on the sale.

For income tax purposes, the buyer of the shares (under normal circumstances) will continue to operate Candy with the same inside tax basis of the assets as before the transaction.

Cash for Assets

If the seller of Candy agreed to exchange the assets (instead of the shares) of Candy for cash, generally more income taxes will be due and the seller will enjoy a lower amount of after-tax proceeds from the sale.

The sale of the assets of the corporation for a price greater than the inside tax basis of those assets will generate a gain to the corporation on the sale of its assets. After paying the tax on the gain on the inside basis of the assets at the ordinary corporate income tax rate, Candy's owner could then liquidate the company and distribute the proceeds. Those proceeds would be subject to the capital gains tax on the owner's outside basis.

Suppose the inside tax basis of Candy's assets is $400,000. When the buyer pays $500,000 for those assets, then Candy recognizes a gain of $100,000 and pays the 35 percent ordinary income tax of $35,000. The seller liquidates Candy in order to generate proceeds of $465,000. And, after subtracting the $100,000 outside tax basis, the seller pays a 20 percent capital gains tax of $73,000 ($365,000 times 20 percent) on his or her personal tax return. The seller nets $392,000 ($500,000 minus the $35,000 tax on the inside tax basis minus the $73,000 tax on the outside basis) after selling the assets of Candy.

Stock for Stock

If Candy's owner accepts equity from the buyer in exchange for Candy's equity, generally there are no immediate tax consequences to Candy's owner. The outside basis of the new equity is equal to the outside basis of the Candy equity regardless of the observable value of that new equity and no gain is recognized by Candy's owner until the new equity is sold.

Stock for Assets

If Candy's owner accepts equity from the buyer (that has a value of $500,000) in exchange for Candy's assets (that have an inside tax basis of $400,000), the corporation recognizes a gain of $100,000 and pays the 35 percent ordinary income tax of $35,000. The new equity is held inside of the Candy corporation. The seller's outside tax basis of $100,000 is unchanged until the new shares are sold.

In each of these transactions, the buyer has paid a cash-equivalent price of $500,000. However, the business value of Candy to its owner is not always $500,000.

Obviously, the seller of Candy will almost always prefer to receive cash for stock in order to avoid incurring a tax on the gain on the inside basis of the assets of Candy.

Conversely, the buyer of Candy will almost always prefer to pay cash for the assets so that a higher carryover basis in the assets can be established. The higher basis means that there will be more depreciation and amortization deductions available to reduce taxable income in the future.

The Tax Amortization Benefit

In a transaction such as the acquisition of the stock of Candy, whether the buyer pays with cash or equity, the buyer merely carries forward the tax bases in the existing tangible assets and the existing intangible assets—and continues to depreciate and amortize them. To the buyer, this is considered a nontaxable transaction.

The ability to recognize for income tax purposes the fair market value of all of the assets acquired (instead of only those that had been recognized in the hands of the seller), is one important reason why buyers prefer to buy assets and may be willing to pay a higher price to acquire assets instead of stock.

The present value of the projected income tax savings related to the property depreciation deductions increases the income approach value indication of real estate and personal property.

Similarly, with intangible assets, including intangible assets that were not recognized on the balance sheet of the target corporation, the tax amortization benefit increases the income approach value indication of intangible assets. The tax amortization benefit represents the present value of the income tax deductions associated with the tax amortization of acquired intangible assets.[3]

Tax Protection Agreements

In certain circumstances, tax protection agreements can be negotiated between the buyer and the seller in a stock transaction in order to prevent any future transactions from occurring that might be deemed a sale of assets that have a low inside tax basis.

For example, tax protection agreements are commonly made between long-time owners of real estate in a transaction in which the real estate is acquired by a REIT. In this situation, the buyer (the REIT) agrees to pay with equity to acquire the seller's equity and to not trigger the built-in tax on either the outside basis or the inside basis of the seller's investment for some period of time. If the REIT does breach the agreement and triggers the seller's personal income tax liability, then the typical remedy is for the REIT to pay economic damages equal to the amount of seller's personal income taxes that are due on the gain that was protected by the agreement.

In a bankruptcy proceeding, there is generally an effort made to retain and protect the seller's income tax attributes. Those income tax attributes are generally relatively costless to the acquirer of property from a bankruptcy estate and so the parties to a bankruptcy transaction may be willing to enter into a tax protection agreement that benefits the seller.

Even if the tax protection agreement states that the benefit of the tax protection is not transferable, that statement doesn't mean that the benefit of deferring the income tax does not have a value.

For partnerships, a Section 754 election may be made by the partnership which reconciles a buyer's inside tax basis with the outside tax basis. However, the Section 754 election is not necessarily a right of the buyer of partnership units. In other words, it means that the buyer of an ownership interest in a partnership might not be able to eliminate the timing difference between the gain on (1) the sale of the units (the outside tax basis) and (2) the inside tax basis in the underlying assets of the partnership. Not being able to make the Section 754 election may reduce the value of a partnership unit.

Some acquired entities have suffered losses historically in taxable income. In a C corporation ownership structure, a net operating loss (NOL) can be applied in future years to offset taxable income. This is called an NOL carryforward, and it may be considered a deferred asset of the C corporation.

The use of an NOL is restricted and can easily be forfeited inadvertently. For example, NOLs usually expire when a change-in-control transaction is deemed to have taken place. In some circumstances, when share redemptions take place in complex capital structure situations, a valuable NOL can be forfeited if the transaction is not structured carefully to protect the use of the NOL carryforward.

A deferred tax liability (or asset) and income tax attributes (such as an NOL or tax credit carryforwards) that are eligible to be transferred should be included in the businesses value when the analyst assumes that the hypothetical buyer and seller would include them.[4] In many circumstances, those income tax attributes are valuable even though they cannot be transferred.

The fair market value of an entity depends on whether the hypothetical buyer and seller would

> "In a marital dissolution setting, analysts often consider different valuation methods that require the consideration of the impact of income taxes."

base their analysis on a transaction structured as a taxable transaction versus a nontaxable transaction. For purposes of estimating the fair market value of the assets of the entity, the income tax bases of the entity's assets and liabilities should be consistent with the assumption about the taxability of the transaction structure upon which the hypothetical buyer and seller would base their analysis.

An S Corporation Value Advantage

Internal Revenue Code Section 338(h)(10) (the "338 election") provides a particular federal income tax advantage in transactions involving the sale of the S corporation equity. The 338 election allows the buyer that acquires the S corporation equity to treat the transaction as if it was a purchase of S corporation assets (but only if all of the seller shareholders agree). The 338 election allows the buyer to enjoy the more attractive depreciation deductions related to the step-up in the income tax basis of the purchased assets.

Under the 338 election, the seller of the S corporation's equity pays the personal income tax on the outside tax basis. However, the seller does not have to pay the tax on the gain over the inside tax basis of the assets of the S corporation.

Therefore, in certain situations, the purchase price for an S corporation can be greater than the purchase price for an otherwise identical C corporation.

Value to the Holder

For the purpose of many business valuation assignments, the value to the holder of the ownership interest is the appropriate standard of value to be adopted. The value to the holder, or to the current owner, may be relevant in certain assignments where economic damages have been suffered. The value from the perspective of the holder does not necessarily contemplate a sale transaction. The holder may have a different overall effective income tax rate than the hypothetical willing buyer and seller due to the holder's other sources of income, expenses, and deductions.

Investment value is a different standard of value than the value to the holder standard of value. One difference is that investment value takes into consideration a particular defined set of individual investment criteria or unique attributes—such as a favorable income tax attribute that a potential buyer or group of buyers may have.

Conclusion

Income taxes do matter in certain investment decision making. In a marital dissolution setting, analysts often consider different valuation methods that require the consideration of the impact of income taxes.

For many purposes, the income tax consequences associated with an ownership interest exert a meaningful impact on the value of the interest, and should be part of the business valuation analysis. The entity level income taxes and the personal income taxes due from the holder of the interest should be part of many valuation analyses.

An important reason to analyze income tax consequences of ownership interests is that income tax rates can change. When a new federal administration considers a new tax regime, typically it is because that new administration anticipates that the new tax regime will exert a positive effect on business decisions.

By carefully analyzing the income tax attributes upon which the value of businesses and business ownership interests depend, the analyst can offer a more complete client service.

Notes:

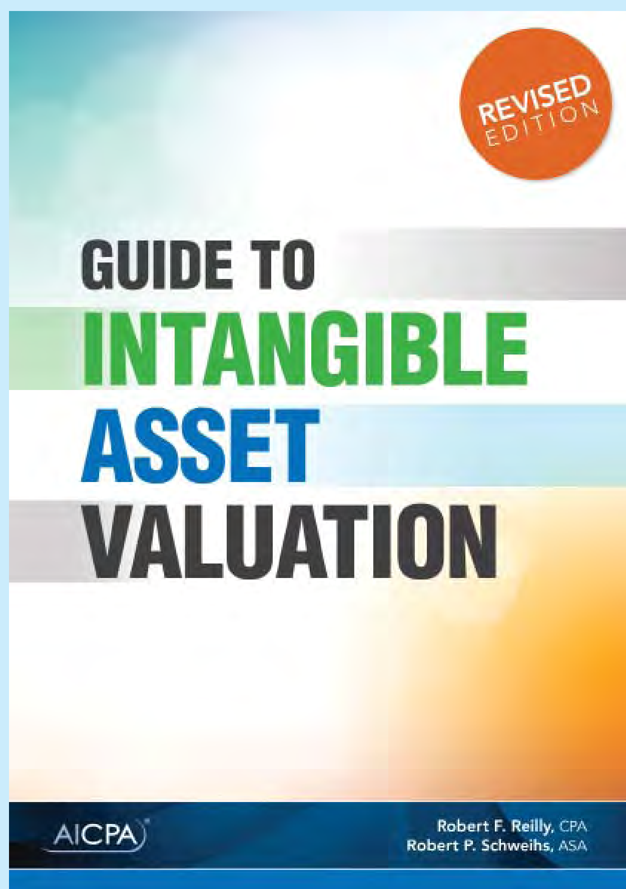
1. As explained elsewhere in *Insights*, this discussion is not intended to provide legal, accounting, or taxation advice. Appropriate professional advisers should be consulted. This discussion is intended to be general in nature and not intended to address the specific facts and circumstances of any particular client situation.
2. Publicly traded real estate investment trusts (REITs) are tax pass-through entities. An analyst valuing a privately owned REIT may be able to match its income tax characteristics with publicly traded REITs and apply a guideline publicly traded company business valuation method.
3. For a discussion of the tax amortization benefit and how to quantify it, see *Guide to Intangible Asset Valuation* by Robert F. Reilly and Robert P. Schweihs (New York: American Institute of Certified Public Accountants, 2014), 354.
4. Financial Accounting Standards Board Accounting Standards Codification 350-35-21.

Robert Schweihs is a managing director of the firm and is resident in our Chicago practice office. Bob can be reached at (773) 399-4320 or at rpschweihs@willamette.com.

We are pleased to announce the Revised Edition of . . .

Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

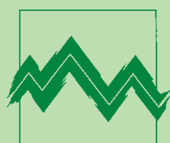
Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

- Identifying intangible assets and intellectual property
- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

Illustrative examples are provided throughout the book, and detailed examples are presented for each generally accepted (cost, market, and income) valuation approach.

Who Would Benefit from This Book

- Litigation counsel involved in tort or breach of contract matters
- Intellectual property counsel
- International tax practitioners
- Property tax practitioners
- Auditors and accountants
- Valuation analysts
- Licensing executives
- Multinational corporation executives
- Commercial bankers and investment bankers
- Merger & acquisition professionals
- Bankruptcy professionals
- Judges and arbitrators



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Best Practices

Business Valuation in a Divorce Setting

Charles A. Wilhoite, CPA

Business valuation in a divorce setting requires a broad understanding of generally accepted business valuation theory and practice. This discussion addresses several considerations regarding a business valuation completed in a divorce setting, including (1) the development of the engagement specifics, (2) the relevant standards of value, and (3) the generally accepted standard valuation approaches and methods. Further, topics that often are the subject of significant disagreement in a divorce valuation setting are considered, including (1) the analysis of controlling versus noncontrolling and marketable versus nonmarketable ownership interests, (2) the impact of ownership agreements and prior transactions on the valuation process, and (3) intangible assets (i.e., "goodwill").

Introduction

Generally, and for decades, the national divorce rate has been estimated at roughly 50 percent, implying that 50 percent of all marriages end in divorce. However, several factors, including (1) increasing participation rates of women in the workforce, (2) greater control by women over reproductive rights, and (3) a higher average marrying age (and presumed maturity level) of couples are creating expectations that the overall divorce rate eventually will center closer to 33 percent over time. In Oregon, recent statistics indicate that the total number of reported divorces has declined annually for the past five years, from 15,312 in 2010 to 13,831 in 2015.

Setting the *estimated rate* of divorce aside, the *actual event* of divorce typically requires the identification and quantification of assets (and liabilities) contained within a marital estate, which typically is deemed to have been created when a divorce filing occurs. The basis for the division of marital property varies among the states, between a standard based on (1) community property (i.e., equal property division) and (2) equitable distribution (i.e., either equal property division or "equitable" property division based on an allocation process supported by specific facts and circumstances).

Often, a financial analyst, and other professionals (e.g., real estate and personal property appraisers and forensic accountants) are required to assist with the identification, valuation, and division of a marital estate based on the type, number, and/or estimated value of assets contained within a marital estate.

From the perspective of a financial analyst focused primarily on business valuation and related issues, the following important considerations should be addressed to properly identify and estimate the value of relevant property includable within a marital estate:

1. The names of the divorcing parties (and their respective legal counsel)
2. A list identifying owned businesses, business interests, and other investment-based assets (e.g., investment portfolios, income-producing properties) includable within the marital estate
3. A brief summary regarding each business and/or business interest includable within the marital estate, including (a) name of company, (b) description/business focus, (c) date acquired, (d) the ownership interest level maintained by the marital estate, and (e) the legal structure of each business in which the marital estate maintains an ownership interest (e.g., regular C corporation, S corporation, limited liability company, partnership)

4. The relevant, effective valuation date (e.g., date of separation, date of divorce, trial date)
5. The relevant standard of value (e.g., fair market value or fair value)
6. The relevant valuation approaches and methods (based on the nature of the subject business operations)
7. Normalized economic earnings (based on consideration of key circumstances regarding owners' compensation, nonrecurring and/or discretionary income and/or expense items, related party activity, and seasonal/cyclical operating impacts)
8. Ownership characteristics (e.g., controlling versus noncontrolling and marketable versus nonmarketable status)
9. The relevance and impact of shareholder/operating agreement terms and/or historical transactions in the equity of the subject company(ies)
10. Intangible asset considerations

The following discussion addresses the above-listed 10 factors from the perspective of a business valuation analyst ("analyst"), and touches on the related interaction between the analyst and legal counsel. For purposes of this discussion, it is assumed that items (1) through (3) in the list above have been adequately identified and addressed by the analyst.

The identification of the parties to a divorce action—including the divorcing parties as well as their respective legal counsel—allows for the identification of conflicts or potential conflicts. Such conflicts might prevent the analyst from being deemed to represent an independent party, and, therefore, being unable (in the eyes of the court) to render an independent opinion.

The specific identification of the valuation subject(s)—including the companies and/or relevant ownership interests includable in the marital estate—provides important information required for the purpose of establishing a credible and relevant approach to the valuation process. The identification process should include summary descriptions of the business focus for each company includable in the marital estate, as well as the identification of (1) officer/operating positions held by the divorcing parties, (2) all family members/related parties who have received any form of compensation (e.g., cash, company paid expenses, reimbursements), and (3) all business activity between/among related (either through common ownership or board involvement) parties/companies in the five-year period preceding the valuation date.

Items (4) through (10) are discussed below.

Valuation Date

Generally, the "valuation date" represents the date on which the conclusion, or opinion, of value rendered by an analyst is deemed relevant. Clearly, the valuation date selected in any valuation process can have a pronounced effect upon the ultimate value of a business or ownership interest therein.

In a divorce setting, the valuation date typically is identified as one of the following dates (depending on the specific circumstances):

1. The date of marriage
2. The date of legal separation
3. The date of divorce (i.e., the current date or date closest to trial)

Typically, the appropriate valuation date is determined by the case law of the specific state/jurisdiction in which the marriage will be dissolved. In some instances, and based on the circumstances, multiple valuation dates may be identified by legal counsel as potentially being relevant, requiring an analyst to develop an opinion(s) of value relevant for each date. For these reasons, an analyst should rely on guidance provided by legal counsel regarding the appropriate valuation date(s) to assume for the purpose of completing a valuation in a divorce setting.

Some states/jurisdictions establish the date of marriage as one relevant valuation date when a business or ownership interest was brought into a marriage by one of the divorcing parties—rather than acquired or developed during the marriage. In these particular states/jurisdictions, equitable distribution typically is the relevant property division standard, and the asset subject to allocation is represented by the increase in the value of the business or ownership interest from the date of marriage to either the (1) date of separation or (2) date of divorce. Different valuation allocation procedures are then applied in order to estimate the marital portion of the asset subject to division.

Generally, the date of separation is the relevant valuation date when the business or business interest subject to division is highly dependent upon the efforts of one of the parties in the divorce action. The valuation of accounting, law, medical, and other professional practices are typical examples of situations in which the efforts of the "practicing" spouse typically exert a significant impact upon the

continuing operations of the related business, and thus significantly affect the underlying value of the entity.

The date of divorce, or date closest to trial, often is considered the most relevant valuation date when the business interest subject to division represents ownership in a larger company (i.e., a company not dependent on a single individual).The valuation of an ownership interest in large manufacturing or service businesses which are not highly dependent upon the efforts or reputation of one of the divorcing parties, are typical examples of situations in which the date of divorce may represent the most relevant valuation date.

Standard of Value

The "standard of value" in a business valuation context may be described as the definition of the value being sought. However, "value" is a nebulous term, typically determined by circumstances. Although most state divorce statutes require either equal or equitable division of assets included within a marital estate, the statutes generally are silent with regard to the definition considered most appropriate for estimating value.

The standard, or definition, of value includes an implied response to the question, "Value to whom?" Because divorce statutes and judicial precedents vary from state to state, a clear understanding of the following, generally accepted standards of value is required when estimating the value of assets in a divorce setting is needed:

1. Fair market value
2. Investment value
3. Fair value
4. Intrinsic value

Fair Market Value

In a divorce setting, fair market value typically is a common standard of value. Fair market value is defined as follows:

> 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 arms' length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of relevant facts.[1]

An important consideration within the definition of fair market value is the premise of hypothetical parties dealing at arm's length. Such a premise necessarily excludes from the estimated value conclusion the impact of any of the following:

1. Special motivations not characteristic of a typical buyer or seller
2. Parties not having the ability or willingness to engage in a transaction
3. Economic and market conditions at a time other than the valuation date

A fair market value conclusion should reflect the economic impact of all rights and benefits inherent in the subject ownership interest(s)—including voting control status—as well as the detrimental economic impact of any limitations. Such limitations typically include (1) a lack of voting control and (2) limited marketability with regard to an ownership interest(s) in nonpublic companies. These two economic limitations typically are addressed by discounts for lack of control and lack of marketability, respectively.

Investment Value

Investment value is defined as follows:

> The value to a particular investor based on individual investment requirements and expectations.[2]

The definition is deemed relevant whether the subject asset is an entire business or a fractional ownership interest in a business. Generally, the investment value standard is assumed to consider the impact of the following:

1. The specific owner's expectation of risk
2. The potential synergy associated with ownership of the subject business
3. The specific earnings expectations resulting from the subject ownership
4. In some cases, the relationship of the spouse/owner to the other owners of the business.[3]

As suggested, the investment value standard is based on the theory that "value" to the marital estate is most appropriately measured from the perspective of how much value a particular asset is expected to generate for its current owner (i.e., a

member of the marital estate that will be dissolved upon completion of the divorce). This is contrary to the definition of fair market value, which is based on the premise of value to a hypothetical owner.

Fair Value

In a divorce setting, fair value typically is equated with the statutory definition applicable in cases of dissenting stockholders' appraisal rights. In states that have adopted the Uniform Business Corporation Act, the following definition applies:

> Fair value, with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.[4]

States that have adopted the fair value standard in a divorce setting can be interpreted as adopting the premise that the divorce is creating a forced, or oppressed, circumstance. Based on the circumstance, one of the divorcing parties—typically the spouse not participating directly in business operations—is deemed to be "forced" into a transactional setting.

Comparable to a dissenters' rights circumstance, the "forced" party in a divorce setting is deemed to be entitled to the "fair" value of the subject ownership interest(s). Generally, fair value is often equated with fair market value absent the impact of valuation discounts for lack of control and lack of marketability.

Intrinsic Value

Intrinsic value—also referred to as fundamental value—is defined as follows:

> The value that an investor considers, on the basis of an evaluation of available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion.[5]

Intrinsic value is based upon a fundamental (i.e., analytical) analysis of an investment (e.g., the subject company or subject interest), and assumes, at least temporarily, a higher level of insight and knowledge regarding the investment than the typical investor.

The intrinsic value standard is often considered more relevant than the fair market value standard in many divorce situations because no firm basis for an assumed hypothetical sales transaction can be established with regard to the subject ownership interest. In these particular circumstances, it is arguably more reasonable to estimate value based upon the intrinsic value standard assuming that no actual transfer of ownership will occur.

Divorces requiring the valuation of a professional practice for property division purposes are prime examples in which the intrinsic value standard can be applied. When one of the divorcing parties is a 100 percent owner and sole practitioner in, for example, a medical practice, it is generally assumed (barring facts to the contrary) that the party will continue in the practice of medicine subsequent to the divorce. Accordingly, the intrinsic value standard can be applied to estimate the value of the practice to the existing owner/operator.

It is important to note that intrinsic value differs from investment value based on the fact that intrinsic value is estimated through the fundamental analysis and judgment of an analyst, ignoring characteristics particular to any one investor (i.e., the owner/operator).

While no sale of the subject practice is assumed, an intrinsic value for the practice is established to the extent that ownership of the practice is expected to provide a monetary return to the investor (i.e., owner/operator) during the period that it is owned.

Generally Accepted Valuation Approaches and Methods

Family law courts throughout the country typically recognize the three generally accepted business and security valuation approaches:

1. The asset-based approach (which includes the asset accumulation method and the adjusted net asset value method)
2. The income approach (which includes the discounted cash flow method and the direct capitalization method)
3. The market approach (which includes the guideline publicly traded company method, the guideline merged and acquired method, and the backsolve method).

Each valuation approach, as well as frequently used valuation methods categorized within each approach, is discussed in the following sections.

Asset-Based Approach

The asset-based approach is based upon the economic principle of substitution. The principle serving as the anchor for the asset-based approach is the premise that an investor will pay no more for an asset (i.e., a business or an interest in a business) than the cost to obtain—either through purchase or construction—an efficiently organized assemblage of assets with equal utility.

Although utility can be measured in many ways, generally speaking, the utility measure considered most relevant with regard to the purchase of a business is represented by the level of economic returns (e.g., earnings or cash flow) that the investor expects the investment (i.e., "assembled operating assets") to generate.

With regard to the valuation of a company or fractional interest in a company based upon the asset-based approach, the analyst typically approaches the engagement from the perspective of viewing the subject company as an organized assemblage of revenue-producing assets—both tangible and, potentially, intangible.

The asset-based approach can be applied based upon the identification and discrete appraisal of each of the subject company's assets (i.e., the asset accumulation method), or the collective revaluation of the subject company's assets (i.e., the capitalized excess earning method). Generally, the assets of a company can be grouped into three broad categories: (1) financial assets, (2) tangible personal property and real estate, and (3) intangible assets.

The summation of the estimated market value of each tangible and intangible asset controlled by the subject company produces the overall asset value of the subject company on a market value basis. Based on the nature of certain assets, specific analysts are often required to estimate the market value of the related assets (e.g., professionals specializing in the valuation of real estate, buildings, art and fine jewelry).

To arrive at the equity value of the subject company, the total value of all liabilities is deducted from the estimated total asset value. Typically, the resulting equity value is assumed to represent a controlling, marketable value indication based on the fact that only a controlling owner would possess the authority to initiate (1) the sale of the assets of the subject company and (2) the distribution of the related proceeds.

Typical Subject Company Assets

Typically, most economically viable operating companies maintain some level of assets that can be classified into one of the three general categories previously identified: (1) financial assets, (2) tangible personal property and real estate, and (3) intangible assets.

Financial assets typically include cash and highly liquid investments, accounts receivable, prepaid expenses, and inventory and supplies.

The tangible personal property and real estate categories typically include office furniture and fixtures, operating equipment, buildings and land, and leasehold improvements.

The existence and value of intangible assets for any company will vary on a case-by-case basis, and typically are determined based on consideration of legal rights and a history/expectation of continuing earnings and cash flow generating capacity. Generally, the intangible assets of a company can be categorized into the following groups:

1. Technology-related (e.g., patents, proprietary technology, technical know-how, systems and procedures, technical manuals and documentation)

2. Customer-related (e.g., customer lists, customer relationships, referral relationships).
3. Contract-related (e.g., purchase contracts, supply contracts)
4. Data-processing-related (e.g., computer software, automated databases)
5. Human-capital-related (e.g., a trained and assembled workforce, employment/non-competition agreements)
6. Marketing-related (e.g., copyrights, trademarks/service marks, and trade names)
7. Location-related (e.g., leasehold interests)
8. Goodwill-related (e.g., going-concern value)

While numerous intangible assets within each identified category may exist at a particular company, generally the most significant intangible assets of a company are represented by the economic earnings attributable to customer/client/patient relationships, technology, trade name, and going-concern value (including a trained and assembled workforce).

The valuation of the identified intangible assets of a company typically is based upon the income approach, typically through a variation of the discounted cash flow analysis (which is discussed below). The cost approach is sometimes employed, though companies rarely maintain detailed and readily available cost analysis data regarding internally developed intangible assets. The market approach is also utilized, but it is often challenging to locate market-based data supporting transactions involving specific intangible assets.

The asset accumulation approach is fairly self-explanatory—all assets are identified, valued, and summed to arrive at the total asset value of the subject company, with all liabilities deducted to arrive at the indicated equity value of the subject company.

The capitalized excess earnings method, which continues to be relied upon by business valuation analysts (primarily in a divorce setting and involving smaller companies), is discussed below.

Adjusted Net Asset Value Method

The adjusted net asset value (ANAV) method is an asset-based approach valuation method. The aggregate asset revaluation in this method is often performed using the capitalized excess earnings method (CEEM). The CEEM is sometimes considered to be a hybrid valuation method since it is based on the combination of (1) the asset-based approach (i.e., asset accumulation method) and (2) the income approach (i.e., earnings capitalization) to estimate the intangible asset value, and total value, of the subject company.

A current version of the CEEM is defined in Revenue Ruling 68-609. The foundation for Internal Revenue Service Revenue Ruling 68-609 is the U.S. Treasury Department Appeals and Review Memorandum Number 34 (ARM 34). The "Treasury Method," as it was called, was initially adopted to estimate the value of goodwill that breweries and distilleries lost because of Prohibition.

While there are several variations to the method, the typical steps in the CEEM are as follows:

1. Estimate the fair market value of the subject company's net tangible assets (i.e., the asset accumulation aspect of the analysis).
2. Estimate a normalized level of long-term economic earnings (e.g., cash flow) for the subject company based on consideration of the most likely level of future economic earnings achievable over a long-term (i.e., 20-plus year) operating horizon.
3. Estimate an appropriate required rate of return for the subject company's net tangible assets.
4. Multiply the estimated fair market value of the subject company's net tangible assets by the appropriate required rate of return (estimated in step 3).
5. Subtract the estimated, fair return on net tangible assets (the product of step 4) from the estimated level of normalized, long-term economic earnings (the earnings level established in step 2).
6. Divide the indicated level of "excess" earnings (the result of step 5) by the risk-adjusted rate of return considered appropriate based upon the specific operating characteristics of the subject company (as pertaining to earnings attributable to intangible assets). In selecting the relevant rate of return, consider the operating history of the subject company, the industry in which the subject company operates, and the subject company's size, market position and reputation.
7. Add the estimated value of the subject company's net tangible assets to the indicated value of the subject company's intangible assets.

With regard to the CEEM, a potential acquirer of the subject company is assumed to contemplate the acquisition of the subject company based on an expected ability to earn a fair return on investment after recognizing all necessary expenses. The

fair return on the overall investment is bifurcated between (1) a reasonable return on net tangible assets and (2) a reasonable return on intangible assets.

The present and future earning power of the subject company is of primary importance to a potential acquirer. If the net tangible assets of the subject company do not generate returns in excess of those reasonably expected in the market, based on the nature of the assets, the buyer usually will not be willing to pay more than the estimated value of the net tangible assets to acquire the related business (i.e., no "excess" earnings are expected, so no material intangible assets are deemed to exist).

For reference, an estimated excess earnings capitalization rate of 25 percent implies that an acquirer would be willing to pay for approximately four years (i.e., 1 ÷ 0.25 = 4) of expected future excess earnings. Generally, and based on the fact that earnings attributable to intangible assets have a higher risk profile (i.e., are subject to greater variability with no tangible asset support), the excess earnings capitalization rate typically is at least equal to the estimate cost of equity capital for the subject company.

A simplified model of the CEEM is presented in Exhibit 1.

Considerations regarding the Asset-Based Approach

In summary, the asset-based approach can be equated to recasting the historical, cost-based balance sheet of the subject company to a market-value-based balance sheet as of the relevant valuation date. As a result, the following questions require rational, well-supported responses from an analyst in order to gain the necessary comfort that the valuation conclusion produced by the asset-based approach is reasonable and reliable:

1. Have all material assets and liabilities been identified—including assets and liabilities of a contingent nature?
2. Have all material assets and liabilities been adjusted, appropriately, to market value?
3. Has appropriate consideration been paid to the existence of potential intangible assets?
4. If the CEEM has been utilized, does the level of normalized economic earnings reflect an achievable level over the assumed, forward-looking operating period?
5. If the CEEM has been utilized, has an appropriate required rate of return on net tangible assets been applied?
6. If the CEEM has been utilized, does the risk-adjusted rate of return used to capitalize indicated excess earnings appropriately reflect the risk inherent in the subject company's ability to continue to generate the excess earnings over the assumed, forward-looking operating period?
7. Is the indicated valuation conclusion consistent with (within a reasonable range of) the valuation conclusions produced by other valuation approaches considered?
8. Has the implied equity value conclusion been adjusted appropriately for consideration of control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest (e.g., a noncontrolling equity interest in a privately held company)?

Exhibit 1
Capitalized Excess Earnings Method
Calculation of Equity Value on a Controlling Ownership Interest Basis

	After-Tax, Normalized Net Cash Flow to Total Invested Capital		$ 1,300,000
	Fair Market Value of Net Tangible Assets	$500,000	
×	Required Return on Net Tangible Assets	5.0%	
=	Fair Return on Net Tangible Assets		($ 25,000)
	Indicated Excess Earnings		$ 1,275,000
÷	Estimated Excess Earnings Direct Capitalization Rate		25%
=	Indicated Intangible Asset Value		$ 5,100,000
+	Fair Market Value of Net Tangible Assets		$ 500,000
=	Indicated Total Asset Value		$ 5,600,000
–	Reported Interest-Bearing Debt		($1,300,000)
=	Indicated Market Value of Equity		$ 4,300,000

Income Approach

The income approach to valuation is based upon the premise that the value of a company is represented by the present value of all estimated future income (e.g., earnings or cash flow) expected to be realized by the individuals possessing ownership interests in the company. Ownership interests are understood to represent both equity investments (e.g., various classes of shareholders) and debt investments (e.g., bondholders or other interest-charging lenders).

Discounted Cash Flow Method

An example of an income approach method is the discounted cash flow (DCF) method, also referred to as yield capitalization. This method requires the following analyses:

1. Revenue analysis
2. Expense analysis
3. Investment analysis
4. Capital structure analysis
5. Residual value analysis

Each analysis, including related considerations, is discussed briefly below.

Revenue Analysis

Revenue analysis involves a projection of prospective revenue from the provision of goods and/or services by the subject company. This analysis generally includes consideration of the following microeconomic factors: primary goods/services provided; pricing and price elasticity; market dynamics, including competition; regulatory factors; geographic markets served and demographic factors; and technological influences.

Expense Analysis

The expense analysis requires consideration of the following operating factors: cost of goods/services provided, fixed versus variable costs, product/service versus period-based costs, cash versus noncash costs, direct versus indirect costs, cost absorption/allocation practices, cost/efficiency relationships, and cost/volume/profit relationships.

Investment Analysis

The investment analysis requires consideration of the following factors: required minimum cash balances and working capital needs, accounts receivable/payable turnover, facilities utilization and related constraints, and capital expenditure requirements and related financing implications.

Capital Structure Analysis

The capital structure analysis requires consideration of the following factors: current capital structure, market-based/optimal capital structure, cost of debt and equity capital components, the marginal cost of capital, systematic and nonsystematic risk factors, and the weighted average cost of capital (WACC).

Residual Value Analysis

The residual value analysis results in an estimation of the value of the prospective cash flow generated by the subject company after the conclusion of a discrete projection period. The residual value can be estimated by various methods—for example, a price/earnings multiple or, typically, the Gordon growth model (i.e., the capitalization of normalized, expected earnings).

Based on the results of the above-mentioned analyses, a projection of after-tax net cash flow from operations can be developed for a reasonable, discrete projection period (e.g., three years or five years). The projected cash flow is discounted at an appropriate after-tax, present value discount rate, resulting in an indication of the present value of each year's cash flow.

The residual value of the subject company is estimated at the end of the discrete projection period. This residual value is also discounted to a present value. The present value of the discrete net after-tax cash flow projection is added to the present value of the residual value. This summation results in the estimated value of the subject company—representing the total value of all invested capital (i.e., all interest-bearing debt capital and all equity capital).

Present Value Discount Rate

If the cash flow being discounted is projected on an after-tax, invested capital basis, the appropriate discount rate must represent a combination of risk applicable to both equity investors and debt investors. This rate is typically referred to as the WACC.

To estimate the WACC, the analyst must estimate (1) the relevant, required rate of return on equity capital; (2) the relevant, required rate of return on debt capital, and (3) the proportions of debt capital and equity capital comprising the relevant capital structure of the subject company.

Return on Equity

The required rate of return on equity typically is developed based on the analysis of empirical market evidence and recognition of the subject company's investment risk.

Developing a required rate of return on equity begins with estimating a risk-free rate of return that incorporates investors' expectations for the real rate of interest on money and the impact of inflation, or loss of purchasing power, over time. Because we are interested in concluding a required rate of return for an equity investment, equity risk premiums (i.e., incremental risk components) relative to the risk-free rate of return must also be researched.

The relevant required rate of return on equity generally is developed based upon the capital asset pricing model. Using this model, the return on equity is estimated by adding to the risk-free rate of return an equity risk premium(s) based on an analysis of the risk characteristics of the subject company relative to similar characteristics for the relevant industry and/or a relevant group of guideline publicly traded companies within the industry.

Beta, which represents the relative risk of a company in relation to general market risk, is used to estimate some portion of the incremental risk premium relevant for the subject company. The appropriate beta factor is applied to the estimated equity risk premium in order to estimate the relevant equity risk premium for the subject company.

When dealing with smaller companies, financial analysts are often required to make subjective determinations regarding any incremental, or reduced, equity premiums warranted for the subject company, based on consideration of factors and characteristics specific to the subject company.

Based on the limited nature of direct comparable information that can be relied upon to estimate the required rate of return on equity for smaller, closely held companies, analysts often employ a "build-up" equity method. In this method, analysts start with a risk-free rate and add relevant equity risk premiums to estimate the appropriate required rate of return on an equity investment in the subject company. A frequently utilized source of equity premium components is *Duff & Phelps Valuation Handbook: Guide to Cost of Capital*.

Exhibit 2 presents a simple application of the estimation of a required rate of return on equity based on the build-up method (assuming a relatively small—i.e., annual revenue between $10 million and $20 million—subject company):

Exhibit 2
Cost of Equity Capital
Build-Up Method

Equity Component	Rate (%)	
Risk-Free Rate (20-year Treasury bond)	2.8	[a]
Long-Horizon Equity Risk Premium	6.9	[b]
Small Stock Equity Risk Premium	3.6	[c]
Company-Specific Equity Risk Premium	4.7	[d]
Estimated Required Rate of Return on Equity (rounded)	18.0	

a. Represents the yield on a 20-year U.S. government bond, as published by the Federal Reserve, effective December 31, 2016.
b. Represents the large company stock total returns minus long-term government bond income returns, as presented in the Duff & Phelps *2016 Valuation Handbook—Guide to Cost of Capital*.
c. Represents the "micro-cap" decile premium, as presented in the Duff & Phelps *2016 Valuation Handbook—Guide to Cost of Capital*.
d. Estimated based on consideration of company-specific factors, including size, key person/key customer dependence, geographic market concentration, and relatively short operating history of the company.

As indicated, the summation of the risk-free rate of return and the estimated equity risk premiums represents the estimated required rate of return on equity.

Return on Debt

The required return on debt for the subject company typically is estimated based on consideration of the subject company's (1) current weighted average cost of debt (i.e., total interest expense in the most recent 12-month period divided by average interest-bearing debt outstanding) and (2) marginal cost of borrowing (i.e., estimated current borrowing rate). Because the DCF method is performed on an after-tax basis, the relevant borrowing rate is reflected after the impact of effective taxes, or as follows:

Borrowing rate × (1 – effective income tax rate)

Cost of Capital Weightings

The overall required rate of return, or WACC, for the subject company can now be estimated based on consideration of the estimated cost of each capital component and the relevant weight of each capital component in the overall capital structure for the subject company.

The relevant capital structure typically is estimated based upon consideration of the subject company's historical/expected capital structure and

an analysis of the capital structures of the relevant industry/selected guideline publicly traded companies within the relevant industry.

Weighted Average Cost of Capital

Assume that a reasonable weighting of debt and equity components comprising the subject company's capital structure as of the valuation date is 20 percent and 80 percent, respectively. Further, assume that the estimated, after-tax required rate of return on equity and debt is 18 percent and 3 percent, respectively.

Applying this capital structure weighting to the subject company's estimated cost of debt and equity capital results in the estimated WACC presented in Exhibit 3.

Direct Capitalization Method

Another example of an income approach method is the capitalization of economic earnings, or cash flow, method, most commonly referred to simply as the direct capitalization method.

Unlike the DCF method, which produces an indication of the value of a company based on discounting a series of projected future cash flow to a present value, the direct capitalization (DC) method produces an indication of the total value of a company based on the conversion of a single cash flow amount into an indication of value. The indication of value resulting from the DC method represents the value of the entire subject company, with no distinction between tangible and intangible assets.

In a divorce setting, the DC method typically is employed more frequently than the DCF method. This is based primarily on the fact that smaller companies subject to valuation in a divorce setting often do not prepare the long-term operating projections required to complete the DCF method.

The following steps identify a typical process implemented to complete the DC method:

1. *Estimate normalized earnings and cash flow for the subject company*. Normalized earnings typically are estimated for the subject company based on consideration of a historical average (straight or weighted) covering a period of time deemed relevant for purpose of estimating the most likely level of long-term future earnings. All nonrecurring items—both revenue and expense—should be removed from historical earnings to estimate a normalized earnings base. Depending on the duration and operating stage of the subject company, and based on consideration of economic and industry conditions as of the valuation date, normalized earnings are sometimes, and rationally, based on the subject company's most recent operating results.

   Adjustments are then made to convert normalized earnings to cash flow, or cash flow that can be distributed to stakeholders (i.e., debt and equity investors) without affecting the future operations of the subject company.

   Typical adjustments required to convert normalized earnings to cash flow available to stakeholders include the add back of reported interest expense, the addition of depreciation and amortization (i.e., "noncash") charges, and the deduction of annual required capital expenditures and working capital requirements.

2. **Estimate a long-term growth rate**. The long-term growth rate represents growth expected over a 20-plus year operating horizon. Therefore, the growth rate should be achievable given the subject company's planned capital expenditure capacity and working capital limits. Generally, the estimated long-term growth rate will be developed based upon an analysis of historical growth, as well as consideration of long-term inflation, expected population increases, and projected industry and economic conditions.

3. **Estimate the required rate of return on capital for the subject company**. Normalized earnings and estimated free cash flow calculated in step 1 above represent earnings and cash flow available to all investors. Therefore, the appropriate required rate of return should reflect the risks inherent in a weighted investment

Exhibit 3
Weighted Average Cost of Capital

Required Rate of Return on Capital Components		% of Total Capital Structure		Weighted Cost of Capital (%)
Debt Capital @ 3%	×	0.20	=	0.60
Equity Capital @ 18%	×	0.80	=	14.40
Present Value WACC Discount Rate (rounded)				15.00

in the subject company's debt and equity. The relevant weights are represented by the proportion of debt and equity in the subject company's expected long-term, or optimal, capital structure.

Typically, the prospective capital structure is altered from the historical capital structure only when a control level of value is being sought. In such instances, the capital structure often is assumed to be optimized at a level represented by the industry average capital structure.

Factors generally considered in estimating the appropriate required rate of return on equity for the subject company include the duration of the company, the company's position within its market and industry, the size of the company, the threat of existing competitors and new competitors, the level of historical returns provided by the company and the variability in the returns, the financial structure and operating structure of the company, the degree of reliance on key personnel and significant customers, management depth and experience, and exposure to uncontrollable operating risks, such as the regulatory environment.

Factors generally considered in estimating the relevant cost of debt include the subject company's current cost of debt, existing debt level and capacity for additional debt, and historical debt servicing patterns and relevant coverage ratios.

4. **Deduct the long-term growth rate estimated in step 2 from the required rate of return on invested capital estimated in step 3**. Deducting the expected long-term growth rate from the estimated required rate of return on invested capital results in the direct capitalization rate applicable to the economic earnings estimated in step 1. The direct capitalization rate, or divisor, can be converted into an economic earnings multiple by dividing the indicated capitalization rate into one. For example, a capitalization rate of 20 percent converts to an earnings multiple of 5 as (1 ÷ 0.20) = 5.

5. **Capitalize economic earnings by the indicated direct capitalization rate**. Economic earnings estimated in step 1 can be divided by the indicated capitalization rate or multiplied by the implied economic earnings multiple estimated in step 4 to estimate the value of the subject company.

A simplified model of the DC method is presented in Exhibit 4.

Exhibit 4
Direct Capitalization Method
Calculation of Equity Value on a Controlling Ownership Interest Basis

	After-Tax, Normalized Net Cash Flow to Total Invested Capital	$ 500,000
×	(1 + Expected Long-Term Growth Rate of 3%)	1.03
=	Long-Term, Normalized Cash Flow to Total Invested Capital	$ 515,000
÷	WACC Direct Capitalization Rate (15% – 3%)	12%
=	Indicated MVIC (rounded)	$ 4,300,000
–	Interest-Bearing Debt	($1,300,000)
=	Market Value of Equity	$ 3,000,000

Considerations regarding the Income Approach

The income approach can be equated to the present value summation of all economic returns (i.e., cash flow) expected to be received during the period that an asset (i.e., company or interest in a company) is owned. As a result, the following questions require rational, well-supported responses from an analyst in order to gain the necessary comfort that the value conclusion produced by the income approach is reasonable and reliable:

1. If the DCF method has been utilized, were the projected operating statements incorporated in the analysis developed by management in the normal course of operations, or were they developed by the analyst (and, therefore, subject to greater challenge)?

2. Do the projected operating statements and related cash flow reflect growth, margins, and investment levels (i.e., capital improvements and working capital requirements) that are consistent with historical results and industry norms?

3. Has the present value discount rate been developed in a manner consistent with the cash flow stream that is being converted to a present value (e.g., projected, after-tax cash flow available to equity investors should be discounted using an after-tax, equity-based discount rate, while projected,

after-tax cash flow available to debt and equity investors should be discounted using an after-tax WACC discount rate)?

4. Is the estimated, long-term terminal growth rate consistent with historical growth and supported by expected economic and industry growth?
5. If the DC method has been utilized, has the level of cash flow incorporated in the model appropriately been "normalized" to reflect a reasonable level of long-term, expected cash flow that is consistent with historical and expected operating results given the development stage of the subject company and expected economic and industry conditions?
6. Was the direct capitalization rate (i.e., the estimated discount rate reduced by expected, long-term growth) developed in a manner consistent with the cash flow being capitalized (as discussed above regarding the DCF discount rate), and does the capitalization rate appropriately reflect the risks inherent in the expected cash flow (i.e., have industry risk, size risk, and company-specific risk—including product/service and key person risk—factors appropriately been considered?)?
7. Is the estimated, long-term growth rate reasonable based on consideration of (a) how the long-term, normalized cash flow was estimated; (b) historical operating results; (c) cyclical/seasonal impacts; and (d) economic and industry expectations.
8. Is the indicated valuation conclusion consistent with (within a reasonable range of) the valuation conclusions produced by other valuation approaches considered?
9. Does the value conclusion consider the impact of nonoperating assets (e.g., excess cash, nonoperating investments)?
10. Has the implied equity value conclusion been adjusted appropriately for consideration of control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest (e.g., a noncontrolling equity interest in a privately held company should reflect appropriate adjustments to value for noncontrolling, nonmarketable status)?

Market Approach

The third approach that often is used to estimate the value in a divorce setting is the market approach. The market approach is based on the premise that the value of a company can be estimated by considering the price investors are willing to pay for similar companies (or ownership interests) with comparable risk profiles and offering comparable economic returns.

The following two methods may be used when the market approach is deemed relevant for the purpose of estimating value in a divorce setting:

1. The guideline publicly traded company (GPTC) method
2. The guideline merged and acquired company (GMAC) method.

The GPTC method is based on the analysis of pricing (i.e., trading volume and "per-share" value), operating and financial data relating to the stock of publicly traded companies.

The GMAC method is based on the analysis of pricing (i.e., total, or controlling, sale value), operating and financial dating relating to completed transactions involving transfers of publicly traded and private companies.

Because the pricing data incorporated in the GPTC method relates to transfers of noncontrolling interests (i.e., noncontrolling shares) in the related companies, the initial indication of value resulting from the GPTC method typically is interpreted as representing a noncontrolling indication of value.

Because the pricing data incorporated in the GMAC method relates to transfers of controlling interests (i.e., mergers and acquisitions) involving the related companies, the initial indication of value resulting from the GMAC method typically is interpreted as representing a controlling indication of value.

Guideline Publicly Traded Company Method

The first step in the GPTC method is to search for publicly traded companies deemed reasonably comparable to the subject company by identifying the most appropriate Standard Industrial Classification (SIC) or North American Industrial Classification System (NAICS) code. Sources typically reviewed for information on publicly traded companies include the following:

- S&P Capital IQ—www.capitaliq.com (information regarding 79,000 publicly traded companies—domestic and foreign)
- MergentOnLine—www.mergentonline.com (information regarding 15,000 domestic companies and 20,000 international companies)

- Bloomberg—www.bloomberg.com/professional/ (information regarding nearly all active and inactive domestic/international companies)
- Thomson ONE or Thomson Eikon—www.thompsonreuters.com (information regarding 52,000 public companies and 1 million private companies)
- FactSet—www.factset.com (information regarding 73,000 companies worldwide)
- Pitchbook/BVR Guideline Public Company Comps—www.bvmarketdata.com (information regarding nearly all publicly traded domestic companies)

The next step is to narrow the list of potential guideline publicly traded companies to arrive at a list of relevant guideline publicly traded companies.

Some of the factors considered for the purpose of narrowing the list of potential guideline publicly traded companies to the group considered most representative of the risk, return, and pricing characteristics relevant for the purpose of valuing the subject company typically include the following:

1. Comparability of business description/operating focus
2. Reasonable size comparability
3. Domestic companies
4. Relative financial and operating comparability
5. Absence of financial/operating distress
6. Pricing and trading activity

After a list of guideline publicly traded companies has been selected, typically five years of historical financial statement data (and projected data, if available) is used by the analyst to calculate various pricing multiples, which are applied, after any necessary adjustments, to the subject company's appropriate fundamentals.

Pricing multiples that often are considered for the purpose of completing the GPTC method typically include the following:

1. Equity pricing multiples:
   - Price per share/earnings per share
   - Price per share/cash flow per share
   - Price per share/book value per share
   - Price per share/revenue per share
2. Invested capital pricing multiples:
   - Market value of invested capital (MVIC—total debt and equity)/earnings before interest and taxes (EBIT)
   - MVIC/earnings before depreciation, interest, and taxes (EBDIT)
   - MVIC/debt-free net income (DFNI)
   - MVIC/debt-free cash flow (DFCF)
   - MVIC/revenue
   - MVIC/tangible book value of invested capital (TBVIC)

Depending on the specific circumstances regarding the subject company as of the valuation date, each of the pricing multiples deemed relevant may be calculated based on consideration of (1) latest 12-month (LTM), last fiscal year (LFY), average, weighted-average, or projected fundamentals.

The next step in the application of the GPTC method is to select the appropriate pricing multiples to apply to the relevant financial fundamentals of the subject company. Adjustments to the indicated pricing multiples of the guideline publicly traded companies generally are required to reflect differences in the risk profiles between the subject company and the publicly traded companies, based primarily on consideration of the following:

- Size (e.g., assets, revenue, customers/clients, products/services)
- Geographic diversity and differences in the demographics of markets served
- Market position
- Depth of management
- Capital and access to capital
- Profitability
- Expected growth
- Variability of earnings and cash flow

After estimating the appropriate pricing multiples, the analyst applies the selected multiples to the relevant fundamentals—as appropriately normalized—of the subject company.

The indications of value resulting from the application of the various pricing multiples are then reconciled and weighted, typically to produce a single, "point-estimate" of value. (Recognized valuation standards allow for the value conclusion to be presented as a "range of values" in certain, agreed-upon circumstances.)

MVIC-derived pricing multiples are most useful when comparing the subject company to guideline

publicly traded companies that have substantially different capital structures. Applying invested capital pricing multiples to the fundamentals of the subject company results in an estimate of MVIC for the subject company.

To estimate the value of the equity, the market value of the interest-bearing debt for the subject company as of the valuation date should be subtracted from the indicated MVIC.

In some states/jurisdictions, and based on the belief that the GPTC method is not appropriate for the purpose of estimating the value of smaller, non-public companies, the GPTC method generally is limited to the analysis of larger private companies. As a result, the GMAC method often is considered more relevant regarding the valuation of smaller, nonpublic companies.

Guideline Merged and Acquired Company Method

Based on the GMAC method, the value of a subject company can be estimated by analyzing completed transactions involving companies deemed reasonably comparable. To search for mergers and acquisitions, the analyst focuses on the appropriate SIC/NAICS codes, as previously discussed in the GPTC method.

Commonly used sources for identifying relevant merger and acquisition data include the following:

- Capital IQ
- Thomson ONE
- Pratt's Stats
- Bizcomps
- FactSet Mergerstat
- Bloomberg
- Mergerstat Review

In addition, there are also publications that summarize completed transactions for specific categories of health care organizations (e.g., hospitals, HMOs, and physician practices), such as Irving Levin Associates, Inc., the *Health Care M&A Report*.

Further, with regard to certain medical and dental practices, *The Goodwill Registry* publishes data regarding the estimated price paid for intangible assets of the selected professional practices (as a percentage of gross revenue). These data, published annually, is sorted by year of the transaction and by medical/dental specialty.

Implementing the GMAC requires that the terms of each relevant transaction be reviewed to determine the actual price paid, and whether the transaction involved the sale of equity or assets. If the transaction involved the sale of assets, it is important to determine the exact assets purchased and the treatment of any liabilities.

After identifying and selecting a group of guideline transactions and determining the purchase price for each transaction, various pricing multiples are calculated. As in the GPTC method, after estimating the appropriate pricing multiples, the analyst applies the relevant, selected pricing multiples to the normalized fundamentals of the subject company.

An example of the guideline merged and acquired company data is presented in Exhibit 5. This example presents pricing multiples resulting from the analysis of 11 acquired[6] multi-specialty practices for the valuation of Medical Clinic, Inc. (MCI), which operates as a 100-physician multi-specialty practice with five sites in a metropolitan area.

Based on the information provided by the analysis of the merged and acquired physician practices, an analyst faced with the challenge of appraising MCI should consider and analyze the following factors, among others, for the purpose of making appropriate pricing multiple selections:

- The dates of the guideline transactions relative to the valuation date of MCI
- Market conditions at the date of the GMAC transactions relative to market conditions existing at the valuation date of MCI
- Size of MCI (based on assets, revenue, and number of physicians) relative to the GMACs
- Physician mix (i.e., primary care versus specialty care) of MCI relative to the GMACs
- Payer mix (i.e., fee-for-service, HMO, PPO, Medicare, Medicaid) of MCI relative to the payer mix of the GMACs

Exhibit 5
Multi-Specialty Clinic Merged and Acquired Company Analysis
Medical Clinic, Inc.

Acquired Practice	Location	Physicians	Revenue ($)	Price/ Physician ($)	Price/ Revenue ($)
Riverside Medical Clinic	Riverside, CA	90	50,000,000	355,556	.64
Lexington Clinic	Lexington, KY	125	51,000,000	512,000	1.25
Arnett Clinic	Lafayette, IN	109	87,438,000	660,528	.82
Diagnostic Clinic	Largo, FL	93	49,000,000	395,699	.75
Glen Ellyn Clinic	Glen Ellyn, IL	89	60,000,000	707,865	1.05
Cardinal Healthcare, PA	Raleigh-Durham, NC	75	34,170,500	573,333	1.26
Summit Medical Group	Summit, NJ	75	47,000,000	736,087	1.17
Lewis-Gale Clinic, Inc.	Roanoke, VA	106	68,200,000	410,377	.64
Clinical Associates	Baltimore, MD	71	35,870,000	245,070	.49
Meridian Medical Group	Marietta, GA	67	63,950,000	419,597	.44
Berkshire Physicians	Pittsfield, MA	93	43,683,000	317,204	.68

- Profitability—measured by consideration of operating income and total physician compensation and benefits—of MCI relative to that of the GMACs
- Historical growth—in assets, revenue, physician compensation and profits—of MCI relative to that of the GMACs
- Diversity of practice (i.e., level of ancillary services) of MCI relative to that of the GMACs
- Location of MCI (i.e., rural, urban, suburban) relative to the locations of the GMACs
- Market position of MCI relative to the market position of the GMACs in their respective catchment areas

While all of the above information may not be readily available with regard to the identified acquired companies, an analysis of all pertinent and available information often is an important step in the selection of relevant and supportable market-derived pricing multiples.

Upon selecting the appropriate pricing multiples and applying them to the relevant fundamentals of the subject company, the GMAC method is completed in the same fashion as the GPTC method.

Considerations regarding the Market Approach

The market approach can be equated to a relative value process—in essence, estimating the value of a company based on comparability with other, similar companies that either (1) are publicly traded or (2) have recently been acquired. As a result, the following questions require rational, well-supported responses from an analyst in order to gain the necessary comfort that the valuation conclusion produced by the market approach is reasonable and reliable:

1. Based on consideration of relative (a) business focus, (b) size, (c) diversity of product/service offerings, (d) markets served, and (e) growth and profitability, has a relevant and adequate pool of GPTC or GMAC been identified (i.e., considering both comparability and number of companies)?
2. Based on consideration of the business focus of the subject company and the industry in which it operates, have the appropriate pricing multiples (e.g., price/asset, price/book value, price/revenue, price/earnings, price/cash flow) been emphasized?
3. Based on consideration of the stage of operations for the subject company and the industry in which it operates, have the pricing multiples been developed with appropriate emphasis on the most relevant operating periods (e.g., LTM, LFY, three-year average or three-year weighted-average, five-year average or five-year weighted-average)?
4. Are the selected pricing multiples reasonable in the context of the indicated pricing multiple ranges and comparative analysis between the subject company and the GPTC/GMAC?
5. Is the weight attributed to each indication of value reasonable based on consideration of the stage of operations for the subject company and the industry in which it operates?
6. Is the indicated valuation conclusion consistent with—within a reasonable range of—the valuation conclusions produced by other valuation approaches considered?
7. Does the value conclusion consider the impact of nonoperating assets (e.g., excess cash, nonoperating investments)?
8. Has the implied equity value conclusion been adjusted appropriately for consideration of

control/lack of control and marketability/lack of marketability considerations relevant for the subject ownership interest (e.g., a noncontrolling equity interest in a privately held company should reflect appropriate adjustments to value for nonmarketable status when using the GPTC method)?

Normalized Economic Earnings

As previously discussed, normalized earnings are intended to represent an earnings level for the subject company that reflects financial performance under "normal" operating circumstances. In essence, normalized earnings should represent a true indication of the historical and expected financial operating results for the subject company that an investor reasonably could rely upon for the purpose of making an investment decision.

In a divorce setting, the process of normalizing earnings often proves to be one of the more challenging aspects of an engagement that an analyst must address when valuing the subject company. Some level of forensic, or investigative, analysis is required in most divorce circumstances. The following areas of interest typically should be addressed when normalizing the earnings of a subject company:

1. The reasonableness of owner/operator compensation and benefits (i.e., are compensation and benefit levels in line with industry norms based on related responsibilities and commitment level?)
2. The existence, significance, and reasonableness of related party activity (e.g., does income recognized/expense reported as a result of related party dealings reflect market-based levels?)
3. The impact of unusual/nonrecurring income and expense items (e.g., litigation awards/settlements, regulatory fines/penalties, unique/discontinued business lines, theft losses/write-offs, loss recoveries/insurance proceeds, significant gains/losses on asset sales, discretionary/non-business-related income/expense, etc.)
4. The impact of seasonal/cyclical influences on reported operating results (e.g., cyclical industries such as forest products and real estate, or seasonal considerations such as retail and agriculture)

A well-reasoned valuation analysis prepared in a divorce setting will identify and appropriately address those items deemed material and included within the categories identified above. In some instances, doubts regarding the persistence and/or materiality of required normalizing adjustments may be so significant that a formal forensic analysis may be required. Such an analysis will not only enable an analyst and legal counsel to gain the comfort necessary to develop a reasonable level of normalized earnings for the subject company, but may also result in the identification of undisclosed assets that should be included in the marital estate.

Ownership Characteristics

The valuation subject in a divorce setting can be represented by any level of ownership, ranging from 1 percent to 100 percent of the equity in a subject company. The nature of the ownership interest can range from highly liquid, publicly traded stock, to an equity interest represented by stock or membership units in a privately owned, (1) regular corporation, (2) subchapter S corporation, (3) limited liability company, or (4) partnership.

One significant issue with regard to the analysis and valuation of an equity interest includable in a marital estate is a clear understanding of the economic rights and benefits inherent in the subject ownership interest.

A controlling equity position in a nonpublic company typically would require the concluded value to incorporate the impact of (1) a reasonable adjustment for controlling ownership status (i.e., a control premium) and, possibly, (2) some consideration for the estimated cost to convert the position to cash (i.e., illiquidity discount).

Similarly, a noncontrolling equity position in a nonpublic company typically would require the concluded value to incorporate the impact of (1) a reasonable adjustment for noncontrolling status (i.e., a discount for lack of control) and (2) a reasonable adjustment for nonpublic status (i.e., a discount for lack of marketability).

Control (or lack of control) and marketability (or lack of marketability) adjustments regularly are addressed in valuations completed for divorce purposes. Further, there are numerous authoritative valuation standards, texts, articles, and judicial precedents that provide guidance regarding the identification and treatment of control and marketability considerations, a more detailed presentation of which is beyond the scope of this discussion. However, it is worth noting that a combined discount for lack of control and lack of marketability

status can often approach 50 percent of an otherwise controlling level value, emphasizing the importance of these considerations.

In addition to adjustments relating to control and marketability characteristics inherent in an ownership interest, a thorough valuation completed in a divorce context should also address and indicate how the following factors—when relevant—were considered in arriving at the opinion of value presented:

1. Key person dependency (i.e., whether a direct discount was applied, or whether an "implied" discount is reflected in the calculation of the discount/capitalization rate in the income approach, and/or the multiple selection process in the market approach)
2. Key customer dependency (i.e., whether a direct reduction was applied when normalizing earnings, or whether an "implied" discount is reflected the manner previously identified with regard to key person dependency)
3. S corporation or other tax pass-through entity status (i.e., whether a direct premium was applied, or whether an "implied" premium is reflected in the form of a reduced discount for lack of liquidity or marketability)

Valuation-Based Organizational Agreement Terms/Prior Transactions

Shareholder, operating, and partnership agreements, and related documents, often include provisions intended to address the question of "value" with regard to the underlying equity of the subject company. Often, the related provisions provide very specific definitions of "value," and/or detailed processes for estimating value.

While the provisions often included in the organizational documents related to the above may be precise with regard to the definition of value and the process for estimating the value of the underlying equity of the subject company, the definition of value provided may not be consistent with the standard of value required in the relevant state/jurisdiction in a particular divorce setting. This, however, does not mean that the valuation-related provisions incorporated in organizational documents should be ignored.

Prudent valuation practice considers that the valuation-related provisions in organizational documents are thoroughly reviewed (if available) and considered. When appropriate and possible, "value" should be estimated (i.e., "calculated" when formulas are presented) pursuant to the terms established by the relevant provisions.

At this point, the analyst can then reconcile the value indication resulting from the related provisions with his/her independently estimated value indication. The reconciliation process will enable the analyst to establish whether the provision-based value indication is relevant for consideration (i.e., given any weight) when rendering a final opinion of value.

Similarly, prior transactions in the equity of the subject company should be reviewed and analyzed. Considerations when analyzing prior transactions in the equity of the subject company include (1) the date of the transaction(s), (2) the size of the interest(s) involved, (3) the parties involved, and (4) the terms of the transaction(s)—including price and payment terms. Clearly, arm's-length transactions involving unrelated parties that occurred within a reasonably recent period relative to the valuation date and that reflected cash-equivalent consideration would provide the best evidence of value regarding the equity of the subject company. Such transactions may provide meaningful indications of value that are relevant to the analyst and that should be considered for the purpose of rendering a final opinion of value.

Intangible Asset Value Considerations

The intangible asset value of the subject company in a divorce setting routinely is referred to as "goodwill." Technically, goodwill represents residual intangible asset value remaining after specific intangible assets (e.g., a trade name and a patent) have been identified and valued. As previously discussed, and from an economic perspective, the potential total intangible asset value of a company is based primarily on the expectation of continued earnings and cash flow in excess of normal returns on the tangible operating assets of the company.

In many instances, the intangible asset value inherent in a company can significantly exceed the tangible asset value of the company. This is often the case when a professional practice (i.e., service-based firm) is the subject company in a divorce setting, and why the identification and evaluation of intangible asset value is a key property division consideration in many divorce matters.

In a broad sense, goodwill is defined as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."[7]

The treatment of goodwill (i.e., the inclusion or exclusion of goodwill as divisible property) in a divorce setting varies from state to state. The classification of goodwill for property division purposes appears to be dependent primarily on whether the related intangible value is attributable to the subject company (i.e., "enterprise," or "entity," goodwill), or attributable to—and inseparable from—an individual (i.e., "personal") goodwill.

Generally, the majority of states recognize enterprise goodwill as a divisible marital asset, but typically exclude personal goodwill.

Enterprise Goodwill versus Personal Goodwill

Enterprise goodwill generally is interpreted as representing intangible asset value that is owned and/or that has been created by a commercial enterprise and that can be transferred. Identifiable intangible assets typically classified within the enterprise goodwill category include the following:

1. Trademarks and trade names
2. Patented and unpatented technology
3. Copyrights
4. Customer lists and relationships
5. Contracts, including employment agreements and noncompetition agreements
6. Phone number
7. Leasehold
8. Trained and assembled workforce

These assets possess certain attributes that provide a foundation for their existence, including the following:

1. They can be identified and described.
2. They can be substantiated legally, and defended.
3. They can be owned.
4. They can be documented.
5. They can be purchased or created.
6. Generally, they have defined lives, or their existence can be intentionally terminated.

Personal goodwill generally is interpreted as representing intangible asset value, or, more appropriately, attributes, that are unique to, and inseparable from, an individual. Attributes typically classified within the personal goodwill category include the following:

1. Personality
2. Reputation
3. Personal skill, expertise and knowledge
4. Personal relationships

In essence, personal goodwill is represented by certain attributes that are deemed to be incorporated into the very being of an individual, and, therefore, are unable to be sold or transferred to another individual.

Valuations in a divorce setting involving a subject company that is very large, or the continuing economic viability of which is not highly dependent on the personal goodwill of a divorcing party, typically do not create significant challenges regarding the divisibility of intangible asset value. In such circumstances, and depending on the subject ownership interest, the primary challenge is developing a reasonable conclusion regarding the value of the subject interest, rather than allocating estimated intangible asset value between enterprise goodwill and personal goodwill.

Implications of *Slater v. Slater*

In the matter of the *Marriage of Shelly A. Slater v. Paul J. Slater*,[8] the Oregon Appellate Court ruled that the trial court erred in including the value of a hypothetical noncompetition covenant when it valued Slater Chiropractic (the "Practice") and, consequently, erred in determining the value of the business.

The opinions of the fair market value of the Practice offered by the analysts—$610,000 by the wife's analyst and $504,152 by the husband's analyst—were within a reasonable range. However, the wife's analyst concluded that all of the indicated practice value above the estimated net tangible asset value of $160,902—that is, $449,098—was independent of the husband (the sole owner and primary practitioner) and attributable to "entity goodwill."

Conversely, the husband's analyst concluded that only $30,373 of an estimated $303,730 in total intangible asset value for the practice was attributable to a noncompetition agreement between the practice and the associate (i.e., employee) chiropractor, Dr. Miller. The husband's analyst further concluded that the remaining $273,357 in estimated intangible asset value for the practice was attributable to the "ongoing personal services of Husband," and, as personal goodwill, should be excluded from the estimated total practice value for property division purposes.

In agreeing with the husband's analyst, the Appellate Court concluded that the fair market value of the practice was $230,795 (i.e., the $504,152 estimated total practice value less "personal goodwill" estimated at $273,357), rather than the $500,000 conclusion presented by the trial court. The reasoning offered by the Appellate Court in rendering its

decision (i.e., that the preponderance of the indicated goodwill was personal to the husband) and remanding the matter to the trial court included the following:

1. The husband was the sole owner of the practice.
2. The practice bore the husband's name.
3. Half of the practice's business (i.e., revenue) originated from the husband's status as a preferred provider (with no evidence that such status could be transferred to the practice or a new owner)
4. When the husband purchased the practice in an arm's-length transaction (10 years prior to the divorce), payment for his predecessor's noncompetition covenant (in essence, personal goodwill) was substantially more than payment for the business goodwill.

Of particular significance in the Appellate Court's opinion is emphasis of the fact that the wife made no attempt to present a valuation of the business differentiating between enhanced earnings attributable to the entity and enhanced earnings attributable to the husband individually. While the wife's analyst testified that <u>none</u> of the enhanced value of the practice was attributable to husband personally, the wife's analyst agreed that, if husband were to sell his business, it would be necessary for him to execute a noncompetition covenant.

As stated by the Appellate Court:

> **That acknowledgement is irreconcilable with the position that Husband's personal skills, services, and continued presence are immaterial to the business's enhanced earnings. If that were so, the assumption of a noncompetition covenant would be inapposite to valuation.** [emphasis added]

While the facts and circumstances regarding *Slater v. Slater* are specific to that matter, the Appellate Court's ruling and related foundation are instructive when valuation in a divorce setting involves a professional practice or service-based entity that is highly dependent on the continued presence and participation of a single individual. It is worth noting that the Appellate Court provided "hints" regarding how the wife could have presented rational evidence segregating the indicated goodwill between the husband (i.e., personal) and the practice (i.e., entity):

- Was the "preferred provider" status specific to the husband, or general with regard to the practice? The record indicates that the husband underwent back surgery shortly before trial, and was expected to be in recovery and unable to work for three to six months. He wrote a letter to his patients encouraging them to seek treatment from Dr. Miller in his absence. Such a circumstance implies some level of transferability with regard to goodwill that would otherwise be deemed personal to the husband. Further, such a circumstance suggests that the practice, rather than the husband, maintained the "preferred provider" status that was credited with generating over half of the practice's business.
- Of the remaining 40 percent of the practice's business—attributable to word-of-mouth referrals and advertising in the Yellow Pages—what percentage of patient services were attributable to Dr. Miller? The record indicates that the husband's analyst determined that 10 percent of total goodwill, based on the percentage of collected revenue, was attributable to Dr. Miller's practice.
- What portion of the practice's business was attributable to insurance that was contracted with the practice, as a qualified provider, rather than the husband, as a specific provider?

Addressing "Double Dipping"

In a divorce setting, "double dipping" is the term often ascribed to the inappropriate inclusion, or "double counting," of the same economic value in both property division and marital support determinations.

The rationale supporting the inappropriateness of double dipping is premised on the concept that earnings that are capitalized or otherwise incorporated into the valuation process for the purpose of estimating the value of marital property should be excluded from earnings that serve as the basis for establishing marital support.

A simple example clarifies the point and the significant impact that double dipping can exert with regard to the division of a marital estate.

Let's assume the following facts:

- The wife owns and operates 100 percent of a closely held company.
- The wife's total compensation from the business has averaged $750,000 annually, with little variability, in the five years preceding the valuation date.

- Average company earnings, after taxes, averaged $2 million annually, with little variability, in the five years preceding the valuation date.
- A very qualified, rational, and diligent analyst has concluded, using the capitalization of earnings method, that market-based, total compensation for the wife is stated reasonably at $450,000, and that a reasonable capitalization rate for the company is 15 percent.

A potential "double dip" would occur if (1) for support purposes, the wife's total gross income is based on assumed, continuing compensation of $750,000 annually, and (2) the company is valued based on a "normalization" of earnings for the company including an assumption that the wife's annual compensation should be restated to $450,000. The normalization process would result in annual, expected earnings for the company increasing by $300,000, or the difference between the wife's actual compensation of $750,000 and reasonable, market-based compensation of $450,000.

The incremental earnings level attributed to the company as a result of the normalization of compensation equals $180,000 on an after-tax basis (i.e., $300,000 in incremental earnings reduced by a 40 percent effective income tax rate).

Based on a 15 percent direct capitalization rate (or an implied earnings multiple of 6.7 times—i.e., 1 ÷ 0.15 = 6.666, or 6.7), the normalization process results in an increase in the value of the company of approximately $1.2 million: $180,000 ÷ 0.15 = $1,200,000. It is clear that the $300,000 reduction in compensation for valuation purposes results in a higher business valuation and should, therefore, not also be included in the assumed, continuing gross income for the wife, which would result in a higher level of marital support.

Avoiding the "double dip" would require either (1) estimating support based on the normalized compensation level of $450,000 incorporated in the valuation process or (2) estimating support based on the historical compensation level of $750,000 and excluding the compensation adjustment from the valuation process.

From the analyst's perspective, and barring unusual circumstances, it would be inappropriate to complete the valuation ignoring market-based evidence indicating that an adjustment to owner's compensation was (1) relevant and appropriate, based on generally accepted valuation practice; (2) supportable; and (3) quantifiable.

Summary and Conclusion

A thorough and defensible business valuation requires strict adherence to generally accepted business valuation practice. Such adherence is achievable only through the consistent application of relevant business valuation standards, and consideration of authoritative financial, economic and valuation theory (as embodied in authoritative literature and court precedents).

Business valuation in a divorce setting often is complicated by challenges relating to the completeness and accuracy of data, and access to data. Further, the nature of a divorce circumstance often creates a less than optimal environment for analysts to deliver services due to what is generally deemed emotionally driven behavior on the part of one, or both, of the divorcing parties.

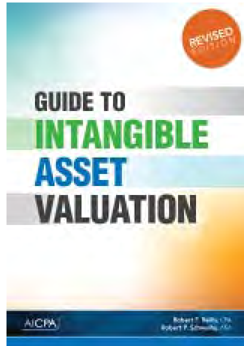
This discussion identifies some of the considerations that qualified analysts and legal counsel should address when faced with the task of placing "value" on business-related assets includable within a marital estate. The discussion also identified several issues that should be addressed during the valuation process in order to ensure that a relevant and defensible opinion of value is developed.

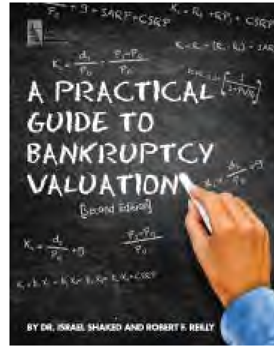
Notes:

1. "International Glossary of Business Valuation Terms" in *Statement on Standards for Valuation Services, VS 100, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (New York: American Institute of Certified Public Accountants, June 2007).
2. Ibid.
3. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 945.
4. Oregon Revised Statutes, Section. 60.551(4).
5. "International Glossary of Business Valuation Terms."
6. Based on data presented in Irving Levin Associates, Inc., *The Health Care M&A Report*.
7. "International Glossary of Business Valuation Terms."
8. Marriage of Shelly A. Slater v. Paul J. Slater, 06DS0016, A137465 (Crook County, Oregon, Circuit Court, December 29, 2010).

Charles Wilhoite is a managing director in our Portland, Oregon, practice office. Charles can be reached at (503) 243-7500 or at cawilhoite@willamette.com.

Valuation Textbooks Authored by Robert Reilly and Robert Schweihs





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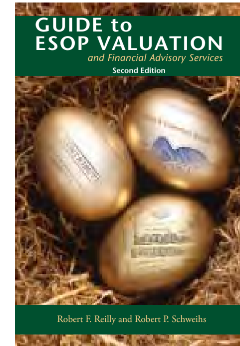

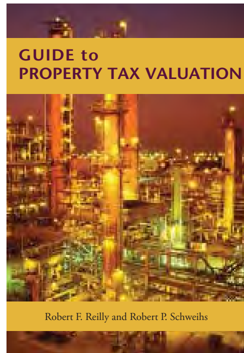

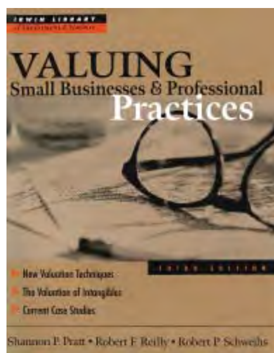

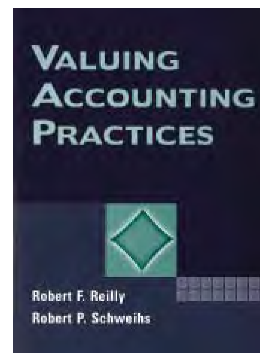

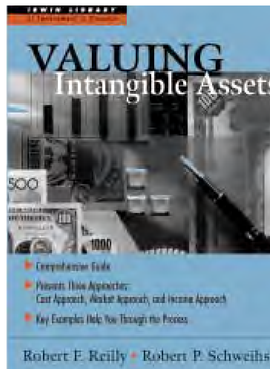

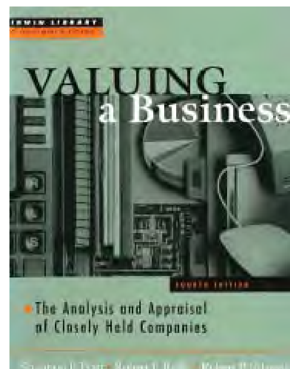

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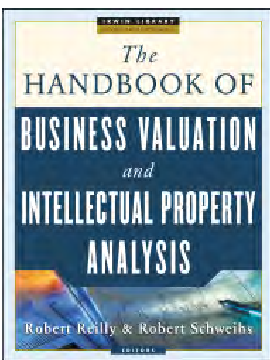

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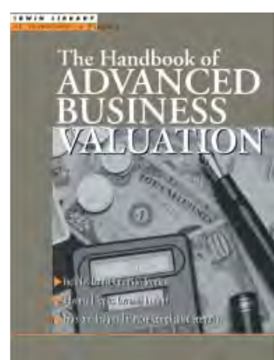

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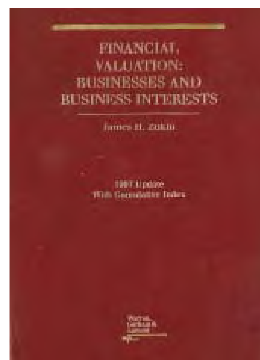
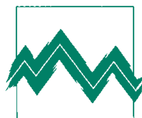


* Authored by Robert Reilly and Israel Shaked, Ph.D.
** Authored with Shannon Pratt
*** Edited by Robert Reilly and Robert Schweihs



Willamette Management Associates

Estimating Discount Rates and Direct Capitalization Rates in a Family Law Context

Stephen P. Halligan

Estimating the risk-adjusted discount rate or direct capitalization rate are among the more challenging aspects of developing a reasonable business value indication when using the income approach to valuation. Generally accepted business valuation practice recognizes multiple methods for the development of discount rates and capitalization rates. Analysts that (1) implement generally accepted practice, (2) rely on credible sources for rate of return information, and (3) provide circumstance-specific support and rationale when developing discount and capitalization rates will be better positioned to defend their business value conclusions.

Introduction

Valuation analysts ("analysts") often use the income approach to value a business, business ownership interest, security, or intangible asset within a family law context. In the income approach, the analyst will use a discount rate or direct capitalization rate to convert projected income (e.g., net income or cash flow) into an estimate of value.

The discount or capitalization rate, if calculated incorrectly, may exert a significant impact on the concluded value of the subject company or subject business interest. Therefore, it is important that the analyst (1) understands the differences between discount rates and capitalization rates, (2) knows the methods commonly used to estimate discount rates and capitalization rates and understands how to properly apply them, and (3) considers and assesses the unsystematic risks specific to the subject company.

This discussion will summarize (1) the distinctions between a discount rate and a direct capitalization rate, (2) the methods and formulas commonly used to estimate discount rates and capitalization rates, and (3) the identification and quantification of size risk premiums, industry-specific risk premiums, and company-specific risk premiums that may affect the discount rate or capitalization rate.

The Discount Rate and Capitalization Rate Defined

In its most basic form, the income approach estimates the value of a business or asset as the present value of the income to be generated by that particular business or asset. In other words, the income approach values a business or asset by discounting a projected income by a rate of return that reflects the risk inherent in the business and/or income steam.

Principally, there are two valuation methods within the income approach: (1) yield capitalization and (2) direct capitalization. Both of these methods use analogous measures of return and, if properly applied in the appropriate income-based analytical method, should produce consistent results.

Depending on the income approach valuation method selected (i.e., yield capitalization or direct capitalization), the analyst will use either a discount (yield capitalization) rate or a capitalization (direct capitalization) rate to convert the projected level of income into an estimated present value. Discount rates and capitalization rates represent risk-adjusted rates of return that investors expect on various investment options.

Both rates of return (i.e., a discount rate or a capitalization rate) take into account the risks and

uncertainties associated with the income stream that is projected for the subject investment (i.e., the subject company or asset). It is important to note, however, that although these measures of risk and return are related and have the ability to produce complementary results, they are not interchangeable.

Within the yield capitalization method, it is appropriate to use the discount rate, which may also be referred to as the "present value rate," "present value discount rate," "required rate of return," or the "yield capitalization rate." Within the direct capitalization method, it is appropriate to use the direct capitalization rate, often referred to simply as the "capitalization rate."

Yield Capitalization and the Discount Rate

By definition, the discount rate is a rate of return used to convert a future monetary sum into present value.[1]

Alternatively, the discount rate is the "opportunity cost" that an investor would have to forego by investing in the subject company rather than investing in other investments that have similar risk-return profiles. This opportunity cost (i.e., discount rate) is estimated based on consideration of market conditions prevailing as of the valuation date and as they apply to the specific characteristics of the subject investment.

The discount rate is estimated through the use of one of several generally accepted models used in the calculation of the cost of equity capital. These models include, but are not limited to, (1) the capital asset pricing model (CAPM) or modified capital asset pricing model (MCAPM) and (2) the build-up model (BUM). These models are described later in this discussion.

The discount rate is the required rate of return used in a yield capitalization analysis. In a yield capitalization analysis, the analyst projects an appropriate measure of income for several discrete time periods into the future. This projection of prospective income is then converted to a present value by the use of the discount rate. An example of an income approach method that uses yield capitalization is the discounted cash flow method.

Direct Capitalization and the Capitalization Rate

Within the direct capitalization method—incorporating a *capitalization* rate rather than a *discount* rate—a single-period, or point-estimate, measure of income expected to be generated by a business over a long-term operating horizon (i.e., 20-plus years) is "capitalized by"—or divided by—a capitalization rate. The expected level of income should reflect a reasonable level of earnings based on consideration of (1) historical earnings, (2) expected earnings, and (3) the anticipated impact of industry and economic conditions.

By definition, a capitalization rate is any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.[2]

It is important to note that although the definition of the capitalization rate is similar to the definition of the discount rate, it contains a subtle, yet significant, difference from the discount rate definition. A discount rate is used to convert a *series* or stream of future income to an indicated present value, while a capitalization rate is used to convert only a *single-period* expected level of income to an indicated present value.

The difference between discounting a series of future income returns and capitalizing a single-period level of income is rooted in the assumptions underlying the direct capitalization and yield capitalization models.

The direct capitalization method assumes that the projected level of normalized income will either (1) remain constant or (2) increase at a constant rate over time. In instances where the projected income is expected to increase at a constant rate over time, the capitalization rate is equal to the discount rate minus the expected long-term growth rate in the income measure.

The long-term growth rate is subtracted from the discount rate due to the fact that a discount rate considers the inflationary effects incorporated by the CAPM (or MCAPM) and BUM. This concept is explained further in *Valuing a Business*.

> If the build-up procedure or the capital asset pricing model procedure is used to develop the present value discount rate from which the growth rate is to be subtracted in order to derive a direct capitalization rate, that discount rate incorporates the expected rate of inflation as part of the required rate of return. Since the nominal government bond interest rates used in developing these discount rates incorporate expected inflation over the duration of the bond, the implication is that the selected long-term growth rate should also reflect the impact of expected inflation on the economic income variable being capitalized.[3]

> **"The CAPM recognizes there is a direct correlation between the cost of capital and the risk associated with a particular investment. . . ."**

Therefore, in its most simple form, the capitalization rate is equal to the discount rate for the subject company, less the expected long-term sustainable growth rate in the income measure, however defined. This means that in order to develop a more meaningful understanding of the capitalization rate, it is important to understand the components of the discount rate.

Estimating the Discount Rate

Estimating a reasonable discount rate may be a challenging and controversial aspect of the business valuation, particularly as relating to the analysis of nonpublic (i.e., closely held) companies.

To estimate the required rate of return for a particular company, the analyst should be prepared to deal with the risk-related complexities associated with nonpublic companies. These complexities include the consideration of risk-based adjustments for size, management depth, liquidity, and other company-specific (i.e., unsystematic) risk factors.

Several generally accepted methods are available to estimate a discount rate, from which a capitalization rate may be derived. A description of all of the available methods used to estimate a discount rate is beyond the scope of this discussion. Therefore, this discussion focuses on two of the more common methods used to estimate a discount rate. These methods are (1) the CAPM (or MCAPM) and (2) the BUM.

Capital Asset Pricing Model

The CAPM is a widely recognized method used to estimate a discount rate. It is discussed extensively in valuation literature and in the valuation community. The focus of this discussion is to understand the basic concepts of the CAPM, the underlying assumptions inherent in those basic concepts, and the use of the CAPM as it relates to the estimation of discount and capitalization rates. Therefore, this section includes only a simplified description of the CAPM.

The CAPM is defined as follows:

> A model in which the cost of capital for any stock or portfolio of stocks equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the stock or portfolio.[4]

Simply stated, the CAPM reflects the relationship between (1) the risk of an asset and (2) its expected return. While the CAPM was originally developed for the analysis of marketable securities, analysts have found the CAPM to be a practical method for estimating the expected rate of return for assets that do not trade in a public marketplace.

The CAPM recognizes there is a direct correlation between the cost of capital and the risk associated with a particular investment, and that every such investment carries two distinct risks: (1) systematic risk and (2) unsystematic risk. Systematic risk, also referred to as "market risk," is the risk associated with investing in the market as a whole and that cannot be eliminated through diversification. This measure of systematic risk is often referred to as "beta."

The second type of risk—unsystematic risk—is the risk that is unique to an individual investment and represents the volatility of an investment that is uncorrelated with general market moves. The calculation of unsystematic risk, to be discussed in more depth later, requires a complete analysis of the company or investment, comparing characteristics of the subject investment to (1) other companies or practices in the same industry and (2) the market as a whole. In contrast to systematic risk, unsystematic risk typically can be mitigated through diversification.

The CAPM equation is often expressed as follows:

$$E(R_i) = R_f + \beta\ (RP_m)$$

where:

$E(R_i)$ = Expected return for an individual security (i)

R_f = Rate of return available on a risk-free security

β = Beta

RP_m = Equity risk premium (ERP) for the market as a whole[5]

Three of the company-specific equity risk premium components of the CAPM are as follows:

1. The risk-free rate
2. The market-derived ERP
3. The selected beta

The risk-free rate reflects the minimum return an investor expects to receive from his or her investment, based on the impact of inflation over time and expectations regarding the real rate of interest on money.

The market-derived ERP is the market return that an investor can expect over the risk-free rate by investing in the market portfolio, which is assumed to consist of a fully diversified bundle of perfectly liquid securities and is the same for all investors.

The beta component of the CAPM represents the subject security's sensitivity to the market as a whole. This variable calculates the amount of expected systematic risk, or market risk, for the subject security.

These three components of the CAPM, in part, compensate the investor for the assumed risk he or she takes by investing in a certain security. Because the risk of the security, as measured by the CAPM, is based on its relationship to the diversified portfolio, it assumes that the unsystematic risks (i.e., company-specific risks), are diversified away. Therefore, in the CAPM, the investor is only compensated for the systematic risk.

As a result, the original unmodified version of the CAPM assumes that the only component of risk that investors care about is the risk of the market (i.e., systematic). In practice, however, it is common to adjust the CAPM (to the MCAPM) in order to reflect different risk-return profiles and the additional risk normally associated with investments other than publicly traded equity securities. Therefore, the basic form of the CAPM is typically modified to reflect the additional risk associated with (1) the size of the subject company and (2) company-specific risk factors.

The MCAPM seeks to incorporate these risk premiums in the quantification of a required rate of return.

The MCAPM formula is often expressed as follows:

$$E(R_i) = R_f + \beta \times RP_m + RP_s \pm RP_c$$

where:

$E(R_i)$ = Expected return for an individual security (i)

R_f = Rate of return available on a risk-free security

β = Beta

RP_m = ERP for the market as a whole

RP_s = Risk premium for small size

RP_c = Risk premium attributable to other company-specific risk factors[6]

Build-Up Model

A second method commonly used to estimate a discount rate in valuations of small businesses is the BUM. In the BUM, a discount rate is estimated by summing the analyst's quantified assessments of the systematic and unsystematic risks associated with a particular business or interest. The BUM uses four basic elements to estimate a discount rate.

The BUM formula is often expressed as follows:

$$E(R_i) = R_f + RP_m + RP_s \pm RP_i \pm RP_c$$

where:

$E(R_i)$ = Expected (market required) rate of return on security (i)

R_f = Rate of return available on a risk-free security as of the valuation date

RP_m = General expected ERP for the "market"

RP_s = Risk premium for smaller size

RP_i = Risk premium attributable to the specific industry

RP_c = Risk premium attributable to the specific company[7]

The first component of the CAPM, the MCAPM, and the BUM is the risk-free rate of return. The risk-free rate is considered to represent a riskless investment with virtually no risk of default. The most common source for a risk-free rate proxy is U.S. Treasury bonds.

When selecting a risk-free rate, it is appropriate to select a Treasury bond with the same maturity as the investment horizon for the subject company. Typically, the 20-year Treasury bond is used. This is

because the 20-year Treasury bond is the benchmark that the Duff & Phelps (D&P) data used to estimate the equity risk premium.

The second component of the BUM is the ERP. This element of the discount rate considers the general expectations of the market as a whole. This is the premium that investors should receive in order to entice them to invest in the public equity markets instead of in riskless, long-term government securities (e.g., risk-free Treasury bonds).

The third component of the BUM is a size premium that is often added when valuing small, closely held businesses. This risk premium is added because the empirical evidence provided by D&P and others show that, generally speaking, as the size of a company or practice decreases, the risk of that company increases. Therefore, a smaller company or practice must pay an additional risk premium in order to attract funds. Both the ERP and size premium can be obtained from the D&P *Valuation Handbook: Guide to Cost of Capital*.

The final component of the BUM is the risk specific to the company being valued and the industry in which it operates. This is often one of the more subjective areas of business valuation and one that should be given careful consideration in family law cases.

Company-specific risk includes risk associated with the particular industry in which the subject company operates in relation to the economy as a whole, as well as the risks associated with the internal workings of the subject company, including such things as management, leverage, key person reliance, dependence on specific suppliers and customers, and the like.

Estimation of Premiums in the MCAPM and BUM

Equity Risk Premium

The ERP, as discussed previously, is the measure of the incremental return that investors demand to be compensated for when investing in the market portfolio of common stocks, represented by a broad-based market index (e.g., S&P 500), rather than investing in risk-free securities. If an investor opts to invest funds in an investment that is riskier than the risk-free rate (e.g., a U.S. Treasury bond), the investor expects to be compensated for the increased risk assumed by investing in the market.

There is no single, universally accepted methodology for estimating the ERP. As a result, there are many different types of ERP estimates, though some may be labeled with the same general term. The estimated ERPs can vary widely based on assumptions used in the calculation of each (e.g., time period analyzed, risk-free rate used, computation of the average returns).

As a result of the wide variations in ERPs, it is common for the analyst to use one of the ERPs calculated and published by D&P. As of the current date, D&P publishes two unconditional ERPs and one conditional ERP for analysts to use to estimate discount and capitalization rates. These ERPs are provided in D&P's annual publication, the *Valuation Handbook: Guide to Cost of Capital*. The three ERPs are as follows:

1. The long-horizon expected ERP (historical)
2. The long-horizon expected ERP (supply-side)
3. The D&P recommended ERP (conditional)

The calculations of these three ERPs can be categorized as either ex ante or ex post. Ex ante is a Latin phrase meaning "before the event." Methods referred to as "ex ante" mean that the ERP was estimated using the returns on a diversified portfolio implied by expected (future) stock prices or expected dividends. Ex post is a Latin phrase meaning "after the event." Methods referred to as "ex post" mean that the ERP was estimated using the averages of realized (historical) single-period returns, or by using the returns on common stocks in terms of realized multiyear compound returns.[8]

The historical ERP and the supply-side ERP are both considered "unconditional" ERPs, and are essentially the same equation with slightly different inputs. The D&P historical ERP is calculated as the large company stock total returns minus long-term government bond income returns. The D&P supply-side ERP is calculated as the historical equity risk premium minus the price-to-earnings ratio calculated using the three-year average earnings.

The difference lies within the equity returns whereby the supply-side ERP only includes the returns attributable to economic growth (i.e., inflation) and company earnings as it removes the price-to-earnings ratio from the calculation.

The ERP, in general, assumes the historical data—which covers the period from 1926 to present—included within the calculation is representative of the future. The supply-side ERP was created to remove unsustainable growth.

It is worth noting that when the supply-side ERP is lower than the historical ERP, it implies that investors expect growth in future earnings. This

would mean that in periods of economic downturn, when investors foresee decreasing earnings, it is not unrealistic to see a supply-side ERP that is higher than the historical ERP.

The terms "conditional" and "unconditional," when used in reference to the ERP, are intended to mean that the ERP reflects current market conditions or does not reflect market conditions, respectively.

Size Premiums

Consideration of the size of the business to be valued as part of a marital dissolution case is important. Many empirical studies have provided evidence that the degree of risk (i.e., cost of capital) has an inverse relationship with the size of a company.[9] These studies have found that the realized returns on smaller companies have been substantially greater over a long period of time than the basic CAPM would have predicted. This means that the betas for smaller companies do not account for all of the risks faced by those who invest in small companies.

The size risk premium is applied specifically to compensate investors for the uncertainty associated with the continued operations of the smaller company. This risk premium generally, but not exclusively, is based on the assumptions that smaller companies have:

- less resources and access to capital than their larger counterparts;
- less money to spend on research and development, advertising, and human capital;
- a greater dependency on fewer customers; and
- less resources to fend off competition and redirect themselves after changes in the market occur.[10]

These assumptions typically translate into a greater degree of difficulty for smaller companies relative to larger companies to sustain their cash flow and return value to owners. Therefore, based on the previously referenced assumptions, and consideration of the fact that the risks associated with size are unlikely to be eliminated through diversification, it is generally recommended that a size risk premium be considered when estimating a discount rate for smaller companies.

The principle source of size premium data is the Center for Research in Security Prices (CRSP) at the University of Chicago. The CRSP data categorizes the public stock marketplace into 10 deciles based on the market capitalization of the companies in the market. The largest cap companies are categorized in decile 1 and the smallest cap companies are categorized in decile 10. More recently, the 10th decile of the CRSP has been broken down into six subparts, referenced as 10a, 10b, 10w, 10x, 10y, and 10z.

The analyst should select the appropriate size premium based on the characteristics of the subject company being valued relative to the characteristics of the companies comprising each decile, or subpart decile.

Summary descriptions of the CRSP deciles are located in the D&P *Valuation Handbook: Guide to Cost of Capital*. Additional information related to size premium data and calculation methodology can be found in the D&P *Risk Premium Report Size Study*.

Industry-Specific Risk Premiums

In the BUM, the analyst will include an adjustment for industry-specific risk. This additional risk premium—or discount, in some cases—is a modification

> **"Quantifying . . . a company-specific risk premium (C-SRP), is one of the more challenging and subjective tasks required during the development of a reasonable discount rate and direct capitalization rate."**

to the BUM, which is meant to incorporate a measure of beta risk for companies that participate in a particular industry.

This adjustment has the ability to affect the estimate of value if the industry in which the subject company operates has more or less risk than the average of other companies in the same size category.

The D&P *Valuation Handbook: Guide to Cost of Capital* provides industry risk premium data based on Standard Industrial Classification (SIC) codes. The industry risk premium is calculated by D&P using the following formula:

$$RP_i = (FI\text{-}beta \times RP_m) - RP_m$$

where:

RP_i = Industry risk premium

FI-beta = Full-information beta

RPm = ERP estimate used in calculating RP_i[11]

The industry risk premium is a simple concept at first glance; however, despite the simplicity of the industry risk premium formula, there are a few caveats the analyst should be familiar with before incorporating this risk premium in the BUM.

The first point of caution is that these adjustments are valid only to the extent that the subject company's risk characteristics are similar to the weighted average of the companies that make up the industry for the SIC code shown.[12] Therefore, the analyst will inspect the list of companies in the subject company's relevant SIC code to verify that the companies included in the calculation of the industry-specific risk premium are substantially similar to the subject company.

In addition to this point, it is not recommended to incorporate an industry risk premium if the market approach, guideline publicly traded company method, has been rejected as a viable valuation methodology.

The second important point to note is that the industry risk premium should not be used in the context of a cost of equity model that already incorporates beta risk. Industry-specific risk likely will be overstated if beta, in conjunction with the addition of an industry-specific risk premium, is used to calculate the ERP.

Company-Specific Risk Premium

As previously mentioned, risk can be divided into two separate categories: (1) systematic risk, commonly known as market risk, and (2) unsystematic risk, also known as company-specific risk. Quantifying an unsystematic risk premium, or rather a company-specific risk premium (C-SRP), is one of the more challenging and subjective tasks required during the development of a reasonable discount rate and direct capitalization rate.

The C-SRP is the additional return required by investors to compensate them for the additional unsystematic risk associated with the subject company/interest. Typically, in a family law context, this additional unsystematic risk is often attributable to reliance of the subject company on a key person (i.e., key person dependence risk), the reliance of the subject company on a key supplier (key supplier dependence risk), or the concentration of business revenue in a key customer or a small number of key customers (customer concentration risk).

To quantify certain risk-related adjustments (e.g., industry risk premium and size premium) when estimating the required rate of return on an investment, an analyst can rely on generally accepted, quantifiable procedures to assess the subject company's risk. However, to assess and estimate a C-SRP, there is no generally accepted model or method available. As a result, estimating the C-SRP generally is based on the analyst's informed assessment of the investment-specific internal and external factors faced by the subject company.

There are several judgment-based models that analysts can consider to estimate a reasonable level of C-SRP. These models include the following:

1. The Warren Miller factors
2. The Gary Trugman factors
3. The Black/Green factors

Each of the aforementioned models provides an outline for evaluating certain risk factors regarding the subject company. These C-SRP factor sets aid in identifying the individual risk factors in relevant categories.

The Warren Miller factors are grouped in a SWOT (strengths, weaknesses, opportunities, and threats) analysis with three categories: (1) macro

environmental, (2) industry, and (3) company. The Gary Trugman risk factors are also presented in three categories: (1) financial risk, (2) nonfinancial risk, and (3) company-specific factors. The Black/Green factors are presented in five main categories: (1) competition, (2) financial strength, (3) management ability and depth, (4) profitability and stability of earnings, and (5) macroeconomic and microeconomic effects.

Based on either the analyst's own experience and judgment, or consideration of one of the models identified, a list of key company-specific factors is developed. At this point, an analyst must consider the relevant facts and circumstances and quantify the level of risk relating to the key company-specific factors identified.

Three procedures frequently used to estimate the C-SRP are as follows:

1. The plus/minus procedure
2. The numeric procedure
3. The listing procedure

In the plus/minus procedure, the analyst indicates either a "+" notation or a "-" notation next to each identified risk factor. A plus notation indicates that the factor is assumed to increase the appropriate C-SRP; a minus notation indicates that the factor is assumed to decrease the appropriate C-SRP. A blank notation indicates that the factor is assumed to exert a neutral, or no, impact on the C-SRP. Double or triple notations can be used to indicate the expected severity of the impact on the C-SRP.

This procedure is intended to reflect only the analyst's opinion regarding whether a certain factor affects the C-SRP for the subject company. The procedure provides no mathematical quantification of an appropriate C-SRP.

The numeric procedure is similar to the plus/minus procedure, though the analyst assesses a percentage value to each C-SRP factor. In contrast to the plus/minus procedure, the percentage numbers assigned to each factor are summed to estimate a C-SRP.

Based on the listing procedure, the analyst identifies and lists all of the key positive and negative company-specific risk factors. Professional judgment is then used to estimate a reasonable level of C-SRP.

After the assessment of the company-specific risk factors, the analyst generally compares the identified risk attributes to the risk attributes of a benchmark investment. Based on this comparison, the analyst decides how much (if any) additional risk is associated with the subject company, as compared with the industry benchmark.

Again, it is important to note that the quantification of a C-SRP is subjective and based on the analyst's professional judgement regarding the company-specific risk factors identified.

Summary and Conclusion

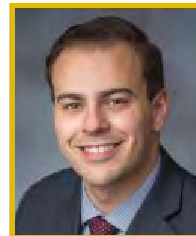
This discussion (1) addressed the difference between a discount rate and a capitalization rate, (2) described the methods commonly used to estimate a discount rate and a direct capitalization rate, and (3) summarized the quantification of a C-SRP using various analytical models.

It is important that the analyst using the income approach is well-versed regarding:

1. the fundamental differences between a discount rate and a direct capitalization rate;
2. the assumptions that are inherent in the models used to quantify a discount rate and the risk premiums that are incorporated in the development of a discount rate; and
3. the company-specific risk factors that may exert an impact on the estimation of the discount rate and direct capitalization rate.

Notes:

1. Business Valuation Standards, American Society of Appraisers, 2009.
2. Ibid.
3. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 247.
4. Shannon Pratt and Roger Grabowski, *Cost of Capital*, 5th ed. (Hoboken, NJ: John Wiley & Sons, 2014), 1254.
5. Ibid., 192.
6. Ibid., 197.
7. Ibid., 180.
8. Ibid., 113.
9. *2016 Valuation Handbook: Guide to Cost of Capital* (Hoboken, NJ: John Wiley & Sons, 2016).
10. Ibid., 4-2.
11. Pratt and Grabowski, *Cost of Capital*, 181.
12. Ibid., 181.



Stephen P. Halligan is an associate in our Portland, Oregon, office. Stephen can be reached at (503) 243-7529 or at sphalligan@willamette.com.

Understanding the Appraisal Review Process

Lisa H. Tran and Irina V. Vrublevskaya

The review of another valuation analyst's family-law-related work product requires an understanding of generally accepted valuation practice, including relevant valuation standards and relevant judicial precedents. This discussion addresses (1) applicable standards to consider when completing an appraisal review, (2) the applicable standards to follow in a valuation engagement or a calculation engagement, and (3) some common inconsistencies or errors identified during an appraisal review.

Introduction

In many litigation cases, particularly in marital dissolution matters, a valuation analyst ("analyst") is often asked to review and critique the opposing analyst's analysis and opinions. The process of reviewing another analyst's report is not limited simply to identifying possible calculation errors in the analysis. The review of another analyst's work requires the reviewer to (1) adhere to applicable standards when conducting the appraisal review and (2) determine if the opposing analyst's work was developed consistent with generally accepted valuation practices and applicable standards.

This discussion will focus on the appraisal review process and the applicable standards analysts typically follow when completing such engagements.

The Appraisal Review

An appraisal review is the "process of developing and communicating an opinion about the quality of all or part of the work of another appraiser."[1] An appraisal review is intended to provide information to the intended users about the credibility of the work under review.

While litigation circumstances often drive the need for an appraisal review, the motivation for an appraisal review may be as simple as a client seeking a second opinion, or "comfort," regarding a valuation that has already been completed. Rather than hiring another analyst to complete a new valuation, it is typically easier and less costly to obtain a review opinion regarding the completeness, accuracy, and reasonableness of the first valuation.

"Stakeholders in the appraisal process look to a reviewer to provide them with assurance the opinion provided by a valuation analyst is reliable."[2] These stakeholders may include judges, legal counsel, clients, divorcing spouses, and regulatory bodies who may not have the theoretical or technical training in business valuation, but need to make significant decisions based on the acceptability of a valuation.

Applicable Standards for an Appraisal Review

When reviewing another analyst's work, the reviewer should follow the applicable professional standards for appraisal review, development, and reporting. These standards may include the following:

1. The Appraisal Foundation Uniform Standards of Professional Appraisal Practice (USPAP)
2. The Professional Standards promulgated by National Association of Certified Valuators and Analysts (NACVA)

3. The Statement on Standards for Valuation Services No. 1 (SSVS), promulgated by the American Institute of Certified Public Accountants (AICPA).

Uniform Standards of Professional Appraisal Practice

USPAP was developed by the Appraisal Standards Board of the Appraisal Foundation and is applicable for certain valuations.

USPAP Standard 3, Appraisal Review, Development, and Reporting[3] is directed toward developing a credible opinion of the quality of another analyst's work. It addresses the content and level of information required in a report to communicate the results of an appraisal review engagement. However, this standard does not dictate the form, format, or style of an appraisal review report. Standard 3 calls on the analyst to understand and correctly employ the methods and techniques necessary to produce a credible appraisal review.

According to USPAP Standard 3, in developing a review, the analyst should determine whether the analyses, opinions, and conclusions presented in the work under review are appropriate and credible within the context of the requirements applicable to that engagement. These requirements may include (1) the applicable standards for the engagement; (2) completeness, accuracy, and adequacy of the analysis; and (3) relevance and reasonableness of the analysis, given the regulations, or intended use, of the valuation work under review. The reviewer should provide a reasonable explanation for any disagreement with the work under review.

National Association of Certified Valuations and Analysts

Standard VI—Business Valuation Review of the Professional Standards[4] promulgated by NACVA are applicable to review engagements of appraisals where the subject interest is a business, business ownership interest, security, or intangible asset. Based on NACVA standards, a business valuation review is intended to determine the credibility of a valuation.

Based on NACVA standards, the reviewer must provide an opinion, and support for the opinion, regarding whether the valuation under review is appropriate and not misleading. The review opinion can be presented in either a written or an oral report. The reviewer should opine whether the valuation under review is appropriate within the context of the requirements applicable to that valuation. The reviewer should state the reason for any disagreement with the appraisal under review.

Based on NACVA standards, the scope of the review should be sufficient to provide a basis for rendering a credible review opinion "regarding the relevance, reliability, completeness, and reliable application of the business valuation methodology under review, and its consistency with generally accepted valuation practices."[5]

As a result, the reviewer needs to consider the completeness, reasonableness, and accuracy of the valuation under review in the context of applicable laws, regulations, and intended use requirements.

American Institute of Certified Public Accountants

SSVS[6] is binding with regard to business valuations performed by members of the American Institute of Certified Public Accountants. However, if an AICPA member performs a review engagement, but does not develop an independent value conclusion, SSVS is not applicable. SSVS does not cover review appraisal engagements and does not have a provision that corresponds to USPAP Standards Rule 3.

This means that an AICPA member may review the analysis, including, but not limited to, items such as sources, approaches and methods, mathematical issues, logical issues, consistency, or clarity issues, without following SSVS.

The AICPA member may provide corrected values resulting from the correction of any errors identified during the review process. However, "if the CPA also concludes that the corrected values represent the CPA's value conclusion, SSVS would apply."[7] SSVS also would apply if the CPA develops a value conclusion that is presented as his or her opinion of value.

Business Valuation Review Process

When conducting a business valuation review, the analyst should determine whether the work product under review provided a credible and reliable opinion of value that is consistent with generally accepted valuation practices as of the valuation date. Generally, valuation stakeholders base the credibility of a valuation, in part, on consideration of the inclusion of all known facts and circumstances.

Credibility is understood to relate to the connection between (1) the opinion of value and (2) the relevance, completeness, and application of generally accepted valuation methodology.

The elements of a credible opinion include, but are not limited to, the following:

1. Adequate disclosure
2. Completeness
3. Nonadvocacy
4. Relevance
5. Reliability
6. Transparency

The reviewer should consider whether the valuation under review presents or considers all material known facts and circumstances about the valuation process that was conducted. Further, the valuation report should include sufficient relevant disclosures that help stakeholders understand the foundation for the analyst's conclusions.

Did the analyst include and assess all facts and circumstances known without limitation or exclusion? Are the data, assumptions, and explanations in the valuation presented in sufficient detail for a reader to understand and duplicate the process? Are the assertions and estimates considered logical? Was the analyst objective in formulating his or her opinion? Does the particular standard, method, or procedure form a supportive basis for the analyst's opinion? Were the methods used appropriately applied?[8]

The analyst should consider whether the approaches and methods used in the valuation were relevant to the objective and purpose stated in the valuation. The reviewer's goal is to establish whether the analyst appropriately performed the analysis based on the requirements of the engagement, in terms of the stated purpose, standard of value, valuation date, intended use, and generally accepted valuation practices.

In applying this "credibility" framework, the reviewer can assess the valuation to determine if the valuation process undertaken resulted in a credible and reliable opinion of value. In the review process, the analyst develops an opinion regarding the appropriateness and credibility of the analyses, opinions, and conclusions within the context of the requirements applicable to the valuation.

The analyst also develops and identifies reasons for any disagreement with the valuation. When conducting a valuation review, the analyst should "identify and articulate the components of a valuation report that (1) require additional support, (2) are inherently inconsistent, (3) lack relevance to the purpose of the engagement, [and] (4) have an impact on credibility."[9]

A analyst may need to complete independent research and analysis to produce a credible appraisal review. Some of the review methods and techniques necessary to produce a credible review are presented below.

Valuation Review "Checklist"

The typical narrative valuation report contains a number of sections. These sections include the following:

- A description of the subject business interest and the effective valuation date
- The purpose and objective of the engagement
- The standard of value
- A description of the subject company and an analysis of historical and projected financial operating results
- A discussion of relevant industry and economic conditions
- A discussion of generally accepted valuation approaches and methods
- The selection and application of relevant valuation approaches and methods
- The value conclusion, including discussion of relevant valuation adjustments (e.g., control premium or discount for lack of control, discount for lack of marketability, blockage discount, key person discount)

Additionally, and consistent with most valuation standards, a typical valuation report includes information such as the analyst's credentials, assumptions and limiting conditions, and an analyst's certification or representation.

Based on the numerous components incorporated in a typical valuation report, a review "checklist" serves as a useful tool when the analyst is engaged to review a valuation report.

A review checklist helps the reviewer critically assess the validity of the report and reliability of the conclusions. It also helps the reviewer establish whether the report appropriately identifies and includes sufficient, accurate, and consistent discussion of the components of a valuation analysis and the related report.

The following list identifies the broad categories that the analyst can consider when reviewing a valuation report. The list is presented in a manner consistent with the order that a reviewer may expect to

find the related information presented in a typical valuation report.

- Definition of the valuation assignment
  - Definition of the subject property/entity (including the size of the subject ownership interest)
  - Purpose and objective of the valuation
  - Standard of value
  - Characteristics of ownership (including control and marketability characteristics)
- Premise of value
- Effective date of the valuation and date of report
- Sources of information
  - Site inspection and interviews
  - Company financial statements
  - Information known or knowable as of the valuation date
  - Past transactions
- Description of the company
  - Capitalization and ownership
  - Company background and operations
- Economic and industry data and analysis
- Analysis and adjustment of company financial statements
- Comparative ratio analysis
- Income approach and methods
  - Discounted cash flow method
  - Capitalization of cash flow method
- Market approach and methods
  - Guideline publicly traded company method
  - Guideline merged and acquired company method
  - Backsolve method
- Asset-based approach and methods
  - Asset accumulation method
  - Adjusted net asset value method (capitalized excess earnings method)
- Valuation adjustments—discounts and premiums
- Synthesis and conclusion
  - Overall assessment
  - Comprehensiveness
  - Accuracy
  - Coherence and cohesion
  - Internal consistency
  - Incisiveness
- Signature of the analyst or the analyst's firm
- Analyst's curriculum vitae
- Analyst's certification or representation
- Contingent and/or limiting conditions or assumptions

Further, the valuation may include specific definitions of terms, formulas, and standards of value, as they may vary from one context to another. The valuation should be well documented and include sufficient information about the source materials considered. The valuation should be adequately documented so that another qualified analyst, in this case the reviewer, would be able to locate the identified source materials and replicate the analysis.

Chapter 19 of *Valuing a Business*[10] and Chapter 25 of the *The Lawyer's Business Valuation Handbook*[11] present checklists that can be considered for the purpose of reviewing a business valuation report. When using these checklists, it is important that the reviewer understands that not every item on these checklists will be applicable or relevant to every valuation engagement. Further, sometimes certain information can only be found in the original analyst's work papers or through a diligence interview with the original analyst.

Applicable Standards for a Valuation or a Calculation Engagement

One aspect of a valuation review assignment is establishing whether the valuation was developed consistent with applicable professional standards. The valuation should clearly state what professional standards were applied in the development of the opinion of value and the report. These may include standards presented in USPAP, SSVS, NACVA standards, or American Society of Appraisers (ASA) standards with regard to business valuation development and reporting.

The valuation may be either a valuation engagement or a calculation engagement. The format of the written report may be a (1) detailed report, (2) summary or restricted report, or (3) calculation report. The valuation report should identify the type of engagement and/or the type of report issued. The analyst reviewing the valuation should confirm that it is documented in a manner that complies with the professional standards applicable to the type of the engagement (valuation or calculation) and the format of the report.

In a valuation engagement, the analyst selects and uses the valuation approaches or methods deemed to be appropriate to arrive at a reasonable conclusion of value with regard to the subject interest. The conclusion of value resulting from a valuation analysis may be presented in a detailed report or a summary/restricted report.

A summary report presents the conclusion of value in a shortened, summarized version of a detailed report. The presentation of a valuation conclusion in a detailed report or a summary report typically is based on "the level of reporting detail agreed to by the analyst and the client."[12]

If the valuation is a valuation engagement, the following professional standards specific to a valuation engagement may apply:

- NACVA Professional Standards: II, General and Ethical Standards; III, Scope of Services (B)(1) Valuation Engagement; IV, Development Standards; and V, Reporting Standards (C)(1) Contents of Report for detailed reports and (C)(2) Contents of Report for summary reports
- SSVS Section .21(a); Sections .23 through .45, for valuation engagements; Sections .48 (a) and (b); Sections .51 through .70, for detailed valuation engagement reports; and Sections .71 and .72, for summary valuation engagement reports
- USPAP: Standard 9, Business Appraisal, Development, and Standard 10, Business Appraisal Reporting; specifically, Standard 10-2(a) for a detailed report and Standard 10-2(b) for a summary/restricted report
- ASA: BVS-I, General Requirements for Developing a Business Valuation, and BVS-VIII, Comprehensive Written Business Valuation Report

In a calculation engagement, the analyst and the client agree on the valuation approaches and methods to be used, and the extent of the procedures to be performed. A calculation engagement results in a calculation of value and is presented in a calculation report.

If the analysis is the product of a calculation engagement, the following professional standards specific to a calculation engagement may apply:

- NACVA Professional Standards: II, General and Ethical Standards; III, Scope of Services (B)(2) Calculation Engagement; IV, Development Standards; and V, Reporting Standards (C)(3) Contents of Report for calculation reports
- SSVS Section .21(b); Section .46, for calculation engagements; Section .48(c); and Section .73 through Section .77, for calculation reports

Neither USPAP nor ASA standards have an alternative to a valuation engagement, such as a calculation of value. The analyst may be required to follow USPAP in performing a valuation. In this case, the analyst should follow all applicable USPAP standards.

In addition to analyzing the valuation for accuracy or reasonableness, the analyst has the objective of establishing whether the valuation complies with applicable professional standards.

Computational Errors

Many errors committed in a business valuation engagement are the result of a lack of understanding regarding valuation principles or the improper application of valuation methods. However, a reviewer has the responsibility to establish that the work under review is complete and free of computational errors.

Computational or mathematical errors generally fall in the category of (1) mathematical calculation errors and (2) incorrect formulas. Based on the extensive use of computerized, linked worksheets to complete valuations, errors often result when worksheets are not properly linked or formulas are modified without verification.

Additional human errors occur simply as a result of inputting incorrect numbers retrieved from third-party source documents (e.g., subject company financial information or publicly obtained documents).

A thorough review includes the recalculation of amounts and values presented in the subject report, including (1) footing (summing vertically), (2) cross-footing (summing horizontally), (3) cross-referencing (confirming the consistency of amounts produced in multiple places), and (4) recalculating amounts and value indications presented in the attached exhibits and schedules.

Examples of measures that often are not presented consistently throughout a report include revenue, earnings, income tax rates, and outstanding debt amounts.

Application of Generally Accepted Business Valuation Principles

The specific methods and procedures applied to value a business will vary based on the facts and circumstances specific to each engagement.

However, the basic principles of business valuation generally remain consistent.

All other factors remaining constant, the use of generally accepted valuation practices and methods by multiple analysts should result in reasonably reconcilable conclusions of value for a subject interest. This, of course, assumes the same (1) subject interest, (2) definition of the assignment, (3) standard and premise of value, (4) valuation date, (5) access to the same subject company information, and (6) industry and economic conditions.

Consistent adherence to and application of generally accepted business valuation principles and procedures provides a reasonable expectation of consistency in an analyst's work product. This consistency enables a reviewer to complete the review process in an orderly manner, using applicable standards as a guide.

In many valuation reviews, the primary errors identified typically relate less to computational errors and more to inconsistencies in the application of business valuation principles. Below are examples of some common theoretical inconsistencies committed by analysts.

Common Inconsistencies and Errors

In using the discounted cash flow (DCF) method or the direct capitalization method, an analyst may mismatch the discount rate and the expected earnings. The discount rate should match conceptually to the definition of income being discounted. The analyst should use the weighted average cost of capital to discount net cash flow to invested capital investors (debt and equity stakeholders) and the equity discount rate to discount net cash flow to equity investors.

If the analyst does not understand that there are conceptual differences between the DCF method and the direct capitalization method, he or she may inappropriately implement the methods. The direct capitalization method is an abridged, or summary, of the DCF method. The direct capitalization method typically is the relevant valuation method within the income approach to value a company with stable growth. The DCF method typically is appropriate for valuing a company with high or erratic growth.

In the valuation of some closely held companies, an adjustment for executive compensation may be required. According to Internal Revenue Service Revenue Ruling 68-609, "If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business." Shareholder employees of successful closely held companies sometimes pay themselves compensation in excess of indicated market-based compensation for services rendered. If compensation is not adjusted, the business value of the company may be understated.

In development-stage or unprofitable corporations, shareholder executives sometimes pay themselves below-market compensation. Failure to adjust compensation may result in a business value that is overstated as a result of the understated operating expenses and the resulting overstatement of earnings. In general, adjustments for compensation typically are made when valuing controlling ownership interests. This is because only the controlling shareholder has the ability to change such compensation.

Some privately held companies own assets that are not part of their operations. If nonoperating assets are given separate consideration, any income generated or expenses incurred with regard to the nonoperating assets should be separated from the earnings used to complete an income-based valuation method. Sometimes, an analyst may separate the nonoperating assets from the overall value of the business but maintain the income generated by the nonoperating assets in the earnings used to value the company, thereby artificially inflating the value conclusion.

Some analysts mistakenly believe that asset-based approach methods can be used only with a liquidation premise of value. The asset-based approach can be used with all premises of value—going concern or liquidation. Typically, the asset-based approach is most relevant when the subject company in an asset-intensive company (i.e., a real estate holding company or another form of holding company).

When applying the different valuation methods, it is important for an analyst to understand the level of value indication each method initially produces and

whether the value indication represents a controlling or noncontrolling level of value. An income approach method can produce either a controlling or a noncontrolling indication of value depending on the earnings level or cash flow incorporated. The guideline publicly traded company method typically concludes a noncontrolling level of value, while the merged and acquired company method and asset-based methods typically concludes values on a controlling level.

When a valuation analysis reconciles the indications of value resulting from different valuation methods to arrive at a single concluded value, it is important that the value indications are reduced to a common basis—whether controlling or noncontrolling.

Sometimes, when completing a business valuation, it is tempting to use hindsight as direct evidence of value, and to consider events that occurred after the effective valuation date. The consideration of subsequent events and related information that was not known or knowable as of the effective valuation date, and that ultimately would affect the estimation of value as of the effective valuation date, is typically inconsistent with developing a relevant value opinion as of a specific date.

As stated in the *International Glossary of Business Valuation Terms*, and reproduced verbatim in SSVS, the "effective date," also referred to as the "valuation date" or the "appraisal date," is "the specific point in time as of which the valuator's opinion of value applies."[13] Within the valuation profession, achieving the appropriate valuation objective established in an engagement is contingent on consideration of information that is known or knowable as of the effective valuation date. However, certain valuation standards indicate that an analyst may consider a subsequent event (i.e., an event occurring after the effective valuation date) if the event was known or knowable as of the valuation date and if the event occurs within a reasonable time frame relative to the effective valuation date.

Reasonableness of Assumptions and Conclusions

In conducting an appraisal review, the analyst should consider the reasonableness and appropriateness of the assumptions, adjustments, and conclusions made in the appraisal. For example, is it reasonable to apply the average or median guideline company multiples to the fundamentals of the subject company for the purpose of estimating a value?

Simply relying on the average or median guideline company multiples without performing comparative analysis between the subject company and the guideline companies implies that the subject company is identical to the guideline companies. It is rare that a subject company and the guideline companies are identical based on their financial characteristics.

Another area where the analyst can easily err is in the estimation of the expected income used in the direct capitalization method. Sometimes, an analyst will simply rely on the average of historical financial results to estimate expected earnings. Income approach methods are forward looking, but sometimes, the future simply is not a repetition of past performance.

By (1) completing a thorough review of the subject company's past operating results and (2) considering prospective operating results for the subject company in light of expected industry and economic conditions, an analyst establishes a solid foundation for estimating a normalized income level for the subject company.

After a value for the subject company has been estimated, an analyst can test the reasonableness of the value conclusion by reviewing the implied range of values derived from the various valuation methods employed. If properly applied and based on reasonable assumptions, the valuation methods used ideally produce a narrowly dispersed range of values for the subject company. If the different valuation approaches and methods used result in materially different value indications, the consideration, review, and potential modification of key assumptions incorporated in the valuation process probably may be warranted.

Another method often used to test the reasonableness of a value conclusion is to calculate certain implied valuation, or pricing, multiples. The pricing multiples for the subject company implied by the value conclusion should compare reasonably to similar pricing multiples for the guideline companies.

Observed differences among the implied pricing multiples for the subject company and the guideline companies should be rationalized. For example, identified differences in size, profitability, and growth among the subject company and the guideline companies are reasonable grounds for differences in pricing multiples.

Preparing a Valuation Review Report

A valuation review report communicates the results of the review. According to NACVA standards, the reviewer's findings and conclusions should be stated

in the form of an opinion. According to NACVA Standard VII and USPAP Standard 3, when developing a valuation review and a written or oral valuation review report, the analyst should identify (1) the client or intended user, (2) the intended use of the opinion, (3) the purpose of the appraisal review, (4) the work under review and the characteristics of that work (ownership interest, valuation date, the original analyst, etc.), (5) any extraordinary assumptions and hypothetical conditions necessary in the review, and (6) the scope of work necessary to produce a review in accordance with the scope of work rule.

The analyst also should identify the characteristics of the property or market area in the work under review.

The review report content and level of information should be specific to the needs of the client and the intended users, the intended use, and the requirements applicable to the engagement. The reporting requirements in USPAP Standard 3 represent the minimum level of information for an appraisal review report. The analyst should supplement the report with information sufficient enough for the intended users to understand the report properly and not be misled. Such additional information may include the disclosure of research and analyses performed and not performed.

Once the analyst has identified sufficient information regarding the work under review and the research and analyses performed, he or she should state his or her opinion and conclusions about the work under review, including the basis for the opinion offered. In stating his or her opinion, the analyst should include the reasons for any disagreement with the work under review.

Typically, a business valuation review does not entail the completion of a valuation and is not construed as an opinion of value or a calculation of value. A business valuation review is not intended to provide a second opinion of value. However, certain review engagements may request that the analyst develops an opinion of value. If the analyst develops an opinion of value or review opinion regarding the subject of the review, all applicable professional standards relevant to the issuance of an opinion will apply.

Conclusion

Many business valuation errors can be avoided if valuation standards and principles are properly implemented when completing the valuation. The improper or inconsistent application of generally accepted valuation practices can lead to unreasonable value conclusions, causing the client to seek the review and evaluation of a business valuation work product.

A valuation review involves the reviewer (1) following applicable standards in conducting the appraisal review and (2) determining if the opposing analyst's work was developed consistent with generally accepted valuation practice, including applicable valuation standards. As a result, it is important for the reviewer to understand the valuation review process and relevant standards in order to effectively serve a client and the court in litigation settings, such as a marital dissolution context.

Notes:

1. Francisco Rosillo, "A New Perspective on Business Appraisal Review," *Valuation Strategies* (January/February 2011).
2. Ibid.
3. Standard 3 in *2016-2017 Uniform Standards of Professional Appraisal Practice* (Washington, D.C.: The Appraisal Foundation, 2016).
4. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,* VS Sec. 100 (New York: American Institute of Certified Public Accountants, 2007), Standard VI.
5. Ibid., Standard VI (B).
6. Ibid.
7. *Companion to PPC's Guide to Business Valuations* (Fort Worth, TX: Thomas Reuters, 2010).
8. Rosillo, "A New Perspective on Business Appraisal Review."
9. Ibid.
10. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed. "Reviewing a Business Valuation Report" (Chapter 19) (New York: McGraw-Hill, 2000), 453–475.
11. Shannon P. Pratt, "Chapter 25—Checklist for Reviewing a Business Valuation Report," *Business Valuation Review* 28, no. 2 (Summer 2009): 100–119.
12. SSVS, VS Sec. 100, Section .48(b).
13. Ibid., International Glossary of Business Valuations Terms.

Lisa Tran is a vice president and the financial accounting valuation services practice leader in our Portland, Oregon, practice office. Lisa can be reached at (503) 243-7510 or at lhtran@willamette.com.

Irina Vrublevskaya is a manager in our Portland, Oregon, practice office. Irina can be reached at (503) 243-7504 or at ivborushko@willamette.com.

Implementing Normalization Adjustments

Benjamin H. Groya

The valuation of a closely held business or security typically involves analyzing historical financial statements to estimate a normalized level of expected cash flow. Analysts generally adjust certain expenses to facilitate comparison to similar publicly traded companies and to provide a picture of the normal operations of the subject company. The following discussion addresses the application of these income normalization adjustments.

Introduction

A fundamental premise of the business valuation income approach is that the value of an investment is equal to the present value of its future benefits.[1] Future benefits, or future cash flow associated with a financial investment in an operating company, are estimated under the assumption of normal operating conditions. Normal operating conditions are subjective for any given company, but could be considered the conditions in which the managers of the enterprise expect to operate.

The circumstances that determine "normal" conditions are based primarily on consideration of historical results, given industry and economic conditions at the time. Therefore, the valuation analyst ("analyst") should look at historical financial statements to determine which reported items are representative of an entity's expected normal operations, and how these items compare with the results of similar public companies or relevant industry indexes. This is the foundation for the income normalization process.

The American Society of Appraisers *Business Valuation Standards* define normalized earnings as, "economic benefits adjusted for nonrecurring, non-economic, or other unusual items to eliminate anomalies and/or facilitate comparisons."[2]

Normalized earnings are essentially a rendition of the financial statements with adjustments, inclusions, or exclusions of certain items. Within the business valuation market approach, normalization adjustments are made to enhance comparability. Thus, changes are made to reflect the true economic benefits of a company's operating activities from a fair market value perspective. There is a systematic approach to provide a reasonable basis for a normalized level of cash flow.

This discussion (1) presents these circumstances and procedures involved in making normalization adjustments and (2) provides examples, caveats, and exceptions to such normalization adjustments.

Normalization adjustments are adjustments made to the amounts reported in financial statements such as the balance sheet and income statement. Financial statement adjustments can be distinguished by two primary types:

1. Normalization adjustments
2. Control adjustments

Normalization adjustments are changes made to a private company's earnings to translate to a "reasonably well run, public company equivalent basis."[3] In other words, these adjustments indicate how a private company's earnings would look to a sophisticated outside investor using data from public companies as a reference point to estimate the fair market value of the subject company.

Control adjustments are made "for (1) the economies and efficiencies of the typical financial buyer and (2) the synergies or strategies of particular buyers."[4] The second type of control adjustments are more relevant to investment value (i.e., value to a specific buyer) and will not be covered in this discussion. Although both types of adjustments ultimately will affect value, this distinction provides a framework to consider why a particular adjustment should be made.

Normalization adjustments, based on the definition provided, are made to enhance comparability between the subject company and comparable public companies. Unusual, extraordinary, and nonrecurring items are eliminated. This is because these item may distort the earnings resulting from the normal operations of the subject company.

Nonoperating assets, and their associated income and expenses, are also removed. This is because analysts often seek to compare only the operating activities of companies within the market approach. Adjustments are also made to present financial data in conformance with industry accounting standards.

Control adjustments are implemented when estimating the value of a controlling ownership interest in a company relative to the value of a noncontrolling ownership interest. These adjustments are necessary because a potential buyer obtaining a controlling interest, unlike a noncontrolling shareholder, may be able to directly affect various company policies and practices (e.g., compensation and distributions), thus affecting cash flow.

Most companies produce some form of an income or profit and loss statement, whether internally or through an auditor. These statements should be analyzed thoroughly to understand historical operating results and the conditions under which they were achieved, accounting methods, and asset functions. This is generally the first step in the normalization process: holistically understanding normal operating conditions of a company and the relevant, associated industry.

It may be appropriate to interview company management or industry experts during this process. Characteristics of the subject interest may also be analyzed for the purpose of establishing the relevance and magnitude of control adjustments.

Only after the analyst has completed the due diligence required to understand the nature of a company's operations and the industry in which it operates, can relevant and appropriate adjustments be made.

The following section discusses the broad categories of normalization adjustments.

Adjustments for Unusual, Extraordinary, and Nonrecurring Items

During January 2015, the Financial Accounting Standards Board (FASB) issued an amendment to Accounting Standards Codification (ASC) topic 225-20, regarding accounting for "extraordinary and unusual items" in an income statement. Essentially, this update no longer requires items considered "unusual" or "extraordinary" to be reported separately in an income statement.

According to the ASC, "unusual" and "extraordinary" items are items that have one or both of two characteristics, "infrequency of occurrence" or an "unusual nature."

The former is defined as: "The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates."

The latter is defined as: "The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates."

Such items can now be "presented within income from continuing operations or disclosed in notes to financial statements."[5]

Although this may simplify accounting practices and financial statement presentation, it may require more effort on the part of the analyst to identify and account for such items. These items may still be mentioned within notes to the financial statements, but the changes in presentation within the income statement increase the importance of interviewing management to identify these items.

The objective of adjusting for unusual, extraordinary, and nonrecurring items is to present the financial results associated with normal operating conditions that can be indicative of future operating performance and benefits under similar operating circumstances. Additionally, these adjustments enhance comparability among the subject company and guideline public companies, assuming consistent accounting practices and industry impacts.

Items typically included in the unusual, extraordinary and nonrecurring category include events such as damage from fires, hurricanes, and other natural catastrophes, or human events such as a labor strike. Additionally, insurance claims and benefits related to such items may also require adjustments.

For example, assume a plant fire destroys the factory of a manufacturing company. However, the company owned an insurance policy covering part of the costs to repair the plant. Any reported loss resulting from the destruction of the asset, and the income recognized from the insurance recovery, should be removed from the normalized income statement. Additionally, adjustments may be required to reflect some portion of cash, representing unusual insurance proceeds, as a nonoperating asset.

Events such as the incurrence of major repairs or capital maintenance to a facility may also be normalized based on the significance and circumstances regarding the event. Although such an item—maintaining infrastructure—typically would seem to be a part of normal operations, if the expense can be categorized as a significant, nonrecurring, one-time expenditure that yields no easily quantifiable increase in future productive capacity or benefits, it may be excluded from the normal operating cycle.

For example, a manufacturing company has several factories, one of which is an old facility that is derelict and inefficient. The company undergoes significant expense to repair and update this factory, which it regards as a one-time expense. The company management believes this renovation will not increase production capacity, but rather, will enable the factory to perform at an efficiency level comparable to the other factories. Adjusting expenses, and operating results, by excluding or reducing the one-time expenditure, may provide a better picture of future operating results for the purpose of completing a valuation analysis.

One could argue such an expense would likely provide future benefits in the form of increased efficiency or profitability. However, the nonrecurring nature and significance of the expense clouds the picture of normal operations by significantly increasing expenses during the period the expense is incurred.

It is possible, depending on the accounting methods employed, that this expenditure will be capitalized and added to the value of the factory. In this case, the expense will be recognized over time as the utilization of the enhanced productive capacity resulting from the expenditure is recognized in the form of depreciation expense in the income statement. The treatment of this depreciation expense, when compared with other firms, is a matter of accounting normalization, which will be discussed below.

On the other hand, a significant capital expenditure, such as the building of a new factory, should not be considered for adjustment. This is because such an investment would lead to quantifiably enhanced capacity and is well within the normal operating nature of a manufacturing company. In this example, the business cycle may also be considered.

During the analysis of an industry and its corresponding business cycle, the analyst may find it is common for a manufacturing company to update its productive equipment every five years. Thus, these updates could be considered "normal" capital maintenance or capital investment, and would, therefore, not need to be adjusted or excluded.

Adjusting for significant revenue or expense items that appear to be related to the operating interests of a company requires the informed judgment of the analyst.

Adjustments for Nonoperating Assets

According to the *International Glossary of Business Valuation Terms*, the definition of a nonoperating asset can be summarized as an asset that is "not necessary to ongoing operations of the business enterprise."[6] Nonoperating assets typically are excluded and added back to the estimated operating value of a company after the operating assets and associated cash flow have been separately analyzed and valued.

A common example is an investment in an unrelated company. Although this investment may provide an income stream, such as dividends, this income typically would not be considered to represent a normal part of the investor company's normal operations. As a result, the income stream could be reasonably excluded from normal operating income. This investment would be valued separately, with the fair market value of the investment added to the estimated operating value of the subject company.

Within many family enterprises, it is not uncommon to see real estate held for investment purposes within an operating entity. Such real estate, though often a source of rental or lease income, should be excluded from normalized earnings if the company's operations are not focused primarily in real estate investment. Furthermore, these adjustments eliminate income that is not earned from operations, thus facilitating a better comparison with the operating results of similarly focused public companies or relevant industry indexes.

Adjustments for Accounting Conformity

Privately held companies often deviate from industry standard accounting methods. Normalization of accounting methods is appropriate within the business valuation market approach. This is because it allows for easier comparison between the incomes of the subject company and the comparable publicly traded companies.

A private company may account for inventory using the first-in, first-out (FIFO) method, while many comparable public companies use the last-in, first-out (LIFO) method. These methods typically result in different values for inventories and cost of goods sold, thus could exert an impact on the subject company value. Therefore, and for consistency purposes when implementing the market approach,

the operating results of a subject company using the FIFO inventory method typically are adjusted to reflect operating results and its financial position as if using the LIFO inventory method.

The following list contains financial statement items that may be subject to accounting method normalization:[7]

- Allowance for doubtful accounts (corrected for historical results and management interviews)
- Pension liabilities
- Inventory accounting methods
- Write-down and write-off policies for inventory
- Depreciation and depletion methods
- Leases (adjusted to market value)
- Intangible assets
- Policies regarding the capitalization or expensing of various costs
- Timing and recognition of revenue and expenses
- Net operating losses carried forward
- Treatment of interests in affiliates
- Adequacy or deficiency of assets (such as cash or working capital)

The last item, the adequacy or deficiency of assets, generally relates to what could be considered excess or insufficient balances in certain asset accounts based on normal operating needs, or relative to normal industry (or guideline publicly traded company) standards. For example, if analysis indicates that the subject company is carrying significantly more cash as a percentage of assets relative to comparable publicly traded companies, some portion of the cash may be determined to represent "excess," or "nonoperating," cash.

The operating value of the subject company typically would be increased by the estimated level of nonoperating cash on hand. Estimated interest income attributable to the nonoperating cash would need to be removed from historical earnings during the normalization process.

The following section refers to controlling ownership interest adjustments.

Controlling Ownership Interest Adjustments

Controlling and noncontrolling ownership interests are often treated differently in the normalization process. The differences are most evident regarding operating expenses and shareholder distributions, as controlling interests often have the ability to directly control both.[8]

When valuing a controlling ownership interest within the income or market approaches, there are several scenarios in which earnings may be adjusted in order to make comparisons of historical earnings and operating results for the subject company with earnings and operating results reported by public companies more relevant and meaningful.

For example, the owner of a car dealership, who also functions as a salesman for the dealership, owns a controlling interest in the subject company. He or she may take a salary above what a competitive market rate may be for his or her given level of responsibility and productivity. The average salary, based on publicly available data, is $100,000 per year for a comparable salesperson at a comparable dealership. The owner of the subject company receives a salary of $150,000 per year.

The analyst, in order to better reflect comparable economic benefits, may reduce salary expense by $50,000 (i.e., the difference between the actual compensation level/expense and the market-based

compensation level/expense), thus increasing net earnings and cash flow from operations. The additional $50,000 in income from operations reflects what a competitively and economically motivated company, effectively managing expenses, potentially could generate. Because only a controlling ownership interest has the authority to influence compensation expense, and assuming no unusual or contractual circumstances, adjusting compensation typically is limited to the valuation of controlling ownership interests.

The following equations illustrate the potential impact that the previously discussed compensation adjustment could exert on the fair market value (FMV) of the subject company when the analyst relies on the income approach direct capitalization method:

- Net cash flow (NCF), is estimated at $950,000 based on analysis of the subject company's historical income statements and operating outlook
- Excess compensation, or difference in net cash flow, is $30,000; or the excess of actual compensation expense relative to market-rate compensation, or $50,000, reduced by a 40 percent tax rate
- $d - g$ = 10% (discount rate – expected long-term growth rate = direct capitalization rate)

$$\text{FMV} = \frac{NCF}{d - g}$$

$$\text{Noncontrolling interest} = \$9.5 \text{ million} = \frac{\$950{,}000}{10\%}$$

$$\text{Controlling interest} = \$9.8 \text{ million} = \frac{(\$950{,}000 + \$30{,}000)}{10\%}$$

Based on the direct capitalization method, the value of a controlling ownership interest would be more valuable, on a relative basis, than the value of a noncontrolling ownership interest based on a controlling owner acquiring the authority to affect salary expense. Absent consideration of this adjustment, and all other factors remaining the same, the value of the subject company would be the same to both controlling and noncontrolling investors.

Compensation adjustments typically are appropriate when (1) the value of the subject company is being estimated from the perspective of a controlling owner and (2) sufficient diligence has been performed to establish a thorough understanding regarding the scope of responsibilities attributed to the position(s) being analyzed and a sound foundation for the relevant level of market-based compensation.

The analyst will establish solid justification for any adjustments to the reported historical earnings of the subject company. For example, an analyst notes that no other companies in an industry offer health care benefits to their employees other than the subject company. Is it appropriate, then, to add back this expense to increase operating cash flow? This adjustment requires careful consideration.

An argument could be made that the health care benefits allow the subject company to recruit and retain unique talent, providing a competitive advantage and future economic benefits. However, such a claim would be subject to the immediate counterpoint that, were such benefits necessary, clearly other companies within the industry would offer them. Operating results of the subject company reflecting margins that are superior to those of the industry, would serve as strong support for the economic benefit attributable to the expense, eliminating the need for adjustment.

Professional service firms, or industries heavily reliant on human capital and the retention of human capital, may reflect benefits packages that warrant expenses that otherwise may seem excessive. As is the case with normalizing adjustments, the analyst should exercise prudence and decide what best reflects the economic reality of the subject company from a fair market value perspective.

Other noteworthy items often subject to adjustment when valuing a subject company from the perspective of a controlling owner include the following:

1. Travel and entertainment expenses
2. Transactions with related companies or parties
3. Legal expenses
4. Restructuring fees

These items are commonly considered when normalizing the earnings of family-owned enterprises.

A controlling shareholder or partner may expense all personal travel and entertainment (T&E) to the firm. Unlike compensation, it is not necessarily the amount of T&E expensed, but rather the nature of the expenditure.

For example, a controlling shareholder expenses all of his family's vacations to the firm, as well as work-related travel. Typically, it would be appropriate for an analyst to exclude all non-business-related T&E expenses from operating expenses.

In a family law context, and regarding the division of business interests includable in the marital estate, personal travel typically is excluded from reported operating income during the income normalization process.

Often, family-owned businesses operate within a group of related companies and partnerships with overlapping ownership. A valuation analysis often is required to estimate the stand-alone value of a particular operating entity, holding company, related partnership, and so forth. However, the operations of each company may include the impact of activity with related entities, such as lessors, customers, or suppliers.

For example, a residential construction company buys gravel and sand from a mining company. Both companies have the same controlling shareholder, a family-owned holding company. The mining company sells its raw materials to the construction company at prices well above the market spot rate. For simplicity, assume the sole customer of the mining company is the construction company. This situation would lead to normalization adjustments for both companies in the case of a divestiture of the controlling interest of either entity.

The mining company would have a revenue adjustment, as the per-unit sales price should be adjusted to the historical market spot price. The construction company could then reduce its cost of revenue, as this figure would be lower if the company purchased raw materials on the open market.

It should be noted that such adjustments are not always appropriate and should be incorporated when the adjustment is objective and based on factual support. For example, Walmart enjoys lower costs than many of its competitors, but this is generally understood to be based on Walmart's ability to benefit from economies of scale rather than related-party activity.

Legal expenses are incurred for many reasons, with some being unique and circumstance-based, and others being recurring in nature. For companies that require the maintenance of patents and other assets protected by law, a regular legal expense is often incurred. In such a circumstance, recurring legal expenses would be normal. However, a lawsuit often results in significant, one-time legal costs. The fees associated with such suits, including legal fees and related expenses, typically would be excluded from reported expenses when normalizing earnings.

Restructuring fees often are incurred in order for a company to reorganize in some capacity. Typically, restructuring activity is completed in order to reorganize a company's operations in a more productive and cost-effective manner in anticipation of improving long-term profitability.

A common example includes discontinuing a product line. In such a circumstance, costs associated with discontinuing the product line from the production process and revamping existing capacities to create a different product may need to be adjusted. Due to the nonrecurring nature of such an expense, it may be appropriate to remove certain historical operating expenses, and nonrecurring restructuring expenses, during the income normalization process.

Conclusion

Income normalization is a common procedure in estimating the fair market value of a subject company. Within the business valuation income approach, the normalization process enables the analyst to develop a better picture of the expected, true economic benefits of operations for the subject company under normal operating conditions. Within the business valuation market approach, the normalization process eliminates the impact of unusual and/or nonrecurring events, resulting in an estimated earnings level for the subject company reflective of a "reasonably well run, public company equivalent."

In one regard, normalized earnings may seem to be a distortion of actual financial results. However, if executed carefully and sensibly, the normalization process—and resulting normalized earnings—should provide a better indication of sustainable economic benefits for the subject company. Such a level of economic benefits provides a solid foundation for a value conclusion.

Notes:

1. James R. Hitchner, "Income Approach" (Chapter 4) in *Financial Valuation: Applications and Models* (New York: John Wiley & Sons, 2003), 87.
2. Gary R. Trugman, *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-sized Businesses*, 4th ed. (New York: American Institute of Certified Public Accountants, 2012), 22.
3. Ibid., 204.
4. Ibid.
5. FASB, Accounting Standards Codification (ASC), Topic 225-20, Income Statement—Extraordinary and Unusual Items (Norwalk, CT: Financial Accounting Standards Board, 2015).
6. "International Glossary of Business Valuation Terms," SSVS (New York: American Institute of Certified Public Accountants, 2007).
7. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*. 5th ed. (New York: McGraw-Hill, 2008), 131-32.
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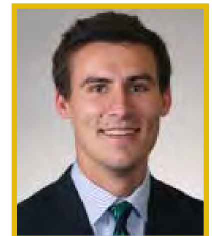

Benjamin H. Groya is an associate in the Chicago office. Ben can be reached at (773) 399-4312 or at bhgroya@willamette.com.

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111 S.W. Fifth Avenue
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503 • 222 • 7392 (fax)

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1355 Peachtree Street, NE
Suite 1470
Atlanta, GA 30309
404 • 475 • 2300
404 • 475 • 2310 (fax)

Calculation Engagement versus Valuation Engagement in a Marital Dissolution Context

Justin M. Nielsen

In a marital dissolution context, legal counsel hired by each party often will require the services of a valuation analyst to assist with certain property settlement aspects of the divorce. Specifically, an analyst may be retained to provide an independent opinion of the value of certain marital property, such as a closely held business interest, included in a marital estate. Typically based on cost considerations, legal counsel frequently find themselves considering between two scopes of service that an analyst can provide in a divorce setting: (1) a calculation engagement or (2) a valuation engagement. This discussion highlights the differences between a calculation engagement and a valuation engagement within a marital dissolution context, and explains the business valuation standards and requirements associated with each engagement. Also discussed is the assessment of projections that may be used in a discounted cash flow analysis in a calculation engagement.

Introduction

Over the last several decades, Americans have continued to divorce at a rate approaching 50 percent. Typically, both husband and wife are represented by legal counsel. Similarly, legal counsel have relied increasingly on valuation analysts ("analysts") in order to assist with certain property settlement aspects associated with marital dissolutions, specifically, obtaining independent estimates of the value (as defined in the relevant jurisdiction) of certain closely held business ownership interests included in a marital estate.

According to the American Institute of Certified Public Accountants (AICPA) *Statement on Standards for Valuation Services* (SSVS), there are two types of engagements that can be completed to produce a value indication: (1) a valuation engagement and (2) a calculation engagement.[1] Generally, these are the two types of engagements for which the analyst would be retained within a marital dissolution context.

A calculation engagement is performed when (1) the analyst and a client (i.e., legal counsel)[2] agree in writing on the specific valuation approaches and methods the analyst will use to calculate the value of a closely held business ownership interest(s) and (2) the analyst calculates the value of a closely held business ownership interest(s) according to the written agreement.

A valuation engagement is performed when (1) the engagement letter specifically requires the analyst to estimate the value of a closely held business ownership interest(s) and (2) the analyst estimates the value of the closely held business ownership interest(s) based on the full application of generally accepted valuation practice, including adherence to relevant business valuation standards and legal precedents. In other words, there are no limitations placed upon the analyst when completing a valuation engagement, other than natural, unavoidable limitations encountered during the valuation process (such as unavailable data).

This discussion highlights the differences between a calculation engagement and a valuation engagement within a marital dissolution context (in addition to considering when each engagement may be most appropriate). Also, this discussion will present the business valuation standards and requirements associated with each type of engagement.

This discussion also addresses management-prepared financial projections, in a litigation context, and their application within the income approach, discounted cash flow method.

Calculation Engagement versus Valuation Engagement

When the analyst is retained by legal counsel to provide services in a marital dissolution context, typically the analyst is retained through what generally can be described as an "engagement to estimate value." While the analyst may be retained to provide other services within a marital dissolution context, such as general consulting or forensic accounting services, this discussion will focus on the situation where the analyst is retained to estimate the value of a closely held business ownership interest.

SSVS provides guidance to the business valuation profession with regard to the types of services, and more specifically, the types of engagements and reports, that the analyst may provide (in a marital dissolution context as well as in other contexts). It is important for the analyst to adhere to relevant business valuation standards and procedures when being retained to estimate the value of a closely held business ownership interest in a marital dissolution context.

As presented in SSVS, an engagement is defined as follows:

> Engagement to estimate value. An engagement, or any part of an engagement (for example, a tax, litigation, or acquisition-related engagement), that involves determining the value of a business, business ownership interest, security, or intangible asset. Also known as *valuation service*.[3]

Once it is determined that the analyst will be formally retained by a client/legal counsel for the purpose of completing an engagement to estimate value, it should then be determined what type of engagement (as defined in SSVS) will be completed. As presented in SSVS, the types of engagements are described as follows:

> There are two types of engagements to estimate value—a **valuation engagement** and a **calculation engagement**. The valuation engagement requires more procedures than does the calculation engagement. The valuation engagement results in a conclusion of value. The calculation engagement results in a calculated value. The type of engagement is established in the understanding with the client (see paragraphs .16 and .17):
>
> a. *Valuation engagement*. A valuation analyst performs a valuation engagement when (1) the engagement calls for the valuation analyst to estimate the value of a subject interest and (2) the valuation analyst estimates the value (as outlined in paragraphs .23-.45) and is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation as a conclusion of value; the conclusion may be either a single amount or a range.
>
> b. *Calculation engagement*. A valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest (these procedures will be more limited than those of a valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement (see paragraph .46).

Is a Calculation Engagement or a Valuation Engagement More Appropriate?

While SSVS provides important guidance to the business valuation profession with regard to the valuation of a closely held business ownership interest in a marital dissolution context, other professional organizations have issued standards that provide similar guidance.

Because cost typically is a consideration in the resolution of most marital dissolutions, divorcing parties and their legal counsel typically perform cost-benefit analysis when deciding the level of

services required to develop and support rational positions. The decision to engage an analyst to perform a calculation engagement versus a valuation engagement often is one such decision when marital property includes business interests.

Though cost is a consideration, the defensibility of opinions rendered by the analyst is also a key consideration. The opinion of the analyst resulting from a calculation engagement may not be attributed the same weight as the opinion of an opposing analyst based on a valuation engagement due to court perceptions regarding differences in the level of diligence and/or objectivity between the two levels of service.

Applicable Standards for a Valuation Engagement or a Calculation Engagement

Once again, the AICPA is one professional organization that provides practitioner guidance to the business valuation profession. While SSVS is developed and published by the AICPA, it provides relevant guidance to all business valuation practitioners (not just certified public accountants). Although different organizations produce different business valuation standards, there is a relative commonality to the relevant business valuation standards and procedures within each organization that can assist the analyst in performing the assignment properly.

Examples of other professional valuation standards include (1) the *Uniform Standards of Professional Appraisal Practice* (USPAP), issued by the Appraisal Foundation, (2) the National Association of Certified Valuators and Analysts (NACVA) Standards, and (3) ASA Business Valuation Standards issued by the American Society of Appraisers (ASA).

If the analyst agrees with a client/legal counsel to enter into a valuation engagement, the professional standards specific to a valuation engagement may apply. These specific standards are listed on page 74 of this *Insights* issue in the discussion, "Understanding the Appraisal Review Process."

If the analyst agrees with client/legal counsel to enter into a calculation engagement, the following professional standards issued by the AICPA and NACVA specific to a calculation engagement may apply:

- NACVA Professional Standards II General and Ethical Standards; Standard III Scope of Services (B)(2) Calculation Engagement; Standard IV Development Standards; and Standard V Reporting Standards (C)(3) Contents of Report for calculation reports

- SSVS No. 1 0.21(b), .46 for calculation engagements, .48(c), .73 through .77 for calculation reports

Neither USPAP nor the ASA provide an alternative to a valuation engagement, such as a calculation engagement. The analyst may be required to follow USPAP in performing a valuation. In this case, the analyst should follow all applicable USPAP standards.

When appropriate, the analyst should ensure that each segment of a valuation engagement or a calculation engagement is compliant with all applicable professional standards.

Consideration of a Calculation Engagement Based on the Income Approach

A client may request that the analyst complete a calculation engagement based on consideration of several factors, including the estimated cost difference between a calculation engagement and a valuation engagement. Other factors that may drive a client to opt for a calculation engagement include the following:

1. Timing limitations
2. Data limitations
3. Facts and circumstances specific to the subject company that render the application of a specific valuation approach most relevant

Regardless of the reason(s) for an engagement being structured as a calculation engagement, it is incumbent on an analyst to deliver the service

consistent with relevant standards in order to produce a defensible opinion.

The following sections of this discussion focus on the use of the income approach discounted cash flow (DCF) method when completing a calculation engagement. The discussion emphasizes the use of business projections to complete the DCF method.

Courts throughout the country have rendered numerous decisions discussing the DCF method and the underlying financial projections serving as the foundation for the method. As a result, the remainder of this discussion focuses on both valuation theory and judicial decisions regarding the use of forecasts and projections to complete the DCF method.

While much of the discussion addresses the use of the DCF method and projections in the context of shareholder disputes, the concepts and principles are equally relevant in a marital dissolution context.

The DCF and Management-Prepared Financial Projections

When completing a calculation engagement, the analyst can consider each of the three generally recognized valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach. Within the three approaches, there are a number of generally accepted valuation methods on which an analyst can rely.

Fundamentally, each method is based on the premise that the value of an investment is a function of the income that will be generated by that investment over its expected life. Further, most of the available methods, either directly or indirectly, are based on the estimation of an investment's future earnings stream, and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The income approach DCF method is a generally accepted method used to value companies on a going-concern basis. The DCF method is appealing to investors because it directly incorporates the trade-off between risk and expected return, a critical component to the investment decision and the value calculation process.

The DCF method produces an indication of value based on (1) estimating the future earnings (e.g., cash flow) of a business and (2) estimating an appropriate risk-adjusted required rate of return used to discount the estimated future earnings—including the terminal or final cash flow—to a present value.

There are many issues the analyst should consider in developing the discount rate (i.e., step two in the DCF method) that appropriately reflect the estimated risk inherent in the subject company's expected future earnings. However, this discussion will focus on the development and application of the projected future earnings used in the DCF method (i.e., step one in the DCF method).

In defining the economic earnings of a business, there are a number of common measurements, which include the following:

1. Dividends or partnership distributions
2. Net cash flow to equity or net cash flow to invested capital (i.e., total market value of company debt and equity)
3. Various accounting measures of income, such as net income, net operating income, and numerous others

One consideration for the analyst in appropriately implementing the DCF method is developing a measure of earnings and a discount rate on a consistent basis.

Generally, if the subject interest in a calculation engagement represents the direct calculation of an equity position, then an appropriate earnings measure is "net cash flow to equity." Similarly, if the initial objective is the direct calculation of total invested capital (i.e., debt and equity capital), then an appropriate earnings measure is "net cash flow to invested capital."

Once the analyst determines the appropriate measure of earnings to apply in the DCF method, the next step is to estimate the earnings over a defined future time period.

Courts have demonstrated a preference for analysts to rely on management-prepared projections developed in the normal course of business operations when completing the DCF method. Generally, courts have expressed the opinion that management-prepared, board-approved projections relied upon for strategic planning and day-to-day decision making represent operating perspectives on which the analyst reasonably can rely.

While it may seem unimportant, the simple labeling of the estimated earnings of a business as either a forecast or a projection is a topic of discussion within the valuation industry. As presented in *Understanding Business Valuation*[4] and *PPC's Guide to Business Valuations*,[5] respectively, a forecast and a projection can be differentiated as follows:

1. Financial forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's financial position, results of operations, and cash flow. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take.
2. Financial projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flow. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . .?"

According to *Understanding Business Valuation* and *PPC's Guide to Business Valuations*, the analyst may refer to the management-prepared estimated future earnings as a financial forecast.

However, there are differing points of view. For instance, *Valuing a Business*[6] prefers the term "projected" in defining the estimated future benefits of ownership of a business. Similarly, *Financial Valuation Applications and Models*[7] applies the term "projections" to define estimated future cash flows or economic benefits.

While *PPC's Guide to Business Valuations* and *Understanding Business Valuation* prefer to use the term "forecast" rather than "projection" based on the above definitions, for purposes of this discussion the term "projection" will encompass all company management estimations of future cash flow, earnings, or benefits to be utilized in the income approach—the DCF method.

Further, it is probably ill-advised for an analyst to use the term "forecast" unless the analyst is prepared to be the "responsible party" for all of the financial information used to prepare the forecast. A projection, however, generally means that the analyst is using data that has been provided by a third party (i.e., company management), and adjusted, if necessary, by the analyst.

Shareholder Appraisal Right Actions—Use of and Reliance on Management-Prepared Projections as Proffered by the Delaware Chancery Court

As a large number of business entities within the Unites States are organized in the State of Delaware, the Delaware Chancery Court has become an influential voice in providing guidance related to business valuation issues. One of those valuation issues is the use of, and reliance on, management projections in shareholder dispute matters that utilize the DCF method.

There are several categories of shareholder disputes. Some of the common types include the following:

1. Dissenting shareholder appraisal rights (i.e., appraisal action)
2. Shareholder oppression
3. Noncontrolling shareholder "freeze-out"
4. Breach of noncompete agreements
5. Purchase/sale agreement dispute
6. Shareholder derivative action

The following sections focus on the development and use of management financial projections when applying the DCF method in calculating an opinion of value within appraisal actions.

In an appraisal action, a noncontrolling shareholder has the right to object or dissent to certain extraordinary actions taken by a corporation, such as a merger. The "appraisal remedy" requires the corporation to repurchase the shareholder's stock at a price equivalent to the corporation's value immediately prior to the corporate action.

As documented in past opinions, the Chancery Court has demonstrated that the favored method in valuing a dissenting shareholder's stock is the DCF method. As opined in *Crescent/Mach I P'ship, L.P. v. Turner* and *Cede & Co. v. JRC Acquisition Corp.*, respectively:

> [T]he Court tends to favor the discounted cash flow method ("DCF"). As a practical matter, appraisal cases frequently center around the credibility and weight to be accorded the various projections for the DCF analysis.[8]

> In recent years, the DCF valuation methodology has featured prominently in this court because it "is the approach that merits the greatest confidence" within the financial community.[9]

It should be noted that, according to general valuation theory, the analyst should consider all available valuation approaches and methods when calculating the value of a dissenting shareholder's stock. Of course, the objective of using more than one valuation approach is to develop mutually supporting evidence as to the conclusion of value.

Prior to 1982, the "Delaware Block" method was employed by the Court as the method of valuation in an appraisal hearing. The "Delaware Block" method entailed assigning specific weights to certain "elements of value," such as total assets, current market price, and company earnings.

The Chancery Court ultimately opined that the "Delaware Block" method was archaic and excluded other generally accepted valuation approaches and methods that were being utilized by the valuation profession and the courts. In critiquing the previous "Delaware Block" method, the Chancery Court opined in *Weinberger v. UOP, Inc., et al.:*

> Accordingly, the standard "Delaware Block" or weighted average method of valuation . . . employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings. We believe that a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible."[10]

Nevertheless, while the analyst should consider all available valuation approaches and methods, the DCF method is generally viewed by the Chancery Court as the favored method in valuing a dissenting shareholder's stock, assuming the company can reasonably project performance beyond the next fiscal year.

To Adjust or Not to Adjust Management-Prepared Projections

The Chancery Court has a consistent history of preferring management-prepared financial projections for the subject company to any alternative projections. Therefore, any valuation analysis that does not incorporate management-prepared projections, when available, is at risk of being rejected by the Chancery Court. In many instances the Court has rejected alternative financial projections that were created solely for litigation purposes.

As explained in *Agranoff v. Miller*:

> [C]ontemporary pre-merger management projections are particularly useful in the appraisal context because management projections, by definition, are not tainted by post-merger hindsight and are usually created by an impartial body. In stark contrast, post hoc, litigation-driven forecasts have an "untenably high" probability of containing "hindsight bias and other cognitive distortions." When management projections are made in the ordinary course of business, they are generally deemed reliable. Experts who then vary from management forecasts should proffer legitimate reasons for such variance.[11]

The Chancery Court recently has affirmed its opinion that management projections produced during the ordinary course of business will typically be deemed reliable.[12]

However, it is important to note that the analyst is expected to incorporate judgment with regard to the use of management projections based on consideration of information obtained through due diligence procedures. The Chancery Court simply explains that in varying from management projections, the analyst must provide legitimate and cogent reasons for the variation.

As opined by the Chancery Court in *Prescott Group Small Cap, L.P., et al., v. The Coleman Company, Inc*., and *In re Appraisal of the Orchard Enterprises, Inc.*, respectively:

> [Respondent's expert witness firm] has failed to "proffer legitimate reasons" to vary from the projections that management prepared and delivered to [the acquiring Company's] banks on January 31, 2000, and that were ascertainable on the merger date.[13]

> The fact that [Respondent] has not offered any straightforward explanation of why [Respondent's expert] alterations to his model in between the fairness opinion and the valuation report make any sense, coupled with the fact that these unexplained alterations had the effect of benefiting [Respondent's] litigation position, precludes me from finding [Respondent's expert] most recent NOL adjustments warranted.[14]

Accordingly, a prudent analyst will provide detailed and compelling support in order to substantiate adjustments made to management projections utilized in an appraisal action or a marital dissolution context.

Additionally, the Chancery Court clearly expects the analyst to perform appropriate due diligence in regard to management projections, regardless of whether they are adjusted by the analyst.

Normal diligence performed by analysts includes reviewing management projections and confirming that the assumptions on which the projections are based are reasonable and appropriate. As explained

by the Chancery Court *In re John Q. Hammons Hotels Inc. Shareholder Litigation*:

> Generally, management projections made in the ordinary course of business are considered to be reliable. In this case, however, testimony at trial established that management's projections were not created in the ordinary course of business. [Plaintiff's expert], nonetheless, performed no independent analysis of the assumptions underlying management's projections and did nothing to determine whether those projections were prepared by management in the ordinary course of business.[15]

The Chancery Court has further indicated a preference for contemporary management projections that benefit from being relied upon by independent third parties. Projections that are prepared for purposes of obtaining financing, or for fairness opinions in preparation of a potential merger, are viewed as independent and unbiased (e.g., nonlitigation driven). As opined in *WaveDivision Holdings, LLC v. Millennium Digital Media Systems, LLC*:

> [Plaintiffs] Base Case projections that it provided to its lenders are the fairest representation of [the Company's] expectations in the record . . . the Base Case projections provided to the bank provide a sound, conservative estimate of [Plaintiffs] expectations at the time of the breach. These estimates have the added benefit of having been relied upon by a party—the bank—with a strong interest in getting repaid.[16]

Therefore, based on guidance from the Chancery Court, management projections used in an appraisal action are considered relevant when (1) created by management or with management's in-depth input; (2) as close to, but not subsequent to, the valuation date as possible; (3) created in the ordinary course of business for general management planning or non-litigation-driven purposes; (4) fully supported and documented if adjusted by the analyst; and (5) appropriately scrutinized for reliability and reasonableness by the analyst.

The Chancery Court has also expressed a preference for management projections that have been prepared for independent, third-party purposes, such as to obtain financing or for pre-merger fairness opinions.

Guidance from the Valuation Profession

It is intuitive that wholesale acceptance of management projections, when applying the DCF method in an appraisal action, may beg the immediate question regarding an analyst's objectivity. If data provided by management are blindly accepted by the analyst as being appropriate and reasonable, absent independent diligence establishing the credibility of the information, the resulting conclusion of value may be unduly influenced by management.

The Chancery Court has opined that, in applying the DCF method to a subject company involved in an appraisal action, the analyst's due diligence process should include a detailed analysis of the assumptions on which management's financial projections are based.

As presented in *Understanding Business Valuation*, general factors to consider that can assist the analyst in analyzing management projections include the following:

1. Company-specific factors
2. Economic conditions
3. Industry trends[17]

In looking at company-specific factors, *PPC's Guide to Business Valuations* suggests several company-specific assumptions related to management financial projections that the analyst can examine, including the following:

1. Assumptions about revenue and receivables
2. Assumptions about cost of sales and inventory
3. Assumptions about other costs (such as selling, general, and administrative costs)
4. Assumptions about property and equipment, and related depreciation
5. Assumptions about debt and equity
6. Assumptions about income taxes[18]

While it is important that the analyst vet the assumptions on which management projections are based, it is equally important that the analyst document and justify any changes made to management-prepared financial projections.

Best practices of the valuation profession indicate that analysts assess the reasonableness of management-prepared projections by ensuring the financial projections are:

1. consistent with the company's growth prospects;
2. reasonable as compared to the company's historical financial results;
3. achievable based on the company's operating capacity and expected future capital expenditures;
4. reasonable as compared to the company's client and supplier projected financial results;

5. reasonable based on the industry's historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy; and
7. extensively documented and justified if the projections have been amended by the analyst.

Conclusion

In a marital dissolution context, clients face the choice of retaining an analyst to perform a calculation engagement or a valuation engagement. Generally, and relative to a valuation engagement, a calculation engagement results in a conclusion or opinion of value based on agreed upon procedures and methods that typically are more limited in scope and disclosure.

The income approach DCF method is often relied upon to complete calculation engagements. In a marital dissolution context, the analyst completing a calculation engagement that relies on the DCF method faces the challenge of establishing the reasonableness of management-prepared financial projections.

Generally accepted valuation theory and judicial precedents—including decisions issued by the Delaware Chancery Court—provide significant guidance to analysts regarding the assessment of financial projections incorporated in a DCF analysis.

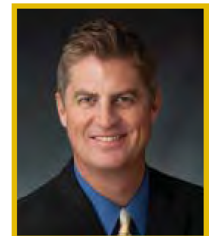
Because a financial projection serves as the foundation for the DCF method, prudent analysts conduct diligence necessary to establish the reasonableness of the projections and provide rational, documented explanations for any adjustments to the financial projections.

Adherence to applicable appraisal standards—whether completing a valuation engagement or a calculation engagement—and providing rational, documented support for key assumptions, is an analyst's best procedure to developing value conclusions on which clients in a marital dissolution context reasonably can rely.

Notes:

1. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,* VS Sec. 100 (New York: American Institute of Certified Public Accountants, 2007), 21.
2. It is important to note that the analyst can be retained directly by the husband or wife, rather than by legal counsel, and may be retained by the husband and wife on a joint basis (or retained by the husband and wife through legal counsel). This means that the estimated value concluded by the analyst, as a result of a calculation engagement or a valuation engagement, may be accepted by both parties.
3. SSVS, .82.
4. Gary Trugman, *Understanding Business Valuation*, 4th ed. (New York: American Institute of Certified Public Accountants, 2012), 428.
5. Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, James H. Hitchner, Stanton L. Meltzer, Mark W. Wells, and Eric G. Lipnicky, *PPC's Guide to Business Valuations*, 22nd ed. (Fort Worth, TX: Thomson Reuters/PPC, 2012), 5–7.
6. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 57.
7. James R. Hitchner, *Financial Valuation Applications and Models*, 3rd ed. (New York: John Wiley & Sons, 2011), 138.
8. Crescent/Mach I P'ship, L.P. v. Turner, No. Civ.A 17455-VCN, Civ.A. 17711-VCN, 2007 WL 1342263, at *9 (Del. Ch. May 2, 2007).
9. Cede & Co. v. JRC Acquisition Corp., No. Civ.A. 18648-NC, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004).
10. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Ch. 1983).
11. Agranoff v. Miller, 791 A.2d 880, 892 (Del. Ch. 2001).
12. In re BJ's Wholesale Club, Inc., Shareholders Litigation, C.A. No. 6623-VCN 2013, WL 396202 (Del. Ch. Jan. 31, 2013).
13. Prescott Group Small Cap, L.P., et al., v. The Coleman Company, No. Civ. A. 17802, 2004 WL 2059515 (Del. Ch. Sep. 8, 2004).
14. In re Appraisal of the Orchard Enterprises, Inc., C.A. No. 5713-CS, 2012 WL 2923305 (Del. Ch. July 18, 2012).
15. In re John Q. Hammons Hotels Inc. Shareholder Litigation, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
16. WaveDivision Holdings, LLC, et al., v. Millennium Digital Media Services, LLC, et al., C.A. No. 2993-VCS, 2010 WL 3706624 (Del. Ch. Sep. 17, 2010).
17. Trugman, *Understanding Business Valuation*, 239.
18. Fishman, Pratt, Griffith, Hitchner, Meltzer, Wells, and Lipnicky, *PPC's Guide to Business Valuations*, 5–9.

Justin M. Nielsen is a vice president in our Portland, Oregon, practice office. Justin can be reached at (503) 243-7515 or at jmnielsen@willamette.com.



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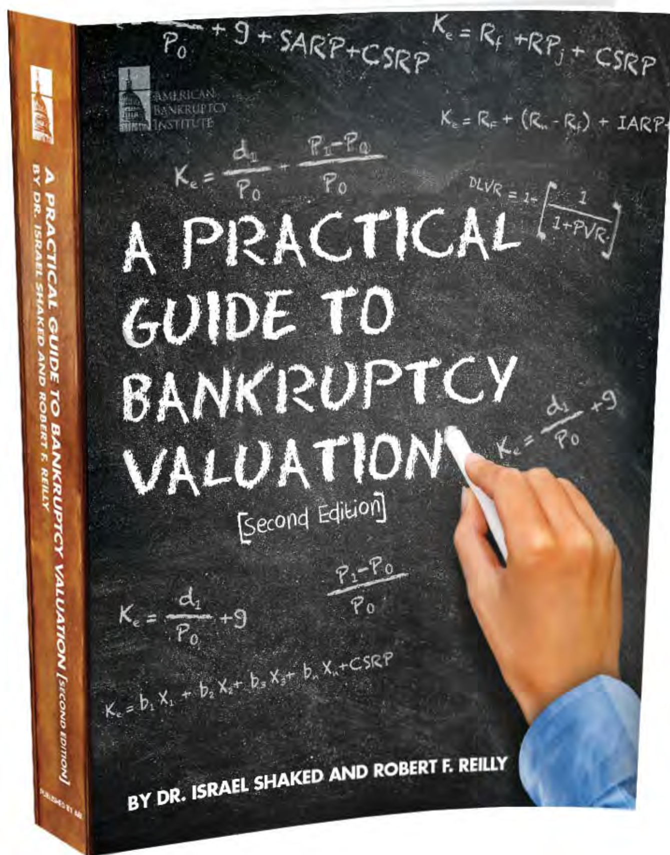

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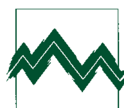

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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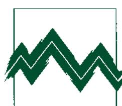

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Recent Articles and Presentations

Robert F. Reilly, firm managing director, authored an article that was published in the February/March 2017 issue of the *Financial Valuation Litigation Expert*. The title of Robert's article is "The Asset-Based Approach to Business Valuation, Part 1."

Robert discusses the various situations where it may be appropriate to use an asset-based approach in the valuation of a closely held company. Robert examines the theory of this approach. He also discusses reasons why this approach is not used more often. Part II of this article will appear in the April/May 2017 issue. This article will explore the asset accumulation approach to valuation.

Robert F. Reilly authored an article that was published in the February 2017 issue of the *ABI Journal*, a publication of the American Bankruptcy Institute. The title of Robert's article is "Discount for Lack of Marketability for a Closely Held Debtor Company."

Robert discusses the empirical and theoretical models that analysts may use to estimate the discount for lack of marketability (DLOM) that may be applied in the valuation of a debtor company. He explores the application of the DLOM to a debtor company valuation. Robert also discusses factors that may be considered in the selection of the appropriate DLOM to apply.

Robert F. Reilly authored an article that appeared in the Winter 2017 issue of the *American Journal of Family Law*. The title of Robert's article is "DLOM for a Controlling Ownership of a Closely Held Company."

In many marital dissolution cases, an analyst may be asked to value a controlling ownership interest in a closely held company. In some cases, a discount for lack of marketability (DLOM) may be appropriate. Robert discusses the factors that an analyst typically considers when measuring a DLOM to apply in the valuation of a controlling ownership interest in a closely held company in the context of marital dissolution.

Robert F. Reilly authored an article that appeared in the September/October 2016 issue of the *Construction Accounting and Taxation*. The title of Robert's article is "Consider the Asset-Based Approach in the Construction Company Valuation."

Robert discusses various reasons why this approach is used less often than the income and market approaches for construction company valuations. He examines the theory of the asset-based approach. He then discusses situations where it may be appropriate to use this approach when valuing a construction company. Robert also explores the treatment of income taxes within the approach.

Robert F. Reilly authored an article that was published in the September 2016 issue of the *ABI Journal*, a publication of the American Bankruptcy Institute. The title of Robert's article is "12 Reasons to Value IP."

Robert focuses on the valuation of debtor company intellectual property (IP) within a bankruptcy proceeding. He discusses the various types of debtor company IP that analysts are asked to value within a bankruptcy controversy context. He also discusses the various reasons that an IP valuation may be needed in this context.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the November 30, 2016, issue of the National Association of Certified Valuators and Analysts (NACVA) online publication quickreadbuzz.com. The title of Robert's article was "Analyst Considerations of a Taxable Stock Purchase M&A Structure."

Robert Reilly's article "Distinguishing Personal Goodwill from Entity Goodwill in the Closely Held Company Acquisition" was selected as one of the "most popular articles in 2016" from the publication *Transaction Advisors*. Robert's article originally appeared in their 1st Quarter 2016 issue.

Robert Reilly also authored an article that appeared in the November/December 2016 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Considerations of a Taxable Stock Purchase Acquisition Structure."

Robert Reilly also authored an article that appeared in the February 2017 issue of the *ABI Journal*, the monthly publication of the American Bankruptcy Institute. The title of Robert's article is "Discount for Lack of Marketability for a Closely Held Debtor Company."

Robert Reilly also authored an article that appeared in the January/February 2017 issue of *Construction Accounting and Taxation*. The title of Robert's article is "Construction Company Valuation—The Asset Accumulation Method."

Robert Reilly also authored an article that appeared in the February/March 2017 issue of *Financial Valuation and Litigation Expert*. The title of Robert's article is "The Asset-Based Approach to Business Valuation (Part 1 of 3)."

Robert Reilly authored an article that appeared in the February 22, 2017, issue of the National Association of Certified Valuators and Analysts (NACVA) online publication quickreadbuzz.com. The title of Robert's article was "Asset-Based Valuation Approach."

Timothy Meinhart, Chicago office managing director, authored an article that appeared in the December 5, 2016, issue of *Wealth Management's* online publication wealthmanagement.com. The title of Tim's article was "Taxpayer Was Entitled to Challenge Valuation Report: First Circuit sends Cavallaro case back to the Tax Court."

In Person

Robert Reilly delivered a presentation at the American Bar Association/Institute of Property Taxation (ABA/IPT) Advanced Property Tax Seminar conference in New Orleans on March 23. The topic of Robert's presentation was "Issues in Unit Assessment Valuation Properties."

Charles Wilhoite, the firm's national director of tax-exempt entity and health care industry valuation services, will serve as a Portland representative for the Federal Reserve Bank of San Francisco at the Federal Reserve Bank of San Francisco's Annual Conference of the Twelfth District Directors on April 13 and 14, 2017, in San Francisco.

Charles Wilhoite will participate as a panelist on May 12, 2017, for the State Bar of Arizona continuing legal education seminar, "Honey, I Shrunk the Documents," in Phoenix, Arizona.

Encomium

Robert Schweihs, firm managing director, was nominated by his peers as one of the world's leading practitioners in the *Who's Who Legal Corporate Tax 2016* directory.

Natasha Perssico, Chicago office senior associate, has earned the accredited member (AM) designation from the American Society of Appraisers.

Tim Meinhart, a managing director in our Chicago office, has been appointed as the chair of the webinar subcommittee of the American Society of Appraisers business valuation committee.

Charles Wilhoite received the William S. Naito Outstanding Service Award from the Portland Business Alliance at its annual Business Leadership Evening event on November 1, 2016. The award represents the Alliance's most prestigious honor, recognizing a professional's contributions to business, community, and philanthropic activities.

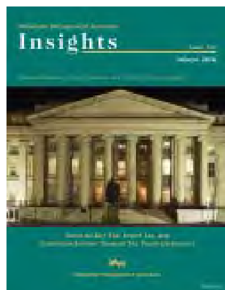
Charles Wilhoite will serve as the chair of the board of trustees for Meyer Memorial Trust for the fiscal year beginning April 1, 2017.

Charles Wilhoite was appointed to the board of directors of PacificSource Health Plans.

INSIGHTS ARCHIVES

❑ Winter 2017

Thought Leadership in Estate and Gift Tax Valuation Services

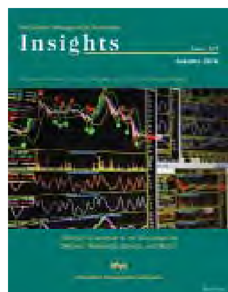


❑ Winter 2016

Focus on Gift Tax, Estate Tax, and Generation-Skipping Transfer Tax Valuation

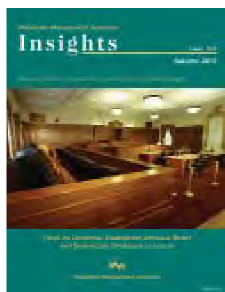
❑ Winter 2015

Focus on Intercompany Transfer Price and Other Income Tax Insights



❑ Autumn 2016

Thought Leadership in the Valuation of Options, Warrants, Grants, and Rights

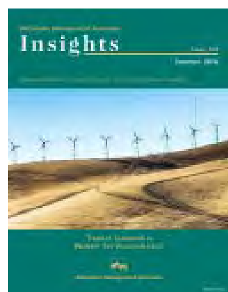


❑ Autumn 2015

Focus on Dissenting Shareholder Appraisal Rights and Shareholder Oppression Litigation

❑ Autumn 2014

Focus on Gift, Estate, and Generation-Skipping Tax Issues



❑ Summer 2016

Thought Leadership in Property Tax Valuation Issues

❑ Summer 2015

Focus on Reasonable Compensation in Eminent Domain and Expropriation Controversies

❑ Summer 2014

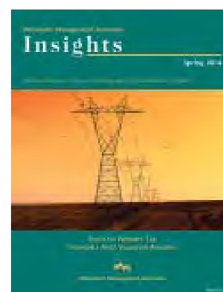
Focus on Forensic Analysis and Litigation Services

❑ Spring 2016

Focus on Intellectual Property

❑ Spring 2015

Focus on Corporate Transaction Advisory Services



❑ Spring 2014

Focus on Property Tax Intangible Asset Valuation Analyses

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Willamette Management Associates
111 S.W. Fifth Avenue, Suite 2150
Portland, Oregon 97204-3624

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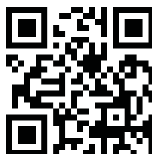

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BY FAX (503) 222-7392
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Willamette Management Associates

thought leadership

Willamette Management Associates provides thought leadership in business valuation, forensic analysis, and financial opinion services. Our professional services include: business and intangible asset valuation, intellectual property valuation and royalty rate analysis, intercompany transfer price analysis, forensic analysis and expert testimony, transaction fairness opinions and solvency opinions, reasonableness of compensation analysis, lost profits and economic damages analysis, economic event analysis, M&A financial adviser and due diligence services, and ESOP financial adviser and adequate consideration opinions.

We provide thought leadership in valuation, forensic analysis, and financial opinion services for purposes of merger/acquisition transaction pricing and structuring, taxation planning and compliance, transaction financing, forensic analysis and expert testimony, bankruptcy and reorganization, management information and strategic planning, corporate governance and regulatory compliance, and ESOP transactions and ERISA compliance.

Our industrial and commercial clients range from substantial family-owned companies to Fortune 500 multinational corporations. We also serve financial institutions and financial intermediaries, governmental and regulatory agencies, fiduciaries and financial advisers, accountants and auditors, and the legal profession.

Willamette Management Associates analysts apply their experience, creativity, and responsiveness to each client engagement. And, our analysts are committed to providing thought leadership—by delivering the highest level of client service in every engagement.

Chicago Office
8600 West Bryn Mawr Avenue
Suite 950-N
Chicago, IL 60631
(773) 399-4300
(773) 399-4310 (FAX)

Portland Office
111 S.W. Fifth Avenue
Suite 2150
Portland, OR 97204
(503) 222-0577
(503) 222-7392 (FAX)

Atlanta Office
1355 Peachtree Street, N.E.
Suite 1470
Atlanta, GA 30309
(404) 475-2300
(404) 475-2310 (FAX)