

# Viewpoint on Value



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Cross-examining  
a valuator:  
Where do I start?

DCF method is only  
as good as what lies beneath

It's only reasonable  
**5 factors to help determine  
reasonable compensation**

Picking the "right"  
standard of value in divorce



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# Cross-examining a valuator: Where do I start?

Effective cross-examination takes patience, skill and planning. You could ask a valuation expert a thousand questions, but judges and juries obviously have limited attention spans. Save the extensive inquiry for deposition. Then cherry-pick the most relevant, and damaging, questions for the courtroom.

## The best line of inquiry

As an advocate for your clients, you want to demonstrate that the opposing expert is less qualified, objective and knowledgeable than your own expert witness. Some key questions with which to cast doubt on the opposition include:

**How does your background qualify you to value businesses?** Accounting and economics curricula normally don't teach undergraduates how to value businesses. Make sure the expert has a finance degree or some postcollege appraisal training. Real-world experience tends to be more persuasive to judges and juries than book learning.

Also inquire about professional credentials. Nowadays, a CPA license alone is not enough to qualify an appraiser. Expect all testifying experts to possess a valuation designation from an accredited appraisal organization and to be current in their continuing professional education requirements.

**What information did you rely on in arriving at your conclusion?** Most valuation reports list all the professional publications and company documents the appraiser used. The expert's opinion could be compromised if a relevant piece of information, or the most recent version of a key document, is not listed. Some dishonest attorneys and clients strategically limit an appraiser's access to key information to skew the expert's opinion.

**What approaches did you use to value the business?** The three broad approaches to value a business are the cost, market and income approaches. Several methods fall under each approach. For example,



the guideline public company and the merger-and-acquisition methods fall under the market approach. Valuators *consider* all three approaches for every valuation, but they may decide to omit one or two, depending on the facts and circumstances of the case.

Ask why they chose (or discarded) each approach, especially if your expert selected different methods. Then ask what basis of value their methodology generates (for example, controlling or minority, nonmarketable).

Your own expert or a separate valuation consultant (see "Use consultants to gain an edge" on page 3) can help you dig deeper into the specific methodology to unearth flaws, subjective components and errors.

**What adjustments did you make?** Every appraisal requires subjective adjustments. Examples include changes to the company's financial statements as well as rates of return or pricing multiples derived from comparable companies. Appraisers also may adjust their preliminary value conclusions for specific items, such as excess working capital, nonoperating assets or contingent liabilities.

Find out how the expert quantified each adjustment. Did he or she rely on trade journals and benchmarking studies? Are these timely and truly comparable to

the subject company? All adjustments should be reasonable and well supported by real-world data.

Minor differences in adjustments can have major impacts on an appraiser's conclusion. To drive this point home, you can show how a 1% difference in, say, the long-term sustainable growth rate or small-stock premium (components of the capitalization rate) might alter the valuator's conclusion.

**What discounts did you take?** The most common valuation discounts are for lack of control and marketability. Compare the basis of value derived from each method to the appropriate basis of value for your case. Is a separate discount warranted, or is it already implicit in the valuator's methodology? How did the appraiser quantify the discounts? Never accept an average or median from an empirical study without more in-depth support.

Inquire whether statutes and case law permit valuation discounts. For example, many states do not permit valuation discounts in dissenting or oppressed

minority shareholder lawsuits. And don't forget to ask about the less common discounts and premiums, such as key person discounts, blockage discounts and swing vote premiums.

### On the attack

Before going to trial, read the valuator's report, taking notes and highlighting confusing sections. Ask for clarity from your own expert or at deposition. Also have a paralegal or junior associate recalculate the math underlying the valuation. You might find an error or unearth an errant spreadsheet formula.

Finally, review the opposing expert's previous courtroom transcripts and professional publications. Any inconsistencies between what he or she has said in the past and current courtroom testimony could discredit the expert.

### Preparation is key

Be sure to take the time to gain a general understanding of valuation techniques and issues. You'll be more effective and successful in cross-examination. ●

## Use consultants to gain an edge

Cross-examining a valuation expert can be a daunting task. The last thing you want is for your unfamiliarity with appraisal techniques and jargon to provide an opportunity for the opposing expert to showcase his or her expertise.

Fortunately, valuers can do more than merely prepare valuation reports and testify. They can also:

- Perform a cost-benefit analysis to determine whether to settle or pursue a trial,
- Strategize the most effective line of attack,
- Review the opposing expert's report and draft rebuttal reports, and
- Brainstorm relevant deposition and trial questions.

It's often necessary to hire a separate valuator to act as a consultant to preserve your testifying expert's perceived objectivity. Once a valuator crosses the line between expert and advocate, there's no turning back — he or she will lose credibility if attempting to fill both roles. Further, anything a valuation consultant does for the case is generally protected under attorney-client privilege.



# DCF method is only as good as what lies beneath

The decision in the case *In re Bachrach Clothing* reminds us that the discounted cash flow (DCF) method is only as reliable as its underlying assumptions — and the objectivity of the experts performing the analyses.

## Background

Bachrach Clothing, a 125-year-old men's retailer, was sold to a private equity firm for \$4 million cash and \$4 million in subordinated debt in 2005. The PE firm structured the sale as a leveraged buyout (LBO), transferring stock to an affiliate entity and replacing the company's board of directors.

The board appointed a new CEO, who made substantial changes to Bachrach's operations. For example, she discounted inventory by \$7 million, paid \$2 million in dividends, wrote off \$3 million in extraordinary expenses related to the LBO and

continued to pay the PE firm \$400,000 a month in management fees. These changes eroded Bachrach's borrowing base from \$4.3 million to \$1.3 million.

The court commented that "each expert generally selected parameters that pushed his valuation in the direction he wanted to go."

Bachrach began experiencing cash flow shortages in early 2006. When the PE firm refused to contribute additional capital, the company filed for Chapter 11. A fraudulent conveyance lawsuit was filed against the former owners, alleging that Bachrach was insolvent at the time of sale.

## Valuation discrepancies

Both sides' valuation experts relied on the same cash flow projections and used the DCF method to value Bachrach on the LBO date. But their conclusions were more than \$6 million apart. The bankruptcy court stated that "the disparity in their valuations is striking given that they relied on the same data as their starting point. It lends credibility to the concept that the DCF method is subject to manipulation."

The primary source of the discrepancy was the way in which the experts determined the weighted average cost of capital (WACC), which was used to discount Bachrach's cash flows to their net present value.

The debtor's expert used a 19.5% WACC and the seller's expert used a 12.3% WACC. A lower WACC results in a higher value. The court commented that "each expert generally selected parameters that pushed his valuation in the direction he wanted to go."





## Elusive parameters

Some important points the court made in the 2012 ruling about the parameters underlying the WACC include:

**Capital structure.** The court recognized that the company's low leverage and high borrowing capacity made it a valuable prospect in 2005.

Therefore, the judge sided with the seller's expert, who used Bachrach's actual capital structure to derive his WACC.

**Equity risk premium.** The court opined that the geometric mean, rather than the historic mean, is appropriate when estimating the equity risk premium (a component of the cost of equity). After reading materials cited by both experts, the judge decided that the "arithmetic average return is likely to overstate the premium."

**Size premium.** The court accepted the smaller size premium set forth by the seller's expert, because that expert had considered industry-specific evidence to "inform" his decision about size.

Specifically, the expert's research revealed that smaller apparel shops tend to perform better than their larger counterparts, thereby warranting a lower size premium.

## Hard lessons

Overall, the court decided that the seller's expert provided "better reasoned" explanations for his DCF assumptions. Thus, his value of approximately \$6 million was "more aligned with real world events or contemporaneous market data."

The company had no long-term debt, was current on payables and held significant excess working capital in 2005. So, the court ruled that Bachrach was solvent on the LBO date.

Make no mistake, the court did *not* disregard the DCF method in its opinion. It remains a technically sound, widely used tool for valuing private business interests. But the case cautions business owners and experts that shortcuts and bias won't lead to the desired result.

Experienced valuers understand the need to support their assumptions with objective, market-derived evidence — as well as with sanity checks and other valuation approaches — in order to ensure a well-reasoned value conclusion that can withstand court scrutiny. ●



# It's only reasonable

## 5 factors to help determine reasonable compensation

The question of reasonable compensation is frequently debated in shareholder disputes, divorces and IRS audits. Owners' compensation is a discretionary expense that controlling owners can alter. It can vary significantly from company to company depending on many factors, including the owner's education, licenses, training and salary history; the

business's size and financial health; the business's location; industry trends; and the state of the economy.

A valuator can help a company estimate a range of reasonable compensation that eliminates "owner bias" and adjusts income to a level that reflects economic reality based on objective market data.

## The IRS and the Tax Court weigh in

It's not unusual for the IRS to question the compensation that closely held companies pay their owners. But in a 1983 decision, *Elliot's Inc. v. Commissioner*, and in several subsequent decisions, including *Multi-Pak Corp. v. Commissioner*, the Tax Court provided some guidance, articulating five factors, or tests, that often come into play in determining whether an owner-employee's compensation is reasonable:

**1. Employee's role.** This focuses on the employee's importance to the success of the business, including his or her position, hours worked and duties performed. For instance, in the *Multi-Pak* case, the court found that, during a two-year period, the owner "made every important decision" for Multi-Pak's operations, and that his efforts "directly contributed" to its financial condition.

**2. Comparison with other companies.** How does compensation compare with that paid by similar companies for similar services? This factor frequently calls for expert testimony, because valuers have the expertise to evaluate appropriate comparable businesses.

**3. Company's character and condition.** This factor considers the company's size as measured by its sales,

net income or capital value; the complexities of the business; and general economic conditions.

**4. Potential conflicts of interest.** When an employee controls a company, his or her relationship with it is closely scrutinized. For example, does the relationship allow the company to disguise nondeductible corporate distributions as compensation? However, in subchapter S corporations, owner-operators may do the opposite — attempt to disguise owner compensation as distributions. When compensation is understated in this way to avoid payroll taxes, the IRS may challenge the amount.

The Tax Court may apply the "independent investor test." According to the test, if the company's earnings on equity after payment of the owner's compensation would satisfy a hypothetical independent investor, the compensation would probably be reasonable.

**5. Internal consistency.** An internal inconsistency in the company's compensation policies may indicate that the payments are unreasonable compensation.

## What's reasonable?

Of course, reasonable replacement compensation may, on occasion, differ from the criteria the Tax Court uses to challenge executive compensation. In the business world, for instance, it may be possible to justify paying much more than what might be considered reasonable to maintain the operation if the company requires special talents to improve or dramatically grow.

There are always exceptions, and reasonableness is, to some extent, in the eye of the beholder. But typically, reasonable compensation is objective, unbiased and based on relevant empirical data.

But the Tax Court's decisions and analysis provide a valuable roadmap for withstanding IRS challenges. Business owners, attorneys and other interested parties can benefit from understanding the five factors the Tax Court takes into account when evaluating reasonableness of an owner's compensation. Qualified experts apply these factors — and others — to help enable business owners and attorneys to prevail in court. ●



# Picking the “right” standard of value in divorce

In divorce cases that include a private business, attorneys and clients need to know how much the interest is worth to equitably distribute marital assets. But a universal standard of value that applies in all divorce cases doesn't exist. In fact, legal precedent may conflict — even within your state.

## Review case law carefully

Most states fail to define “value” in their marital dissolution statutes, probably to avoid being saddled by legal precedent associated with valuations prepared for other purposes. As a result, attorneys and valuers must decipher case law to define “value” in a divorce context.

But case law often is inconsistent, because family court judges, who have wide discretion in distributing marital assets, typically review only a handful of business valuation-related cases each year. It doesn't help that court opinions are generally much shorter for divorce cases than for tax or dissenting-shareholder cases. When little relevant case law exists, judges sometimes consider case law outside their jurisdictions.

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## Know your options

The most common standards of value in divorce are fair market value and fair value. Fair market value — the standard of value in all Tax Court cases — is essentially the price that a well-informed hypothetical buyer and seller would agree on for a business interest without being under duress to transact.



Fair value is typically taken from dissenting or oppressed minority shareholder cases. In a nutshell, fair value is fair market value without discounts for lack of control or marketability. Some states, including New Jersey, Indiana and Washington, have borrowed the “fair value” definition for divorce cases.

## Research goodwill

The intangible asset of goodwill is another important issue in divorce cases. A few states include all business value — both tangible and intangible — in the marital estate. But most require goodwill to be separated from tangible net worth. A handful of states specifically exclude goodwill from marital estates.

Many states require experts to distinguish between personal and business goodwill. Personal goodwill is inextricably linked to the owners' reputation, skills and training. It may be excluded from the marital estate, depending on state law and the specific facts and circumstances of the case.

## Collaborate with a valuation professional

Hire a credentialed appraisal professional at the onset of your case to define “value” in a divorce context. An expert who is knowledgeable in divorce is familiar with both relevant state divorce statutes and case law in your jurisdiction — and thus can minimize valuation-related complications. ●



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**John M. Leask II (Mac), CPA/ABV, CVA**, values 25 to 50 businesses annually. Often, Mac's valuations, oral or written, are compiled in conjunction with the purchase or sale of a business, to assist shareholders prepare buy/sell agreements, or to set values when shareholders purchase the interest of a retiring shareholder. Here are examples:

- **Due Diligence & Assist with Purchase of a Business.** Mac has assisted purchasers of businesses by determining or reviewing the offer. He helps negotiate the price, perform due diligence prior to closing and/or helps structure and secure financing. Services have included, but are not limited to, verifying liabilities and assets, reviewing sales and expense records, and identifying critical issues relating to future success, and helping management plan future operations.
- **Family Limited Liability Partnerships, Companies & Closely Held Businesses.** Mac regularly values various sized business interests for estate and gift tax purposes. He provides assistance to estate and trust experts during audits of reports prepared by other valuers.

Mac also helps business owners and their CPAs and/or lawyers in the following ways:

- Planning — prior to buying or selling the business
- Prepare valuation reports in conjunction with filing estate and gift tax returns
- Plan buy/sell agreements and suggest financing arrangements
- Expert witness in divorce & shareholder disputes
- Support charitable contributions
- Document value prior to sale of charitable entities
- Assist during IRS audits involving other valuers' reports
- Succession planning
- Prepare valuation reports in conjunction with pre-nuptial agreements
- Understanding firm operations & improving firm profitability

More information about the firm's valuation services (including case studies) may be found at [www.LeaskBV.com](http://www.LeaskBV.com).

To schedule an individual consultation or to discuss any other points of interest, Mac may be reached at 203 - 255 - 3805. The fax is 203 - 380 - 1289, and e-mail is [Mac@LeaskBV.Com](mailto:Mac@LeaskBV.Com).

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If you have a business valuation problem, Mac is always available to discuss your options — at no charge.