

# Viewpoint on Value



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# Do I *really* need an appraisal expert?

DIY valuations can lead to inequitable divorce settlements

Owners usually have a general sense of what their businesses are worth based on competitor sales or industry “rules of thumb.” But gut instinct or appraisal folklore may be off the mark — and these metrics rarely stand up in court.

When divorcing spouses own a business, it’s usually their biggest, most illiquid asset. Why guess at its value — or leave it to the whim of the court? An appraiser can bring concrete market evidence and other resources to the table.

## Proven valuation techniques

Appraisers typically use several generally accepted methods to value businesses, including the adjusted book value, guideline public company, merger and acquisition, capitalization of earnings and discounted cash flow methods. Courts prefer these proven techniques.

Shortcuts, such as industry rules of thumb, net book value or buy-sell formulas, rarely pass muster. In

addition, if a divorce case ends up in court, a valuator can serve as a compelling expert witness and provide an edge in any negotiations.

## Insight into selling terms

Unlike real estate transactions, which are a matter of public record, private business sales aren’t publicly disclosed. But valutors have access to proprietary databases of private sales transactions reported by business brokers that can provide insight into current selling terms for an industry.

For example, buyers sometimes don’t pay 100% cash up front. Terms of a deal may involve stock transfers, noncompete agreements and postsale consulting agreements. In addition, installment sales and seller notes may be used to finance deals.

Before splitting up assets in a divorce, the parties should consider whether comparable transactions include noncash terms — such as stock or a noncompete agreement — or payments spread over a period of time. If buyouts are based on comparables having these features but no adjustment is made for them, the concluded value could be substantially incorrect.

To illustrate: Suppose three comparables sold for an average pricing multiple of one times revenues, but all the deals were paid 20% up front with the remainder spread over five years. It would be inequitable for the court to expect one spouse to buy out the other *today* at a multiple of one times revenues. A fairer approach would be to incorporate installment payments into the settlement — or to adjust the pricing multiple to reflect a cash-equivalent price.

When both spouses have operated a business before a divorce, a valuator might suggest incorporating an earnout (where a portion of the selling price is contingent on future performance) into the buyout agreement. Buyouts with earnout clauses ensure both



parties share in the risk of business failure after the loss of a key person (for example, the spouse who was bought out).

### Menu of adjustments

A business's book value and its fair market value are rarely synonymous, which is why professional valuers consider a series of possible adjustments when appraising a business for divorce. Thus, the balance sheet might not report all of the assets — for example, internally generated intangibles aren't reported on a GAAP financial statement. Or there may be contingent liabilities, such as pending lawsuits or built-in capital gains tax liabilities.

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On the income statement side, unscrupulous owners sometimes defer revenue recognition or overstate expenses to lower value, which may require an adjustment. Other common adjustments include

reasonable replacement compensation, quasi-business expenses, and nonrecurring income and expenses. These adjustments must be identified and quantified *before* applying pricing multiples or discounting future earnings.

### Case law repertoire

An experienced valuator also can advise attorneys in divorce cases about valuation-related cases in the particular jurisdiction. Relevant issues include the appropriate standard of value, the appraisal date and local courts' treatment of buy-sell agreements and goodwill.

An understanding of legal precedent in *other* jurisdictions can be helpful, too. Family courts sometimes consider cases in other states — or even U.S. Tax Court cases — especially if the state hasn't ruled on a similar case or if state case law is contradictory.

### A smart investment

In today's era of frugality, divorcing couples may wonder whether appraisal expertise is a must-have — or whether the parties can work out their settlement on their own. But appraisal and expert witness fees are usually money well spent when the marital estate includes a closely held business interest.

Valuators help the parties accurately value assets. Without reliable appraisal evidence, it's unlikely that complex marital estates will be equitably distributed. ●

## Buy-sells may not reflect fair market value

If a business has a buy-sell agreement in place, it may be tempting to use its prescribed formula — or a previous transaction — rather than pay for an up-to-date, formal appraisal. But even the most comprehensive buy-sell may not hold up when challenged.

For example, in the recent case *Wood v. Wood*, the husband owned a 30% interest in a privately held flooring store. The Missouri Appellate Court struck down the wife's value of approximately \$1.063 million for the interest, a number based solely on a buy-sell formula. Instead, the court advised the trial court to reconsider the fair market value of \$325,000 set forth by the husband's expert.

His lower appraisal factored in goodwill, minority ownership and the recession. By comparison, the wife's expert used a starting point of \$3 million — the *historical* value of the entire business in 2007 when the shareholders bought the store — rather than the fair market value on the date of divorce.

Although buy-sell agreements and previous transactions are worth considering, today's fair market value may deviate from these indicators. There's no substitute for a current professional appraisal.

# Valuators can play a supporting role in business growth strategies

Among the many roles valuers play in facilitating a company's success, one of the most overlooked may be their support in evaluating strategic investment decisions. Valuers have many tools at their disposal that can help management determine the winning investment strategy.

## Methods for acting

Businesses seeking growth have several choices, including:

### 1. Organic or internal growth.

Generally this is the slow and steady path. Strategies include building a new plant, purchasing new machinery, developing a new product or service and expanding into new markets.

Building from within isn't without drawbacks, however. New products might cannibalize existing ones, or new target markets might reject product extensions. Opening another facility in a new location also involves a host of uncertainties, including underutilized capacity, unexpected sources of competition and skilled labor shortages.

**2. Mergers and acquisitions (M&As).** Buying another company is the fast track for growth. M&As typically provide assets and an established track record, including immediate cash flow, an assembled workforce, a pre-existing client base and customer referrals.

They make the most sense when the value of the combined entity is greater than the sum of its parts, as in a strategic purchase. Strategic value represents the value of a business to a particular investor based on that investor's investment requirements and expectations. For such buyers, acquisitions typically



create value via economies of scale, operating synergies and cross-selling opportunities. Acquisitions don't always pan out, however. Incongruent corporate cultures, incompatible operating systems, unrealistic value estimates and seller misrepresentations can lead to failure.

**3. Joint ventures.** Joint ventures and other contractual relationships, such as licensing and franchising, allow businesses to grow with minimal capital infusion. By starting slowly, two organizations can test their congruence and, if compatible, add incremental layers over time. Nevertheless, conducting financial due diligence is critical.

## Using financial tools

Businesses facing growth opportunities may have limited resources to pursue all of their ideas. When prioritizing and selecting expansion alternatives, projected financial statements are useful.

However, projections ignore the time value of money because, by definition, they describe what's *going to* happen given a set of circumstances. So it's difficult to compare detailed projections against other investments a business might be considering. Valuators, therefore, use other financial tools — such as net present value (NPV), internal rate of return (IRR) and accounting payback period calculations — to generate comparative metrics.

Valuators may use the accounting payback period tool to estimate how long an investment will take to recoup its initial cost.

In an NPV analysis, a valuator projects each alternative's expected cash flows. Then he or she discounts each period's projected cash flow to its present value, using a discount rate proportionate to its risk. If the sum of these present values — the NPV — is

greater than zero, the investment is worthwhile. When comparing alternatives, higher NPV is generally better.

IRR relies on the same data as NPV. But it computes the required return that results in a zero NPV. A valuator compares a company's IRR to pre-established hurdle rates (often the cost of capital). For example, if a new product line is projected to generate an IRR of 20% and the hurdle rate is 15%, the new product makes sense. When comparing competing alternatives, the one with the highest IRR is typically preferred.

Finally, valuators may use the accounting payback period tool to estimate how long an investment will take to recoup its initial cost. Using this tool, the payback for a machine that costs \$200,000 and generates \$40,000 in annual incremental profits would be five years.

### Understand the valuator's role

Clearly, poor investment decisions can lead to bankruptcy. So business owners can benefit from understanding the supporting role valuators can play in helping their companies pursue the growth strategies most likely to succeed. ●

## Replacement compensation Q&A

Why these valuations pose challenges for experts

Owner replacement compensation refers to the amount an unrelated person would be paid for performing the same duties that an owner performs at the subject company. It includes salaries and commissions, payroll taxes, benefits and perks. Estimating replacement compensation is especially challenging when owners receive noncash perks, such as stock or stock options. Here is a brief look at some common questions related to replacement compensation.

### Q: How does owners' compensation affect value?

A: The more owners pay themselves, the lower the company's reported earnings will be. Value typically is based on earnings or some income stream that is affected by owners' compensation. Unless adjustments are made, above-market owners' compensation lowers a company's value (and vice versa).

Regardless of whether valid reasons exist for above- or below-market compensation, appraisers customarily adjust for reasonable replacement compensation to accurately value a controlling interest. However, valuers generally don't adjust for replacement compensation when valuing a minority interest. That's because minority shareholders lack the requisite control to alter owners' compensation.

### Q: Why might actual and replacement compensation differ?

A: Actual compensation often differs from replacement compensation. Differences may be justified — for example, if the owners personally guarantee the company's debt or possess advanced skills and training that warrant higher salaries.

Sometimes owners have tax incentives to tinker with their compensation. A C corporation might pay above-market compensation in lieu of paying dividends, because the earnings of a C corporation (from which dividends are paid) are taxed at the corporate level and then dividends are taxed *again* at the personal level. Conversely, an S corporation or partnership — which isn't taxed at the corporate level — might *undercompensate* its owners and instead make larger distributions to them, which minimizes payroll taxes.

The IRS and local taxing authorities are on the watch for these tax avoidance techniques. A valuator is sometimes called in to defend owners' compensation levels for tax purposes.

### Q: When is replacement compensation an issue?

A: Replacement compensation is a major contention point when a marital estate includes a private business interest. The owner-spouse's compensation factors into the value of the business, as well as into alimony and child support payments.

Minority shareholders also may dispute replacement compensation. For example, the adjustment for reasonable replacement compensation was a major issue



in a recent minority shareholder dissension case, *Hubbard v. Phil's BBQ of Point Loma, Inc.*

Here, the California Southern District Court upheld the trial court's combined replacement compensation estimate of \$610,000 for the CEO, COO and a market consultant, based on Economic Research Institute (ERI) executive compensation surveys. To arrive at this estimate, three court-appointed appraisers — one nominated by each side and the third nominated by the first two appraisers — submitted a single appraisal report.

On appeal, the plaintiff hired a fourth expert who unsuccessfully claimed that executive replacement compensation for these executive functions should be only \$195,000, based on Bureau of Labor Statistics (BLS) data for California. Overall, the court accepted the three experts' joint appraisal — including the adjustment for replacement compensation.

### Q: What sources support replacement compensation estimates?

A: Besides ERI and BLS publications, other common sources of compensation data include, but are not limited to:

- *Salary Guide* (Robert Half International),
- *Annual Statement Studies* (The Risk Management Association),

- *Statistics of Income: Corporation Income Tax Returns* (a federal government publication),
- *Executive Compensation* survey (Compdata Surveys), and
- Relevant trade association publications and information from executive recruiters.

Valuators need accurate job descriptions before researching these sources and also can consider personal factors such as the owners' qualifications, age, health and hours worked. External factors — such

as company size and financial condition, geographic location, industry trends, and economic conditions — also come into play.

### Q: Who can objectively estimate replacement compensation?

A: Owners' compensation is one of the biggest, most subjective expenses on the books because what's "reasonable" often is in the eye of the beholder. But experienced valuers know how to support their replacement compensation calculations with thorough, well-founded research that's likely to withstand IRS and court scrutiny. ●

## Visual aids have a strong impact

Concise visual aids — combined with succinct expert testimony — can help laypeople understand complex financial matters. Take, for example, a valuator who uses the guideline private transaction method to value a business for divorce purposes. He employs regression analysis to derive a pricing multiple from more than 40 comparables.

Because statistical nuances — such as the line of best fit and R-squared, a measure of reliability — are beyond most people's expertise, the expert prepares a scatter-graph that compares sales price to operating cash flow. His demonstrative exhibit first plots the individual transactions as dots on the graph. Then the computer model adds the line of best fit.

This visual aid helps the judge better understand the expert's analysis. Quite simply, it's memorable and the judge may even mention it in the court opinion.

Valuation experts can use several types of visual aids. For instance, a line graph might demonstrate sales and expense trends over the previous five years to support a lost profits claim. Or a flowchart might be used to depict a shareholder's percentage ownership in a multitiered business organization, such as a partnership that owns stock in an LLC having fractional interests in several real estate ventures. Not only can visual aids facilitate expert testimony, but they also can be attached as appendices to help explain a lengthy written appraisal report.

Thoughtful, relevant visual aids make a valuation expert stand out and appear better prepared for trial. The next time your eyes start to glaze over when a valuator explains complex financial issues, consider requesting visual aids to help him or her more effectively communicate value conclusions.





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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.