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Viewpoint on Value

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PLUS: Rules of thumb tell just part of the story



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Setting the record straight

5 common valuation myths

Business valuation is a complex financial discipline. Much of its lingo, logic and underlying mathematics can be incomprehensible to those outside the profession, giving rise to confusion and misconceptions. So let's set the record straight concerning five common valuation myths.

1. The net misnomer

Myth: Net income and net free cash flow are synonymous.

Net income is an artificial accounting concept that is quite separate from cash flow. Net income includes a deduction for depreciation expense, which many small businesses base on accelerated tax schedules rather than assets' useful lives. And net income *excludes* debt service, financing proceeds, owner distributions, capital expenditures and changes in working capital. Accordingly, net income is a poor substitute for net free cash flow.

For example, consider a fictitious business with obsolete fixed assets. Its equipment is in dire need of repair and replacement, because the owner pays himself excessive distributions in lieu of making regular capital improvements. On the surface, the company may appear more profitable than its competitors because its assets have been fully depreciated and current net income includes no depreciation expense.

A novice who substitutes net income for net free cash flow risks overvaluing this hypothetical business. Net income disregards the company's imminent need to update equipment and the shareholder's reluctance to reinvest in future operations, whereas net free cash flow takes into account capital expenditures and working capital requirements.

In sum, free cash flow is more inclusive and more relevant to value because it represents the amount of cash available to investors (equity holders and debt holders) in excess of the current operating needs of a business — the essence of value.

2. The bottom-line blunder

Myth: Unprofitable companies aren't worth much.

Historic profits are relevant in business valuation only to the extent that they may help predict future cash flow. For example, startups and high-tech ventures may incur losses until they are up and running. Despite being unprofitable, these fledgling businesses often possess value because of their potential to generate future cash flow. Hard assets and internally generated intangibles (such as patents, customer lists and proprietary software) are also salable to a third party and, therefore, contribute value.

Profit also may be artificially suppressed for tax reasons. For example, some professional service firms intentionally minimize net income for tax purposes through partner bonuses. Cash businesses, such as car washes or restaurants, may underreport cash receipts to evade taxes. Values for these companies are often higher than their reported income would otherwise indicate.



3. The sales-price slip-up

Myth: If a competitor sold for 1.5 times revenues two years ago, a comparable business could be sold for a similar price-to-revenues multiple today.

Although comparable transactions may seem to provide objective, convenient valuation evidence, a lone transaction doesn't provide a representative sample.

Each transaction is unique. For example, a competitor's sale might include buyer-specific synergies or unique terms, such as an earnout or employment contract for the seller. Consider, too, the reliability of the informant. Like fish stories, transaction details often become exaggerated over time or metamorphose as the story passes from one individual to the next.

The funeral industry illustrates how anecdotal valuation evidence might mislead. In the late 1990s, public companies in the funeral industry aggressively acquired small local funeral homes. Acquisition mania drove industry pricing multiples to record highs.

These roll-ups intended to introduce economies of scale and professional management. But the strategy failed and forced many acquirers into bankruptcy or reorganization. Today the industry has largely recovered, and pricing multiples have returned to more realistic levels.

4. The taxing trip

Myth: Tax status has no impact on value.

In several landmark cases — including *Gross v. Commissioner*, *Wall v. Commissioner*, *Heck v. Commissioner* and *Adams v. Commissioner* — the Tax Court accepted IRS arguments that S corporations (and other pass-through entities) are worth more than otherwise identical C corporations because of their numerous tax benefits.

The most notable advantage to electing Subchapter S status is exclusion from corporate-level income taxes, including corporate-level capital gains tax after a statutory holding period. And S corporation shareholders may receive tax-free distributions as long as their equity basis in the company remains positive.

Tax-affecting S corporations remains a controversial topic in business valuation. When valuing S corporations, valuers must decide on a case-by-case basis

whether to apply after-tax discount rates and pricing multiples to either tax-affected or pretax earnings. Factors to consider when making this complicated decision include the valuation's purpose, relevant case law, the company's distribution history and whether the business interest possesses elements of control.

5. The big one

Myth: Business value matters only when it's time to buy or sell.

This is perhaps the biggest valuation myth of all. In truth, virtually every business could benefit from a regular valuation study. From an operational perspective, many business owners have no idea what their asset is worth. An informal valuation can teach management what drives value and ways to increase short- and long-term cash flow.

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Furthermore, a valuator can shed light on economic conditions and industry trends. This knowledge can improve operating efficiency and, ultimately, increase sales proceeds when the time comes.

Understanding business value is also an important part of contingency planning. For instance, it can help management assess the adequacy of commercial and key person life insurance coverage. Valuation is also an underpinning of effective buy-sell agreements, succession plans and individual wealth management planning.

One universal truth

If you are confused about business valuation, you're not alone — its ins and outs are frequently misunderstood. An experienced valuation professional can become one of your most trusted advisors. ■

Value added

Appraisers can help divorcing parties in many ways

It's not easy to keep all the parties happy in a marital dissolution case. But from the beginning to the end of the divorce process, valuation professionals can help handle financial issues in a fair, expedient manner.

Valuation nuances in divorce

The most obvious ways valuers help divorcing spouses are in valuing private business interests (and other marital assets) and in providing expert witness testimony related to business valuations. But valuations in divorce differ from other types of valuations in several ways.

For instance, family courts may prefer the market approach for its perceived objectivity. Many courts also embrace the excess earnings method — a hybrid of the cost and income approaches — especially for small professional practices.

Divorce cases frequently require valuers to reconcile the income approach with these preferred methods as well as with other, nontechnical value indicators, such as rules of thumb, purchase offers, loan applications, insured values and buy-sell agreements.

Another nuance of divorce valuations is dealing with goodwill. Valuers must separate goodwill from both the company's tangible value and from other identifiable intangible assets, such as patents, brand names, client lists or proprietary software.

Many jurisdictions require valuation experts to split goodwill into two components: 1) personal goodwill, which cannot be separated from the practitioner; and 2) business goodwill, which is

salable to a third party. In roughly half of the states, personal goodwill is not part of the marital estate.

Rather, it's considered part of the monied spouse's future earnings capacity. When assessing goodwill in marital dissolution cases, valuers need to review applicable state statutes and case law.

Beyond valuation

A marital estate needn't include a private business interest to benefit from a valuation professional's expertise. Valuers have the requisite training, experience and professional resources to handle a wide range of financial issues, including forensic accounting matters.

For instance, some unscrupulous monied spouses hide assets and income, employ unorthodox accounting techniques or intentionally deplete business values. Many valuers are qualified to conduct fraud investigations if foul play is suspected. Others can refer clients to a forensic accountant who specializes in divorce.

During settlement talks, bickering about personal matters or trivial details can waste time and energy. Valuers often act as the voice of reason, keeping parties focused on financial matters and pinpointing key differences. With customized spreadsheets at hand, valuers also evaluate proposed settlement options — including anticipated tax consequences — while the parties sit around the negotiating table.

In court and after

When the parties can't settle their differences out of court, valuers are there to help address complex financial matters. In addition to



EXPERT OR CONSULTANT? YOU DECIDE.

When hiring a valuation professional to help with divorce proceedings, you face a tough question: Do you need an expert or a consultant? The differences between these two types of services are more than semantic. Failure to understand them can compromise a valuator's perceived objectivity — both in and out of court.

The expert. Experts provide unbiased opinions on technical matters. In a divorce case, an expert might appraise, say, a private business interest or an intangible asset, such as a patent, copyright or professional license. Or an expert might estimate how much a premarital asset appreciated during the marriage, bifurcate a business's goodwill into its personal and professional components, or prepare a rebuttal report refuting the opposing expert's conclusions.

Valuation experts help divorcing parties, attorneys and judges make sense of complicated financial issues. Accordingly, all their work products — including correspondence, draft reports, work papers and electronic files — are typically discoverable. Unfortunately, courts often perceive experts as "hired guns." To counter any preconceived notions, most experts charge by the hour, rather than on a contingent basis.

The consultant. Consultants act as advocates for their clients. Most jurisdictions don't require disclosure of consultants' identities. Accordingly, a consultant's work product is generally not discoverable.

Examples of consulting services that valuers routinely offer in divorce include assisting in developing case strategy and drafting cross-examination scripts for the opposing expert.

It's common for a valuator's role to evolve during divorce proceedings. For instance, after the court issues its final ruling, an expert witness may be called on to advise the client on personal financial matters. But once an expert crosses the advocacy line, he or she usually can't turn back without risking his or her independence, professionalism and integrity.



testifying on marital asset values or, in some cases, fraud investigation findings, valuers can help attorneys draft technical questions for deposition and trial. They can assist with jury instructions or critique the opposing expert's report as well.

Valuers can ease postdivorce transitions. A valuator's financial expertise can serve both imminent needs, such as personal budgeting and tax preparation, and long-term goals, such as investments, insurance and retirement planning.

Flexibility and openness

The key to getting the most from a financial professional is communicating your expectations soon after

filing for divorce. A detailed engagement letter can help define the assignment's parameters.

A valuator's role often changes during the course of a case. So, it's important to keep the lines of communication open. For example, valuers should immediately report financial statement irregularities. Similarly, attorneys need to call valuers to confirm trial dates and discuss technically relevant case law. Miscommunications can lead to wasted efforts, excessive professional fees and costly courtroom mistakes.

A valuator's early involvement improves the chances of discovering all relevant financial information and completing key valuation procedures. Valuers can help at all stages of the process, leading to the best results. ■

Don't put estate planning on the back burner

As a result of the estate tax repeal scheduled for 2010, many people mistakenly believe that estate planning is no longer necessary. Others think that estate planning is just for the very wealthy. But the estate tax is scheduled to return in 2011, and, thanks to years of rapid real estate appreciation and entrepreneurial growth, many estates already exceed the \$1 million estate tax exemption scheduled to be in effect for 2011 and after. So having an up-to-date estate plan in place is important and a valuator can play a key role in the process.

The team approach

With so much at stake, a team approach to estate planning is important. Attorneys specialize in legal matters. Valuators help crunch the numbers, strategize and support estate tax filings.

Some estate planning teams might also include other types of professionals — such as tax and insurance specialists and personal property appraisers — to ensure all the bases are covered.

Think beyond business valuation

The estate planning process starts by identifying assets and estimating how much they're worth. Valuators are an integral part of this early phase, and they do more than appraise businesses. They also help identify and value intangible assets, such as customer lists, patents, copyrights, lease agreements, noncompete agreements and proprietary software.

Some intangibles are transferable to a third party. Others represent personal goodwill, which means their values are inextricably linked to the business owner as an individual. If the owner dies, personal goodwill usually fades away. A valuator can help decide into which category a business's intangibles fall.

Moreover, a valuator can identify key person risks. If a business anticipates economic hardship following the unexpected loss of a key person, management



needs a contingency plan. A valuator can help. For example, he or she can assign a dollar value to the time required to get the business back up and running after a key person's departure.

This figure can then be used to purchase key person life insurance coverage. It can also be a wake-up call to management underscoring the importance of grooming successor managers capable of continuing operations.

Responding to IRS challenges

Credible and independent valuation expertise is especially important if the IRS challenges values assigned to assets on a gift or estate tax return. In the negotiations stage, valuators can field technical IRS inquiries, provide additional documentation for valuation conclusions and prepare rebuttal memos.

If a settlement can't be reached, a formal valuation report may demonstrate that the estate provided credible valuation evidence, thereby shifting the burden of proof to the IRS. Customarily, the expert's written report also serves in lieu of verbal direct testimony, unless the Tax Court permits otherwise.

Start planning today

There's no time like the present to start (or revisit) estate plans — with the help of a competent team

of professionals. Once valuers identify assets and assign value, they can help brainstorm which tools — such as annual gifts, trusts or family limited partnerships — will help minimize taxes and meet other estate planning objectives.

Many believe that Congress is unlikely to allow estate tax repeal to occur but that legislators will take action to ensure some continued estate tax relief during and after 2010. This uncertainty makes estate planning complicated but critical. ■

RULES OF THUMB TELL JUST PART OF THE STORY

Valuers customarily use the cost, income and market approaches when valuing a business. But where do less scientific metrics — like industry rules of thumb — fit into the valuation paradigm?

The *International Glossary of Business Valuation Terms* defines “rule of thumb” as:

“a mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay, or a combination of these; usually industry specific.”

Rules of thumb serve as useful sanity checks for controlling interests valued using more technically sound methods, but valuers universally agree that they should not be used as a sole method of valuation — for several fundamental reasons:

They’re unsupported. Not to be confused with the market approach — which derives valuation multiples from customized empirical data and in-depth statistical analysis — rules of thumb are based largely on folklore or word of mouth.

For instance, suppose an owner hears “through the grapevine” that a competing business sold for 80% of revenues. Although the formula may be worth noting, the firm has no means of verifying the rumor’s accuracy or underlying details.

They’re oversimplified. Valuation formulas also fail to account for differences between industry participants, such as nonoperating assets, niche markets, management quality, operating risks or geographic location. Simply stated, they don’t consider many of the underlying factors, risks and attributes specific to a business that directly affect its overall value.

Moreover, ambiguous rules of thumb leave many unanswered questions. To illustrate, consider the prevalent rule of thumb for manufacturers of three to five times earnings:

- Does the term “earnings” refer to net income; earnings before interest, taxes, depreciation and amortization (EBITDA); or something in between?
- Does the formula assume an asset or a stock sale?
- Does it include real estate, inventory and intangibles?
- Does it generate a cash equivalent price, or did underlying transactions involve extended payouts, such as earnouts or seller financing?

They’re outdated. As demand fluctuates, old transaction data may lose its relevance. Pricing multiples are affected by general economic conditions, as well as industry forecasts and trends. For instance, an influx of new competitors, revolutionary technology or industry roll-ups might have an impact on pricing multiples.

They’re not credible in court. Historically, courts have rejected rule-of-thumb value determinations if used as a stand-alone valuation method.

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.

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.

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



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