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Goodwill hunting in divorce

A private business owner's largest personal asset often is his or her investment in the company. So if divorce strikes, expect a fight. Parties — and experts — seldom agree on the value of the business, especially when the business has significant intangible assets. To make matters worse, statutes may be ambiguous, legal precedent is inconsistent and courts may be granted significant leeway in divvying up business assets.

Small Frye, big potatoes

Goodwill can be a big deal in divorce cases. Consider Mr. Frye, the managing partner of Frye & Associates, a small urban CPA practice that opened in 1980, shortly after Mr. Frye graduated from college.

Mr. Frye recently filed for divorce and argued that his 20% interest in the business was worth \$60,000, based on initial capital contributions required for new equity partners. This amount also coincided with each owner's pro rata share of the business's net book value (\$300,000).



Mrs. Frye's attorney raised the issue of goodwill during settlement talks. Using data her valuator provided on recent accounting firm acquisitions, she demonstrated that book value may understate fair market value. She argued that Frye & Associates could expect to sell for \$2.3 million, based on the company's earnings history and pricing multiples derived from the comparable private transactions. Accordingly, she believed Mr. Frye's 20% interest was worth \$460,000.

The Fryes' discrepancy is no small potatoes. Assume the book value of \$300,000 approximates the company's net tangible value and that the value estimated by Mrs. Frye's expert (\$2.3 million) is reasonable. This would mean that Frye & Associates possesses approximately \$2 million of intangible value.

So which value should the court use to distribute the Fryes' assets — \$60,000, \$460,000, or an amount between the two? The correct answer varies depending on the case's venue.

What tangled webs

As this case study illustrates, balance sheets tell only part of the story. Many important intangible assets are not reported on financial statements because they're generated internally. Moreover, book values of intangible assets — typically from a former purchase — often understate their contributions to business value.

In a divorce context, goodwill is a generic term that refers to all unidentified intangible value. Usually, it is the difference between a company's net tangible value and its fair market value.

A few states include all business value — both tangible and intangible — in the marital estate (assuming the subject business interest meets the jurisdiction's requirements for marital property). But most require goodwill to be separated from tangible net worth. Of those states that separate goodwill, a few specifically *exclude* all goodwill from the marital estate.

Bifurcating goodwill

But the majority of states take the goodwill analysis one step further, requiring experts to distinguish between two types of goodwill:

1. Personal. Some intangible value can't be separated from the company's owners. Personal goodwill is associated with an owner's reputation, skills and personal efforts, and when owners leave their businesses they usually take their personal goodwill with them, unless they execute specific steps to transfer it. A retiring lawyer, for example, might mentor a junior associate and encourage clients to transition their work with the retiree's short-term supervision.

Although personal goodwill commonly is associated with professional practices, others such as manufacturers and retailers also may possess personal goodwill.

The underlying rationale for excluding personal goodwill from a marital estate is that nonmonied spouses who receive both personal goodwill and support payments are credited twice for the same asset (the monied spouse's future earnings capacity). But not all states accept this logic. (See "Getting a handle on personal goodwill," at right.)

2. Business. Alternatively, some intangible value may be linked to the business itself, including its brands, location and assembled workforce. Valuators may differentiate business goodwill by carving out and appraising identifiable intangible assets.

Financial Accounting Standards Board (FASB) Statement No. 142, *Goodwill and Other Intangible Assets*, lists some assets that could be considered business goodwill (though there are others):

- Patents,
- Copyrights,
- Brand names,
- License agreements,
- Leases, and
- Technology-based assets (such as proprietary databases or software).

Business goodwill isn't limited to manufacturers and others that rely on hard assets. For example, a regional accounting firm's assembled workforce, client lists, name recognition and proximate locations might suggest business goodwill.

Pieces of the marital estate

Divorce engagements differ from other types of valuation assignments. Many jurisdictions require experts to dissect value into its component parts, including net tangible value, personal goodwill and business goodwill. Which pieces to include in the marital estate vary from state to state.

Where little or contradictory legal precedent exists, a judge may look to other jurisdictions for guidance. State law varies concerning both personal and business goodwill. Both attorney and valuator need to possess an in-depth understanding of applicable state statutes and case law. ■

GETTING A HANDLE ON PERSONAL GOODWILL

How much personal goodwill contributes to value varies case by case. The following questions help valuers gain footholds on this slippery slope:

- Is the owner's name included in the company's name, and would a name change adversely affect business value?
- How long has the business been at its current location, and would relocation adversely affect business value?
- Do barriers to entry — such as education or licensing requirements — limit who can own or operate the business?
- Do business owners have positive reputations in the community? Has an owner, for instance, published articles, participated in charity events, taught classes or received awards that enhance his or her reputation?
- If current owners left the business, would its value decline, and would they take employees with them? What costs would the company incur to replace key business owners?
- What is the current rate of employee turnover, and to what extent are employees and customers loyal to owners?
- What percentages of new customers come from referrals, personal contacts, advertisements and walk-ins?
- Does the company require employees or shareholders to sign noncompete agreements? And are noncompete agreements, postsale consulting agreements or earnouts customary for business sales in the company's industry?
- Has the company purchased life insurance policies on the lives of key shareholders?
- How much time do current owners spend working on the business? How does this amount compare with competing businesses?

In addition, valuers consider the age, health and retirement plans of shareholders. Personal goodwill is limited if shareholders are expected to participate in operations only for a short remaining time.

Which income projections, when?

Future earnings often serve as the basis of value. But a company's earnings capacity is in the eye of the beholder. Controlling owners have financial and tax incentives to downplay income — thereby minimizing business value — in divorce, when gifting stock to heirs or when buying out disgruntled minority shareholders. On the other hand, nonmonied spouses, the IRS and exiting minority shareholders typically prefer higher values.

A menu of options

Valuators have several options when deciding the basis for income projections. They can look at:

Historic data. This is the starting point. Financial statements and tax returns sometimes provide objective sources of income data to use in estimating future earnings. But historic results may contain financial misstatements or require subjective normalizing adjustments — for example, for discretionary business expenses or nonrecurring items.

In addition, a company's future operations may deviate from the past. Startups may anticipate greater profitability, or a business may discontinue an unprofitable product line.

Management projections. Typically, an appraiser asks management to provide an educated guess about a company's future performance. Although management is more familiar than anyone with the

company's operations, it may be an unreliable source of information.

Management may use financial performance projections to apply for business loans, to solicit private equity investors, to discuss purchase offers or for internal planning reasons. Executives may be tempted to skew projections to decrease (or increase) business value, depending on the purpose.

Appraiser analyses. Some valuers estimate future earnings themselves. Objective, expert-generated analyses may minimize the risk of management bias, but valuers are less intimate with companies' inner workings. So it's imperative that management sign off on the estimates before valuers use them to appraise businesses.

Alternatively, management and appraisers can work together to develop joint earnings estimates. Although it may take longer, collaborative efforts often lead to more accurate valuations.

In selecting an income stream, the appraiser documents why this income stream is the optimal choice in light of the company's characteristics and the valuation assignment parameters.

Recent case in point

Projected income is a subjective assessment that can have a material impact on the valuator's final conclusion. A recent divorce case, *Aukeman v. Aukeman*, drives this point home.

During his seven-year marriage, Dean Aukeman started a business that operated three Save-A-Lot grocery stores in Michigan. Mr. Aukeman filed for divorce in January 2004, and both spouses hired valuation experts to determine the business's value.

Mr. Aukeman's expert used management projections to arrive at a value of \$1,534,000. These projections assumed that the stores' future sales would increase only slightly from historic results.



Conversely, Mrs. Aukeman’s valuator appraised the business at \$3,050,000 — nearly twice the amount the opposing expert estimated. This second assessment relied on actual store records and the company’s probable debt load, as well as expected increases in competition and population.

This expert also considered projections Mr. Aukeman had previously used to obtain financing for one of the stores. These projections predicted weekly average sales of \$122,000 — which were significantly higher than the store’s historic average of \$58,000 per week.

The Ottawa Circuit Court ruled that both experts relied on speculative earnings estimates and, instead, chose a value between the two assessments

(\$2,225,000). The Michigan Court of Appeals upheld the trial court ruling, opining that the decision was within the range the evidence established.

Professionalism is the bottom line

A valuation is only as reliable as the assumptions upon which it is based. Historic financial statements and management projections provide a useful starting point for estimating future income.

But independent valuation professionals consider all possible sources of earnings data, including the extent to which the future may deviate from the past, loan applications and internal business plans. ■

Expert witnesses

Surviving *Daubert* challenges

If disputing parties can’t settle their differences, valuers can act as expert witnesses. In addition to defending their appraisal opinions, valuers can critique opposing experts’ work and help attorneys draft deposition and cross-examination questions.

But increasingly courts hold expert witnesses to a higher standard, considering, among other things, the expert’s education, experience and credentials. It’s imperative to understand the guidelines for admitting expert witnesses when using valuers in legal contexts. An expert who fails the admissibility standards may be completely or partially excluded from testifying — putting the party that’s retained the expert at significant disadvantage.

Admissibility ground rules

Federal Rules of Evidence (FRE) govern the admission of facts in federal courts. Although permitted to adopt different rules, states usually model their rules of evidence after FRE. According to FRE Rule 702, if scientific, technical or other specialized knowledge will help the judge or jury make sense of the evidence or understand the facts, an expert witness may testify.

A 1993 U.S. Supreme Court case, *Daubert v. Merrell Dow Pharmaceuticals Inc.*, affirmed judges’ roles as “gatekeepers” against “junk science.” Rather than addressing the accuracy of an expert’s opinion, *Daubert* focuses on the reliability and relevance of the expert’s analyses, applying the following four-prong test to his or her methodology:

1. **Testing.** Has it been tested?
2. **Peer review.** Has it been reviewed by other practitioners? Has the methodology been published in professional journals?
3. **Error rate.** What is its known rate of error? Has the expert’s profession established standards to control its use? If so, has the expert complied with these standards?
4. **Acceptability.** Is it generally accepted among members of the scientific community?

The Supreme Court intended courts to apply these factors with flexibility and consideration of the method’s replicability. To illustrate, a new method might pass muster if another expert can replicate the

expert's analyses — and if the expert can persuade the court that the method is appropriate for the case.

Because *Daubert* dealt specifically with medical testimony, the legal community initially questioned whether it applied to technical or specialized expert testimony. But in 1999, *Kumho Tire Company v. Carmichael* ended the debate, extending the scope of *Daubert* beyond scientific testimony to other academic disciplines.

Proving admissibility

Attorneys needn't wait until cross-examination to discredit opposing experts. During a *Daubert* hearing, the court makes a preliminary ruling on the admissibility of expert testimony. The proponent of an expert bears the burden of proving his or her admissibility. Conversely, the opposing side presents evidence — including opposing expert testimony — regarding the challenged expert's errors, biases and shortcomings.

When assessing an expert's chances of surviving a *Daubert* challenge, look beyond education, professional designations, industry experience and reputation for qualities that could lead to exclusion during a *Daubert* challenge:

Mathematical errors. Little discredits an expert faster than basic math mistakes in his or her report. Inquire about the quality control procedures an expert's firm has mandated and, if possible, double-check the math yourself.

Self-serving or speculative financial data. Courts have disqualified experts for cherry-picking those documents and data sets that supported their side's financial interests.

Failure to conduct due diligence. Courts often expect a higher level of due diligence on the company's operating history, management-provided financial projections or other information than is expected for typical valuation assignments. For instance, a disclaimer that the valuator accepted management's projections at face value (without assessing

Look beyond education, professional designations, industry experience and reputation for qualities that could lead to exclusion during a *Daubert* challenge.

reasonableness) might raise a red flag during a *Daubert* hearing.

Conflicts of interest. Ongoing professional relationships or contingent fees may impair an expert's perceived objectivity. Reliable experts maintain independence and avoid acting as advocates for their clients.

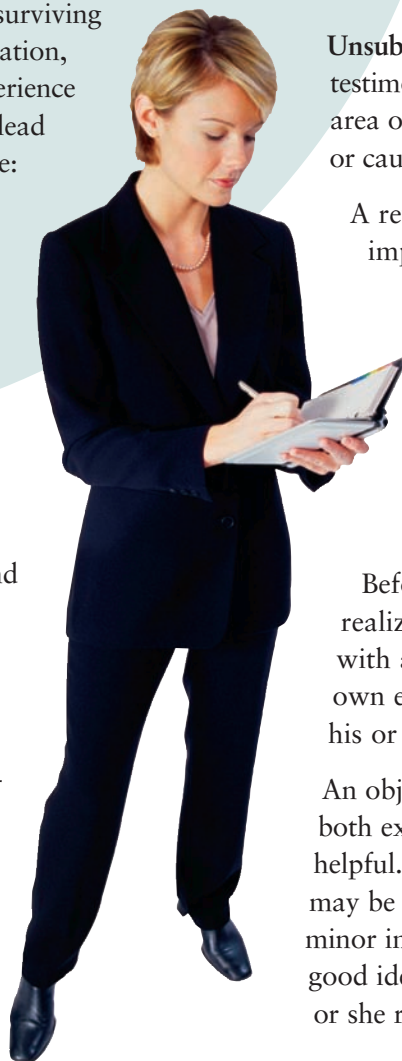
Unsubstantiated testimony. An expert's testimony shouldn't extend beyond his or her area of expertise — or into factual assertions or causation.

A review of relevant *Daubert* case law is imperative when challenging opposing experts or defending your expert. LexisNexis subscribers can access The Daubert Tracker™, a database that compiles recent court decisions on expert witness admissibility.

Motions that backfire

Before motioning for a *Daubert* hearing, realize that the opposition will likely fire back with a similar motion. So first consider your own expert's reliability and the relevance of his or her methodology.

An objective review by a third expert to reveal both experts' mistakes and weaknesses could be helpful. In some cases, your expert's methodology may be sound, but his or her report may require minor improvements. For instance, it might be a good idea to ask your expert to explain why he or she rejected alternative methods or excluded



specific documents — before you launch an attack on the opposition.

Protecting your expert

In addition to assessing their expert witnesses' qualifications, *Daubert*-savvy attorneys review valuator's

reports and evaluate whether the underlying methodology conforms to academic literature and professional standards. In doing so, “junk science” can be identified before it has a chance to waste resources and cause courtroom blunders. A qualified, experienced valuator can be a tremendous asset to both attorney and client. ■

THE NUTS AND BOLTS OF VALUING MANUFACTURERS

A valuation report contains valuable information a manufacturer can use in assessing its overall efficiency, profitability and direction. A reliable manufacturing valuation hinges on an in-depth understanding of current industry trends and value drivers.

Methods

A manufacturer's value generally is tied to its underlying hard assets, most notably receivables, inventory, machinery and real estate. So the cost approach is often relevant. But most manufacturers also possess a variety of intangible assets, including customer lists, brands, patents, formulas and proprietary processes. Because the income and market approaches can incorporate the value of intangibles, these approaches may more reliably estimate a firm's entire fair market value.

Risks and trends

The U.S. manufacturing sector represents more than 12% of annual GDP, outpacing overall economic growth in recent years. Other important trends also tend to affect domestic manufacturer value, including:

Global competition. Foreign manufacturers may enjoy cost advantages over domestic firms, including cheaper labor, lower taxes, less stringent regulatory oversight and reduced risk of litigation. Some countries — such as Mexico and Canada — benefit from free trade agreements with the United States.

On the other hand, offshore production has drawbacks — such as shipping and tariff costs, cultural differences, quality control issues, communication delays and oversight limitations — that may persuade customers to choose domestic suppliers. Safety concerns (involving such imported products as toys and pet food) also may revive domestic production.

Supply chain power imbalance. Many private manufacturers operate at the mercy of large public suppliers or customers. Valuator's assess the relative power along a company's supply chain and identify companies that represent 10% (or more) of a firm's annual material purchases or revenues. Additional risks exist if the company doesn't secure key relationships with long-term contracts or if contracts are soon to expire.

Mounting expenses. High material, labor, health care and energy costs, as well as environmental and safety compliance costs in many sectors, are eroding manufacturing profits. Global pricing pressures and increasingly demanding customers prevent many from passing cost increases down the supply chain.

To preserve profits, manufacturers can improve productivity and utilization rates, reduce scrap, automate production, and enhance energy efficiency. They can also add service offerings and participate in roll-ups to achieve economies of scale.



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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