



Certified Public Accountants | Financial and Management Consultants

## UNRAVELING THE MYSTERIES OF VALUATION!

### Dissecting A Valuation Report To Determine Available Income & Value

Presented By  
Michael J. Garibaldi, CPA/ABV/CFF/CGMA  
Divorce Professionals Conference  
November 8, 2019



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Michael J. Garibaldi is the President of the Firm and in charge of the Law Firm Services, Forensic Accounting, Litigation and Business Valuation Groups. In addition to traditional accounting for law firms, the Law Firm Services Group provides services designed to help identify and understand a full range of firm governance, partner compensation and profitability issues to help law firms gain a competitive advantage. The Forensic Accounting, Litigation and Business Valuation Group uncovers hidden assets, provides expert testimony, analyzes damages and values the minority and controlling interests in closely held businesses and professional practices for the purpose of acquisition, sale, estate tax and estate planning, shareholder litigation, equitable distribution, structuring buy/sell agreements, financial planning, arbitration and litigation.

One of the industry's leading law firm services experts, Michael Garibaldi has a strong background providing efficient and affordable solutions to the many complex issues facing the legal profession today. He works closely with law firms and other professional service firms, as well as clients in manufacturing, wholesale/retail, technology, medical, artists and galleries, construction and real estate where he is responsible for providing accounting, tax planning, management consulting services, and financial reporting. He has extensive experience assisting attorneys and their clients with the financial aspects of a case throughout the litigation process, from contemplation of action through expert witness testimony. Mr. Garibaldi brings an in-depth understanding of the business and technical aspects of valuation, finance and accounting that is required in complex litigation and arbitration cases. His areas of expertise include accounting and consulting, forensic accounting, and the valuation of closely held businesses and professional practices in the context of a marital dissolution, shareholder or partner dissolution/oppression actions, fraud, embezzlement, bankruptcy, equitable distribution, structuring buy/sell agreements, personal injury, wrongful death or termination, business loss, breach of contract, acquisition, sale, estate tax and estate planning. In addition, he has also performed damage due diligence reviews for potential real estate acquisitions.

Michael J. Garibaldi qualifies as an expert in valuation matters in the Supreme Courts of New York, Nassau, Suffolk, Kings, Queens, Richmond, Orange, Monmouth and Westchester Counties, and has been called upon by the courts to serve as a neutral expert. As an instructor of the AICPA Certificate of Achievement Program in Business Valuation, Mr. Garibaldi teaches his specialty to other professionals.

A Certified Public Accountant licensed by the State of New York, Mr. Garibaldi is a Chartered Global Management Accountant (CGMA), and Accredited in Business Valuation (ABV) and Certified in Financial Forensics (CFF) by the American Institute of Certified Public Accountants (AICPA). He is a Member of the Institute of Business Appraisers (IBA), the American Society of Appraisers (ASA), the ASA-LI Chapter, the Association of Certified Fraud Examiners, the AICPA and the NYSSCPA. He is a Past President and former member of the Board of Directors of the NYSSCPA-Nassau Chapter, and has held a variety of positions on the Litigation Support Committee of the Nassau County and State Chapters of the NYSSCPA. Mr. Garibaldi has also held a number of positions on other committees and sub-committees within these organizations.

The Garibaldi Group offers a wide range of traditional and non-traditional services including accounting and auditing, forensic accounting, business valuation, merger and acquisition consulting, income tax consultation and preparation, litigation support, management consulting, private wealth management and financial and estate planning.



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Agenda  
**Unraveling The Mysteries of Valuation**  
Dissecting A Valuation Report To Determine Available Income & Value  
Divorce Professionals Conference  
November 2019

- I. The When & Why of a Valuation Report in a Matrimonial Action
  - A. To determine income available for support
  - B. To determine the value of a business or professional practice
  
- II. The Backbone of Valuation
  - A. Revenue Ruling 59-60
  
- III. Valuation Overview
  - A. Define the engagement
  - B. Standard and premise of value
  - C. Principles of valuation
    - 1. Principle of substitution
    - 2. Principle of future benefits
  - D. Three approaches to value
    - 1. Market
    - 2. Income
    - 3. Cost
  - E. Define the income stream
  - F. What is the appropriate discount or capitalization rate?
  
- IV. The Magic Formula!
  
- V. Types of Reports
  
- VI. Premiums and Discounts
  - A. Control or lack of control
  - B. Marketability/Liquidity
  - C. Key person
  
- VII. Other Valuation Issues
  - A. Subsequent events
  - B. Non-operating assets
  - C. Double dipping
  - D. Role of the Expert Witness



**Unraveling The Mysteries of Valuation**  
Dissecting A Valuation Report To Determine  
Available Income & Value

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**The When & Why of a Valuation Report in a Matrimonial Action**

To determine income available for support

To determine the value of a business or practice



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## The Backbone of Valuation

IRS Revenue Ruling 59-60



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## 8 Fundamentals of Revenue Ruling 59-60



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## The Standards of Value

Fair market value

Fair value

Liquidation or break-up value

Book value

Intrinsic value

Investment value



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Principles of Valuation

Principle of Substitution

Principle of Future Benefits



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3 Approaches To Value

Income Approach

Market Approach

Cost (Asset-Based) Approach



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Income Streams

Net income after tax

Net income before  
income taxes

Debt-free net income

Cash flow

Debt-free cash flow

Earnings before  
interest and taxes  
(EBIT)

Earnings before  
depreciation, interest,  
taxes and amortization  
(EBDITA)



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**Discount Rates**

- Determined by the market
- Vary with time, even for the same investment
- Sensitive to & incorporate inflation
- Accommodates market risk & must be adjusted for specific risk
- Based on yields available on alternative investments
- Depend on future "income" stream being reduced to present worth




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**Capitalization Rate**

- Determined by the market
- Vary with time, even for the same investment
- Sensitive to & incorporate long-term inflation
- Accommodates market risk & must be adjusted for specific risk
- Based on yields available on alternative investments
- Depend on the nature of the income stream being capitalized to value




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**The Magic Formula**

**Income ÷ Capitalization Rate = Value**




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### Types of Reports

Appraisal

Limited appraisal

Calculations



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### Premiums & Discounts

Discount for lack of marketability

Minority interest discount

Premium for control

Discount for legal or contractual restrictions

"Key-Man" discount



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### Other Valuation Issues To Consider

- Subsequent events
- Non-operating assets
- Double dipping between support payments and the value of the business



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### The Role Of The Expert Witness

- Are they independent?
- Type of retention
- What are their qualifications and designations?



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## Why Assets Must Be Valued

- A. Business Interest(s)
  - 1. Active: Operating companies in which owner is actively involved
  - 2. Passive: Holding companies or entity in which the owner is merely a passive investor, i.e. real estate entities.
- B. Income Available for Maintenance and Child Support
- C. Income converted into the value of the business.

## The Backbone of Valuation

- A. IRS Revenue Ruling 59-60
  - 1. Formed the basis to value closely held entities
  - 2. Established eight fundamental areas to consider in determining fair market value of closely held entities
    - a. The nature of the business and the history of the enterprise from its inception
    - b. The economic outlook in general, and the condition and outlook of the specific industry in particular
    - c. The book value of the stock and the financial condition of the business
    - d. The earning capacity of the company
    - e. The dividend paying capacity
    - f. Whether or not the enterprise has goodwill or other intangible value
    - g. Sales of the stock and the size of the block of stock to be valued
    - h. The market price of stock of corporations engaged in the same or a similar line of business having their stock actively traded in a free and open market, either on an exchange or over the counter
  - 3. Defines Fair Market Value

## Valuation Overview

- A. Define the Engagement Assignment
  - 1. Who is the client
  - 2. Define business or interest being valued
  - 3. Date of valuation
  - 4. Standard and premise of value
  - 5. Purpose and use of the appraisal
  - 6. Type of work product
  - 7. Scheduling arrangements
  - 8. Fee arrangements
  - 9. Contingent and limiting conditions
- B. Standards of Value
  - 1. Fair Market Value
    - a. Defined by the Internal Revenue Service in Revenue Ruling 59-60 as: “the price at which a property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.”
  - 2. Fair Value
    - a. Court-determined fair value provided for under some states’ law
    - b. Used when a corporation agrees to a merger, sale or other action, and minority shareholders believe they will not get adequate consideration for their stock. Those stockholders may have their stock appraised and get “fair value” in cash
  - 3. Liquidation or Break-up Value
    - a. Assumes operations will cease and individual assets will be sold (disposed of)
    - b. Orderly Liquidation: Selling assets over a reasonable time period in order to obtain the highest price
    - c. Forced Liquidation: Selling assets quickly as possible such as at auction

#### 4. Book Value

- a. Asset: The capitalized cost of an asset, less accumulated depreciation, depletion and amortization as it appears on the books
- b. Business Enterprise: The difference between total assets (net of depreciation, depletion and amortization) and total liabilities (net book value, net worth, shareholders' equity)

#### 5. Intrinsic Value

- a. The value of a company's stock based on the analysis and judgment of an independent security analyst, investment banker, or financial manager
- b. Ambiguous when valuing a business (often used interchangeably with investment value)
- c. Confusing in court cases where it may be used when referring to fair market value, fair value or some other type of value

#### 6. Investment Value

- a. The value of a business or asset as it relates to a specific purchaser or owner
- b. Takes into account the owner or purchaser's abilities, knowledge, financial condition, track record, etc.

### Principles of Valuation

Principle of Substitution – One would not pay more for an asset than it would cost to acquire or create some other asset that would provide equal or greater economic utility to the owner.

Principle of Future Benefits – One would not pay more for an asset than the present value of the future benefits the asset is expected to deliver to its owner after adjusting the future values of those benefits to a present value at a rate that recognizes the time value of money and the risk (uncertainty) of realizing those future benefits when expected.

## Three Approaches To Value To Determine The Appropriate Approach and Methodology

- A. Income Approach - The term income does not refer to income in the accounting sense, but to the future benefits accruing to the owner. Under the income approach, one estimates the future ownership benefits and discounts those benefits to present value using a rate suitable for the risks associated with realizing those benefits.

<u>Concept</u>	<u>Method</u>
Capitalizes returns	Capitalization of earnings Capitalization of net cash flow Capitalization of gross cash flow
Discounted future returns	Discounted net cash flow Discounted future earnings

### Strengths and Weaknesses of Income Approach

Closest to "pure" value theory.

Very difficult to project future ownership benefits.

Estimates of capitalization or discount rates are difficult to prepare.

- B. Market Approach - This approach assumes that value can be estimated from analyzing recent sales of comparable assets. This approach is commonly used to value single family homes, where the appraiser estimates a house's value by comparing it to similar houses recently sold or offered for sale. In business valuations, one analyzes comparative public companies (and private companies, whenever possible) and/or comparative transactions to determine a company's value. Using this approach requires a thorough search for comparatives and thorough analysis and adjustment of the comparative data, both public and private.

<u>Concept</u>	<u>Method</u>
Value multiples using comparative company data or transactions	Price/earnings Price/dividends Price/gross cash flow  Price/book value Price/revenues Price/net asset value

### Strengths and Weaknesses of Market Approach

Direct method of valuation if similar companies can be found.

"Easy."

Very difficult to find similar companies.

Difficulty in translating this value indication to a control unmarketable value.

Stock market has an emotional aspect to it (re: public companies).

- C. Cost (Asset Based) Approach -- This approach assumes that an asset's value is indicated by the cost of reproducing or replacing it, less an allowance for physical deterioration and obsolescence. The approach is commonly used for assets that are not sold on an active market, such as land improvements and special purpose equipment. For business valuations, the approach generally applies to companies with little value beyond the value of their tangible assets, such as real estate holding companies. It is also used when valuing individual components of a business enterprise.

D.

<u>Concept</u>	<u>Method</u>
Underlying assets	Net asset value Liquidation value
Other	Excess earnings Rules of thumb Sellers' discretionary cash flow Company specific methods

### Strengths and Weaknesses of Cost Approach

Useful for holding companies.

Gives no credit for income being produced.

Inapplicable to the valuation of some intangible assets and to many asset light businesses

Not very applicable in minority interest valuations.

## Revenue Ruling 59-60

- A. States "...determination of the proper capitalization rate presents one of the most difficult problems in valuation."

## Income Streams

- A. Income streams are converted into indications of value of the business that throws the income stream off through the process of:
  - 1. Discounting – A multiple period valuation model that converts a future series of "incomes" into value, by reducing them to present worth at a rate of return that reflects the risk inherent therein.
  - 2. Capitalization – A single period valuation model that converts "income" into value through division by an interest rate that is explicitly adjusted for growth.
- B. Examples of Different Income Streams
  - 1. Net income after tax
  - 2. Net income before income taxes
  - 3. Debt free net income
  - 4. Cash flow
  - 5. Debt free cash flow
  - 6. Earnings before interest and taxes (EBIT)
  - 7. Earnings before depreciation, interest, taxes, & amortization (EBDITA)

## Discount Rates

- A. Definition of Discount Rate/Discounting
  - 1. Defined as "A rate of return used to convert a monetary sum, payable or receivable in the future, into present value." (Business Valuation Standard I, American Society of Appraisers)
  - 2. A discount rate is the rate of return that an investor will demand before agreeing to invest in an asset or right anticipated to be the source of a definable income stream over a predictable period of time in the future. It is the required rate of return.
  - 3. Discounting is a multiple period valuation model that converts a future series of "incomes" into value by reducing them to present worth at a rate of return that reflects the risk inherent therein.



B. What You Should Know About Discount Rates

1. Discount rates are determined by the market.
2. Discount rates vary with time, even for the same investment (can change even on a short term basis).
3. Discount rates are sensitive to, and incorporate inflationary expectations.
4. Discount rates accommodate the risk generally resident in the market, and must be adjusted to allow for the risk that is specific to the asset or right being appraised.
5. Discount rates are based on yields available on alternative investments.
6. Discount rates depend on the nature of the future "income" stream and being reduced to present worth.

C. What Every Discount Rate Includes

1. Regardless of the theory underlying its selection or the source of the basic information which is incorporated therein, every discount rate includes the following elements:
  - a. A risk free rate of return – sometimes referred to as a "safe rate" or the "cost of money"
  - b. A general risk premium – that is reflected in the perceptions and expectations of a broad measure of the market
  - c. A specific risk premium – that which allows for the special risk characteristics of the subject that are not accommodated by the general risk premium

D. Example of the Makeup of A Discount Rate

Risk free rate	7.5%
General risk premium	13.0%
Specific risk premium	<u>4.0%</u>
Discount rate	<u>24.5%</u>

E. Business Valuation and the Discount Rate

1. The discount rate is most commonly applied to a company's net cash flow, defined as follows:

Net income

- + Non-cash charges (depreciation, amortization, etc.)
- ± Changes in working capital necessary to support the projected net income
- ± Capital expenditures necessary to support the projected net income
- ± Changes in debt (this step sometimes omitted on the general assumption of a constant debt level)

Capitalization Rate

A. Definition of Capitalization Rate/Capitalization

1. "Any divisor (usually expressed as a percentage) that is used to convert income to value." (Business Valuation Standard I, American Society of Appraisers)
2. Capitalization is a single period valuation model that converts "income" into value through division by an interest rate that is explicitly adjusted for growth.
3. A capitalization rate, as the term is generally used in business valuation, is the rate utilized to convert the income reported or forecast for a single operating period into an indication of the fair market value of the property, right or interest which is its source.
4. A capitalization rate is a required rate of return from which anticipated growth has been eliminated, thus, a capitalization rate is a discount rate minus growth.
5. Capitalization rates are employed as reflected in the following equation:

$$\text{Income Stream} \div \text{Capitalization Rate} = \text{Value}$$

B. What You Should Know About Capitalization Rates

1. Capitalization rates are determined by the market
2. Capitalization rates vary with time, even for the same investment
3. Capitalization rates are sensitive to, and incorporate, long-term inflationary expectations
4. Capitalization rates accommodate the risk generally resident in the market, and must be adjusted to allow for the risk that is specific to the asset or right being appraised
5. Capitalization rates are based on yields available on alternative investments
6. Capitalization rates depend on the nature of the income stream being capitalized to value

C. Factors Affecting The Discount Rate and Capitalization Rate Selection

1. External Factors

- a. Existing general economic conditions, and the economic outlook
- b. The nature of the industry within which the business functions, and of the market served
- c. The economic condition of the industry specifically
- d. The perceptions of the market regarding similar investment opportunities
- e. The sources and availability of capital

2. Internal Factors

- a. The financial condition of the business being appraised
- b. The level and quality of its earnings
- c. The security of its sources of supply and access to its market
- d. The quality of management
- e. The accounting systems, methods and controls
- f. The future expectations of the business

D. An Example of the Makeup of a Capitalization Rate

Risk free rate	7.5%
General risk premium	13.0%
Specific risk premium	<u>4.0%</u>
Discount rate	24.5%
Anticipated rate of growth (long-term growth rate)	<u>3.0%</u>
Capitalization rate	<u>21.5%</u>

E. Aspects To Consider In The Selection of A Capitalization Rate

1. Capitalization of total income yields the value of the entire business. Increments of total income, at least in theory, can be capitalized to indicate the value of individual assets, or classes of assets, making up the entire business.
2. It is an error of potentially significant magnitude to use a capitalization rate designed for application to one level of income in the treatment of another.
5. Value conclusions are very sensitive to the capitalization rate selected, with mistaken conclusions directly proportionate to the error in selection

Types of Reports

- A. Appraisal
- B. Limited appraisal
- C. Calculations

## Sample Valuation Report Contents

### A. Letter of transmittal

#### 1. Body of report

- a. Services performed and limiting conditions
- b. Introduction
- c. Sources of information
- d. History and nature of the business
- e. Economic outlook
- f. Industry history and outlook
- g. Financial performance of the company
  - Financial analysis
  - Adjustments to financial statements
- h. Valuation methodology
  - i. Asset Approach
  - j. Income Approach
  - k. Market Approach
  - l. Synthesis of Asset, Income and Market approaches
- m. Discounts and premia
- n. Conclusion of value

## Discounts and Premia In The Valuation of Closely Held Businesses

Rationale - Recognize that the value of a particular interest in a business may not be the same as a proportionate share in that business ("the sum of the parts doesn't necessarily equal the whole")

### Types of Discounts and Premia

- A. Discount for Lack of Marketability
- B. Minority Interest Discount
- C. Premium for Control
- D. Discount for Legal or Contractual Restrictions
- E. "Key-Man" Discount

### Other Factors In Valuations

- A. Voting Rights: Voting vs Non-voting Shares
- B. Share Type: Preferred vs Common Stock

PRINCIPAL PREMIA & DISCOUNTS

CONTROL VALUE

IIII  
III  
I

FREELY TRADED VALUE, MINORITY INTEREST

I  
III  
IIII

LIMITED MARKETABILITY, MINORITY INTEREST

LIQUIDITY TABLE

HIGH

IIII MINORITY INTEREST IN PUBLIC COMPANY

III LARGE BLOCK OF PUBLIC COMPANY

III CONTROL BLOCK OF CLOSELY HELD COMPANY

II MINORITY INTEREST IN CLOSELY HELD COMPANY

LOW

## Discount for Lack of Marketability ("DLOM")

- A. Definition - Reflect liquidity of typical closely held stock
- B. Rationale
  - 1. Most valuation approaches derive an "as if freely traded" or publicly traded value, since most available information for determining discount or capitalization rates comes from highly liquid, publicly traded securities
  - 2. Closely held shares cannot be sold on the open market (call your broker, cash in three days, ... )
- C. Studies of DLOM (generally applicable to minority interests)
- D. Factors Affecting Size of DLOM
  - 1. Attractiveness of subject company's business or industry
  - 2. Dividend history - size, stability
  - 3. Size of subject company
  - 4. Likelihood of future public offering
  - 5. Historical profitability
  - 6. Control v Minority interest block to be valued
  - 7. Information access
  - 8. Information reliability
  - 9. Shareholder/Partnership agreement to repurchase

## III. Minority Interest Discount ("MID")

- A. Definition - Recognize common sense principle that a knowledgeable buyer will pay more per share for an interest in a company that confers management and operational control than an interest that solely confers rights of a passive investor
- B. Rationale - Controlling interest retains substantial benefits unavailable to minority shareholder:
  - 1. Set management compensation and perquisites
  - 2. Declare and pay dividends
  - 3. Make acquisitions or liquidate all or part of the business
  - 4. Establish operating policies, decide with whom to do business and award contracts
- C. Consideration of Particular Facts & Circumstances, including:
  - 1. Rights associated with share ownership and control
  - 2. Shareholder/partnership agreement
  - 3. Ownership structure & size of various blocks
  - 4. Prior transactions
  - 5. Dividend history



## Premium for Control ("PFC")

- A. Applicability of Premium for Control
  - 1. Typically apply to greater than 50% (controlling) interest
    - a. 50/50 ownership does not provide control, but does not warrant full MID either
- B. Consideration for particular facts and circumstances.

## "Key-Man" Discount

- A. Transferability of income stream in question
- B. Risk Factor

## THE ROLE OF THE EXPERT WITNESS

Are they Independent?

- A. Identify potentially problematic relationships with any party involved in the case
  - 1. Financial
  - 2. Family
  - 3. Close personal relationships
- B. Avoid billing relationships that are not the expert's standard practice
- C. When an expert typically represents only one side of an issue, independence may be called into question

What Type of Retention Letter?

- A. Consulting Expert Vs. Expert Witness
- B. "Kovel" Letter

What Are Their Qualifications/Designations?

- A. Request samples of past valuation reports
- B. Proper documentation within report
  - 1. Intent
  - 2. Summary
  - 3. Method
  - 4. Disclosure of adjustments
  - 5. Disclosure of basis for amounts used
- C. Professional Designations
  - 1. Determine whether credentials are meaningful
    - a. Does the expert adhere to standards of practice and a code of professional ethics when providing service?
    - b. Is continuing education required in the area of expertise?
    - c. Does the expert participate in formal education programs?
    - d. Does the expert follow the institution's guidelines for engagements?
    - e. Has the expert passed a comprehensive exam?
    - f. Does the expert demonstrate work product for peer review?



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## Business Valuations: Different Values for Different Purposes?

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There are many more purposes for which valuations are used. Each has its unique presumptions. It must be understood that there is no one value and that the same investment can have a different value to different people and for different reasons. Each valuator must analyze such differences, understand the presumptions inherent in the purpose for which the valuation is to be used, and select and implement a method to determine proper value for the purpose.

### **Purchases or Sales**

The most common purpose for determining the value of an investment is a purchase or sale, and the most common investment being valued is an operating business. When a business becomes available for sale the seller has placed a value on the business. The presumptions as to the value determined by the seller include the value in their hands, as an operating, going concern entity, with limited risks relating to continuity of customer relations and knowledge of the industry. These are different from assumptions as to whether sales will increase 4% per year or whether the capitalization rate

should be 18%. When the buyer receives the opportunity to acquire the business, they evaluate the business as an addition to their current operations, presuming incremental value, as a new venture with estimates of risk and analysis of uncertainties, or presuming future benefits they can bring to the operation. As the negotiations progress, with neither party under duress to sell or buy, hopefully a value can be agreed upon and a deal consummated. This provides a reconciliation of the presumptions between the buyer and the seller.

### **To Obtain Financing**

Another common purpose of a business valuation is to obtain financing. The lending officer's valuation presumes projected future cash flow to meet the bank's interest and principal payments and the liquidation value of collateral in case the worst happens. These are presumptions different from those of a seller or a buyer who presumes going concern values and evaluates historical earnings. They are also different from the actual assumptions which are used to calculate the future cash flow.

Valuation for tax purposes has been the focus of much of the current written materials. Most appraisers quickly recite the definitions in Revenue Ruling 59-60. Revenue Ruling 59-60 is often used as the starting point for many current valuations of businesses. In its discussion of "fair market value," the ruling states, "the determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will generally apply to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, the appraiser should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

The fair market value of specific shares of stock will vary as general economic conditions change from 'normal' to 'boom' or 'depression,' that is, according to the degree of optimism or pessimism with which the investing public regards the future at the required date of appraisal. Uncertainty as to the stability or continuity of the future income from a property decreases its value by increasing the risk of loss of earnings and value in the future. The value of shares of stock of a company

with very uncertain future prospects is highly speculative. The appraiser must exercise his or her judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting value."

In addition, there are different rules relating to the valuation of shares contributed to an Employee Stock Ownership Plan; completely different basis for determining a company's value in connection with fraudulent conveyances in ERISA matters; and again differences in valuation or fraudulent conveyances for bankruptcy matters. Gift tax valuations also set a different standard. How often does an evaluator or trier of fact point to a previously determined tax value and attempt to propose comparability? Is the tax value appropriate to the other purpose?

### **Partners/Shareholders**

Valuations between partners/shareholders also have different presumptions. If the buy/sell agreement is designed to penalize the shareholder for termination of ownership/employment, the valuation method would clearly not be reflective of fair market value, even though the agreement may refer to the buyout price as being at market value.

Many times, book value is the transfer value, but rarely does book value correspond to value for any purpose.

On the opposite end of the spectrum, when the buy/sell agreement is funded with the proceeds of life insurance, the controlling presumption in determining the fair market value of the business is often the life insurance/estate needs of the owner and not the value of the company.

Finally, there are valuations for litigation purposes. The presumptions selected by the valuator may be affected by the nature of the claims and the side of the litigation being represented.

Each valuator points to many of the above examples in order to substantiate the appropriateness of their opinion. In shareholder disputes, is the market value multiple of a multi-national, public company representative in determining the value of an entrepreneurial business?

In domestic relations matters, is there really a contemplated sale to use the tax definition presuming a willing buyer and a willing seller, or is the business owner/spouse really a willing seller and, at the same time, a unique buyer?

## Conclusion

There are many presumptions inherent in performing a valuation. Such presumptions vary with the purpose of the valuation. The presumptions can range from the most conservative as “in the event of immediate liquidation,” to the most aggressive as “in the case of a unique buyer.” Such presumptions also arise from legal precedents, regulations and rulings and business or marketplace practices.

Presumptions that are purpose based are different from assumptions that are specifically case based. The investment, with the same set of facts and assumptions, can be valued at a different amount depending upon the purpose of the valuation, which has different presumptions.

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## Full Valuation vs. Calculation Of Value: Which One Does Your Client Need?

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Attorneys call on appraisal experts to provide various services, including both full valuations and calculations of value. While the two may sound the same, full valuations are preferable in certain circumstances.

### Full valuations

Business valuation analysts must follow the professional standards of the appraisal organizations with which they are affiliated. For example, CPAs with the Accredited in Business Valuation (ABV) designation must follow the standards set forth by the American Institute of Certified Public Accountants (AICPA). Each appraisal organization has its own set of professional standards. Although these standards vary from each other somewhat, they generally concur on the amount of research and analysis required to prepare a full valuation.

According to the AICPA's Statement on Standards for Valuation Services No. 1 (SSVS 1), for example, a full valuation is performed when the valuation analyst:

- Is asked to estimate the value of the subject interest,
- Estimates the value in accordance with SSVS 1,

- Is free to apply the valuation approaches and methods he or she deems appropriate for the circumstances, and
- Expresses the results of the valuation as a "conclusion of value."

This type of engagement is often most appropriate for litigation — including divorce proceedings — and estate and gift tax filings.

### Calculations of value

Under SSVS 1, a calculation of value is performed when three conditions are met:

1. The valuation analyst and client agree on the valuation approaches and methods the analyst will use and the extent of procedures he or she will perform in the process of calculating the value of the subject interest. These procedures typically will be more limited than those in a full valuation engagement.
2. The analyst calculates the value in accordance with the agreement.
3. The analyst expresses the result as a calculated value.

SSVS 1 explicitly indicates that the valuation analyst should qualify the

calculated value by stating in the report that the calculation doesn't include all of the procedures required for a full valuation. The analyst might also add a disclaimer that, if a full valuation had been performed, the results could have been different.

Sometimes, though, a full valuation isn't necessary or possible, and a calculation of value will suffice — for example, when the analyst doesn't have complete access to all of the relevant information. A calculation of value also could be appropriate for negotiating the purchase or sale of a business, for facilitating settlements or for mediation purposes. Your clients may further find a calculation of value useful for strategic planning, including tax and estate planning, and key-person insurance purposes.

### **Comprehensive often is preferred**

As previously discussed, a calculation engagement is limited in scope and won't consider any valuation approaches and methods beyond those agreed upon with the client. In fact, many experts consider a calculation of value a "quick and dirty" estimate of a subject interest's value. Unlike a full valuation, a calculation of value typically doesn't involve a detailed report that can be time-consuming to produce. Instead, a calculation engagement might lead to an abbreviated letter report, numerical exhibits or oral presentations.

Although there's no rule against testifying based on a calculation of value, courts usually prefer the more comprehensive full valuation. (See the sidebar "Court rejects calculation of value.") The IRS and Securities and Exchange Commission also typically prefer full valuations. For example, the IRS lays out guidelines for supporting documentation for tax purposes, which calculations of value don't satisfy.

### **Selecting the right service**

Calculations of value typically are less expensive than full valuations, and it may be tempting to cut corners on price. But the tab could end up much higher in the long run if the appraiser's limited procedures and reporting format prove inadequate for your client's needs. To ensure you retain the appropriate service, provide your valuation expert with as much information as possible at the beginning of the process. © 2014

## Court Rejects Calculation of Value

A recent shareholder dispute provides a good example of courts' preferences for full valuations over calculations of value (see main article). *Surgem, LLC v. Seitz*, heard by the New Jersey appellate court, involved a minority shareholder's interest in a company that provided management services to ambulatory surgical centers.

The expert for the minority shareholder testified that he'd been engaged to prepare only a calculation of value using the method determined by the client. He further testified that his client didn't supply him with numerous materials that were necessary for a full valuation. In addition, the expert acknowledged that more work should have been done for him to arrive at a formal conclusion of the business's fair market value.

After rejecting the calculation of value set forth by the minority shareholder's expert, the trial court found the opposing expert's full valuation report uncontroverted. The lower court therefore accepted his analysis and calculations, and the appellate court affirmed.



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## Fair Market Value: Dissecting Revenue Ruling 59-60

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Did you know that a milestone piece of IRS guidance provides a step-by-step outline of the factors to consider when valuing a private business? Here's an overview of those factors, along with other hidden details found in IRS Revenue Ruling 59-60's fine print.

### Customize the analysis

According to the Revenue Ruling, business valuation is an inexact science, often resulting in "wide differences of opinion" about the value of a particular business interest. Therefore, experts must take a customized approach that considers the following factors:

- Nature and history of the subject company,
- Outlook for the general economy and industry,
- Book value and financial condition (from at least two years of balance sheets),
- Earnings capacity (from at least five years of income statements),
- Dividend-paying capacity (as opposed to dividends actually paid),
- The value of goodwill and other intangible assets,

- Previous arm's-length transactions involving the subject company's stock and the size of the block of stock, and
- Market prices paid in comparable transactions.

When evaluating these factors, valuers try to gauge a company's risk and financial condition, as well as estimate its future performance. Historical levels of stability, profits, growth and diversity are relevant to a hypothetical investor only if this data can be used to develop the subject company's future performance trends.

### Consider three approaches

After experts learn about business operations and market conditions, Revenue Ruling 59-60 instructs them to consider three approaches in every valuation assignment. First, the cost approach looks at the company's book value, its financial condition and the value of intangibles. Next, the income approach is based on earnings and dividend-

paying capacity. Finally, the market approach reflects previous transactions involving the company's stock and market prices of comparable businesses. An expert may choose to



apply one or more of these approaches when estimating business value.

Revenue Ruling 59-60 cautions against the blind use of averages when considering these approaches. Instead, it's better to pick the technique that provides the most meaningful result than to simply average all three together. Averaging the results "excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts of the case except by mere chance."

### Review the fine print

In its discussion of these factors, Revenue Ruling 59-60 describes several other factors that may affect the value of a closely held business. For example, when a company relies heavily on key people, its value may be impaired if they leave. The depressing effect is especially pronounced if the company hasn't implemented a succession plan or required key people to sign noncompete agreements. Life insurance policies and competent management can offset these risks, however.

Another consideration when valuing a business is nonoperating assets. Investments, real estate and other assets that aren't essential to a company's normal business operations may require a higher or lower rate of return. So, experts typically value them separately when appraising a business. They also adjust for income and expenses related to the nonoperating assets.

Likewise, adjustments may be required to the company's historical earnings for income and expense items that aren't expected to happen again in the future. Examples include revenues and expenses from discontinued product lines or a one-time windfall from an insurance claim.

Revenue Ruling 59-60 doesn't prescribe a universal capitalization rate for every company. Instead, rates of return on earnings must be determined based on the nature of the business, risk, and stability or irregularity of earnings. Riskier businesses generally require higher capitalization rates, which results in lower values (and vice versa).

### Read the full text

Have you taken the time to read Revenue Ruling 59-60 in its entirety? It provides definitive guidance for business valuations prepared for tax purposes. But, over the last 60 years, it's been cited in valuations used for a wide variety of purposes. Contact your valuation professional with questions or to learn how it applies to a specific subject company.

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## What's It Worth? 3 Approaches To Valuing A Business

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Business valuation professionals typically apply three different approaches when valuing a business — the cost, market and income approaches — ultimately relying on one or two depending on the type of case and other factors. It's vital that attorneys and clients who rely on business valuations understand the basics of each approach.

### 1. Cost approach

The cost (or asset-based) approach derives value from the combined fair market value (FMV) of the business's net assets. This technique usually produces a "control level" value, meaning the value to an owner with the power to sell or liquidate the company's assets. For that reason, a discount for lack of control (DLOC) may be appropriate when using the cost approach to value a minority interest. This approach is particularly useful when valuing holding companies, asset-intensive companies and distressed entities that aren't worth more than their net tangible value.

The cost approach includes the book value and adjusted net asset methods. The former calculates value using the data in the company's books. Its flaws include the failure to account for unrecorded intangibles and its reliance on historical costs, rather than current

FMV. The adjusted net asset method converts book values to FMV and accounts for all intangibles and liabilities (recorded and unrecorded).

### 2. Market approach

The market approach bases the value of the subject business on sales of comparable businesses or business interests. It's especially useful when valuing public companies (or private companies large enough to consider going public) because data on comparable public businesses is readily available.

Under this approach, the expert identifies recent, arm's length transactions involving similar public or private businesses and then develops pricing multiples. Several different methods are available, including the:

***Guideline public company method.*** This technique considers the market price of comparable (or "guideline") public company stocks. A pricing multiple is developed by dividing the comparable stock's price by an economic variable (for example, net income or operating cash flow).

***Merger and acquisition (M&A) method.*** Here, the expert calculates pricing multiples based on real-world transactions involving entire comparable companies or operating

units that have been sold. These pricing multiples are then applied to the subject company's economic variables (for example, net income or operating cash flow).

Under the market approach, the level of value that's derived depends on whether the subject company's economic variables have been adjusted for discretionary items (such as expenses paid to related parties). If the expert makes discretionary adjustments available to only controlling shareholders, it may preclude the application of a control premium. If not, the preliminary value may contain an implicit DLOC.

### 3. Income approach

When reliable market data is hard to find, the business valuation expert may turn to the income approach. This approach converts future expected economic benefits — generally, cash flow — into a present value. Because this approach bases value on the business's ability to generate future economic benefits, it's generally best suited for established, profitable businesses.

The capitalization of earnings method capitalizes estimated future economic benefits using an appropriate rate of return. The expert considers adjustments for such items as discretionary expenses (for example, for above- or below-market owner's compensation), nonrecurring revenue and expenses, unusual tax issues or accounting methods, and differences in capital structure. This method is most appropriate for companies with stable earnings or cash flow.

## Excess Earnings Method Blends The Cost and Income Approaches

The excess earnings method derives value from the sum of 1) adjusted net assets, and 2) capitalized "excess" earnings. The second component represents the extra earnings that the company has been able to achieve beyond the return that comparable businesses earn on a similar set of net assets.

Essentially, this method equates capitalized excess earnings with the value of the business's goodwill. It's calculated using a technique similar to the capitalization of earnings method (see main article) — that is, excess earnings are divided by an appropriate capitalization rate.

This method was originally developed to compensate distilleries and breweries for loss of business value during the Prohibition era. However, to date, there's no reliable source of market data to support comparable returns on net assets or capitalization rates for excess earnings. So, experts generally refrain from using it as a sole method of valuation, unless a particular court has shown a preference for this technique. In addition, IRS Revenue Ruling 68-609 suggests that the excess earnings method be used only if there are no other appropriate methods.

The discounted cash flow (DCF) method also falls under the income approach. In addition to the factors considered in the capitalization of earnings method, the expert accounts for projected cash flows over a discrete period (say, three or five years) and a terminal value at the end of the discrete period. All future cash flows (including the terminal value) are then discounted to present value using a discount rate instead of a capitalization rate.

As with the market approach, the income approach can generate a control- or minority-level value, depending on whether discretionary adjustments are made to the future economic benefits.

## Important decision

No universal formula exists for all businesses. Therefore, it's essential for experts to explain why they chose a specific method (or methods) over all the possible options.

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## Standards Of Value: A Cheat Sheet

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Attorneys aren't expected to be valuation experts. That's why they hire professional appraisers when clients need a company or business interest valued for litigation, tax or other purposes. But a basic understanding of the various standards of value enables you to work more effectively with your expert — and better serve your clients.

### Fair market value

The most widely recognized standard of value is fair market value (FMV), which is almost always used for valuing business interests for estate and gift tax purposes. The IRS defines FMV as the price at which the property would change hands between a hypothetical buyer and seller who have reasonable knowledge of the relevant facts and are under no compulsion to enter into the transaction.

FMV reflects the price at which a transaction would occur under the conditions that existed as of the valuation date. For some standard-setting bodies, FMV represents the highest and best use that the property could be put to on the valuation date, taking into account special uses realistically available. It doesn't matter whether the owner has actually chosen that use for the property.

### Fair value

According to the Financial Accounting Standards Board, fair value (FV) is the price it would take — in an orderly transaction between market participants — to sell an asset or transfer a liability in the market where the reporting entity would typically transact for the asset or liability.

The FV standard usually is applied for financial reporting purposes. But it's also used in shareholder or divorce litigation and is generally defined by state law in such cases. In many states, FV for litigation involving dissenting shareholders is considered to be the pro rata share of a controlling level of value. Thus, control and/or marketability discounts generally aren't applied.

### Investment value

Investment value represents the value of an asset to a specific investor. For real estate purposes, it's typically defined as the value of an investment to a particular investor or class of investors based on their investment requirements. Value is estimated by discounting an anticipated income stream while also considering potential benefits from synergies such as revenue enhancement or lower expenses.

Investment value can vary from FMV for several reasons. These include contrasting estimates of future income and different perceptions of risk. There may also be income status differences and synergies with other operations owned or controlled by the investor. In shareholder litigation, investment value is based on earning power. But the appropriate discount or capitalization rate typically is a consensus rate that isn't specific to any investor.

### Intrinsic value

Intrinsic value usually is employed when valuing an equity share to determine its "real worth." Also known as fundamental value, intrinsic value considers an asset's primary value. Relevant factors include:

- The value of the company's physical assets,
- Expected future interest and dividends payable,
- Expected future earnings, and
- Expected future growth rate.

Some appraisers use the term "intrinsic value" to refer to investment value. Others use it to describe the independent analysis of an investment analyst, banker or financial manager. And courts don't always clearly define the term, either. Therefore, appraisers are challenged to establish a clear, upfront definition with clients and attorneys.

### Sifting the options

How do valuation experts decide which standard to apply when performing a business appraisal? Professional judgment certainly factors into the decision. And the appropriate standard often is determined by state or federal statute, case or administrative law, or specific court orders. Corporate documents, such as buy-sell agreements or articles of incorporation, also might dictate the applicable standard. © 2014

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## Calculation vs. Valuation: A Critical Difference

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Attorneys and their clients sometimes ask professional valuers to provide preliminary estimates — called “calculations” — rather than full-fledged business appraisals. While such requests might save money up front, a recent Iowa case, *In re Marriage of Hagar*, illustrates why calculations are no substitute for valuations.

### Dry cleaners divorce

Jodi and Michael Hagar married in July 1999. In December 1999, Jodi quit her job as a publishing sales representative and joined Michael at Goliath, Inc., where he had worked since 1996.

Goliath was established by Michael’s parents to operate a dry cleaning business. In 1996, the parents formed Hagar, Inc. to purchase real estate and distribute income to themselves. Goliath remained the dry cleaning operating entity and leased its buildings and land from Hagar, Inc. In December 2000, the parents’ CPA, Ron Helle, roughly estimated Goliath’s value at about \$500,000.

In January 2002, Michael entered into a purchase agreement and note to purchase Goliath for \$300,000 from his parents’ trust, which held all of the Goliath stock. Over the course of the marriage, Jodi and Michael reduced the

note obligation to \$160,000, creating \$140,000 in equity.

When they divorced, the trial court found that Helle, who testified in court, estimated Goliath’s value to be between \$71,000 and \$120,000. Neither party presented formal valuation testimony from a qualified valuation expert. In fact, Helle testified that his “computation” was *not* a valuation. Eventually the court determined that the business’s value was \$95,500.

### Court of appeals decides

On appeal, Michael claimed that the trial court had overvalued Goliath. He argued that Helle had provided an upper range of \$71,000, and a lower range of *negative* \$120,000. Jodi, on the other hand, asserted that the court had undervalued Goliath. She pointed out that the company had been “valued” at \$500,000 in December 2000 and that half of the purchase price had been paid off.

The court of appeals agreed with both of them. It held that the \$120,000 figure had been expressed as a negative number, as Michael contended. But it rejected Helle’s calculations (which the CPA himself described as “thumb-nail”) because he admittedly hadn’t used “judgment” or recognized the family

relationship between Goliath and its landlord.

The court found that Goliath and Hagar were, first and foremost, operated to benefit the family. For example, one unprofitable Goliath location wasn't closed as quickly as it could have been because the rent paid on it benefited Michael's parents. A qualified expert would have incorporated such factors in a thorough valuation.

## Real cost revealed

Goliath was ultimately valued at \$140,000, about \$70,000 more than the highest calculation provided by the CPA. Don't risk such a discrepancy in your own cases — get a thorough valuation.

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## Breaking Up Is Costly To Do: How a Divorce Ruling May Affect Private Partnership Valuations

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Divorce proceeding valuations involving a spouse's "partnership" interest in a large professional practice have commonly been limited to the terms of the partnership agreement's buy-sell provisions. So, divorce courts based the value on the partner's capital account, which represents his or her capital contributions plus share of partnership income minus his or her partnership distributions. Even when the cash basis determines income, some values haven't provided for accrual method increases.

But all this may change because of an October 2002 Indiana court ruling in the divorce proceedings of Ernst & Young's CEO. Not only did the divorce court include the partner's capital account as a marital asset, but also the value of his share of the accounting firm's intangible assets. Partners, their spouses and their firms will all feel this issue's reverberations.

### The Ruling

*In re Janet L. Bobrow v. Richard S. Bobrow* involved the value of Richard Bobrow's 0.22% ownership in Ernst & Young (E&Y), a Big Five accounting firm at the time. In

interrogatory answers, Richard included his E&Y capital account in the marital estate's estimated value, but not his share of E&Y's enterprise goodwill. His expert witness testified that Richard had no personal goodwill in E&Y, apparently based on the E&Y partnership agreement's buy-sell provisions. The partnership agreement states that an E&Y partner owns a capital account, which does not include goodwill.

Contrary to the buy-sell provision, the court included the value of Richard's share of E&Y's enterprise goodwill in the marital estate. The court cited a 1999 Indiana Supreme Court case (*Yoon v. Yoon*) that defined enterprise goodwill as "the value of a business or practice that exceeds the combined value of the net assets used in the business."

*Yoon* goes on to state that enterprise goodwill "is based on the intangible, but generally marketable, existence in a business of established relations with employees, customers and suppliers."

The ruling refers to these intangibles as the "Yoon assets." It characterizes as intangibles not only goodwill but also E&Y's trade name,

favorable business reputation, name recognition, and “methods and tools” that provide value to the firm.

As for the transferability of E&Y partnership interest, the court noted that the E&Y interest may transfer to its new partners or to a buyer. For the latter, the court cited two transactions that included enterprise goodwill value. One transaction involved E&Y’s sale of its consulting practice to another firm. The other transaction was the sale of an Indiana-based firm to a large tax-preparation company. The court, relying on *Yoon*, held that “Indiana law provides that enterprise goodwill need not actually be transferred to be included in the marital estate -- only that it be ‘*transferable*’ [emphasis supplied].

### The Valuation

Meanwhile, Jan Bobrow hired a rival expert to value E&Y’s enterprise goodwill. The court noted that this firm “employed the typical methods for the valuation of the assets of an enterprise” and that these methods were the same used by E&Y in the valuation of its consulting practice, which another firm bought.

The court used the discounted cash flow valuation method to value Richard’s share of E&Y’s enterprise goodwill. Based on E&Y’s fiscal year 2000 income, and historical and estimated future growth rates, the value of E&Y in its entirety was \$5.53 billion as of March 31, 2000 (the Bobrows separated in March 2000). The cost approach was then used to value E&Y’s tangible assets at \$1.12

billion. Subtracting the \$1.12 billion value of tangible assets from the \$5.53 billion total value resulted in a value of the E&Y enterprise goodwill of \$4.41 billion. Richard’s share of the enterprise goodwill was determined to be approximately \$9.7 million (\$4.41 billion multiplied by his 0.22% ownership), and the court included this as an additional marital asset.

### The Excess Earnings

Another interesting component of the valuation analysis performed by Jan’s expert was supporting the enterprise goodwill valuation by estimating Richard’s E&Y ownership earnings, separate from his estimated CEO salary. Jan’s expert accomplished this by first estimating the reasonable compensation component of Richard’s 2000 earnings at \$900,000 to \$1.3 million (based on an executive compensation study). Then the expert estimated the excess earnings attributable to his ownership value as the difference between the reasonable compensation and the total \$2.75 million earnings -- or \$1.45 million to \$1.85 million of excess earnings. Finally, the expert determined the present value of this excess earnings range through age 58, or the value of enterprise goodwill, between \$8.5 million to \$10.9 million. The court then noted that the \$9.7 million value of Richard’s share of enterprise goodwill “falls squarely” between the present values of Richard’s excess earnings range.

## The Ramifications

The *Bobrow* ruling's impact on partnership valuations is enormous. Three major areas are particularly affected:

1. Partners in large professional partnerships, their divorce counsel and the partnerships themselves may no longer be able to avoid disclosure of information necessary for valuing a partner's interest. Note that the court ordered Richard Bobrow to pay \$100,000 of his wife's attorney fees because of discovery disputes that occurred here.

2. Partnership agreements, including the buy-sell provision, do not necessarily control the treatment of enterprise goodwill in a marital dissolution. The court cited, in addition to *Yoon*, the Indiana case of *Porter v. Porter* and the 1987 Arizona case of *Mitchell v. Mitchell*. The court noted, "*Mitchell* observed that the husband's contention that his ownership interest did not include the value of his firm's enterprise goodwill ignores the fact that if the partnership were sold to a third party, the firm's purchase price would generally include goodwill." *Mitchell* had reversed the trial court's exclusion of enterprise goodwill as a marital asset.

In *Bobrow*, on the issue of enterprise goodwill, the court considered but gave no weight to the E&Y partnership agreement. The court held that the E&Y partnership agreement didn't control Richard's actual interest in E&Y (including his portion of E&Y's enterprise goodwill)

for purposes of valuing the marital estate.

3. The supporting valuation analysis of Richard's earnings in excess of his fair market salary links excess officer compensation to the value of the company's goodwill. The key issues still revolve around determining "reasonable" compensation and the valuation multiple.

Richard is appealing, so this case's ramifications continue to evolve.

## The Thing To Do

As to the potentially broad-reaching effects of *Bobrow*, the court also noted that "courts across the country agree with Indiana that a partnership agreement that governs the distribution of assets among partners upon withdrawal from the partnership cannot and does not control what constitutes 'property' under state law for purposes of marital dissolution." This application to a large professional practice has projected this issue into the headlines. Please call us; we can help you unravel this matter's complex, technical details, and assess how *Bobrow v. Bobrow* may apply to one of your cases.

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# Valuing “Blue Sky” ... Why Goodwill Matters and How It’s Measured

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Goodwill is an indefinite-lived intangible asset. Some businesses have no goodwill. For others, goodwill is a significant part of their value. It comes into play in various business valuation assignments, from divorce and shareholder litigation to business combinations and financial reporting. Not surprisingly, the purpose of a valuation assignment can affect how it’s measured.

## In a nutshell

Goodwill can be hard to define. Examples of the way goodwill can be viewed include:

- 1. *Going concern value.*** This comes from business assets that are producing income. The assemblage of capital (financial resources and equipment), labor and management creates intangible value.
- 2. *Excess business income.*** This is the amount of business income that exceeds the amount necessary to provide a fair rate of return on tangible assets (for example, buildings and equipment) and identifiable intangible assets (for example, patents, trademarks, copyrights, trade secrets, franchises and licenses). The theory is that such excess income is due to goodwill.

**3. *Expectation of future economic benefits.*** The third component arises from expected economic benefits that aren’t directly related to current assets or operations. The value is the net present value of income that will come from expectations of attracting new customers, developing new goods or services and participating in M&As.

How much is goodwill worth? Parties — and experts — seldom agree on the value of this intangible or the appropriate valuation technique to apply.

## Under GAAP

Under U.S. Generally Accepted Accounting Principles (GAAP), goodwill normally goes unreported on the balance sheet unless it’s purchased, as in the sale of a business. The term “goodwill” refers to the residual asset recognized in a business combination after all other identifiable tangible and intangible assets acquired and liabilities assumed have been recognized. GAAP requires goodwill to be carried on the books at its initial fair value less any impairment. It generally isn’t subject to amortization.

Goodwill is impaired if the implied fair value of goodwill of a reporting unit

(basically, an operating unit with its own discrete financial information, separate from the overall company) drops to an amount less than its carrying amount, or book value, including any deferred income taxes. Most companies are required to test for impairment at least annually, and more frequently under certain conditions.

Private companies can elect out of impairment testing, and, instead, amortize goodwill over a period not to exceed 10 years. But they're still required to test for impairment if a "triggering event" — such as the loss of a major customer or the enactment of an adverse government regulation — occurs.

### In divorce cases

How goodwill is handled in a divorce context varies depending on state laws and the facts of the case. When the marital estate includes a private business interest, most states include some or all goodwill when divvying up the couple's assets. In a few states, all goodwill is specifically *excluded* from the marital estate.

Often, the treatment of goodwill in divorce cases hinges on whether a spouse who doesn't participate in the business (the noncontrolling spouse) will receive alimony based on the earning capacity of the spouse that will retain the business (the controlling spouse). The logic here is known as "double dipping." That is, the noncontrolling spouse shouldn't benefit twice from the same asset by receiving 1) alimony based on the controlling spouse's salary, and 2) half of the fair value of goodwill or, in some states, personal goodwill. (See sidebar)

A critical factor in valuing goodwill is whether the controlling spouse's salary is *reasonable* compared to what other people receive for performing comparable work elsewhere. If the controlling spouse is under- or overpaid, adjustments to the amount of alimony awarded and income stream that's used to value the business may be warranted.

### Goodwill hunting

Different circumstances call for different approaches to valuing goodwill. Whether you're valuing goodwill for financial reporting or litigation purposes, retaining a qualified professional will ensure you get a value you can count on. © 2017

## What's The Difference Between Personal and Business Goodwill?

In divorce cases in most states, it's not enough to value goodwill as a whole. Your valuation expert also might need to break it down between personal and business goodwill. Why? Because some states specifically exclude *personal* goodwill from the marital estate.

*Personal* (or professional) goodwill is linked to individual business owners and their abilities to generate future income. It often attaches to a professional person because of confidence in that person's skills and credentials, but the courts in some jurisdictions have rules that owners of manufacturing and retail businesses can also generate personal goodwill. Personal goodwill typically can't be transferred to a third party unless the seller enters into a postclosing consulting or employment agreement with the buyer.

Conversely, *business* (or enterprise) goodwill arises from factors that separate it from the skills or attributes of an individual owner of the business. Examples of these factors include the company's location, assembled workforce, brands, patents and name. Business goodwill is generally easier to transfer to a third party buyer than personal goodwill.

To ensure proper treatment of goodwill, it's imperative to review the statutes and case law in the applicable jurisdiction of the divorce action.



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## Business Valuation: Court Weighs In On Quality And Quantity Of Evidence

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When a business's value is in dispute, the dueling parties usually turn to qualified valuation experts. However, sometimes parties assert their own opinions about value. Or they submit expert opinions that are rejected for failure to meet professional standards and reliance on insufficient data.

After the trial court was confronted with a case featuring both of these circumstances, it declined to assign a value. However, in its unpublished opinion (*Hugh v. Hugh*), the Virginia court of appeals found that the lower court had possessed "a relative wealth of information" from which it could have valued the business.

### **Trial court punts**

The business was a marital asset in a divorce case. The wife had held a 51% interest in the predecessor business, but the husband ran the company. He dissolved that company in June 2011 and reopened under another name. The husband was listed as the 100% owner of the new business. Tax returns showed a massive drop in income from 2010 to 2012, and the husband — who didn't present expert testimony — claimed the company was worth nothing.

The wife's expert received "scant" evidence from the husband. Instead, he reviewed the company's website, tax returns, financial and bank statements, invoice and purchase orders, and depreciation and amortization schedules, as well as depositions of the husband and his CPA. Applying a market approach, the expert valued the business at \$1.4 million. He testified that this value was based on "sound foundation and fact and accounting theory." But he acknowledged that, due to the limited data made available by the husband, it didn't meet the American Institute of Certified Public Accountants' standards.

Citing insufficient evidence, the trial court declined to value the business or subject it to equitable distribution. The wife appealed.

### **Appellate court returns to sender**

The court of appeals pointed out that "the type or quantity of evidence required to enable a trial court to value a business is not fixed." Although the trial court had "understandable doubts" about the husband's credibility and the professionally limited basis for the wife's expert testimony, it had sufficient information to value the company.

The court of appeals sent the case back. It directed the lower court to value and distribute the company.

### **Come prepared**

The greater the amount of discretion a court exercises when valuing a business, the less likely the decision will be fair and accurate. Arm yourself with a qualified valuation expert who can guide the trial court to the right value.

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## IRS Easing Restrictions On Innocent Spouse Relief

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

Years after a divorce decree has been signed and entered, an innocent former spouse could end up on the hook for the misstatement of taxes on a couple's joint tax return. Even if the decree stated that one spouse would be responsible for any amounts due on previously filed tax returns, the nonresponsible spouse must request innocent spouse relief from the IRS.

Until recently, though, the innocent spouse ran the risk of exceeding the IRS time limit on certain relief requests. That limit was expanded recently and many spouses — divorced or not — who previously were denied relief because of the limit may now qualify.

### Necessary change

Since 2002, regulations required that innocent spouse requests seeking equitable relief be filed within two years after the IRS first takes collection against the requesting spouse. But the IRS determined last year that changes were necessary to help innocent spouses who didn't know and didn't have reason to know that their spouses understated or underpaid an income tax liability.

It announced that it will no longer apply the two-year limit to new equitable relief requests or requests currently under consideration. A taxpayer whose

equitable relief request was previously denied based solely on the two-year limit can reapply if the collection statute of limitations for the tax years involved hasn't expired. The IRS won't apply the two-year limit in any pending litigation involving equitable relief. Where litigation is final, it will suspend collection action under certain circumstances.

### Nonequitable relief

Taxpayers seek equitable relief because they don't qualify for the two other primary types of relief — both of which are considered nonequitable. These are:

*Innocent spouse.* This relief may be available from understated tax, interest and penalties due to erroneous items such as unreported income or an improper deduction. The taxpayer must show that 1) he or she signed the joint return without actual knowledge or reason to know of the understated tax, and 2) it would be unfair to hold the taxpayer liable.

*Separation of liability.* Here, the understated tax, plus penalties and interest, is allocated between the taxpayer and the spouse. The taxpayer must establish the basis for allocating the erroneous items. Relief doesn't apply to understated tax for erroneous



items of which the taxpayer had actual knowledge.

### **Some caveats**

Even with these changes, the IRS's two-year election period for seeking nonequitable innocent spouse relief continues to apply. The normal refund statute of limitations also continues to apply to tax years covered by any innocent spouse request.

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## Why Proper Training And Experience Are Essential In An Expert

*Michael J. Garibaldi, CPA/ABV/CFF/CGMA*

In estate tax disputes, it's critical to hire a qualified, informed appraiser. One recent case, *Estate of Thompson v. Commissioner*, demonstrates why.

### Alaskan error

Josephine Thompson died in 1998 owning almost 21% of the shares in Thomas Publishing, the New York-based publisher of the Thomas Register. This closely held business was solely paper-based until the 1990s, when it began adapting to the digital marketplace.

In the six years preceding Thompson's death, the company's operating income was constant at around \$25 million. In the years after her death, it dropped and eventually turned to losses. The estate reported a fair market value of \$1.75 million for the decedent's interest. The IRS countered with a value of \$32 million.

For its valuation, the estate hired an Alaska attorney who was assisted by a local CPA. Neither had significant valuation experience. The attorney, however, had represented to the estate that he could secure a more favorable result for them in Alaska than would be

available from the IRS office in New York.

The Tax Court found fault with both parties' valuations. It described the estate experts' reports and testimony as "only marginally credible" and the experts themselves as "barely qualified to value a highly successful and well-established New York City-based company with annual income in the millions of dollars." The court ultimately valued the decedent's interest at \$13.5 million.

### The penalty issue

Both parties appealed. In its appeal, the IRS argued that the Tax Court should have imposed an accuracy-related underpayment penalty on the estate. In the words of the appellate court, the Tax Court had declined to impose a penalty "principally on the grounds that the Commissioner's estimate [of value] was so high in the other direction and that the valuation issues were fairly debatable."

Under the penalty provision of the Internal Revenue Code then in effect, if the claimed value of an estate was not more than 25% of the amount determined to be correct, the taxpayer

had to pay a penalty of 40% of the underpayment. Here the estate's proposed value of \$1.75 million was less than 15% of the Tax Court's determination.

The penalty was mandatory unless it was shown that "there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith with respect to such." The Tax Court invoked this exception when declining to impose the penalty.

### Reasonable reliance

As the Second Circuit explained, the existence of reasonable cause is determined on a case-by-case basis: "Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability."

Reliance on an appraiser, however, doesn't necessarily demonstrate reasonable cause and good faith. Such reliance will only suffice if, under all of the circumstances, the reliance was reasonable, and the taxpayer acted in good faith. Notably, reliance might not meet those two standards if the taxpayer knew, or reasonably should have known, the expert lacked knowledge in the relevant aspects of tax law.

The Tax Court made no finding assessing the estate's reliance on its experts, though it found the experts lacked experience with technology and Internet-based companies and were "too inexperienced, accommodating, and biased in favor of the estate."

Further, the Tax Court regarded the attorney's role as the estate's administrator for the anticipated audit of the estate tax return as "somewhat in tension with his role as a purported independent valuation expert." The appellate court concluded that a determination as to good faith was required and remanded the case to the Tax Court.

### Avoid costly mistakes

The *Thompson* case serves as a reminder that attorneys and their clients can't afford to cut corners when selecting experts. Choosing experts based on criteria other than their experience and expertise with the specific matter can be a costly mistake.

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## Highlights Of The New Tax Reform Law

Michael J. Garibaldi, CPA/ABV/CFF/CGMA

The new tax reform law, commonly called the “Tax Cuts and Jobs Act” (TCJA), is the biggest federal tax law overhaul in 31 years, and it has both good and bad news for taxpayers.

Below are highlights of some of the most significant changes affecting individual and business taxpayers. Except where noted, these changes are effective for tax years beginning *after* December 31, 2017.

### Individuals

- Drops of individual income tax rates ranging from 0 to 4 percentage points (depending on the bracket) to 10%, 12%, 22%, 24%, 32%, 35% and 37% — through 2025
- Near doubling of the standard deduction to \$24,000 (married couples filing jointly), \$18,000 (heads of households), and \$12,000 (singles and married couples filing separately) — through 2025
- Elimination of personal exemptions — through 2025
- Doubling of the child tax credit to \$2,000 and other modifications intended to help more taxpayers benefit from the credit — through 2025
- Elimination of the individual mandate under the Affordable Care Act requiring taxpayers not covered by a qualifying health plan to pay a penalty — *effective for months beginning after December 31, 2018*
- Reduction of the adjusted gross income (AGI) threshold for the medical expense deduction to 7.5% for regular and AMT purposes — *for 2017 and 2018*
- New \$10,000 limit on the deduction for state and local taxes (on a combined basis for property and income taxes; \$5,000 for separate filers) — through 2025
- Reduction of the mortgage debt limit for the home mortgage interest deduction to \$750,000 (\$375,000 for separate filers), with certain exceptions — through 2025
- Elimination of the deduction for interest on home equity debt — through 2025
- Elimination of the personal casualty and theft loss deduction (with an exception for federally declared disasters) — through 2025
- Elimination of miscellaneous itemized deductions subject to the 2% floor (such as certain investment expenses, professional fees and unreimbursed employee business expenses) — through 2025
- Elimination of the AGI-based reduction of certain itemized deductions — through 2025
- Elimination of the moving expense deduction (with an exception for members of the military in certain circumstances) — through 2025
- Expansion of tax-free Section 529 plan distributions to include those used to pay qualifying elementary and secondary

school expenses, up to \$10,000 per student per tax year

- AMT exemption, the amount of tax, increase to \$109,400 for joint filers, \$70,300 for singles and heads of households, and \$54,700 for separate filers — through 2025. Earnings thresholds increase to \$500,000 for an individual and \$1 million for a couple
- Doubling of the gift and estate tax exemptions, to \$10 million (expected to be \$11.2 million for 2018 with inflation indexing) — through 2025

### Businesses

- Replacement of graduated corporate tax rates ranging from 15% to 35% with a flat corporate rate of 21%
- Repeal of the 20% corporate AMT
- New 20% qualified business income deduction for owners of flow-through entities (such as partnerships, limited liability companies and S corporations) and sole proprietorships — through 2025
- Doubling of bonus depreciation to 100% and expansion of qualified assets to include used assets — *effective for assets acquired and placed in service after September 27, 2017, and before January 1, 2023*
- Doubling of the Section 179 expensing limit to \$1 million and an increase of the expensing phaseout threshold to \$2.5 million
- Other enhancements to depreciation-related deductions
- New disallowance of deductions for net interest expense in excess of 30% of the business's adjusted taxable income (exceptions apply)
- New limits on net operating loss (NOL) deductions

- Elimination of the Section 199 deduction, also commonly referred to as the domestic production activities deduction or manufacturers' deduction — *effective for tax years beginning after December 31, 2017, for noncorporate taxpayers and for tax years beginning after December 31, 2018, for C corporation taxpayers*
- New rule limiting like-kind exchanges to real property that is *not* held primarily for sale
- New tax credit for employer-paid family and medical leave — through 2019
- New limitations on excessive employee compensation
- New limitations on deductions for employee fringe benefits, such as entertainment and, in certain circumstances, meals and transportation

### More to consider

This is just a brief overview of some of the most significant TCJA provisions. There are additional rules and limits that apply, and the law includes many additional provisions. Contact your tax advisor to learn more about how these and other tax law changes will affect you in 2018 and beyond.

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