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Business Valuation for Attorneys

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Marc is nationally recognized in the fields of business valuation and forensic accounting. Marc regularly provides business valuations in the context of marital dissolution, shareholder and partner disputes, financial reporting, gift and estate planning, business planning and decision-making. Marc's clients include attorneys and business owners throughout New England and beyond and span industries such as manufacturing, healthcare, high tech, construction, automotive, start-ups, and professional service advisors.

Attorneys turn to Marc to provide litigation support as an expert witness in the areas of business valuation, forensic accounting, lost profits, business interruption, economic damages and taxation. He has appeared in the United States Tax Court as well as Massachusetts Superior Courts and Probate Courts. Attorneys value Marc's thorough analysis and ability to present complex facts involved in high stakes disputes, in a clear and compelling manner.

Divorce situations often present sensitive financial matters. Attorneys turn to Marc to address complex compensation issues, such as stock options, restricted stock, phantom stock plans, double dip factors, determining annual income and calculating support orders. His forensic accounting experience enables him to identify hidden income and assets that can be pivotal to divorce resolutions.

Marc has also proven to be a valuable asset to business owners. He advises them on potential exit strategies, identifies value-added drivers, and establishes stock-based compensation plans. Marc also works with business owners to develop a comprehensive estate plan which often requires a business valuation as part of the analysis.

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Jesse works with attorneys, shareholders, executive teams and other stakeholders through complex financial problems and disputes. From war room to board room, Jesse serves clients in a variety of contexts.

In addition to his primary client serving responsibilities, Jesse is involved in the day-to-day management of the valuation, forensic and litigation support department; business development; recruiting and hiring; and strategic planning. Jesse has written several articles, presented to business groups, as well as trained attorneys and coworkers on various business valuation and financial related topics.

Prior to joining Edelstein & Company, Jesse was a consultant at a boutique business advisory and forensic accounting firm in Boston. Prior to that, Jesse began his career in the Providence office of a big four public accounting firm in its audit practice.

Agenda

1. Overview of Business Valuation
2. Understanding how the engagement meets the business valuation
3. Procedures in Fact Gather and Financial Analysis
4. Valuation Approaches
5. Valuation Discounts
6. Tips to Critique a Business Valuation

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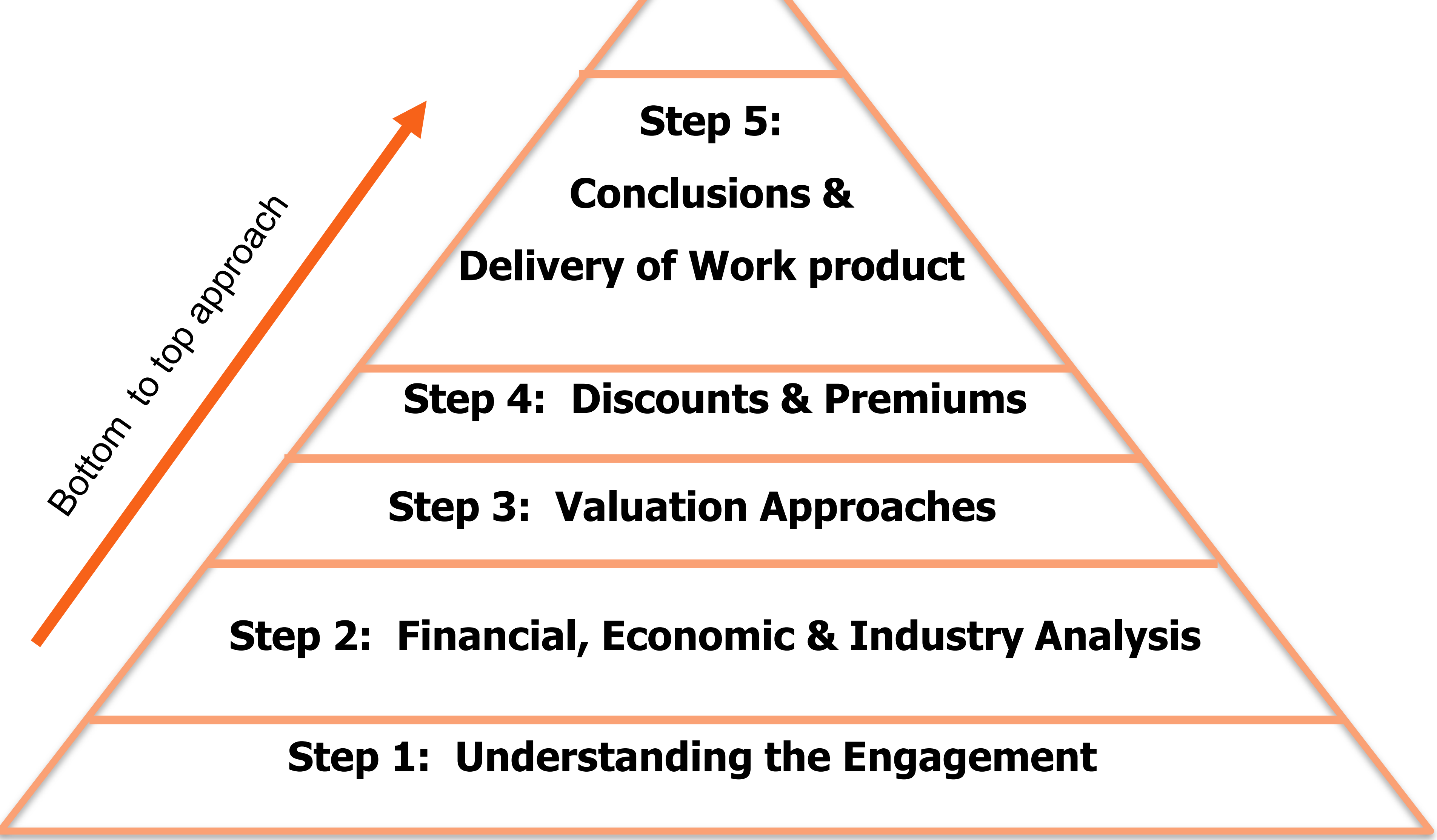
Overview of the Valuation Process



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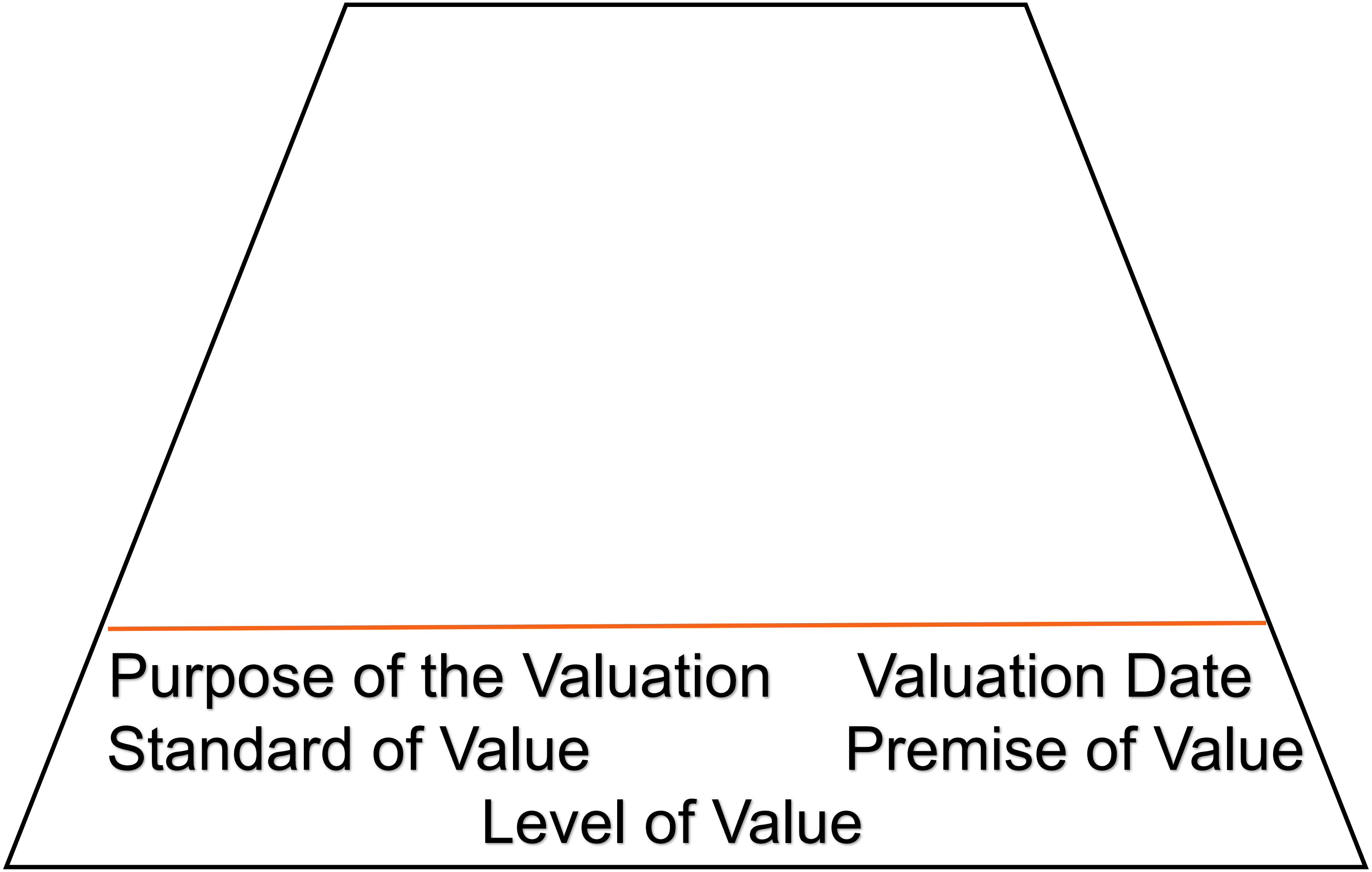
Step 1:Understanding the Engagement



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Purpose Matters

- Actual Transaction
  - Selling the business - Type of Buyers
  - Employee Stock Compensation Plans
- Hypothetical Transaction
  - Gift & Estate
  - Divorce

Standard of Value

- Roadmap valuation experts follow from a procedural standpoint.
  - Authoritative sources
    - Revenue Rulings
    - Judicial Holdings
    - Defined Valuation Standards

Fair Market Value

The IRS has defined FMV in Revenue Ruling 59-60 as follows:

> "The price at which the 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 us not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts."

Recommendation: Download a copy of Revenue Ruling 59-60

Appraiser Considerations Under Revenue Ruling 59-60

- *.01 It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, <u>all available financial data, as well as all relevant factors affecting the fair market value, should be considered. The following factors, although not all-inclusive are fundamental and require careful analysis in each case</u>:*

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Considerations under Rev. Rul. 59-60 (cont.)

(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.*

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Considerations under Rev. Rul. 59-60 (cont.)

(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 stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.*

Fair Value Standard

Fair Value in Legal/Disputes Context

- Fair value typically believed to exclude valuation discounts, but that comes with a sweeping caveat:
  - Definitions vary generally state by state, based in case law primarily in dissenting shareholder and oppression actions. Additionally, see corporate dissolution statutes.
- Proper definition of standard should be discussed between legal counsel and appraiser.
- <u>Common theme:</u> regardless of definition, parties might disagree whether a fair value case is really a fair value case.

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Fair Value Standard – MA Divorce

- ***Bernier v. Bernier*** **– SJC-09836**
  449 Mass. 774 (2007)

"the judge must take particular care to treat the parties ***not*** as **arm's-length hypothetical buyers and sellers** in a theoretical open market but as **fiduciaries** entitled to **equitable distribution** of their marital assets".

- Departure language paved the way to Fair Value as commonly accepted Standard of Value for a divorce

Other Standards of Value

- Investment Value
  - To a specific buyer
- Intrinsic Value
  - Fundamentally derived value often associated with security analysts.
- Fair Value for Financial Reporting
  - Common in valuing companies for equity based compensation.

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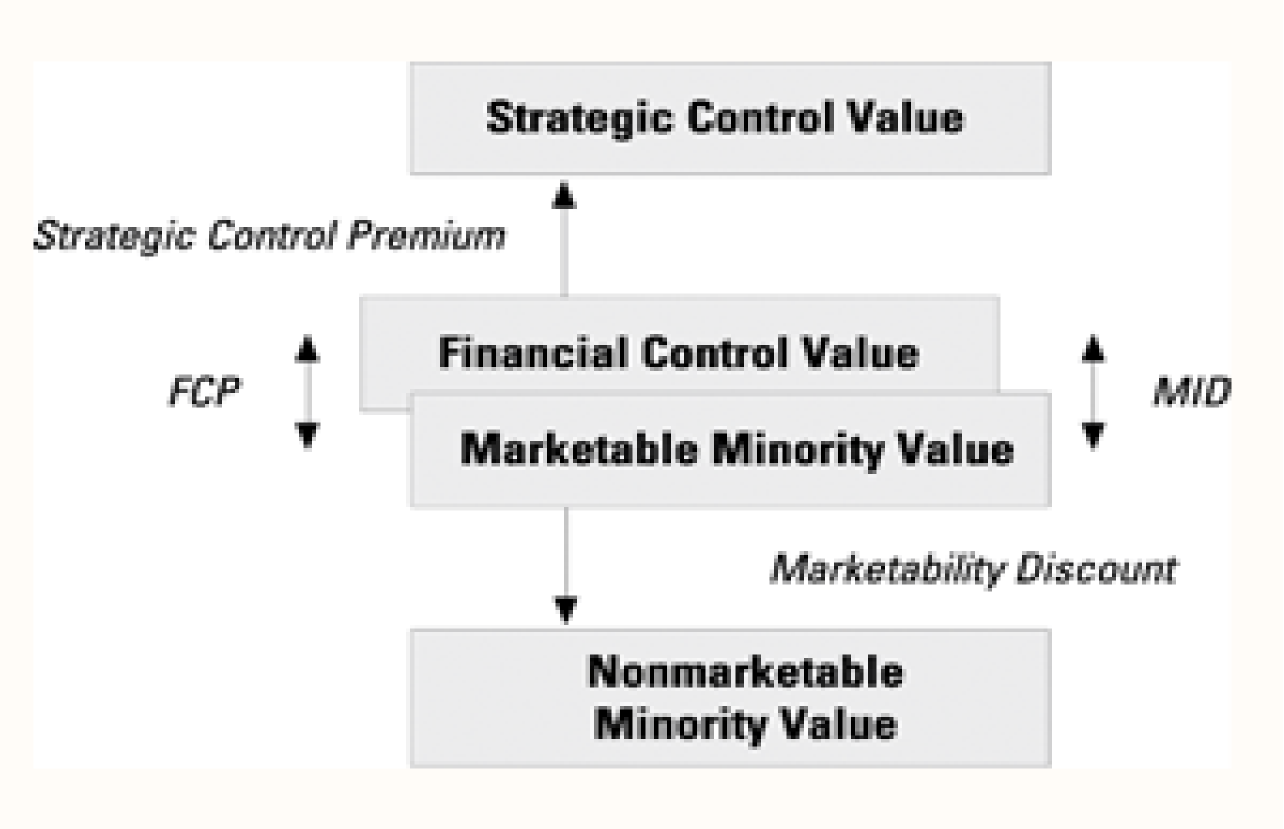
Premise of Value

- Liquidation Value
  - Asset Approach
  - Market Method
    - Beware of difference between forced and orderly liquidation

- Going Concern Value
  - Income Method
  - Market Method

Level of Value



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Valuation Date

- Determines information a business appraiser can consider.
- “Known and Knowable”
- Events affecting value
  - COVID-19
  - Fire or natural disasters
  - Stock Market Crash
- Indications of Value
  - Actual Transaction of Company Shares

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AICPA's Statement on Standards for Valuation Services- Subsequent Events (VS Sec. 100 Para. 43)

- The valuation date is the specific date at which the valuation analyst estimates the value of the subject interest and concludes on his or her estimation of value.

- Generally, the valuation analyst should consider only circumstances existing at the valuation date and events occurring up to the valuation date.

- An event that could affect the value may occur subsequent to the valuation date; such an occurrence is referred to as a ***subsequent event***.

- Subsequent events are indicative of conditions that **were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date.**

- The valuation would not be updated to reflect those events or conditions.

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AICPA's Statement on Standards for Valuation Services- Subsequent Events (VS Sec. 100 Para. 43) - continued

- Moreover, the valuation report **would typically not include a discussion of those events** or conditions because a valuation is performed as of a point in time—the valuation date—and the events described in this subparagraph, occurring subsequent to that date, are not relevant to the value determined as of that date.

- In situations in which a valuation is meaningful to the intended user beyond the valuation date, the events may be of such nature and significance as to warrant disclosure (at the option of the valuation analyst) in a separate section of the report in order to keep users informed (see paragraphs 52*p*, 71*r*, and 74).

- Such disclosure should clearly indicate that information regarding the events if provided for informational purposes only and does not affect the determination of value as of the specified valuation date.

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Defining Known or Knowable (VS Sec. 100 Para. 43)

- The valuation analyst should consider only facts and circumstances existing at the valuation date and events occurring up to the valuation date that could have been reasonably known, foreseen, understood or comprehended.

- For illustrative purposes, consider whether an agreement executed shortly after the valuation date with a new major customer would likely be known or knowable at the valuation date.
  - It was most likely in the works at the valuation date and, therefore known or knowable at that point.
  - On the other hand, a major storm that causes major damage to the business and its facilities shortly after the valuation date would not have been known or knowable and, therefore, should not be considered in the valuation.

Subsequent Events (VS Sec. 100 Para. 43)

- The valuation analyst is not required to disclose a subsequent event in a report
- The valuation analyst may disclose a subsequent event, but must clearly disclose the subsequent event is for information purposes and does not affect the determination of value as of the valuation date.
- Disclosing what the value would have been if components of the subsequent event where included constitutes a **new valuation as of a new valuation date**.

Personal Goodwill

- Value created and attributed to an individual's efforts
- Attributes of Personal Goodwill
  - Education
  - Experience Relationships
  - Role and Responsibility in the Company

Business (Enterprise) Goodwill

- Value created and attributed to an individual's efforts
- Attributes of Business Goodwill
  - General Inbound Referrals
  - Workforce
  - Business Name and Number of Locations

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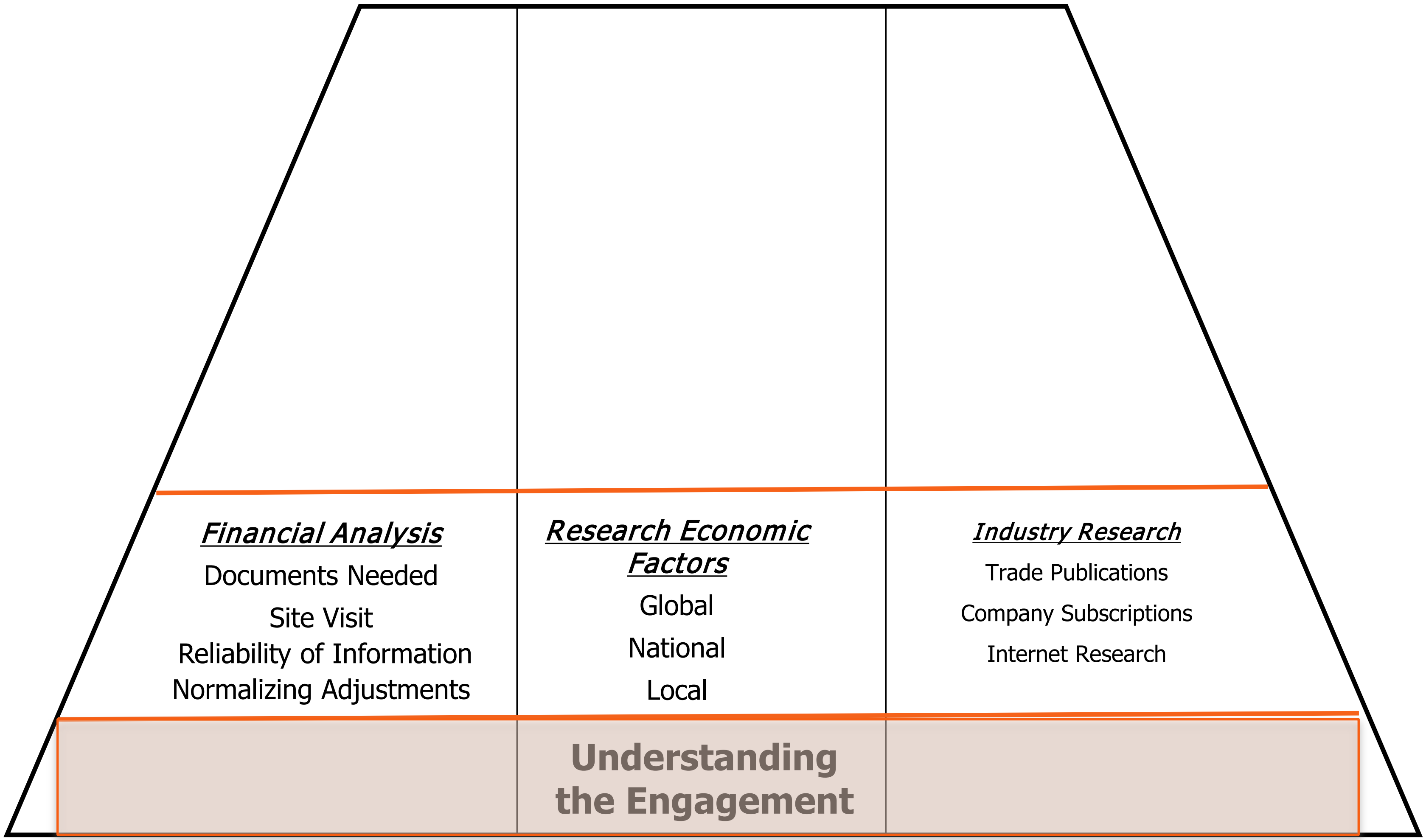
Step 2: Financial Economic & Industry Analysis



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Valuation Process Begins

- Document request list
  - What documents are needed to understand the business
  - How many years are needed
  - Challenges in getting documents & timing
- Management interviews
  - Should you attend
  - Joint interview
  - Seeing the actual business location

Valuation Analyst Will Work Behind the Scenes

- All documents have been provided
- Management questions have been answered

Recommendation: Connecting with expert on next deadline

Normalizing Adjustments

- Owner's Compensation

  Attorney Beware: Priority, Prejudices, and Pitfalls

- Tax affecting for Pass-through entities
- Depreciation
- Related Party Transactions
  - Shareholder Loans
  - Real Estate
- Non-recurring activity
- Non-operating assets and/or liabilities

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Normalization Illustration

Sample Historical Profit and Loss - C Corporation					
	2017	**2018**	**2019**	**2020**	**2021**
Sales	950,000	1,200,000	1,300,000	800,000	1,200,000
Operating Expenses					
Depreciation	5,000	20,000	120,000	5,000	5,000
Officer Compensation	350,000	500,000	500,000	200,000	500,000
401 Company Contribution - Children/Spouse	78,000	78,000	78,000	78,000	78,000
Related Party Rent	34,000	34,000	34,000	34,000	34,000
Other Operating Expenses	470,000	525,000	575,000	475,000	575,000
Total Operating Expenses	937,000	1,157,000	1,307,000	792,000	1,192,000
Operating Profit	13,000	43,000	(7,000)	8,000	8,000
Net Income	1%	4%	-1%	1%	1%

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How Normalization Adjustments Work

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		2017	2018	2019	2020	2021
Historical	Sales	950,000	1,200,000	1,300,000	800,000	1,200,000
	Reported Operating Income	**13,000**	**43,000**	**(7,000)**	**8,000**	**8,000**
	Operating Profit as % of Revenue	1%	4%	-1%	1%	1%

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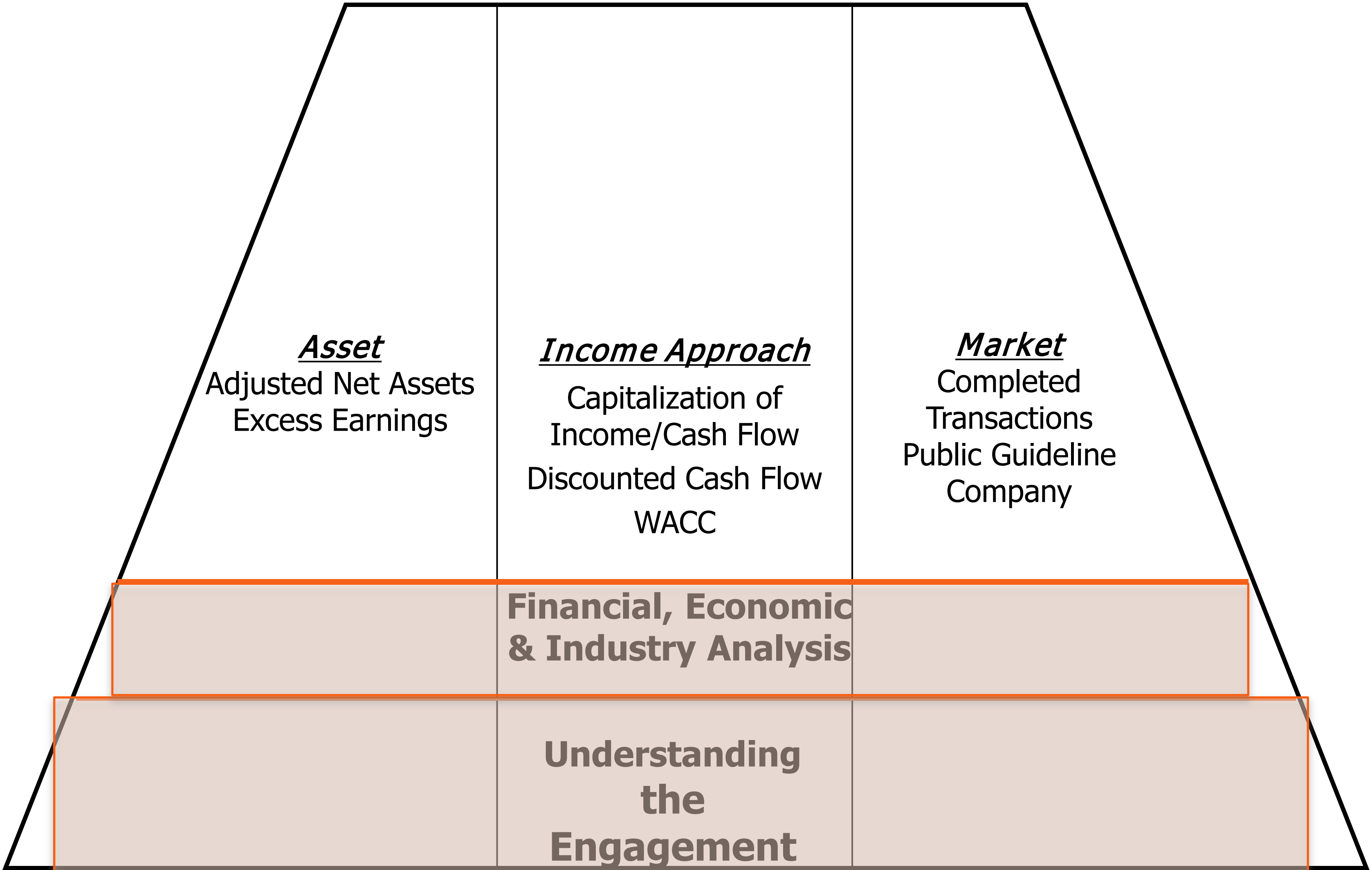
Step 3: Valuation Approaches



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Valuation Approaches

Asset Approach

- Based on a balance sheet
- Historical vs. Adjusted to Fair Market Value

Income & Market Contain Similar Characteristics

Future Benefits, or Performance Indicators

Income Approach

Value of future benefits via capitalization rates and discount rates

Market Approach

Value of future benefits via market pricing multiples

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Asset Approach

- Premise is value of the business consists only of tangible assets less liabilities

Value of the Business =

Market Value of all Assets less Liabilities & Debt

Asset Approach

- Assets
  - Should be at current or market value
  - Accounts receivable – collectability issues
  - Fixed Assets – on a balance sheet fixed assets are reported at cost less depreciation.
    - May need Real Estate or Machinery / Equipment Appraisal to determine current/market value
- Liabilities
  - Be aware of all debts and current balances

Warning be Aware: Shareholder / Related Party Loans

Income Approach Terminology

- Discounted Cash Flow
- Discount Rate

Ability to use projections. Illustrate volatility over a period of future year. Including a final year of consistent growth

- Capitalization of Earnings
- Capitalization Rate

Historical performance provides the appraiser to determine one year of normalized profits with consistent growth in future years.

- Long Term Growth Rate – The sustainable long-term growth into the future. Converts the discount rate into a capitalization rate.

Income Approach

Expected future **profitability** measured against a **multiple**

Profitability

Normalized After Tax Profit
Normalized After Tax Cash Flow

Based on a single annualized number - Capitalizing
Based on a number of projected years - Discounting

Multiple

Starts with a **discount rate**
subtracts out long term expect growth
results in a capitalization rate

capitalization rate is nothing more than a multiple of the earnings stream

Discount rate:

		Additive Disc. Rate	*Indiv. Returns*
Risk derived from public rates of return			
Additive Risk			
	20 year treasury (lowest risk)	2%	*2%*
plus:	Risk of investing in S&P 500	8%	*10%*
Plus:	Riskier Public Companies	6%	*18%*
Plus:	Subjective Additional Risk	5%	
	Total Discount Rate	**21%**	

One More Step: Need to convert Discount rate to a **Capitalization rate**
Capitalization Rate = Discount Rate Less Long Term Growth Rate

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Capitalization of Income v. Discounting

Capitalization of Income			
Income		285,000	A
Discount Rate		21%	B
Long Term Growth		3%	C
Capitalization Rate		18%	D
			(B-C)
Next Years Income		293,550	E
			(A * (1+C))
Value of Company		1,631,000	D/E

Capitalization rate can also be a converted to multiple (1/18% = 5.5) $293,550 * 5.5 = $1.6 M

Income is growing annually at 3%

Discounting Income over 15 Years

Year	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036
Income	285,000	293,550	302,357	311,427	320,770	330,393	340,305	350,514	361,029	371,860	383,016	394,507	406,342	418,532	431,088	444,021
Discount Rate	21%															
Present Value of Discount Rate		0.90909	0.75131	0.62092	0.51316	0.42410	0.35049	0.28966	0.23939	0.19784	0.16351	0.13513	0.11168	0.09230	0.07628	0.06304
Present Value		266,864	227,165	193,372	164,606	140,119	119,275	101,531	86,428	73,571	62,626	53,310	45,380	38,629	32,882	27,991
Sum of Present Value over 20 years		1,634,000														

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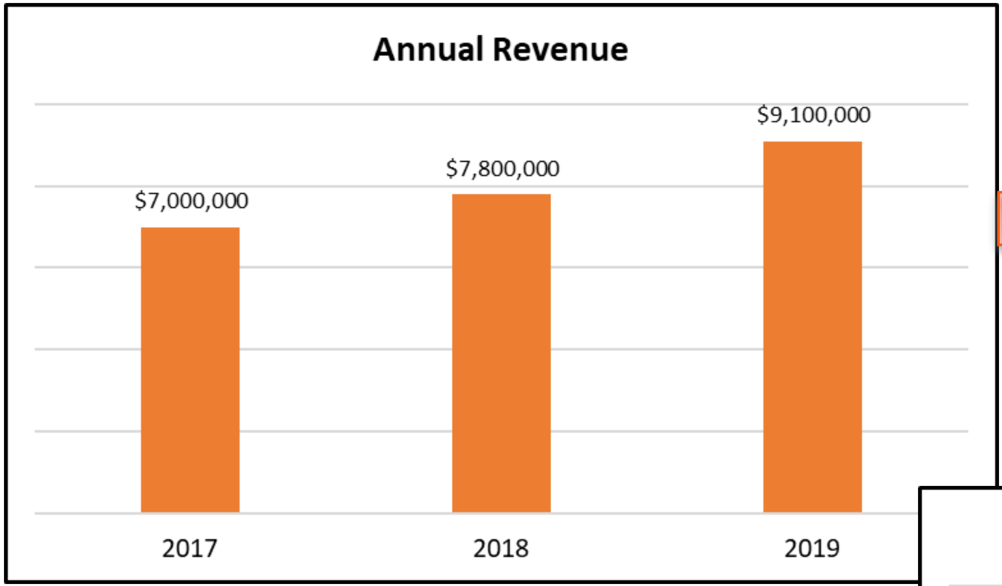
Illustration of Income Approach Capitalization of Income vs. Discounted Cash Flow Methods

Profit and Loss Considerations

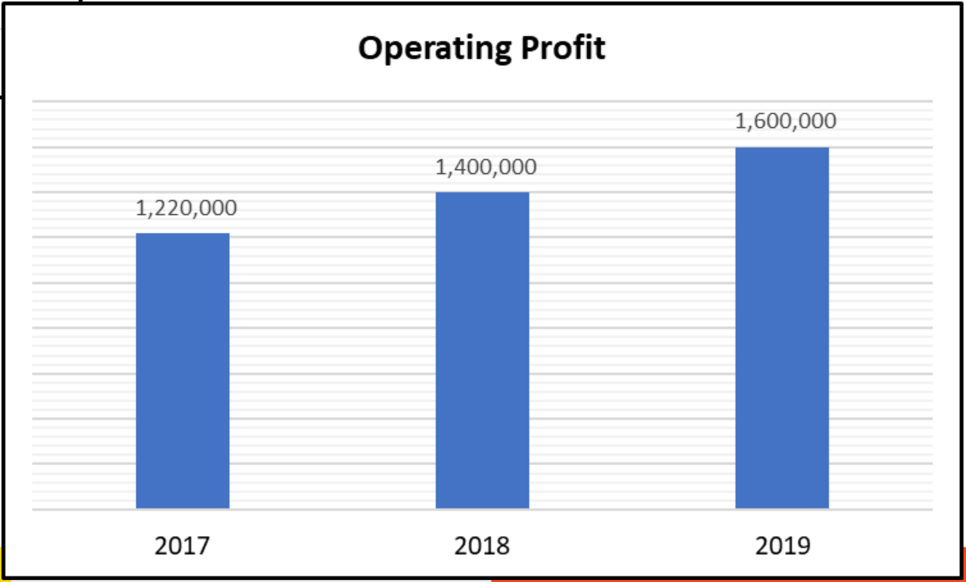
- Appropriate to analyze historical trends, assess normalized earnings, and risk prior to COVID-19.
- Determine factors currently facing the subject company.
- Assess the ability to develop defendable projections during the disruption.

Historical Profit and Loss



Covid 19 and Revenue Considerations:

- Will customers order products / services and have ability to pay.
- Any concentration of customers
- Increase in uncollectible accounts receivable or longer period to pay.
- Subject company increases procedures with customer credit approvals



Covid 19 and Expense Considerations:

- Ability to defer fixed Costs
- Managing Payroll Costs
- Vendors ability to purchase required material and supplies

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Example – Business Valuation & COVID-19

- Scenario A – Company does not begin operations until 1/1/21
- Scenario B – Company begins operations 9/30/20 – avg. 70% compared to prior year capacity for last 3 months of 2020.
- Scenario C- Company begins operations 6/30/20 – avg. 80% compared to prior year capacity for last 6 months of 2020.

	Year End	COVID - 19 Disruption 2020				2020 Annualized Projections		
	2019	1st qtr - actual	Projections April 1 - December 31, 2020					
			Scenario A	Scenario B	Scenario C	Scenario A	Scenario B	Scenario C
Revenue	$ 9,100,000	$2,400,000	$ -	$ 1,600,000	$ 3,600,000	$ 2,400,000	$ 4,000,000	6,000,000
Cost of Sales	$ 6,200,000	1,600,000	$ 2,325,000	1,600,000	2,700,000	3,925,000	3,200,000	4,300,000
Gross Profit	$ 2,900,000	$ 800,000	$ (2,325,000)	$ -	$ 900,000	$ (1,525,000)	$ 800,000	$ 1,700,000
Operating Expenses	1,300,000	350,000	490,000	650,000	850,000	840,000	1,000,000	1,200,000
Operating Profit (Loss)	1,600,000	450,000	(2,815,000)	(650,000)	50,000	(2,365,000)	(200,000)	500,000
Operating Profit(Loss) as % of sales	18%	19%		-41%	1%	-99%	-5%	8%
Estimate after tax cash flow *	**1,060,800**		**-**	**-**	**50,000**			

*Net of taxes, working capital, loan proceeds, depreciation and capital needs

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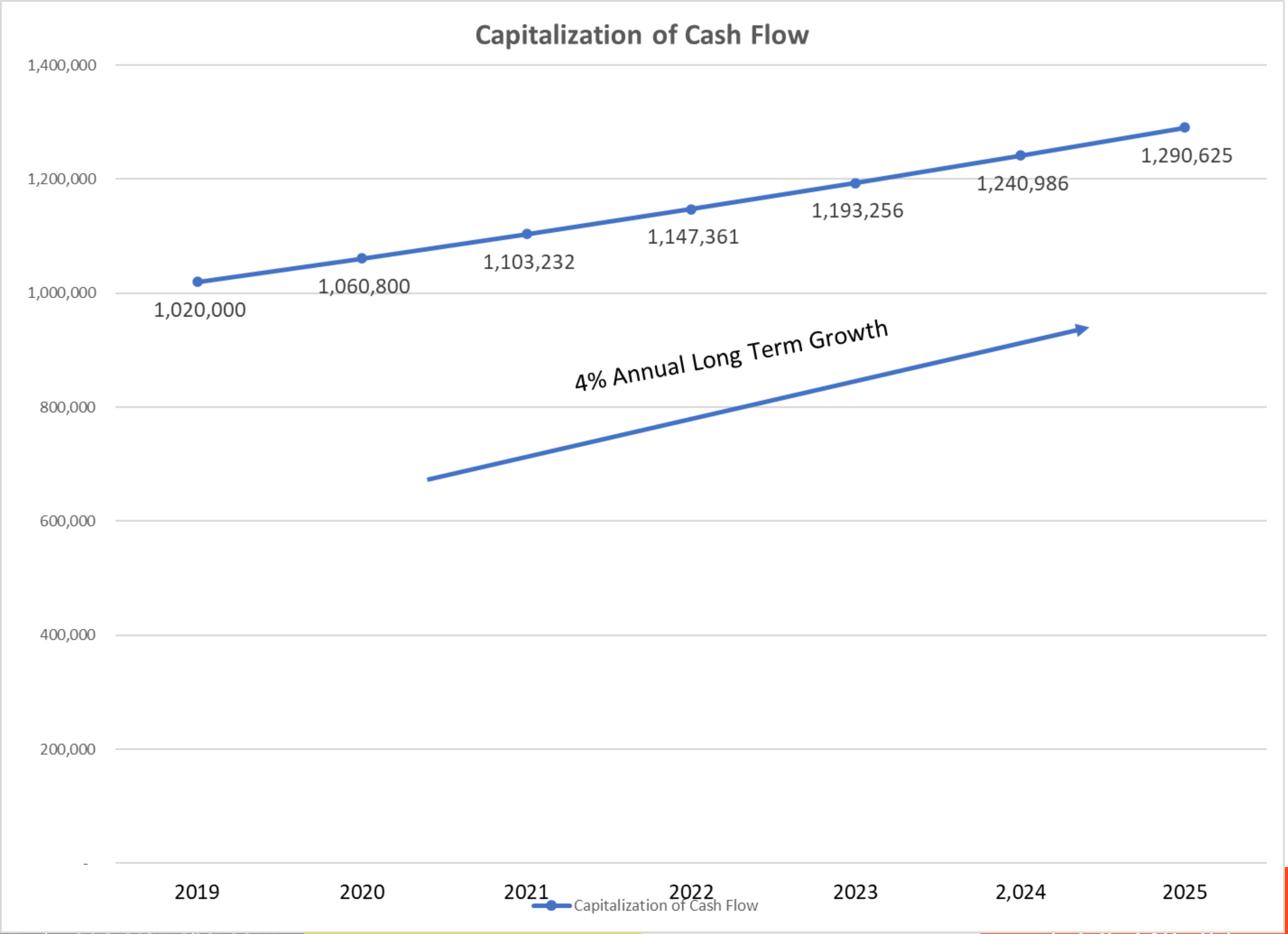

Valuation Model – Capitalization of Cash Flow

Business Valuation Model - Capitalization of Cash Flow

Valuation date december 31, 2019

	2017	2018	2019
Normalized Historical Operating Profit	1,220,000	1,400,000	1,600,000

Normalized Ongoing Operating Profit Current Year		1,600,000
Estimated taxes	30%	(480,000)
Cash Flow adjustments		(100,000)
After tax cash flow - Current Year		1,020,000
After tax cash flow - Next Year		1,060,800
Capitaliztion Rate		17%
Value of Equity		$ 6,200,000

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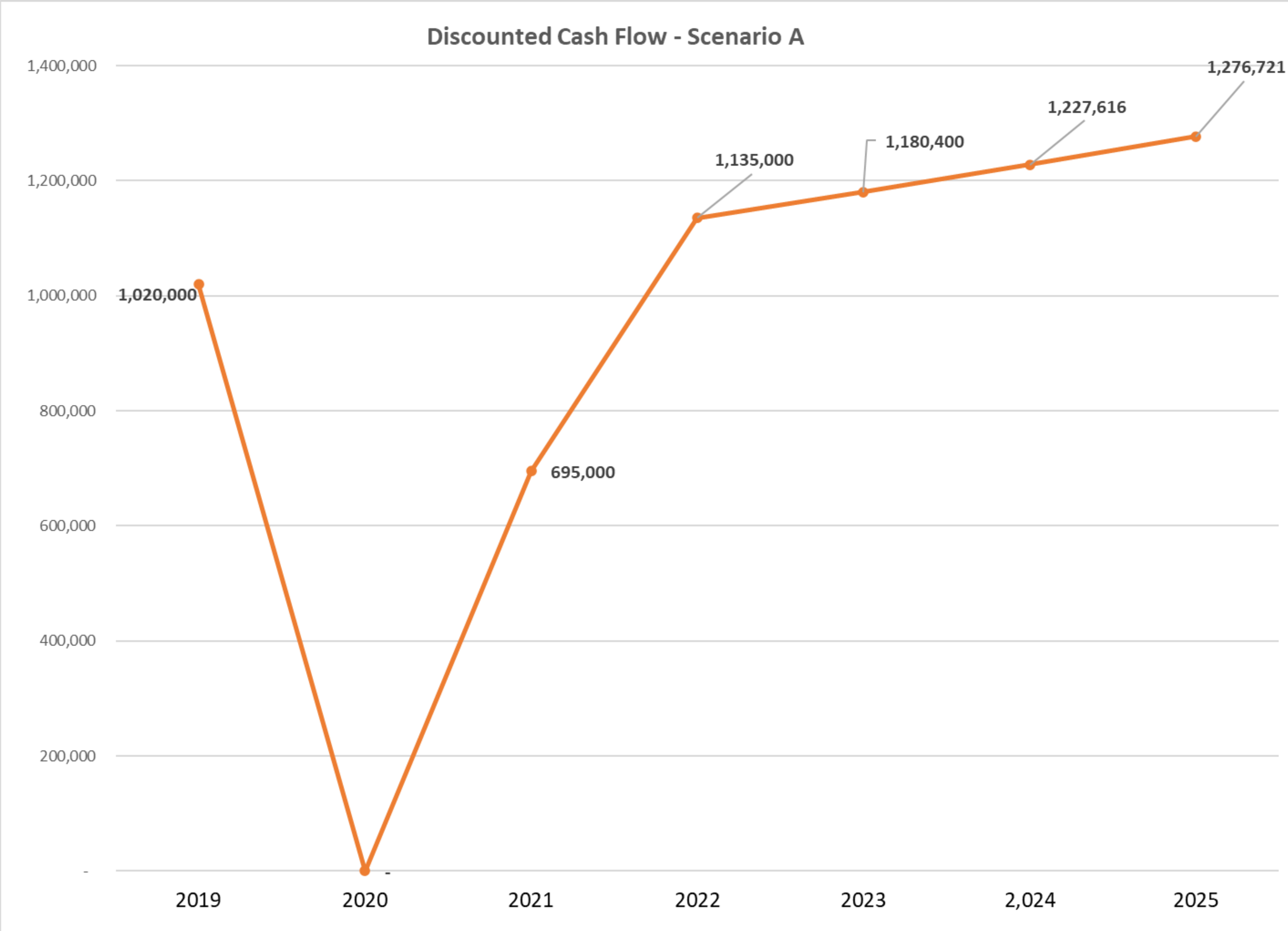

Discounted Cash Flow Model – Scenario A

Example based on Scenario A
Valuation Date: March 31, 2020

	2020	2021	2022	Terminal
Normalized Estimated Profit	(2,815,000)	1,000,000	1,700,000	
Estimated Income taxes (30%)		(300,000)	(510,000)	
Cash Flow adjustments	2,815,000	(65,000)	(105,000)	
After tax Interest	-	60,000	50,000	
After tax cash Flow	-	695,000	1,135,000	1,180,400
Capitalziation (wacc) rate				13%
				9,080,000
Discount rate (17%) (Present Value Factor)	0.8889	0.7598	0.6494	0.6494
	-	528,031	737,029	5,896,234

summary of discounted cash flow 3/31/20	
Present Value of Cash Flow	1,265,060
Terminal Value	5,896,234
Total Value of Debt and equity	7,161,295
Less: Bank debt 3/31/20	(2,815,000)
Value of Equity	4,300,000

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Discounted Cash Flow- Scenario B

Example based on Scenario B
Valuation Date: March 31, 2020

	2020	2021	2022	Terminal
Normalized Estimated Profit	(650,000)	1,400,000	1,700,000	
Estimated Income taxes (30%)		(420,000)	(510,000)	
Cash Flow adjustments	650,000	(65,000)	(105,000)	
After tax Interest	-	30,000	15,000	
After tax cash Flow	-	945,000	1,100,000	1,144,000
Capitalziation (wacc) rate				16%
				7,150,000
Discount rate (20%) (Present Value Factor)	0.8722	0.7268	0.6057	0.6057
	-	686,854	666,261	4,330,695

summary of discounted cash flow 3/31/20	
Present Value of Cash Flow	1,353,115
Terminal Value	4,330,695
Total Value of Debt and equity	5,683,810
Less: Bank debt 3/31/20	(650,000)
Value of Equity	5,000,000

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Discounted Cash Flow – Scenario C

Example based on Scenario C
Valuation Date: March 31, 2020

	2020	2021	Terminal
Normalized Estimated Profit	50,000	1,600,000	
Estimated Income taxes (30%)		(480,000)	
Cash Flow adjustments	-	(100,000)	
After tax cash Flow	50,000	1,020,000	1,060,800
Capitalziation (wacc) rate			17%
			6,240,000
Discount rate (21%) (Present Value Factor)	0.8668	0.7164	0.7164
	43,339	730,678	4,470,027

summary of discounted cash flow 3/31/20	
Present Value of Cash Flow	774,017
Terminal Value	4,470,027
Total Value of Debt and equity	5,244,044
Less: Bank debt 3/31/20	-
Value of Equity	5,200,000

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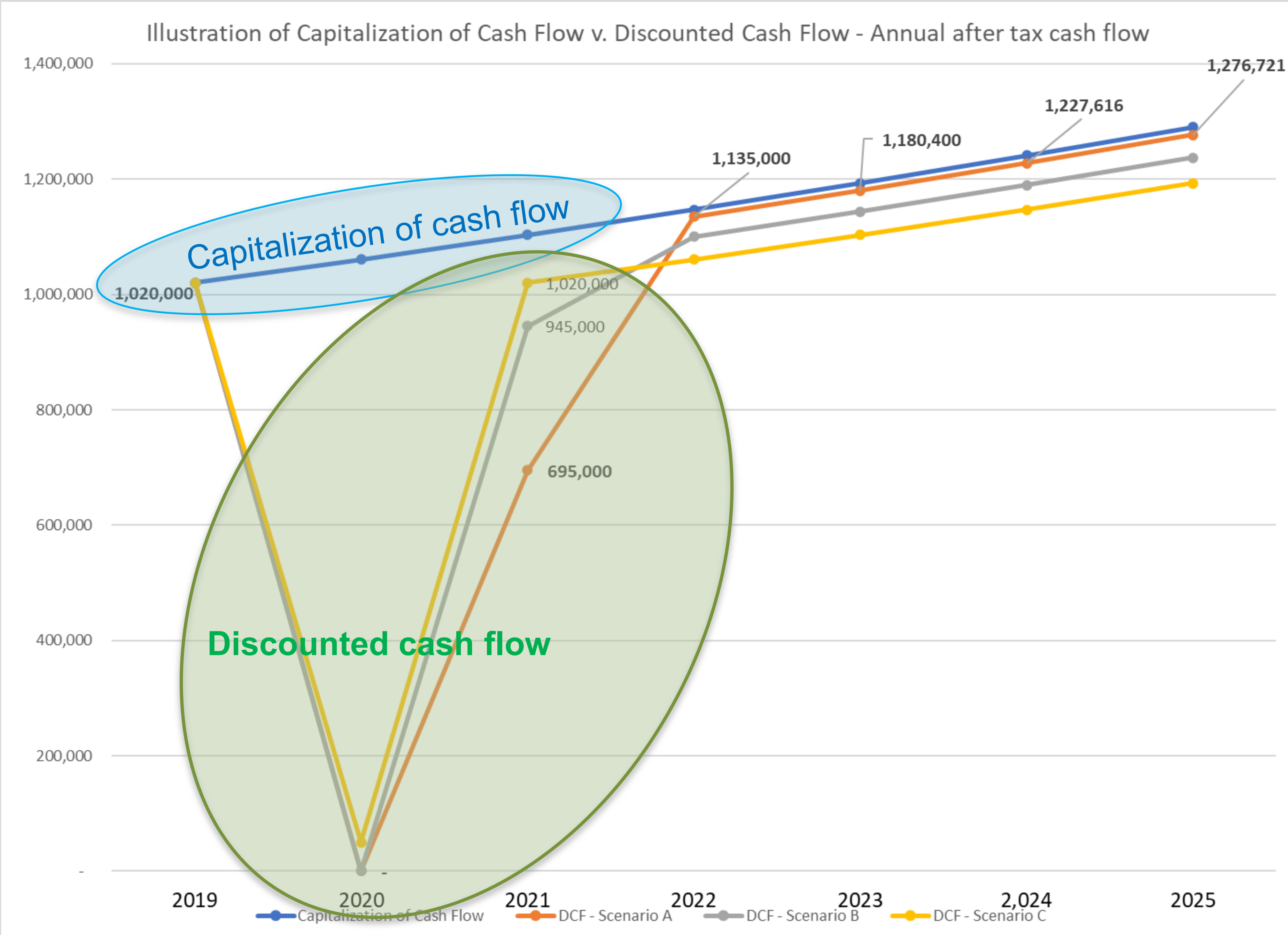
Illustration of Capitalization of Cash Flow v. Discounted Cash Flow - Annual after tax cash flow
1,400,000
1,200,000
1,000,000
800,000
600,000
400,000
200,000
-
2019
2020
2021
2022
2023
2,024
2025
1,020,000
1,020,000
945,000
695,000
-
1,135,000
1,180,400
1,227,616
1,276,721
Capitalization of cash flow
Discounted cash flow
Capitalization of Cash Flow
DCF - Scenario A
DCF - Scenario B
DCF - Scenario C

Conclusion:

Summary of Values:		
	Value of 100% of equity	Change in value from 12/31/19
Valuation 12/31/19	$ 6,200,000	
Valuation 3/31/20		
Scenario A	4,300,000	-31%
Scenario B	5,000,000	-19%
Scenario C	5,200,000	-16%
Avg. of A, B, C	$ 4,800,000	-23%

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Market Approach

- Based on Comparability
  - How does the subject company compare to other private / public companies which have sold.
  - How does the subject company compare to publicly traded companies.
- 2 Step Process:
  - Determine the financial measurement of the subject company
    - Revenue, EBITDA, Operating Profit
  - Apply the multiple from comparable company.

CAUTION: Understand Comparability

Income Approach- Profitability Terminology

- **EBITDA** – Profit before Interest Expense, Taxes, Depreciation Expense and Amortization Expense
- **Operating Profit** – Profit before tax, gains/loss on non operating items such as sale of equipment, loan forgiveness
- **Net Income** – profit after all expenses
  - Warning – Pass though entities do not have taxes reduced on business tax return, appraiser will impute income taxes due
- **Cash Flow** - Net Income adjusted for business use of working capital, fixed assets and potentially debt.

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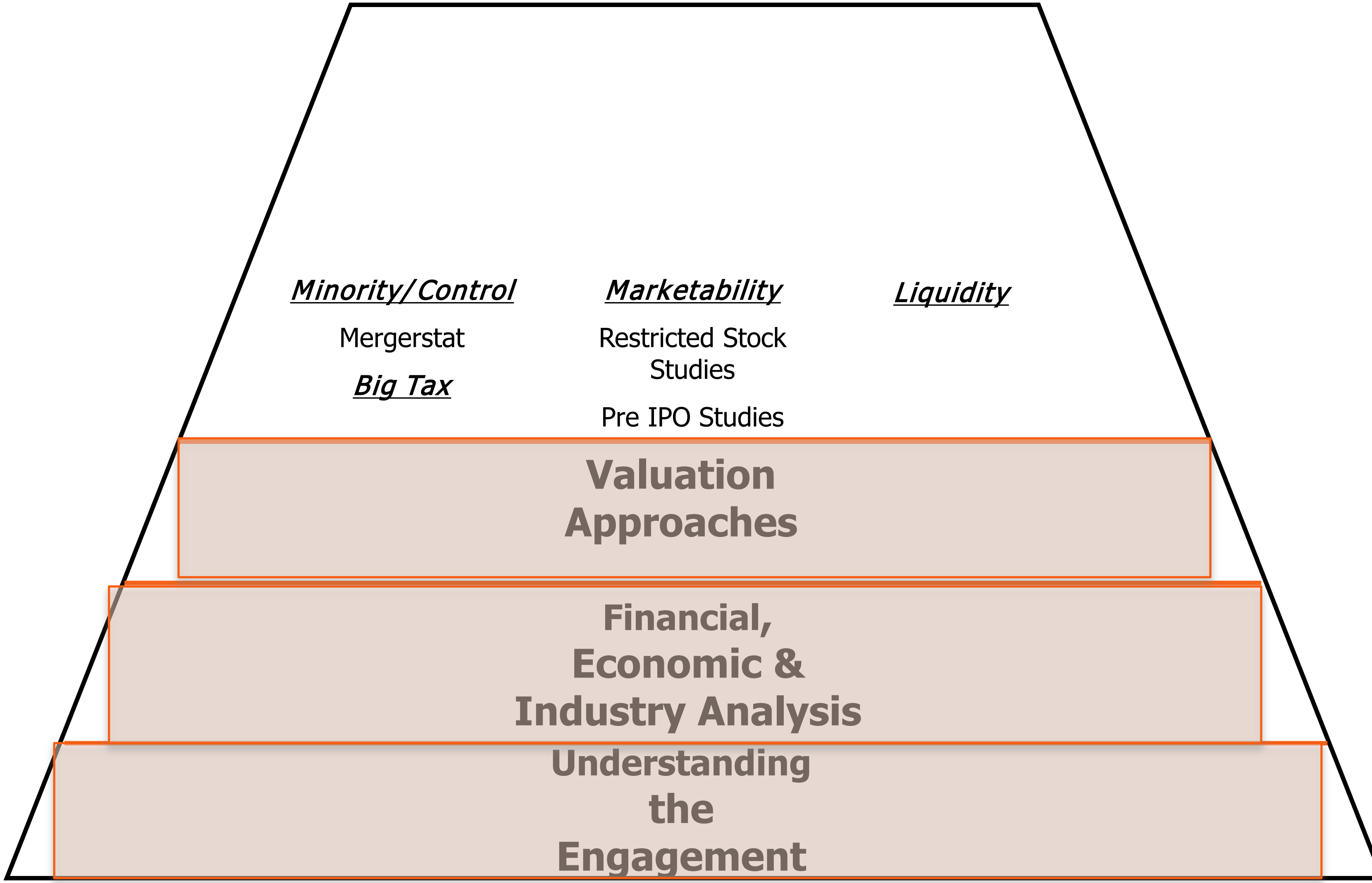
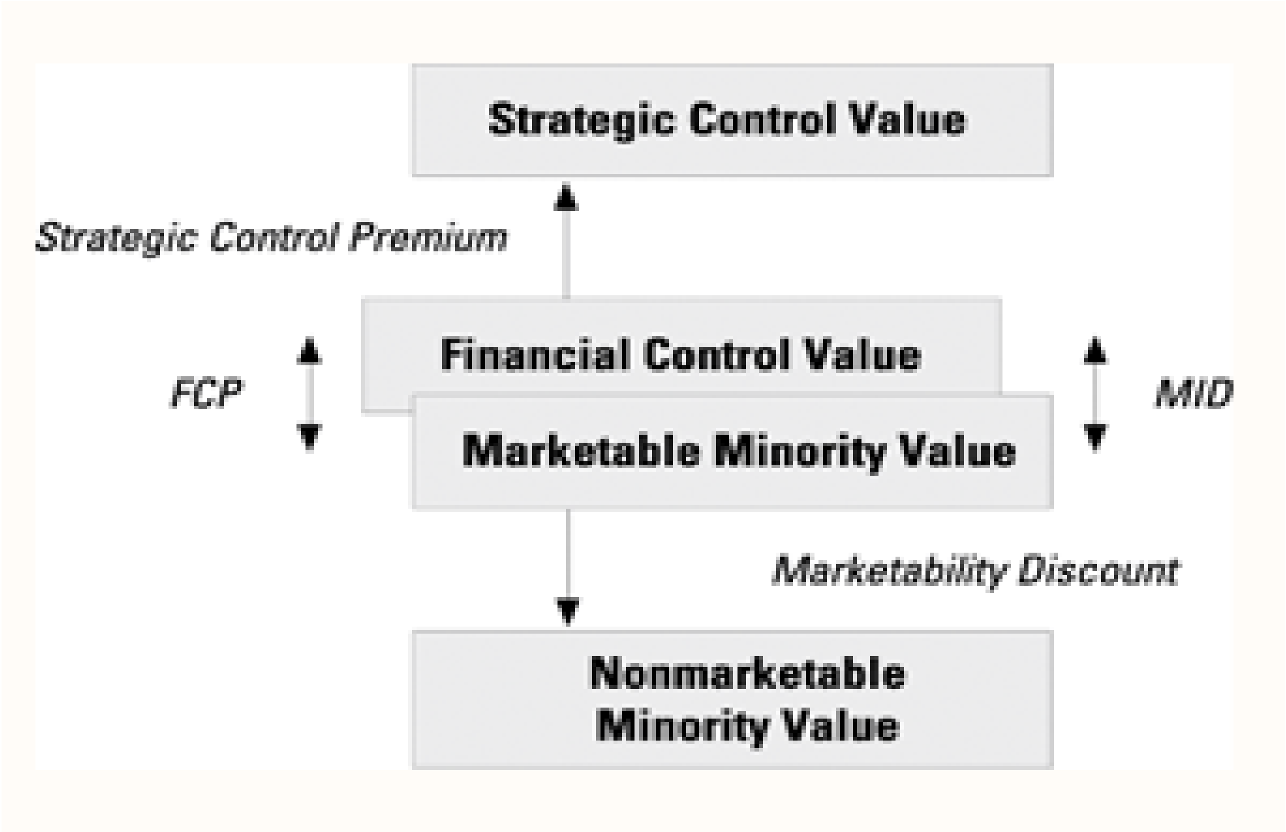
Step 4: Discounts & Premiums



Level of Value



Source: ChrisMercer.net

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Discounting for Minority Interests Why When How

- Why discount
  - The value of the company arrived at before discounting to not take into account additional risks based on non-controlling ownership. (Valuation <50%)
- When to discount
  - Depends
    - Understand the applicable standard of value
    - Determine extraordinary or unique circumstance exist
- How are discounts applied
  - Each discount is determined independently
  - Determined from sources disclosed by an expert

Understand Context Before Discounting

- Are discounts appropriate to the assignment?
  - Fair Market Value → Discounts typically are acceptable to consider.
  - Fair Value → Discounts often not acceptable, although this may depend on how fair value is defined.
  - Ambiguous or modified standard → Applicability may defer to analyst judgment, stipulation of parties, etc.

Context (Continued)

- Which discounts – or occasionally premiums – are relevant to my assignment?

Frequently Seen

Lack of Control

Lack of Marketability

Sometimes Relevant → Voting / Non-Voting Status

S Corp or Pass-Through Status → Controversy

Blockage → Less Common Issue

Guidance on Discount Determination

- **Lack of Control:**
  - The analyst can bake it into the cash flows – i.e., controlling owner perks are already devaluing the interest, and no explicit discount is required.
  - Use of Mergerstat or other data sources to support an explicit percentage discount
    - **Beware:** does the data include issues that go beyond the scope of differences between financial control and lack thereof? Example would be strategic / synergistic premiums baked into the data.

Guidance (Continued)

- **Lack of Marketability**:
  - Consideration of qualitative factors:
    - “Mandelbaum” factors
    - Issues around holding period, growth, distributions/dividends.
  - Publications:
    - Revenue rulings (e.g., 77-287).
    - Restricted stock and pre-IPO studies.
    - Past court decisions.
  - Quantitative models:
    - Analogy of discount to the value of a put option (right to sell).
    - Mercer’s QMDM model (essentially runs a shareholder-level discounted cash flow model).

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One more publication

Discount for Lack of
Marketability
Job Aid for
IRS Valuation Professionals
September 25, 2009
Developed by Engineering/Valuation Program
DLOM Team

Source: https://www.irs.gov/pub/irs-utl/dlom.pdf

Considerations: Mandelbaum Factors

- Value of co.'s private securities relative to its traded securities.
- Analysis of the subject company's financials.
- Dividend-paying capacity, history of paying, and amount of prior dividends.
- Nature of the company, its history, industry position and its economic outlook.
- Company management.
- Degree of control transferred with the subject block of stock.
- Holding period to realize a sufficient profit.
- Company's redemption policy.
- Any restrictions on transfer of the ownership interest.
- Costs associated with making a public offering.

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Considerations: Fundamental Matters

Growth:

- Would you prefer to invest in something that you expect will grow 50% in value or 1%?

Cash Flows:

- To be able to extract dividends or distributions from time to time is preferable.

Holding Period:

- Wouldn't it be nice to be able to get out in 2 years as opposed to never?

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Order of Operations: Making Sense of The Math

10% DLOC + 20% DLOM **is not** 30% in total

Controlling Valuation:		$	1.00
Lack of Control	10%		(0.10)
Non-Controlling, Marketable			0.90
Lack of Marketability	20%		(0.18)
Non-Controlling, Non-Marketable			$0.72

Hypothetical illustration. Actual discounts will be specific to the fact pattern of the ownership interest under review.

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Fun Discounts Case Study With Ambiguity

CASE CONTEXT

- Shareholder dispute – judge orders parties to engage a joint valuation to follow shareholder agreement
- Parties have disagreeing interpretations on discount appropriateness

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AGREEMENT OVERVIEW

- Agreement defines “Appraisal Value”
- Incorporates term “fair market value”
- States to appraise the *singular* “shareholder interest” as opposed to plural

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APPRAISER'S TAKE

- Language points towards the application of discounts:
  - Attributes of the individual interest as opposed to a corporate level of appraisal
  - Use of term FMV in defining appraisal value
- What the parties didn't expect:
  - Whether the individual shares also could have an S Corp premium at the time.

Expanding the Case Study

- **Other Cues in Shareholder Agreements:**
  - Specific exclusions or inclusions of discounts written in.
  - Silent on discounts, but suggests appraising corporate value and simply multiplying that value by owner's percentage interest.
  - Payment terms are already not 100% cash equivalent, marketable value (e.g., a 10-year note at 1% interest).

Discounts in Hiding

- Beware of hidden discounts!
- Discounts are applied to some specific base of value. So if you start from a “controlling” base – question whether it is actually a controlling value. Examples:
  - “Controlling” value ends up less than book value or less than the value of working capital.
  - Cost of capital used in an income methodology is not truly reflective of reasonable actions of a controlling owner (e.g., business is debt-free by choice).
- Duplicating Marketability Discounts already in Cost of Capital

Step 5: Conclusion and Work product

Conclusion & Work product

- Types of Work product
  - Oral reporting - discussion with expert
  - Answering expert interrogatories
  - Reports
- Litigation arena
  - Trial and Testimony
  - Conciliation and Mediation

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Overview of the Valuation Process

Weightings Selecting Approaches	**Value & Delivery**	***Report*** Calculation of Value Summary Report Oral Report
Purchase Justification *Rules of Thumb*	**Sanity Checks**	*Other Approaches* *Subsequent Events*
Minority/Control Mergerstat ***Big Tax***	**Discounts & Premiums**	***Marketability*** Restricted Stock Studies Pre IPO Studies
Income Capitalization of Income/Cash Flow Discounted Cash Flow WACC	**Valuation Approaches**	***Asset*** Adjusted Net Assets Excess Earnings ***Market*** Completed Transactions Public Guideline Company
Economic/Industry Global/National/Local Analysis Trade Publications Internet/Web Sites	**Financial, Economic & Industry Analysis**	***Financial*** Site Visit Reliability of Information Normalizing Adjustments Benefit Stream
Determine Purpose & Client; Valuation Date Standard of Value; Premise of Value Interest to be Valued; Type of Report	**Understanding the Engagement**	***Analyze*** Limiting Conditions Experience & Qualifications Legal & Regulatory Requirements Professional Standards

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What are common conundrums in a small business valuation

1. Quick and dirty (Calculation of Value) vs. Independent full valuation opinion (Conclusion of Value)
2. Does the business represent an asset or an income stream?
3. How to deal with a business owner that represents themselves as the whole business?
4. What is reasonable compensation adjustment and should one be made?
5. Do we have a potential double dip?
6. Personal vs. Enterprise Goodwill.

Critiquing and Evaluating a Business Valuation

Valuation Standards:
USPAP Standard #3
&
NACVA Review Standards

Situations where you *might (always)* have conflicting opinions:

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Hypothetical Valuation	Actual Transactions
* Divorce	Actual Sale
* Shareholder disputes	Mergers
* Estate & Gift- IRS Dispute	
*Estate & Gift –Decedent vs. survivor(s)	

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Planning the Engagement

- Questions to ask (at the beginning of the engagement) to clarify and avoid known discrepancies
  - Standard of Value
  - Date of Valuation
  - Interest being Valued
  - Jurisdiction – e.g. PGW vs. EGW

Standard of Value

- Implications of Fair Market Value vs. Fair Value
- Purpose of the valuation can direct standard of value
- Trap: Documentation v. Opinion
  - Documentation – Supportive
  - Opinion - Persuasive

Agreements in Place

- A careful INITIAL reading of all agreements can be tremendously valuable
- Are there any inconsistencies?
- Consider the purpose
- Signed v. Draft Copies
- Timing of Documents

Date of Valuation

- How is the date of divorce determined:
  - Divorce example of de facto date vs. current date

- Understanding the impact of Subsequent Events
  - Known or Knowable Standard

Interest Being Valued

- Why does this matter…other than the obvious?

  - Minority vs. Control

Jurisdiction

- Why does this matter?
  - Divorce example of PGW vs. EGW
  - Standard of Value
  - Interest being Valued

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Why do we still see inconsistent valuation opinions?

- Normalization Adjustments
- Approach / Methodology selected
- Discounts applied
- Assumptions considered (or not)
- Calculation vs. Opinion

Normalization Adjustments

- Balance Sheet Differences:
  - Valuation of Inventory (Method Counts)
  - Valuation of Fixed Assets
  - Required Working Capital
  - Identification of excess and/or non-operating assets and/or liabilities
  - Handling Related Party Assets / Liabilities

Normalization Adjustments (cont.)

- Income Statement Differences
  - Control v. Non-Control Adjustments
  - Officer Compensation
  - Related Party Compensation
  - Forensic Adjustments (Considered / Ignored)
    - Business v Personal Expenses
  - Extraordinary and non recurring income and expenses

Approach / Methodology Selected

- Income Approach vs. Asset Approach
- Income Approach vs. Market Approach
- Asset Approach vs. Market Approach

Methodology – Income Approach

- Income approach
  - Capitalization of Earnings vs. Discounted Cash Flow methodology
    - DCF allows us to vary growth, margins, capital requirements – in the interim / projected years
    - Minority stream vs. controlling stream
    - Equity stream vs. Debt & Equity stream
    - Cost of Equity / Weighted Average Cost of Capital

Methodology – Income Approach

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Capitalization of Earnings Example

- Seasonal business
- $250,000 of debt
- $100,000 of excess cash
- Earnings before Taxes
  - 2014 = $100,000
  - 2015 = $115,000
  - 2016 = $125,000
  - 2017 = $140,000
  - Average = $120,000
  - Weighted Average = $126,500

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Capitalization of Earnings

Capitalized Earnings			
Adjusted EBT (Selected)		$ 140,000	What were the adjustments?
Less: Normalized Taxes	30.00%	(42,000)	Appropriate tax rate?
Plus: Depreciation & Amortization		-	
Less: Capital Expenditures		-	Should these offset?
Changes in Working Capital		-	
Current Sustainable Distributable Cash Flow		98,000	
Multplied by: One plus Growth Rate	2.50%	1.025	Appropriate growth rate?
Projected Sustainable Distributable Cash Flow		100,450	
Capitalization Rate			
Cost of Equity		19.30%	How was this derived?
Less: Long-Term Growth Rate		-2.50%	
Capitalization Rate		16.80%	
Conclusion of Value			
Sustainable Distributable Cash Flow		100,450	
Divided by: Capitalization Rate		16.80%	
Multiplied by: Mid-Year Convention Factor		109.22%	Do you / should you use a mid-year convention?
Concluded Equity Value		653,072	
Less: Interest Bearing Debt		-	Not relevant for these earnings
Plus: Cash		-	Not relevant for these earnings? Is it?
Concluded Equity Value		$ 653,072	

Capitalization of Earnings

Cost of Equity	
Risk-Free Rate of Return	
Long-term (20-year) U.S. Treasury Yield	2.72%
Equity Risk Premium	6.94%
Small Stock Risk Premium	
10b decile - size premium	5.59%
Industry and Company Specific Risk Premium	4.00%
Net Discount Rate (After-Tax)	19.25%
Net Discount Rate (After-Tax) - Rounded	**19.30%**

Capitalization of Earnings

	Original		Change Selected EBT		Change Tax Rate		Change Selected EBT Tax Rate & Growth Rate	
Capitalized Earnings								
Adjusted EBT (Selected)		$ 140,000		$ 126,500		$ 140,000		$ 126,500
Less: Normalized Taxes	30.00%	(42,000)	30.00%	(37,950)	40.00%	(56,000)	40.00%	(50,600)
Plus: Depreciation & Amortization		-		-		-		-
Less: Capital Expenditures		-		-		-		-
Changes in Working Capital		-		-		-		-
Current Sustainable Distributable Cash Flow		98,000		88,550		84,000		75,900
Multplied by: One plus Growth Rate	2.50%	1.025	2.50%	1.025	2.50%	1.025	1.50%	1.015
Projected Sustainable Distributable Cash Flow		100,450		90,764		86,100		77,039
Capitalization Rate								
Cost of Equity		19.30%		19.30%		19.30%		19.30%
Less: Long-Term Growth Rate		-2.50%		-2.50%		-2.50%		-1.50%
Capitalization Rate		16.80%		16.80%		16.80%		16.80%
Conclusion of Value								
Sustainable Distributable Cash Flow		100,450		90,764		86,100		77,039
Divided by: Capitalization Rate		16.80%		16.80%		16.80%		16.80%
Multiplied by: Mid-Year Convention Factor		109.22%		109.22%		109.22%		109.22%
Concluded Equity Value		653,072		590,097		559,776		500,863
Less: Interest Bearing Debt		-		-		-		-
Plus: Cash		-		-		-		-
Concluded Equity Value		$ 653,072		$ 590,097		$ 559,776		$ 500,863

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Conclusion:

- Where Appraisers can agree to disagree on:
  - Standard of Value
  - Normalization Adjustments
  - Benefits Stream
  - Cost of Capital
  - Discounts

- Avoid Disagreements to benefit Client
  - Understand Facts
  - Read Documents
  - Challenge Opinion

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Questions
&
Thank You

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