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Liza F. Bercovici

COMMON ERRORS IN BUSINESS VALUATIONS

by

MARK KOHN, CPA, CVA

Business valuations are prepared by a variety of professionals, including business appraisers, business brokers, financial analysts, certified public accountants and economists. On occasion, the background of the evaluator preparing the valuation may predispose that individual to serious errors in the valuation of the business. This article will explore some of the most common errors made in business valuations in dissolution proceedings.

I. USE OF A VALUATION METHOD NOT ACCEPTED BY THE COURTS

A. Market Value Method

A common error in the valuation of businesses - particularly with appraisers who are unfamiliar with the practice of family law - is the application of the market value method to privately-held companies. Using the market value method, the appraiser simply applies to the business being valued the price-earnings ratio of a comparable public company.

For example, if the business being valued is a cosmetic company, and publicly-held cosmetic companies are selling for twenty times eamings, then the subject cosmetic business would be valued by multiplying by twenty its annual earnings. If the current market price of a publicly-held cosmetic company were $50 per share, and there were ten million shares of stock outstanding, then the market value of the company would be $500 million. If the marketplace currently expects that the company will have annual eamings of $100 million dollars, then the price-earnings ratio would be 500 to 100, or 5 to 1. Using this approach, the privately-held cosmetics company with $2 million in earnings would be valued at $10 million, by using the price-earnings ratio of 5 to 1, or five times annual earnings.

Two cases, *In Re Marriage of Lotz* (1981) 120 Cal.App.3d 379, 174 Cal. Rptr. 618, and *In Re Marriage of Hewitson* (1983) 142 CaI.App.3d 874, 191 CaI.Rptr. 392, have held that relying solely on the price-eamings ratio of publicly-traded corporations to value closely-held corporations is error. These cases have reasoned that one cannot compare the stock of a business owned by a single shareholder, responsible to no one, that cannot be easily sold, to a company that is publicly-held and easily sold. Furthermore, an owner of a private company may eliminate most of the corporate profits by paying himself a large salary; a public company will not arbitrarily eliminate profits by paying out large salaries.

B. Discounted Future Earnings Method

Another valuation method that is occasionally used is the "discounted future earnings method." This method equates the value of a company to the present discounted value of the company's expected future eamings. The evaluator, for example, may determine that the company will earn $2 million in the two years following valuation, $2.5 million in the next two years, and $3 million for each year thereafter. The present discounted value of those millions, after adding in the residual value of the business at the end of the cash flow stream, constitutes the business' value. This approach, while acceptable as a valuation method for certain businesses, should not be used in valuing a professional practice. As the court in *Marriage of Fortier* (1973) 34 CaI.App.3d 384, 109 CaI.Rptr. 915, held: "Since the philosophy of the community property system is that a community interest can be acquired only during the time of the marriage, it would then be inconsistent with that philosophy to assign to any community interest the value of post-marital efforts of either spouse." *In Re Marriage of King* (1983) 150 Cal.App.3d 304, 197 Cal. Rptr. 716, similarly rejected a valuation where the appraisal was "replete with references to post-separation efforts of husband."

II. USE OF VALUATION METHODS THAT DO NOT INCLUDE ALL OF THE ASSETS OF THE BUSINESS

There are certain accepted formulas and rules of thumb often used in valuing a small business. An appraiser relying on a particular formula or rule of thumb should keep in mind that many formulas addressing the valuation of small businesses do not necessarily consider all of the assets of the business. For example, one formula used to value a retail auto parts business produces an indicated value for the fixed assets, the lease and the "intangibles" of the business, but it omits from the valuation the company's cash in hand, accounts receivable, prepaid expenses and all of its liabilities. Another method produces an indicated value for the company's lease and intangibles, but omits from the valuation the fixed and current assets of the company and the business' liabilities.

Similarly, the calculation of goodwill may be so complicated that it becomes the exclusive focus of attention. In one recent trial court case, an appraiser ended up using goodwill alone as the value of the business, inadvertently omitting consideration of all other assets and liabilities.

III. APPLICATION OF VALUE MULTIPLES TO THE WRONG INCOME STREAM

Certain valuation methods use income multiples to determine goodwill. In one industry, for example, goodwill may be a multiple of the company's eamings. To properly figure goodwill, however, an appraiser will need to determine whether goodwill in that industry is based on after-tax or pre-tax earnings. The difference may be significant. Imagine, for example, that a company's pre-tax earnings are $100,000 and the after-tax eamings are $70,000. The difference in the goodwill value, at five times earnings, will be $150,000 - the difference between $500,000 and $350,000 - a thirty percent error.

Similarly, in applying valuation methods that use a multiple of gross revenue, one should guard against the inadvertent use of a multiple of net income, or the use of income where cash flow instead is required.

IV. OMISSION OF MINORITY DISCOUNTS

Imagine two identical businesses, with the same sales and profits, except that Company A is owned by a single stockholder, whereas Company B is owned equally by five shareholders. A valuation of both businesses concludes that each company is worth $25 million. The stock of Company A's sole stockholder is accordingly worth $25 million. Presumably, the stock of Company B's five equal shareholders is also each worth $5 million.

The valuation assigned to Company B's shareholders' stock is wrong. The value of each of Company B's shareholders' stock must be discounted because each stockholder has only a minority interest in the company. The Company B shareholder cannot dictate company policy (unlike the sole stockholder of Company A) and he cannot control profits (as can Company A's stockholder). To illustrate this, assume that the sole stockholder of Company A sold his shares to a new owner on the express condition that the new owner could not change sales policies, production methods, personnel or purchasing practices. The new buyer would technically own Company A, but he would have no real control over it. Presumably, he would pay much less for the stock than if he were able to run the company however he chose. The new owner is simply a passive investor; if he had true control over the company, he would be an active owner. A passive investor will pay less because he has no control over his investment.

V. FAILURE TO CONSIDER UNIQUE EVENTS

In calculating goodwill, a common practice is to average the more recent years' income and expenses to arrive at an average net income, which then forms the basis for a goodwill calculation. In calculating goodwill, it is usually appropriate to eliminate all atypical income and expense for the company, because the purpose of the valuation is to determine the value of the business without the effect of unusual events which might cause temporary fluctuations in the market for the goods or services. A prospective buyer, for example, would probably ignore unusual occurrences such as earthquakes, floods and fire in determining business value. The buyer will want to know the value of the business under **normal** circumstances. The appraiser must therefore eliminate the effects of unusual, non-recurring income or losses from the company's financial statements. For example, the costs of nonrecurring litigation should be "normalized" by the appraiser, as should the financial effects of an earthquake. The appraiser should determine if anything unusual has happened during the years being considered, and the necessary adjustments should be made.

VI. FAILURE TO ADJUST GOODWILL TO RISK FACTORS

Goodwill is usually found where a business both generates and appears likely to continue generating income which exceeds the norm for that type of business. One commonly-used goodwill calculation incorporates at least two steps - a determination of the business' excess income and an assessment of whether the excess income is likely to continue. An appraiser may be valuing an accounting or legal practice using methods that are perfectly appropriate to the valuation of those practices, but the result will be flawed if those practices are unusual in nature. For example, a law practice may be highly specialized with a unique referral source. A law firm focussed primarily on asbestos litigation, for example, which was at one time a lucrative area of practice, typifies the problem. The likelihood of continued future eamings at previous levels in such a firm would be much different from the eamings of a law firm with a wide area of practice which is not dependent on a single or atypical referral source. A manufacturer may be very successful, and his product may be similar to others in the industry, but the success may be dependent on a patent that is about to expire. A retail store may be very successful, but the neighborhood may be full of people who work at the nearby General Motors plant, which has just announced it is about to close. A local hardware store may be thriving, but a hardware chain may be building a massive store nearby.

Furthermore, using the prior example, it is not even necessary that the General Motors plant announce a closing to affect the valuation of the retail store. Even if no such announcement were made, one must at least consider that the success of the retail business may depend on the General Motor plant's continued operation. The risk factor for the retail business must consider the risk factor of that General Motors plant.

VII. OMISSION OF CERTAIN ASSETS OR LIABILITIES

Certain assets and liabilities are easily overlooked because of their nature. One such asset is "work in progress." Work in progress is a form of accounts receivable for services rendered, for which no invoices have yet been issued. For certain businesses, work in progress can form a substantial portion of the accounts receivable. For example, a construction company typically bills only when a significant part of the job is completed. The value of those unbilled services needs to be reflected as an asset of the business.

Another asset to be considered is the value of a lease. A below-market lease may be a considerable asset and should likewise be reflected in assessing the business' value.

VIII. OVERLY THEORETICAL ANALYSES

Some business appraisals are prepared by experts who are theoretically inclined. Their appraisals may be based upon complex theoretical assumptions and analyses. When the same business is valued by a business broker, however, the broker may give a much different value. The business broker operates in the real world, and he knows how that business will be sold on the market. Complex theoretical analysis is rarely the basis for determining real world value. An appraisal based on theoretical analysis is often out of touch with reality.

IX. BUY-SELL AGREEMENTS

A buy-sell agreement may form part of a firm's partnership agreement, goveming the terms of a partner's buy-out if the partner leaves or dies or a new partner wants in. A buy-sell agreement may also be used to determine the value for the transfer of shares in a stockholders agreement. In family law valuations, depending on the circumstances, it is sometimes appropriate to use buy-sell agreements. In the valuation of professional practices, for example, the courts have held that a buy-sell agreement may be considered, but will not be determinative. *Marriage of Slater* (1979) 100 CaI.App.3d 241, 160 CaI.Rptr. 686. A recent case, *Marriage of Nichols* (1994) 27 CaI.App.4th 661,33 CaI.Rptr.2d 13, concluded that it was not an abuse of discretion for the trial court to value the husband's shareholder interest in his law firm based on the formula set forth in his firm's stock purchase agreement. The *Nichols* stock purchase agreement excluded the value of accounts receivable and work in progress although in *Marriage of Lopez* (1974) 38 Cal.App.3d 93, 113 Cal. Rptr. 237, the court held that these should be included in valuing a law practice interest. The court in *Nichols, supra,* found that the stock purchase agreement, which the firm had consistently adhered to with every shareholder who had retired or left, was an appropriate valuation method in this particular case. The *Nichols* court recognized that the law firm at issue was a large firm where the shareholder did not share in the firm's earnings, but was compensated as an employee based upon his own productivity and length of service to the firm. In assessing whether a buy-sell agreement should be determinative, the *Nichols* Court set forth the following criteria:

- The proximity of the date of the buy-sell agreement to the date of separation to ensure that the agreement was not entered into in contemplation of marital dissolution;

- The existence of an independent motive for entering into the buy-sell agreement, such as the firm's desire to protect all partners from the possible effects of a partnership dissolution; and

- The similarity of the value resulting from the agreement's purchase price formula to the value produced by other approaches.

Mrs. Nichols was, however, awarded an interest in her husband's professional goodwill. The court reasoned that the stock purchase agreement did not determine the lawyer's goodwill, and that Mr. Nichols had personal goodwill whether he remained with the firm or not. In effect, the court said, goodwill cannot be eliminated merely by a recital in a buy-sell agreement. "It is a community asset because husband's experience, reputation and skill, which enabled him to command this high income, were developed while he was married to wife. It directly creates excess income for husband whether he stays with his firm or strikes out on his own" *Marriage of Fenton* (1982) 134 Cal.App.3d 451,463, 184 Cal.Rptr. 597.

Because *Nichols* upheld a buy-sell agreement as to accounts receivable and work in progress, but not as to goodwill, it appears that trial courts will have to examine carefully, on a case-by-case basis, the facts behind individual buy-sell agreements.

X. CONCLUSION

Business appraisals require close attention both to theoretical and practical considerations. Attorneys and clients typically want a speedy, low-cost appraisal, but that approach invites errors such as the ones described above. In appraising businesses in family law actions, the appraiser should keep in mind these possible errors and avoid such pitfalls.