

Business Valuation in a Tennessee Divorce

A Case Study Using a Professional Practice

Presented by:

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What is the Essence of a Business Valuation?

Estimation of two primary components

- 1) The future expected benefits
- 2) The risk related to receiving those future expected benefits

A valuation measures the:

- Present Value of the future benefits (e.g. The Time Value of Money; a dollar today is worth more than a dollar in one year)
- **A business is only really worth the present value of the cash flow over and above a “normal” owner compensation**

Fair Market Value Standard of Value

Definition per IRS Revenue Ruling 59-60

“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 and both parties have reasonable knowledge of the relevant facts.”

Fair Market Value Standard of Value

*Powell v. Powell*¹

- 1) Fair Market Value Standard as in IRS Rev. Rul. 59-60 does not have to be strictly followed when valuing a business in a divorce
- 2) Business owners can be held to values in personal financial statements submitted to banks
- 3) Credentials and experience of business valuation analysts are *critical*

1. *Powell v. Powell*, 124 S.W.3d 100 (Tn. Ct. App. 2003)

What are the Approaches to Valuation?

*Blasingame v. American Materials, Inc.*²

“There are a number of acceptable methods available to determine the value of a corporation.” *Blasingame* recognized three of these methods [approaches]:

- 1) **Market Value [approach],**
- 2) **Asset Value [approach], and**
- 3) **Earnings Value or Capitalization of Earnings [Income] [approach]**

2. *Blasingame v. American Materials, Inc.*, 654 S.W.2d 659, (Tenn. 1983)

What are the Approaches to Valuation?

1) Market Approach

- a) Think of this as being similar to pricing your home for sale using comps in the neighborhood

2) Asset Approach

- a) Identifiable Tangible & Intangible Assets Adjusted to FMV – Liabilities = Value

3) Income Approach

- a) Net present value of expected future benefit, usually cash flow, with the discount rate being risk adjusted

Valuation Case Study

Dental Practice

- 1) Sole practitioner
- 2) Earnings well above the average dentist
- 3) Owner has spent much time, effort and money on branding the practice with a corporate-type image and name: “Metro Family Dentistry”
- 4) Main Issues:
 - a) Does value exist above the net “hard assets” (i.e.: Goodwill)?
 - b) If so, what portions are personal and enterprise?

Asset Approach-Adjusted Net Asset Value Method

	Unadjusted Balance Sheet	Adjustments	Adjusted Balance Sheet	Source
Bank xxx6530	14,314	0	14,314	Statement 3/26/12
Bank xxx4958	6,705	0	6,705	Statement 3/26/12
Accounts Receivable	0	69,216	69,216	Acct. Rec. Aging
Accounts Payable	0	(50,000)	(50,000)	Estimated
Credit Card xxx2001	0	(6,816)	(6,816)	Statement 2/7/12
Credit Card xxx3765	0	(7,177)	(7,177)	Statement 3/17/12
Business LOC xxx1234	(20,000)	(15,839)	(35,839)	Statement 3/26/12
Other Current Liabilities	(3,117)	0	(3,117)	1/31/12 Balance Sheet
Adjusted Net Operating Assets (Deficit)	(2,098)		(12,714)	
Equipment	55,000	171,000	226,000	S/L Depreciated Value
Business LOC (\$60k) xxx8899	(60,000)	0	(60,000)	Statement 3/26/12
Indicated Value, Net of Debt	(7,098)	160,384	153,286	

Market Approach-Market Transaction Method

Summary Market Transactions from The Goodwill Registry General Dentistry; Year 2010; The Health Care Group, Inc.

LOCATION	# OF TRANS.	GROSS REV	SELLING PRICE	PRICE % OF GR REV	GW VALUE	GW % OF GR REV
All of USA-Gross \$400k-\$1.2m	143	103,770,016	66,796,651	64.4%	50,271,939	48.4%
All of USA-Gross \$850k-\$1.2m	46	45,773,213	29,176,818	63.7%	22,617,566	49.4%
South-Gross \$400k-\$1.2m	36	25,522,936	16,988,400	66.6%	12,561,869	49.2%
TN,GA,KY,NC-Gross \$400k-\$1.2m	20	13,864,901	9,578,200	69.1%	6,880,625	49.6%

* General Dentistry; Year 2010; The Health Care Group, Inc.

Market Approach-Market Transaction Method

Market Transaction Method Using The Goodwill Registry

<u>Total Value</u>		<u>Source</u>
Gross Revenues (Collections)-2011	947,647	Gross receipts per QuickBooks
Goodwill Registry Average Price/Rev %-General Dentistry	<u>66.6%</u>	South-Gross \$400k-\$1.2m
Indicated Selling Price - Includes Equipment	630,766	
Adjusted Net Operating Assets (Deficit)	<u>(12,714)</u>	
Indicated Value, Net of Debt	<u>618,052</u>	
<u>Total Goodwill Value</u>		
Gross Revenues (Collections)-2011	947,647	Gross receipts per QuickBooks
Goodwill Registry Average GW/Gross Revenues %-General Dentistry	<u>49.2%</u>	Exhibit E - South-Gross \$400k-\$1.2m
Indicated Goodwill Included in Selling Price	<u>466,413</u>	

Income Approach-Capitalization of Earnings Method

Schedule C (Form 1040)		Profit or Loss From Business (Sole Proprietorship)		OMB No. 1545-0074	
Department of the Treasury Internal Revenue Service (991)		Partnerships, joint ventures, etc., generally must file Form 1065 or 1065-B. Attach to Form 1040, 1040NR, or 1041. See instructions for Schedule C (Form 1040).		2010 Attachment Sequence No. 09	
Name of proprietor		Social security number (SSN)			
A Principal business or profession, including product or service (see instructions) DENTIST		B Enter code from instructions 621210			
C Business name. If no separate business name, leave blank.		D Employer ID no. (EIN), if any			
E Business address (including suite or room no.) City, town or post office, state, and ZIP code					
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶					
G Did you "materially participate" in the operation of this business during 2010? If "No," see instructions for limit on losses		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No			
H If you started or acquired this business during 2010, check here					
Part I Income					
1 Gross receipts or sales. Caution. See instructions and check the box if:					
<ul style="list-style-type: none"> This income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, or You are a member of a qualified joint venture reporting only rental real estate income not subject to self-employment tax. Also see instructions for limit on losses. 					
		▶ <input type="checkbox"/>		1 1,141,502.	
2 Returns and allowances				2 2,974.	
3 Subtract line 2 from line 1				3 1,138,528.	
4 Cost of goods sold (from line 42 on page 2)				4	
5 Gross profit. Subtract line 4 from line 3				5 1,138,528.	
6 Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)				6	
7 Gross income. Add lines 5 and 6		▶		7 1,138,528.	
Part II Expenses. Enter expenses for business use of your home only on line 30.					
8 Advertising		8 23,867.		18 Office expense	
9 Car and truck expenses (see instructions)		9		18 2,502.	
10 Commissions and fees		10		19 Pension and profit-sharing plans	
11 Contract labor (see instructions)		11		19	
12 Depletion		12		20 Rent or lease (see instructions):	
13 Depreciation and section 179 expense deduction (not included in Part III) (see instructions)		13 14,703.		20a Vehicles, machinery, and equipment	
14 Employee benefit programs (other than on line 19)		14		20b Other business property	
15 Insurance (other than health)		15 16,962.		20b 49,355.	
16 Interest:		16		21 Repairs and maintenance	
a Mortgage (paid to banks, etc.)		16a 30,518.		21 2,851.	
b Other		16b		22 Supplies (not included in Part III)	
17 Legal and professional services		17 4,626.		22 39,651.	
				23 Taxes and licenses	
				23 25,087.	
				24 Travel, meals, and entertainment:	
				a Travel	
				24a 34,196.	
				b Deductible meals and entertainment (see instructions)	
				24b 1,513.	
				25 Utilities	
				25 4,648.	
				26 Wages (less employment credits)	
				26 145,635.	
				27 Other expenses (from line 48 on page 2)	
				27 220,656.	
28 Total expenses before expenses for business use of home. Add lines 8 through 27		▶		28 616,770.	
29 Tentative profit or (loss). Subtract line 28 from line 7				29 521,758.	
30 Expenses for business use of your home. Attach Form 8829				30	
31 Net profit or (loss). Subtract line 30 from line 29.				31 521,758.	
<ul style="list-style-type: none"> If a profit, enter on both Form 1040, line 12, and Schedule SE, line 2, or on Form 1040NR, line 13 (if you checked the box on line 1, see instructions). Estates and trusts, enter on Form 1041, line 3. 					

Income Approach-Capitalization of Earnings Method

Capitalization of Earnings Method	Dec 2011	Dec 2010	Dec 2009	Dec 2008	Dec 2007
Net Income-Schedule C	423,159	521,758	285,605	227,878	322,479
Adjustments:					
Add Back Building Mortgage Interest on Sched C	0	30,518	36,124	32,329	24,296
Non-Recurring Memphis Net Income	0	(144,595)	0	0	0
Depreciation & Amortization	0	14,894	19,481	71,148	13,301
Adjusted EBITDA	423,159	422,575	341,210	331,355	360,076
Mean Compensation for Independent Dentists*	(192,680)	(192,680)	(192,680)	(207,210)	(205,960)
Adjusted Earnings Before Depreciation and Taxes	230,479	229,895	148,530	124,145	154,116
Weight	2	1	0	0	0
Stream Weight	460,958	229,895	0	0	0
Weighted Average	230,284				
Less Ongoing Depreciation/Amortization Expense	(14,894)				
Taxable Base	215,390				
Less State Income Taxes	0.0%	0			
Sub-Total	215,390				
Less Federal Taxes	(67,252)				
Sub-Total	148,138				
Add Back Ongoing Depreciation/Amortization Expense	14,894				
Decrease/(Increase) in Working Capital	0				
Decrease/(Increase) in Capital Expenditures	(12,000)				
Ongoing Earning Capacity	<u>151,032</u>				

* American Dental Association, 2010 Survey of Dental Practice; Table 3: Real and Reported Net Income from the Primary Practice of Independent Dentists; 2007-2009 reported

Income Approach-Capitalization of Earnings Method

Capitalization Of Earnings Capitalization Rate

Risk-free Rate of Return	4.5%
Common Stock Equity Risk Premium	6.7%
Small Stock Risk Premium	12.1%
Company Specific Premium	
Depth of Management	0.0%
Importance of Key Personnel	3.0%
Stability of Industry	-1.0%
Diversification of Product Line	0.0%
Diversification of Customer Base	0.0%
Diversification/Stability of Suppliers	0.0%
Geographic Location	-1.0%
Stability of Earnings	0.0%
Earnings Margins	0.0%
Financial Structure	1.0%
Company Specific Premium	<u>2.0%</u>
Net discount rate	25.3%
Less Sustainable Growth	<u>5.0%</u>
Next Year Capitalization Rate	<u>20.3%</u>
Current Year Capitalization Rate	<u><u>19.3%</u></u>
Capitalization Multiple	<u><u>5.2</u></u>

Capitalization Of Earnings Indicated Value

Ongoing Capacity	151,032
Capitalization Multiple	<u>5.2</u>
Indicated Value, Net of Debt	<u><u>782,743</u></u>

Capitalization Of Earnings Indicated Value

Ongoing Capacity	151,032
Capitalization Rate	<u>19.3%</u>
Indicated Value, Net of Debt	<u><u>782,743</u></u>

* Next Year Capitalization Rate divided by 1 + the Growth Rate

Conclusion of Value for the Enterprise

Conclusion of Value	Indicated Value	Weight	Weighted Value
Asset Approach-Adjusted Net Asset Value Method	153,286	0%	0
Market Approach-Market Transaction Method	618,052	50%	309,026
Income Approach-Capitalization Of Earnings Method	782,743	50%	391,371
Conclusion of Equity Value		<u>100%</u>	<u>700,398</u>
Rounded			<u><u>700,000</u></u>

Personal Goodwill in a Tennessee Divorce

Generally

- 1) Fair Market Value inherently includes Goodwill when valuing with a going concern premise
- 2) Personal goodwill is generally not to be considered in valuation of professional practices and small, closely-held businesses primarily dependant upon the individual for success
- 3) Courts often use a standard other than FMV

Personal Goodwill in a Tennessee Divorce

*Hazard v. Hazard*³

- 1) Dr. Hazard's practice was highly specialized and very dependent upon referrals from other physicians
- 2) Court rejected gross income approach to value Husband's medical practice
- 3) Goodwill in a professional practice is not a marital asset subject to equitable distribution

3. *Hazard v. Hazard*, 833 S.W.2d 911 (Tn. Ct. App. 1991)

Personal Goodwill in a Tennessee Divorce

Hazard v. Hazard (cont'd)

- 4) Sole practitioner professional practice is to be valued using the “net tangible assets with ascertainable value.” Cites *Smith v. Smith*⁴
- 5) Net Asset Value a.k.a. Net Book Value

4. *Smith v. Smith*, 709 S.W.2d (Tn. Ct. App. 1985)

Personal Goodwill in a Tennessee Divorce

*Witt v. Witt*⁵

- 1) If the professional practice or closely-held business is large and diverse enough and not solely dependent on the individual, goodwill may be considered as part of the ownership interest
- 2) Dr. Witt's clinic was found to have separate goodwill that was not directly related to his professional or personal goodwill

5. *Witt v. Witt*, 17 TAM 15-6 (Tn. Ct. App. 1992)

Personal Goodwill in a Tennessee Divorce

*Eberting v. Eberting*⁶

- 1) Orthodontia practice value at FMV by Vance at \$700k; included Enterprise (not Personal) Goodwill
- 2) Opposing expert valued practice At \$224k (net book value with no Goodwill)
- 3) Trial judge found value to be \$500k, which was a value indicated by the owner in a personal financial statement; judge knew that any value north of \$224k was including Goodwill

Personal Goodwill in a Tennessee Divorce

Eberting v. Eberting (cont'd)

- 4) “A trial judge, as the fact finder, is not required to check his or her common sense at the door when considering evidence. The Trial Court had before it evidence of values that Husband himself had applied to his practice, and had Husband’s own testimony that he would be upset if he were to sell the practice and receive only the value assigned by his expert. The Trial Court found a value for the practice that was within the range of values presented by the evidence.” [emphasis added]

Conclusion of Value for the Enterprise

Conclusion of Value	Indicated Value	Weight	Weighted Value
Asset Approach-Adjusted Net Asset Value Method	153,286	0%	0
Market Approach-Market Transaction Method	618,052	50%	309,026
Income Approach-Capitalization Of Earnings Method	782,743	50%	391,371
Conclusion of Equity Value		<u>100%</u>	<u>700,398</u>
Rounded			<u><u>700,000</u></u>

Asset Approach-Adjusted Net Asset Value Method

Identified Assets and Debts

	Unadjusted		Adjusted	
	Balance Sheet	Adjustments	Balance Sheet	Source
Bank xxx6530	14,314	0	14,314	Statement 3/26/12
Bank xxx4958	6,705	0	6,705	Statement 3/26/12
Accounts Receivable	0	69,216	69,216	Acct. Rec. Aging
Accounts Payable	0	(50,000)	(50,000)	Estimated
Credit Card xxx2001	0	(6,816)	(6,816)	Statement 2/7/12
Credit Card xxx3765	0	(7,177)	(7,177)	Statement 3/17/12
Business LOC xxx1234	(20,000)	(15,839)	(35,839)	Statement 3/26/12
Other Current Liabilities	<u>(3,117)</u>	0	<u>(3,117)</u>	1/31/12 Balance Sheet
Adjusted Net Operating Assets (Deficit)	(2,098)		(12,714)	
Equipment	55,000	171,000	226,000	S/L Depreciated Value
Business LOC (\$60k) xxx8899	<u>(60,000)</u>	0	<u>(60,000)</u>	Statement 3/26/12
Indicated Value, Net of Debt	<u>(7,098)</u>	160,384	<u>153,286</u>	

Enterprise Goodwill Component

Enterprise Goodwill Component Breakdown

Cash	21,019
Accounts Receivable	69,216
FMV of Equipment	226,000
Accounts Payable	(50,000)
Credit Cards	(13,993)
FT TN Business LOC	(35,839)
Other Current Liabilities	(3,117)
Total Goodwill* (a balancing figure using this build-up)	486,714
Enterprise Value	700,000
Business LOC (\$60k) xxx8899	(60,000)
Conclusion of Equity Value Including Total Goodwill	640,000

* Goodwill Registry Indication of Total Goodwill 459,838

Goal for Allocating Personal vs. Enterprise Goodwill

Find an objective method to analyze subjective data:

Multiattribute Utility Model (MUM)

Decision making matrix for applications such as:

- 1) Placement of surplus weapons-grade plutonium
- 2) Plant and treatment facility locations
- 3) Restoration of contaminated ecosystems in the former Soviet Union

**Allocation of Goodwill Between Personal and Enterprise
Multiattribute Utility Model (MUM)***

Personal Goodwill Attributes		Importance Utility	Existence Utility	Multiplicative Utility	Percent
Ability, Skill & Judgment	1	4	4	16	7.9%
Lacks Transferability	2	5	0	0	0.0%
Age & Health	3	5	3	15	7.4%
Personal Staff	4	4	2	8	4.0%
Personal Reputation	5	4	3	12	5.9%
Personalized Name	6	4	3	12	5.9%
Marketing & Branding	7	2	2	4	2.0%
In-bound Personal Referrals	8	5	2	10	5.0%
Knowledge of End User/Customer	9	2	2	4	2.0%
Important Personal Nature	10	3	2	6	3.0%
Total Personal Utilities		38	23		
Total Personal Multiplicative Utility				87	43.1%

Enterprise Goodwill Attributes		Importance Utility	Existence Utility	Multiplicative Utility	Percent
Enterprise Staff	1	5	3	15	7.4%
Business Reputation	2	4	3	12	5.9%
Business Name	3	5	2	10	5.0%
Marketing & Branding	4	4	3	12	5.9%
Business Locations	5	5	5	25	12.4%
Years in Business	6	4	3	12	5.9%
Systems & Organization	7	3	2	6	3.0%
Out-bound Referrals	8	3	1	3	1.5%
Repeating Revenue Stream	9	5	4	20	9.9%
Total Enterprise Utilities		38	26		
Total Enterprise Multiplicative Utility				115	56.9%
Total Multiplicative Utility				202	100.0%

*Wood, David, BVR's Guide to Personal v. Enterprise Goodwill, Business Valuation Resources, LLC, Portland OR, 2010.

Enterprise Goodwill Component Breakdown

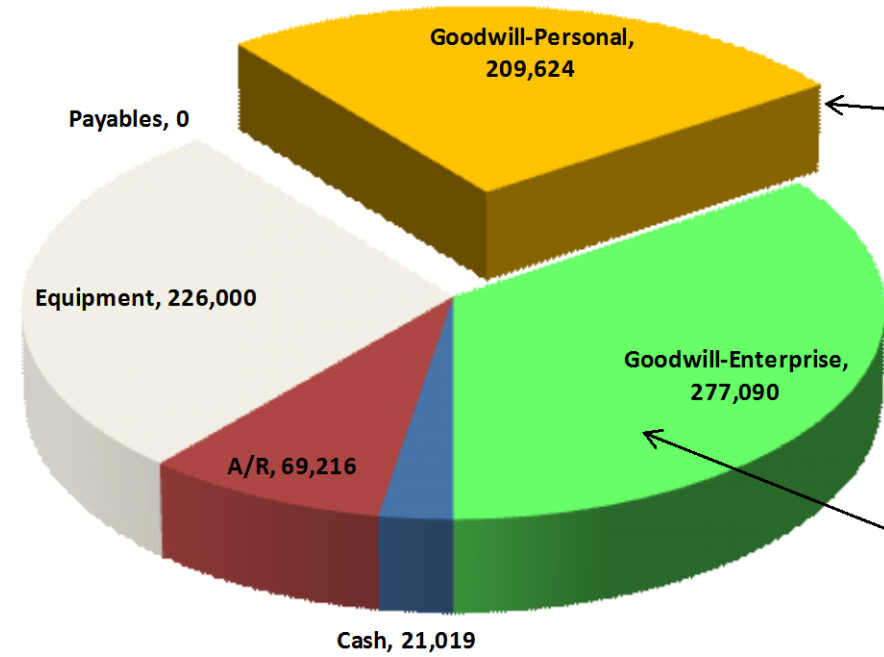
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Other Current Liabilities	(3,117)
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Enterprise Value	700,000
Business LOC (\$60k) xxx8899	(60,000)
Conclusion of Equity Value Including Total Goodwill	<u><u>640,000</u></u>
* Goodwill Registry Indication of Total Goodwill	<u><u>459,838</u></u>

Estimated Personal GW per MUM	209,624	43.1%
Estimated Enterprise GW per MUM	277,090	56.9%
See Exhibit B	<u>486,714</u>	<u>100.0%</u>

Estimated "Divorce" Value Available for Equitable Distribution

Conclusion of Equity Value Including Total Goodwill	640,000
Less Estimated Personal GW per MUM	(209,624)
Total "Divorce" Value (after subtracting the debt)	<u>430,376</u>
Rounded	<u><u>430,000</u></u>

Asset Component Breakdown



- Identifiable Intangibles**
- Patient Charts/Repeat Business
 - In-place Value of Equipment
 - Trained & Assembled Workforce
 - Location
 - Covenant Not to Compete
 - Systems & Organization
 - Website (www.MetroDentist.com)

Unidentifiable Intangibles

Goodwill

- Personal Goodwill Attributes 43.1%**
- Ability, Skill & Judgment
 - Lacks Transferability
 - Age & Health
 - Personal Staff
 - Personal Reputation
 - Personalized Name
 - Marketing & Branding
 - In-bound Personal Referrals
 - Knowledge of End User/Customer
 - Important Personal Nature

- Enterprise Goodwill Attributes 56.9%**
- Enterprise Staff
 - Business Reputation
 - Business Name
 - Marketing & Branding
 - Business Locations
 - Years in Business
 - Systems & Organization
 - Out-bound Referrals
 - Repeating Revenue Stream

■ Cash ■ A/R ■ Equipment ■ Payables ■ Goodwill-Personal ■ Goodwill-Enterprise

Thank You!

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