

**2018 Tennessee Judicial Conference**

**March 7, 2018**

**Montgomery Bell State Park**

*The Essentials of Business Valuation*

*For Tennessee Judges*

*(Why are the Experts so Far Apart?)*

Presented by:

**Robert Vance, CPA, ABV, CFF, CVA, CFP**



**Forensic & Valuation Services, PLC**

**901-507-9173**

**[www.ForensicVal.com](http://www.ForensicVal.com)**

**[rvance@ForensicVal.com](mailto:rvance@ForensicVal.com)**

# Valuation Expert Credentials

- × Accredited Senior Appraiser (ASA) offered by the American Society of Appraisers
- × Accredited in Business Valuation (ABV) offered by the American Institute of CPAs
- × Certified Valuation Analyst (CVA) and Accredited Valuation Analyst (AVA) credentials offered by the National Association of Valuators and Analysts (NACVA)
- × Certified Business Appraiser (CBA) credential formerly offered by the Institute of Business Appraisers (IBA), absorbed by NACVA and now defunct

# Valuation Expert Credentials

- × Accredited Senior Appraiser (**ASA**) offered by the American Society of Appraisers
- × Accredited in Business Valuation (**ABV**) offered by the American Institute of CPAs
- × Certified Valuation Analyst (**CVA**) and Accredited Valuation Analyst (**AVA**) credentials offered by the National Association of Valuators and Analysts (**NACVA**)
- × Certified Business Appraiser (**CBA**) credential formerly offered by the Institute of Business Appraisers (**IBA**), absorbed by **NACVA** and now defunct

# If You Don't Remember Anything Else Today

- × A business valuation is essentially the Present Value of the future expected benefits (cash flow)
- × A closely-held business is, in reality, only worth the present value of the future cash flow over and above a “normal” owner compensation; a.k.a Ongoing Earning Capacity
- × Consider whether the Owner simply owns a job with little value otherwise
- × The particular owner's interest is being valued, not necessarily the entire company (unless he/she owns 100%)
- × The Ongoing Earning Capacity is the return on investment the willing buyer “receives” by investing in this particular business

# Standard of Value in TN: Fair Market 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.”

## *Powell v. Powell* - 2003

- × The Fair Market Value Standard as in IRS Rev. Rul. 59-60 **does not** have to be strictly followed when valuing a closely-held business in a Tennessee divorce

# Three Approaches to Valuation

## *Blasingame v. American Materials* – 3 Approaches

- × Shareholder Oppression case
- × “There are a number of acceptable methods available to determine the value of a corporation. Blasingame recognized three of these methods [approaches] and “*requires*” them:
  - × **Market Value [approach],**
  - × **Asset Value [approach], and**
  - × **Earnings Value or Capitalization of Earnings [approach].**
- × Minimum of 3 years of earnings to be considered unless clear evidence to use less
- × **Delaware Block Method**

*Blasingame v. American Materials, Inc.*, 654 S.W.2d 659, 667(Tenn.Supt.Ct. 1983)

# **Three Approaches to Valuation**

## **Each with Underlying Methods**

### **1) Asset Approach**

- × Start with the balance sheet of a business, but with identifiable tangible and intangible assets adjusted to Fair Market Value minus liabilities
- × Adjusted Net Asset Value Method

### **2) Market Approach**

- × Comparable sales of other businesses; similar to pricing your home for sale using comps in the neighborhood
- × Guideline Transactions Method
- × Publicly Traded Guideline Companies Method

# **Three Approaches to Valuation**

## **Each with Underlying Methods**

### **3) Income Approach**

- × Net present value of expected future benefits to the owner, usually the cash flow, with the discount rate/multiplier being risk adjusted
- × Capitalization of Earnings Method
- × Discounted Cash Flow Method



## **What is Included in Each Approach?**

- × The inclusion of **both** Personal and Enterprise Goodwill is implied in the final conclusion of value using the valuation approaches of :

**Market Approach - Yes**

**Income Approach - Yes**

**Asset Approach - No**

- × Usually **all** assets and debts of the business are included with the Market and Income Approach conclusions of value

# What is Included in Each Approach?

Conclusion of Value Using an Income Approach		750,000
<u>"Hard" Assets and Debts</u>		
Cash	75,000	
Accounts Receivable	50,000	
FMV of Equipment	100,000	
Loan	<u>(60,000)</u>	
Adjusted Net Asset Value		<u>165,000</u>
<b>Total Goodwill (a balancing or plug figure using this build-up)</b>		<b><u><u>585,000</u></u></b>

# **Why Are Opposing Expert Values Different? Supposed Small Changes = Big Value Differences**

- 1) Normalizing Expense Adjustments
- 2) Weighting of Economic Income Streams
- 3) Weighting of Values in the Conclusion
- 4) Capitalization Rates/Multipliers
- 5) Discounts for Lack of Control & Marketability
- 6) Interpretations of the Law
- 7) Different Approaches/Methods
- 8) Different Time Periods
- 9) Information Availability to Each Side
- 10) Not Considering Actual Arm's-Length Transactions in the Subject Company Stock
- 11) Reliance on Bad Market Approach Multiples

# **Why Are Opposing Expert Values Different? Supposed Small Changes = Big Value Differences**

- 1) Normalizing Expense Adjustments**
- 2) Weighting of Economic Income Streams**
- 3) Weighting of Values in the Conclusion**
- 4) Capitalization Rates/Multipliers**
- 5) Discounts for Lack of Control & Marketability**
- 6) Interpretations of the Law**
- 7) Different Approaches/Methods
- 8) Different Time Periods
- 9) Information Availability to Each Side
- 10) Not Considering Actual Arm's-Length Transactions in the Subject Company Stock
- 11) Reliance on Bad Market Approach Multiples

# Normalizing Expense Adjustments

**Usually must be made to any set of financials or tax returns used as a valuation basis**

- 1) Owner's compensation and perks**
- 2) Personal expenses
- 3) Excessive distributions
- 4) Unusual and/or extraordinary items
- 5) Non-recurring and/or one-time items
- 6) Non-operating assets
  - × Real estate, excess cash, obsolete inventory, etc.

# Normalizing Expense Adjustments

## Income Statement Normalizing Adjustments

	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
Historic Net Income Before Taxes	42,000	40,000	(32,000)	(12,500)	55,000
Adjustments to Expense:					
Owner Compensation #1-Actual	(314,914)	(379,766)	(286,260)	(318,692)	(124,204)
Owner Compensation #2-Actual	(257,414)	(319,764)	(224,156)	(254,170)	(75,796)
<b>Owner Compensation #1-Adjusted</b>	<b>150,000</b>	<b>150,000</b>	<b>150,000</b>	<b>150,000</b>	<b>150,000</b>
<b>Owner Compensation #2-Adjusted</b>	<b>125,000</b>	<b>125,000</b>	<b>125,000</b>	<b>125,000</b>	<b>125,000</b>
Rent Paid to Owners-Actual	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
Rent Paid to Owners-Adjusted	50,000	50,000	50,000	50,000	50,000
	(347,327)	(474,530)	(285,416)	(347,862)	25,000
Net Increase (Decrease) to Net Income	347,327	474,530	285,416	347,862	(25,000)
<b>Adjusted Net Income</b>	<b>389,327</b>	<b>514,530</b>	<b>253,416</b>	<b>335,362</b>	<b>30,000</b>

# Normalizing Expense Adjustments

## Income Statement Normalizing Adjustments

	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
Historic Net Income Before Taxes	42,000	40,000	(32,000)	(12,500)	55,000
Adjustments to Expense:					
Owner Compensation #1-Actual	(314,914)	(379,766)	(286,260)	(318,692)	(124,204)
Owner Compensation #2-Actual	(257,414)	(319,764)	(224,156)	(254,170)	(75,796)
<b>Owner Compensation #1-Adjusted</b>	<b>225,000</b>	<b>225,000</b>	<b>225,000</b>	<b>225,000</b>	<b>225,000</b>
<b>Owner Compensation #2-Adjusted</b>	<b>200,000</b>	<b>200,000</b>	<b>200,000</b>	<b>200,000</b>	<b>200,000</b>
Rent Paid to Owners-Actual	(100,000)	(100,000)	(100,000)	(100,000)	(100,000)
Rent Paid to Owners-Adjusted	50,000	50,000	50,000	50,000	50,000
	<u>(197,327)</u>	<u>(324,530)</u>	<u>(135,416)</u>	<u>(197,862)</u>	<u>175,000</u>
Net Increase (Decrease) to Net Income	197,327	324,530	135,416	197,862	(175,000)
<b>Adjusted Net Income</b>	<b><u>239,327</u></b>	<b><u>364,530</u></b>	<b><u>103,416</u></b>	<b><u>185,362</u></b>	<b><u>(120,000)</u></b>

# Normalizing Expense Adjustments

Capitalization Of Earnings Economic Stream Compensation Adjusted to \$150k & \$125k	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
<b>Adjusted Income Before Taxes</b>	<b>\$389,327</b>	<b>\$514,530</b>	<b>\$253,416</b>	<b>\$335,362</b>	<b>\$30,000</b>
Adjusted Depreciation	14,345	1,786	1,633	11,050	23,185
	403,672	516,316	255,049	346,412	53,185
Weight	1	1	1	1	0
Weighted Average	380,362				
Less Ongoing Depreciation	(7,203)				
Sub-Total	373,159				
Less State Taxes	6.5% (24,255)				
Taxable Base	348,903				
Less Federal Taxes	(118,627)				
Sub-Total	230,276				
Add Back Ongoing Depreciation/Amortization	7,203				
Decrease/(Increase) in Capital Expenditures	(7,200)				
Ongoing Earning Capacity	230,280				
Capitalization Multiple	x 4.4				
<b>Indicated Operating Value</b>	<b>= \$1,005,460</b>				
Capitalization Rate	÷ 22.9%				
<b>Indicated Operating Value</b>	<b>= \$1,005,460</b>				

$$\frac{1}{22.9\%} = 4.4$$



# Normalizing Expense Adjustments

Capitalization Of Earnings Economic Stream Compensation Adjusted to \$225k & \$200k	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
<b>Adjusted Income Before Taxes</b>	<b>\$239,327</b>	<b>\$364,530</b>	<b>\$103,416</b>	<b>\$185,362</b>	<b>(\$120,000)</b>
Adjusted Depreciation	14,345	1,786	1,633	11,050	23,185
	253,672	366,316	105,049	196,412	(96,815)
Weight	1	1	1	1	0
Weighted Average	230,362				
Less Ongoing Depreciation	(7,203)				
Sub-Total	223,159				
Less State Taxes	6.5% (14,505)				
Taxable Base	208,653				
Less Federal Taxes	(64,625)				
Sub-Total	144,029				
Add Back Ongoing Depreciation/Amortization	7,203				
Decrease/(Increase) in Capital Expenditures	(7,200)				
Ongoing Earning Capacity	144,032				
Capitalization Multiple	x 4.4				
<b>Indicated Operating Value</b>	<b>= \$628,881</b>				
Capitalization Rate	÷ 22.9%				
<b>Indicated Operating Value</b>	<b>= \$628,881</b>				

# Weighting of Economic Income Streams

Capitalization Of Earnings Economic Stream	Dec	Dec	Dec	Dec	Dec
Weighted Evenly	2017	2016	2015	2014	2013
Adjusted Income Before Taxes	\$389,327	\$514,530	\$253,416	\$335,362	\$30,000
Adjusted Depreciation	14,345	1,786	1,633	11,050	23,185
	403,672	516,316	255,049	346,412	53,185
<b>Weight</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>1</b>
Weighted Average	314,927				
Less Ongoing Depreciation	(10,400)				
Sub-Total	304,527				
Less State Taxes	6.5% (19,794)				
Taxable Base	284,733				
Less Federal Taxes	(94,296)				
Sub-Total	190,437				
Add Back Ongoing Depreciation/Amortization	10,400				
Decrease/(Increase) in Capital Expenditures	(10,000)				
Ongoing Earning Capacity	190,837				
Capitalization Multiple	x 4.4				
<b>Indicated Operating Value</b>	<b>= \$833,242</b>				
Capitalization Rate	÷ 22.9%				
<b>Indicated Operating Value</b>	<b>= \$833,242</b>				

# Weighting of Economic Income Streams

Capitalization Of Earnings Economic Stream Weighted Heavier to Current	Dec 2017	Dec 2016	Dec 2015	Dec 2014	Dec 2013
Adjusted Income Before Taxes	\$389,327	\$514,530	\$253,416	\$335,362	\$30,000
Adjusted Depreciation	14,345	1,786	1,633	11,050	23,185
	403,672	516,316	255,049	346,412	53,185
<b>Weight</b>	<b>5</b>	<b>4</b>	<b>3</b>	<b>2</b>	<b>1</b>
Weighted Average	372,985				
Less Ongoing Depreciation	(8,603)				
Sub-Total	364,382				
Less State Taxes	6.5% (23,685)				
Taxable Base	340,697				
Less Federal Taxes	(115,837)				
Sub-Total	224,860				
Add Back Ongoing Depreciation/Amortization	8,603				
Decrease/(Increase) in Capital Expenditures	(9,000)				
Ongoing Earning Capacity	224,463				
Capitalization Multiple	x 4.4				
<b>Indicated Operating Value</b>	<b>= \$980,065</b>				
Capitalization Rate	÷ 22.9%				
<b>Indicated Operating Value</b>	<b>= \$980,065</b>				

# Weighting of Values in the Conclusion

## Conclusion of Value-Heavier Weight to Income Approach

	Indicated Value	Weight Percent
Asset Approach-Adjusted Net Asset Value Method	625,000	25.0%
Market Approach	350,000	0.0%
Income Approach	850,000	75.0%
<b>Calculated Weighted Average Conclusion of Value</b>	<b>\$793,750</b>	<b>100.0%</b>
<b>Rounded</b>	<b>\$794,000</b>	

## Conclusion of Value-Even Method Weighting

	Indicated Value	Weight Percent
Asset Approach-Adjusted Net Asset Value Method	625,000	33.3%
Market Approach	350,000	33.3%
Income Approach	850,000	33.3%
<b>Calculated Weighted Average Conclusion of Value</b>	<b>\$608,273</b>	<b>100.0%</b>
<b>Rounded</b>	<b>\$608,000</b>	

# Capitalization Rates/Multipliers

Ongoing Earning Capacity		230,280			
Capitalization Multiple	x	<u>4.4</u>			
Indicated Operating Value	=	<u>\$1,005,460</u>	$\frac{1}{22.9\%}$	=	4.4

Capitalization Rate	÷	<u>22.9%</u>			
Indicated Operating Value	=	<u>\$1,005,460</u>			

## Higher Cap Rate/Lower Multiple

Ongoing Earning Capacity		\$230,280			
Capitalization Multiple	x	<u>3.6</u>			
Indicated Operating Value	=	<u>\$822,427</u>	$\frac{1}{28.0\%}$	=	3.6

Capitalization Rate	÷	<u>28.0%</u>			
Indicated Operating Value	=	<u>\$822,427</u>			

# Discounts for Lack of Control & Marketability

## DLOC

- × Shares of stock or an LLC or partnership interest that is 50% or less in total ownership is worth less per share than if 51%+ is owned by an individual
- × Lack of control in a closely held company implies you are at the mercy of the controlling owner(s)
- × Substantial discounts may be necessary to attract an investor to purchase a minority interest in a closely held company
- × Could be in the range of 15% to 50%
- × How much research was done for this haircut?

# Discounts for Lack of Control & Marketability

## DLOM

- × The time required to convert an ownership interest to cash affects the level of marketability; factors that affect marketability:
  - × 100% ownership
  - × Distributions of earnings
  - × Active market or industry roll-up
  - × Key person
  - × Number and profile of owners e.g., family owned
  - × Restrictions on transfer of stock
- × Could be in the range of 10% to 35%
- × How much research was done for this haircut?

# Discounts for Lack of Control & Marketability

## Applying a DLOC and DLOM-Lower

Calculated Weighted Average Conclusion of Value	\$793,750
Subject Ownership Percentage	<u>100.0%</u>
	793,750
Less Discount for Lack of Control	<u>20.0%</u>
Sub-Total	635,000
Less Discount for Lack of Marketability	<u>10.0%</u>
Indicated Value	<u>\$571,500</u>
<b>Rounded</b>	<b><u><u>\$572,000</u></u></b>

## Applying a DLOC and DLOM-Higher

Calculated Weighted Average Conclusion of Value	\$793,750
Subject Ownership Percentage	<u>100.0%</u>
	793,750
Less Discount for Lack of Control	<u>25.0%</u>
Sub-Total	595,313
Less Discount for Lack of Marketability	<u>20.0%</u>
Indicated Value	<u>\$476,250</u>
<b>Rounded</b>	<b><u><u>\$476,000</u></u></b>



# Discounts for Lack of Control & Marketability

## New TN Law on DLOM Negates *Bertuca*

- × 110th Tennessee General Assembly passed House Bill 348 during the 2017 session; effective 7/1/2017
- × *“In determining the value of an interest in a closely held business or similar asset, all relevant evidence, including valuation methods typically used with regard to such assets without regard to whether the sale of the asset is reasonably foreseeable. Depending on the characteristics of the asset, such considerations could include, but would not be limited to, a lack of marketability discount, a discount for lack of control, and a control premium, if any should be relevant and supported by the evidence;”*

# Why Are Opposing Expert Values Different? Supposed Small Changes = Big Value Differences

			<u>Indicated</u> <u>Values</u>	<u>Difference</u>
<u>Normalization Differences</u>				
Compensation Adjusted to \$150k & \$125k			1,005,460	
Compensation Adjusted to \$225k & \$200k			628,881	(376,579)
<u>Weighting Differences in Economic Stream</u>				
Economic Earnings Stream Weighted Evenly			833,242	
Economic Earnings Stream Weighted Heavier to Current			980,065	146,823
<u>Weighting Differences in Conclusion</u>				
Conclusion of Value-Heavier Weight to Income Approach			794,000	
Conclusion of Value-Even Method Weighting			608,000	(186,000)
<u>Capitalization Rate/Multiplier Differences</u>				
	<u>Cap Rate</u>	<u>Multiplier</u>		
Lower Capitalization Rate/Multiplier	22.9%	4.4	1,005,460	
Higher Capitalization Rate/Multiplier	28.0%	3.6	822,427	(183,033)
<u>Applying a DLOC and DLOM</u>				
	<u>DLOC</u>	<u>DLOM</u>		
Higher Discounts	25.0%	20.0%	476,000	
Lower Discounts	20.0%	10.0%	572,000	96,000

# Interpretations of the Law

- × What interpretation of case law has the expert been told to follow?
- × Goodwill – Yes or No?
- × Tennessee has a well-established case law history that does not provide for the inclusion of **Personal Goodwill** (a.k.a. professional goodwill) as an asset of the marital estate, but does allow for the inclusion of **Enterprise Goodwill** (a.k.a. business goodwill)
- × However, things are murky these days

# Interpretations of the Law

## Personal Goodwill in a Tennessee Divorce

### **Hazard (1991) - No Goodwill Allowed**

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

### **Witt (1992) - Enterprise Goodwill Allowed**

*Witt v. Witt*, No. 01-A-019110CH00360, 1992 WL 52746 (Tenn. Ct. App. Mar. 20, 1992)

### **Eberting (2012) - Enterprise Goodwill Allowed**

*Eberting v. Eberting*, No. E2010-02471-COA-R3CV, 2012 WL 605512 (Tenn. Ct. App. Feb. 27, 2012)

### **Hartline (2013) – No Goodwill Allowed**

*Hartline v. Hartline*, No. E2012-02593-COA-R3CV, 2014 WL 103801 (Tenn. Ct. App. Jan. 13, 2014)

# **Interpretations of the Law**

## **Personal Goodwill in a Tennessee Divorce**

### **Barnes (2014) – Enterprise Goodwill Allowed**

*Barnes v. Barnes*, No. M2012-02085-COA-R3-CV, 2014 WL 1413931 (Tenn. Ct. App. Apr. 10, 2014)

### **Lunn (2015)-No Goodwill Allowed**

*Lunn v. Lunn*, No. E2014-00865-COA-R3-CV (Tenn. Ct. App. June 29, 2015)

### **Mabie (2017)-GW Allowed**

*Mabie v. Mabie*, No. W2015-01699-COA-R3-CV (Tenn. Ct. App. Jan 9, 2017)

**Thank You!**

**Robert Vance, CPA, ABV, CFF, CVA, CFP**



**Forensic & Valuation Services, PLC**

**901-507-9173**

**[www.forensicval.com](http://www.forensicval.com)**

**[rvance@forensicval.com](mailto:rvance@forensicval.com)**