

***Business Valuation –
Dissecting Closely Held Entities***

Presented by:

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Business Valuation Standards- SSVS1

- In June 2007, the AICPA Consulting Services Executive Committee issued Standards for Valuation Services No. 1 (“SSVS1)
- ALL CPAs must follow SSVS1 even if not a member of the AICPA
- AICPA Web site at www.aicpa.org/bvstandard

Business Valuation Standards- SSVS1

SSVS No. 1 specifies two types of engagements:

1. Valuation Engagements

- For valuation engagements, two types of written reports are permitted – detailed reports and summary reports

2. Calculation Engagements

- For calculation engagements, one type of written report is permitted – calculation reports

Oral reports are allowed for all engagements under the Standard

Business Valuation Standards- SSVS1

SSVS No. 1 applies to an engagement or any part of an engagement that estimates value when the member:

1. Applies valuation approaches and methods, and
2. Uses professional judgment in that application

Does not apply:

1. Value as part of an audit, review or compilation engagement
2. Exclusively for the purpose of determining economic damages (unless used to estimate value of a subject interest)
3. There is a jurisdictional exemption whereby the SSVS No.1 differs from published governmental judicial or accounting authority

Business Valuation Standards- Other Organizations

- National Association of Certified Valuators and Analysts (NACVA)-Professional Standards
- American Society of Appraisers (ASA)-Business Valuation Standards
- The Appraisal Foundation-Uniform Standards of Professional Appraisal Practice (USPAP)

Docs Necessary for a Business Valuation

1. Previous business val. performed within the past 5 years
2. Annual financial statements (balance sheet & income statement) for the last 5 years & year-to-date
3. Aged Accounts Receivable as of same year-to-date as latest financial statement
4. Detailed general ledgers for past 24 months; alternatively, QuickBooks backup file with password (*Litigation*)
5. Listing of any and all personal expenses or fringe benefits paid for by the company including, but not limited to, vehicle notes and expenses for those driven by owners, meals, travel, etc. for the last 5 years
6. Federal and state income tax returns, with all schedules, for the last 5 years

Docs Necessary for a Business Valuation

7. Fixed asset register or depreciation schedule
8. Schedule of officers', partners' or directors' compensation for the last 5 years (and W-2s)
9. Appraisals of real estate or specialty machinery
10. Brochures, price lists, catalogs, or other product information
11. Organization chart
12. Stockholder agreement or LLC/Partnership Operating agreement, including related stock option agreement
13. Buy-sell agreements & non-compete agreements
14. Written offers to purchase or sell company stock/assets

Docs Necessary for a Business Valuation

15. Details of transactions in the company's stock within the last ten years including buy-sell transactions and gift/estate transfers
16. List and description of patents, copyrights & trademarks
17. A completed Business & Industry Background document along with option to interview management

The Essence of a Business Valuation

Estimation of two primary components

1. Present Value of the future expected benefits
 - The Time Value of Money; a dollar today is worth more than a dollar in one year)
2. The risk related to receiving those future expected benefits

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

- 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
- Business owners can be held to values in personal financial statements submitted to banks
- Credentials and experience of business valuation analysts are *critical*

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

The Approaches to Valuation

1) Asset Approach

- Think of a balance sheet; Identifiable Tangible & Intangible Assets Adjusted to FMV – Liabilities

2) Market Approach

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

3) Income Approach

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

Choosing a Valuation Method

- A business is really only worth the present value of the cash flow over and above a “normal” owner compensation
- What is “normal”?
- How do they make their money, i.e. “value drivers”
- Size does matter
- Branding
- Staff
- Ancillary Services

Choosing a Valuation Method

The inclusion of both Personal and Enterprise Goodwill is implied using the valuation Approaches of Market and Income, but not Asset

Normalization

Normalizing/GAAP Adjustments

1. Personal expenses
 2. Unusual and/or extraordinary items
 3. Non-recurring and/or one-time items
 4. Non-operating assets
- Real estate, excess cash, obsolete inventory, etc.

Control Adjustments

1. Owner's compensation and perks
 2. Excessive distributions
 3. Non-operating assets
- Cars, airplanes, vacation homes, yachts, etc.

The Asset Approach

All of the Fred Jones, DDS Entities Adjusted Net Asset Value Method

	Unadjusted Balance Sheet Per Internal Books	Adjustments	Adjusted Balance Sheet
Cash	15,000	0	15,000
Accounts Receivable	0	65,000	65,000
Supplies	0	4,500	4,500
Equipment	55,000	155,000	210,000
Accounts Payable	0	(35,000)	(35,000)
Credit Cards	0	(9,500)	(9,500)
Business LOC	(20,000)	0	(20,000)
Payroll Taxes Due	(3,500)	0	(3,500)
Indicated Value, Net of Debt	<u>46,500</u>	<u>180,000</u>	<u>226,500</u>

The Market Approach

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory

Market Transaction Method Using The Goodwill Registry for General Dentistry

Total Value

Gross Revenues	1,285,000
Goodwill Registry Average Price/Rev %	<u>66.6%</u>
Indicated Selling Price - Includes Equipment	855,810
Adjusted Net Operating Assets	<u>16,500</u>
Indicated Value, Net of Debt	<u><u>872,310</u></u>

Total Goodwill Value

Gross Revenues (Collections)-2011	1,285,000
Goodwill Registry Average GW/Gross Revenues %	<u>49.2%</u>
Indicated Goodwill Included in Selling Price	<u><u>632,220</u></u>

The Income Approach

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory Capitalization of Earnings Method

	PC	PLLC
Net Income Before Tax	15,500	465,500
Normalizing Adjustments		
Actual Deducted Compensation	450,000	0
Mean Compensation for Independent Dentists*	(200,000)	(200,000)
Cash Flow Adjustment		
Depreciation & Amortization	40,000	40,000
Adjusted EBITDA	305,500	305,500
Less Ongoing Depreciation/Amortization Expense	(40,000)	(40,000)
Taxable Base	265,500	265,500
Less State Income Taxes	6.5% (17,258)	(17,258)
Sub-Total	282,758	282,758
Less Federal Taxes	35.0% (98,965)	(98,965)
Sub-Total	183,792	183,792
Add Back Ongoing Depreciation/Amortization Expense	40,000	40,000
Decrease/(Increase) in Capital Expenditures	(20,000)	(20,000)
Ongoing Earning Capacity	203,792	203,792

Normalizing



The Income Approach

Developing a Capitalization Rate using the Build-Up Approach

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory Capitalization Of Earnings Capitalization Rate

Risk-free Rate of Return	2.5%
Common Stock Equity Risk Premium	6.6%
Small Stock Risk Premium	9.1%
Company Specific Premium	
Depth of Management	3.0%
Importance of Key Personnel	4.0%
Diversification of Product Line	1.0%
Financial Structure	1.0%
Company Specific Premium	<u>9.0%</u>
Net discount rate	<u>27.2%</u>
Less Sustainable Growth	<u>2.0%</u>
Next Year Capitalization Rate	<u>25.2%</u>
Current Year Capitalization Rate	<u><u>24.7%</u></u>
Capitalization Multiple	<u><u>4.05</u></u>

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

The Income Approach

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory

Capitalization Of Earnings Indicated Value

Ongoing Capacity		203,792
Capitalization Multiple	x	4.05
Indicated Value, Net of Debt	=	<u><u>824,874</u></u>

Capitalization Of Earnings Indicated Value

Ongoing Capacity		203,792
Capitalization Rate	÷	24.7%
Indicated Value, Net of Debt	=	<u><u>824,874</u></u>

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory**Conclusion of Value**

	Indicated Value	Weight	Weighted Value
Capitalization Of Earnings Method	824,874	50%	412,437
Market Transaction Method	872,310	50%	436,155
Adjusted Net Asset Value Method	226,500	0%	0
Conclusion of Equity Value		100%	848,592
Rounded			849,000

Enterprise Goodwill Component Breakdown Using a Build-Up

Cash	15,000
Accounts Receivable	65,000
Supplies	4,500
Equipment	210,000
Accounts Payable	(35,000)
Credit Cards	(9,500)
Business LOC	(20,000)
Payroll Taxes Due	(3,500)
Total Goodwill (a plug figure using this build-up)	622,500
Conclusion of Equity Value Including Total Goodwill a/k/a/ Enterprise Value	849,000

Personal Goodwill in a Tennessee Divorce

- Fair Market Value standard inherently includes both Personal and Enterprise Goodwill when valuing with a going concern premise
- The inclusion of both Personal and Enterprise Goodwill is implied using the valuation Approaches of Market and Income, but not Asset
- Personal goodwill is generally not to be considered in the valuation of professional practices and small, closely-held businesses primarily dependent upon the individual for success

Personal Goodwill in a Tennessee Divorce

Hazard v. Hazard

- Dr. Hazard's practice was highly specialized and very dependent upon personal referrals from other physicians
- Goodwill in a professional practice is not a marital asset subject to equitable distribution
- Sole practitioner professional practice is to be valued using the "net tangible assets with ascertainable value." Cites *Smith v. Smith*
- Net Asset Value a.k.a. Net Book Value

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

Personal Goodwill in a Tennessee Divorce

Witt v. Witt

- 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
- Dr. Witt's clinic was found to have separate good-will that was not directly related to his professional or personal goodwill
- Size Does Matter

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

Personal Goodwill in a Tennessee Divorce

Eberting v. Eberting

- Orthodontia practice value at FMV by Vance at \$700k; included Enterprise (not Personal) Goodwill
- Opposing expert valued practice At \$224k (net book value with no Goodwill)
- 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

Allocating Personal vs. Enterprise Goodwill

Find an objective method to analyze subjective data

Multiattribute Utility Model (MUM)

Decision making matrix for applications such as:

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

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%

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory**Conclusion of Value**

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Allocating Personal & Enterprise Goodwill

Fred Jones, DDS, PC (PLLC) d/b/a Mid-South Smiles Factory Allocation of Goodwill Between Personal and Enterprise

Estimated Personal GW per MUM	268,106	43.1%
Estimated Enterprise GW per MUM	354,394	56.9%
Total Goodwill from Build-Up	<u>622,500</u>	<u>100.0%</u>

Estimated "Divorce" Value Available for Equitable Distribution

Conclusion of Equity Value Including Total Goodwill	849,000
Less Estimated Personal GW per MUM	<u>(268,106)</u>
Total "Divorce" Value	<u>580,894</u>
Rounded	<u>581,000</u>

Calculating Discounts and Premiums

Depend on the interest to be valued and the techniques used to establish the value conclusion

- Discount for lack of control (DLOC)
- Premium for control
- Discount for lack of marketability (DLOM)
- Key person discount

Calculating Discounts and Premiums

Discount for Lack of Control a/k/a Minority Interest Discount

- 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

Calculating Discounts and Premiums

Discount for Lack of Marketability

- The time required to convert an ownership interest to cash affects the level of marketability
- Factors that affect marketability
- 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

Thank You!

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