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Thought Leadership in Family Law Valuation Issues

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Insights

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We welcome reader comments, suggestions, and questions. We welcome reader recommendations with regard to thought leadership topics for future *Insights* issues. In particular, we welcome unsolicited manuscripts from legal counsel, accountants, bankers, and other thought leaders involved in the valuation and forensic services community. Please address your comments or suggestions to the editor.

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Thought Leadership in Family Law Valuation Issues

Editor for This Issue: Justin M. Nielsen

Celebrating 50 Years of Thought Leadership

Forethoughts

This *Insights* issue provides thought leadership with regard to the financial planning, economic analysis, forensic accounting, and valuation aspects of family law. The discussions in this *Insights* issue consider practical procedures for legal counsel working with a valuation specialist, the differences between a calculation engagement and a valuation engagement, the performance of valuation review engagements, and the identification and valuation of goodwill—and of intellectual property.

Family law counsel and parties to a marital dissolution often deal with complex issues, including the equitable division of the marital estate assets, the valuation of personal and professional goodwill, the valuation of family-owned businesses and professional practices, the valuation of professional licenses and intellectual property, the analysis of reasonable alimony/spousal maintenance payments, and the analysis of reasonable compensation for family-owned company and professional practice owners.

Family law statutes and judicial precedent vary from state to state. Further, many of these statutory and judicial guidelines provide conflicting or unclear guidance with regard to the property distribution of a marital estate. This is why legal counsel should provide legal instructions and legal directions to valuation analysts and forensic accountants in any family law engagement.

Each discussion presented in this *Insights* issue was developed by valuation analysts with significant experience in family law matters. Willamette Management Associates analysts regularly provide forensic analysis and valuation consulting services relating to family law matters. Our valuation services include (1) the development and issuance of fair value and fair market value opinions, (2) the independent review and rebuttal of opposing expert valuation reports, (3) forensic analyses, and (4) reasonableness of compensation analyses. In addition, our analysts provide testifying expert and related litigation support services.

About the Editor

Justin M. Nielsen

Justin Nielsen is a vice president of the firm, and he is located in our Portland, Oregon, office. His practice includes valuation engagements for the firm such as income tax planning and compliance engagements, employee stock ownership plan administration engagements, and gift and estate tax planning engagements. In addition, Justin specializes in matters related to shareholder/commercial litigation and family law. He has extensive experience providing business valuation, financial advisory, and forensic accounting services in a family law context.

Prior to joining Willamette Management Associates, Justin was a managing consultant for LECG and Bates Group, LLC, in Lake Oswego, Oregon. Justin routinely provides forensic accounting services, securities litigation and business valuation services, and directly performed business, stock, and intangible asset valuation services for transaction pricing and structuring (merger, acquisition, and restructuring), forensic analysis, fraud, and dispute resolution (including dissenting shareholder appraisal actions), taxation planning and compliance (federal income, gift, and estate tax), employee corporate ownership, strategic information and planning, regulatory compliance, bankruptcy and reorganization, and fiduciary advice and financial counseling.

Justin has testified on numerous occasions in Financial Industry Regulatory Authority/Securities Industry and Financial Markets Association arbitration forums related to securities damages.

Justin holds a bachelor of science degree in finance from Northern Arizona University and a masters degree in business administration (finance emphasis) from the University of New Mexico. He is a certified valuation analyst (CVA) granted by the National Association of Certified Valuators and Analysts. Justin currently serves on the Dress For Success Oregon advisory board, as well as on the Dress For Success Oregon finance committee.

Justin applies his experience and expertise in both business valuation and forensic services to assist legal counsel and parties to family law matters.

Thought Leadership Discussion

Practical Guidance to the Family Law Counsel Working with a Valuation Specialist

Robert F. Reilly, CPA

When the marital estate includes a closely held business, a business ownership interest, debt or equity securities, or intangible assets, the family law counsel ("counsel") may retain a valuation analyst ("analyst") who specializes in the valuation of such financial assets. The counsel may retain such a valuation specialist when the marital estate ownership interest includes shares in a family-owned or otherwise closely held company, partnership interests in a professional practice, a professional license, or family-owned intellectual property rights. This discussion summarizes some of the issues that counsel may consider in the selection of such a valuation specialist. In addition, this discussion summarizes the development procedures and the reporting procedures with regard to such a family-law-related business or intangible asset valuation. Counsel should be generally familiar with the professional standards and practices for the valuation development and the valuation reporting related to such marital estate financial assets. This is because, in addition to retaining the analyst, the counsel will have to work with, rely upon, examine, and defend the selected analyst—and the analyst's valuation expert report. And, in a deposition or at trial, the counsel may have to cross-examine an opposing analyst—and respond to the opposing analyst's valuation expert report.

Introduction

When there is a controversy regarding the ownership or the distribution of a closely held business ownership interest in the marital estate, the family law counsel ("counsel") may retain a valuation analyst ("analyst") who specializes in such valuation-related forensic analyses.

Such closely held business ownership interests may include the stock (or limited liability company membership units) of the family-owned or otherwise closely held company, the partnership units of a professional practice (or a professional services company), a practitioner's professional license, and family-owned intangible assets and intellectual property rights.

As explained below, counsel may look for an analyst who has specialized experience and expertise in at least one of the following:

1. Valuing the subject type of family-owned closely held business ownership interest
2. Conducting valuations in the subject entity's industry or profession
3. Conducting analyses in a family law or similar forensic environment
4. Providing testifying expert services at deposition and/or at trial.

This discussion provides practical guidance to counsel with respect to selecting and working with a valuation specialist in a family law matter. This discussion summarizes the typical development procedures and the typical reporting procedures with respect to the family-law-related valuation of such financial assets. And, this discussion summarizes the professional standards and practices that the analyst will typically follow in the family-law-related valuation.

In other words, this discussion summarizes what the counsel needs to know to retain and work with an analyst in the valuation of the marital estate's business ownership interests.

Considerations Related to Selecting the Valuation Specialist

Counsel will exercise due diligence in selecting the valuation consulting firm—and the individual analyst—to conduct the valuation of the marital estate's closely held business, business ownership interest, securities, or intangible assets.

Some of the criteria that counsel may consider during the valuation specialist selection process include the following:

1. The qualifications (experience and expertise) of the valuation services firm
2. The qualifications (experience and expertise) of the individual valuation analyst
3. Any prior relationships of the valuation services firm with the subject business

Considerations regarding the Valuation Services Firm

There are many types of professional services firms that provide financial asset valuation services in family law matters. Such professional services firms include public accounting firms, industry-specialist consulting firms, valuation groups within general financial advisory services firms, business valuation firms, forensic analysis firms, economic consulting firms, and many others.

Some of these firms may be very small, including sale practitioners and sole professional practices. Some of these firms may be quite large, with dozens of officers and hundreds of practitioners.

Some of these professional services firms specialize in the analysis of certain types of business ownership interests, such as closely held companies, closely held business ownership interests and securities, professional practices or licenses, or intangible assets and intellectual property. Some professional firms specialize in the analysis of certain industries or professional practice specialties.

Some of these professional firms specialize in controversy-related forensic analyses; these firms primarily specialize in providing consulting expert services and testifying expert services. And, some professional firms provide valuation services for a broad variety of purposes, including transactions, taxation, financial accounting, corporate planning—as well as litigation support.

The qualifications of each valuation services firm can be demonstrated in different ways. Some counsel may consider retaining a firm that specializes in performing the valuation of marital-estate-owned business interests. Other counsel may prefer to work with a firm that is more generalist—that is, a firm that does not focus exclusively on family law engagements or other types of litigation-related controversies.

Nonetheless, the selected professional firm should be able to demonstrate experience and expertise related to:

1. working within a controversy environment and
2. conducting valuation analyses with a forensic analysis component.

And, the counsel may be particularly interested in the professional firm's relevant valuation experience and expertise:

1. in the subject company industry or subject professional practice specialty area and
2. in the family-law-related controversy discipline.

Important Issues in the Family-Law-Related Valuation

There are relatively few areas that distinguish family law valuations from other private company or professional practice valuations. However, the professional services firm—and the selected individual analyst—should be familiar with such differences.

For example, in family-law-related business and security valuations:

1. the appropriate standard of value and the appropriate premise of value may vary by jurisdiction—and may be different from the standards and premises applied in business and security valuations performed for transaction, taxation, or other purposes;
2. the identification and the valuation of the personal goodwill component of the subject closely held business enterprise may be an important issue;

3. the measurement of any value appreciation (or depreciation) between two dates (e.g., a date of marriage and a date of filing for a divorce) may be an important issue;
4. the amount of any extraordinary (i.e., above the industry average) business value appreciation during the marriage period may be important issue;
5. the valuation of the subject business on multiple dates (e.g., the date of the spousal separation, the date of the filing for divorce, the trial date, etc.) may be an important issue; and
6. the use of forensic accounting procedures—to identify hidden assets, company-paid personal expenditures and the like—may be an important issue.

Considerations regarding the Valuation Analyst

The professional qualifications of the individual analyst are also important. Since the individual analyst will likely be providing testifying expert services at deposition or at trial (or both), the professional qualifications of the individual analyst should (1) impress the finder of fact and (2) withstand rigorous contrarian scrutiny.

While assessing the professional qualifications of the individual analyst, the counsel may inquire about the analyst's personal experience in conducting valuations:

1. related to the subject business ownership interest,
2. in the subject entity's industry, and
3. within a litigation or forensic environment.

For further reading on this subject, see "Professional Designations: Evaluating Expert Witness Credentials in Divorce Cases Involving Professionals" (Chapter 23), by Charlene Blalock and Charles Wilhoite, in *Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner*, Ronald L. Brown, ed. (New York: Wolters Kluwer, 2017)

In terms of education, many valuation analysts have formal education in finance, accounting, and/or economics. In the same respect, many (but not all) analysts hold one or more professional accreditations that are related to the business valuation discipline.

There is no statutory, judicial, or regulatory requirement that the analyst in a family law matter holds a valuation-related professional credential. Many industry consultants, economists, college professors, forensic accountants, and other types of consultants provide family-law-related valuation services—without having earned a business-valuation-related professional credential.

Nonetheless, counsel should be aware of the types of valuation professional organizations ("VPOs") that offer valuation-related training, examination, credentialing, and continuing education programs.

Some of the professional accreditations—and the related VPOs—in the business valuation profession include the following:

1. The accredited senior appraiser ("ASA") business valuation credential is granted by the American Society of Appraisers.
2. The certified business appraiser ("CBA") credential was previously granted by the Institute of Business Appraisers ("IBA") (see explanation below).
3. The certified valuation analyst ("CVA") credential is granted by the National Association of Certified Valuators and Analysts ("NACVA").
4. The accredited in business valuation (ABV) credential is granted by the American Institute of Certified Public Accountants ("AICPA").

In 2008, the IBA merged into NACVA. While NACVA no longer grants the CBA credential to new valuation candidates, it does support and maintain the CBA program for the current CBA credential holders.

It is noteworthy that each of these VPOs has developed its own set of requirements in order for a candidate to earn its professional credential. However, generally, each of the VPO credentialing requirements include college education, a minimum amount of practical experience, attendance at courses and technical training programs, reviews of demonstration reports, recommendations of current credentialed members, and the passing of a comprehensive technical examination.

In addition, each of the VPOs have ongoing ethical standards and continuing professional education requirements.

In addition to the business-valuation-specific credentials, it is noteworthy that many family-law-related valuation practitioners are either a certified public accountant ("CPA") or a chartered financial analyst ("CFA").

The CPA credential involves a uniform national examination and state-specific accountancy licensing requirements. Many CPAs are (but are not required to be) members of the AICPA. The CFA credential is granted by the Chartered Financial Analyst Institute ("CFAI").

It is noteworthy that each of the four above-mentioned VPOs (i.e., the ASA, IBA, NACVA, and AICPA) have promulgated their own set of professional standards. (In 2008, the IBA professional standards were conformed to—and then merged into—the NACVA professional standards.)

The most voluminous of these various sets of business valuation professional standards is the AICPA *Statement on Standards for Valuation Services* ("SSVS"). The title of SSVS is *Valuation of Businesses, Business Ownership Interests, Securities, and Intangible Assets.*

Unrelated to any of the above-mentioned VPOs, the Appraisal Standards Board of the Appraisal Foundation promulgates the *Uniform Standards of Professional Appraisal Practice* ("USPAP"). The USPAP standards numbers 9 and 10 relate to the development and the reporting (respectively) of a closely held business valuation or an intangible asset valuation.

Prior Relationship of the Valuation Services Firm and the Subject Company

The counsel may also inquire about independence issues when retaining the selected valuation services firm or the individual analyst. A concern may arise if the valuation services firm works regularly for the subject closely held company or professional practice.

That association may present the appearance of a bias. That is, the valuation services firm may appear to be partial to the interests of the "inside spouse"—that is, the spouse that regularly retains the services of that professional firm at the subject company or professional practice.

Considerations Related to Reviewing the Business Interest Valuation Report

The first step in the counsel's review of the family-law-related business or security valuation report is to become familiar with the business valuation process. The counsel should understand the level of due diligence and analysis that was conducted by the analyst in order to reach the closely held business or security valuation conclusion.

For example, the counsel may be interested in whether the analyst will conduct interviews with the subject company/practice management—or with other parties—during the course of the valuation. These interviews may be conducted to:

1. understand the nature and history of the subject closely held company or professional practice and
2. discuss the historical and prospective performance of the subject closely held company or professional practice.

If all of the parties agree, the counsel may arrange for these interviews to take place in person at the subject company/practice facilities. This arrangement may provide the analyst with the opportunity to tour the subject company/practice facilities and to view the physical condition of the subject company/practice tangible assets.

Again, if all of the parties agree, the interview process may also allow the analyst to gain a better understanding of the subject company/practice (1) products and/or services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

The family-law-related business or security valuation analysis may be documented with a narrative valuation report. As stated above, each of the above-listed VPOs has issued professional standards with regard to the reporting of closely held business, security, and intangible asset valuations.

The following sections provide a summary of the typical contents of the family-law-related closely held business or security valuation report. This summary may be of interest to the family law counsel involved in the valuation of the marital estate's financial assets.

Objective of the Analysis

The family law business or security valuation report should describe the objective of the analysis. That objective statement should include the following:

1. A description of the subject business ownership interest
2. The intended standard of value
3. The valuation "as of" date

Each of these topics is discussion below.

Description of the Subject Ownership Interest

The family law business or security valuation report should adequately describe the marital estate's business ownership interest subject to valuation. Typically, this description includes the following:

1. The number of shares (or other ownership units) subject to valuation
2. The name of the closely held company or professional practice
3. The form of ownership

For example, a description of the valuation subject may read as follows:

> We estimated the fair market value of 20,000 shares of the voting common stock of ABC, Inc. ("ABC"). ABC is a corporation organized in the State of Delaware.

The above description provides the finder of fact in the family law matter with (1) the exact number of shares (or units) that are subject to the valuation and (2) the name of the closely held company/practice that is the subject of the analysis.

Standard of Value and Premise of Value

The family law business or security valuation report should describe the standard of value (or definition of value) that is concluded in the analysis.

Most jurisdictions have jurisdiction-specific standards of value and premises of value that are appropriate for family law purposes.

Counsel should inform the analyst—as a legal instruction to the analyst's assignment—of the appropriate standard of value in the subject family law matter.

These jurisdiction-specific standards (or definitions) of value are usually based on statutory authority or judicial precedent. Often (but not always), these standards (or definitions) of value are generally consistent with the fair market value standard of value.

There are several definitions of fair market value, but most of these definitions contain similar language. Fair market value is generally defined to be the price at which the property would change hands between a willing buyer and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some analysts expand this definition to add that the willing buyer and seller are hypothetical parties—as opposed to a specific buyer and/or a specific seller. Nevertheless, the important elements of the fair market value definition remain the same.

That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information concerning the subject business ownership interest.

The family law business or security valuation report should also describe the premise of value—that is whether the subject closely held company/practice was valued:

1. as a going-concern business enterprise or
2. based on a liquidation premise of value.

If the analyst did not value the subject closely held company/professional practice as a going concern, the valuation report should discuss the rationale for conducting the valuation in that manner.

Purpose of the Analysis

The family law business or security valuation report should describe the purpose of the analysis.

Typically, the purpose of the business or security valuation report is to provide information for the finder of fact in the family law matter.

In any event, the business or security valuation report should describe the purpose of the analysis so there is no confusion over the intended use of the valuation report.

Valuation Date and Report Date

The family law business or security valuation report should indicate (1) the valuation date and (2) the report date.

The valuation date is the date "as of" which the analyst's opinion of value applies. The report date is the date the valuation report was prepared.

For example, the valuation report may summarize the fair market value of the ownership interest as of December 31, 2018. However, the valuation report may not be prepared until April 15, 2019. In this case, the valuation date is December 31, 2018, and the report date is April 15, 2019.

In this example, the counsel should understand that the valuation opinion takes into account all known and knowable information available through December 31, 2018. Under the fair market value standard of value, the valuation report will typically not take into account any information that became available, or known, subsequent to the valuation date.

Level of Value and the Prerogatives of Ownership Control

During the valuation analysis, the analyst will gain an understanding of the ownership control attributes (or the lack thereof) associated with the marital estate's business ownership interest. For example, the subject business ownership interest may be one of the following:

1. A 35 percent noncontrolling ownership interest in the closely held company or professional practice total equity
2. A 51 percent ownership interest that has some ownership control level attributes
3. An 80 percent ownership interest that has many of the features of absolute ownership control

The family law valuation report should clearly identify the subject business ownership interest and describe the prerogatives of ownership control that accompany the subject ownership interest.

For example, a 35 percent ownership interest may allow the holder to elect one board member but may not provide any other opportunities to effectuate change at the closely held company/practice. In this case, the ownership interest would normally be valued as a noncontrolling ownership interest.

In contrast, a 51 percent ownership interest may allow the holder to exercise ownership control over several aspects of the closely held company or professional practice. These prerogatives of control may include, but are not limited to the following:

1. The appointing of new board members and management personnel
2. The changing or renegotiation of management compensation and perquisites
3. The issuing or repurchasing of the closely held company shares
4. The issuing or repaying of the closely held company debt
5. The changing of the strategic direction of the closely held company

In this case, the family law business or security valuation report should:

1. identify the specific control attributes of the subject business ownership interest and
2. explain how these attributes were considered in the valuation process.

A holder of an 80 percent ownership interest may have not only the prerogatives of control listed in the previous paragraph. That ownership interest holder may also have the ability to sell the closely held company/practice or substantially all of the closely held company/practice assets. Once again, this level of ownership control should be identified in the family law valuation report and properly reflected in the valuation analysis.

In addressing the level of ownership control within the business or security valuation report, the analyst may also discuss the distribution of stock or unit ownership. This may be particularly relevant in situations where no one shareholder has a controlling ownership interest in the closely held company stock or partnership units.

Sources of Information

A family law business or security valuation report will typically include a section that lists the data and documents that the analyst relied on to develop the closely held company or professional practice valuation opinion.

By reviewing this section of the family law business or security valuation report, counsel will have an understanding of the documents that were considered in the valuation process, including both publicly available documents and non-publicly-available documents.

The sources of information list should include not only the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data), but the non-financial-related documents as well (e.g., customer or supplier contracts, leases, licenses, corporation documents).

When it is properly prepared, the sources of information list may enable an opposing analyst to identify the documents necessary to replicate the family law business or security valuation analysis.

Description of the Subject Closely Held Company or Professional Practice

A family law valuation report will provide an adequate description for the reader to understand the fundamental position of the subject closely held company or professional practice.

A comprehensive description of the business of the subject closely held company/practice will normally include the following:

- A discussion of the history of the closely held company/practice and its current position
- A description of the products and/or services provided by the closely held company/practice
- A description of the markets served by the closely held company/practice

- A description of the environment in which the closely held company/practice competes and how the closely held company is positioned within that environment
- A discussion of the qualifications of closely held company/practice management and its depth
- A discussion of significant relationships with related parties, customers, suppliers, and so on
- A discussion of pending litigation that is significant to the closely held company/practice
- A review of recent transactions in the closely held stock/partnership units (if any)
- A discussion of any recent offers received for the closely held company/practice or its assets

Overview of General Economic Conditions and Industry Conditions

The family law business or security valuation report should provide an overview of the general economic conditions and industry-specific factors that affect the valuation of the subject closely held company or professional practice.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject closely held company/practice.

This section of the valuation report may also include a discussion of leading economic indicators that may provide insight into the future performance of the closely held company/practice.

The industry overview section of the family law valuation report will typically discuss how the industry operates and recent trends affecting companies within the subject industry. The section may also describe the closely held company's position in the industry and its market share relative to other competing companies.

Subject Company or Professional Practice Financial Performance

As part of the business or security valuation process, the analyst will assess the financial performance and financial condition of the closely held company or professional practice. A summary of this financial analysis should appear in the family law business or security valuation report.

The historical financial performance of the closely held company/practice is reflected on the subject company/practice income statements and cash flow statements. The family law valuation report may include a discussion of the following:

- The historical growth or decline in revenue
- The historical growth or decline in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit)
- The historical growth or decline in profit margins
- The historical growth or decline in cash flow
- The historical payments of dividends

The analyst will also review the closely held company/practice balance sheet to assess its financial condition. The family law business or security valuation report may contain a discussion of the following balance-sheet-related items:

- The closely held company/practice liquidity and working capital position
- The closely held company/practice asset utilization by means of various financial ratios (e.g., accounts receivable turnover, inventory turnover, etc.)
- The closely held company/practice tangible asset base
- The closely held company capital/practice structure and leverage

The financial analysis will include not only a discussion of certain financial statement trends but also a discussion of what factors caused the respective trends.

The family law valuation report may also include a discussion of how the closely held company/practice performed relative to other companies in the industry. This comparative financial analysis typically identifies the financial strengths and weaknesses of the closely held company/practice compared to other guideline/competing companies.

The comparative analysis will help the counsel—and the finder of fact—to understand how the closely held company/practice performed relative to other companies in the industry. This comparative performance analysis may be based on such factors as growth, profitability, and volatility.

Financial Statement Normalization Adjustments

When appropriate, the analyst may make financial statement normalization adjustments to (1) the closely held company/practice and (2) the selected guideline publicly traded companies.

The financial statement normalization adjustments are necessary so that the closely held company/practice financial performance is on the same basis as the selected guideline companies' financial performance.

Some of the more common financial statements adjustments made to the closely held company/practice include the following:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory (and other) accounting methods
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements
- Adjustments for excess compensation or other benefit expense

The family law business or security valuation report should identify the financial statement adjustments and adequately explain the rationale for each adjustment.

Generally Accepted Business Valuation Approaches and Methods

There are three generally accepted business valuation approaches: the market approach, the income approach, and the asset-based approach.

The family law business or security valuation report should clearly describe which approaches—and which valuation methods within each approach—were used in the analysis. In the same respect, the family law valuation report should explain which approaches were not used in the analysis—and why they were not used.

With regard to the market approach, and specifically the guideline publicly traded company method and the guideline merged and acquired company (or guideline transactions) method, the family law business or security valuation report should include the following:

- The criteria used to select the guideline companies. The selection criteria may include standard industrial code, business description, size, growth, profitability or a combination of several relevant factors.

- A description of each selected guideline company. This description may include a discussion of the selected guideline company's business, its products and/or services, and its position in the market.

  Other information, such as whether the guideline company recently completed acquisitions, may also be relevant.

- The market-derived valuation pricing multiples that were selected for the analysis. These pricing multiples may include invested capital pricing multiples or equity pricing multiples. Industry-specific factors often influence the type of market pricing multiples that are used in the stock/units valuation analysis.

  For example, the valuation of a commercial bank may involve the application of market-derived valuation pricing multiples that are based on (1) the market value of equity and (2) earnings and/or book value of total equity capital.

  In contrast, the valuation of a manufacturing company may involve the application of market-derived valuation pricing multiples that are based on (1) the market value of invested capital and (2) invested capital earnings and/or invested capital cash flow.

- The rationale for selecting the market-derived invested capital pricing multiples that are applied to the closely held company/practice financial fundamentals. The reader of the family law valuation report should be able to understand the analyst's thought process for arriving at the selected valuation pricing multiples.

  The application of an average or median market-derived pricing multiple, but without support for such a selection, is typically not appropriate.

- The rationale for the selected weighting used in the valuation synthesis. For example, if the value indication based on projected cash flow is given more (or less) weight than the value indication based on trailing 12-month cash flow, the family law valuation report should explain why.

With regard to the income approach, and specifically the discounted cash flow method, the family law business or security valuation report should include the following:

- A discussion of who prepared the financial projections. The projections are often prepared by closely held company/practice management. In other cases, the projections are prepared by the analyst with input from closely held company/practice management.

In the case of management-prepared financial projections, the valuation report may explain how the analyst tested the reasonableness of the financial projections. In all cases, the financial projections should be supportable.

- The appropriate matching of financial projections and the present value discount rate. For example, if the discounted cash flow method analysis incorporates a projection of invested-capital-basis cash flow (or cash flow available to invested capital), then the present value discount rate should be the weighted average cost of capital.

  In contrast, if the financial projections are of the cash flow available to equity capital, then the present value discount rate should be the cost of equity capital.
- A discussion of the cost of capital components. This discussion may include an explanation of how the analyst estimated the cost of equity capital, the cost of debt capital, and the weighting of each cost component in a weighted average cost of capital calculation.
- Support for the selected residual value pricing multiple or residual value direct capitalization rate. In many family law business or security valuations, the residual value calculation may represent a significant portion of the total company/practice value.

  As a result, the selected residual value pricing multiple, or the residual value direct capitalization rate, often has a substantial effect on the concluded value of the closely held company/practice. The rationale for the selected residual pricing multiple, or the selected residual growth rate within the residual direct capitalization rate, should be adequately explained and supported.

The generally accepted asset-based approach valuation methods include the asset accumulation method and the adjusted net asset value method. While the income approach and the market approach valuation methods focus on the subject company/practice income statement, the asset-based approach methods focus on the company/practice balance sheet.

The application of the asset-based approach involves a valuation of both:

1. all of the company/practice assets—both tangible and intangible—and
2. all of the company/practice liabilities—both recorded and contingent.

The asset accumulation method involves the discrete revaluation of all of the subject company/practice assets and liabilities. The adjusted net asset value method involves the collective—or aggregate—revaluation of all of the company/practice accounts. This revaluation procedure often involves the application of the capitalized excess earnings method ("CEEM").

"[C]ounsel should be aware that the asset-based approach may be used to estimate the going-concern value of an operating company business enterprise."

Typically, in the application of the asset-based approach, at least one intangible asset category is revalued by the application of either (1) the multiperiod excess earnings method ("MEEM") or (2) the CEEM.

In any event, counsel should be aware that the asset-based approach may be used to estimate the going-concern value of an operating company business enterprise. That is, the asset-based approach (unless specifically applied) does not include the liquidation value of the subject going-concern closely held company.

Finally, before the application of any valuation adjustments, the asset-based approach typically concludes a marketable, controlling ownership interest level of value.

Valuation Synthesis and Conclusion

The family law business or security valuation report should contain a section that provides (1) a valuation synthesis of alternative value indications and (2) a final conclusion of the subject company/professional practice value.

The following factors should be included in this section of the family law business or security valuation report:

- A discussion of how each value indication from each valuation approach and valuation method was weighted in the value conclusion. An explanation should be provided for each of the selected weightings.
- A discussion of any valuation adjustments—premiums or discounts—that may be appropriate to reflect the ownership control, or lack of ownership control, attributes of the subject marital estate's business ownership interest.

  The discussion of the application of valuation adjustments should include:

1. the rationale for each valuation premium or valuation discount and
2. the supporting data or factors used to estimate the valuation premium or valuation discount.

The estimated ownership control premium should reflect the adjustments that were made to the closely held company/practice financial statements. In other words, if the analyst adjusted the subject company/practice financial performance for ownership control level/discretionary items, then the analyst should not reflect these same control price benefits a second time through the application of an ownership control premium.

- A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis. These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the closely held company/practice valuation analysis.
- A discussion of the illiquidity, or lack of marketability, of the subject marital estate's business ownership interest. Most noncontrolling ownership interests in closely held companies or professional practices are relatively illiquid.
- A discussion of any contingent and limiting conditions. The family law business or security valuation report should contain language that lists any contingent and limiting conditions regarding the analysis and opinion.

After reviewing the family law business or security valuation report in its entirety, counsel should be in a position to understand the following issues:

- Was the valuation report readable and easy to understand or was it filled with undefined valuation terms and jargon?
- Was the valuation report comprehensive and organized in a logical manner?
- If more than one valuation date is considered, has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., subject company/practice performance, market performance, or a combination of the two)?
- Has the subject company/practice financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Which generally accepted business valuation approaches and methods were used in the analysis—and why were they applied?
- Does the closely held company or professional practice valuation conclusion seem reasonable given (1) the historical and projected financial performance of the subject company/practice, (2) the relevant market-based data, and (3) the relevant general economic conditions and industry-specific conditions?
- Does the valuation conclusion properly reflect the relevant family law standard of value, premise of value, and other purpose-specific factors and/or legal instructions?

Summary and Conclusion

When the marital estate includes a closely held business, a business ownership interest, securities, or intangible assets, the family law counsel may retain a analyst who specializes in the valuation of such financial assets.

The counsel may retain such a valuation specialist when the marital estate's business ownership interest includes shares in a closely held company, partnership interests in a professional practice, a practitioner's professional license, or family-owned intellectual property rights.

This discussion summarized some of the issues that counsel may consider in the selection of such a valuation specialist. In addition, this discussion summarized the valuation development procedures and the valuation reporting process related to such a business, security, or intangible asset valuation.

Counsel should be generally familiar with the professional standards and practices related to the business or security valuation reporting and valuation development. This is because, in addition to retaining the analyst, the counsel will have to work with, rely upon, examine, and defend the work product of the selected valuation analyst. And, in a deposition or at trial, the counsel may have to cross-examine an opposing analyst—and respond to the opposing analyst's work product.

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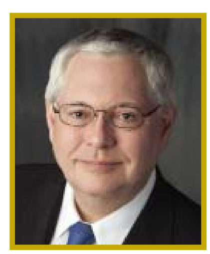

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Calculation Engagement versus Valuation Engagement in a Family Law Context—Can a Valuation Engagement be More Efficient and Effective?

Justin Nielsen

Within a family law context, legal counsel ("counsel") to each marital estate party may retain a valuation analyst ("analyst") to assist with certain equitable property settlement aspects associated with the marital dissolution. Namely, the analyst may be retained to estimate the value of certain marital property, such as a family-owned business ownership interest. In such instances, counsel may retain the analyst to perform either (1) a calculation engagement or (2) a valuation engagement. This discussion (1) highlights the differences between a calculation engagement and a valuation engagement within a family law context and (2) explains when each engagement may be most appropriate, efficient, and effective. This discussion also includes a summary of certain business valuation professional standards and practices associated with each type of engagement.

Introduction

Over the last several decades, Americans have been getting divorced at an increasing rate. Within these increasing marital dissolutions, both marriage parties are typically represented by family law legal counsel ("counsel").

Similarly, counsel rely on valuation analysts and forensic accountants (collectively, "analysts") in order to assist with certain property settlement aspects associated with the marital dissolution. In particular, analysts assist with estimating the value of certain marital property, and more specifically, assist with estimating the value of certain closely held business ownership interests that may be included in the marital estate.

According to the American Institute of Certified Public Accountants Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* ("SSVS"), there are two types of engagements that analysts may perform to estimate the value of a marital estate closely held business interest:

1. A valuation engagement
2. A calculation engagement.[1]

Generally, these are the two types of engagements for which an analyst would be retained by family law legal counsel within a marital dissolution context.

According to SSVS, a calculation engagement is performed when:

1. the analyst and the client (e.g., counsel)[2] agree in writing on the specific valuation approaches and methods the analyst will

use in calculating the value of the closely held business ownership interest and

2. the analyst calculates the value of the closely held business ownership interest according to the written agreement.

Further, according to SSVS, a valuation engagement is performed when:

1. the engagement letter specifically requires the analyst to estimate the value of the closely held business ownership interest(s) and
2. the analyst estimates the value of the closely held business ownership interest(s) and is not required to select certain valuation approaches (i.e., the analyst is permitted to apply the valuation approaches and methods he or she feels is most appropriate for the engagement).

This discussion explains the differences between a calculation engagement and a valuation engagement within a family law context. This discussion considers the appropriateness of each engagement within certain family law frameworks (including which of the two engagements should be utilized when the family law matter will likely end in trial or in arbitration).

Also, this discussion summarizes certain business valuation professional standards associated with the reporting of each engagement (i.e., a calculation report versus a valuation report).

Calculation Engagement versus Valuation Engagement

When an analyst is retained by counsel to provide services in a family law context, typically the analyst is retained through what is termed an "engagement to estimate value."

While the analyst may be retained to provide other services within a family law context, such as general consulting or forensic accounting services, this discussion will focus on the situation where an analyst is retained to estimate the value of a closely held business ownership interest that is held within a marital estate.

SSVS provides guidance to the valuation profession with regard to the types of services, and more specifically the types of engagements and reports, that the analyst can provide in a family law context.

To avoid any relevant analysis being excluded from the family law proceedings, it is important for the analyst to adhere to relevant business valuation professional standards when being retained to estimate the value of a closely held business ownership interest within the marital estate.

The first procedure is for the analyst to understand what constitutes an engagement to estimate value. As explained in SSVS:

> **Engagement to estimate value**. An engagement, or any part of an engagement (for example, a tax, litigation, or acquisition-related engagement), that involves determining the value of a business, business ownership interest, security, or intangible asset. Also known as *valuation service*.[3]

Once it is determined that the analyst will be retained by counsel through an engagement to estimate value, the analyst and counsel should agree on what type of engagement the analyst will perform.

Two common types of potential engagements are described in SSVS:

> There are two types of engagements to estimate value—a **valuation engagement** and a **calculation engagement**. [emphasis added] The valuation engagement requires more procedures than does the calculation

engagement. The valuation engagement results in a conclusion of value. The calculation engagement results in a calculated value. The type of engagement is established in the understanding with the client:

a. *Valuation engagement*. A valuation analyst performs a **valuation engagement** when (1) the engagement calls for the valuation analyst to estimate the value of a subject interest and (2) the valuation analyst estimates the value . . . and is free to apply the valuation approaches and methods he or she deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation as a conclusion of value; the conclusion may be either a single amount or a range.

b. *Calculation engagement*. A valuation analyst performs a calculation engagement when (1) the valuation analyst and the client agree on the valuation approaches and methods the valuation analyst will use and the extent of procedures the valuation analyst will perform in the process of calculating the value of a subject interest (these procedures will be more limited than those of a valuation engagement) and (2) the valuation analyst calculates the value in compliance with the agreement. The valuation analyst expresses the results of these procedures as a calculated value. The calculated value is expressed as a range or as a single amount. A calculation engagement does not include all of the procedures required for a valuation engagement.[4]

The next procedure is for counsel and the analyst to determine whether a calculation engagement or a valuation engagement is more appropriate. This decision will be based on the facts and circumstances of the individual family law matter.

Is a Calculation Engagement or a Valuation Engagement More Appropriate?

Determining which level of service, that is, which type of engagement, is most appropriate when estimating the value of a closely held business ownership interest within a family law context can be problematic.

It is important that the analyst consider the circumstances surrounding each potential engagement, and discuss with counsel what the ultimate goal, result, and audience will be for the engagement.

A few examples may be helpful in understanding when a calculation engagement or a valuation engagement may be most appropriate.

First, let's assume that the purpose of the valuation is to assist with preliminary management planning associated with the potential sale of the closely held business ownership interest (i.e., not within a family law context).

In this circumstance, a calculation engagement is likely appropriate and acceptable as the goal is to estimate the value of the closely held business ownership interest in order to obtain an idea of what a hypothetical willing buyer may pay for said interest.

The hypothetical willing buyer would likely perform its own due diligence and analysis in order to estimate what it may pay for the closely held business ownership interest as well. Therefore, the result of the calculation engagement may be used as an initial negotiating tool in the up-front discussions with the hypothetical willing buyer.

While updating the calculation engagement to a valuation engagement (once an agreement to sell has been finalized) may be appropriate, a calculation engagement can be a suitable and cost effective option to a valuation engagement when the purpose is for general management planning purposes.

Second, let's assume that the individual with the same closely held business ownership interest is involved in a family law matter. Further, let's assume that the family law matter will require a division of the relevant assets held within the marital estate.

One of the more significant assets in the marital estate may be the closely held business ownership interest. Therefore, a value needs to be estimated in order to equitably divide the value of the closely held business ownership interest between the marital parties.

If the family law matter is in its early stages, then a calculation engagement may be appropriate in order to assist with up-front settlement discussions.

However, it is important for the analyst (and for the counsel) to consider that in proceedings that may end up in a court of law or arbitration, the selected engagement should ultimately adhere to the standards of a valuation engagement, allowing the analyst to opine on an estimated *conclusion of value*.

As mentioned above, a calculation engagement results in a calculated value, not a *conclusion of value*, which provides the analyst's direct opinion or conclusion that can be easily testified to or defended in court or arbitration.

In fact, SSVS explicitly states that in a calculation engagement, the analyst should disclose that the calculation engagement does not include all the procedures required of a valuation engagement.

Further, SSVS requires the analyst to state that if a valuation engagement had been performed, then the resulting indications of value may have been different.[5]

Due to this difference, among others, many analysts will not testify in a court of law or arbitration without having completed a valuation engagement that results in a *conclusion of value*, which, again, represents the analyst's professional opinion or valuation conclusion.

While marital dissolutions have the ability to be settled prior to any formal court or arbitration proceedings, the analyst should be wary of completing calculation engagements within a family law context. This statement is true for several reasons.

The first reason is efficiency. If a valuation engagement is completed as the initial engagement, then there will be no need for counsel to request an update once the family law matter proceeds to court or arbitration.

The valuation engagement can be more efficient by saving additional costs and fees associated with:

1. completing a calculation engagement/report and
2. having to update the calculation engagement/report to a valuation report.

The second reason is: in updating from a calculation report to a valuation report, the value conclusions of the subject business can change significantly. This is because in a calculation engagement, the analyst and the client (i.e., counsel) agree on the valuation approaches and methods the analyst will use, rather than the analyst applying the valuation approaches and methods that he or she deems most appropriate in the circumstances.

Further, the degree of analysis in a valuation engagement is typically more robust than the degree of analysis in a calculation engagement, which can contribute to large discrepancies in value indications between the two reports.

The third reason is: as previously mentioned, analysts will often not testify in a court of law or arbitration without having completed a valuation engagement. This can result in an unsupported analysis, and/or additional expense, for counsel and the marital parties.

This is not to say that each family law engagement should be a valuation engagement. A calculation engagement may be appropriate for purposes of up-front settlement discussions outside a court of law or arbitration.

However, the analyst, and counsel, should both reasonably consider the goals, result, and audience in order to determine which engagement would be most appropriate within a family law context.

Applicable Standards for a Valuation Engagement or a Calculation Engagement

As mentioned, SSVS is one set of professional standards that provide practitioner guidance to the business valuation profession. While SSVS is promulgated by the American Institute of Certified Public Accountants ("AICPA"), it provides relevant guidance to all analysts (and not just to certified public accountants).

This is because, while different organizations have different business valuation professional standards, there is a relative commonality to the relevant business valuation standards and procedures within each organization that can assist the analyst in performing assignments properly.

"Regardless of which VPO standards the analyst selects to adhere to, the analyst should ensure that each segment of the valuation complies with all applicable professional standards of the selected VPO."

Some examples of other valuation professional organizations ("VPOs") professional standards include the following:

1. *Uniform Standards of Professional Appraisal Practice* ("USPAP")
2. National Association of Certified Valuators and Analysts ("NACVA") Standards.

For example, if the analyst agrees with counsel to enter into a valuation engagement, the following professional standards from the AICPA, USPAP, and NACVA specific to the valuation engagement may apply:

- NACVA Professional Standards II General and Ethical Standards; Standard III Scope of Services (B)(1) Valuation Engagement; Standard IV Development Standards; and Standard V Reporting Standards (C)(1) Contents of Report for detailed reports and (C)(2) Contents of Report for summary reports
- SSVS No. 1 0.21(a), .23 through .45 for valuation engagements, .48 (a) and (b), .51 through .70 for detailed valuation engagement reports; .71 and .72 for summary valuation engagement reports
- USPAP Standard 9 Business Appraisal, Development and Standard 10 Business Appraisal Reporting; specifically, Standard 10-2(a) for a detailed report and Standard 10-2(b) for a summary/restricted report

Alternatively, if the analyst agrees with counsel to enter into a calculation engagement, the following professional standards from the AICPA and NACVA specific to the calculation engagement may apply:

- NACVA Professional Standards II General and Ethical Standards; Standard III Scope of Services (B)(2) Calculation Engagement; Standard IV Development Standards; and Standard V Reporting Standards (C)(3) Contents of Report for calculation reports
- SSVS No. 1 0.21(b), .46 for calculation engagements, .48(c), .73 through .77 for calculation reports

It is noteworthy that USPAP does not have an alternative to a valuation engagement, such as a calculation engagement as referenced in SSVS and NACVA professional standards.

If an analyst is required to follow USPAP in performing a closely held business valuation, then the analyst should follow all applicable USPAP standards for a valuation engagement (i.e., a full appraisal engagement—as there is no calculation engagement, or calculation report, option within USPAP).

Regardless of which VPO standards the analyst selects to adhere to, the analyst should ensure that each segment of the valuation complies with all applicable professional standards of the selected VPO.

Calculation Report versus Valuation Report

Once the appropriate type of engagement (i.e., a calculation engagement or a valuation engagement) is determined, the analyst should then prepare a report commensurate with the selected engagement.

If the analyst is required to produce a valuation report (as a result of being retained on a valuation engagement), it is important for the analyst to follow applicable professional standards in completing the valuation report.

The AICPA (and specifically, SSVS), among other professional standard organizations (including the VPOs presented above), provides guidance with regard to the content and presentation of a valuation report.

It is noteworthy that SSVS provides two options with regard to a valuation report:

1. A valuation engagement, detailed report
2. A valuation engagement, summary report

For purposes of this discussion, we present only the structure of a valuation engagement, detailed report.[6]

As described in SSVS:

> The detailed report is structured to provide sufficient information to permit intended users to understand the data, and analyses underlying the valuation analyst's conclusion of value. A detailed report should include, as applicable, the following sections titled using wording similar in content to that shown:

- Letter of transmittal
- Table of contents
- Introduction
- Sources of information
- Analysis of the subject entity and related nonfinancial information
- Financial statement or financial information analysis
- Valuation approaches and methods used
- Valuation adjustments
- Nonoperating assets, nonoperating liabilities, and excess or deficient operating assets (if any)
- Representation of the valuation analyst
- Reconciliation of estimates and conclusion of value
- Qualifications of the valuation analyst
- Appendixes and exhibits

> The report sections previously listed and the detailed information within the sections described in the following paragraphs . . . may be positioned in the body of the report or elsewhere in the report at the direction of the valuation analyst.[7]

If the analyst is required to produce a calculation report (as a result of being retained on a calculation engagement), as mentioned above it is important for the analyst to follow applicable professional standards in completing the calculation report.

SSVS also provides guidance with regard to the content and presentation of a calculation report. As presented in SSVS:

> . . . a calculation report is the only report that should be used to report the results of a calculation engagement. The report should state that it is a calculation report. The calculation report should include the representation of the valuation analyst . . . , but adapted for a calculation engagement.[8]

More specifically, SSVS presents a checklist of what should be included in a calculation report. As described in SSVS:

> The calculation report should include a section summarizing the calculated value. This section should include the following (or similar) statements:
>
> a. Certain calculation procedures were performed; include the identity of the subject interest and the calculation date.
>
> b. Describe the calculation procedures and the scope of work performed or reference the section(s) of the calculation report in which the calculation procedures and scope of work are described.
>
> c. Describe the purpose of the calculation procedures, including that the calculation procedures were performed solely for that purpose and that the resulting calculated value should not be used for any other purpose or by any other party for any purpose.
>
> d. The calculation engagement was conducted in accordance with the *Statement on Standards for Valuation Services* of the American Institute of Certified Public Accountants.
>
> e. A description of the business interest's characteristics, including whether the subject interest exhibits control characteristics, and a statement about the marketability of the subject interest.
>
> f. The estimate of value resulting from a calculation is expressed as a calculated value.

g. A general description of a calculation engagement is given, including that

  i. a calculation engagement does not include all of the procedures required for a valuation engagement, and

  ii. had a valuation engagement been performed, the results may have been different.

h. The calculated value, either a single amount or a range, is described.

i. The report is signed in the name of the valuation analyst or the valuation analyst's firm.

j. The date of the valuation report is given.

k. The valuation analyst has no obligation to update the report or the calculation of value for information that comes to his or her attention after the date of the report.[9]

It is noteworthy that the above professional standard guidance is only a brief summary of some of the standards presented in SSVS.

It is the responsibility of the analyst to ensure that the presentation of the estimated value indications, as a result of completing a calculation engagement or valuation engagement, adhere to all relevant standards as presented in SSVS (or adhere to all relevant standards as proffered by USPAP and the NACVA).

Summary and Conclusion

Counsel often have to work with—and rely on—analysts in order to assist with certain property settlement aspects associated with family law matters.

In particular, counsel have to work with—and rely on—analysts to assist with estimating the value of family-owned or other closely held business, business ownership interests, debt and equity securities, or intangible assets owned by the marital estate.

In assisting counsel, the analyst may decide (in conjunction with counsel) whether the engagement should be a calculation engagement or a valuation engagement. The AICPA (through the application of SSVS) and other VPOs provide professional standards guidance with regard to the structure and requirements of a calculation report and a valuation report.

However, regardless of the selected VPO standards to which the analyst will rely on in completing the engagement, it is important to consider the goals, result, and audience for each engagement when determining whether a calculation engagement or a valuation engagement is most appropriate within a family law context.

This is because, depending on the selected engagement, the analysis:

1. may be overly expensive due to having to update from a calculation engagement to a valuation engagement,
2. may not be effective based on potential significant changes in the value indications when having to update from a calculation engagement to a valuation engagement, and
3. may not be property defended at trial or at arbitration, if at all.

Notes:

1. SSVS, .21.
2. It is important to note that the analyst can be directly retained by the husband or wife, rather than by counsel, and may be retained by the husband and wife on a joint basis (or retained by the husband and wife on a joint basis through counsel). A joint retention means that the estimated value concluded by the analyst, as a result of a calculation engagement or a valuation engagement, will be accepted by both parties.
3. SSVS, .82.
4. Ibid, .21.
5. Ibid, .76.
6. As presented in SSVS paragraph .48, "Valuation engagement—summary report. This report may be used to communicate the results of a valuation engagement (conclusion of value); it should not be used to communicate the results of a calculation engagement (calculated value) (paragraph .71). For a valuation engagement, the determination of whether to prepare a detailed report or a summary report is based on the level of reporting detail agreed to by the valuation analyst and the client."
7. SSVS, .51.
8. Ibid., .73.
9. Ibid., .76.

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The Business Valuation "Baker's Dozen": Questions Legal Counsel Should Consider Asking (and the Expert Should Expect to Hear) in Deposition/Cross-Examination—And Why

Charles A. Wilhoite, CPA

Business valuation in a family law setting requires a broad understanding and reasonable application of generally accepted business valuation theory and practice. This discussion identifies 13 questions that a testifying expert should expect to hear, and opposing legal counsel ("counsel") should consider asking, in a deposition/cross-examination. The questions typically are relevant with regard to any business valuation performed in a family law context. Responses to the questions can provide significant information (1) regarding the foundation for an opposing expert's valuation analysis and opinion, and any weaknesses that can be exploited, and (2) that can be used to support the valuation variables underlying the valuation analysis and opinion of counsel's own expert.

Introduction

For nearly 30 years, the author has provided business valuation services in a wide variety of settings, including transactional settings, tax and other regulatory settings, and litigation settings. The demand for business valuation services and related financial advisory service support within the family law context has been constant, if not increasing.

The preparation of credible business valuation opinions, regardless of the context in which they are prepared, require:

1. a broad understanding of financial, economic and valuation theory;
2. compliance with relevant business valuation professional standards; and
3. consideration and application of appropriate legal and regulatory guidelines, including judicial precedents.

For purposes of this discussion, this collective body of business valuation theory and guiding principles comprise what will be referred to as generally accepted valuation practice ("GAVP").

Because "analyst judgment" typically plays a significant role in the application of GAVP and developing business valuation opinions, the question of "art versus science" often is raised with regard to the valuation process. To characterize a valuation process as "art," however, inappropriately implies that the analyst judgment incorporated in an appraisal is devoid of any reasonable empirical support or foundation.

Unfortunately, assumptions in a valuation process that are not appropriately documented and supported necessarily should be characterized as arbitrary, thereby rendering them more art than science. In the author's experience, however, this is more the exception than the rule when business valuations are completed by well-qualified, experienced analysts.

Herein lies the challenge faced by legal counsel ("counsel") when attempting to discredit or impugn the valuation opinion of a valuation testifying expert. Piercing the foundation of a qualified financial expert opinion in a manner that does not give an expert the freedom to claim "analyst judgment" as a recurring defense requires collaboration and coordination between counsel and his/her financial expert.

The effectiveness of such collaboration and coordination can be increased significantly by incorporating the following business valuation "baker's dozen" of questions in a deposition/cross-examination of an opposing testifying expert:

1. Based on the professional associations in which you are a member, and your professional designation(s)/certification(s), what valuation professional standards are relevant to your engagement and please describe how you have complied with those professional standards?
2. Please identify companies that you have previously valued that operate in the same industry classification as the subject company(ies) in this engagement.
3. Are there any errors in your analysis/report that you would like to bring to the court's attention?
4. What were the total hours billed by your firm to complete the engagement, and what percentage of the time did you bill?
5. Please describe the "reasonableness test" you completed at the conclusion of your engagement and the findings of your "reasonableness test."
6. What level of intangible asset value, or "goodwill," is implied by your valuation opinion, and why is the indicated level reasonable?
7. Please explain your basis for excluding any of the three generally accepted valuation approaches (i.e., the income, market, and asset-based approaches) from your analysis.
8. Please explain how you have established "normalized earnings" for the subject company, and the basis for any "normalizing adjustments."
9. Please explain the basis for your selection of valuation pricing multiples within your market approach (including both the guideline publicly traded company method and the guideline transactions method).
10. Please explain the basis for the weighting you have applied to each valuation approach and method value indications used to establish your opinion.
11. Is business valuation as much "art" as it is "science?"
12. Please explain how you have considered "key person risk" in your valuation.
13. Please explain the basis for any valuation adjustments (e.g., premium for ownership control or discount for lack of ownership control, discount for lack of marketability) you have applied in arriving at your opinion of value.

The questions are intended to be directed at counsel's opposing valuation testifying expert, with the expectation that they have been developed in collaboration with counsel's own valuation testifying expert.

Therefore, it is expected that counsel's own valuation testifying expert has already:

1. developed credible responses to each question as relating to his/her own analysis and opinion, and
2. reviewed the opposing expert's analysis and opinion and developed an idea regarding likely responses counsel will receive from the opposing testifying expert.

The following discussion addresses the "baker's dozen" of suggested business valuation deposition/cross-examination questions previously identified. The questions identified are not intended, initially, to induce "gotcha" responses from an opposing expert.

However, the responses should produce information to counsel that:

1. enables counsel to develop a reasonable understanding regarding the foundation for the opposing testifying expert's analysis and opinion,
2. facilitates more detailed inquiries, the responses to which may result in discrediting certain aspects of a testifying expert's analysis and opinion, and
3. provides direct and indirect support for the analysis and opinion offered by counsel's own testifying expert.

For each question, discussion is provided regarding:

1. the basis for each question (i.e., why counsel should consider asking each question),
2. a general response that likely will be received from the valuation testifying expert under examination, and
3. how a response provided by the opposing business valuation expert can be used to support the analysis and opinion offered by counsel's own valuation testifying expert.

1. Based on the valuation professional associations in which you are a member, and your professional designation(s)/certification(s), what valuation professional standards are relevant to your engagement and please describe how you have complied with those professional standards?

Basis for question: Business valuation professionals typically are "qualified" to render opinions in court as "experts" based on the proven attainment of relevant and adequate education, experience and training.

The training aspect of an expert's qualifications typically includes attaining professional designations/certifications conferred by a valuation professional organization ("VPO") that attest to the mastery of specific business valuation body of knowledge by an individual.

Business valuation designations/certifications typically recognized by the courts include (among others):

- Certified Public Accountant ("CPA"), granted by the American Institute of Certified Public Accountants
- Accredited in Business Valuation ("ABV"), granted by the American Institute of Certified Public Accountants
- Accredited Senior Appraiser in Business Valuation ("ASA"), granted by the American Society of Appraisers
- Certified Valuation Analyst ("CVA"), granted by the National Association of Certified Valuators and Analysts
- Chartered Financial Analyst ("CFA"), granted by the CFA Institute

As indicated, each of the business valuation designations/certifications identified above is conferred by a different VPO. And, each VPO promulgates its own set of professional standards.

Experts who are members of these various associations and who maintain the identified designations/certifications are expected to comply with the relevant professional standards when providing business valuation services.

Asking question (1) forces the valuation testifying expert to identify those standards which he/she is bound to comply with and to explain how his/her analysis complies with the relevant professional standards.

General Response: An experienced valuation testifying expert typically will produce a report that states, explicitly, that his/her analysis complies with the relevant professional standards binding him/her as a result of membership in identified professional associations. Further, an experienced valuation testifying expert typically will respond that his/her valuation process is designed to comply with relevant professional standards.

Use of Response: A valuation testifying expert who affirmatively states that an analysis and opinion have been developed in compliance with relevant business valuation standards is subject to impeachment if it can be established that the subject analysis and opinion deviate from the identified standards.

While some deviations may be deemed minor, a major deviation from the relevant business valuation standards, or multiple, minor deviations, can be used to impugn the credibility of the testifying expert's analysis and opinion.

If counsel's valuation testifying expert has produced an analysis and report that are compliant with the VPO to which he/she belongs, establishing any points of noncompliance by the opposing testifying expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert. This is particularly effective when the testifying experts share common professional associations and credentials.

2. Please identify companies that you have previously valued that operate in the same industry classification as the subject company(ies) in this engagement?

Basis for question: The "experience" aspect of a valuation testifying expert's qualifications includes both experience completing business valuations in general, and experience valuing companies of the specific type involved in the subject dispute. Broad and long-term valuation experience typically are recognized by the courts as providing a solid foundation for the capable delivery of business valuation services and related opinions.

However, the "first-time" valuation experience, or limited valuation experience in a particular industry, often presents a circumstance that allows counsel to challenge an opposing valuation testifying expert's analysis in a manner that calls into question the depth of understanding that the expert possesses with regard to the analysis of certain types of companies, and his/her ability to complete a fully informed valuation.

Asking question (2) forces the valuation testifying expert to provide specific examples of companies that he/she has valued in a particular industry, thereby enabling counsel to determine if further examination will result in demonstrating that the opposing testifying expert has rendered an opinion that is assailable based on limited familiarity with the subject company industry and factors that affect value.

General Response: An experienced valuation testifying expert typically will express that he/she has completed prior valuations of companies operating in the same, or "related," industries as the subject company. Further, an experienced valuation testifying expert typically will express that relevant business valuation professional standards have been complied with in completing the analysis and developing the opinion.

Such professional standards typically require that a valuation analyst who has not previously valued a company within a particular industry perform the necessary research required to develop a reasonable understanding of the industry, thereby providing a sound foundation on which to base his/her analysis and opinion.

Use of Response: A valuation testifying expert who possesses limited valuation experience in the subject company industry should be challenged with additional questions designed to emphasize his/her limited understanding of the subject company industry. This is particularly relevant in those circumstances where the subject company operates in a highly regulated industry or an industry with specialized practices (e.g., health care, utilities, hedge funds).

If counsel's valuation testifying expert has prior experience in the relevant industry, the ability to demonstrate specific, relevant experience comparable to, and potentially exceeding, that of the opposing expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert.

3. Are there any errors in your analysis/report that you would like to bring to the court's attention?

Basis for question: Errors, even insignificant ones, are unfortunate for the analyst. Identifying even a single major error in an opposing testifying expert's analysis may render the expert's opinion irrelevant and unreliable.

A series of minor errors can call into question the level of care and diligence exercised by an expert, thereby reducing the credibility and reliability of his/her opinion in the eyes of the court.

Generally, errors relate to computational (i.e., mathematical) or procedural (i.e., business valuation process) issues. Accordingly, errors should be distinguished from differences in "analyst judgment." Qualified valuation professionals can, and do, often arrive at different valuation positions based on unique assessments of a set of facts and circumstances.

However, "analyst judgment" can be pushed toward the direction of "error" when such judgment results in valuation assumptions or positions that are not well-reasoned because they are not consistent with, or supported by, empirical data.

Asking question (3) forces the valuation testifying expert to identify any known errors in his/her analysis.

General Response: An expected response to question (3) by an experienced valuation testifying expert is, "I am not aware of any errors in my analysis that would cause me to change my opinion." Because all valuation testifying experts are human, achieving perfection in any business valuation circumstance is not a realistic pursuit.

Therefore, experienced valuation testifying experts typically allow for a small margin of error when responding to question (3). Further, business valuation models and internal professional standards review processes relied on by experienced analysts typically are designed to prevent and identify any significant issues before a valuation opinion is finalized.

Use of Response: A testifying valuation expert who states that his/her analysis is error free is subject to impeachment if it can be established that the subject analysis does contain errors. Once again, the identification of a material error, or a series of minor errors, can serve to totally discredit an opposing testifying expert's opinion.

For this reason, the first process counsel's own valuation testifying expert should complete in preparation for the deposition/cross-examination of the opposing valuation analyst is to test and recalculate the components of the opposing testifying expert's analysis.

If counsel's valuation expert has completed a thorough and accurate analysis, identifying errors committed by the testifying expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert.

4. What were the total hours billed by your firm to complete the engagement, and what percentage of the time did you bill?

Basis for question: Generally, a business valuation of any size is completed by a valuation team that includes a number of analysts with varying degrees of education, training and experience; research professionals; and support staff.

Each of the participants on the engagement team typically "bills," or "charges," the engagement for time committed to an engagement based on varying billing rates relating to qualification levels.

Asking question (4) forces the valuation testifying expert to identify his/her time specifically committed to an engagement. While fees often are the focus of counsel inquiries, assessing commitment based on time typically provides a more meaningful indicator of the level of involvement and the role the opposing expert played in developing the analysis and opinion offered.

General Response: An expected response to question (4) by an experienced valuation testifying expert is, "Based on my position with the firm, and the size and scope of the engagement, I would estimate that my time to commitment to the engagement approximated 20 percent to 25 percent of the total time billed through the most recent billing cycle.

Often, a valuation testifying expert is asked to produce internal engagement accounting records that enable counsel to identify all individuals who worked on a particular engagement, the hours worked, and the tasks performed.

Use of Response: Whether estimated by the valuation testifying expert, or established based on consideration of the engagement time accounting records, establishing an understanding of the time committed by a valuation testifying expert to a particular business valuation allows counsel to establish a sense of the level of effort dedicated to the matter by the expert.

A disproportionately high level of commitment or number of hours provides an opportunity to emphasize unique challenges encountered in completing the engagement. A disproportionately low level of commitment or number of hours provides an opportunity to challenge the adequacy of effort committed to the analysis and opinion.

If counsel's valuation testifying expert can establish that a reasonable level of effort was committed at touch points throughout the engagement, the credibility and reliability of the analysis and opinion offered by the expert may be enhanced.

5. Please describe the "reasonableness test" you completed at the conclusion of your engagement and the findings of your "reasonableness test."

Basis for question: An expert opinion resulting from a business valuation that is developed consistent with GAVP typically includes some form of "reasonableness test."

Such a test is designed to evaluate the reasonableness of the resulting valuation conclusion by performing logic tests, such as whether, based on the concluded value (i.e., price), (1) the cash flow expected to be generated by the subject company could support reasonable financing terms, or (2) implied valuation pricing multiples are reasonable relative to comparable valuation pricing multiples attributable to publicly traded companies or acquired companies operating in the same industry classification as the subject company.

Asking question (5) forces the valuation testifying expert to step away from GAVP and provide a "big picture," logical assessment of the reasonableness of the valuation conclusion and opinion offered.

General Response: When the circumstances warrant, an expected response to question (5) by an experienced valuation testifying expert is, "I have developed my analysis and opinion consistent with GAVP, and the indications of value resulting from each of my valuation approaches and methods occur within a fairly tight range. This mutually supporting evidence provides me with a high level of confidence that both the key assumptions supporting my analysis and the overall conclusion are reasonable."

Use of Response: A valuation testifying expert who provides the general response noted above may indeed have a defensible position. However, a narrow range of values produced by a valuation analysis completed consistent with GAVP does not necessarily guarantee that the concluded value is reasonable.

A simple example to dispel this notion is represented by a valuation conclusion that is weighted heavily on indications of value tied directly to a normalized earnings level for the subject company that were improperly calculated or unreasonable based on the facts and circumstances.

Indications of value resulting from market approach and income approach methods based primarily on an unreasonable level of normalized earnings may occur within a narrow range of value. However, relying on the narrow range of value to support the reasonableness of the assumptions supporting each valuation method, and the overall valuation conclusion, clearly would be inappropriate and misleading.

If counsel's valuation testifying expert has completed a meaningful "reasonableness test" regarding his/her valuation conclusion, and it can be established that the opposing valuation expert has not or has been proven to have relied on a faulty reasonableness test, the credibility and reliability of the analysis and opinion offered by counsel's expert may enhanced.

6. What level of intangible asset value, or "goodwill," is implied by your valuation opinion, and why is the indicated level reasonable?

Basis for question: Generally, intangible asset value, or "goodwill," represents the amount of value implied by a valuation conclusion in excess of the value of the tangible assets controlled by the subject company. Typical tangible assets include cash, accounts receivable, inventories, property, plant and equipment, and other assets that, typically, have a "physical" existence.

Identifying the level of intangible asset value or goodwill implied by a valuation conclusion and assessing whether it is consistent with the facts and circumstances is a form of reasonableness test.

Asking question (6) forces the valuation testifying expert to identify the amount of "value" included in his/her valuation conclusion that is most challenging to maintain or transfer because it is dependent on difficult-to-measure factors such as customer/client/patient loyalty, brand recognition, technologically driven effectiveness and efficiency, reputation, specialized skills, and creativity, to name a few.

General Response: An expected response to question (6) by an experienced valuation testifying expert is, "Each business valuation is affected by the specific facts and circumstances existing at the valuation date, which in turn affects the level of intangible asset value, if any, implied by a valuation conclusion. The level of intangible asset value resulting from business valuations can therefore vary widely and is based primarily on the economic earnings a company is expected to generate and the persistence of those earnings."

Use of Response: In certain circumstances, the reasonableness of the level of intangible asset value implied by a business valuation can be analyzed by examining the level of intangible asset relative to total asset value or revenue for comparable businesses. This is particularly true regarding certain professional practices, such as medical and dental practices.

Empirical data are available that can enable an assessment of the reasonableness of intangible asset value implied by a valuation conclusion based on the ratio of intangible asset value relative to gross receipts (i.e., collected revenue) for a medical practice or dental practice.

If counsel's valuation testifying expert has completed a meaningful assessment of implied intangible asset value resulting from his/her valuation conclusion, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

7. Please explain your basis for excluding any of the three standard valuation approaches (i.e., the income, market, and asset-based approach) from your analysis.

Basis for question: Generally, the valuation professional standards of the previously discussed VPOs that confer business valuation designations/certifications require their members to comply with their standards and consider the three generally accepted business valuation approaches when completing business valuations: the income approach, the market approach, and the asset-based approach.

It is noteworthy that the requirement to "consider" the three generally accepted business valuation approaches does not "require" that each approach must be used and relied on to produce a credible business valuation opinion.

The valuation approaches applied in a valuation engagement are based on the facts and circumstances particular to the engagement and analyst judgment.

Asking question (7) forces the valuation testifying expert to explain why a particular approach(es) were excluded from his/her analysis.

General Response: An expected response to question (7) by an experienced valuation expert is, "Relevant valuation standards allow an analyst to exercise judgment in determining which valuation approaches are most relevant in a particular valuation, based on consideration of the relevant facts and circumstances."

Use of Response: Business valuation professional standards and analyst judgment do afford a business valuation expert latitude regarding which approaches to incorporate in a business valuation. However, certain companies, such as retail, manufacturing and service companies, typically are most reasonably valued using income and market approaches, while asset-intensive companies, such as real estate holding and real estate development companies, are most reasonably valued using the asset-based approach.

Counsel can challenge an expert who excludes from his/her analysis any valuation approach that typically would be relied on to estimate value based on the business focus of the subject company.

If counsel's valuation testifying expert has, based on reasonable consideration of relevant facts and circumstances, incorporated valuation approaches in his/her valuation analysis that were excluded by the opposing valuation expert, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

8. Please explain how you have established "normalized earnings" for the subject company, and the basis for any "normalizing adjustments."

Basis for question: Normalized earnings represent the level of earnings that a subject company reasonably would be expected to generate in future operating periods based on the efficient and effective operation of the business under "normal" operating circumstances.

Normalized earnings typically are estimated for the subject company based on consideration of a historical average (straight or weighted) covering an operating period deemed relevant for the purpose of estimating the most likely level of long-term future earnings.

All material nonrecurring items—both revenue and expense—should be removed from historical earnings to estimate a normalized earnings base, including the impact of revenue and expense items that do not reflect arm's-length business transactions.

Depending on the duration and operating stage of the subject company, and based on consideration of economic and industry conditions existing as of the valuation date, normalized earnings sometimes reasonably can be based on the subject company's most recent operating results.

Typical adjustments made to "normalize" the earnings of a business include the following:

- Removing nonrecurring revenue/income items, such as insurance recoveries, litigation awards and income or significant gains realized on the sale of assets
- Removing nonrecurring expense items, such as asset write-offs, litigation settlements, regulatory fines and penalties, and losses realized on the sale of assets
- Adjusting owner compensation and benefits to reasonable, market-based levels
- Adjusting related-party activity (e.g., family member compensation and benefits, rental arrangements, supplier relationships) to reasonable, market-based levels

Asking question (8) forces the valuation testifying expert to define normalized earnings in the context of his/her analysis and explain the rationale for normalizing adjustments.

General Response: Based on the significant impact that normalized earnings can exert on a valuation analysis and opinion, an experienced valuation testifying expert typically responds to question (8) by referring to a schedule or exhibit in his/her analysis that provides detail supporting the calculation of normalized earnings.

Use of Response: The calculation of normalized earnings often represents the most critical aspect of a business valuation because the level of normalized earnings typically flows directly into the income and market valuation approaches used to estimate the value of the subject company.

Counsel can challenge an expert who has incorporated unsupported or unreasonable normalization adjustments, or who has relied on an unreasonable operating period for the purpose of developing normalized earnings.

If counsel's valuation testifying expert has established a solid foundation for developing normalized earnings, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

9. Please explain the basis for your selection of valuation pricing multiples within your market approach (including both the guideline publicly traded company method and the guideline transactions method).

Basis for question: The market approach—whether based on the guideline publicly traded ("GPT") company method or the guideline transactions method—is based on the principle that the value of a subject company can be estimated based on consideration of the prices that investors are willing to pay for ownership in reasonably comparable businesses.

Market-based valuation pricing multiples are estimated by analyzing (1) the observed relationship between the value (i.e., price) of each GPT company/guideline transaction and (2) the relevant operating fundamentals, such as revenue, earnings and cash flow.

Based on consideration of differences in the risk profiles among the subject company and the GPT companies/guideline transactions, market-based valuation pricing multiples are selected for the subject company and applied to the relevant operating fundamentals of the subject company to develop indications of value.

The risk profile assessment typically includes considering relative differences in several of the following factors among the subject company and the selected GPT companies/guideline transactions:

- Size, including assets, revenue, customers/clients, products/services
- Geographic presence and markets served
- Market position
- Management depth
- Total capital and access to capital
- Profitability
- Historical and expected growth
- Variability in earnings and cash flow
- Capital investment and working capital needs

Asking question (9) forces the valuation testifying expert to provide a basis for the selection of valuation pricing multiples.

General Response: When the subject company is noticeably smaller than the GPT companies/guideline transactions, an expected response to question (9) by an experienced valuation testifying expert is, "Based on consideration of differences in size, historical and expected operating results, growth prospects, and other key factors distinguishing the subject company from the GPT companies/guideline transactions, valuation multiples were selected for the subject company near the low end of the market-based range."

Use of Response: Generally, the selection of valuation pricing multiples incorporated in the market approach is based on the risk profile assessment previously identified and on analyst judgment. Though analyst judgment varies, counsel can challenge an expert who has selected market-based valuation multiples for the subject company that appear to be inconsistent with the risk profile assessment.

If counsel's valuation testifying expert has established a solid foundation for the selection of market-based valuation pricing multiples, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

10. Please explain the basis for the weighting you have applied to the valuation approaches and methods used to establish your opinion.

Basis for question: The weighting applied by a valuation testifying expert to establish a valuation opinion, similar to the selection of valuation approaches and methods incorporated in a business valuation, is based on consideration of the facts and circumstances in a particular valuation and analyst judgment. Valuation professional standards allow analysts to exercise such judgment.

Further, recognized valuation standards do not require analysts to follow or present any specific quantitative weighting to the indications of value resulting from a business valuation in arriving at a final opinion of value.

Asking question (10) forces the valuation testifying expert to provide the rationale for the valuation conclusion presented.

General Response: An expected response to question (10) by an experienced valuation testifying expert is, "Relevant valuation standards allow an appraiser to exercise judgment in determining the relative weight to apply to the indications of value in a particular valuation based on consideration of the relevant facts and circumstances."

Use of Response: While valuation professional standards and analyst judgment do afford a valuation testifying expert latitude regarding the weighting to apply to indications of value in arriving at a final opinion of value, the weighting —whether explicit or implicit—typically correlates with the quantity and quality of information serving as the foundation for each valuation approach and method.

Counsel may challenge an expert whose weighting process and resulting valuation opinion appear to be arbitrary and inconsistent relative to the indicated range of value and the "relevance and reliability" of each valuation approach and method based on the facts and circumstances.

For example, establishing a valuation opinion at the "high end" of a valuation range, represented by the indicated value resulting from the GPT company method, would seem arbitrary and inconsistent if the subject company is significantly smaller than each of the GPT companies.

If counsel's valuation testifying expert has concluded an opinion of value that is reasonably situated within the indicated valuation range based on consideration of the relevant facts and circumstances, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

11. Is business valuation as much "art" as it is "science?"

Basis for question: While analyst judgment typically plays a significant role in developing a business valuation opinion, such judgment exercised by an experienced analyst is best described as "reasoned and informed" judgment.

As a result, it is a mischaracterization to describe a well-reasoned and credible business valuation completed by a qualified and experienced analyst as reflecting as much art as it does science.

Asking question (11) forces the valuation testifying expert to provide perspective regarding the level of technical sophistication and the adequacy of support he/she believes backs the analysis completed and the related opinion rendered.

General Response: An expected response to question (11) by an experienced valuation testifying expert is, "A credible business valuation is based on the thorough application of GAVP and the exercise of well-reasoned, informed judgment by a qualified and experienced valuation professional. As a result, it is my opinion that business valuation is more science than art."

Use of Response: Counsel can challenge an expert who gives equal weight to the notion that business valuation is as much art as it is science. An expert espousing such a position can be cast in the light of having developed an analysis and opinion that are grounded more in analyst judgment than objective analysis and empirical support.

If counsel's valuation testifying expert has been consistent in the application of GAVP and thorough regarding the consideration and presentation of empirical data in exercising reasoned and informed judgment, while the opposing valuation testifying expert elects to emphasize that business valuation is as much art as it is science, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

12. Please explain how you have considered "key person risk" in your valuation.

Basis for question: Key person risk represents risk to business operations attributable to reliance on the special skills, talents and abilities of an individual. The concept of key person risk is premised on the notion that the loss of a key person can exert a significant, detrimental impact on the going concern operations of a subject company.

Within a valuation process, key person risk can be addressed in different ways, including the following:

- Purchasing insurance on the health/life of a key person
- Incorporating a key person risk premium when developing the discount/capitalization rate used to complete the income approach
- Applying a direct key person discount to develop the final opinion of value

Asking the question (12) forces the valuation testifying expert to specifically address how key person risk has been considered in the valuation process.

General Response: An expected response to question (12) by an experienced valuation testifying expert is, "The discount rate [developed in a specific schedule or exhibit] incorporates a specific risk premium to address key person risk."

Use of Response: Key person risk is a widely recognized risk within the business valuation profession. While key person risk is particularly relevant regarding the analysis and valuation of smaller companies, key person risk also can exist in very large companies.

The identification and assessment of key person risk is a reasonable expectation in the valuation of most closely held companies.

Counsel can challenge an expert who fails to provide an assessment of key person risk and/or fails to specifically identify how key person risk has been considered for the purpose of completing the valuation.

If counsel's valuation testifying expert has incorporated an assessment of key person risk and incorporated the related impact in his/her analysis, and it can be established that the opposing business valuation has not completed such an assessment or incorporated any key person risk impact in his/her analysis, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

13. Please explain the basis for any valuation adjustments (e.g., premium for ownership control or discount for ownership lack of control, discount for lack of marketability) you have applied in arriving at your opinion of value?

Basis for question: The ownership interest in the subject company that is includable as divisible property in a marital estate has inherent attributes that impact value. Generally, a controlling ownership interest (i.e., typically greater than 50 percent ownership) in the subject company normally would be valued at a pro rata interest of the controlling level of value for the subject company.

A noncontrolling ownership interest (i.e., typically less than 50 percent ownership), on the other hand, would be valued at a pro rata interest of the controlling level of value, discounted for lack of control.

Further, the valuation of an ownership interest in a privately owned company typically would reflect a discount for lack of marketability to reflect the detrimental impact on value attributable to the nonpublic (i.e., relatively illiquid) status of the ownership interest.

It is beyond the scope of this discussion to address the many factors and circumstances that affect controlling versus noncontrolling ownership interests in companies, and the magnitude of adjustments required to adjust from a controlling level of value to a noncontrolling level of value.

Similarly, it is beyond the scope of this discussing to address the many factors and circumstances that affect the liquidity of ownership interests in private companies, and the magnitude of adjustments required to reflect the detrimental impact that illiquidity typically exerts on such interests.

Finally, courts are varied regarding whether discounts for lack of control and lack of marketability are warranted at any level when estimating the value of business ownership interests subject to property division in a marital dissolution context.

Asking question (13) forces the valuation testifying expert to specifically address what adjustments have been incorporated in his/her analysis, the magnitude of such adjustments, and the basis for any valuation adjustments incorporated in the analysis.

General Response: An experienced valuation testifying expert typically will produce an analysis/report that identifies valuation adjustments, the magnitude of such adjustments, and the basis for the adjustments.

Use of Response: Counsel can challenge an expert who fails to provide a basis for valuation adjustments and the magnitude of the adjustments presented in an analysis.

If counsel's valuation testifying expert has incorporated rational support for the valuation adjustments and the magnitude of valuation adjustments incorporated in his/her analysis, and it can be established that the opposing business valuation has not provided such support, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

Summary and Conclusion

Rendering a credible and supported business valuation opinion in a family law context requires the analyst to demonstrate that he/she possesses relevant and sufficient (1) education, (2) experience and (3) training, and that he/she has adhered to GAVP.

Counsel facing the task of challenging an opinion rendered by an opposing valuation testifying expert can collaborate with his/her own valuation testifying expert to develop deposition/cross-examination questions, responses to which can serve to:

1. inform counsel regarding the foundation for the opposing valuation testifying expert's analysis and opinion and weaknesses in the foundation that can be attacked and
2. establish support for key aspects of the analysis and opinion offered by his/her own valuation testifying expert.

This discussion identifies a business valuation "baker's dozen" of deposition/cross-examination questions that regularly can be considered by counsel when addressing the analysis and opinion offered by an opposing valuation testifying expert.

While counsel may have reservations about asking certain questions of experienced valuation analysts due to concerns regarding relative differences in valuation knowledge that favor the valuation analyst, the questions identified provide relevant information that typically is required in order to appropriately understand and challenge the opposing testifying expert's analysis and opinion.

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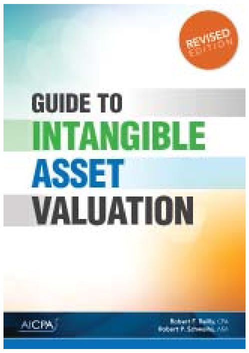

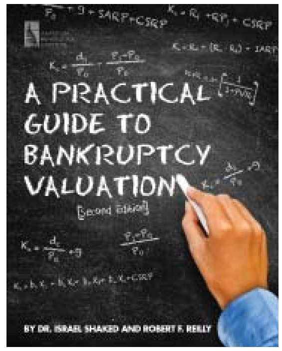

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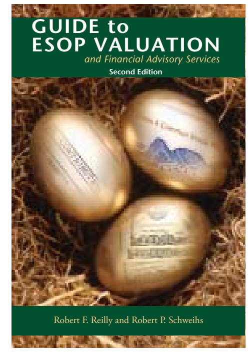

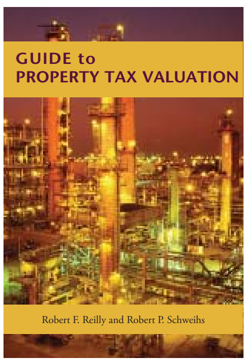

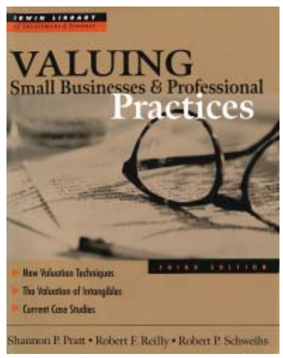

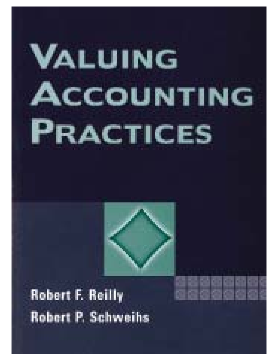

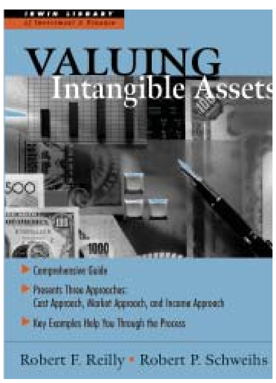

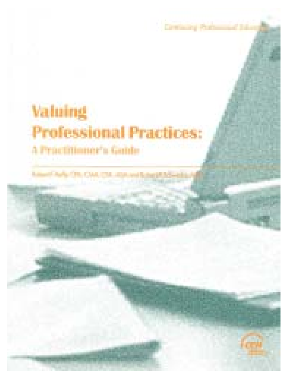

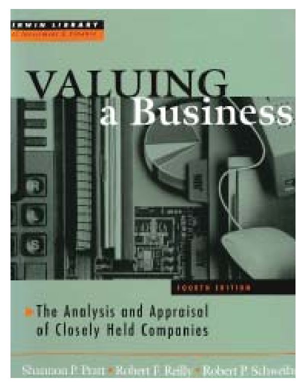

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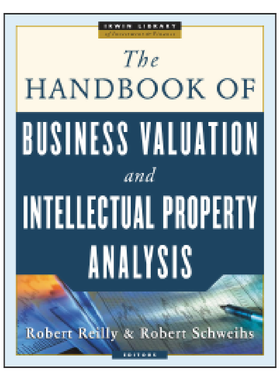

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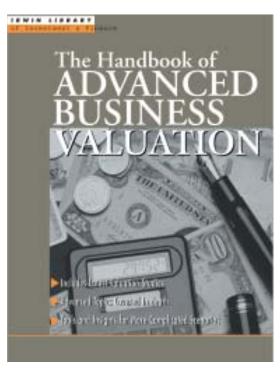

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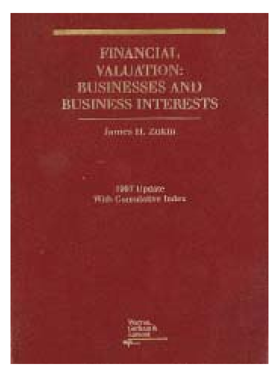

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Business Valuation Review Engagements in a Family Law Context

Lisa H. Tran

In a family law context, the valuation analyst ("analyst") may be retained by legal counsel to review the valuation of a business, business ownership interest, or security prepared by another analyst. The review of another analyst's business valuation report requires an understanding of generally accepted business valuation practices, including an understanding of relevant business valuation standards and procedures. This discussion addresses the applicable professional standards that analysts consider when completing a review of a business valuation report and provides analyst guidance with regard to some of the more common inconsistencies or errors identified during a review engagement.

Introduction

In many litigated matters, and particularly in family law matters, the valuation analyst ("analyst") may be asked to review the opposing analyst's valuation analyses, report, and opinions. This is because, in a family law setting, the marital dissolution parties may have differing views as to the value of certain marital estate assets.

This discussion applies to situations when the marital estate includes a family-owned or other closely held business, business ownership interest, debt or equity security, or intangible asset such as the value of a closely held business ownership interest held within the marital estate.

The process of reviewing another analyst's valuation report is not limited to simply identifying possible calculation errors within the underlying analysis. Rather, the review of another analyst's valuation report requires the reviewer to:

1. adhere to applicable business valuation professional standards and procedures when conducting a review engagement and
2. determine if the opposing analyst's work was developed in a manner consistent with generally accepted business valuation professional standards and practices.

This discussion focuses on the process of a review engagement. This discussion provides analyst guidance with regard to the applicable standards analysts follow when completing such engagements. This discussion also provides examples of common inconsistencies or errors identified during a business valuation review engagement.

The Review Engagement

As presented in "A New Perspective of Business Appraisal Review," an appraisal review is the "process of developing and communicating an opinion about the quality of all or part of the work of another appraiser."[1]

In general, a review engagement is intended to provide information to the users of the subject business valuation about the credibility of the work under review.

Further, as promulgated by the National Association of Certified Valuators and Analysts ("NACVA"), a business valuation review is, "the act or process of developing and communicating a [NACVA] member's opinion regarding the credibility of the work product of another valuation analyst. It is a type of service, whether in written or oral form, intended to provide to identified users that the report is credible."[2]

For purposes of this discussion, the terms "appraisal review" and "business valuation review" are used interchangeably. Nonetheless, family law counsel should be aware that there are meaningful differences in the processes and procedures required by each valuation professional organization ("VPO") for review engagements.

Accordingly, when tasked with a review assignment, it is important for the analyst to understand the differences in the processes and procedures between the VPOs when performing a review assignment.

Litigation circumstances often drive the need for a review engagement (i.e., such as in a family law matter where there is a high level of distrust between the marital dissolution parties). Nonetheless, the motivation for a review assignment may be as simple as a client seeking a second opinion, or "comfort," regarding a business or security valuation that has already been completed.

Rather than hiring another analyst to complete a new valuation (resulting in a significant additional expense), it is often more efficient to obtain a review opinion regarding the completeness, accuracy, reasonableness, and credibility of the initial business valuation report.

Further, and specifically in a family law context, a review engagement may have several different "stakeholders." These stakeholders may include judges, legal counsel ("counsel"), clients, the marital dissolution parties, and regulatory bodies.

The analyst can provide value in a review engagement by providing relevant opinions to these stakeholders, who may not have the theoretical or technical training in business valuation but need to make significant decisions based on the reliability of the valuation (such as in determining appropriate spousal support and equalization payments).

As further presented in "A New Perspective of Business Appraisal Review," "Stakeholders in the appraisal process look to a reviewer to provide them with assurance the opinion provided by a valuation analyst is reliable."[3]

The following section provides an overview of the applicable business valuation professional standards related to a review engagement.

Applicable Standards for a Review Engagement

When an analyst is hired to perform a review engagement, the analyst should first be familiar with the applicable professional business valuation professional standards. In order to provide a credible review report, the analyst should follow the applicable review engagement professional standards for the development and reporting of the review analysis.

These business valuation professional standards include the following:

1. *Uniform Standards of Professional Appraisal Practice* ("USPAP") promulgated by The Appraisal Foundation
2. The professional standards promulgated by the NACVA
3. The Statement on Standards for Valuation Services No. 1 ("SSVS") promulgated by the American Institute of Certified Public Accountants ("AICPA")

The following sections summarize each of the business valuation professional standards related to a review engagement.

Uniform Standards of Professional Appraisal Practice

USPAP was developed by the Appraisal Standards Board of the Appraisal Foundation and is applicable for certain business valuations. Specifically, as presented in USPAP:

> In developing an appraisal review, an appraiser must identify the problem to be solved, determine the scope of work necessary to solve the problem, and correctly complete research and analyses necessary to produce a credible appraisal review.[4]

As presented above, USPAP Standard 3, Appraisal Review, Development is directed toward developing a credible opinion of the quality of another analyst's work. While USPAP Standard 3 addresses the content and level of information required in a report to communicate the results of a review engagement, this standard does not provide guidance with regard to the form, format, or style of an appraisal review report.

Rather, USPAP Standard 3 requires the analyst to understand and correctly employ the methods and techniques necessary to produce a credible appraisal review.

As presented in USPAP Standard 3:

> (b) When necessary for credible assignment results in the review of a report, the reviewer must:
>
> i. Develop an opinion as to whether the report is appropriate and not misleading within the context of the requirements applicable to that work; and

ii. Develop the reasons for any disagreement.

Comment: Consistent with the reviewer's scope of work, the reviewer is required to develop an opinion as to the completeness, accuracy, adequacy, relevance, and reasonableness of the report, given law, regulations, or intended user requirements applicable to that work.[5]

However, USPAP Standard 3 does provide guidance in the instances where the reviewer provides his or her own opinion of value or review opinion. As further presented in USPAP:

> (c) When the assignment includes the reviewer developing his or her own opinion of value or review opinion, the following apply:
>
> i. The requirements of STANDARDS 1, 5, 7, or 9 apply to the reviewer's opinion of value for the property that is the subject of the appraisal review assignment.
>
> ii. The requirements of STANDARD 3 apply to the reviewer's opinion of quality for the work that is the subject of the appraisal review assignment.[6]

While there are additional USPAP requirements for when the reviewer develops his or her own opinion of value or review opinion, the reviewer is not required to explicitly replicate the steps completed by the original appraiser. Rather, those items in the report under review that the reviewer deems credible can be included in the reviewer's development process as an extraordinary assumption.

This means that, in a review engagement, the review report should only include the analysis and discussion related to those items for which there is any disagreement between the original analyst and the reviewer.

National Association of Certified Valuators and Analysts

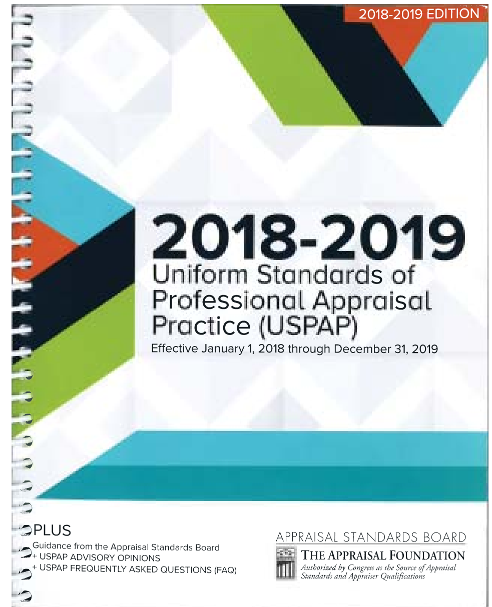
NACVA is a VPO that has trained over 35,000 certified public accountants, and other business valuation and consulting professionals, in the fields of business valuation, financial litigation, and various other specialty services.

Standard VI—Business Valuation Review—of the Professional Standards promulgated by the NACVA ("NACVA Standard VI")[7] is applicable to review engagements where the subject interest is a business, business ownership interest, security, or intangible asset.

Based on NACVA standards, as previously mentioned, a business valuation review is intended to determine the credibility of the work product of another valuation analyst.

As presented in NACVA Standard VI:

> The scope of a Business Valuation Review should be sufficient to provide a [NACVA] member a basis for rendering a credible Business Valuation Review opinion regarding the relevance, reliability, completeness, and reliable application of the business valuation methodology under review, and its consistency with generally accepted valuation practices.[8]



Further, while a NACVA business valuation review opinion is not a conclusion of value or calculated value, the analyst should understand that additional standards apply should the analyst provide an opinion other than whether the work under review is misleading or not misleading.

As presented in NACVA Standard VI:

> The General and Ethical standards apply to all professional services performed by [NACVA] members.
>
> (1) Under these Review Standards, if the [NACVA] member provides a Conclusion of Value or Calculated Value as a part of the Review of another valuation analyst's work, the member must follow NACVA's General Business Valuation Standards as outlined in paragraphs III. through V. above. In the context of preparing the Conclusion of Value or Calculated Value, the Litigation Engagement Reporting Standards as outlined in (paragraph V. D.) applies.
>
> (2) If the [NACVA] member does not provide a Conclusion of Value or Calculated Value as part of the Business Valuation Review, the [NACVA] member need

> only provide an opinion, including the basis and reason for the opinion, as to whether the report under review is appropriate and not misleading within the context of the requirements applicable to that work, stating the reasons for any disagreement, following the Review Standards below.

Based on the NACVA standards (and somewhat similar to USPAP), the reviewer should provide an opinion, and support for said opinion, regarding whether the valuation under review is appropriate, reasonable, and not misleading. The review opinion can be presented in either a written report or an oral report.

And, as previously mentioned, the reviewer should opine whether the valuation under review is appropriate within the context of the requirements applicable to that valuation. The reviewer should also state and develop reasons for any disagreement with the business valuation under review, and follow the appropriate NACVA reporting standards for a review engagement.

American Institute of Certified Public Accountants

SSVS[9] provides guidance with regard to business valuations performed by members of the American Institute of Certified Public Accountants. However, if an AICPA member performs a review engagement, but does not develop an independent value conclusion or independent calculation of value, SSVS is not applicable.

SSVS does not cover review engagements and does not have a provision similar to USPAP Standard 3 or to NACVA Standard VI.

This means that an AICPA member may review an analyst work product (or business valuation) without adherence to SSVS. This review, without adherence to SSVS, can include the review of items such as the sources of information, business valuation approaches and methods, mathematical issues and calculations, logical inconsistencies, or clarity issues presented in the original analyst work product.

The AICPA member may provide corrected values resulting from the correction of any errors identified during the review process. However, "if the CPA also concludes that the corrected values represent the CPA's value conclusion, SSVS would apply."[10]

This means that if the analyst provides any suggested changes to the indications of value included in the original analyst report, then the analyst is required to follow (and comply with) SSVS. Said another way, SSVS would apply if the CPA develops a value conclusion that is presented as his or her opinion of value.

Review Engagement—The Process

Based on the guidance previously presented, when conducting a review engagement, the analyst should determine whether the work product under review provides a credible and reliable opinion of value that is consistent with generally accepted business valuation practices and procedures.

Generally, valuation stakeholders base the credibility of a business valuation, in part, on consideration of the inclusion of all known facts and circumstances as of the analysis (or valuation) date.

Credibility is understood to relate to the connection between:

1. the opinion of value and
2. the relevance, completeness, and application of generally accepted business valuation methodology.

For example, the elements of a credible opinion may include the following:

1. Adequate disclosure
2. Completeness
3. Nonadvocacy
4. Relevance
5. Reliability
6. Transparency

The reviewer should consider whether the business valuation under review presents or considers all material known facts and circumstances related to the applied valuation process. Further, the business valuation report should include sufficient relevant disclosures that help stakeholders understand the foundation for the original analyst's valuation conclusions.

In a review engagement, there are many questions the reviewer should be considering.

Did the original analyst include and assess all facts and circumstances known without limitation or exclusion? Are the data, assumptions, and supporting explanations in the valuation report presented in sufficient detail for a reader (i.e., stakeholder) to understand and duplicate the process?

Are the assertions, assumptions, and estimates included in the valuation report considered credible (i.e., logical and reasonable)? What was the original analyst's objective in formulating his or her opinion? Does the particular standard, method, or procedure form a supportive basis for the analyst's valuation opinion? Were the methods used in the valuation report appropriately applied?

The reviewer analyst should consider whether the approaches and methods applied in the business valuation were relevant to the objective and purpose stated in the valuation. This is because the reviewer's goal is to establish whether the original analyst appropriately performed the analysis based on the requirements of the engagement, including the stated purpose, standard of value, valuation date, and intended use.

In applying this "credibility" framework, the reviewer can appropriately scrutinize the original valuation report to determine if the valuation process undertaken resulted in a credible and reliable opinion of value.

As mentioned previously, the reviewer analyst should also develop and properly identify any reasons for disagreement with the original valuation report. When conducting a review engagement, the reviewing analyst should "identify and articulate the components of a valuation report that (1) require additional support, (2) are inherently inconsistent, (3) lack relevance to the purpose of the engagement, [and] (4) have an impact on credibility."[11]

Some of the methods and techniques that can assist the reviewer analyst in providing an appropriate, defensible business valuation review are presented below.

Review Engagement—The "Checklist"

In performing a review engagement, it is helpful for the analyst to understand the structure and content of a business valuation report. This understanding will provide the reviewing analyst with a "road map" of potential areas of inconsistency or error.

The narrative business valuation report typically contains a number of sections. These sections often include the following:

- A description of the subject business interests and the effective analysis (valuation) date
- The purpose and objective of the engagement
- The standard of value
- A description of the subject company and an analysis of historical and projected financial operating results
- A discussion of relevant industry and economic conditions
- A discussion of generally accepted business valuation approaches and methods
- A discussion of the selection and application of relevant business valuation approaches and methods
- A discussion of the value conclusion, including discussions of relevant valuation adjustments (e.g., control premium or discount for lack of control, discount for lack of marketability, blockage discount, key person discount, etc.)

Additionally, and consistent with most generally accepted business valuation standards, a business valuation report typically includes information such as the following:

1. The analyst's credentials
2. Assumptions and limiting conditions
3. An analyst's certification or representation

Based on the numerous components incorporated in a typical valuation report (such as those previously mentioned), a review "checklist" can serve as a useful tool when the analyst is engaged in a review assignment.

A review checklist can assist the reviewer in assessing the validity of the original analyst's report and reliability of the corresponding conclusions. It can also assist the reviewer in establishing whether the report identifies and defines the components of the valuation analysis in an appropriate manner.

The following list presents some categories that the analyst can consider when reviewing a valuation report. The list is presented in a manner consistent with the order that a reviewer may expect to find the related information in a narrative valuation report.

- Definition of the valuation assignment
  - Definition of the subject property/entity (including the size of the subject ownership interest)
  - Purpose and objective of the valuation assignment
  - Standard of value
  - Characteristics of ownership (including control and marketability characteristics)
- Premise of value
- Effective date of the valuation and date of the valuation report
- Sources of information
  - Site inspection and interview
  - Company financial statements
  - Information known or knowable as of the valuation date
  - Past transactions
- Description of the subject company
  - Capitalization and ownership
  - Company background and operations
- Economic and industry data and analysis
- Analysis and adjustment of company financial statements
- Comparative ratio analysis
- Income approach and methods
  - Discounted cash flow method
  - Capitalization of net cash flow method
- Market approach and methods
  - Guideline publicly traded company method
  - Guideline merged and acquired company method
- Asset-based approach and methods
  - Asset accumulation method
  - Adjusted net asset value method (applying the capitalized excess earnings method)
- Valuation adjustments (discounts and premiums)
- Synthesis and conclusion
  - Overall assessment
  - Comprehensiveness
  - Accuracy
  - Coherence and cohesion
  - Internal consistency
  - Incisiveness
- Signature of the analyst or the analyst's firm
- Analyst's curriculum vitae
- Analyst's certification or representation
- Contingent and/or limiting conditions or assumptions

Further, the original valuation report may include specific definitions of terms, formulas, and standards of value, as they may vary based on the original assignment. Overall, the valuation report should be well documented, easily understood, and include sufficient information about the source materials considered.

This means that the valuation report should be adequately documented such that another qualified analyst—in this case the reviewer—would be able to locate the identified source materials and replicate the analysis included in the original valuation report.

Chapter 19 of *Valuing a Business*[12] and Chapter 25 of *The Lawyer's Business Valuation Handbook*[13] also present detailed checklists that can be considered for the purpose of reviewing a business valuation report. When using these checklists, it is important that the reviewer understands that not every item on these checklists will be applicable or relevant to every valuation engagement.

There may be items relevant to the original valuation report that are not included in the above checklists. This can sometimes include certain information that can only be found in the original analyst's work papers, or through a due diligence interview with the original analyst.

Applicable Standards for a Valuation Engagement or a Calculation Engagement

Obviously, one important aspect of a review assignment is establishing whether the valuation analysis and report were developed consistent with applicable business valuation professional standards.

The original valuation should clearly state what professional standards were applied in the development of the opinion of value and the report. These may include standards presented in USPAP, SSVS, or NACVA standards (as previously mentioned), or

American Society of Appraisers ("ASA") standards with regard to business valuation development and reporting.

Based on these applicable business valuation standards, the engagement will typically be either a valuation engagement or a calculation engagement. Further, and based on these applicable business valuation standards, the format of the written valuation report may be one of the following:

1. A detailed valuation report
2. A summary or restricted valuation report
3. A calculation valuation report

The original valuation report, based on these applicable business valuation standards, should identify the type of engagement and/or the type of report issued. This is one example of what the reviewing analyst should confirm when being retained on a review engagement (i.e., the reviewing analyst should confirm that the type of engagement is documented in a manner that complies with the business valuation professional standards applicable to that engagement, and the format of the original valuation report).

In a valuation engagement, the analyst selects and uses the valuation approaches and methods deemed to be appropriate to arrive at a reasonable conclusion of value with regard to the valuation subject company. The conclusion of value resulting from a valuation analysis may be presented in a detailed report or a summary/restricted report.[14]

The presentation of a valuation conclusion in a detailed report or a summary report typically is based on "the level of reporting detail agreed to by the analyst and the client."[15]

If the subject of the review is a valuation engagement report, the following professional standards related to a valuation engagement report may apply:

1. NACVA Professional Standards: II, General and Ethical Standards; II, Scope of Services (B)(1) Valuation Engagement; IV, Development Standards; and V, Reporting Standards (C)(1) Contents of Report for detailed reports and (C)(2) Contents of Report for summary reports
2. SSVS Section .21(a); Sections .23 through .45, for valuation engagements; Sections .48 (a) and (b); Sections .51 through .70, for detailed valuation engagement reports; and Sections .71 and .72, for summary valuation engagement reports
3. USPAP: Standards 9, Business Appraisal, Development, and Standard 10, Business Appraisal Reporting; specifically, Standard 10-2(a) for a detailed report and Standard 10-2(b) for a summary/restricted report
4. ASA: BVS-1, General Requirements for Developing a Business Valuation, and BVS-VIII, Comprehensive Written Valuation Report

In a calculation engagement, the analyst and the client agree up-front on the valuation approaches and methods to be used, along with the extent of the procedures to be performed in the engagement. A calculation engagement results in a calculation of value and is presented in a calculation report.

If the subject of the review is a calculation engagement report, the following professional standards related to a calculation engagement report may apply:

1. NACVA Professional Standards: II, General and Ethical Standards; III, Scope of Services (B)(2) Calculation Engagement; IV, Development Standards; and V, Reporting Standards (C)(3) Contents of Report for calculation reports
2. SSVS Section .21(b); Section .46, for calculation engagements; Section .48(c); and Section .73 through Section .77, for calculation reports

It is important to note that neither USPAP professional standards, nor ASA professional standards, have an alternative to a valuation engagement such as a calculation engagement.

Next, this discussion provides common errors and inconsistencies that the reviewing analyst can look for when conducting a review engagement.

Computational Errors

Many errors committed in a business valuation engagement are the result of:

1. a lack of understanding regarding business valuation principles and procedures or
2. the improper application of business valuation approaches and methods.

However, a reviewer has the responsibility to establish that the work under review is not only credible, but also free of computational errors.

Computational or mathematical errors generally fall in the category of:

1. mathematical calculation errors and
2. incorrect formulas.

While mathematical calculation errors are relatively self-explanatory, with the extensive use of computerized, linked worksheets to complete business valuations (such as Microsoft Excel), errors often result when worksheets are not properly linked or formulas are modified without subsequent confirmation and verification.

Incorrect formula errors seems to have increased significantly over the last several decades due to the increased use of these computerized, linked worksheets. This can present a relatively simple and direct critique by the reviewing analyst.

Additional human errors occur simply as a result of inputting incorrect numbers retrieved from third-party source documents (e.g., subject company financial information or publicly obtained documents).

A thorough review engagement includes the recalculation of all amounts and values presented in the subject report, including:

1. footing (summing vertically),
2. cross-footing (summing horizontally),
3. cross-referencing (confirming the consistency of amounts produced in multiple places), and
4. recalculating amounts and the value indications presented in the original report attached exhibits and schedules.

Proper Application of Generally Accepted Business Valuation Practices and Procedures

The specific valuation approaches, methods, and procedures applied to value a business will vary based on the facts and circumstances specific to each engagement. However, the basic principles of business valuation generally remain constant.

All other factors remaining the same, the use of generally accepted business valuation approaches, methods, and practices by multiple analysts should result in reasonably reconcilable conclusions of value for a subject company. This, of course, assumes (in part) that the following are the same:

1. Subject company
2. Definition of the assignment
3. Standard of value and premise of value
4. Valuation date
5. Access to the subject company information
6. Industry and economic conditions

Adherence to, and application of, generally accepted business valuation approaches, methods, and procedures provides a reasonable expectation of consistency in an analyst's work product. This consistency enables a reviewer to complete the review process in an orderly and time-efficient manner, using the applicable business valuation standards as a guide.

However, in many review assignments, it is important to note that the primary errors identified typically relate less to computational errors and more to inconsistencies in the application of standard business valuation practices and procedures.

The following section provides seven examples of common theoretical inconsistencies committed by analysts when preparing a valuation report.

Common Inconsistencies

First, in using the income approach, either the discounted cash flow ("DCF") method or the direct capitalization method, the analyst may inappropriately mismatch the discount rate and the expected earnings. Based on generally accepted business valuation standards and procedures, the discount rate should match conceptually to the definition of the normalized income (e.g., net cash flow) being discounted.

Further, the analyst may use the weighted average cost of capital to discount net cash flow to invested capital investors (i.e., debt and equity stakeholders) and the equity discount rate to discount net cash flow to equity investors.

Second, if the analyst does not understand that there are distinct conceptual differences between (1) the income approach, DCF method, and (2) the income approach, direct capitalization method, he or she may incorrectly apply these methods to the valuation analysis.

In general, the direct capitalization method is the relevant valuation method used within the income approach to value a company with stable, nonvolatile earnings (i.e., cash flow) and stable, nonvolatile earnings growth.

Conversely, the DCF method is typically the relevant valuation method for valuing a company with inconsistent earnings (i.e., cash flow) and/or inconsistent earnings growth.

Third, in the valuation of some closely held businesses within a family law context, an adjustment for executive compensation may be appropriate.

According to Internal Revenue Service Revenue Ruling 68-609, "If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner or partners engaged in the business."

This can be an issue for the analyst as shareholder executives of successful closely held companies sometimes pay themselves compensation in excess of indicated, market-based compensation for the services rendered. If this executive compensation is not appropriately adjusted by the analyst, the indicated value of the subject company may be understated.

Conversely, in development-stage or unprofitable companies, shareholder executives may pay themselves below-market compensations. Failure to properly adjust this executive compensation could result in a business value that is overstated as a result of the understated operating expenses (and the resulting overstatement of earnings, leading to an indicated higher value).[16]

Fourth, some private companies may own assets that are not used in their core operations. If nonoperating assets are given separate consideration, any income generated, or expenses incurred, with regard to the nonoperating assets should be separated from the earnings (i.e., cash flow) used to complete an income-based valuation method of the subject company.

Sometimes, an analyst may separate the nonoperating assets from the overall value of the business but incorrectly include the income generated by these nonoperating assets in the earnings (i.e., cash flow) used to value the subject company, thereby artificially inflating the value conclusion.

Fifth, some analysts mistakenly believe that asset-based approach methods can be used only under a liquidation premise of value. In actuality, and based on generally accepted business valuation standards and practices, the asset-based approach can be used with all premises of value—that is, from a going concern premise of value to a liquidation premise of value.

However, the analyst should be aware that when applying the asset-based approach under a liquidation premise of value, the subject interest to be valued should have the ability (i.e., control) to liquidate the underlying assets of the subject company.

For example, as presented in the textbook *Guide to Business Valuations*:

> If the consultant plans to value a partial interest in the subject company using the NAV [asset-based approach, net asset value] method, there is another important consideration. The subject ownership interest should be able to cause the sale of the company's assets. Accordingly, the NAV method is more appropriate for valuing controlling interests than for minority interests.[17]

Sixth, when applying the different valuation methods, it is important for an analyst to understand the level of value indication each method initially produces, and whether the ultimate goal of the valuation analysis is to produce a controlling or noncontrolling level of value.

An income approach method can produce either a controlling or a noncontrolling indication of value depending on the earnings level, or cash flow, incorporated within the DCF analysis. Comparatively, the guideline publicly traded company method typically concludes a noncontrolling level of value, while the merged and acquired company method and the asset-based methods typically conclude values on a controlling interest basis.

When the analyst ultimately reconciles the indications of value resulting from each of the different valuation methods applied, it is required that the value indications are synthesized on a common basis, whether it be controlling or noncontrolling.

Seventh, when completing a business valuation, the analyst may be tempted to use hindsight as direct evidence of value. That is, the analyst may be tempted to consider events that occur subsequent to the effective valuation date in the analysis of the subject company. Consideration of subsequent events and related information, which is not known or knowable as of the effective valuation date, is typically inconsistent with developing a relevant value opinion as of a specific analysis (or valuation) date.

As presented in the *International Glossary of Business Valuation Terms*, and reproduced verbatim in SSVS, the "effective date," also referred to as the "valuation date" or the "appraisal date," is "the specific point in time as of which the valuator's opinion of value applies."[18]

Within the valuation profession, achieving the appropriate valuation objective established in an engagement is contingent on consideration of information that is known or knowable as of the effective valuation date.

However, certain valuation standards do indicate that an analyst may consider a subsequent event (i.e., an event occurring after the effective valuation date) if the event was reasonably known or knowable as of the valuation date, and if the event occurs within a reasonable time frame relative to the effective valuation date.

"It is a rare instance when a subject company and each of the selected guideline companies are identical based on their operating characteristics and financial performance."

Reasonableness of Assumptions and Conclusions

In conducting a review engagement, the analyst should always consider the reasonableness and appropriateness of the assumptions, adjustments, and conclusions presented in the valuation report.

For example, when applying the market approach, guideline publicly traded company method, is it reasonable to apply the average or median indicated guideline company multiples to the fundamentals of the subject company? The quick answer to the above question is typically no, for a number of reasons.

Simply relying on the average or median guideline company multiples without performing a comparative analysis between (1) the subject company and (2) each of the selected guideline companies implies that the subject company is identical to the guideline companies, which generally is not a reasonable assumption.

It is a rare instance when a subject company and each of the selected guideline companies are identical based on their operating characteristics and financial performance.

Another area where an analyst can easily err is in the estimation of the expected income (i.e., cash flow) that is applied in the income approach, direct capitalization method. Sometimes, an analyst will simply rely on the average of historical financial results to estimate the subject company expected future earnings/cash flow.

However, income approach methods used in business valuation are forward looking in nature. Relying on average historical operating results to estimate the future value of a subject business could severely overstate, or understate, the indicated value of the business.

By (1) completing a thorough review of the subject company's past operating results and (2) considering prospective operating results for the subject company in light of expected industry and economic conditions, the analyst can establish a reasonable, credible foundation for estimating a normalized earnings (i.e., cash flow) level for the subject company over the long-term.

Further, once a value for the subject company has been estimated, the analyst can test the reasonableness of the value conclusion by reviewing the implied range of values derived from the various valuation methods employed. If properly applied and based on reasonable assumptions, the valuation methods used should ideally produce a relatively narrow range of values for the subject company.

If the different valuation methods applied result in material difference in the individual value indications, a review and potential modification of assumptions incorporated in the valuation process likely is warranted.

Lastly, the analyst can test the reasonableness of the overall value conclusion of a subject company by calculating certain implied valuation pricing multiples. These valuation pricing multiples for the subject company implied by the overall value conclusion should compare reasonably to identical pricing multiples for the selected guideline companies.

Said another way, the implied valuation or pricing multiples based on the overall value conclusion for the subject company should compare reasonably to the same pricing multiples for the selected guideline companies.

Preparing a Review Report

The final step in a review engagement is for the analyst to communicate the results of the review analysis. A valuation review report communicates these results.

According to NACVA standards, the reviewer's findings and conclusions should be stated in the form of an opinion. According to NACVA Standard VII and USPAP Standard 3, when developing a valuation review and a written or oral valuation review report, the analyst should identify the following:

1. The client or intended user
2. The intended use of the opinion
3. The purpose of the appraisal review
4. The work under review and the characteristics of that work (ownership interest, valuation date, the original analyst, etc.)
5. Any extraordinary assumptions and hypothetical conditions necessary in the review
6. The scope of work necessary to produce a review in accordance with the scope of work rule

The analyst should also identify the characteristics of the property, or market area, in the work under review.

The review report content and level of information should be specific to the needs of the client and the intended users (i.e., stakeholders), the intended use, and the requirements applicable to the review engagement. The reporting requirements in USPAP Standard 3 (as previously discussed) represent the minimum level of information for a review report.

The analyst should supplement the report with information sufficient enough for the intended users (i.e., stakeholders) to fully understand the review report and the review report conclusions. Such additional information may include the disclosure of research and analysis performed, and research and analysis that was not performed.

Once the analyst has identified sufficient information regarding the work under review and the research and analysis performed, he or she should state his or her opinion and conclusions about the work under review, including the basis for the opinion offered.

As previously discussed, in stating his or her opinion, the review analyst should appropriately identify, explain, and document the reasons for any disagreement with the report under review.

Conclusion

Many business valuation report errors can be avoided if generally accepted business valuation standards and procedures are properly applied. Neglecting to do so can open up the analyst to credibility critiques should the business valuation report be reviewed by another analyst.

In performing a review engagement, the reviewer should:

1. follow applicable business valuation standards and procedures in conducting the review engagement and
2. determine if the opposing analyst's work was developed in a manner consistent with generally accepted business valuation practices and applicable standards.

As a result, it is important for the reviewer to understand the review engagement process and relevant standards in order to effectively serve clients (i.e., stakeholders) in a family law context.

Notes:

1. Francisco Rosillo, "A New Perspective of Business Appraisal Review," *Valuation Strategies* (January/February 2011).
2. National Association of Certified Valuators and Analysts *Professional Standards*, Standard VI (B).
3. Ibid.
4. Standard 3 in 2018-2019 *Uniform Standards of Professional Appraisal Practice* (Washington, D.C.: The Appraisal Foundation, 2018).
5. Ibid.
6. Ibid.
7. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, VS Sec. 100 (New York: American Institute of Certified Public Accountants, 2007), Standard VI.
8. NACVA *Professional Standards*, Standard VI (B).
9. Ibid.
10. Jay E. Fishman, Shannon P. Pratt, James R. Hitchner, and J. Clifford Griffith, *PPC's Guide to Business Valuations*, 28th ed. (Carrollton, TX: Thomson Reuters, 2018), 1-8.
11. Rosillo, "A New Perspective of Business Appraisal Review."
12. Shannon P. Pratt, "Reviewing a Business Valuation Report" (Chapter 22) in *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 535–544.
13. Shannon P. Pratt, "Chapter 25—Checklist for Reviewing a Business Valuation Report," *Business Valuation Review* 28, no. 2 (Summer 2009): 100–119.
14. A summary report presents the conclusion of value in a shortened, summarized version of a detailed report.
15. SSVS, VS Sec. 100, Section .48(b).
16. It is important to note that, in general, adjustments for executive compensation typically are made only when valuing controlling ownership interests. This is because only the controlling executive shareholder has the ability to adjust executive compensation.
17. Fishman, et al., *PPC's Guide to Business Valuations*, 28th ed., 7-2.
18. Ibid., *International Glossary of Business Valuation Terms*.

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Willamette Management Associates
Thought Leadership in Valuation, Damages Analyses, and Transfer Price Analyses

Willamette Management Associates consulting experts and testifying experts have achieved an impressive track record in a wide range of litigation matters. As independent analysts, we work for both plaintiffs and defendants and for both taxpayers and the government. Our analysts have provided thought leadership in breach of contract, tort, bankruptcy, taxation, family law, and other disputes. Our valuation, damages, and transfer price analysts are recognized for their rigorous expert analyses, comprehensive expert reports, and convincing expert testimony. This brochure provides descriptions of some recent cases in which we provided expert testimony on behalf of the prevailing party.

Transfer Pricing Testifying Expert Services

In the matter of ***Amazon.com, Inc. & Subsidiaries v. Commissioner*** (148 T.C. No. 8 (2017)), the U.S. Tax Court found in favor of the taxpayer plaintiff. The case involved a 2005 cost sharing arrangement that Amazon entered into with its Luxembourg subsidiary. Amazon granted its subsidiary the right to use certain pre-existing intangible property in Europe, including the intangible assets required to operate Amazon's European website business. The Tax Court held that (1) the Service's determination with respect to the buy-in payment was arbitrary, capricious, and unreasonable; (2) Amazon's CUT transfer price method (with some upward adjustments) was the best method to determine the requisite buy-in payment; (3) the Service abused its discretion in determining that 100% of technology and content costs constitute intangible development costs (IDCs); and (4) Amazon's cost-allocation method (with certain adjustments) was a reasonable basis for allocating costs to IDCs. Robert Reilly, a managing director of our firm, provided expert testimony on behalf of taxpayer Amazon in this Section 482 intercompany transfer pricing case.

Income Taxation Testifying Expert Services

On February 21, 2017, the U.S. Court of Federal Claims dismissed (with prejudice) the complaint filed by plaintiff **Washington Mutual, Inc.**, against the United States (Nos. 08-321T, 08-211T). The taxpayer plaintiffs were seeking a refund of at least $149 million in certain federal taxes paid by H.F. Ahmanson & Co. ("Ahmanson") during several tax years in the 1990s, based upon the abandonment loss and amortization deductions available under the Internal Revenue Code. The case involved the fair market value determination of the regulatory right to open deposit-taking branches in certain states other than California ("branching rights"), the contractual approval right to treat the goodwill created by certain acquisitions as an asset for regulatory accounting purposes ("RAP rights"), and certain other intangible assets. Curtis Kimball, a managing director of our firm, critiqued the valuation report presented by the plaintiff's valuation expert and provided rebuttal expert testimony on behalf of the U.S. Department of Justice regarding the valuation of branching rights and RAP rights intangible assets. The Claims Court dismissed the plaintiffs' tax refund claims.

Condemnation Proceeding Testifying Expert Services

In the matter of ***Town of Mooresville v. Indiana American Water Company*** (2014), Willamette Management Associates was engaged by the defendant to perform a valuation analysis of the Indiana American Water Company (the "company") retail water system located in Mooresville, Indiana. The purpose of the analysis was to assist the company in a condemnation proceeding initiated by the town of Mooresville, Indiana. Our assignment was to estimate the fair market value of the company total operating assets (as part of a going concern). The primary valuation issue in the dispute was: should all of the company operating assets (financial asset accounts, tangible property, and intangible assets) be assigned value in a condemnation proceeding? Or, should the condemnee receive the accounting book value (or regulatory "rate base") of the tangible assets only? After a jury trial, at which Robert Reilly, a managing director of our firm, provided expert testimony, the jury's decision favored our analysis and awarded Indiana American Water Company the value of both its tangible assets and its intangible assets.

Family Law Testifying Expert Service

In a marital dissolution matter in 2016, the Superior Court of Arizona, Maricopa County, found in favor of the husband in the family law case ***In re the Marriage of Julie Anne Bowe and Gregory James Vogel, Sr.*** (No. FC2014-001952), Willamette Management Associates was engaged by Gregory Vogel, as president and owner of Land Advisors Organization (LAO), a national land brokerage business, to prepare a valuation analysis. Charles Wilhoite, a managing director of our firm, provided expert testimony. The purpose of the analysis was to assist with facilitating the property settlement aspects of the parties' marital dissolution. The primary valuation issues in the dispute were (1) the most appropriate valuation date and (2) the appropriate historical period of operating results to be relied on as a foundation for estimating the expected future earnings in a capitalization of cash flow business valuation analysis. The Court favored the Willamette positions, resulting in a judicially concluded value for LAO significantly lower than the opinion offered by the opposing valuation experts. This case is currently being appealed.

Bankruptcy Testifying Expert Services

Willamette Management Associates was engaged by the proponents of a reorganization plan to prepare a declaration in the matter of *In re Plant Insulation Company* (No. 09-31347, U.S. Bankruptcy Court, N.D. Cal. 2014). Our assignment was to review the declarations of the opposing experts in this case and to offer our opinion on certain shareholder agreements related to the matter. In particular, we were asked to review a right of first offer agreement and to opine on its impact on the control, transfer, and value of common stock and warrant interests in Bayside Insulation and Construction, Inc. Following a trial, at which Willamette managing director Curtis Kimball offered rebuttal expert testimony, the U.S. Bankruptcy Court accepted the plan of reorganization proposed by the Futures Representative of the Official Committee of Creditors.

Property Taxation Testifying Expert Services

Willamette Management Associates was engaged by the plaintiff to prepare a forensic analysis expert report for *Sandy Creek Energy Associates, LP, and Brazos Sandy Creek Electric Cooperative, Inc. v. McLennan County Appraisal District* (No. 2014-3336-4, Dist. Ct. McLennan County, Texas, August 2016). The purpose of the Willamette expert report and expert testimony was to assist the owners of the Sandy Creek coal-fired electric generating plant (the "plant") in a property taxation dispute with the McLennan County Appraisal District (the "district"). Our assignment was to review and rebut the unit valuation expert report and testimony provided by the district's valuation expert. One issue in the dispute was the amount of economic obsolescence associated with the plant. As of the property tax assessment date, the plant's cost to produce electricity was significantly greater than the wholesale price of electricity. As described in the Willamette expert report, these operating conditions indicated that economic obsolescence was present in the plant. After a week-long trial, at which Willamette managing director Robert Reilly offered expert testimony, a jury decided that the fair market value of the plant was less than half of the value asserted by the district. This jury decision significantly favored the taxpayer, and it resulted in a substantial reduction in the plant's property tax assessment.

Dissenting Shareholder Rights Testifying Expert Services

In the case, ***In Re Appraisal of The Orchard Enterprises, Inc.*** (No. 5713-CS, 2012 WL 2923305 (Del. Ch. 2012), *aff'd* No. 470, 2013 WL 1282001 (Del. 2013)), Willamette Management Associates was retained on behalf of the petitioners in a case where the subject of the dispute was the fair value of the Orchard Enterprises, Inc. ("Orchard") common stock at the time the company was taken private. Orchard was a digital media services company specializing in music from independent labels with a mission to acquire distribution rights, build sales channels, and monetize these rights in new and innovative ways. The petitioners had received $2.05 per share in the going-private transaction. At trial, Tim Meinhart, a managing director of our firm, testified that the fair value of the Orchard common stock at the time of the go-private transaction was $5.42 per share. The court agreed with our overall conclusion that the transaction occurred at a price that was lower than the fair value of the stock. The court concluded that the common stock fair value was $4.67 per share at the time of the go-private transaction.

Best Practices Discussion

Practical Guidance to Identifying and Valuing Goodwill in a Family Law Context

Justin Nielsen and Connor J. Thurman

In family law matters, the valuation analyst ("analyst") may be retained to provide an independent estimate of the value of closely held service-oriented company ownership interests, or professional practice ownership interests, to assist in the equitable settlement of the marital estate. During these assignments, one common issue that analysts and legal counsel confront is the identification and treatment of any goodwill included in the value of the closely held service-oriented company or professional practice. In general, this goodwill can be identified as either (1) enterprise (or institutional) goodwill or (2) personal goodwill. This discussion summarizes the differences between enterprise goodwill and personal goodwill. This discussion addresses state statute guidance with regard to the treatment of enterprise goodwill and personal goodwill within a family law context. This discussion also summarizes (and provides an illustrative example) of the generally accepted valuation approaches, methods, and procedures that can be applied in the analysis of goodwill within a family law context.

Introduction

Many businesses, particularly service-oriented businesses, are worth more than the fair market value of their tangible assets and their cash on hand. This is because these businesses likely own some amounts of intangible asset value that is derived from the ability to generate substantial income with limited tangible assets.

The intangible asset value of a subject closely held service-oriented company, or professional practice, in a family law setting is sometimes referred to as "goodwill." However, goodwill technically represents the residual intangible asset value component of a business enterprise that cannot be specifically assigned to (or identified with) any of the other three intangible asset types (i.e., intangible financial asset instruments, general commercial intangible assets, and intellectual property).

In a broad sense, goodwill may be defined as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."[1]

Within this broad definition, goodwill can also be classified into two distinct components when valuing a closely held service-oriented business, or professional practice, within a family law context:

1. Enterprise (or institutional) goodwill
2. Personal goodwill

The treatment of goodwill in a family law setting (i.e., the inclusion or exclusion of enterprise goodwill or personal goodwill as divisible property within the marital estate) varies from state to state.

Further, the classification of goodwill (i.e., the classification of enterprise goodwill versus personal goodwill) for marital estate property division purposes has historically been dependent on whether the goodwill intangible value is attributable to the subject company (i.e., enterprise goodwill) or attributable to—and inseparable from—an individual within the marital estate (i.e., personal goodwill), as proffered by various state judicial precedent.

With regard to the marital estate service-oriented business ownership interest, or the marital estate professional practice ownership interest, there should be a collaboration between the valuation analyst ("analyst") and family law counsel ("counsel"). In particular, the analyst can assist counsel with regard to identifying and quantifying the closely held company/practice enterprise goodwill and personal goodwill in a family law context.

Conversely, counsel can provide meaningful guidance to the analyst with regard to the interpretation of relevant statutory authority and judicial precedent associated with enterprise goodwill and personal goodwill in a family law context.

Once the analyst and counsel have collaborated with regard to the appropriate statutory authority and judicial precedent for the marital dissolution assignment, it is important that both parties understand the generally accepted valuation approaches, methods, and procedures that can be used in performing an analysis of goodwill within a marital estate closely held service-oriented business interest or professional practice.

This discussion provides a definition of goodwill, and addresses the differences between enterprise goodwill and personal goodwill. This discussion summarizes state statute guidance regarding the treatment of goodwill in a family law context. And, this discussion summarizes the generally accepted approaches, methods, and procedures that can be used in the analysis of goodwill within a family law context.

Goodwill

Goodwill is a common, but often misunderstood, term that is used consistently in the analysis of both public and private businesses. To understand and perform an analysis of goodwill within a family law context, it is important for both the analyst and counsel to first understand:

1. the definition of intangible assets and
2. the various types of intangible assets (such as goodwill).

While the distinction between a tangible asset and intangible asset may be intrinsically simple—many analysts pontificate that the distinction is whether you can physically hold or touch an asset (i.e., a tangible asset) versus an asset that you cannot physically hold or touch (i.e., an intangible asset)—from a valuation perspective, a more definitive distinction is required.

As presented in *Guide to Intangible Asset Valuation*:

> The important economic difference between a tangible asset and an intangible is this:
>
> - The value of a tangible asset is derived from its tangible nature.
> - The value of an intangible asset is derived from its intangible nature.[2]

Said another way, the physical components of a tangible asset—or value of the physical components of a tangible asset—<u>are</u> the asset. Conversely, the value of an intangible asset is derived from the legal rights associated with the intangible asset and the intellectual property content of the intangible asset (i.e., the value of an intangible asset does not flow from its physical components).

According to *Guide to Intangible Asset Valuation*, the four generally accepted categories of intangible assets are the following:

1. Intangible financial assets
2. General commercial intangible assets
3. Intellectual property intangible assets
4. Intangible value in the nature of goodwill[3]

While the analyst and counsel may not initially think of financial assets as intangible assets, the cash, accounts and notes receivable, and stocks and bonds presented on a company's balance sheet represent intangible financial assets.

This is because the value of these assets does not come from the actual tangible nature of the assets, but rather the value of these assets is derived from the fact that an owner has the legal right to exchange these assets for goods and services.

General intangible assets are typically created in the normal course of business operations. Company executives do not have to make special efforts to create these general intangible assets; rather they naturally develop as company executives manage the day-to-day operations of the business.

Examples of general intangible assets include customer contracts and relationships, supplier contracts and relationships, a trained and assembled workforce, certain licenses and permits, proprietary operating systems and procedures, and company books and records.

In contrast, intellectual property is typically created by specific and conscious intellectual activity of the intellectual property developer. The creativity involved in developing an intellectual property can typically be identified and attributed to a specific individual (or group of individuals).

Once created, intellectual property is a new and unique invention that can be either artistic, such as a book or a photographic image, or technological, such as a chemical process or computer software code.

Specifically, the four types of intellectual property are as follows:

1. Trademarks and trade names
2. Patents
3. Copyrights
4. Trade secrets

At a basic level, intangible value in the nature of goodwill is typically considered to be a residual intangible asset. This means that goodwill is often considered to be the intangible component of a business enterprise that cannot be directly assigned to, or identified with, any of the other three identifiable intangible assets.

However, while there are many professional interpretations of goodwill, these interpretations are typically grouped into two categories: residual-based interpretations of goodwill and income-based interpretations of goodwill (which are addressed in greater detail later in this discussion).

From both the analyst and the counsel perspective, while the income-based interpretations of goodwill generally are more useful in a marital dissolution context, the analyst and counsel should be familiar with the residual-based interpretations of goodwill as well. This is because both categories of goodwill interpretations generally agree on the components of goodwill and the types of goodwill (i.e., the factors that create goodwill and the situations in which goodwill arises).

There are three primary components of goodwill. As presented in the textbook, *Guide to Intangible Asset Valuation*:

> The first goodwill component is the existence of operating business assets that are in place and ready to use. This component is sometimes referred to as the *going-concern value* element of goodwill. The fact that all of the elements of a business enterprise are physically and functionally assembled creates an intangible asset.
>
> The second goodwill component is the existence of excess income (however measured) . . . This excess income component relates to the concept of goodwill as that portion of business value that cannot be specifically assigned to the owner/operator's tangible assets or identifiable intangible assets.
>
> The third goodwill component is the expectation of future events that are not directly related to the owner/operator's current operations. Goodwill may be created by the expectations of future capital expenditures, future mergers and acquisitions, future to-be-developed products or services, and future customers or clients. This future expectations component relates to the concept of goodwill as the current value of future assets (both tangible assets and intangible assets) that do not yet exist on the analysis date.[4]

While the above descriptions provide a summary of the goodwill component, they do not differentiate between enterprise (or institutional) goodwill and personal goodwill.

Enterprise Goodwill versus Personal Goodwill

Personal goodwill is often most applicable to professional practices and similar service-oriented businesses. Due to the nature of professional practices, their value is highly dependent on the skills, reputation, and knowledge of the individual professionals working at the practice.

Therefore, some (or much) of the value of these types of businesses is attributable to specific individuals rather than the business enterprise itself.

Generally, enterprise goodwill (sometimes referred to as business, practice, or institutional goodwill) is goodwill that is interpreted as representing intangible asset value that is owned and/or that has been created by a commercial enterprise (i.e., business or practice) and that can be readily transferred.

A simple example of enterprise goodwill would be when a company hires a large, recognizable international law firm to assist with a litigation because the company wants a "recognizable" law firm name. The "recognizable" nature and reputation of the large, international law firm would represent enterprise goodwill.[5]

Personal goodwill, on the other hand, is typically interpreted as representing intangible asset value (or, more appropriately, attributes) that is unique to and inseparable from an individual. Meaning, personal goodwill is typically represented by certain attributes (i.e., intangible asset value) that are incorporated into the very being of an individual as opposed to a business enterprise.

A simple example of personal goodwill would be if a company specifically requests an individual law practitioner to provide assistance with the litigation due to his or her reputation. Due to the company specifically requesting the individual law practitioner, this attorney likely has some form of personal goodwill.[6]

In the examples above, the existence of personal goodwill for the individual law practitioner is tied to the fact that a client is primarily engaging the individual, rather than a law firm. The implied assumption is that at some level, if the individual moved to another firm, the clients would migrate with him or her (due to the personal goodwill).

Conversely, the implied assumption in the existence of enterprise goodwill in the above examples is that the company would continue to work with the large, recognizable international law firm despite any change in ownership or in personnel.

Within a family law context, the difference between enterprise goodwill and personal goodwill can be an important and disputed issue. This is because many times the marital estate-owned closely held service-oriented business, or professional practice, can possess both enterprise goodwill and personal goodwill.

While the differentiation between enterprise goodwill and personal goodwill can be a difficult task, it is the responsibility of the analyst and counsel to:

1. identify and quantify any goodwill that is included in a marital-estate-owned closely held service-oriented business or professional practice and
2. appropriately analyze the identified and quantified goodwill as enterprise goodwill or personal goodwill—based on the appropriate state statutes and judicial precedent and on generally accepted business valuation approaches and methods (i.e., primarily the analyst's task in collaboration with counsel).

The following section presents a discussion of the state statutes and judicial precedent with regard to the treatment of enterprise goodwill versus personal goodwill within a family law context.

Marital Dissolution State Statute and Judicial Precedent Guidance

While most family law state courts and magistrates acknowledge the existence and differentiation of personal goodwill versus enterprise goodwill, not all courts and magistrates treat it the same. In fact, the treatment of goodwill in a marital dissolution setting (e.g., the inclusion or exclusion of goodwill as a divisible property within the marital estate) varies significantly between states.

Some state courts and magistrates have provided guidance that both forms of goodwill are to be included in the marital estate in cases of marital dissolution, while other states have determined that personal goodwill should be excluded from the equal division of the marital estate assets.

Still other state courts and magistrates have either not given a clear indication of whether or not personal goodwill should be included in the marital estate, or not provided any formal statutory or judicial guidance with regard to the treatment of enterprise goodwill and personal goodwill.

Generally, in a marital dissolution context, the majority of states recognize enterprise goodwill as a divisible marital asset but exclude personal goodwill as a divisible marital asset.

However, in family law matters where goodwill (and, specifically, personal goodwill) has been identified, it is important that the analyst work with counsel to ensure the proper treatment of goodwill in determining the equitable distribution of the marital estate assets.

According to *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence*, 28 states (and the District of Columbia) currently recognize enterprise goodwill as a divisible marital asset. These states include Alaska, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming.[7]

Conversely, the states of Arizona, Colorado, Montana, Michigan, Nevada, New Mexico, New York, New Jersey, North Carolina, North Dakota, Ohio, and Washington (12 states) recognize both enterprise goodwill and personal goodwill as a divisible marital asset.8

There are also currently 6 states that have provided complicated or conflicting statutory or judicial guidance with regard to the treatment of goodwill in a marital dissolution context. These states include California, Idaho, Indiana, Iowa, South Dakota, and Tennessee.[9]

Two states, Kansas and Wisconsin, while providing statutory or judicial guidance that implies that professional goodwill (i.e., personal goodwill) is includable as divisible property within the marital estate, qualifies this guidance by noting that only professional goodwill (i.e., personal goodwill) that is "marketable" or "salable" should be included as divisible property within the marital estate.[10]

Finally, the remaining two states either have provided no statutory or judicial guidance with regard to the treatment of goodwill within a family law context (Alabama) or do not allow either enterprise goodwill or personal goodwill to be included as divisible property within the marital estate (Mississippi).[11]

While the above information, and the information presented in *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence*, can be useful, the analyst should always rely on the expertise of counsel with regard to the treatment of enterprise goodwill and personal goodwill within a family law context.

Valuation Analysis of Goodwill

There are several generally accepted goodwill valuation approaches and methods available that may be applied in the marital estate service-oriented business or professional practice. The three generally accepted intangible asset valuation approaches include the cost approach, the market approach, and the income approach.

However, prior to discussing these three intangible asset valuation approaches, it is helpful to first present a more detailed summary of the two categories of professional interpretations of goodwill: the residual-based interpretation of goodwill and the income-based interpretation of goodwill.

As previously mentioned, while the income-based interpretations of goodwill generally are more commonly used in a family law context, the analyst and counsel should also be familiar with the residual-based interpretations of goodwill.

This is because both categories of the interpretation of goodwill generally agree on the components of goodwill (i.e., the factors that create goodwill) and the types of goodwill (i.e., the situations in which goodwill arises), and can be applied to analyze both enterprise goodwill and personal goodwill.

Residual Interpretation of Goodwill

Under generally accepted accounting principles, goodwill that is developed through the normal course of business operations is rarely recorded on an entity's financial statements. And, the accounting recognition for internally created goodwill is different than the accounting recognition for goodwill that has been purchased or acquired.

While internally created goodwill is rarely recorded on the subject company/practice balance sheet, purchased goodwill is recorded on the acquirer's balance sheet once the transaction is completed. Under generally accepted acquisition accounting principles, the fair value of purchased goodwill is calculated as the residual value from the total consideration of the purchase (i.e., total purchase price), and is recorded as an intangible asset on the acquirer's balance sheet.

Often, accountants use a broad definition of goodwill, which represents the residual value of (1) the acquired entity's total purchase price less (2) the fair value of all acquired tangible and identifiable intangible assets.

However, sometimes this definition of goodwill quantifies all of the intangible value of an acquired company, such as when each of the individual identifiable intangible assets are not separately identified and valued. This means that, in some instances, the residual value definition of goodwill may capture the total intangible value of the acquired business entity with little consideration to the individual identifiable intangible assets.

Income Interpretation of Goodwill

The income-based interpretation of goodwill is likely more conceptually robust than the residual-based interpretation of goodwill. As such, the income-based interpretation of goodwill may be more useful to the analyst who is attempting to value goodwill specifically (such as within a family law context), as opposed to attempting to value the total intangible value of a business.

In the income-based interpretation of goodwill, the analyst will typically quantify all of the income of the subject business. For example, for purposes of an excess income analysis (i.e., an income-based interpretation analysis of goodwill), the total income of a subject business can be measured in a number of different ways.

The only requirement for income measurement is that it is calculated consistently and incorporates a fair rate of return on the business operating assets (both tangible and intangible).

Next, the analyst will typically assign or allocate a portion of this estimated total income of a subject business to each operating asset category that contributes to the income production (both tangible and intangible). The allocation of this estimated total income is typically based on a fair rate of return on the asset category (both tangible and intangible) multiplied by the value of the asset category.

The analyst will then quantify the portion of this estimated total income that cannot be assigned to any tangible or identifiable intangible asset. This excess income (or excess earnings) is then appropriately allocated to goodwill.

Finally, the value of goodwill is then quantified as this amount of excess income (i.e., the excess income or earnings that cannot be assigned to any tangible or intangible asset), capitalized into perpetuity using a risk-adjusted, and growth-adjusted, direct capitalization rate.

The result of this procedure indicates the total goodwill value of the subject business.

Generally Accepted Approaches and Methods for Valuing Goodwill

There are several generally accepted approaches and methods that are applicable to the valuation of goodwill within a family law context. After consideration of the similarities and the differences, each method may be categorized into one of the three intangible asset valuation approaches.

The following discussion summarizes the generally accepted goodwill valuation approaches.

The Cost Approach

When using the cost approach to value the goodwill of a subject business, the analyst estimates the amount of current cost required to recreate the component elements of the subject business goodwill. The cost approach analysis typically involves a component restoration method.

In the component restoration method, the analyst will list all of the individual components of the subject business goodwill. The next step is to estimate the amount of current cost required to replace each goodwill component (including personal goodwill). This procedure is based on the concept of goodwill as represented by the intangible value of all of the subject business entity assets that are in place and ready to use.

This hypothetical tangible and identifiable intangible asset component restoration method can include the following:

1. The purchase and installation of all subject business equipment
2. The construction or purchase of all subject business real estate
3. The selection of the subject business suppliers

4. The creation of the subject business distribution system
5. The hiring and training of the subject business employees
6. The building of a level of consumer recognition and confidence for the subject business
7. The recreation of the current level of the subject business customer relationships
8. The securing of all sources of the subject business' capital[12]

In the cost approach, component restoration method, all of the component tangible assets and identifiable intangible assets are assembled at a level required to immediately accommodate the subject business entity's current level of operations.

The Market Approach

There are two market approach valuation methods related to valuing the goodwill of a subject business. The first method is the residual from purchase price method. This method utilizes an actual purchase price of the subject business to estimate a goodwill value as the residual value.

The second market approach method for valuing goodwill is the sales comparison method. The sales comparison method relies on analyzing guideline subject business sale transactions that include goodwill.

However, goodwill is rarely sold separately from any other assets (both tangible and intangible) of a going-concern business. Therefore, the selected guideline sale transactions usually involve the sale of a going-concern total business enterprise, or professional practice.

In the residual from purchase price method, the key attribute is there must to be an actual sale of the subject business enterprise to perform the analysis. If there is an actual sale of the subject business enterprise, the analyst will then confirm certain characteristics of the sale (i.e., confirm that it was an arm's-length transaction, that there are no non-cash components or deferred payments, etc.) and perform a residual goodwill valuation analysis of the subject business.

In the sales comparison method, the analyst identifies and analyzes actual sales of guideline business entities that are reasonably similar to the subject business. This method relies on a residual purchase price analysis to estimate the value of the subject business goodwill.

The Income Approach

The income approach valuation methods related to the valuation of goodwill include the following:

1. The residual from business value method
2. The capitalized excess earnings method
3. The present value of future income method

Each of these valuation methods is based on the concept of goodwill (in all forms) as the present value of future income that is not associated with the subject company's tangible assets or identifiable intangible assets.

It is important for both the analyst and counsel to note that the cost approach and the market approach are less commonly used in the analysis of goodwill.

Generally, analysts will rely on the income approach when valuing goodwill (both enterprise goodwill and personal goodwill) within a family law context. Therefore, the following discussion presents an explanation of each of the goodwill income approach valuation methods.

Residual from Business Value Method

The residual from business value method is based on the principle that the value of the total assets of a subject company is equal to the value of the subject company total liabilities and equity.

Specifically, the subject business goodwill is valued as the overall business enterprise value less:

1. the value of all net working capital assets,
2. the value of all tangible assets, and
3. the value of all identifiable intangible assets.

When utilizing the residual from business value method in a family law context, analysts will generally rely on multiple indications of the subject business total value from other generally accepted business valuation approaches and methods. These approaches and methods can include the following:

1. The income approach, direct capitalization method
2. The income approach, discounted cash flow (or yield capitalization) method
3. The market approach, guideline merged and acquire company method
4. The market approach, guideline publicly traded company method

While any of these valuation approaches and methods can indicate a relevant value for the total subject company business enterprise, the income approach, discounted cash flow method, is a common method for quantifying goodwill as the residual value from the total subject business enterprise value.

However, it is important for the analyst to properly apply the income approach, discounted cash flow method, in the analysis of the subject business goodwill. In the application of the income approach, discounted cash flow method, the goodwill analysis typically involves numerous considerations, including the following:

1. Revenue analysis
2. Expense analysis
3. Investment analysis
4. Cost of capital analysis
5. Residual analysis[13]

The revenue analysis typically involves a projection of the prospective revenue from the sale of products or services by the subject company. This analysis can include consideration of many market factors, including expected sales volume, average selling prices or expected contract rates, and macro factors such as market dynamics, competitive pressures, and regulatory changes.

The expense analysis involves a projection of the costs associated with the prospective revenue. This analysis can include consideration of fixed expenses versus variable expenses, cost efficiency relationships, cash versus noncash expenses, direct versus indirect expenses, product versus period costs, and cost-volume-profit relationships.

The third analysis, investment analysis, can include consideration of the minimum required cash balance of the subject business, days sales outstanding in accounts receivable, inventory turnover, expected capital expenditures, and manufacturing plant utilization.

The cost of capital analysis may include consideration of the subject company current capital structure, the subject industry current capital structure, weighted average cost of capital, risk-free rate of return, systematic and unsystematic equity risk premiums, and marginal cost of capital.

The residual value analysis (item 5 above) can include an estimate of the value of the prospective cash flow generated by the subject company at the end of the discrete discounted cash flow analysis period. This residual value can be estimated using various generally accepted income-based valuation procedures, including the direct capitalization method.

When applying the income approach, discounted cash flow method, to analyze the residual goodwill of a subject company, the typical length of the discrete period within the discounted cash flow analysis (i.e., the projected operating period prior to the residual value analysis) should approximate the average length of the subject business industry cycle. The discrete period discounted cash flow analysis is then discounted at an appropriate present value discount rate to determine the present value of the discrete period cash flow.

Next, the residual value of the subject company is estimated at the end of the discrete projection period analysis by using generally accepted business valuation approaches and methods (as previously mentioned), and is discounted to present value at an appropriate present value discount rate (equal to the discrete period present value discount rate).

The discrete projection period present value is then added to the residual present value, resulting in an estimate of the total value of the subject business enterprise (this is typically measured as total invested capital, or the sum of the subject company total long-term debt and total equity).

Finally, the subject company total goodwill value is calculated by subtracting the value of the tangible assets and the identifiable intangible assets from the above-estimated total value of the subject business enterprise.

Capitalized Excess Earnings Method

The second income approach method available to the analyst in estimating a subject company/practice goodwill value is the capitalized excess earnings method. The capitalized excess earnings method involves the quantification and capitalization of the excess income generated by the subject company.

While there are several variations of the capitalized excess earnings method, this discussion focuses on one of the more common applications of this method.

The first step in the capitalized excess earnings method requires the analyst to estimate the required amount of income that a hypothetical investor would expect given the inherent risk of the subject company. Some analysts may apply:

1. an asset-specific rate of return on investment to each asset category or
2. the subject company's cost of capital as the required rate of return on investment.

Typically the weighted average cost of capital is applied if the analyst selects the subject company's cost of capital required by a hypothetical investor.

Regardless of which rate of return the analyst estimates is required by a hypothetical investor, given the risk of the subject company, the next step in the capitalized excess earnings method is to multiply this required rate of return by the value of the subject business net identified assets (i.e., all of the subject company's net working capital assets, tangible assets, and identifiable intangible assets). This calculation quantifies the amount of income required by the hypothetical investor.

Third, the analyst will then quantify the difference between:

1. the required amount of income by a hypothetical investor and
2. the actual amount of income earned by the subject company.

If the actual amount of income exceeds the required amount of income, then the subject company is determined to have excess earnings.

Finally, the analyst capitalizes these excess earnings as an annuity into perpetuity, utilizing the appropriate direct capitalization rate. This direct capitalization rate should be consistent with:

1. the level of income used to estimate the required income of the subject company and
2. the actual amount of income of the subject company.

The result of the direct capitalization of these excess earnings provides an indication of the total goodwill value of the subject company.

Present Value of Future Income Method

The third income approach method available to the analyst in estimating a subject company total goodwill value is the present value of future income method. The first step in the present value of future income method is to identify all future income associated with the subject company that is not associated with the entity's tangible assets, or identifiable intangible assets.

This identification analysis may include identifying future capital expenditures, future mergers and acquisitions, new product or service lines, and new customers, for example.

Typically, this future income is not included in the subject company's current strategic plans or management-prepared financial projections. And, this future income is generally not associated with the subject company's tangible or identifiable intangible assets that are in place as of the analysis date. This is because this future income would be included in the value of the subject company's tangible assets or identifiable intangible assets.

It is important to note that, from an analyst perspective, creating a projection of this future income (i.e., the future income that is not associated with the subject company's tangible and identifiable intangible assets) is many times a difficult task.

The present value of future income method is conceptually correct and appealing from an intellectual point of view. However, long-term management-prepared financial projections of income derived from yet to be identified sources are not always available to the analyst.

As a result, in practice it may be difficult for a analyst to estimate the value of goodwill of a subject company using this method.

How Different Types of Goodwill, Such as Enterprise Goodwill and Personal Goodwill, May Be Valued

As previously mentioned, all generally accepted valuation approaches are appropriate to value both enterprise goodwill and personal goodwill. However, these forms of goodwill are not typically sold or otherwise transferred separately in the marketplace, so the market approach is, therefore, less commonly used when estimating the value of goodwill.

When the market approach is used to value goodwill, the empirical market data are often based on purchase price allocations of acquired entities (i.e., a residual-based interpretation of goodwill).

Further, because both enterprise goodwill and personal goodwill are often measured based on future income for a marital-estate-owned closely held service-oriented company, or professional practice, the cost approach is also less commonly used to value both forms of goodwill. In practice, the income approach is more commonly used to estimate the value of goodwill within a subject company.

One option that the analyst has is to use a version of a residual method analysis in the valuation of enterprise goodwill.

Similar to what was discussed in the "Residual Interpretation of Goodwill" section above, using a residual method analysis requires the analyst to estimate the residual of the overall subject company value (estimated by applying generally accepted business valuation approaches and methods, such as the income approach, market approach, and asset-based approach) less the total value of all the tangible assets and all the identifiable intangible assets used in the subject business enterprise.

The analyst may also use a version of the "with and without" method (also referred to as the comparative business value method) in estimating the value of both enterprise goodwill or personal goodwill. The "with and without" method requires the analyst to estimate the value of the subject company "with" and "without" the relevant goodwill in place.

Generally, the "with and without" method is more commonly used to value personal goodwill than enterprise goodwill. Based on factors such as available management-prepared financial projections and different discount or capitalization rates, the total subject company value is typically greater with the subject individual in place than without the subject individual in place.

Using this method, the value of personal goodwill is estimated as the difference between the "with the individual in place" subject company value and the "without the individual in place" subject company value.

The personal goodwill in this method is identified as the difference between the two subject company value estimates based on the two alternative variable projections of:

1. "with the individual in place" and
2. "without the individual in place."

To help illustrate an analysis of the personal goodwill of a subject company held within a marital estate, the following example illustrates an application of the "with and without" method (when using the income approach, capitalized excess earnings method).

Personal Goodwill Analysis – Illustrative Example

For purposes of this example, let's assume that the marital estate holds an ownership interest in a closely held dental practice called Fuller's Dental. There are three active dentists at Fuller's Dental, and the wife, Freda Fuller, DDS, holds a 100 percent ownership interest in Fuller's Dental (the "Practice").

Let's assume that the appropriate valuation date is as of December 31, 2018.

In this scenario, the analyst has defined excess earnings as the difference between (1) the projected total income of the Practice and (2) a total fair return on the Practice tangible assets and net working capital assets (from a hypothetical investor perspective). The total fair return used for the Practice tangible assets, net working capital assets, and goodwill is based on market-based data.

When valuing goodwill (or other intangible assets) it is important to note that goodwill (and other intangible assets) typically have a greater level of financial and operating risk than tangible assets.

Further, tangible assets typically have a greater level of financial and operating risk than net working capital assets (or financial assets). This means that, in general, intangible assets are expected to earn a higher asset-specific rate of return than tangible assets. And, similarly, tangible assets are expected to earn a higher asset-specific rate of return than net working capital (or financial assets).

Exhibits 1 and 2 present (1) the analyst's estimate of the Practice excess earnings (with Freda as part of the Practice) and (2) the analyst's capitalization of the Practice excess earnings into an estimate of the total goodwill value for Fuller's Dental (with Freda as part of the Practice).

As presented in Exhibit 1, the total Practice excess earnings (with Freda as part of the Practice) are estimated at $310,000. And, as presented in Exhibit 2, assuming an estimated direct capitalization rate of 25 percent, the total Practice goodwill (with Freda as part of the Practice) is estimated at $1,240,000.

Next, in order to estimate the personal goodwill attributable to Freda Fuller, DDS (by applying the "with or without" method), the analyst similarly defines excess earnings as the difference between (1) the projected total income of the Practice (excluding Freda) and (2) a total fair return on the Practice tangible assets and net working capital assets (excluding Freda).

Exhibits 3 and 4 present (1) the analyst's estimate of the Practice excess earnings (without

Exhibit 1
Fuller's Dental
Goodwill Valuation
Estimate of Excess Earnings (with Freda)
As of December 31, 2018

Valuation Analysis		
[1] Projected Practice Net Cash Flow	$ 500,000	
[2] Net Working Capital Asset Value	$ 1,000,000	
[3] Required Rate of Return on Net Working Capital Assets [a]	7.0%	
[4] Fair Return on Net Working Capital Assets	$ 70,000	[2] x [3]
[5] Net Tangible Asset Value	$ 1,000,000	
[6] Required Rate of Return on Net Tangible Assets [a]	12%	
[7] Fair Return on Net Tangible Assets	$ 120,000	[5] x [6]
[8] Total Fair Return on Net Working Capital Assets and Net Tangible Assets	$ 190,000	[4] + [7]
Estimated Practice Excess Earnings	$ 310,000	[1] - [8]

[a] Required rates of return based on market-derived data.

Exhibit 2
Fuller's Dental
Goodwill Valuation
Capitalization of Excess Earnings Method Value Conclusion (with Freda)
As of December 31, 2018

Valuation Analysis		
[1] Estimated Practice Excess Earnings	$ 310,000	
[2] Selected Direct Capitalization Rate	25%	
Indicated Practice Goodwill Value (rounded)	$ 1,240,000	[1] / [2]

Exhibit 3
Fuller's Dental
Goodwill Valuation
Estimate of Excess Earnings (without Freda)
As of December 31, 2018

Valuation Analysis			
[1] Projected Practice Net Cash Flow	$	200,000	
[2] Net Working Capital Asset Value	$	400,000	
[3] Required Rate of Return on Net Working Capital Assets [a]		10%	
[4] Fair Return on Net Working Capital Assets	$	40,000	[2] x [3]
[5] Net Tangible Asset Value	$	400,000	
[6] Required Rate of Return on Net Tangible Assets [a]		17%	
[7] Fair Return on Net Tangible Assets	$	68,000	[5] x [6]
[8] Total Fair Return on Net Working Capital Assets and Net Tangible Assets	$	108,000	[4] + [7]
Estimated Practice Excess Earnings	$	92,000	[1] - [8]

[a] Required rates of return based on market-derived data.

Exhibit 4
Fuller's Dental
Goodwill Valuation
Capitalization of Excess Earnings Method Value Conclusion (without Freda)
As of December 31, 2018

Valuation Analysis			
[1] Estimated Practice Excess Earnings	$	92,000	
[2] Selected Direct Capitalization Rate		36%	
Indicated Practice Goodwill Value (rounded)	$	255,600	[1] / [2]

Freda as part of the Practice) and (2) the analyst's analysis for the capitalization of the Practice excess earnings into an estimate of the goodwill value for Fuller's Dental (without Freda as part of the Practice).

As presented in Exhibit 3, the Practice excess earnings (without Freda as part of the Practice) are estimated at $92,000. And, as presented in Exhibit 4, assuming an estimated direct capitalization rate of 36 percent, the Practice goodwill (without Freda as part of the Practice) is estimated at $255,600.

Based on the data presented in Exhibits 2 and 4, the indicated personal goodwill attributable to Freda Fuller, DDS, is equal to $984,400 (i.e., $1,240,000 – $255,600). This is the amount that may, or may not, be includable in the marital estate—based on state statutory guidance and judicial precedent (as previously discussed).

Conclusion

This discussion provided a general definition of goodwill, and addressed the differences between enterprise goodwill and personal goodwill within a family law context.

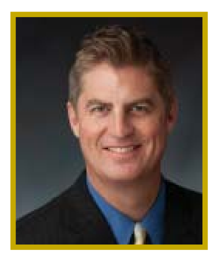
When a closely held service-oriented company, or professional practice, ownership interest is held within a marital estate, it is important that the analyst and counsel collaborate in order to properly analyze any potential goodwill.

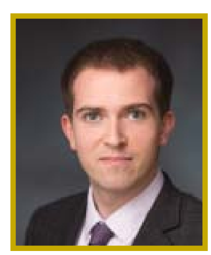
This is because analysts can provide significant assistance to counsel with regard to (1) identifying and (2) quantifying enterprise goodwill and personal goodwill in a family law context.

Conversely, counsel can provide meaningful guidance to analysts regarding the interpretation of relevant statutory authority and judicial precedent when analyzing enterprise goodwill versus personal goodwill within a family law context.

Notes:

1. "International Glossary of Business Valuation Terms" in Statement on Standards for Valuation Services, VS 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (New York: American Institute of Certified Public Accountants, June 2007).
2. Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation*, Revised ed. (New York: American Institute of Certified Public Accountants, Inc., 2014), 9.
3. Ibid., 14.
4. Ibid., 697–698.
5. Enterprise goodwill is typically associated with the business entity. The enterprise goodwill is attributable to the fact that clients engage with the business entity based on location, performance, reputation, facilities, and other factors.
6. Personal goodwill is typically associated with the individual. The personal goodwill arises out of an individual's expertise or reputation that attracts and keeps customers (i.e., generates revenue). Personal goodwill is most often found in closely held businesses in technical, specialized, service, or professional vocations. Also, businesses with a limited number of customers or suppliers typically have some form of personal goodwill due to the likely importance of personal relationships.
7. *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence* (Portland, OR: Business Valuation Resources, LLC, July 13, 2018).
8. Ibid.
9. Ibid. For example, in the state of California, a seminal case was *In re Marriage of Lopez*, 38 Cal., App. 3d 93 (1974), which provided the following, "Consistent with the concept of community property, if professional goodwill is found to exist as an asset at the time of family law, it may be separate property, community property, or varying degrees of both depending on particular circumstances." Further, no rule was provided for determining the existence or value of goodwill of a law practice or any other profession as a going-concern business, but factors/attributes were presented that contribute to the value of professional goodwill.
10. Ibid. For example, the State of Kansas guidance includes, "All property owned by married persons . . . including for divorce or separate maintenance actions commenced on or after July 1, 1998, professional goodwill to the extent it is marketable for that particular professional . . . shall become marital property."
11. Ibid.
12. Reilly and Schweihs, *Guide to Intangible Asset Valuation*, 705.
13. For a more detailed description of the analysis related to the income approach, discounted cash flow method goodwill analysis, please refer to *Guide to Intangible Asset Valuation* by Reilly and Schweihs.





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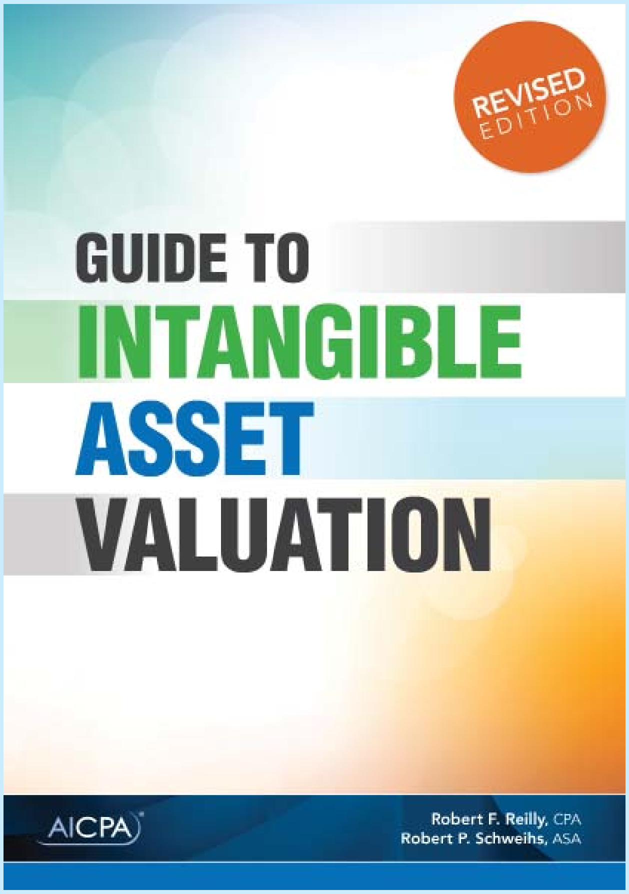
Guide to Intangible Asset Valuation

by Robert F. Reilly and Robert P. Schweihs



This 745-page book, originally published in 2013 by the American Institute of Certified Public Accountants, has been improved! The book, now in hardback, explores the disciplines of intangible asset valuation, economic damages, and transfer price analysis. *Guide to Intangible Asset Valuation* examines the economic attributes and the economic influences that create, monetize, and transfer the value of intangible assets.

Robert Reilly and Bob Schweihs, Willamette Management Associates managing directors, discuss such topics as:

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- Structuring the intangible asset valuation, damages, or transfer price assignment
- Generally accepted valuation approaches, methods, and procedures
- Economic damages due diligence procedures and measurement methods
- Allowable intercompany transfer price analysis methods
- Intangible asset fair value accounting valuation issues
- Valuation of specific types of intangible assets (e.g., intellectual property, contract-related intangible assets, and goodwill)

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Guide to Intangible Asset Valuation

Table of Contents

Goodwill Valuation Considerations Involving Private Companies and Professional Practices

Robert F. Reilly, CPA

The valuation of either business (also called institutional) goodwill or personal (also called professional) goodwill is a common issue in the family law context. The goodwill issue arises when the marital estate owns a private company or a professional practice or when one of the marital parties holds a professional license. The goodwill valuation may affect the value of the private company or professional practice ownership interest. The goodwill valuation may be relevant if the practitioner's personal goodwill either is—or is not—a marital estate asset. And, the goodwill valuation may be relevant if the marital estate includes only the appreciation (or the excess over a normal amount of appreciation) in the goodwill during the term of the marriage. This discussion summarizes many of the analyst's considerations in the valuation of goodwill in a family law context.

Introduction

This discussion summarizes the generally accepted approaches and methods related to the valuation of goodwill within the family law context. This discussion primarily considers the business (or institutional) goodwill that is included in the valuation of a family-owned private company or professional practice. This discussion also considers the personal goodwill that may be included in the valuation of a practitioner's professional license or a celebrity's status.

There is no single definition of goodwill that is applicable to all family law situations. Therefore, alternative definitions of goodwill are considered in this discussion. This discussion summarizes the common types of goodwill and the common attributes of goodwill. This discussion also describes the many non-family-law reasons to value goodwill.

The many interpretations of goodwill are generally grouped into two categories:

1. Residual interpretations
2. Income interpretations

From the valuation analyst ("analyst") perspective in a family law matter, the income interpretation (or measurement) of goodwill may be more useful. However, analysts and family law counsel ("counsel") should be familiar with both categories of interpretations (or measurements) of goodwill.

Both interpretations of what goodwill is (and how it should be measured) generally agree on the following:

1. The components of (or the factors that create) goodwill
2. The types of goodwill (or situations in which goodwill arises)

The Goodwill Components

There are three principal components of goodwill. Analysts consider these three components as either the factors that create goodwill or the reasons why goodwill exists in certain circumstances.

The first component relates primarily to business goodwill. The second component relates to both business goodwill and personal goodwill. And, the third component relates primarily to business goodwill.

For purposes of this discussion, business goodwill includes the goodwill of a family-owned private company or a professional practice. Personal goodwill includes the economic benefits associated with an individual celebrity, a professional athlete, or a professional (including licensed) practitioner.

First Goodwill Component—Operating Business Assets

The first goodwill component is the existence of operating business assets that are in place and ready to use. This component is sometimes referred to as the going-concern value element of goodwill.

The fact that all of the elements of a business enterprise are physically and functionally assembled creates an intangible asset. These elements include capital (e.g., equipment), labor (e.g., employees), and coordination (e.g., management).

Some analysts identify and measure this going-concern value as a separate intangible asset of a private or professional practice. This separate identification may be appropriate for certain taxation or forensic analysis purposes.

Other analysts measure going-concern value as one component of the entity's business goodwill. For example, this aggregate identification of going-concern value and goodwill is appropriate for purposes of Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") topic 805, *Business Combinations*, and the associated fair value accounting for business combinations.

Either identification procedure may be appropriate depending on the specific purpose and objective of the goodwill analysis.

This going-concern value will typically enhance the value of the private company/practice's individual operating assets. For example, the value of a private company's operating equipment is typically greater when the equipment is valued based on a value in continued use (or going-concern) premise of value—rather than based on a value in exchange (or piecemeal disposition) premise of value.

Some going-concern value will typically also attach to the private company/practice's specifically identified identifiable intangible assets. For example, the value of an owner/operator's patent, copyright, or trademark is typically greater when that intangible asset is valued based on a value in continued use (or going-concern) premise of value—rather than based on a value in exchange (or piecemeal disposition) premise of value.

Second Goodwill Component—Excess Income

The second goodwill component is the existence of excess income (however measured) related to either a business entity or an individual. This component is described later in this discussion. For a private company/practice, excess income is typically measured as the amount of income generated by the entity that is greater than the amount needed to provide a fair rate of return on all of the entity's tangible assets and identifiable intangible assets.

This excess income component relates to the concept of goodwill as that portion of private company/practice value that cannot be specifically assigned to the entity's tangible assets or identifiable intangible assets. For the private company or professional practice, this excess income may be measured at the level of earnings before interest and taxes ("EBIT"); earnings before interest, taxes, depreciation, and amortization ("EBITDA"); net operating income; net income; or net cash flow.

For an individual (e.g., professional practitioner, athlete, celebrity), excess income is income generated by the individual that is greater than the income that would be expected to be accrued by a comparably skilled individual working in comparable circumstances. For individuals, this excess income is often measured at the net income or net cash flow level.

Third Goodwill Component—Expectation of Future Events That Are Not Directly Related to the Entity's Current Operations

The third goodwill component is the expectation of future events that are not directly related to the private company/practice's current operations. For example, goodwill may be created by the expectations of future capital expenditures, future mergers and acquisitions, future to-be-developed products or services, future customers or clients, or similar future growth opportunities

This future expectations component relates to the concept of goodwill as the present value of future assets (both tangible assets and intangible assets) that do not yet exist on the analysis date.

Investors assign a goodwill value to a private company or professional practice if they expect that the net present value of the income associated with future events is positive. The positive net present value of the expected future income associated with assets that are already in existence (for example, capital assets, product lines, and customers) is appropriately assigned to those respective tangible assets and identifiable intangible assets.

General Types of Goodwill

There are three general goodwill types. These three goodwill types may affect the identification and the ownership of the goodwill. But, the distinction of these three types of goodwill should not affect the valuation results.

The first goodwill type is institutional goodwill. This is the goodwill that relates to an industrial or commercial business enterprise. This goodwill type typically results from the collective operations of—and the collective assemblage of—the entity's assets. Institutional goodwill is typically owned by the business.

However, in the case of a professional services business (for example, a manufacturer representative company or other professional sales organization), some or all of the institutional goodwill can be created by the individual employee/owners.

The second goodwill type is professional practice goodwill. This type of goodwill relates to medical, dental, legal, accounting, engineering, or other types of professional practice. This goodwill type is distinguished from the other goodwill types because it has two distinct components:

1. The practitioner (or personal) component
2. The business (or practice) component

The practitioner component relates to the goodwill created by the reputation and skills of the individual professional practitioners (the actual physicians, dentists, lawyers, CPAs, engineers, and other professionals). The business component relates to the goodwill created by the location, reputation, longevity, assembled assets, and operating procedures of the institutional professional practice.

One issue that often arises with regard to this goodwill type is: Who owns each of the two components? This ownership question can be controversial in marital dissolution, shareholder dispute, or other types of litigation.

Ultimately, the ownership of the goodwill components is a legal question with a legal answer. However, the analyst may be tasked with the identification and the valuation of these two components of professional practice goodwill.

The third goodwill type is celebrity goodwill. This is the goodwill associated with being a famous individual. Typically, there are three general categories of celebrities who enjoy such goodwill: sports celebrities, entertainment celebrities, and achievement celebrities. These various categories of celebrity goodwill are distinguished by the factors that created the goodwill.

For example, the sports celebrity goodwill is created by the individual's physical prowess. That prowess (and the associated goodwill) may wane with the age of the athlete.

Entertainment goodwill relates to singers, musicians, actors, television talk show hosts, and so on. This type of goodwill also relates to the individual's skill and ability. But for many entertainers, professional skill and ability may increase (and not decrease) with age.

The category of achievement celebrities includes prominent corporate executives, politicians, clergy, or organizational leaders. The goodwill of an achievement celebrity often relates to the career or other professional accomplishments of that individual. Unlike the other types of goodwill, it may be difficult to transfer celebrity goodwill.

It is often important for the analyst to separately identify and individually value the three types of goodwill. There may be different legal, economic, and taxation consequences for each goodwill type.

Some of the factors that affect which type of goodwill exists include the following:

- The type of services or products offered by the business entity
- The individual's personal relationships with customers or clients
- The individual's direct impact on the management and direction of the business entity

Even the goodwill associated with a private company/practice may be personal goodwill (that is, goodwill owned by the business owner/operator, individual practitioner, or celebrity) if:

1. the individual makes essentially all significant management decisions regarding the private company,
2. the operations of the private company or professional practice are not functionally or economically separate from the individual, and
3. the success of the private company is directly related to the activities of the individual.

In the early stages of the private company/practice operations, most internally created goodwill is typically personal goodwill. As the private company/practice matures (as it increases in size and complexity), goodwill usually shifts from the personal goodwill category to the institutional goodwill category.

Other Reasons for an Analyst to Value Goodwill

In addition to family law contexts, there are many circumstances that require the valuation of goodwill. Analysts and counsel should understand that goodwill is not just a marital dissolution issue or a creation of family law.

Some of the reasons why analysts may be asked to value goodwill are summarized below:

- Economic damage analyses. When a private company or professional practice has suffered a breach of contract or a tort (such as an infringement, breach of a fiduciary duty, or interference with business opportunity), one measure of the damages suffered is the reduction in the value of the entity's goodwill due to the wrongful action.

  This analysis may encompass the comparative valuation of the entity's goodwill before and after the breach of contract or tort. This before and after method is also useful for quantifying the economic effects of a prolonged labor strike, a natural disaster, or a similar phenomenon.

- Business or professional practice merger. When two private companies or professional practices merge, the equity of the merged entity typically is to be allocated to the merger partners. One common way to allocate equity in the merged entity is in proportion to the relative value of the assets contributed, including the contributed goodwill.

- Business or professional practice separation. When a private company or professional practice separates, the assets of the consolidated business typically have to be allocated to the individual business owners. One common way to allocate the assets to the separating business partners is in proportion to the relative value of the assets controlled by or developed by each partner, including the goodwill of each partner.

- Solvency test. The solvency of a private company/practice is an issue with regard to lender's fraudulent conveyance concerns during a financing transaction or a financial restructuring.

  One of the specific tests to determine if a private company/practice is solvent is to ask this question: Does the fair value of the entity's assets exceed the value of the entity's liabilities (after consideration of the financing transaction)? One of the private company/practice assets that is considered in a solvency analysis is goodwill.

- Insolvency test. The degree of insolvency of a private company/practice may have federal income tax consequences if debt is forgiven (in whole or in part) during a refinancing transaction or financial restructuring.

  One of the specific tests to determine if a private company/practice is insolvent for federal income tax purposes is to ask this question: Is the fair market value of the entity's assets less than the value of the entity's liabilities (before the debt forgiveness)? The cancellation of debt income is not recognized as taxable income to the extent that the taxpayer debtor is insolvent.

  The federal income tax regulations specifically indicate that one of the assets that should be considered in an insolvency analysis is goodwill.

- Intercompany transfer price. When certain intangible assets are transferred between controlled corporations (for example, between a parent corporation and a wholly owned subsidiary), an arm's-length price should be estimated for the intercompany transfer of the assets.

  Such intercompany transfers may have international, federal, and state income tax ramifications. Such intercompany transfers may have federal income tax consequences if one of the controlled corporations is located in a foreign tax jurisdiction. Depending on the applicable tax regulations, goodwill may or may not be one of the intangible property assets included in the intercompany transfer.

- Bankruptcy and reorganization. Parties in interest to a bankruptcy estate often have to decide if the debtor company is worth more as a going-concern business (pursuant to a plan of reorganization) or as a mass disposition of assets (pursuant to a plan of liquidation).

  A valuation of the debtor company goodwill (if any) may be useful in assessing whether the business is worth reorganizing.

A valuation of the debtor company goodwill (for example, before and after the plan of reorganization) may be useful in assessing the reasonableness of the proposed plan of reorganization. Such an assessment may be of interest to the debtor in possession, the secured and unsecured creditors, the bankruptcy court, and other interested parties.

- Conversion of a C corporation to an S corporation. One factor in the analysis of the costs and benefits of converting an entity's federal income tax status from a C corporation to an S corporation is the quantification of any built-in gains ("BIG" tax) associated with the value of the corporation's assets.

  The federal income tax regulations related to the BIG tax are clear that the corporation's goodwill is one of the assets that should be considered in the conversion valuation.

- Business enterprise valuation. The identification and quantification of goodwill is one procedure of the asset-based approach to business valuation. An asset-based approach is often used in the valuation of an industrial or commercial company or of a professional practice or professional service business. Such business valuations are routinely performed for taxation, ownership transition, financing, bankruptcy, corporate governance, litigation, and other purposes.

  When such asset-based approach valuations are performed on a going-concern business enterprise, the analysis typically includes the valuation of the entity's goodwill (as well as its other intangible assets).

- Deprivation analysis. The goodwill valuation may be one component in the damages analysis associated with a business that is subject to a condemnation, expropriation, or eminent domain action. Analysts sometimes only consider the value of the entity's real estate and tangible personal property subject to the condemnation or other "taking"; however, even if the entity is relocated to a new location as part of the eminent domain action, the business may have suffered a loss of all or part of its goodwill.

  The loss of institutional or practice goodwill value may be a claim in the condemnation or eminent domain action.

- Ownership allocation litigation. Several forms of litigation involve the allocation of direct or indirect ownership interests in a business entity. The following are two examples of such litigation:

  1. Marital dissolution cases (which involve the allocation of the business entity ownership interest within the marital estate)
  2. Dissenting shareholder appraisal rights and shareholder oppression cases (which involve the allocation of the business entity ownership interests to the dissenting or the oppressed stockholders)

  This second category of litigation involves both dissenting shareholder appraisal rights claims and shareholder oppression claims. In such litigation claims, the valuation of the entity's goodwill is often an important issue.

- Ad valorem property tax. In some taxing jurisdictions, state and local ad valorem property tax only applies to real estate and tangible personal property. However, the existence of economic obsolescence (a form of external obsolescence) may have a direct effect on the value of the taxpayer's real estate and tangible personal property.

  Accordingly, an assessment of the existence of economic obsolescence may be an important procedure in the valuation of such industrial or commercial operating property. There are several methods for quantifying economic obsolescence, and most methods incorporate some analysis of the taxpayer entity's goodwill.

  Typically, if the entity enjoys positive goodwill value, then the tangible assets may not experience economic obsolescence. However, if the entity experiences negative goodwill, then the values of the industrial and commercial operating assets are likely to be affected by economic obsolescence.

These examples summarize some of the reasons why analysts may be asked to value goodwill. Of course, these examples do not provide an exhaustive list of all of the reasons to value goodwill.

How the Different Goodwill Types Are Valued

All generally accepted intangible asset valuation approaches may be appropriate to value the different types of goodwill.

Typically, goodwill (whether personal or institutional) is not sold or otherwise transferred in the marketplace separately from other entity assets. Therefore, the market approach is less commonly applied to value goodwill.

When the market approach is used to value goodwill (for example, the goodwill of medical, dental, or other professional practices), the empirical market data are often based on purchase price allocations of the acquired professional practice entities.

Because goodwill (whether personal or institutional) is often measured based on future earnings, the cost approach is somewhat less commonly applied to value goodwill. In practice, for both personal and institutional goodwill, the income approach is more commonly used.

Analysts may also apply some version of a residual analysis in the valuation of personal or institutional goodwill. In such a valuation, the analyst estimates the total amount of goodwill associated with the business entity (however defined). Using this residual analysis, goodwill is measured indirectly using business valuation approaches.

Using a residual analysis, goodwill represents the residual of:

1. the overall business enterprise value less
2. the total value of all tangible assets and identifiable intangible assets used in the business enterprise.

The analyst may also apply some version of the "with and without" method (also called the comparative business value method) in the valuation of personal or institutional goodwill. To apply the "with and without" method, the analyst estimates the value of the subject business entity with and without the goodwill in place.

The "with and without" method is more commonly applied to value personal goodwill than institutional goodwill. Typically, based on the different sets of financial projections and the different discount or capitalization rates, the subject entity value is greater with the subject individual in place than without the subject individual in place.

Using the "with and without" method, the value of personal goodwill is estimated as the difference between:

1. the "with the individual in place" private company/practice value and
2. the "without the individual in place" private company/practice value.

The personal goodwill value is the difference between the two business value estimates based on the two alternative sets of financial projections. The analyst may also estimate the value of the institutional goodwill using a combination of a residual method analysis and a "with and without" method analysis.

The value of the entity's institutional goodwill may be estimated as the difference between:

1. the business entity goodwill value (based on the residual method analysis) and
2. the personal goodwill value (based on the "with and without" method).

The Goodwill Valuation

In most valuation analyses, goodwill includes concepts from both the residual goodwill definitions and the income goodwill definitions.

Analysts sometimes identify and value goodwill collectively as the total intangible value of a business entity. In this regard, goodwill may be valued using an aggregate residual analysis. In such an analysis, the goodwill can be either a residual from:

1. a total business acquisition price or
2. a concluded business enterprise value.

In this analysis, the total goodwill value is measured as the unidentified residual amount after the values of the identified tangible assets are subtracted from the total business value.

Analysts often measure goodwill as a discrete (or separate) intangible asset. Using this definition, goodwill is measured as the remaining unidentified intangible value of the entity after subtracting the values of all tangible assets and all identifiable intangible assets.

Accordingly, this discrete goodwill may be quantified using either a residual analysis or an income analysis. In either type of analysis, goodwill is the residual business value (or capitalized excess income) that is not allocated to any of the following assets:

- Working capital assets (for example, receivables, prepaid expenses, and inventory)
- Tangible personal property (for example, machinery, equipment, and vehicles)
- Real estate (for example, land, buildings, and improvements)
- Intangible personal property (for example, patents, copyrights, trademarks, and trade secrets)
- Intangible real property (for example, leasehold interests, rights of way, and easements)

Goodwill under Alternative Premises of Value

A premise of value is an assumption about the set of actual or hypothetical transactional circumstances applicable to the analysis. The premise of value describes the facts surrounding the operational environment in which the defined standard of value transaction will take place. As a result, the premise of value may have an impact on the value of an entity's—or an individual's—goodwill.

All intangible assets, including goodwill, can be valued under the following alternative premises of value:

- Value in continued use as part of a going concern
- Value as an assemblage of assets in place, but not in current use
- Value in exchange as part of an orderly disposition of asset
- Value in exchange as part of a voluntary liquidation of assets
- Value in exchange as part of an involuntary liquidation of assets

The same goodwill of the same entity will likely have a different value conclusion depending on the premise of value that is applied in the analysis.

A value in continued use, going-concern value indication is influenced by the relative contribution and mutual economic benefits that are created by all assets of the entity.

Accordingly, the business value of most companies is greater than the sum of the values of the component tangible assets and identifiable intangible assets. One goodwill component relates to the incremental value that is created by assembling these tangible assets and identifiable intangible assets in an income-producing, going-concern business.

As a result, goodwill is often identified and quantified in a business valuation that is conducted based on a going-concern premise of value. However, a business valuation conducted on the various value in exchange premises of value may not include the contributory value of all assembled tangible assets and intangible assets because the entity's tangible assets and intangible assets are valued on an individual or piecemeal basis.

As a result, goodwill value is often limited in a business valuation that is conducted based on one of the alternative value in exchange premises of value.

For example, a business valuation that is based on a value in exchange or liquidation premise of value for (say) a bankruptcy purpose often may not involve the identification or valuation of goodwill.

When the analyst selects the appropriate premise of value on which to conduct the business valuation, he or she considers whether the entity has goodwill. If goodwill exists within the entity, then it is likely that the entity does not have going-concern risk.

In other words, the entity's highest and best use ("HABU") is likely to be as a going concern. Therefore, it is likely to be appropriate to value the entity (and the tangible assets and intangible assets) based on the premise of value in continued use.

"The same goodwill of the same entity will likely have a different value conclusion depending on the premise of value that is applied in the analysis."

However, if no goodwill exists in the entity, then that entity may suffer from going-concern risk. If there is no goodwill, the analyst may conclude that a value in exchange premise of value represents the HABU. Typically, the selection of the appropriate premise of value is based on the HABU of the entity or the tangible assets and intangible assets.

Of course, there may be circumstances when the entity is not being operated at its HABU. In those circumstances, the goodwill may have a greater value based on a value in exchange premise of value rather than on a value in continued use premise of value.

Conclusion

This discussion considered the types of business and personal goodwill that are commonly considered in a family law valuation. The goodwill valuation may be relevant when a private company, professional practice, or individual's professional license or celebrity are part of the marital estate. This discussion summarized the common components and types of goodwill.

With consideration to the legal instructions obtained from counsel, the analyst should apply an approach and method that concludes the standard of value and the premise of value that are appropriate to the family law valuation assignment—given the relevant statutory authority and the relevant judicial precedent.

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The Identification and Valuation of Intellectual Property for Family Law Purposes

John C. Ramirez

Valuation analysts ("analysts") are often called on to value intellectual property for family law purposes. This is because a marital estate may own, directly or indirectly (through a family-owned or private company or professional practice), intellectual property. In such instances, the value of the intellectual property can be the subject of considerable controversy between the marital parties. For this reason, family law legal counsel—and other parties involved in the marital dissolution process—should (1) understand the procedures and factors commonly used to identify intellectual property assets, (2) recognize the generally accepted approaches to use to value intellectual property assets, and (3) be familiar with the intellectual property economic attributes that analysts consider when valuing intellectual property assets for family law purposes.

Introduction

There are many reasons why a valuation analyst ("analyst") may be called on to value intellectual property in the context of litigation disputes. These reasons include providing assistance with infringement claims, breach of contract claims, damage claims, and tax controversies. Another common reason why analysts may be asked to value intellectual property is for family law purposes.

The marital estate may include either a direct or an indirect ownership interest in the subject intellectual property. That is, either spouse may directly own or operate the subject intellectual property. Or, either spouse may have an ownership interest in a private company or a professional practice that owns and operates the subject intellectual property.

Directly or indirectly, the value of the subject intellectual property may significantly affect the value of the marital estate. This is often the case when one or both spouses holds a license as a professional practitioner.

The meaning of the term "intellectual property" is widely understood by experienced valuation analysts. However, many business owner/operators, accountants and auditors, family law counsel ("counsel") and judges, and other parties involved in the marital dissolution process may not have as strong an understanding of the term "intellectual property."

These interested parties should be aware of what intellectual property is, as well as what is not considered intellectual property. And, these parties should be aware that there are generally accepted approaches and considerations related to the identification and valuation of intellectual property assets.

First, this discussion describes intellectual property and the procedures and factors that analysts commonly use to identify marital estate intellectual property.

Second, this discussion summarizes the generally accepted approaches that analysts use to value intellectual property for family law purposes.

Third, this discussion describes intellectual property economic attributes that analysts typically consider when valuing intellectual property within a family law context.

Intellectual Property

There are four types of intellectual property: trademarks, patents, copyrights, and trade secrets. Each of these four types of intellectual property are legally created by and protected by a specific federal or state statute.

Each type of intellectual property is not an asset category that is separate from intangible assets. Rather, intellectual property is a specially recognized subset of intangible assets. Said another way, all intellectual properties are intangible assets, but not all intangible assets are intellectual property.

Intellectual property is a legal creation designed to reward innovation with market exclusivity. In the United States, intellectual property is typically registered under—and protected by—specific federal and state statues.

These statutes give the intellectual property owner specific legal rights regarding the commercial development and the economic exploitation of the subject intellectual property. These statutes also give the intellectual property owner the right to prevent other parties from commercializing the subject intellectual property.

The legal recognition and protection of intellectual property that is found in the United States is also common among many other industrialized countries.

According to *The Concept of Intellectual Property*:

> Countries have laws to protect intellectual property for two main reasons. One is to give statutory expression to the moral and economic rights of creators in their creations and the rights of the public in access to those creations. The second is to promote, as a deliberate act of Government policy, creativity and the dissemination and application of its results and to encourage fair trading which would contribute to economic and social development.[1]

Intellectual property has all of the identification-related and valuation-related economic attributes of other general commercial intangible assets. That is, like general commercial intangible assets, there is a specific bundle of property rights associated with intellectual property. However, unlike general commercial intangible assets, intellectual property enjoys special legal recognition and monopolistic protection.

Another important distinction between intellectual property and general commercial intangible assets relates to how the subject asset is created. Intellectual property is intentionally created by specific human intellectual capital activity. And, such creative activity can be attributed to the activity of specifically identified individuals.

On the other hand, general commercial intangible assets are typically created in the normal course of the subject business operations. These general commercial intangible assets may include, for example, supplier contracts and relationships, customer contracts and relationships, employee relations (as represented by a trained and assembled workforce), licenses and permits, business operating systems and procedures, company books, records, and manuals, leasehold interests, and so forth.

Such general commercial intangible assets are typically created over time in successful going-concern business enterprises. That is, a distinction between intellectual property and general commercial intangible assets is the fact that business owner/operators typically do not make a special effort to create general commercial intangible assets.

Rather, as mentioned, such general commercial intangible assets naturally develop during the day-to-day operations of the subject business enterprise.

The Four Categories of Intellectual Property

There are four common categories of intellectual property. These categories, or types, of intellectual property are described below.

Trademarks and Trade Names

A trademark includes any word, name, symbol, or device, or any combination, used, or intended to be used, in commerce to identify and distinguish the goods of one manufacturer or seller from goods manufactured or sold by others, and to indicate the source of the goods.

Generally, a trademark lets a consumer know that a good is produced by a specific producer (such as the "Apple" from Apple or the Nike "Swoosh"). A service mark is the same as a trademark, except that it identifies and distinguishes the source of a service rather than a product. The "Golden Arches" of McDonald's is an example of a well-known service mark.

The terms "trademark" and "mark" are commonly used to refer to both trademarks and service marks.

Trademark rights may be used to prevent others from using a confusingly similar mark, but not to prevent others from making the same goods or from selling the same goods or services under a clearly different mark. Trademarks may be registered with the United States Patent and Trademark Office. The Lanham Act protects trademarks and defines a trademark as "any word, name, symbol, or device, or any combination thereof."[2]

This category of intellectual property also includes trade dress.

Patents

A patent grants the patent holder the right to exclude others from making, using, or selling the patented invention or product for a specific duration of time. For example, a company that develops computer software will register a patent on each new program that it creates.

While the patent is in effect, no other computer software company can develop a software product using the patented program without permission of the patent owner. Once the patent expires, other computer software developers can produce identical software, generally in the form of generic programs.

Patents may be obtained for "any new and useful process, new machine, manufacture or composition of matter, or any new or useful improvement thereof."[3]

The patents category of intellectual property includes (1) the three kinds of patents—utility, design, and plant patents—and (2) the associated patent applications.

Copyrights

A copyright is an exclusive right to reproduce, publish, or sell an original work of authorship. Similar to patents, the legal protection related to a copyright lasts for a limited period of time. An author of any original work owns a copyright on that original work the moment it is completed.

Typically, in order to have assurance of intellectual property legal protection, the author will register the copyright. Copyright law covers many forms of an author's expression, including books, movies, paintings, and songs.

Specifically, copyrights exist in "original works of authorship fixed in any tangible medium of expression, now known or later developed, from which they can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device."[4]

The intellectual property category of copyrighted material includes musical and literary compositions, other works of art, and copyrights in computer software and engineering drawings.

Trade Secrets or Know-How

A trade secret can be any commercial information that has value due to the fact that it is kept confidential and is not publicly known. For intellectual property to qualify as a trade secret, the commercial information (1) is required to be kept secret from the public and (2) should provide a commercial advantage to the owner/operator of the business.

A trade secret is often a secret process, method, recipe, or formula for producing a certain product or service, such as the secret formula for Coca-Cola or the secret recipe for KFC fried chicken.

Specifically, a trade secret is "information, including a formula, pattern, compilation, program, device, method, technique, or process, that: (1) derives independent economic value, actual or potential, from not being generally known . . . and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[5]

The individual intellectual property in each of these four categories is generally similar in nature, feature, method of creation, and legal protection. Similar valuation approaches, methods, and procedures typically apply to the intellectual property in each of these four categories.

There are also legal distinctions between the various intellectual property categories. For example, there are specific legal rights related to the ownership of patents and copyrights. In the United States, a patent gives the grantee the right to exclude others from practicing the invention for a period of about 20 years.

In the United States, a copyright gives the intellectual property owner the exclusive right (1) to reproduce, distribute, and perform the copyrighted work and (2) to create derivative works for the life of the author plus 70 years following the author's death.

A description of the additional specific legal rights of the various intellectual property categories is beyond the scope of this discussion. However, as illustrated above, each category of intellectual property assets has specific attributes that distinguish it from the other categories of intellectual property assets.

This distinction is important to make because it helps to identify intellectual property assets from the broader category of general commercial intangible assets within a marital dissolution context.

One characteristic of intellectual property is that it is transferable. That is, an ownership interest in the intellectual property should be able to be transferred from one party to another party. This statement does not indicate that the intellectual property must be transferred separately from any other asset. Rather, the intellectual property may be transferred with tangible assets or with other intangible assets.

The Identification of Intellectual Property

For family law purposes, it is often important to distinguish between intellectual property and the broader category of general commercial intangible assets. This is because the marital estate may include either a direct or an indirect ownership interest in intellectual property that will be a part of the equitable distribution of the marital estate assets, as determined by the court.

Further, intellectual property may be more easily identified when it is owned directly by the marital estate, as opposed to when the intellectual property is combined with other commercial intangible assets in the operation of a family-owned business entity. This is because the existence (or ownership) of intellectual property may not be readily discernible from a company's financial statements.

Generally, only intellectual property that is acquired—as opposed to internally developed intellectual property—is required to be presented on a company's financial statements. And, the value of such an intellectual property may not be reflected in the company's current income or cash flow. This is because, for financial reporting purposes, most companies are not required to separately identify income that is derived from the ownership of specific intellectual property.

Despite the possible difficulties in identifying intellectual property within a marital estate, the analyst should be diligent to ensure that all of the marital-estate-owned intellectual property are identified. This is because the exclusion of a potentially significant marital asset (such as intellectual property) in a family law valuation could result in a material understatement of the equitable distribution of the marital estate.

Intellectual Property Valuation Approaches

Once the marital estate intellectual property has been identified, the typical next step includes estimating the value of the intellectual property to assist in equitable distribution of the marital estate assets.

The generally accepted intellectual property valuation approaches include the market approach, the income approach, and the cost approach.

For counsel (and other parties involved in the marital dissolution process) that are unfamiliar with generally accepted intellectual property valuation approaches, the following brief explanations may by helpful.

- Market approach—The market approach to valuing intellectual property is based on the related economic principles of competition and equilibrium.

  In the market approach, value is estimated by (1) analyzing similar intellectual property that has been recently sold or licensed, (2) comparing the similar or "guideline" intellectual property to the subject intellectual property, and (3) applying pricing metrics derived from the guideline intellectual property to the subject intellectual property financial/operating fundamentals.

  When applying the market approach, the level of comparability between the guideline intellectual property and the subject intellectual property, as well as the appropriate adjustments to account for any differences between the guideline intellectual property and the subject intellectual property, are important valuation variables.

- Income approach—The income approach to valuing intellectual property is based on the economic principle of anticipation (also called the principle of expectation).

  In the income approach, value is estimated by analyzing the income and/or cash flow generated by the subject intellectual property owner/operator. The analysis

"[I]t is important for the analyst, . . . to thoroughly understand the effect that certain attributes can have on the subject intellectual property value."

focuses on the present value of the expected income to be earned from the ownership/operation of the subject intellectual property.

When applying the income approach, both (1) the accuracy and reliability of the projected income and/or cash flow and (2) the estimation of an appropriate discount rate, are important valuation variables.

- Cost approach—The cost approach to valuing intellectual property is based on the economic principle of substitution.

In the cost approach, value is estimated by analyzing the current, market-derived cost to replace or recreate the subject intellectual property with intellectual property of equal functionality and/or equal utility.

When applying the cost approach, the reliability of the current, market-derived cost estimate and the estimation of the appropriate level of depreciation, including an allowance for any obsolescence, are important valuation variables.

The selection of intellectual property valuation approaches is typically based on the type or category of intellectual property, the availability of relevant data and information related to the intellectual property, and other facts and circumstances specific to the subject valuation analysis.

The Effect of Intellectual Property Attributes on Value

In estimating the value of intellectual property, it is important for the analyst, as well as family law counsel, to thoroughly understand the effect that certain attributes can have on the subject intellectual property value.

This is because the specific economic attributes of intellectual property, which may not affect the value of general commercial intangible assets, can significantly affect the value of marital-estate-owned intellectual property (and, subsequently, the value of the marital estate to be equitably distributed to each spouse).

A subject intellectual property will typically possess all of the economic attributes that are common to general commercial intangible assets. However, the intellectual property will also possess additional economic attributes that are not common to general commercial intangible assets, such as legal recognition and protection, for example.

This legal recognition and protection attribute is designed to have the dual effect of:

1. motivating and rewarding intellectual property innovators and creators and
2. protecting intellectual property owners and operators.

The legal attributes of intellectual property can affect the value of intellectual property in numerous ways, depending on the purpose and objective of the valuation assignment.

This discussion will focus on six generally accepted intellectual property legal attributes that may significantly affect the value of the marital estate intellectual property.

These generally accepted intellectual property legal attributes are as follows:

1. The legal life of the intellectual property asset
2. The opportunity to commercialize the intellectual property asset
3. The amount and quantity of market data regarding guideline intellectual property asset transactions
4. The generally greater royalty rates earned on intellectual property assets compared to other general commercial intangible assets
5. The quantity of judicial precedent relating to the intellectual property asset
6. The passive value of the intellectual property asset

First, most intellectual property has a specified legal life. This legal life measurement is an integral component of the intellectual property economic analysis. This is because the legal life may influence the analyst's estimation of the remaining useful life ("RUL") of the intellectual property.

The intellectual property RUL estimation will influence:

1. the valuation methods that the analyst uses to analyze the subject intellectual property and
2. the type and amount of data and information required for the intellectual property valuation analysis.

Second, because of the special legal recognition and protection afforded to intellectual property, intellectual property owners generally have more commercialization opportunities. This is particularly true compared to the owners of general commercial intangible assets.

For example, intellectual property owners often enter into license, joint venture, or other exploitation and development agreements. These agreements allow the intellectual property owners to enjoy the economic benefits of commercializing the subject intellectual property separate and apart from their other business interests.

External commercialization opportunities can include licensing the use of and/or the development rights for the intellectual property:

1. through geographic expansion into new territories,
2. through industry expansion into new industries, and/or
3. through product expansion into new products.

In other words, the owner and the operator of an intellectual property can be (and often are) two different parties. Conversely, these external commercialization opportunities are typically not available to the owners of general commercial intangible assets.

For example, the owners of a favorable supplier contract, an ongoing customer relationship, or a trained and assembled workforce generally may derive the economic benefits from these intangible assets by commercializing them only within their own business operations (i.e., the owner and the operator of a general commercial intangible asset are typically the same party).

These external commercialization opportunities also provide guideline, objective market-based data with regard to the value of various intellectual property assets, which can assist the analyst and counsel in considering the market approach when estimating the value of the family law intellectual property assets.

Therefore, and with regard to the third generally accepted legal intellectual property attribute, there are more transactional data available for valuation or other economic analysis regarding intellectual properties as compared with other general commercial intangible assets.

That is, because there are more reported intellectual property sale/license transactions, there is more data available regarding the sale, license, or other external commercialization of intellectual property.

There are more reported sale or license transactions because intellectual property owners are more confident about entering into external commercialization transactions than are general commercial intangible asset owners. This is because parties to a transaction know that their legal and economic interests are more likely to be protected by the laws associated with their particular intellectual property asset.

Fourth, an intellectual property asset generally enjoys higher royalty rates and higher market value pricing multiples than do general commercial intangible assets. That is, an intellectual property asset will commonly trade (i.e., be licensed or sold) at higher prices than general commercial intangible assets.

This is because intellectual property buyers and licensees are willing to pay more for an intellectual property due to the protection and reduced risk afforded to them by intellectual property laws.

Fifth, there is substantially more judicial precedent regarding intellectual property than there is regarding general commercial intangible assets. This judicial precedent attribute itself has three implications:

1. There is greater judicially determined definitions of certain intellectual property than of general commercial intangible assets. For example, due to infringement and other litigation, courts have defined to some extent what a trade name is and what a trade secret is. Analysts can generally rely on these definitions in the identification and valuation of intellectual property.

   There is much less published precedent regarding general commercial intangible assets such as supplier relationships, customer relationships, business operating systems and procedures, or intangible value in the nature of goodwill. Therefore, there is somewhat less definition (at least, judicial definition) as to what constitutes these general commercial intangible assets.

2. With respect to certain intellectual property, there have been more judicial decisions regarding (a) appropriate (and inappropriate) valuation methodologies, (b) reasonable ranges of royalty rates, and (c) reasonable profit margins than of general commercial intangible assets.

   Again, judicial precedent may provide valuable guidance to the analyst and counsel when analyzing the family-owned intellectual property. This is not to suggest that analysts should naively apply valuation pricing multiples or royalty rates in a specific intellectual property analysis just because they are published in a judicial decision.

Obviously, such pricing multiples and royalty rates are only appropriate given the unique facts and circumstances of the specific court case. Nonetheless, a review of published precedent may provide the analyst (and counsel) with an indication of a reasonable range of pricing multiples, royalty rates, profit margins, and so forth.

3. Commercial participants (that is, buyers, sellers, licensors, licensees) in the intellectual property secondary market will be generally aware of the amount of judicial precedent. This judicial precedent will inform market participants that (a) federal and state intellectual property laws exist and (b) the courts recognize and protect various types of intellectual property.

   This level of judicial awareness and protection may motivate market participants to enter into more intellectual property market transactions. This is because market participants may consider the intellectual property market to be relatively safe and protected based on the amount of intellectual property judicial precedent.

Sixth, it is noteworthy that these intellectual property economic attributes can have a positive effect on both the active value and the passive value of the intellectual property.

Active value is generated when an intellectual property asset is used proactively (that is, to increase the intellectual property owner/operator price levels, market share, or profits).

Passive value is generated when an intellectual property asset is used defensively (that is, to protect the intellectual property owner/operator price levels, market share, or profits).

In other words, both active value and passive value may be positively influenced by the legal attributes and the economic attributes of the intellectual property asset as compared to general commercial intangible assets.

For the analyst, and for counsel, the value of the marital estate intellectual property may be observed by examining how the marketplace treats the specific economic attributes of the intellectual property asset.

The six intellectual property attributes discussed above encompass some of the market-specific and asset-specific attributes that the analyst (and counsel) should consider when valuing intellectual property within a family law context.

Summary and Conclusion

When a marital estate owns intellectual property, either directly or indirectly (through a family-owned or private company or professional practice), the value of that intellectual property can be the subject of considerable controversy during the marital dissolution process. This is because the intellectual property owner/operators, accountants and auditors, counsel and judges, and other parties involved in the family law process often have differing opinions of the value of the marital-estate-owned intellectual property.

These parties should be aware that there are generally accepted approaches, methods, and procedures related to:

1. the identification of intellectual property and
2. the valuation of intellectual property.

This discussion described intellectual property, and described the procedures and factors that the analyst typically applies to identify intellectual property. This discussion also summarized the four categories of intellectual property: trademarks, patents, copyrights, and trade secrets.

This discussion summarized the generally accepted approaches that an analyst may apply to value intellectual property for family law purposes.

Finally, this discussion described the intellectual property legal and economic attributes that the analyst, as well as counsel, should consider when valuing marital estate intellectual property.

Notes:

1. *The Concept of Intellectual Property*, World Intellectual Property Organization at www.wipo.int.
2. 15 U.S.C. §1127.
3. Melvin Simensky and Lanning Bryer, *The New Role of Intellectual Property in Commercial Transactions* (New York: John Wiley & Sons, 1994).
4. Ibid.
5. Ibid.

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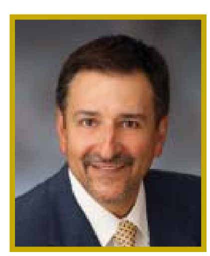

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The Importance of the Subject Industry When Applying the Income Approach in a Family Law Valuation Context

Samuel Nicholls and Justin Nielsen

In a family law context, legal counsel ("counsel") may retain a valuation analyst ("analyst") to estimate the value of a closely held business ownership interest held within the marital estate. When estimating the value of this marital estate business interest, the analyst may apply the income approach, discounted cash flow ("DCF") method. When applying the income approach, the consideration of the subject company industry is an important issue for the analyst. This is because the analyst should apply due diligence procedures when utilizing management-prepared financial projections in the analysis, including the comparison of the management-prepared financial projections to relevant industry data. Further, company management interviews may assist the analyst in performing appropriate diligence procedures with regard to the application of the income approach (including the application of management-prepared financial projections). This discussion summarizes the relationship between the income approach and the subject industry. And, this discussion provides practical guidance regarding the analyst's role in (1) properly addressing the subject industry when applying the income approach and (2) conducting company management interviews in a family-law-related business valuation.

Introduction

It has been said that, "In the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner. The value of the business interest, then, depends upon an estimate of the future benefits and the required rate of return at which those future benefits are discounted back to present value as of the valuation date."[1]

This means, in valuing any business, the income approach, discounted cash flow ("DCF") method, is fundamentally based on the calculation of a current (i.e., present) value of the company's anticipated future economic benefits, or income.

The two components of the DCF method are as follows:

1. The projection of future income
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the projected future income back to present value

While many independent factors influence the estimation of both a subject company's future income and appropriate risk-adjusted required rate of return (i.e., discount rate), an often under-analyzed component in applying the income approach is the subject industry. Therefore, this discussion summarizes the consideration of the subject industry in applying the income approach valuation of a marital estate business ownership interest.

While the Delaware Court of Chancery (the "Court") often rules on matters related to dissenting shareholder appraisal rights and shareholder oppression, Court decisions may provide the valuation analyst ("analyst") with guidance with regard to the application of the income approach within a family law context. With its significant influence on valuation-related matters, counsel and analysts frequently look to the Court for guidance regarding the appropriate methodology to value business ownership interests.

This discussion describes the role of the subject industry within the income approach, and specifically the process of aligning the subject industry with (1) company management-prepared projections and (2) the estimated long-term growth rate applied in the calculation of the company's terminal value.

This discussion includes several industry-related issues that have been addressed by the Court in recent years. And, this discussion proposes procedures that an analyst can take to ensure the appropriate consideration of industry data when applying the income approach to value a closely held business within a family law context.

The Relationship between the DCF Method and the Subject Company Industry

Within the income approach, there are a number of generally accepted valuation methods, each based on the principle that the value of an investment is a function of the income that will be generated by that investment over its expected life.

There are a number of methods that can be used to estimate value under this principle, most of which are based on the estimation of an investment's future income stream, and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is an income approach method that may be used to value companies on a going-concern basis for family law purposes. It has appeal because it incorporates the trade-off between risk and expected return, a critical component to the investment decision and value calculation process.

The DCF method provides an indication of value by (1) projecting the future income of a business and (2) estimating an appropriate risk-adjusted required rate of return used to discount the estimated future income back to present value (i.e., discount rate).

In applying the DCF method, the analyst often assumes that the estimated future income will eventually stabilize. This long-term stabilized benefits stream can then be capitalized into perpetuity and discounted back to the valuation date. The value of the long-term stabilized benefits stream is typically called the terminal value ("TV").

While there are many issues the analyst may consider in estimating the future income of a closely held business within a marital estate (and estimating an appropriate discount rate for a closely held business within a marital estate), the valuation analysis should consider the subject industry.

Specifically, the subject industry may be considered in:

1. assessing the reasonableness of company-management-prepared projections and
2. estimating the appropriate long-term growth rate used in the TV calculation.

A subject industry analysis can provide a useful portrait of how the company fits within an industry by considering (1) where the industry has been and (2) where the industry is likely to be going.

As presented in *Financial Valuation Applications and Models*, the following list presents some questions that can assist the analyst in developing a subject industry road map:

1. What are the prospects for growth?
2. What are the industry's dominant economic traits?
3. What competitive forces are at work in the industry and how strong are they?
4. What are the drivers of change in the industry and what effect will they have?
5. Which companies are in the strongest/weakest competitive positions?
6. What key factors will determine competitive success or failure?
7. How attractive is the industry in terms of its prospects for above-average profitability?
8. How large is the industry?
9. Is the industry dominated by a few large companies?
10. Are there many public companies in this industry?
11. How much merger and acquisition activity is occurring?
12. What are the barriers to entry?
13. Is it a regulated industry?
14. Who are the customers? Is that base growing?[2]


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One of the analyst responsibilities when applying the income approach in a family law context is to align the appropriate income measure and risk-adjusted discount rate with the subject industry historical, current, and projected economic performance. This will, in effect, provide the court with a reasonableness test or "sanity check" with regard to the company-management-prepared financial projections that are used in the DCF analysis of a marital-estate-owned closely held business.

The following section describes several resources that are available to the analyst to obtain industry data and information that can be used in an income approach analysis.

Sources of Industry Information

There are many sources of industry information and data, including fee-based, trade association, and free data and information resources. While it is not practical to list all available sources of industry data in this discussion, some of the sources of industry data and information include the following:

1. *Standard & Poor's Industry Surveys*
2. *IBISWorld Industry Reports*
3. *First Research Industry Profiles*
4. MarketResearch.com
5. Risk Management Association *Annual Statement Studies*

Some additional sources of industry data and information include the following:

1. Integra Information Benchmarking Data
2. Encyclopedia of Associations
3. National Trade and Professional Associations of the United States
4. Hoovers Company Database (Hoovers.com)
5. Factiva (factiva.com)
6. American Society of Association Executives
7. Various search engines such as Google (google.com), *The Wall Street Journal MarketWatch* (marketwatch.com), etc.

Subject Industry Considerations as Proffered by the Court

As a large number of business entities within the Unites States are organized in the State of Delaware, the Court has become an influential voice in providing guidance related to business valuation issues. While these issues are typically related to dissenting shareholder appraisal rights or shareholder oppression matters, Court guidance may be meaningful to the analyst tasked with valuing a closely held business within a family law context.

One of those valuation issues is the appropriate use of, and reliance on, the subject industry when applying the income approach.

The Court has a consistent history of addressing subject-industry-related issues, and specifically the importance of analyzing the subject industry with regard to:

1. company-management-prepared projections and
2. the estimation of the long-term growth rate applied in a TV calculation.

The following two sections summarize several recent Court opinions that address subject-industry-related issues.

Industry Consideration—Management-Prepared Financial Projections

Based on historical and recent opinions, the Court expects the analyst to perform appropriate due diligence with regard to the subject industry, including the reasonableness of management-prepared projections when applying the DCF method.

The analyst may review management projections and confirm that the assumptions on which the projections are based are reasonable and appropriate given the historical, current, and future outlook of the subject industry.

As explained by the Court In re *John Q. Hammons Hotels Inc. Shareholder Litigation*:

> In this case, it is undisputed that JQH operated in a very competitive **industry**

[emphasis added]—the hotel business. JQH had no competitive advantages, such as brand names or proprietary technology. Worse still, a large portion of its portfolio is located in secondary and tertiary markets, which have lower barriers to entry than primary markets. Hotels in secondary and tertiary markets face significant competition because of the lower barriers to entry. . . . And JQH's hotels were even subject to competition from their own franchisors in many of the markets where JQH operated. Dr. Kursh's expert report failed to take into account some of these factors affecting JQH, and his report is significantly impaired as a result.[3]

The above decision highlights the fact that by neglecting to appropriately consider the subject industry, the analyst is at risk of having the Court dismiss the opinion of value entirely.

In explaining the decision to disallow the application of the income approach, DCF method, in *Doft & Co., et al., v. Travelocity.com, Inc. et al.*, the Court relied on, in part, the state of the subject industry as testified to by Anwar Zakkour, the Solomon Smith Barney managing director:

Q. Did Salomon Smith Barney prepare a discounted cash flow analysis of Travelocity in connection with this transaction?

A. Absolutely Not.

Q. Why was no discounted cash flow analysis prepared in connection with this transaction?

A. Because this was an **industry** [emphasis added] that was in flux. And the management team itself, which should have been the team that was most able to put together a set of projections, would have told you it was virtually impossible to predict the performance of this company into any sort of reasonable future term. And they in fact had very little confidence with even their 2002 forecast numbers because of that.

September 11th didn't help the pace of migration from off-line to online. It didn't help. The airlines being very focused on cutting their distribution costs didn't help. These were all things that were happening real time. Travelocity going from being the number one player to being very unfavorably compared to Expedia and certainly losing its number one position to them in a very short time didn't help. These are all things that support that. And other than maybe God himself, I suspect nobody could really predict what this business is going to do in the next five years.[4]

The Court further explains in *Doft & Co., et al., v. Travelocity.com, Inc. et al.*:

For these reasons, the court reluctantly concludes that it cannot properly rely on either party's DCF valuation. The goal of the DCF method of valuation is to value the future cash flows. Here, the record clearly shows that, in the absence of reasonably reliable contemporaneous projections, the degree of speculation and uncertainty characterizing the future prospects of Travelocity and the **industry in which it operates** [emphasis added] make a DCF analysis of marginal utility as a valuation technique in this case.[5]

Industry Consideration—Estimated Long-Term Growth Rate in TV Calculation

The Court has opined on the proper subject industry consideration when estimating an appropriate long-term growth rate utilized in a TV calculation when applying the DCF method.

For example, the Court explains in *Towerview, LLC, et al., v. Cox Radio, Inc.*:

As noted, the rate of inflation generally is the "floor for a terminal value." "Generally, once an **industry** [emphasis added] has matured, a company will grow at a steady rate that is roughly equal to the rate of nominal GDP growth." Some experts maintain that "the terminal growth rate should never be higher than the expected long-term nominal growth rate of the general economy, which includes both inflation and real growth. Moreover, both experts in this case acknowledged that the expected long-term inflation rate in 2009 was 2%–2.5%. There also was some evidence that the expected rate of real GDP growth was between 2.5% and 2.7%, but this evidence was not particularly reliable. I find that the radio **industry** [emphasis added] is a mature industry and that CXR was a solidly profitable company. Thus, a long-term growth rate at least equal to expected inflation is appropriate here.[6]

The Court decision implies that the analyst should address (1) the profitability of the subject company and (2) the maturity stage of the industry (i.e., the current and projected profitability of the subject industry) in order to appropriately estimate the long-term growth rate to be used in the TV calculation.

As further opined by the Court in *Merion Capital, L.P., et al., v. 3M Cogent, Inc.*:

> Relying on historical GDP and inflation data, economic analysts projections, and the growth prospects of the biometrics **industry** [emphasis added], Bailey selected a perpetuity growth rate of 4.5%. The Gordian Experts, on the other hand, used a range of growth rates between 2% and 5%, and implicitly selected the midpoint of 3.5%. The Gordian Experts, however, provided no analysis or explanation in support of the number they chose for the terminal growth rate. Because Bailey was the only expert who sought to justify his conclusions, and his conclusion is within the range of rates identified by Respondent's expert and appears to be reasonable based on the evidence, I adopt Bailey's estimate of a 4.5% perpetuity growth rate.[7]

As opined by the Court in the above decisions, when applying the income approach, the state of the subject industry may be considered:

1. in assessing the reasonableness of company-management-prepared projections and
2. when estimating the appropriate long-term growth rate to be used in a TV calculation.

Further, neglecting to appropriately consider the subject industry may lead to the exclusion of the analyst's report in its entirety. This judicial guidance, while in an appraisal action context, may be relevant for analysts engaged in family law matters as well.

Guidance from the Valuation Professional

It is intuitive that the value of a business is influenced by the operational efficiencies, products, and competitive advantage of the individual company within the context of the historical, current, and projected state of the subject industry.

It is important that the analyst not be myopic in estimating the value of a business. Rather, the analyst should cross-reference a detailed analysis of the subject company with a broader view of the subject industry, specifically highlighting where the subject business may fall within the industry, and why.

As previously mentioned, the Court has opined that, in applying the income approach to a subject company, the analyst's due diligence process should include consideration of the subject industry.

Additionally, the valuation profession also provides guidance with regard to the analysis of the subject industry. As presented in *Understanding Business Valuation*, several general factors that the analyst should consider in analyzing the subject industry may include the following:

1. Who makes up the industry? Are there many companies or are there very few companies that control everything?
2. Is it a cyclical industry?
3. Is it a new industry with many new companies entering it, or is it a mature industry that has reached its saturation point?
4. What are the barriers to entry, if any, into the industry?
5. Is this a self-contained industry, or is it dependent on another industry?
6. Is the industry dependent on new technology? If so, is the appraisal subject keeping up with the industry?
7. Is the industry expected to change? If so, how will that affect the appraisal subject?
8. What is the forecast for growth within the industry?[8]

As further presented in *Understanding Business Valuation*, Trugman reproduces a list from the American Society of Appraisers that presents industry factors that the analyst may consider in analyzing management projections within the context of the subject industry, such as the following:

1. Growth prospects for the subject company's industry at the national and local level
2. Demand factors
3. Maturity of the industry
4. Structure of the industry and level of competition
5. Technological or economic obsolescence factors
6. Barriers to competitor entry[9]

It is important that the analyst vet the assumptions used in the income approach to ensure they are reasonable as compared to the historical, current, and projected economic state of the subject industry.

Further, to help ensure the industry data obtained is applicable to the subject company, the analyst may classify the business activities of the company. Two methods used to classify businesses are:

1. the Standard Industrial Classification ("SIC") system and
2. the North American Industrial Classification System ("NAICS").

Upon determining the appropriate classification of the subject company, the analyst may utilize the aforementioned industry resources to obtain data and information for companies or industries in the same classification.

Considering the data and information previously presented, valuation profession best practices require the analyst to appropriately consider the subject industry.

Therefore, the analyst may ensure the company management-prepared projections and estimated long-term growth rate applied in a TV calculation are:

1. consistent with the industry's growth prospects;
2. reasonable as compared to the industry's historical financial results; and
3. achievable based on the industry's geography and expected future outlook of the regional, domestic, and international (if applicable) economy within the industry's geographic outline.

As presented in item three above, the analyst may also consider the geographic economic influences on the subject industry historical, current, and projected economic performance. Namely, the regional, national, and international (if applicable) economy may have a direct impact on the subject industry economic performance. The analyst may consider and incorporate, as appropriate, geographic economic influences when analyzing the subject industry.

Company Management Interviews

In applying the income approach to value a closely held business within a marital estate (and based on guidance from the Court), the analyst may consider:

1. the subject industry with regard to management-prepared financial projections and
2. the subject industry with regard to the estimated long-term growth rate used in the TV calculation, as previously mentioned.

However, the analyst may also be aware of the facts and circumstances surrounding the family law assignment. Namely, the closely held business owner spouse may purposely provide inaccurate data, information, and management-prepared financial projections due to that spouse wanting to reduce the value of the closely held business ownership interest (thereby reducing any equalization payments required by the family law court in the equitable distribution of the marital estate assets).

Further, the closely held business owner spouse may purposely provide conflicting data with regard to the subject industry in order to paint a negative portrait of the future operations of the company.

The analyst may juxtapose any data and information provided by company management to:

1. industry data,
2. historical company data, and
3. data received from other interviews with company senior management.

In order to perform proper due diligence with regard to management-prepared financial projections that are utilized in a family law context, the analyst may interview relevant company leadership.

Incorporating the data and information previously presented, in general, valuation profession best practices suggest that the analyst assess the reasonableness of management-prepared projections by ensuring the projections are:

1. consistent with the company's growth prospects;
2. reasonable as compared to the company's historical financial results;
3. achievable based on the company's operating capacity and expected future capital expenditures;
4. reasonable as compared to the company's client and supplier projected financial results;
5. reasonable based on the industry's historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy;
7. consistent with other company leadership interview results with regard to the company's historical, current, and projected financial results; and
8. extensively documented and justified if the projections have been amended by the analyst.

The analyst may vet the assumptions on which management projections are based. The analyst may document and justify any changes made to management-prepared projections due to the comparison between the data provided in management interviews, the data provided in the company management-prepared financial projections, and the data analyzed with regard to the subject industry.

Summary and Conclusion

In a family law context, counsel may retain the analyst to estimate the value of a private company ownership interest held within the marital estate. When estimating the value of this marital-estate-owned private company, the analyst may apply the income approach.

When applying the income approach to value a private company ownership interest (within a family law context), the analyst should ensure that appropriate consideration is given to the subject industry.

This is because, as proffered by the Court, when applying the income approach, the subject industry should generally be considered:

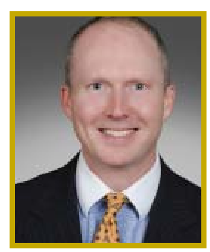
1. in assessing the reasonableness of company management-prepared projections and
2. when estimating the appropriate long-term growth rate to be utilized in a terminal value calculation.

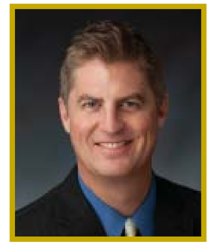
While the Court typically rules on appraisal actions, the guidance from the Court may be meaningful to the analyst assisting with a family law matter. This is because the subject industry is a consideration in an income approach analysis conducted on a private company ownership interest held within the marital estate.

Further, the analyst may also consider valuation profession best practices, and—if possible—conduct due diligence company management interviews, in order to apply the income approach to the valuation of a private company ownership interest within the marital estate.

Notes:

1. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 56.
2. James R. Hitchner, *Financial Valuation Applications and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 64–65.
3. In re John Q. Hammons Hotels Inc. Shareholder Litigation, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
4. Doft & Co., et al., v. Travelocity.com, Inc. et al., No. Civ.A. 19734, 2004 WL 1152338 (Del. Ch. May 21, 2004)
5. Id.
6. Towerview, LLC, et al., v. Cox Radio, Inc., C.A. No. 4809–VCP, 2013 WL 3316186 (Del. Ch. June 28, 2013).
8. Merion Capital, L.P., et al., v. 3M Cogent, Inc., C.A. No. 6247–VCP 2013 WL 3793896 (Del. Ch. July 8, 2013).
9. Gary Trugman, *Understanding Business Valuation*, 5th ed. (New York: American Institute of Certified Public Accountants, 2017), 263.
10. Ibid., 263.





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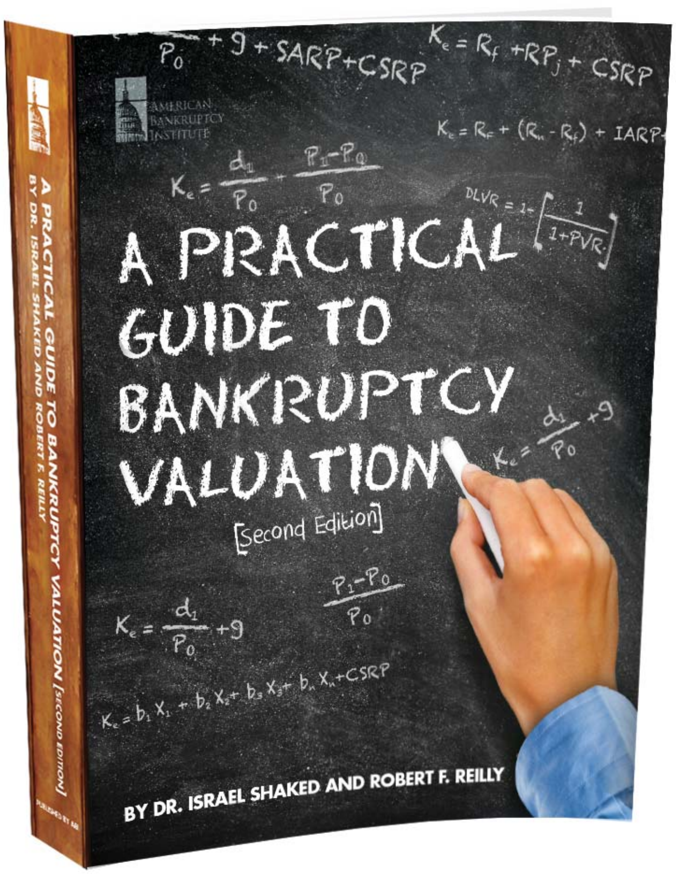

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A PRACTICAL GUIDE TO BANKRUPTCY VALUATION

Dr. Israel Shaked and Robert F. Reilly

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Understanding Key Person Considerations When Valuing a Private Company in a Family Law Context

Matt Courtnage

When retained by family law counsel ("counsel") to estimate the value of a private company within a marital estate, the valuation analyst ("analyst") may consider the potential subject company dependence on one or two key individuals. This "dependence" is typically referred to as key person dependence or "key person risk." Key person risk is recognized within the valuation profession as a relevant company-specific risk characteristic, and it can be accounted for in several ways within a valuation analysis. Therefore, the analyst may perform appropriate due diligence to (1) identify any key person risk associated with the private company and (2) quantify and present the impact of any key person risk within the private company analysis.

Introduction

In any company, there may exist certain individuals who are key to the on-going profitability of the business. However, in a closely held business—and specifically a private company within a family law context—the potential for there to be a "key person" who is largely responsible for revenue generation, customer interaction and development, supplier interaction and development, employee interaction and development, or strategic vision development may be significant.

The dependence on an individual who is key to any of the above-referenced operating tasks is commonly referred to as "key person dependence." Key person dependence, or more commonly referred to as key person risk, is widely recognized in the valuation profession as a relevant company-specific risk attribute.

When valuing private companies for family law purposes, the valuation analyst ("analyst") may evaluate whether the private company has key person risk. And, the analyst should provide support for the level of a key person risk adjustment. This is because, if key person risk is not properly identified and quantified, the estimated value of the private company may be misstated. This misstatement may result in an inequitable division of the marital assets.

This discussion describes key person risk in a private company within a family law context. This discussion also addresses how to evaluate a private company for key person risk, and provides guidance with regard to estimating a key person risk discount in the valuation of a private company.

What Is Key Person Risk in a Private Company?

When valuing private companies for family law purposes, the private company can often be relatively small and may rely on the expertise of one or two individuals to ensure the profitability of the enterprise. In these circumstances, it is important for the analyst to adequately consider the importance of these one or two individuals, often referred to as a "key person(s)."

Many times, in private companies, senior company management is comprised of a relatively limited number of employees. In these circumstances, it is not unusual for a subject company's future success and viability to be reliant on the continued health, success, experience, expertise, and contributions of a key person, such as the private company owner or founder.

When a private company is highly dependent on one individual for its continuing success, it may suffer from what is commonly referred to in the valuation profession as "key person risk."

In order to account for this key person risk in the valuation of a private company within a family law context, the analyst may apply some type of discount to account for this key person risk (i.e., a "key person discount").

As presented in the *International Glossary of Business Valuation Terms*, the definition of a key person discount is:

> an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise.[1]

When valuing a private company ownership interest within a family law context, the analyst should understand key person risk and be able to evaluate the existence, or lack of existence, of said risk. This is because, in a family law context, the private company:

1. may not have a formal transition plan to account for the potential loss of a key person,
2. may not have a noncompete agreement to insure the subject company against the loss of a key person, and/or
3. may not have life insurance payable to the subject company to account for the potential death or disability of a key person.

For federal gift and estate tax purposes, the U.S. Tax Court has allowed for a valuation discount when estimating the value of a private company when the existence of key person risk has been appropriately established. The value adjustment to account for this key person risk is often presented in the form of a key person discount, typically reflected as:

1. an explicit percentage discount at the enterprise (or equity) level before shareholder adjustment considerations,
2. an implicit adjustment to a discount or capitalization rate when estimating the value of a private company by applying the income approach, or
3. an implicit adjustment to the long-term management financial projections (discounted cash flow method) or normalized long-term earnings (capitalization of net cash flow method) to account for the removal of the key person when estimating the value of a private company by applying the income approach.

The analyst may also apply an implicit adjustment to the selected market-derived valuation pricing multiples when estimating the value of a private company by applying the market approach.

As presented in *Business Valuation Discounts and Premiums*:

> The impact or potential impact of the loss of a key person can be reflected either explicitly or implicitly. Sometimes the key person discount may be reflected in an adjustment to a discount or capitalization rate in the income approach or to valuation multiples in the market approach. Alternatively, the key person discount may be quantified as a separate discount, sometimes as a dollar amount but more often as a percentage. It is generally considered to be an enterprise level discount (taken before shareholder level adjustments); it is a function of the valuation subject and impacts the entire company.[2]

When valuing a private company for family law purposes, best practices suggest that the analyst may:

1. complete sufficient diligence procedures to establish whether a company has a key person dependency and
2. identify the key person risk and incorporate elements into the valuation process that adequately address the economic impact of the identified key person dependency.

The following discussion focusses on procedures to (1) evaluate whether key person risk exists in a private company and (2) address key person risk issues when valuing a private company for family law purposes.

Identifiable Key Person Considerations

Simply being an owner of a private company does not automatically result in that individual being a key person. Similarly, just because a company is "small"—in terms of revenue, assets, or employees—

does not necessarily indicate that the company operates with key person risk.

A private company may suffer little to no economic harm upon the departure of a member of senior management if the company operating structure includes:

1. adequately trained employees that can effectively assume the duties and responsibilities of the departing manager, owner, or founder and
2. diversified revenue, supplier, and distribution sources that do not depend significantly on the departing manager, owner, or founder.

Even small companies operating with a well-diversified senior management team capable of fulfilling the role of a departing key person are positioned to mitigate key person risk.

As presented in *Business Valuation Discounts and Premiums*, when analyzing whether a private company has potential key person risk, the following attributes of the key person should be evaluated by the analyst:

1. Relationships with suppliers
2. Relationships with customers
3. Employee loyalty to key person
4. Unique marketing vision, insight and ability
5. Unique technological or product innovation capability
6. Extraordinary management and leadership skill
7. Financial strength (ability to obtain debt or equity capital, personal guarantees)[3]

Each of the above-mentioned key person risk attributes are addressed in the following sections, which include some suggested questions the analyst can ask management in evaluating whether a subject company has key person risk. (We have combined attributes 4 and 5 for purposes of this discussion.)

Suppliers

One question the analyst may research is: "Are relationships with suppliers largely dependent on one key person?" A key person may be able to obtain better prices or more exclusive products from suppliers based on the key person's reputation or personal relationships.

More favorable supplier terms provide a subject company with lower input expenses, which positively affect the profitability of the subject private company.

A private company that can realize lower input expenses can then use this higher profitability to:

1. make further profitable investments in capital equipment,
2. offer higher compensation and draw more skilled employees into the organization, and
3. increase the marketing and/or advertising budget to reach more consumers.

Generally, an analyst may perform diligence procedures to determine whether company suppliers are providing favorable terms based on a relationship with a specific individual (or individuals) within the private company.

If a situation exists whereby the private company is receiving favorable terms from suppliers due to the reputation or personal relationships attributable to one or two individuals, this will likely support a conclusion of key person risk.

Customers

Another question the analyst may pose is, "Are relationships with customers largely dependent on one person?" Customers may purchase goods or services from a subject company because they have a personal relationship with a particular person (or persons) in the subject company.

In general, a company or individual may purchase goods or services from another company because the seller provides a high-quality product or service.

However, if the product or service is not noticeably different from comparable products or services offered by alternative providers, these purchases may be attributable to some form of a personal relationship with the private customer.

In the above circumstance, the personal relationship in effect increases the switching costs to purchase the comparable products or services from another provider. This is because the customer's personal relationship with a key person at the subject company deters them from purchasing the comparable products or services from a competitor.

If a significant number of customer relationships can be attributed to one person at a private company, or if a significant percentage of company revenue is generated by the relationships of one person, then key person risk likely exists at the private company.

Employee Loyalty

With regard to employee loyalty, a question the analyst may pose is, “Are employees who are important to the private company’s on-going operations loyal to a specific person?” And, a potential follow-up question may be, “Would the loyal employees leave if the key person left?”

In some smaller private companies, strong loyalty may exist between a company founder or leader and other employees. Such loyalty could result in the departure of a number of employees should the founder or leader leave the private company.

In such a circumstance, the key person may not even have unique skills or talents that the private company relies on for its on-going success. However, the company could still experience significant disruption and harm if the “charismatic” leader or founder left and a material group of other, important employees followed.

Generally, this is not a significant problem in larger companies with more diversified senior management teams.

However, in smaller companies, such as many private businesses within a marital estate, the departure of “everyone’s favorite leader” could result in the loss of a number of key employees, some of whom may have special knowledge or training that would be difficult to replace. Such a loss could be harmful to the long-term, continuing operating success of the private company.

When valuing a private company within a family law context, the analyst typically performs diligence procedures to evaluate whether the subject company is exposed to employee defection as a result of loyalty to a particular individual or leader. However, the analyst may also consider that such potential losses are mitigated significantly by legally enforceable noncompetition agreements.

The absence of a noncompetition agreement in such a circumstance may lead the analyst to the conclusion that employee loyalty key person risk exists at the private company.

Innovation—Unique Marketing Vision and Product Innovation

In evaluating potential key person risk, a question the analyst may ask company management is: “Does one person in the company have a unique ability to innovate products?” Also, “Does one person in the company have a uniquely successful marketing vision or strategy?”

For companies in the technology industry, or other industries demonstrating significant technological disruption, innovation, or other growth, a key person may be important for understanding the direction in which the industry or products are moving. Steve Jobs at Apple, Inc., would be a reasonably good example of a key person who possessed a unique vision and unique product innovation abilities.

Typically, the analyst performs diligence procedures aimed at understanding to what extent one individual enables a subject company to stay ahead of changing trends or innovations in the subject industry.

If one person has been responsible for identifying changes or important trends in the industry, and the company has performed well as a result of the early identification of these industry shifts, the private company may be exposed to key person risk.

Similarly, if one person has been responsible for developing and implementing a unique marketing plan or vision, and the private company has performed well as a result of this unique marketing plan or vision, then the private company may be exposed to key person risk.

Extraordinary Management and Leadership Skill

Does a key person have management and/or leadership skills that are important to the private company’s profitable operations? In some private companies within a family law context, one individual may have the leadership ability to increase private company revenue and earnings, as well as to navigate the landscape of constantly changing foreign and domestic fiscal policies and industry dynamics.

Further, one key person may be important to defining short-term and long-term goals for the private company. This individual may have the administrative and management leadership skills required to enable the private company to realize its goals and align these goals with employee goals.

If a company is highly dependent on one individual to lead and manage the private company, and this key person is “irreplaceable,” then the private company likely suffers from management and leadership key person risk.

To evaluate the existence and level of extraordinary management and leadership skill key person risk, the analyst may interview the potential key person, as well as several other employees. This due diligence analysis may assist the analyst in estimating the impact that a potential key person’s departure may have on the on-going operations of the private company.

If the key person has unique skills, talents, and qualities, but it is determined that an external hire could assume the key person's role at a comparable cost, then key person risk may not be present.

It is important that the analyst not double count key person risk, as it may be difficult to bifurcate certain key person attributes between innovation—unique marketing vision attributes and product innovation—and extraordinary management and leadership skill attributes.

Financial Strength—Ability to Acquire Debt or Equity

With regard to financial strength, a question the analyst may pose is, "Does one key person have a unique ability to acquire debt or equity capital?" In some instances, one key person within a private company may have the unique ability to raise additional equity capital through a large network of potential investors.

Similarly, if one person has been responsible for obtaining debt, and this key person is deemed "irreplaceable," then the private company may be exposed to key person risk in the form of a threat to the private company's continuing ability to raise additional capital (equity or debt) on favorable terms.

Many closely held companies in a family law context borrow through commercial banks, which generally rely on the financial fundamental position of the private company in making lending decisions.

However, these banking relationships may possess some key person considerations, and the analyst should perform sufficient diligence procedures aimed at understanding the key terms and conditions regarding the acquisition of any private company equity or debt.

If such diligence indicates that a single individual at the private company has a history of achieving favorable debt financing terms based on certain relationships, or has the ability to generate additional equity based on favorable relationships in the equity markets, the private company may be exposed to key person risk.

Adjusting for Key Person Risk in the Valuation of a Private Company within a Family Law Context

Once the analyst has assessed whether certain key person risk is present at a private company, the next steps are as follows:

1. Quantify the significance of the key person risk
2. Incorporate the financial impact of the key person risk in the private company valuation analysis

While there are three generally accepted valuation approaches available to the analyst in valuing a private company within a family law context, the following discussion focuses on the following two business valuation approaches:

1. Market approach
2. Income approach

A brief description of each approach follows, along with a more in-depth discussion regarding the treatment of key person risk within the income approach.

Market Approach

The market approach methods that are available to the analyst rely on the principle that prices of securities of companies in the same or similar lines of business (as compared to the private company) provide informational value guidance to investors.

The market approach methods incorporate a relational analysis between a sample of guideline company security trading prices, or transaction prices, and selected financial/operating fundamentals in order to create a range of relevant pricing multiples.

These pricing multiples are then used as a basis for selecting particular valuation pricing multiples that can be applied to the private company identical financial fundamentals. The informational sources considered for the purpose of completing the market approach can include data regarding privately held companies, publicly traded companies, or public and private merged and acquired company transactions.

Income Approach

Within the income approach, there are a number of generally accepted valuation methods. Each method is fundamentally based on the principle that the value of an investment is a function of the income that will be generated by that investment over its expected life.

There are a number of methods that can be applied to estimate value under this premise, most of which are based on the estimation of an investment's future income, and the application of an appropriate risk-adjusted, present value discount/direct capitalization rate.

Common income approach valuation methods include (1) the discounted cash flow ("DCF") method and (2) the direct capitalization method.

The DCF method is often applied to value private companies on a going-concern basis for family law purposes. It has appeal because it directly incorporates the trade-off between risk and expected return, an important component to the investment decision and value calculation process.

The DCF method relies on the projections of the private company operating results over a discrete, multi-year period. The projected private company operating results are then converted to projected cash flows.

The discounted cash flow projection is then converted to a present value using a market-based, risk-adjusted discount rate. The discounted cash flow method also involves a terminal value analysis at the end of the discrete projection period.

The direct capitalization method involves dividing a market-derived, risk-adjusted direct capitalization rate into a normalized estimate of the expected, long-term stabilized private company income (e.g., cash flow).

The following sections present a discussion of the appropriate ways to incorporate key person risk in the market approach and in the income approach when valuing a private company within a family law context.

Key Person Risk—Market Approach

Key person risk may be incorporated in the market approach by typically adjusting the selected guideline company market-derived valuation pricing multiples that are applied to the private company.

This means that, based on the analyst's evaluation of potential key person risk within the private company, the selected guideline company market-derived valuation pricing multiples are adjusted down (i.e., decreased) in order to account for the key person risk associated with the private company.

When adjusting these guideline publicly traded selected pricing multiples, it is important for the analyst to support the reasons for:

1. decreasing the selected pricing multiples due to key person risk and
2. selecting the magnitude of the decrease of the selected pricing multiples.

A significant issue when incorporating a key person adjustment in the market approach is the high degree of judgment related to said adjustment. Put another way, it may be difficult to provide objective, quantifiable support as to why a certain valuation pricing multiple was adjusted from "2 times revenue" to "1.5 times revenue," for example.

Due to these difficulties, it may be challenging to incorporate key person risk considerations when applying the market approach to value a private company within a family law context.

Key Person Risk—Income Approach

Within the income approach, there are two common procedures that may be used to incorporate key person considerations (i.e., a key person discount) in the valuation of a private company.

The first procedure is the analyst can increase the discount rate/capitalization rate used to present value the normalized income for the private company (when applying the income approach, DCF method, or the income approach, direct capitalization method).

The increase in the discount rate/capitalization rate is intended to reflect the incremental risk the key person dependency exerts on the private company's on-going operations.

The second procedure is the analyst can estimate the projected detrimental effect that the loss of the key person would exert on the private company future operating results (i.e., projected revenue and earnings used in a DCF method analysis or a direct capitalization method analysis).

The estimated effect of the adjustment to incorporate the detrimental effect of the loss of the key person would then be used to:

1. normalize the private company income and net cash flow used in the direct capitalization method analysis (based on the assumed loss of the key person) or

2. develop adjusted private company long-term financial projections to be used in the DCF method analysis (based on the assumed loss of the key person).

When developing a discount rate/capitalization rate, the analyst will typically begin with a risk-free rate of return and add subsequent incremental risk premium components. Based on the facts and circumstances of the private company, additional risk premium components could include an equity risk premium, a size premium, and an industry risk premium.

If an analyst determines that company-specific risk exists that is not captured by the premiums previously identified (such as key person risk), the analyst can then add an additional company-specific risk premium to the risk-adjusted, indicated discount rate/capitalization rate.

Often, key person risk may be incorporated in the development of a discount rate as a component of company-specific risk.[4]

However, as mentioned in the "Key Person Risk—Market Approach" section, the analyst should have support for:

1. increasing the estimated discount rate/ capitalization rate due to key person risk and
2. the magnitude of the increase in the estimated discount rate/capitalization rate.

This is because, similar to the information presented in the "Key Person Risk—Market Approach" section, it is often difficult to provide objective, quantifiable support as to why a discount rate/capitalization rate was "increased by 1 percent for key person considerations."

Common questions may be, "Why not an increase of 0.5 percent, or 1.5 percent, or 2.0 percent, or 3.0 percent?" For these reasons, the analyst should thoroughly document and support the reasons why a key person adjustment was made to the indicated private company discount rate/capitalization rate.

With regard to the second procedure (i.e., estimating the projected detrimental effect that the loss of the key person would exert on the private company future operating results), the analyst may attempt to adjust the private company earnings or future cash flow in order to reflect private company operations as if the key person were no longer present.

A supportable estimate regarding how the private company revenue and operations would change on a day-to-day basis if the key person were no longer present is required.

Typically, the impact on the projected financial results of the private company due to the loss of a key person is estimated based on due diligence interviews with the key person and other management. It is important to note that while it is not an exhaustive list, the six areas previously discussed provide a reasonable interview foundation for the purpose of establishing whether a private company is exposed to key person risk and the nature of that risk.

Through the interview process, an analyst may learn that a suitable replacement for a key person actually exists, which would mitigate, or potentially eliminate, the identified key person risk exposure.

To the extent that key person risk is identified, and the exposure cannot be effectively eliminated, the private company projected revenue and earnings used in a DCF method analysis will likely be materially lower. However, being able to objectively estimate the impact of losing a key person within a long-term financial projection (or a single, normalized long-term estimate of the private company profitability) may be a difficult task.

Key Person Discount—Enterprise Level

One additional option the analyst has in addressing key person risk in the valuation of a private company within a family law context is to incorporate the relevant key person risk at the enterprise (or equity) level. This means that, rather than adjusting for key person risk in the market approach or the income approach, the analyst can apply a dollar amount or percentage adjustment to the indicated enterprise (or equity) value of the private company.

The advantage of applying the key person discount at the enterprise level is that it does not involve any reliance on management-prepared financial projections or attempts to estimate the private company normalized earnings based on the assumed loss of the key person.

Applying a key person discount at the enterprise level enables an analyst to avoid making multiple assumptions regarding:

1. operating measures, such as future revenue and operating margins, and related growth rates and
2. customer/employee retention and supplier relationships.

Further, incorporating a key person discount at the enterprise (or equity) level does not involve any reliance on comparability between guideline publicly traded or merged and acquired companies.

As a result, applying a key person discount as a dollar amount or percentage at the enterprise (or

“[T]he U.S. Tax Court has recognized enterprise (or equity) level discounts for key person considerations.”

equity) level represents a viable, and often preferred, option when key person risk is identified in the valuation of a private company for family law purposes. This is because even the U.S. Tax Court has recognized enterprise (or equity) level discounts for key person considerations.

As presented in *Business Valuation Discounts and Premiums* (and regarding *Estate of Mitchell v. Commissioner*):

> Because (1) the court considered him a very key person, (2) alleged earlier offers to acquire the entire company were contingent upon his continuing service, and (3) there was a marked lack of depth of management, the court determined a 10 percent discount from the company’s enterprise stock value.
>
> The court’s discussion of the key person factor is instructive:
>
> We next consider the impact of Mr. Mitchell’s death on [John Paul Mitchell Systems]. Mr. Mitchell embodied JPMS to distributors, hair stylists, and salon owners. He was vitally important to its product development, marketing, and training. Moreover, he possessed a unique vision that enabled him to foresee fashion trends in the hair styling industry. It is clear that the loss of Mr. Mitchell, along with the structural inadequacies of JPMS, created uncertainties as to the future of JPMS at the moment of death.[5]

While there is a degree of judgment in the application of a key person discount, it is helpful from the analyst point of view to at least be able to rely on certain court decisions as support for an enterprise (or equity) level key person adjustment. This is because, should the family law matter proceed to trial, the analyst will have more objective support for the existence of, and the magnitude of, a key person valuation discount.

Summary and Conclusion

Key person considerations are important for the analyst when estimating the value of a private company, particularly in a family law context. This is because many private companies rely on one or two key individuals to ensure the on-going profitability of a private company. This company reliance on one or two key individuals is often referred to as “key person risk.”

There are several procedures for the analyst to evaluate, and account for (i.e., quantify), key person risk in the valuation of private company. These procedures include the following:

1. An explicit percentage discount at the enterprise (or equity) level before shareholder adjustment considerations
2. An implicit adjustment to a discount or capitalization rate when estimating the value of a private company by applying the income approach
3. An implicit adjustment to the long-term management financial projections (in the discounted cash flow method) or normalized long-term income (in the direct capitalization method) to account for the removal of the key person when estimating the value of a private company by applying the income approach

The analyst may also apply an implicit adjustment to the selected market-derived valuation pricing multiples when estimating the value of a private company by applying the market approach.

Finally, it is not uncommon for the analyst to apply the key person adjustment to the enterprise (or equity) level, based on U.S. Tax Court judicial precedent.

Notes:

1. *International Glossary of Business Valuation Terms* (as adopted by the American Society of Appraisers, 2009).
2. Shannon P. Pratt, *Business Valuation Discounts and Premiums*, 2d ed. (New York: John Wiley & Sons, 2009), 261.
3. Ibid., 260–261.
4. Other common company-specific risk attributes that may result in additional company-specific risk premiums include customer dependency and supplier dependency, for example.
5. Pratt, *Business Valuation Discounts and Premiums*, 266.

Matt Courtnage is a manager in our Portland, Oregon, practice office. Matt can be reached at (503) 243-7520 or at mccourtnage@willamette.com.

On Our Web Site

Recent Articles and Presentations

Curtis Kimball, a managing director in our Atlanta office and head of our wealth management valuation services practice, delivered a presentation to the Estate Planning Council of St. Louis on October 22, 2018. The title of Curt's presentation is "An Update on 50 Year's Worth of Valuation Issues: On Fair Market Value for Business and Other Interests."

Curt's presentation reviews various valuation issues that have been considered in the courts over the years. These issues include valuation of pass-through entities, buy-sell agreements, the impact of subsequent events on valuation, and valuation of intra-family notes. Curt discusses various federal and state court decisions, including decisions from U.S. Tax Court and the Delaware Chancery Court.

Robert Reilly, a managing director of our firm, authored an article that appeared in the October 2018 issue of *The Practical Lawyer*. The title of Robert's article is "What Lawyers Need to Know about the Asset-Based Approach to Business Valuation (Part 1)."

Legal counsel often retain and rely on valuation analysts to estimate the value of a business, business ownership interest, or securities involved in litigation. Analysts typically apply one or more generally accepted approaches to valuing such interests. This article focuses on one such approach—the asset-based approach. Robert examines the use of this approach in the context of both a going-concern-basis valuation and a liquidation-basis valuation

Weston Kirk, a vice president in our Atlanta office, participated in a panel discussion at the American Bar Association Fall Tax Meeting. The meeting was held in Atlanta on October 18, 2018. The topic of the discussion was "Beyond Powel—Examining the Important Provisions of Operating Agreements and Shareholder Agreements."

Weston and the other panel members explored the important provisions of operating agreements and shareholder agreements. Weston's presentation begins by examining the issue of defining "value" in an ownership agreement. Important considerations include the standard of value, premise of value, and level of ownership (control issues). Weston goes on to discuss various issues involved in the valuation process.

Connor Thurman, an associate in our Portland office, authored an article that appeared in the September 2018 issue of the *Journal of Multistate Taxation and Incentives*. The title of Connor's article is "Using the Cost Approach to Value Internally Developed Computer Software for Property Tax Purposes."

Connor discusses on generally accepted methods that valuation analysts may use to value internally developed software for property tax purposes. Connor focuses in particular on the cost approach and the replacement cost new less depreciation method for valuing computer software.

Kyle Wishing, a manager in our Atlanta office, and Nicholas Henriquez, an associate in our Atlanta office, authored an article that appeared in the June/July 2018 issue of the *Financial Valuation and Litigation Expert*. The title of their article is "Overview of the But-for Investment Portfolio to Measure Trustee Breach of Fiduciary Duty Damages."

Kyle and Nicholas provide historical precedence for the but-for investment portfolio. They summarize common allegations in breach of fiduciary duty disputes. And, Kyle and Nicholas examine the construction of the buy-for investment portfolio and explore the accompanying complexities in the construction of such a portfolio.

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Communiqué

In Print

Robert Reilly, firm managing director, authored an article that appeared in the Fall 2018 issue of the *American Journal of Family Law.* The title of Robert's article was "Valuation of Intangible Assets in Family Law Cases, Part II of III." Part II of that article appeared in the Summer 2018 issue of the *American Journal of Family Law*.

Robert Reilly authored an article that appeared in the September/October 2018 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Forensic Accountant Due Diligence Procedures in Commercial Litigation Analyses."

Robert Reilly authored an article that appeared in the September 2018 issue of *les Nouvelles*. The title of Robert's article was "Intellectual Property Valuations for License and Other Transfer Purposes: Part 2." Part 1 of that article appeared in the June 2018 issue of *les Nouvelles*.

Robert Reilly also authored an article that appeared in the July/August 2018 issue of *Construction Accounting and Taxation*. The title of Robert's article was "Applications of the Asset-Based Approach to Construction Company Business Valuation: Part II." Part I of that article appeared in the May/June 2018 issue of that journal.

Dean Driskell, Atlanta office managing director, and John Kirkland, Atlanta office associate, authored an article that appeared in the National Association of Certified Valuators and Analysts ("NACVA") on-line publication quickreadbuzz.com on October 24, 2018. The title of their article was "Overview of Fair Value Considerations in Business Combinations."

Kyle Wishing, Atlanta office manager, and Nick Henriquez, Atlanta office senior associate, authored an article that appeared in the NACVA online publication quickreadbuzz.com on October 18, 2018. The title of their article was "Overview of the But For Investment Portfolio to Measure Trustee Breach of Fiduciary Duty Damages."

In Person

Robert Reilly delivered a presentation at the Subchapter S Bank Association 21st Annual Conference on October 25, 2018, in San Antonio, Texas. The topic of Robert's presentation was "The Application of the Asset-Based Approach to S Corporation Bank Valuation."

Curtis Kimball, Atlanta office managing director, delivered a presentation at the Estate Planning Council of St. Louis conference on October 22, 2018. The topic of Curt's presentation was "An Update on 50 Year's Worth of Valuation Issues."

Curtis Kimball also participated in a roundtable discussion at the National Trust Closely Held Business Association ("NTCHBA") 43rd Annual Conference in Cleveland, Ohio, on September 18, 2018. The topic of the roundtable discussion was "Valuation Roundtable (Hearing about Valuation Issues That All Fiduciaries Should Understand.)"

Curt also delivered a presentation on September 19, 2018, at the NTCHBA conference. The topic of Curt's presentation was "Valuation Court Case Update for 2017-2018."

Weston Kirk, Atlanta office vice president, participated in a panel discussion on October 18, 2018, at the American Bar Association 2018 Fall Tax Meeting in Atlanta, Georgia. The topic of the panel discussion was "Beyond *Powel*—Examining the Important Provisions of Operating Agreements and Shareholder Agreements."

Encomium

Jeff Jensen, Chicago office manager, earned the Accredited in Business Valuation ("ABV") professional credential from the American Institute of Certified Public Accountants ("AICPA"). Jeff also recently became a chartered financial analyst ("CFA") charterholder, a credential issued by the CFA Institute.

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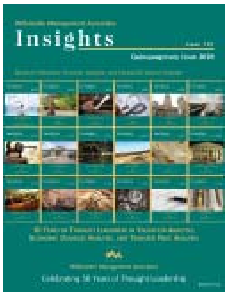

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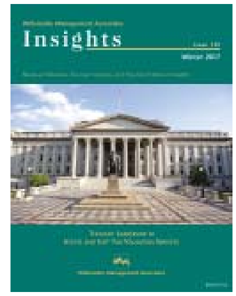

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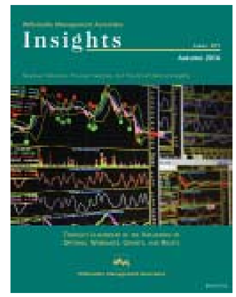

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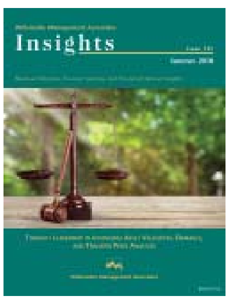

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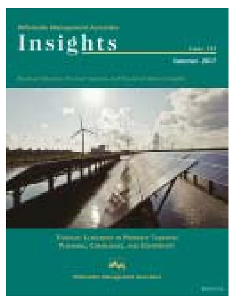

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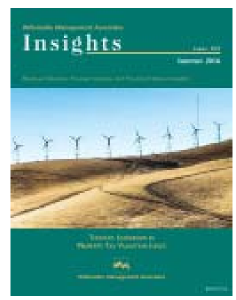

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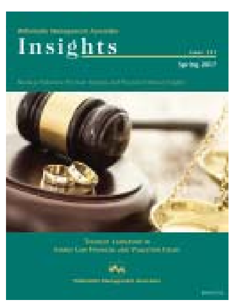

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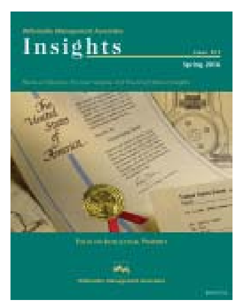

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