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VALUE ADDED™ 2023

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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Valuation of a Business for Divorce

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Overview of Valuation Approaches and Normalizing Adjustments

Valuation of a business can be a complex process requiring accredited business valuation professionals. Valuations of a closely held business in the context of a divorce are typically multifaceted. Business valuations are a vital element of the marital dissolution process as the value of a business, or interests in a business, impact the marital balance sheet and the subsequent allocation/distribution of marital assets. In this article, we introduce the three valuation approaches and discuss the importance of normalizing adjustments to the subject company's income statement.

Valuation Approaches

At the beginning of any valuation, the financial expert will request certain information and interview management of the Company. Information requested typically includes:

- Financial statements (usually the last five years)
- Tax returns (usually the last five years)
- Budgets or forecasted financials statements
- Buy-sell agreement
- Information on recent transactions
- Potential non-recurring and/or unusual expenses
- Qualitative information such as business history and overview, product mix, supplier and customer data, and competitive environment

The financial expert must assess the reliability of the documentation and decide if the documents appear thorough and accurate to ultimately rely on them for his/her analysis. The three approaches to value a business are the Asset-Based Approach, the Income Approach, and the Market Approach.

The Asset-Based Approach

The asset-based approach is a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities. Asset-based valuation methods include those methods that seek to write up (or down) or otherwise adjust the various tangible and intangible assets of an enterprise.

The Income Approach

The income approach is a general way of determining a value indication of a business, business ownership interest, security or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

The income approach can be applied in several different ways. Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings estimates, as well as valuation methods calling for the forecasting of future benefits (earnings or cash flows) and then discounting those benefits to the present at an appropriate discount rate. The income approach allows for the consideration of characteristics specific to the subject business, such as its level of risk and its growth prospects relative to the market.

The Market Approach

The market approach is a general way of determining a value indication of a business, business ownership interest, security or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities or intangible assets that have been sold.

Market methods include a variety of methods that compare the subject with transactions involving similar investments, including publicly traded guideline companies and sales involving controlling interests in public or private guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

Synthesis of Valuation Approaches

A proper valuation will factor, to varying degrees, the indications of value developed utilizing the three approaches outlined. A valuation, however, is much more than the calculations that result in the final answer. It is the underlying analysis of a business and its unique characteristics that provide relevance and credibility to these calculations.

Importance of Normalizing Adjustments

Normalizing adjustments adjust the income statement of a private company to show the financial results from normal operations of the business and reveal a "public equivalent" income stream. In creating a public equivalent for a private company, the marketable minority level of value (sometimes referred to as the "as if freely traded," level of value) emphasizes that earnings are being normalized to where they would be as if the company were public, hence supporting the need to carefully consider and apply, when necessary, normalizing adjustments. (For further information on the Levels of Value, see "What is a 'Level' of Value, and Why Does It Matter?").

There are two categories of adjustments.

Non-Recurring, Unusual Items

These adjustments eliminate one-time gains or losses, unusual items, non-recurring business elements, expenses of non-operating assets, and the like. Examples include, but are not limited to:

- One-time legal settlement. The income (or loss) from a non-recurring legal settlement would be eliminated and earnings would be reduced (or increased) by that amount.
- Gain from sale of asset. If an asset that is no longer contributing to the normal operations of a business is sold, that gain would be eliminated and earnings reduced.
- Life insurance proceeds. If life insurance proceeds were paid out, the proceeds would be eliminated as they do not recur, and thus, earnings are reduced.
- Restructuring costs. Sometimes companies must restructure operations or certain departments, the costs are one-time or rare, and once eliminated, earnings would increase by that amount.

Discretionary Items

These adjustments relate to discretionary expenses paid to or on behalf of owners of private businesses. Examples include the normalization of owner/officer compensation to comparable market rates, as well as elimination of certain discretionary expenses, such as expenses for non-business purpose items (lavish automobiles, boats, planes, etc.) that would not exist in a publicly traded company.

Conclusion

If the business or an interest was recently bought or sold, if it was recently appraised, or if its value is in a financial statement or a loan application, that information may go a long way in establishing the value of the business (if both parties feel that this value is a fair representation). However, since a business valuation report and expert witness are admissible in court as evidence and since the value of a business or interest impacts the marital balance sheet and the subsequent asset distribution, it may be exceedingly beneficial to hire a professional for evidentiary support.