Insights on VALUATION

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Forensic Business Valuation

Under the best of circumstances, a business appraisal is time consuming and involves providing a total stranger (the appraiser) all of the intimate financial, management, and competitive information for the firm. It is a disruptive experience even when it is authorized and cooperative. In some cases, the process is hindered or even uncooperative. When this is the case, the appraiser is forced to take a forensic approach. The experienced appraiser brings the skills of a financial analyst, accountant, economist and, when needed, a detective.

There are three situations that generally describe most "forensic" valuations:

- *Marital dissolution*—usually one spouse has all the information or access to the needed information, and one spouse is on the outside looking in.
- *Disaster*—the raw data simply no longer exists in the form most readily used by an appraiser. For example, if a fire has destroyed the premises, including financial records, then any assistance management can willingly provide will be insufficient to accomplish the appraisal.
- *Litigation*—all the data is available, but the relevant parties refuse to assist or are barred from assisting.

The following is a list of helpful documents that can be obtained from a third party that is either required to, or typically, does retain copies:

- *Tax returns*—usually prepared by an outside firm that retains copies of the tax returns and workpapers. If not, copies can be obtained directly from the IRS.

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- *Financial statements*—prepared by an outside accounting firm The outside firm should be able to provide copies of the statements as well as supporting workpapers.
- *Bank statements*—available directly from the bank. The statements will provide cash flow information as well as clues to other related, and perhaps undisclosed, accounts.
- *Loan applications*—available directly from the lending institution. The lender's loan package will provide prior representations regarding income, management, ownership, etc.
- *Corporate minutes*—usually maintained at attorney's office. The corporate lawyer is also the source for other relevant legal agreements.
- *Valuation reports*—previously prepared for the subject company.
- *Contracts and related correspondence for all prior sales of company stock* – if a business broker, attorney, and/or escrow company was used an independent trail of documentation will exist.

Searching public data sources usually yields a surprising amount of information. The following is a sampling:

- *The subject company web site*. It is sometimes astonishing how much proprietary and sensitive information some firms put up on the World Wide Web.
- *Public database searches*. Subscription or pay-as-you-go services will provide a public record search for liens, lawsuits, UCC filings, judgments, officers, office locations, etc.
- *Industry association web sites and publications*. This is useful to see how the subject firm is viewed in the industry, whether they actively advertise and market their firm, what their ads and marketing say about the business, and identify key people in the company.
- *Competitors*. Information obtained from a competitor should be carefully calibrated with information obtained from other sources.
- *Business brokers*. Brokers in the specific industry of the subject firm can be a great source of "reputation" information as well as identities of people (competitors) who might be willing to talk about the subject firm.
- *Google and other internet searches*. Using the incredibly powerful searching capabilities available via the internet is amazingly simple and provides detailed useful information almost every time.

A "normal" valuation requires a tremendous amount of time, concentration, and objectivity by the appraiser. In cases where there is little or no readily available information, the engagement requires a forensic approach that must be accomplished without compromising the objectivity of the analysis. The goal, then, is the same as a normal appraisal engagement. It will simply take more creativity, drive, and effort to get there.

The Importance of Business Valuation Standards

The Certified Valuation Analyst (CVA) exercises professional judgment throughout the business valuation process from the first client meeting to the delivery of the final report. The valuator's judgment is influenced heavily by work experience and stringent adherence to the standards established by the CVA's governing body, the National Association of Certified Valuators and Analysts (NACVA). As a committed professional, the business valuator is set apart through membership in state and national associations, formal licensing, examination and continuing education requirements, and adherence to a code of professional ethics and standards.

NACVA is one of three major valuation associations in the United States. Each of the three national associations has formal, written business valuation standards. These standards hold in common certain general requirements covering: valuator independence, valuation development and reporting, and disclosure of information and limiting conditions.

The NACVA Professional Standards open with an introductory paragraph stating:

"These principle-based Standards have been developed to provide guidance to members and other valuation professionals performing valuation services. The use of professional judgment is an essential component of estimating value."

The formal standards allow for a certain completeness and consistency in the valuation process. They serve as a measuring stick to assist in evaluating valuator competence. The

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NACVA standards are broken down into four major headings: General and Ethical Standards, Scope of Services, Development Standards, and Reporting Standards.

The General and Ethical Standards address integrity, objectivity, professional competence, due professional care, client communication, and supervision of services rendered. These attributes are the calling card of a valuation professional. These attributes represent what the client and the referral community demand of the valuator's efforts. As long as the valuator exhibits these attributes, his position of trusted advisor is both earned and maintained.

The Scope of Services Standards address the level of service applicable to the particular engagement. These standards are required when valuing a ***business, business ownership interest, security, or intangible asset***. The specific needs of the client are understood and matched with the appropriate level of service. Adherence to these standards allows the valuator to determine whether he can accept the assignment and deliver the appropriate report.

The Development Standards address the data gathering and analysis portion of the valuation. Among the issues considered are: interest to be valued, approaches and methods to be considered, purpose and date of valuation, sources of information, use of specialists, and any scope or limiting conditions. The documentation to be secured and the fundamental analysis of this data are critical to the expression of a conclusion of value.

The Reporting Standards address the presentation of the valuator's findings. The objective is to ensure consistency and quality of reporting. The form of report is typically written; however, in limited situations, it may be oral. The conclusion of value is to be presented in either a Summary or Detailed Report. The valuator will work closely with the client to determine the appropriate form and level of reporting.

Professional Standards aid the valuator throughout the valuation process. They provide guidance and a degree of uniformity, completeness, and consistency to the process and the final report. Standards allow for meaningful professional review of the valuator and his work product. They are the wellspring of a competent professional, resulting in a high-quality report, and a satisfied client.

The Role of a Non-Compete Agreement in a Valuation for Divorce Purposes

Valuation analysts doing divorce work often find themselves following Alice down the rabbit hole into Wonderland where the Red Queen has her own special rules concerning valuation that are found nowhere else. One of those areas where special rules are enforced only in the Wonderland of the divorce arena is that concerning non-compete agreements. In certain jurisdictions (check with a divorce attorney), the assumption of a non-compete agreement that underlies a conclusion of value may trigger argument over whether the value attributable to the non-compete represents personal goodwill and is, therefore, excludable from the marital estate. The idea behind this exclusion is that since the non-compete agreement restricts the post-marital activity of the spouse who would sign it, its value is his personal, non-marital asset. This idea should not apply in most situations for three basic reasons.

First, a non-compete agreement is essential to maximizing the selling price that the seller obtains, as no willing buyer would ever pay for a business without assurances that the seller would not compete with him by soliciting either his customers or employees. Therefore, a willing seller, in order to obtain the highest price possible for his business, will gladly sign a non-compete agreement. By doing so, he agrees to transfer to the buyer not only the business' enterprise goodwill, but his personal goodwill as well, "putting paid" to the idea that personal goodwill is not transferable, and therefore non-marital. No business has ever been sold that had a carve-out for certain customers, clients, or patients who insisted on staying with the seller, as this would be impracticable since he would be unable to service them without the business he had just sold.

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Second, a non-compete agreement protects and is associated with not only personal goodwill, but enterprise goodwill as well. Without a non-compete agreement, the seller would be allowed to make suicidal solicitation calls on all of his former customers, clients, or patients, not just those who had some kind of personal bond with him. These solicitation calls, if effective, would result in the destruction of not only the seller's personal goodwill, but also the business' enterprise goodwill, both of which he just sold to the buyer. Therefore, the non-compete agreement protects all the goodwill associated with the business, not just the seller's personal goodwill.

Third, the restriction on the selling spouse is one he gladly entered into to maximize his economic return, and, therefore, should not be seen as restricting the seller's right to earn a living in some essential way. This type of restriction is not for a lifetime nor

does it cover the continental United States. It is typically for no more than three to five years and covers a limited geographic area, usually up to a 25-mile radius of the city or town wherein the business is located. It is a minimal imposition on the seller, and in no fundamental way, restricts his right to earn a living by practicing his chosen profession or craft.

For these three reasons, divorce courts should not be carving out as a non-marital asset the value associated with a non-compete agreement as the agreement both maximizes the seller's economic self interest and protects the business' enterprise goodwill. If you find yourself in the Wonderland of divorce court, make sure your valuation analyst is familiar with the local rules.

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