The Role of a Business Valuation in Divorce Cases

by Chris Hamilton, CPA, CFE, CVA, DABFA

It is important for attorneys to understand the role of business valuation in divorce matters, so that they can better counsel clients in achieving their goals in asset distribution and financial support. If a business is considered marital property, and therefore subject to division, the value of the business must be determined in order to divide the business in a fair and equitable manner.

As a basic premise, there are two primary financial questions in a divorce matter:

- What are the assets and debts of the marital estate?
- What is the income available for support?

In most divorces these two questions can be resolved without the use of a business valuation firm. This is generally true where the spouses derive their income through employment. However, in cases where a business (or several) is owned by the marital estate the complexities involved can increase exponentially.

Why Obtain a Valuation?

The value of the business is almost always a difficult issue. Income earned from the business also becomes an elusive issue that often requires extensive discovery and analysis.

It often surprises divorcing couples who own a business when they are informed that it needs to be valued for purposes of determining an equitable asset split. If it is not a large enterprise, they might perceive that a valuation is unnecessary, however, this is typically incorrect. For example, a business activity where there are no employees and yet it generates self-employment income is, in fact, a business. To the degree there is any goodwill value in the business it is subject to the asset split.

Business appraisal in the context of divorce is a function of both of the primary financial issues – income and assets. The business itself is an asset subject to an equitable split. Often, the business is also the primary source of income for the family and, as such, is the primary source for marital and child support. This is why, for most family court lawyers, retaining the same expert to address both issues is the most efficient solution.

Valuation Approaches

The most common method used to value a business is an income approach. In simple terms, this approach capitalizes cash flow generated by the business, after payment of all business expenses and taxes. Included in business expenses is the market value of services provided to the business by the divorcing spouse.

To the extent profits distributions are included in the compensation of the business owner, there is an adjustment to increase the net cash flow from the business. The interaction between income and asset value comes down to this single adjustment. In other words, you cannot use the same income to value the business as you use to determine support. That is commonly known as double-dipping and is generally accepted now as unfair.

For example, if Husband draws $500,000 per year from the business each year, leaving a profit of zero, the appraiser will determine whether the services provided to the business would be fairly valued at $500,000. It is very likely that some portion of the compensation will be deemed as profit distribution rather than payment for services. In this example, assume that reasonable compensation is determined to be $200,000. The value of the business would be based on annual net income for the business of $300,000. Support calculations would then reasonably be based on annual compensation of $200,000.

While this is a simplified example, it illustrates the point that using the $500,000 for support and business valuation would work out to an unfair result.

The dynamics of these calculations in a small closely-held business can be confusing and difficult to grasp. The extreme of expectations between the "out-spouse" and the "in-spouse" (directly involved in the business) are a primary factor driving litigation in this area. The expectation gap is often a function of the lack of understanding that income can only be used once in the calculations. The gap is also due to the difference in knowledge about the affairs of the business. The spouse who will retain the business invariably insists that all revenue has been reported and all expenses are true business expenses. Suspicions on the other side revolve around revenue not being reported (particularly in cash businesses) and personal expenses being deducted for tax reasons as business expenses.

This is another reason that most family law practitioners use a single expert to assist with income and business expenses. A single process of discovery is more efficient when the expert is assisting in the development of document request lists which will result in information supporting both income and business value conclusions.

About the author:

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