BUSINESS VALUATION BASICS FOR A DIVORCE

The purpose of this article is to present the basic principles that are used when valuing a business for a divorce. If one of the spouses owns a business, the value of the business needs to be determined because it is typically subject to equitable distribution in the divorce. The spouse who owns the business generally wants a low value assigned to it, because that will result in a lower amount being paid to the other spouse. In contrast, the spouse who does not own or operate the business typically wants a higher value assigned to it. A competent business valuator will not be swayed by the economic incentives of either spouse, but instead will determine the value of the business entity by performing a neutral, fair and impartial analysis. Nevertheless, it is not at all uncommon for each spouse to hire their own business valuator. Since valuation often requires the application of subjective judgment, it is quite common for the values arrived at to be quite different between two valuators.

For purposes of this article, we will assume that the business may be fairly valued using the premise that its past earnings are generally reflective of its anticipated future earnings, and that the business value is attributable primarily to the income that it generates. This is known as the Income Capitalization method and is quite commonly used in divorces. The basic process under this method involves the following. FIRST, the valuator needs to gain an understanding of the business, including its history, ownership, experience of management, competition, sources of revenue, risk components, economic outlook, employee relations, and financial stability. SECOND, the valuator will analyze the tax returns of the business for the last five years, or less, if the business is relatively new.

The THIRD step is for the valuator to perform a process called "Normalization." The concept of normalization is that it is a technique applied to reported earnings of the business to determine those items that are non-recurring in nature, excessive in amount, or personal in nature. One example of a typical normalization adjustment is that if the owner of a corporation pays himself a salary of $150,000 per year, but it is determined that the industry standard for reasonable compensation for a similar type of executive is only $110,000 per year, then a "normalization adjustment" will be made to reduce the owner's salary by $40,000 per year. This adjustment obviously has the impact of increasing the reported profit of the business. This, it will also correspondingly increase the value of the business that is subject to equitable distribution.

Another common example of a normalization adjustment is for Perquisites, or "Owner Perqs." as they are often referred to. If the business owner has been receiving a personal benefit attributable to an amount paid and deducted by the business, then that amount would be added back to income. The determination of the amount of Perquisites or personal expenses that may have been paid and deducted by the business (whether legally allowed or not by IRS rules or regulations) often becomes a hot issue of contention between the spouses in a divorce. The reason is obvious. The higher the amount of personal expenses or Perqs. paid and deducted by the business, then the greater is the normalization addback adjustment for such. Those addbacks in turn increase the business income and thus, also correspondingly increase the value of the business subject to equitable distribution.

The FOURTH step in valuing the business is to assign a "Weight" to the normalized income for each of the years being examined. Typically (although not always), the

most recent year is considered to be the most representative of the anticipated ongoing earnings of the business and thus is given the greatest weight. In contrast, the earnings of the business five years ago, while still relevant, will be assigned a lesser weight. If five years of business activity is being used for the valuation, a typical weighting methodology would be a 5-4-3-2-1 weighting progression. Thus, the most recent year would receive a weight of 5, the second most recent year a weight of 4, and then progressing downward until the last year (i.e. the income from five years ago) receives a weight of only 1.

The FIFTH step is to apply what is known as a "Capitalization Rate" (hereinafter "Cap rate") to the normalized and weighted earnings of the business as described above. The Cap rate is the linchpin in the process. The important thing to remember is that the lower the Cap rate, the higher will be the value of the business. Thus, it is essentially a multiplier. For instance, a Cap rate of 20% has the effect of multiplying the weighted, normalized earnings by five (100/20). A Cap rate of 25% has the effect of multiplying those same earnings by four (100/25). This yields the value of the business before applicable Discounts and/or Premiums. An example of how this works, is that if the normalized, weighted earnings of the business equal $50,000 per year, and the Cap Rate is 20%, then the total value of the business would be $250,000 calculated as $50,000 divided by .20. This would be the value presented for simplicity purposes, without application of any sustainable growth rate, tax impact or discounts or premiums discussed below.

After this value is determined, it then may be reduced by a Discount for Lack of Marketability (DLOM), or a Discount for Minority Interest (if the owner spouse does not

own 100% of the business) or increased for a Premium for Controlling Interest (if the owner spouse has a controlling interest in the business).

The foregoing summarizes the basics of business valuation using the Income Capitalization method in a divorce. However, it should be noted that there are other intricacies that may come into play which are beyond the scope of this summary article. Some examples include application of Sustainable Growth Rates to Income, the impact of Personal Goodwill or Enterprise Goodwill upon business value, issues related to tax effecting the income of the business, and how to value businesses where prior earnings are not reflective of anticipated future earnings or where the business owns substantial high value assets such as real estate.

The main thing to remember is that when selecting a business valuator, you want someone who has a great deal of specialized experience in the field.