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An Understandable Summary of Business Valuation in the Context of Matrimonial Litigation

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The purpose of this article is to provide an easily understandable summary of how business valuation is performed for most businesses within the context of matrimonial litigation. In this article, the methodology examined to determine value is the income capitalization method. There are other valuation methods that can be used, but this is one that is more commonly used to value businesses in divorces. The major exception is a business that owns real estate, in which case a real estate appraisal would be required.

During the course of a divorce, if one of the spouses owns a business, its value is subject to equitable distribution between the parties. In order to determine the amount that each spouse is entitled to, a value must be assigned to the business. That value is typically established by an individual experienced in business valuation. While most business valuers are CPAs, most CPAs typically are not experienced in business valuation. Thus, it is important when hiring a business valuator to find someone who has experience in and understands the intricacies of the field.

The spouse who owns and operates the business typically desires a low value to be assigned to the business, while the spouse who does not own or operate the business has an economic incentive to want a high value assigned to the business. A competent business valuator will not be swayed by the economic incentives of either spouse but instead will determine the value of the business after performing a neutral, fair, and impartial analysis of the business.

The valuator may be hired by either of the spouses, each spouse may hire his or her own valuator, or on occasion the court itself will appoint a valuator. In fact, in particularly large cases where the value of the business is substantial, the husband may

hire a valuator, the wife may hire a separate valuator, and the court may appoint a third valuator on its own.

The valuator will first need to gain an understanding of the business. This will require interviewing the owner of the business on matters including but not limited to the history of the business, its economic outlook, ownership, the experience of management, sources of revenue, competition, and legal structure.

Next, the valuator typically will analyze the tax returns and financial statements of the business for the last five years. These documents show the reported assets, liabilities, equity, income, and expenses of the business. Close examination of them is a critical part of valuation analysis. The reported financial information will be subjected to extensive financial analysis, which will include the calculation of various ratios. These ratios will be compared for each of the five years being examined so the valuator can comprehend trends that influenced the business. Similarly, the individual components of net income, including gross revenues and expenses, will be subjected to a comparative analysis for the five-year period.

After gaining an understanding of the

business and analyzing the tax returns and financial statements of the business, the valuator will perform a process called "normalization." Normalization is a technique applied to the reported earnings of the business by which the valuator adjusts those earnings for any items that are non-recurring, excessive, or personal in nature. For instance, one example is that if the reported salary of a particular management owner of the business is \$200,000 per year, but it is determined that the industry standard for reasonable compensation for a similar type of executive performing the same type of function is only \$140,000 per year, a "normalization adjustment" will be made to reduce salaries by \$60,000.



Once normalized earnings for each year are established, each of the various years being examined is assigned a weight. Typically, the most recent year is most representative of the anticipated ongoing earnings of the business and thus will be given the greatest weight. In contrast, the earnings of the business five years ago, while still relevant, will be assigned a lesser weight. The goal is



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to arrive at an amount of properly weighted and normalized earnings.

The last step in the valuation process is to apply a capitalization rate (cap rate) to the normalized and weighted earnings. The cap rate is the linchpin in determining the value of the business. The important thing to remember is that the lower the cap rate, the higher the value for the business. The cap rate is essentially a reciprocal 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.

The foregoing summarizes in a brief, general manner how the values of most businesses are obtained using the income capitalization

approach. There are, however, numerous other intricacies that come into play which are beyond the scope of this article to describe in detail.

For instance, applying an appropriate growth rate to earnings in the valuation model affects the ultimate calculation. Similarly, the manner in which the cap rate is determined is an exceptionally complex matter involving examination of elements of risk analysis. There also are valuation methods other than the income capitalization approach described above, such as the asset approach and the market approach, which the valuator should consider. There are standards of value that the valuator must consider, such as "fair market value," "fair value," "investment value," or the "value to a specific holder."

Ultimately, the most important thing to remember when selecting a business valuator is to choose someone who has specialized experience in the field. As stated, while most business valuers are CPAs, most CPAs are not business valuers.

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