Litigation Support and Valuation Fundamentals

By Mark Bailey, CPA, ABV

The Judge's final decree was clear:

"The assertion of value of XYZ Corporation presented by Counsel is not supported by the written report of your valuation expert. His testimony was not relevant with respect to a standard of 'fair value', nor were his conclusions of value based on the methodologies employed."

As professionals – we all agree – this is never an acceptable situation or outcome. The attorney blamed the valuation expert, and the valuation expert blamed a lack of communication on the part of the attorney. The loser was their client.

This result not only can be avoided, but it must. To do so requires not only a thorough understanding of the engagement purpose and scope by the retained expert, but also understanding by counsel of the fundamentals and limitations of valuation. There are a variety of reasons why business valuation analysts are retained. For purposes of this article they can best be broken down into two categories.: business consulting and litigation support.

Mergers, acquisitions, reorganizations, buy-sell agreements, ESOP's, estate planning and financial reporting engagements typically fall into the consulting category as

(cont'd. on page 10)

Litigation Support
cont'd. from page 9

defined here. The standard of value most commonly used is 'fair market value' (fmv). Litigation related valuation engagements may include such things as marital dissolution, stockholder disputes, damage calculations and insurance claims. While the standard of value may be fmv for certain assets or liabilities, it is most frequently 'fair value' particularly in the case of marital dissolution in California and Nevada. There are two other common standards of value – liquidation value (common in bankruptcy cases) and intrinsic value. The balance of this article will address the two most common standards – 'fair market value' and 'fair value' and the differences between them. The purpose of any valuation engagement will inevitably influence the standard of value used by the analyst. Let's begin with Fair Market Value.

Standards of Value

The most commonly used standard of value is fair market value. Revenue Ruling 59-60 defines fmv as: "The amount at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy, and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts".

The fmv can best be thought of as the cash price that would be paid for the item at a specific date by a hypothetical buyer. It is imperative that it is a hypothetical buyer and not a specific buyer or a strategic buyer who may receive some other synergistic benefit. This is particularly important in certain litigation scenarios. An offer from a strategic buyer does not generally represent a fair market value. The valuation analyst must be able to assume the item is available to the market. For many assets in a marital dissolution this is not the case which will be discussed along with other differences.

Fair value is defined under US generally accepted accounting principles as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." This hypothetical transaction is normally considered from the perspective of the holder of the asset, and is not necessarily the price that would be required to acquire the asset. The fair value is not adjusted for selling or transactional costs, nor are minority discounts taken into account. Different jurisdictions may modify their definition of what is included in the calculation of fair value, but ultimately the court is concerned with fairness and that an equitable distribution is affected between the parties. It is important to note that the concept of 'fair value' is modified by case law and is ever changing.

The concept of 'market value' embraced in a fair market value determination is absent in a fair value opinion and replaced with a concept of 'fairness'. The most common application of fair value is in marital dissolution, and dissenting/oppressed shareholder actions. Where fair market value requires a willing buyer and a willing seller, neither under compulsion, fair value does not. Nor is there an assumption of reasonable knowledge by both parties in a fair value calculation. These differences become critical when defining the scope and purpose of your engagement to your valuation analyst. After having communicated the purpose and determined the scope of value, it is time to address the various methodologies available.

Methodology

There are three basic approaches to business valuation: the asset based approach; the market approach; and the income approach. Under each approach there are several methodologies frequently employed.

Asset Based Approach

This approach is frequently referred to as the 'cost approach'. The most common methodologies utilized under this approach are: (1) the adjusted book value method; (2) the liquidation value method – frequently used in bankruptcy cases; and (3) the replacement cost method.

The valuation analyst will adjust the various balance sheet accounts to fair market value. The resulting net difference is then the value of the entity. This serves to ignore any intangible items not recorded on the balance sheet, such as patents, trademarks and goodwill. These items should then be calculated and valued using other methods and added to the net value. Unrecorded liabilities, such as future purchase obligations should also be considered and may result in a reduction of entity value.

This approach is commonly used for asset intensive

(cont'd. on page 11)

Litigation Support
cont'd. from page 10

entities, such as manufacturing and holding companies along with non-income producing entities such as not-for-profits. It typically is not used for service businesses lacking significant tangible assets and is generally not appropriate to value minority interests given the minority does not have control over sale particularly in a liquidation scenario.

The primary advantage of this approach is that it is straightforward and easy to understand given that it focuses heavily on tangible assets and liabilities. The primary disadvantage is that unless adjusted properly for intangibles – which can be extremely difficult to value separately – it may not accurately reflect the earning power of the entity.

Market Approach

The most common method under this approach is the 'guideline company method'. Depending on the nature of the entity being valued, when properly applied, this approach would seem to make the most sense given it derives a value from third party 'market' information. The value is determined based on the use of pricing of other traded public company surrogates comparable to the entity being valued. The subjective determination of comparability between the surrogates and the entity can make this methodology extremely difficult to apply when taking into account size, liquidity, market share, longevity, location, and much more.

Other methodologies under this approach are: industry method (rules of thumb); sales of a company's own equity; and the merger and acquisition method (comparable sales).

Income Approach

Philosophically, this approach reflects an investor's estimate of value of the enterprise based on a desired rate of return derived from cash flow or an earnings stream either in the past or projected for the future. There are two methodologies used in the income approach – capitalization and discounting. Both methodologies are based on a benefit stream. Some of the benefit streams used are: net income either before or after tax; earnings before interest and taxes (ebit); earnings before interest, taxes, and depreciation and amortization (ebitda); and cash flow.

A capitalization model is typically a single period earnings stream divided by a rate of return. The earnings stream is normalized for unusual and non-recurring items and is frequently weighted with prior periods to affect market fluctuations over some period of time.

Under a discounting model the valuation analyst relies on a projected earnings stream for multiple future periods and discounts that to a present value based on a desired rate of return reflecting risk. In both models the underlying value of the operating assets is reflected in the benefit stream under the assumption they are worth the return they produce. Once that is determined then the value of any non-operating assets must be added to obtain the entity value.

In Nevada and California discounted methodologies are not generally accepted by the courts. Many valuation analysts believe discounted future benefits are a more reliable reflection of present value than are capitalized historical benefit streams given that perceived value today by an investor is predicated on the future benefits anticipated. When using a capitalization approach, significant consideration must be taken in 'normalizing' and weighting the benefit stream and calculating the capitalization rate.

Some of the advantages of the income approach is that: it is reflective of the benefit stream generated; it utilizes simple mathematical calculations that are easy to understand and defend; it is widely accepted by financial markets; and it is inclusive of tangible and intangible assets. On the contrary, it requires significant subjectivity in determining the proper benefit stream to be used and calculation of the capitalization and discount rates can be extremely subjective. This is particularly true for smaller companies in a dynamic market.

Communicating the scope of the engagement is critical to determining the standard of value needed and the methodologies to be employed.

Ultimately this will lead to the appropriate valuation report. In part two we will discuss the various reports available.

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