

## To Appraise or Not to Appraise, That is the Question

### 3 Tools To Use When Your Divorce Client Owns a Business

By Cathy J. Durham



It is challenging when a new divorce client walks in your door and shares the fact that there is a privately owned business included in the marital estate. Even the most experienced family law attorneys can be stymied by the complexities of the closely held business. Each business is unique, so where do you even begin? The topic certainly can be complex, but here are three tools to set you confidently on the right path.

#### Navigating the Critical Decision of Whether a Business Appraisal is Needed

Next time you hear the words “I own my own business” from a divorce client, you will be able to skillfully navigate the conversation to determine together whether this situation calls for an appraisal or whether this particular business is better described as a career with the tools of the trade needed to carry out the day-to-day business. If the latter is the case, your client would be wise to meet their spouse at a reasonable middle ground without a formal business appraisal. And,

the best part is that you can use these accounting based decision-making tools without needing a CPA to translate.

These tools are for you to use to determine whether a business appraisal is even necessary. It is critical to note that *the tools are not intended to portray how to value a business*. For so many reasons (that’s

#### Do We Need a Business Appraisal? 3 Decision-Making Tools

- Tool 1: Is the business transferable?
- Tool 2: What is the liquidation value of the company?
- Tool 3: Indication of value to determine if appraisal is needed

another article), multiples of some figure on a privately owned business’ income statement are never a meaningful way to value a business. The tools presented in this article are strictly to be used as directional decision-making tools as you and your client decide if there is a need for a professional business valuation.

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## Accounting Versus Valuation

To begin, financial statements are one of a significant number of key documents needed for a valuation, but we can also use the financial statements to help us identify whether an appraisal is even needed.

It is important to understand one significant difference between accounting and business valuation. Accounting looks to historical information and tells you about the company's past financial performance. Business valuation involves analyzing and modeling where the business is going, for it is in the future earnings of the business that a buyer, hypothetical or real, will typically realize the expected return on their investment.

### What You Will Need To Get Started

Before putting the following tools into use, you will need to have the company's most recent (1) Balance Sheet and (2) Year End Income Statement (also known as "statement of operations" or "profit and loss statement").

Now, onto those three tools.

### Decision Making Tool #1: Is the Business Transferable?

While a business can look and smell like a business, it does not mean it is actually a transferable business. In other words, would the business continue without the involvement of the current owner? Additionally, would a buyer be willing to pay more than the value of the tangible assets for the business? If the business is not transferable it means the business does not need to be valued as a separate marital asset. Instead, the company's tangible assets less the liabilities can be easily estimated at market value<sup>1</sup> and added to the marital balance sheet. The income produced from the business is then used only for determining support.

#### What You Need:

Most recent full year income statement

There are two key questions you can discuss with your client to determine whether or not the business is transferable.

- 1) Is the business so dependent on the owner for his/her skills or relationships that the business would end if something happened to the owner such that he/she could not work in the business any longer? Another way to look at this is to ask, would there be a major disruption in the business even if he or she took a 2-3 week vacation and was not able to call in? If the answer is yes, the business is likely not transferable because of the dependence on the individual owner. If the answer is no, go on to the next question.

- 2) Does the business generate sufficient cash flow (profits) for BOTH market compensation and return on investment? To answer this question we need to disregard what the owner is actually compensated and determine "market" compensation. What would the business owner earn if he or she was doing the same work for a competitor but only as an employee, not an owner? This can be determined, in part, by answering the following:

- a. How many hours does the owner work in an average week?
- b. What is the title or position held by the owner?

Now, go online<sup>2</sup> or contact trade associations or publications for the subject business's industry and estimate market compensation. What is the actual

compensation reported versus estimated market compensation for the owner?

Next, look at the income statement to locate the reported net income for the business at the bottom of the statement. Add back the actual W-2 compensation taken by the owner and subtract market compensation as identified above. Is the business still profitable? If the answer to this question is yes, the business may well be transferable and you should move on to the second tool below.

If the answer to this question is no, the business does not likely have transferable value<sup>3</sup>; therefore, there is no need to involve a business appraiser. This is not to say there are no valuable assets in the business; however, the value of those assets can be determined in ways other than through a professional business appraiser (see footnote 1).

After answering the questions above, if the business appears to be transferable, you can move to Tool #2.

#### What You Need:

Most recent balance sheet

### Decision Making Tool #2: Use the Balance Sheet to Estimate the Liquidation Value of the Company

The balance sheet lists what a company owns at each asset's original cost and what it owes as of a specific date in time. The balance sheet summarizes the company's assets (the things that it owns) and its liabilities (the debts it has). When you subtract the company's liabilities from the assets, what is left is considered to be "liquidation value."

The balance sheet informs the reader of a company's financial

position as of a specified date. For example, the amounts reported on a balance sheet as of Dec. 31, 2015, reflect that moment in time when all the transactions through Dec. 31, 2015, have been recorded. The balance sheet typically includes the following:

**Assets** include such things as cash, accounts receivable, inventory, prepaid expenses, fixed or tangible assets such as building, land, vehicles and equipment.

**Liabilities** are obligations of the company including amounts owed to creditors. They can be thought of as a claim against a company's assets. Liabilities are either short-term (or current), meaning they are expected to be paid back within 12 months of the date of the balance sheet; or long-term, meaning they will be paid back over a period of time greater than 12 months from the date of the balance sheet.

Stockholders' (Owners') Equity is often referred to as the book value of the company because the stockholders' equity is equal to the amount the owner(s) would have left if they sold all the company's assets and paid off all the company's liabilities.

**TIP!**

Many business owners will have access to this information and can easily answer these questions.

Since the balance sheet lists the value of each asset at its original cost, not the current market value, we first need to update the balance sheet's assets to their respective estimated market values. For this example, we will focus on restating the tangible assets to their estimated market values. There are additional considerations such as whether the accounts receivable are all collectible

and/or if the inventory is all saleable; however, for this exercise, accept cash, accounts receivable and inventory as reported.

**Restating Tangible Assets to Market Value**

If the operating company owns the business' building and/or land, you must determine the estimated market value of the building/land, as they may well be worth more in terms of fair market value today than what is reported on the balance sheet.

For example, if the business purchased a building in 1975 for \$60,000, the balance sheet will continue to reflect this cost throughout the life of the business, until the building is sold. Therefore, it is important to focus on the company's tangible assets and determine an estimate of the market value of each asset. These market values can be determined via previous appraisals, requesting

an estimate from appraisers, various websites and/or tax assessment estimates (for real estate).

After making the necessary adjustments you can now subtract the company's liabilities from the company's assets to arrive at adjusted book value. This book value basically estimates the amount of cash the owner(s) would have left if the company's assets were all sold and the company's liabilities were all paid. You've now found the liquidation value – or the value if the business operations ended. This value is also considered a floor of value. Based on the adjusted balance sheet example below, the adjusted Stockholder's Equity value is \$1,730,000.

If the adjusted balance sheet results in a positive liquidation value, or equity, move on to Decision Making Tool #3.

<b>BALANCE SHEET</b>			
<b>As of December 31, 201X</b>			
	<b>Balance Sheet As Reported</b>	<b>Adjustment to Market Value</b>	<b>Restated Balance Sheet</b>
<b>Assets</b>			
Cash	\$ 50,000		\$ 50,000
Account Receivable	200,000		200,000
Inventory	450,000		450,000
<b>Fixed Assets</b>			
Building	700,000	500,000	1,200,000
Equipment	300,000	(200,000)	100,000
Land	80,000	50,000	130,000
<b>TOTAL ASSETS</b>	<b>\$ 1,780,000</b>	<b>\$ 350,000</b>	<b>\$ 2,130,000</b>
<b>Liabilities</b>			
Accounts Payable	\$ 100,000		\$ 100,000
Short-term Debt	40,000		40,000
Long-term Debt	260,000		260,000
<b>TOTAL LIABILITIES</b>	<b>400,000</b>	<b>0</b>	<b>400,000</b>
<b>STOCKHOLDER'S EQUITY</b>	<b>\$ 1,380,000</b>	<b>\$ 350,000</b>	<b>\$ 1,730,000</b>

If the conclusion is a negative number, the business is likely not transferable even if the business passed Tool #1's standards. However, be cautious, as this book value might be low or negative if it is the practice of the business to consistently distribute the company's profits/cash flows to the owner(s). It might also be low or negative because the business pays significant non-recurring expenses or personal expenses on a consistent basis.

**Decision Making Tool #3: Use the Income Statement to Estimate an Indication of Value to Determine if a Formal Business Appraisal is Necessary**

Now that we know that 1) the business is transferable and 2) there is positive equity, you next need to be able to determine if there is likely to be sufficient business value to warrant having a formal business appraisal.

**What You Need:**

Most recent full-year income statement

To do this, you will need the most recent year-end income statement, also known as the profit and loss statement, for the business. This statement indicates whether or not the company made a profit or incurred a loss for a specific period of time. This statement discloses information about the company's revenues (sales) and expenses that are a direct result of the regular business operations from the beginning of the chosen time period until the end of the chosen time period. For a company with a calendar year-end, the Dec. 31, 201X, will cover the prior 12 months ending Dec. 31. Ultimately, the income statement discloses whether the business was profitable or not for the defined time period.

When looking at an income statement, it's important to keep in mind that items that are out of the

ordinary or that owners have control over may skew the numbers. This is just one of the many reasons it is never an acceptable business practice to use a multiple of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization) to determine the actual value of a company. However, a somewhat conservative multiplier applied to an adjusted profits number can be a good *directional* indicator whether or not there are significant enough profits generated by the business to warrant having the business appraised or not.

Before describing the steps for this exercise, it is critical that the reader understand that the conclusion of this exercise is NOT the value of the company but rather an aid in your decision making with your client as to whether it is worth it to pursue

hiring a certified business appraiser to provide you with the fair market value of the business.

**Estimating Going Concern Value**

For this tool we are considering the business as a going concern rather than a business being liquidated. As mentioned above, you will need the most recent year-end income statement for the business. This statement should include the company's sales, expenses and net income. See example below.

Begin with the net income as reported and make two key adjustments:

- 1) **Adjust the income statement for market compensation as determined in Tool #1.** Determine the amount of W-2 compensation received by the owner that is reported in

	As Reported	Adjustment	Normalized
Revenues	\$ 7,600,000		\$ 7,600,000
Cost of Goods Sold	6,080,000		6,080,000
Gross Profit	\$ 1,520,000	\$ -	\$ 1,520,000
<b>Operating Expenses</b>			
Owner Wages	200,000	(80,000)	120,000
Wages	850,000		850,000
Payroll Taxes	94,500		94,500
Rent	90,000	(30,000)	60,000
Utilities	12,000		12,000
Telephone	12,000		12,000
Professional Fees	62,000		62,000
Interest Expense	100,000		100,000
Depreciation	40,000		40,000
Total Operating Expenses	\$ 1,460,500	\$ (110,000.00)	\$ 1,350,500
Net Income	\$ 59,500	\$ 110,000.00	\$ 169,500

the expenses on the income statement. This compensation could be listed as a separate expense – Owner’s Compensation” – or could be included in “Salaries” or “Wages” expense. If the owner’s salary is included in a general expense account of “Salaries” or “Wages” you will need to identify the amount and separate it out so it can be adjusted to market levels.

Compare the amount paid to the owner with the market compensation level determined for Tool #1. If the numbers are different, the owner is likely over- or under-compensating himself or herself. We want to adjust the net income to reflect market compensation by subtracting the actual reported compensation and adding in the market compensation. For example, if market compensation was determined to be \$120,000 per year but the owner actually received \$150,000 in W-2 wages (i.e., not including any perks) you would add back \$150,000 to net income and subtract market compensation of \$120,000 from net income, thereby increasing net income by \$30,000. The reverse would be true if the same owner received only \$80,000 of W-2 compensation, requiring you to add back \$80,000 to net income and subtracting market compensation of \$120,000, thereby decreasing net income by \$40,000. Note: There will be payroll tax implications related to these adjustments but that is a minor concern and not relevant to this analysis.

- 2) **Adjust for market rent as determined in Tool #2.** If the business is leasing space from an arm’s-length, third party, there are likely no issues as to whether the company is paying fair market rent. However, if the owner of the operating company also owns the business’s real estate (land and/or buildings) in a separate legal entity, the owner can determine the rent paid by the operating company to the real estate holding company. You need to determine if the operating company is paying at or near market rent to the real estate holding company.

To do this we need an estimate of the market value of the real estate. A recent real estate appraisal would be ideal but is rarely available early in the divorce process. Therefore, you can obtain an estimate of fair market value, albeit often considered to be a conservative estimate, from the real estate assessment for the property (make certain you get the values for both the land and the buildings if both are owned by the real estate holding company). You can estimate annual market rent by calculating 12 percent of the estimated fair market value.

If the estimated fair market rent is different from the rent reported, add the actual rent expense reported to net income and subtract the estimated fair market rent.

### Getting To Your Decision Point

After you have made these two adjustments you will arrive at an adjusted net income. Multiply this number by 3. (See example). Why 3? A multiple of 3 in the majority of cases will result in a relatively conservative estimate of value. This estimate will give you and the client some idea of a range of value to then determine if an appraisal is needed, or whether the estimate considered low enough that an independent appraisal is not needed. Consider this a directional indicator of the business’ value and compare this with the cost of hiring a certified business appraiser.

Only you and your client can determine the amount you are comfortable saying is worth or not worth pursuing.

While you might read about shortcuts to actual valuation that use multipliers, it is necessary to recognize that there are any number of additional items to consider in actually valuing a privately owned business and they can seriously impact value. These additional items could include personal expenses run through the business, non-recurring revenue or expense items that can impact the reported net income, significant future capital expenditures required by the business, working capital needs of the business, and others. All of these factors/details and more are considered in a professional business appraisal.

The steps described above purposely estimate, at a very high level, whether it is likely that a business appraiser is needed. Also, this exercise presumes the divorcing

#### CAUTION

This number is a directional tool to know if an appraiser should be engaged, and is not to be used as the value of the company. In addition to the additional considerations noted within this article, a business appraiser will typically look at five years of historical financial data, industry trends, and more. Here we have used one year of data and directional inputs.

business owner owns 100 percent of the equity, which is not always the case.

If you and your client decide to engage a business appraiser, ask your colleagues for recommendations and always look for an Accredited Senior Appraiser (ASA). This designation assures you that the appraiser has earned and is committed to upholding strict professional standards.

Talk to the appraiser and ask these four questions before you engage:

- 1) Is the appraiser ASA certified?
- 2) Is the appraiser independent (free from any conflicts of interest such as providing

accounting services to the firm)?

- 3) How many appraisals has the appraiser completed, and do they have experience testifying in court to support their conclusions, if needed.
- 4) What is the fee/range of fees and how can we control costs?

Whether you ultimately decide to engage a business appraisal expert or not, the three tools discussed above should serve you well to meet your client's needs with confidence knowing you have an efficient process in place to determine when there is a need for an independent business appraiser.

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### ***About the Author:***

***Cathy J. Durham is the president of Capital Valuation Group, Inc., headquartered in Madison. Capital Valuation Group has specialized in business valuation since 1974 and each of the principals of the firm are experienced in testifying, when needed. Cathy is an Accredited Senior Appraiser through the American Society of Appraisers.***

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### **End Notes**

- <sup>1</sup> Accounts Receivable should be aged to determine if all are collectible; Inventory should be confirmed to be saleable; land and building(s) value(s) can be estimated from the real estate tax assessment; vehicles and equipment can be valued using the internet or hiring an equipment appraiser.
- <sup>2</sup> A number of websites exist such as Salary.com; PayScale.com and Monster.com.
- <sup>3</sup> If the accounting includes significant non-recurring expenses or personal expenses, it may be the business does have transferable value.