BAR BULLETIN

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This is a reprint from the King County Bar Association Bar Bulletin

October 2018

Business Valuation in a Washington Divorce

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For many contested dissolutions in Washington, the single largest asset is often a closely held business owned and operated by one or both parties to the dissolution. Providing guidance to your client through the process of having the business valued for purposes of divorce requires skill, insight and, frankly, vocabulary they don't teach in law school.

Your job as an attorney does not begin and end by choosing a qualified valuation expert (although that move is critical). Ideally you will help your client through the discovery stages and valuation process with that expert and help your client come to terms with business valuation in the context of divorce under Washington law. It is in your best interest to work with the valuation expert to help him obtain the various financial and qualitative information needed to form an independent conclusion of the value of your client's business.

What follows are some of the basic terms and concepts of business valuation that you should learn and understand.

Standard or Premise of Value

The first hurdle your client will have is understanding Washington's standard of value for business valuation, which is different than most other states' and different from most of the values placed on all the other assets at issue in the typical divorce. "Value in the marketplace" — i.e., what would a willing buyer and a willing seller arrive at as a value for this asset today — is the easiest standard to understand; however, it is *not* the standard that Washington uses for business valuation.

Instead, Washington uses a "value to the holder" standard, which determines the economic value of the business in your client's hands. This does *not* refer to what your client could sell the business for today, nor is it exchange value. It specifically refers to the economic benefit your client will receive into the future as the owner of the company in today's dollars.

In short, Washington does not use the "fair market value" standard of value in business valuations for dissolution purposes, but rather a "fair value" standard. Valuation for dissolution purposes generally determines the return to your client by continuing to own and operate this asset.

This can be a hard concept for our clients to understand or accept — particularly as fair value is often higher than what the client believes he or she could sell the business for in the marketplace. It doesn't help that approximately 40 other states, including Oregon, use a "value in the marketplace" standard.

Your client will likely have heard stories about other valuations she will share with you, or she will send you internet articles written in other states, about how the business *should* be valued. We have found that the sooner you lay the groundwork with your client explaining the difference between the two standards, using your valuation expert to help you, the sooner your client will stop complaining about the law and instead focus on getting the best information in front of the expert.

Approaches Used in Valuation

There are three different approaches used in the valuation of a company: the income approach, the market approach and the asset approach. All three will typically be considered in a business valuation, but the conclusion of value determined by the valuation expert may rely more, or even exclusively, on one approach in relation to the others, depending on the specific facts of the business being valued.

The income approach values a business by examining the income stream generated by the business. The market approach compares the business to comparable, publicly traded companies or to other similar businesses whose values are known due to a merger or exchange transaction. The asset approach values a business based on the net value of its assets and liabilities.

The expert will decide which approach is more relevant. For instance, if your client's business is one of a kind, it will be extremely difficult for the expert to use the market approach given a dearth of available transaction data. If the business is in the service industry, an asset approach will likely have limited relevance.

But remember — it's not all or nothing. Multiple approaches can be used and their value outcomes "weighted." Two experts might get the same values for each approach, and then by weighting them differently (for example 60% income and 40% market vs. 40% income and 60% market) arrive at very different values. Talking to your expert about the approaches he used and how he weighted the values can help you understand how he views the business.

Methods of Value

Each approach has different methods for determining value. The asset approach might use an adjusted net asset value, either on a going-concern basis or a liquidation basis, or to a significantly lesser extent, the excess earnings method. The market approach might use guideline public companies; guideline merged and acquired companies; past transactions; or buy-sell agreements.

Income approach methods include discounted cash flow and capitalization of cash flow. It is important to remember that the methods used under an income approach are forward looking. Though the expert examines past earnings and cash flows, he is most interested in the future cash flows expected to be generated by the business that are available to the owner. Since an income approach is used most frequently in Washington, we'll quickly discuss some of the important terms related to this method.

Discounted cash flow: "Discounting" is projecting the expected economic income over the life of the investment and discounting each increment of that expected income back to present value at a rate of return known as a "discount rate."

Discount rate: Think of this as the interest rate the owner would have to pay someone to invest in the company. It is the measure of the inherent risk associated with that particular business. For guidance on where this rate should fall, consider the following.

The risk-free rate of return, typically determined by looking at the return on U.S. Treasury bonds, is currently around 2.5 percent for a one-year bond. The rate of return on large cap stocks, based on the S&P 500, is approximately 10 percent. Small cap stocks average 16.2 percent.

Closely held businesses are considered riskier investments and therefore discount rates usually are between 19 to 25 percent. Your valuation expert will likely build his discount rate by starting at the risk-free rate, and then make various adjustments to account for factors such as an equity risk premium, a premium for the size of the company, specific company risk adjustments, and perhaps an industry adjustment factor (some industries are inherently riskier than others).

Growth rate: This is the sustainable annual rate of growth (or decline) in the expected, long-term cash flows produced by the company. Most often, the growth rate will be near the rate of inflation (currently 2.9 percent), but factors such as the industry in which the business operates and the current and anticipated economic climate can impact the long-term growth (or decline) rate of the business.

Capitalization rate: This is the discount rate minus the growth rate. It bears an inverse relationship to the value of the business: the higher the "cap rate," the lower the value of the company.

Reasonable compensation: This is the fair-market value compensation for the job performed by the business owner, based on her education, experience, expertise and effort. It represents the cost to the business to hire someone to perform those same tasks, and it is removed from the available cash flow to owners in calculating the value of the company.

Experts use a variety of specialized industry journals and databases to determine market compensation for an employee to do the things your client is doing. Reasonable compensation is deducted from the expected cash flows so your client isn't paying for the pleasure of working.

How To Help Your Client

Help your client tell his story. Business valuation is not a data-in, value-out proposition. It is not paint by numbers. The actual value is in the details — and these are details only your client knows. Our job is to help clients tell their story well. We have to help them be good communicators about the nuances and specifics of their business so the valuation expert gets *all* the relevant information from the start.

It may be helpful to your client — and reduce his stress about the valuation process — to schedule a brainstorming session prior to the client's first meeting with the expert. Discussion topics can include the business's "SWOT" — strengths, weaknesses, opportunities and threats. Who are the key personnel? What is the likelihood of losing those employees? What does the company do better than its competitors?

Are there any anticipated changes in the operations that may make it harder or easier to do business? Are there technology or industry changes coming that might change business methods? How will such changes impact the company long term?

Help your client to think of things that don't show up in the financial information you will share with the expert. Some examples from businesses we have been involved with: the head chef (key employee) about to go out on maternity leave; massive DOT project blocking vehicle access for an extended period; a change in state regulations for adult daycare centers; a pending lawsuit; a tax audit; a minimum wage hike.

Share developments that will have a positive impact — you want the expert's report to have considered all angles, to be credible in mediation and in court. Some past examples: a patent application submitted years ago is finally awarded; the main competition goes out of business; a bid on a long-term contract is won.

Such positive developments often require more capital investment in R&D, expanded production or wages for new employees, potentially leaving less cash available. Good news in the long term can have a negative effect on cash flows in the short term. The expert will want to understand and account for these changes.

You also want to help your client talk about their role in the business. How many hours a week does she work? What are the specific elements of her job? What is her educational background? What experience did she have before starting the business that helped her do her job? What annual salary would be needed to pay someone of similar skill, experience and expertise to replace the work she is doing?

The important thing is that you prepare your client to speak in detail to the expert about the salient features of her business that could affect its value, both positively and negatively. The more thoughtful the narrative she presents, the more nuanced (and accurate) the report will be.

Evaluate the Quality of the Financial Data

Ideally, the business financials will be audited or reviewed financial statements prepared by an accountant. However, small-business owners rarely spend money for such statements as they are generally not required in the business's normal operations. The best available information is often accountant-prepared tax returns or internally prepared financial statements (from QuickBooks or other accounting software).

To arrive at a defensible value, your expert may have to spend time "normalizing" the financial information: removing the kid's car payments, the vet bills, the trip to Tahiti. These are not actual business expenses required for normal operations.

If your client's books are more of an

art project than business records, you might advise your client to hire a CPA and work with her to prepare the financials. Particularly if the other spouse is suspicious about the company's books, it can be a good way to reassure everyone that the financial data are solid from the start.

Provide Enough Financial History To Tell the Whole Story

Valuation experts typically ask for five years of financial information for their analysis. However, if your client operates in an industry that experiences significant volatility in its earnings over time, you will want to provide more years of data to show the company's financial situation through the entire business cycle.

This could encompass a period of 10 years or more. Some industries that experience significant volatility are directly tied to the stock market or to real estate. Your job is to help your client provide the information, showing how such volatility affects the business, to the expert for his analysis.

Finally, encourage your client to be transparent and honest about the business's good and the bad points. We are fortunate to have quite a few experienced business valuation experts in town; they have done this long enough to be able to identify "spin." Trying to omit or fudge or play games just ends up costing your client more in fees in the long run, and you don't get a credible product to take to mediation or trial.

What To Do When You Get the Report

Read it! Don't just flip to the bottom line; read the report cover to cover. If details are missing, or you are surprised by assumptions made, put them on a list to discuss with your expert.

Get out your calculator and check the math. Errors happen and they need to be fixed. Now is the time to do it, not at mediation or trial.

Look at the "cash available to owners." Make sure that is available to your client. If your client is a 20-percent owner, she might not have a direct say in distributions and may not receive 20-percent of the cash available to owners in distributions. Double check the assumptions against the reality. Is the assumption of cash flows sustainable over the long term? Or does the company have necessary expenses coming up that will carve into the cash available to owners? (Research and development needs, debt servicing, replacement machinery/infrastructure.)

Look at the growth rate. Growth rates typically are somewhere between the rate of inflation and the historical, national economic growth rate for most businesses. Anything above the economic growth rate or below the rate of inflation should be explained in your expert's report.

Look at the discount or capitalization rate. Does that rate adequately capture the inherent risks of the business? Does it recognize industry trends or volatility?

Look at the tax rate. Does the tax rate used in the calculation of the cash flow generally make sense or does it require additional explanation by the expert?

Look at the reasonable compensation. What is the expert's analysis of a reasonable replacement compensation for your client's business role? Does it make sense? Note: A high reasonable compensation figure lowers the value of the business by decreasing the "cash flow" — *but* reasonable compensation is often used to calculate child support and/or maintenance, if that is at issue.

Finally, if there is a considerable difference between your expert's and the opposing expert's valuations, have your expert review and analyze the other report to determine key differences. Also, consider involving your expert in mediation and preparing for the opposing expert's deposition.

What we have covered in this article are the basics of the key components of a business valuation for dissolution purposes in Washington, and a high-level overview of some of the terms to help lawyers with their financial literacy. Lean on your experts to illuminate the more complicated components of value intrinsic to your client's particular business, and the best methods for arriving at a fair value. ■

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