2020 BENCH-BAR CONFERENCE

BASICS OF BUSINESS VALUATION

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Moderator, Honorable Donald Myers

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October 2, 2020

Dear Conference Attendee,

A basic understanding of business valuation terminology and concepts will help you take on a case where one or more businesses are in play for sale, merger, marital dissolution, tax filing, estate, and gift planning.

My Family Law Client

Needs a valuation when revenues are coming from non-owner activities, e.g., products, a labor force, a sales force, or intellectual property owned by the business.

Fair Market Value ("FMV")

- The current standard of value in Florida's marital dissolution cases **allows** for discounts due to illiquidity, non-competition agreements, and lack of control by a minority shareholder.
- Christians v. Christians, 732 So. 2d 47; (Fla. App.1999): "The valuation of a business is calculated by determining the fair market value of the business, which is the amount a willing buyer and willing seller would exchange assets absent duress." citing Makowski v. Makowski 613 So. 2d 924, 926 (Fla. 3d DCA 1993), "Because of the treatment of goodwill in the valuation of businesses in Florida, we consider Florida a walk-away fair market value state. Although business goodwill may be included in a valuation, Florida cases have recognized business goodwill in a professional practice. However, Florida indicated that the business is to be valued absent from the owner's efforts and assumes the owner is free to compete. We have categorized these assumptions as a "walk-away" doctrine."

Fair Value ("FV")

- Florida's current standard of value for dissenting shareholder cases does **not allow** discounts for illiquidity, non-competition agreements, and lack of control by minority shareholders. See Florida Statute 607.1302(1)
- It is also known as ASC 820, an accounting standard that requires investments to be reported at fair value by the Financial Accounting Standards Board's (FASB) Generally Accepted Accounting Principles (GAAP) guidance.

Revenue Ruling 59-60

Revenue Ruling 59-60 Defines Fair Market Value as the price 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.

Valuation Governance

- Department of Labor when ERISA laws are applicable, e.g., Employee Stock Ownership Plans (ESOP) Plans
- Internal Revenue Service, for gift and estate planning, and tax filing
- The Uniform Standards of Professional Appraisal Practice (USPAP) adopted by Congress in 1989

Valuation of [Assets Only] when:

- The entity is a sole-proprietorship
- When an individual owner generates the revenues, i.e., not selling physical products or physical labor
- Example: Professional License is Required to generate sales
- The reputation of an individual is generating the value
- We value the physical assets, cash, A/R, and debt only, i.e., excluding the value of earnings.

Valuation of [Assets **and** Earnings] when:

- When revenues come from the sale of products or physical labor
- The business has a reputation beyond an individual or owner
- When the systems and organization can operate without the presence of an owner
- We value the cash flows and compare the result to the value of physical assets, cash, A/R, and debt.

Example: Value of Earnings

Banks, credit card companies, auto lenders, and mortgage lenders require a rate of return (the interest charged to you) based on the level of risk they perceive on your credit report. Similarly, an investor or owner of the company requires a return rate based on the relative risk of buying or holding a particular company or stock. The valuation analysts estimate a company's "credit score" or "required rate of return" by comparing the subject company to other investment opportunities by tallying the relative risks of each:

(+) **U.S. Treasuries – Risk Rate**

a. Example: 20-Year Treasury at the Federal Reserve Bank, e.g., 1.18%.

(+) **Large Company Stocks - Risk Rate**

b. Example: Rate from empirical studies, e.g., 6.97%

(+) **Small Company Stocks – Risk Rate**

a. Example: Rate from empirical studies, e.g., 7.64%

(+) **Industry Specific - Risk Rate**

a. Example: Rate from empirical studies, e.g., 1.8%

(+) **Company Specific - Risk Rate**

a. From the appraiser subjective viewpoint, 1.0%

From the list above and other factors, we add-up our company's "credit score" or the investor's "required rate of return" and apply that risk rate to the company's cash flow to determine fair market value.

20-Year Treasury	1.18%
Equity Premium (1928-2018)	6.97%
10th Decile Size Premium	7.64%
Industry Risk (Poultry Processing)	1.18%
Company Specific Risk	1.00%
Equity Discount Rate (rounded):	18.00%
Less Growth Rate (Livingston Survey)	-2.00%
After-Tax CF Cap Rate for next Year	**16.00%**

From the example above, we apply the 16% risk rate to earnings to get an indication of company value:

Cash Flows to Equity	2020	2021	2022	2023	2024	5yr Avg
(+) EBT	656,857	673,594	690,666	708,079	725,841	691,007
(-) Federal Income Tax	-137,940	-141,455	-145,040	-148,697	-152,427	(145,112)
(+) Deprec.& Non-Cash	25,000	25,500	26,010	26,530	27,061	26,020
(-) Capital Expenditures	-25,000	-25,500	-26,010	-26,530	-27,061	(26,020)
(-) Increases in Working Capital	-29,790	-29,790	-29,790	-29,790	-29,790	(29,790)
(+) Debt Issued (Repaid)	0	0	0	0	0	-
Cash Flows to Equity	$489,127	$502,350	$515,836	$529,593	$543,624	$516,106

Projected -Cash Flows to Equity	2020
Normalized Cash Flows to Equity	489,127
Equity Build-up Rate (rounded)	16.00%
Indicated Value	**$3,057,045**

If the company uses debt financing, we modify the Capitalization Rate based on debt versus stock. After this, we capitalize cash flows based on the weighted risk rate or ”required rate of return.”

WACC - Buildup Method		Value ($M)	Weight
Equity Risk Rate	16.00%	3,057,045	96.8%
Yield on Debt/ Net of Tax	2.96%	100,000	3.2%
WACC (rounded)	**16.00%**	**3,157,045**	**100.0%**

Example: Value Conclusion

After determining the owner's control premium or discount, we calculate the company's value by estimating the effort, time, and costs of selling it in an arms-length transaction.

Sample Valuation			
Approach/ Method	**Result**	**Weight**	**Allocation**
Income Approach -DCF	$3,157,045	60%	$1,894,227
Market Approach - MVIC/ EBITDA	$4,182,201	40%	$1,672,880
Working Capital Excess or (Deficit)			$0
Value of Controlling Interest		100%	$3,567,107
Lack of Non-Competition Agreement	-27%		-$972,847
Subtotal			$2,594,260
Minority Discount	-10%		-$259,426
Subtotal			$2,334,834
Marketability / Liquidity	-20%		-$466,967
Value of Non-Controlling Interest			**$1,867,867**

Example of Personal Goodwill

The IRS defines goodwill, “the value of a trade or business based on expected continued customer patronage due to its name reputation or any other factor.”

Personal goodwill that is generated from the personal expertise or business relationships of the employee or shareholder because of:

- Personal reputation
- Personal relationships with customers or suppliers
- Technical expertise
- Distinct personal abilities.

Case Law on Goodwill – Florida

Kearney v. Kearney, 129 So. 3d 381 (Fla. 1st Dist. Ct. App. 2013):

Dissenting opinion by Judge Makar, “I write separately to express disagreement with the astonishing conclusion reached at trial that Mainline-a company with over a half-billion in annual sales, over 600 employees, numerous high-level managers, and over 800 professional certifications among its workers – has not a thimbleful of "institutional goodwill" to its name; instead to the extent Mainline has goodwill, it has been deemed entirely "personal" to the former husband, and thereby not distributable to the former wife as a co-owner. “The valuation of “Mainline” was done with the rudimentary analytical guidelines from the seminal professional services case, Thompson v. Thompson, 576 So.2d 267 (Fla. Supr. Ct.1991), which dealt with valuing a former husband's law firm in which he was the **sole shareholder** which is a poor fit for valuing the goodwill of a complex and uniquely structured **international corporation** that is itself controlled by one of the largest corporations in United States history.

Held v. Held, 912 So.2d 637 (Fla. App 2005):

The adjusted book value was used in determining the fair market value of the business. The court rejected the inclusion of a non-solicitation agreement in enterprise goodwill.

Williams v. Williams, 667 So.2d 915 (Fla. Dist. Ct. App. 1996):

Professional practice's goodwill is a marital asset subject to division if it exists and was developed during the marriage. However, if a non-compete agreement would be required according to a sale, there is no reason to believe that the goodwill adheres to the enterprise.

Thompson v. Thompson, 576 So.2d 267 (Fla. Supr. Ct.1991):

The Fair market value approach should be the exclusive method of measuring business goodwill. In a professional setting, goodwill is the "value of the practice which exceeds its tangible assets and which is the tendency of clients/patients to return to and recommend the practice irrespective of the reputation of the individual practitioner." Id. There are two types of goodwill: enterprise (or institutional) and personal. Enterprise goodwill "exists separate and apart from the reputation or continued presence" of a particular individual.

Case Law on Discounts – Florida

Erp v. Erp, 976 So.2d 1234 (Fla. App. 2007):

"A trial court should be accorded the discretion to determine whether a marketability discount should apply to the valuation of a closely held corporation in a dissolution of marriage case where the court is traditionally charged with achieving equity through the use of various remedies." The appeals court found "no abuse of discretion in the trial court's decision to apply a ten-percent marketability discount in this case."

Case Law on Buy-Sell – Florida

Garcia v. Garcia, 25 So.3d 687 (Fla. App. 2010):

"The sale price set by restrictive provisions on transfer of closely held stock is not conclusive as to the value. However, restrictive transfer covenants affect value through impaired marketability and must be considered when a trial court determines the value of the stock for purposes of equitable distribution. When the stock is subject to a restrictive transfer agreement, the price fixed by such provisions will not control its value, but the restriction on transfer is a factor that affects the value of the stock for purposes of equitable distribution."

Case Law on Goodwill – U.S. Tax Court

MacDonald – 3 T.C. 720 (1944)

The Tax Court held, however, that no goodwill passed to the taxpayers since any goodwill of the business "was due to the personal ability, business acquaintanceship, and other individualistic qualities of [the husband]," and found that the corporation did not have any value beyond its tangible assets since the husband's personal ability was not a corporate asset and there was not a contract or other agreement between the husband and the corporation for his future services.

Martin Ice Cream – 110 T.C. 189 (1998)

The tax court stated, “personal relationships of a shareholder-employee are not corporate assets when the employee has no employment contract with the corporation.” The corporation’s success was attributed to a shareholder’s relationships with his customers, which constituted an asset used to establish revenue streams and develop a customer base.

Norwalk - T.C. Memo (1998-279)

In this case, involving the sale of a CPA firm, the tax court stated the goodwill of a professional service corporation belongs to the employees unless the employees “enter into a covenant not to compete with the corporation or other agreement whereby their personal relationships with clients become the property of the corporation.” The court stated that it did not doubt that most, if not all, of the clients of the corporation would have followed the accountant who serviced them if the accountant left the corporation, and therefore it was “reasonable to assume that the personal ability, personality, and reputation of the individual accountants are what the clients sought.

Muskat v. the United States, 2009 WL 211067 (1st Cir. 2009)

In this case, the trial testimony revealed no discussion of Muscat’s personal goodwill during the negotiations. None of the transaction documents, including the early drafts of those documents, mentioned Muscat's personal goodwill by the same token. Muscat had ample opportunity to introduce the concept of personal goodwill into the non-competition agreement, but he did not do so. And although there is a reference to goodwill in the preamble to the non-competition agreement, its purpose was to protect corporate goodwill. “In our judgment, the absence of any reference to Muscat separate goodwill combined with this expressed reference to corporate goodwill makes it extremely unlikely that the contracting parties intended the payments in a non-competition agreement to serve as de facto compensation for muscats personal goodwill.”

Case Law on Non-Competition – U.S Tax Court

Background

A covenant not-to-compete (CNC) is an agreement between parties to the sale of a business, by which the seller typically agrees not to compete in the same industry for a specified period and within a specific geographic period. A CNC can be part of a large corporate asset sale or divestiture, or it can accompany the sale of a solo professional practice or family business. In either case, the contract for sale may include the covenants, or they can appear in a separate, non-compete agreement.

Allison, No. 9633 (E.D. Cal. 1970)

Despite the lack of agreement between the parties as to the value of the covenant, the court considered not whether the covenant was severable from the purchase of goodwill, but instead if the covenant comprised independent significance separate from the acquisition of goodwill. The IRS and the U.S. Tax Court (in a separate proceeding against the buyer) previously determined that the covenant represented "a surrender of [the taxpayer's] future income rather than the sale of goodwill." Based on the acquirer's testimony, the court agreed with the tax court and the IRS by holding that the covenant was not a transfer of property; instead, the agreement held independent significance apart from the purchase of goodwill and was, in fact, a surrender of future income—i.e., compensation not to compete during the term of the agreement.

Under different facts, however, courts have treated the covenant as capital in nature. In Ullman, the court stated that where a "covenant is so closely related to a sale of goodwill that it fails to have any independent significance apart from merely assuring the effective transfer of that goodwill," the covenant is not separate from the asset acquired (264 F.2d at 307–308). Similarly, "[i]f an agreement not to compete is necessary to effectuate a transfer of goodwill, then the payments made under it may be treated as if made for the sale of a capital asset."[5] Citing Schultz, the court in Allison, stated:

In Schultz, both the commissioner and tax court found that the covenant not to compete, although stated separately as to value, was essential to the sale of the goodwill of the business and had no real economic value of its own. The court was unable to find that the covenant had an independent basis in fact to the extent that reasonable men, genuinely concerned with their economic future, might bargain for such an agreement." 294 F. 2d at 55. In other words, for the covenant to be treated as a surrender of future income, it must appear that the potential competition of the seller would pose a substantial economic threat to the buyer such that the covenant was not appended as a mere tax gimmick. *Source: The Tax Advisor; April 1, 2011; Nick Gruidl, CPA*

Schilbach, T.C. Memo. 1991-556

Addressing a transfer of personal goodwill, the court looked to the intent of the agreement. In that case, the taxpayer lost his malpractice insurance, was physically and emotionally exhausted, and intended to leave his practice and enter a new field of medical

practice. Upon the sale of his business, the taxpayer signed a covenant not to compete; however, due to the taxpayer's intentions and his physical and emotional condition, it was clear that even without the agreement, the taxpayer never intended to and was unable to compete with the buyer. Therefore, the covenant was not meant to compensate the seller for the surrendering of future income. Accordingly, the tax court held that the medical practice had goodwill equal to the value established by the taxpayer as of the date of liquidation. *Source: The Tax Advisor; April 1, 2011; Nick Gruidl, CPA*

Bross Trucking, T.C. Memo 2014-107

In Bross Trucking, Bross, a successful construction businessman, had established close, personal relationships with his primary customers. Additionally, Bross was extremely knowledgeable about the trucking industry because of his many years of experience. To that end, customers sought these personal traits through their relationships with him, which led directly to business for Bross Trucking. As a result, the Tax Court determined that personal goodwill existed through these relationships. *Source: The Tax Advisor; April 1, 2015; Nick Gruidl, CPA*

Case Law on Economic Reality – U.S. Tax Court

A covenant not-to-compete (CNC) is an intangible asset. Since a CNC is based purely on a contractual agreement, it has value to the degree that it protects the value of the purchased assets of the business (both tangible and intangible) by restricting the seller's competitive conduct after the sale. As such, a CNC's value is dependent on the factors listed here:

Beaver Bolt v. Commissioner (TDM 1995-549)

Nine-factor economic reality test for NCA, which considers:

1. The seller's (covenanter's) ability to compete
2. Seller's intent to compete
3. Seller's economic resources
4. The potential damage to the buyer posed by the seller's competition
5. Seller's business expertise in the industry
6. The seller's (covenanter's) ability to compete
7. Seller's intent to compete
8. Seller's economic resources
9. The potential damage to the buyer posed by the seller's competition
10. Seller's business expertise in the industry

Thompson v. Commissioner (TDM 1997-287)

Cites the Beaver Bolt Factors, plus five more:

1. The age and health of the grantor
2. The enforceability of the covenant under State law
3. Whether payments for the covenant are pro-rata to the grantor's stock ownership in the company being sold (relates to economic substance)
4. Whether the payments under the covenant cease upon breach of the covenant or the death of the grantor
5. The existence of active negotiations over the terms and value of the covenant (other than tax-motivated)

Reporting Standards – U.S. and International

The Financial Accounting Standards Board (FASB) issues guidance on a business valuation performed for various reasons and reported under the U.S. Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

- ASB ASC Topic 805, Business Combinations, which introduced significant changes over previous financial reporting standards
- FASB ASC 820, Fair Value Measurements
- FASB ASC 350, Impairment – Goodwill and Other
- FASB ASC 852, Reorganizations
- IFRS 3R, Business Combinations
- IFRS 13, Fair Value Measurement
- US Internal Revenue Code Section 1060, transfer pricing rules.

Valuation - Asset Approach

- Book value method, using historical cost
- Adjusted net assets method, using current value or remaining useful life value

Valuation - Income Approach

- Capitalization of earnings or cash flows method
- Discounted earnings or cash flows method

Valuation – Market Approach

- Guideline public company method
- The comparable private transaction method
- Dividend-paying capacity method
- Prior sales of interest in the subject company