The Subjective Components of Business Valuations That Every Attorney Should Know

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While the family business is often a family's most significant asset, it is also the most challenging to value. In order to best serve their clients, attorneys need to effectively cross-examine experts as to how they arrived at their conclusion of the value of the business. Every business valuation entails numerous subjective assumptions that can be skillfully challenged. Knowing which ones to challenge can be a key element in achieving the appropriate result whether through settlement discussions or even in the courtroom.

The most common approach used to value a business is the Income Approach. This approach incorporates the following integral components, each of which is subjective and therefore subject to effective cross-examination:

- ***Normalization of Earnings.***
- ***Reasonable Compensation Adjustments.***
- ***Discount and Capitalization Rates.***
- ***Long and Short-term Growth Rates.***

Normalization of Earnings

It is essential that any historical data used in the valuation bear relevance to <u>future expectations</u>. Reported earnings, whether on a tax return or in the financial statements, if available, need to be "adjusted" to reflect both recurring revenues and expenses that are relevant to the business and exclude personal expenses. While adjustments would typically include various perquisites and benefits, other adjustments are often required. The inclusion or exclusion of such items could have a major impact on value. Examples include:

1. Recent loss (gain) of new major contract(s).
2. Impact of foreign currency rates.
3. Anticipated lower/higher future costs (i.e., fuel prices, raw materials).
4. New leases at higher/lower rates.
5. New leases for additional/less space.
6. Introduction or discontinuation of product lines.
7. Impact of a hurricane, fire, flood, etc.
8. Competition (new industry entrants or elimination of competitors).
9. Start-up costs, capital expenditures, etc.
10. Change in governmental and/or industry regulations.
11. Technological changes.

Failure to properly address these types of significant factors would seriously impact the credibility of any expert.

Reasonable/Replacement Compensation

An adjustment for Reasonable Compensation is necessary in order to present the business operations on a basis that includes the level of compensation necessary to attract qualified individuals to perform the duties of the company at comparable levels of efficiency. While this is often a significant component of a valuation and can entail various data sources, the conclusions reached are nevertheless subjective. The sources of information and approaches used in determining reasonable compensation presents an opportunity to effectively challenge any expert.

The Development of the Discount Rate and Capitalization Rate

The multiple of earnings used in a valuation is based on the discount rate that is determined by the expert. While certain components in establishing the discount rate (i.e., risk-free rate and the equity risk premium) are relatively objective; other key elements (the specific company risk and short- and long-term growth rates) are primarily subjective and prone to challenge. It is imperative to understand how the expert assessed the various specific risks that the company may be facing such as:

1. Dependence on one or two major customers.
2. Strength of balance sheet - is there a heavy reliance on debt?
3. Exposure to contract performance guarantees, penalties.
4. Foreign currency fluctuations.
5. Raw material availability and current as well as expected prices.
6. Impact of government regulations.
7. Major lawsuits.
8. Early stage of development and capital requirements of new products.
9. Barriers to entry and new competition.
10. Technological challenges.

Growth Rates

The growth rate (both short- and long-term) determined by the expert will significantly impact the valuation. Therefore, the basis for the growth rate selected should be understood and appropriately challenged. Questioning the expert's growth rate assumption should entail such items as: Was it simply based on inflation? What industry sources were utilized? Does the company have the equipment, space, talent, financial resources, etc. to support the level of growth envisioned? How was the size of the market determined?

Business valuation is a complex undertaking that involves extensive training and experience. However, it entails certain key variables that are predicated on both objective and subjective inputs. The ability to identify and challenge experts on the subjective components of their valuations will enable you to achieve an outcome that will best serve your clients and the future clients they will eagerly refer to you.

If you have any questions related to this article, please do not hesitate to reach out to Ilan at ilan@marcumllp.com.