

Business Valuation in Litigation: Where NOT to Cut Corners

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Business valuations, whether for litigation or other purposes, require a careful analysis of economic and industry factors to properly support an expert opinion. As far back as the issuance of Revenue Ruling 59-60, these factors were identified as fundamental to business valuation. In order to understand the future benefits a business expects to realize, it is necessary to understand the impact of these fundamental factors. Unfortunately, these two factors are often the first to be short cut in litigation cases.

Valuators are retained to provide expert testimony regarding value in a variety of litigation situations including: shareholder disputes, loss of value as a damage, and equitable distribution in divorce. Regardless of the purposes of the testimony, the opinion of value of an interest should quantify the expected benefits of the business. The underlying basis for these expectations is supported by the factors identified in Revenue Ruling 59-60, which include not only the economic and industry climate and outlook, but also:

- Nature of the business and the history of the enterprise from inception,
- Book value of the stock and financial condition of the business,
- Earning capacity,

- Dividend paying capacity,
- Goodwill or other intangible value,
- Sales of stock and size of the block being valued, and
- Market price of comparable publicly traded stock.

These factors, widely accepted as cornerstones to valuation, are elemental to supporting an expert opinion. "Revenue Ruling 59-60 is probably the greatest treatise ever issued on valuation."¹ In a litigation context, there are very often budgetary and time pressures to contend with in completing an engagement. Most valuers will consider the internal factors that impact the value of a business in the process of conducting a valuation. The external factors, the economy and the industry, often appear to be the least relevant and therefore the easiest to cut when budgetary and time pressures exist. Failure to comprehend the impact of these external factors on expected benefits can result in a misleading or distorted opinion of damages.

The Economy

In today's business world, the local economy may have very little bearing on the business operation since the Internet has catapulted many businesses into the global marketplace. The expert must be able to identify the factors that af-

fect the future performance of these businesses in calculating damages.

Example: A business located in North Carolina, manufactures its products in China, and distributes them nationally through a website. This business may not be impacted by local economic trends, but the Chinese economic climate may be very relevant.

Economic information is usually easier to access on a national and global basis. Current local economic indicators may be more difficult to obtain as reporting is usually infrequent and not widely disseminated, whereas national and global information is published regularly by the US Bureau of Labor Statistics, US Department of Commerce, the Federal Reserve and numerous financial institutions. In addition, a number of companies publish quarterly economic analyses based on this published economic data.

The travel industry is impacted by economic performance as well as the strength of the dollar abroad for international tourism. Other industries are less impacted by the economy, yet still may be impacted by the economic climate on which investor perception of investment alternatives is often based. While economic information is relatively easy to access, it is more time consuming to determine how this information impacts the company

being valued. In order to understand the impact of the current and forecasted economic climate on a company, it is necessary to understand the historical impact of the economy on the company.

Failing to identify trends in business operations that are caused by external economic factors can result in a misinterpretation of historical operating results. Companies in operation during 2001 may have been impacted by the recession which started during the first quarter before any impact from the disruption to the economy caused by the September 11 attack. Depending upon the business, some operations recovered more quickly than others. A valuator performing a historical financial analysis of a company for a December 31, 2001 valuation date needs to understand how operations were affected in 2001 by the recession, and then September 11th. During 2001, there were some companies that experienced windfalls by providing services after September 11th.

If the operating anomalies resulting from changes in the economy or other external events are not properly identified, the valuator can very easily reach inaccurate conclusions regarding the past performance of the company. Additionally, for companies that are sensitive to changes in economic conditions, it is important to consider whether the historical economic climate is similar to the expected or forecasted climate during the damage period. The economic forecast for the future may be a significant factor in determining whether to consider historical operational trends in arriving at an opinion of value.

The Industry

Gathering information about the industry can be more challenging and time consuming. First, the expert must identify within which industry (or industries) the business operates. If the business has either multiple lines of business, or a business that is affected by multiple industries, the expert must investigate all relevant industries.

Example: A software company that writes software for medical billing may operate as a prepackaged software retailer. However, the business may be more heavily influenced by changes within the healthcare industry such as changes in billing codes and filing procedures for various insurance providers including Medicare.

Relevant industry data may include technological developments as well as regulatory issues.

Examples:

- The implementation of the Do Not Call Registry had an enormous impact on businesses that rely upon telephone solicitation as a driver of revenue.
- Regulatory changes in Florida prohibiting smoking in public buildings resulted in operational changes for many restaurants and bars.

Failure to consider these types of major external events and trends can cause the valuator's credibility to be undermined.

Information on industries is often available from a variety of sources including trade groups and research organizations. The Internet has been a key factor in the quick dissemination of industry information. With the relative ease of finding information, the greatest obstacle to gathering this information is usually budgetary. Many

industry forecasts and reports cost \$2,000 to \$5,000, or more. However, access to these pricey reports may not be critical to arriving at a damage opinion, as long as the expert is able to use other information to assess the industry. The key is to identify the industry drivers and trends to determine if and how they impact operations. Using benchmark financial information is helpful in determining whether the company is typical of the industry in which it operates.

Atypical companies may not follow industry trends or be influenced by the same factors.

Example: A construction company located in Florida may have done very well during the past years. If the company is located in Palm Beach County, the company may have outperformed the industry as a result of the booming market in Florida into 2006 and the reconstruction work resulting from the heavy hurricane activity in 2004 and 2005. A construction company that limits its work to office buildings may not have been affected as much by the slowdown as a company that builds homes. Likewise, a company that does road construction may be feeling the impact of the economic slowdown in 2007 with municipalities delaying projects due to budgetary constraints.

The facts and circumstances of each case must be evaluated. Then the valuator can consider the industry as it applies to the company to determine the outlook for the company within the context of the industry.

It is generally accepted that analysis of the external factors is as important in developing an opinion of value as analysis of the internal factors. The valuator must not only

gather relevant information, but also determine how that information relates to the company with regard to historical operations and future expectations. As illustrated, the failure to consider the economic outlook and impact, as well as that of the industry, can result in a distorted valuation opinion. In litigation, the expert's work is often more closely scrutinized than in other types of valuation work, thus it becomes critical to consider carefully all relevant factors in arriving at an opinion of value that can withstand cross-examination.

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¹ Gary Trugman, Understanding Business Valuation, A Practical Guide to Valuing Small to Medium-Sized Businesses, Second Edition, AICPA, 2002.