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COURT CASE ABSTRACT

'Splitting the Difference' Is Not an Acceptable Valuation Method in Divorce

Augoshe v. Lehman, 2007 Fla. App. LEXIS 6367 (April 27, 2007)

In an attempt to reach fair and equitable solutions, divorce courts will often "split the difference" between the parties' disparate business appraisals. If the court makes an adequate record, including competent evidence to support its ultimate value conclusion, the "midpoint" determination may withstand reconsideration and/or subsequent appeal.

But in this case, the trial court made no such record in deciding the value of a Florida motel, purchased by the parties during a short (three-year) marriage. At trial, the wife's expert had presented two valuations, one based on the comparable sales approach (\$4.40 million) and another based on the income approach (\$4.31 million).

The only evidence of value offered by the husband was the \$2,842,858 purchase price for the motel.

Court cites Solomon

The trial court concluded the motel was worth \$3,576,429, and the husband appealed. On review, the appeals court was unable to find "any competent evidence to support this finding," other than that the value was the "exact midpoint" between the purchase price and the income approach valuation by the wife's expert. Citing the Florida case of *Solomon v. Solomon* (which is hard to resist repeating, simply for the irony of the name), the appeals court found that "simply splitting the difference" between two divergent appraisals was an "improper method of valuation," and it remanded the case for further findings.

SPECIAL REPORT

What CPAs and Attorneys Should Know About the New AICPA Valuation Standards

After six years of drafts, debates, and deliberations, this past summer—in June 2007, the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (the Statement). The Statement applies to any AICPA member, regardless of technical discipline, who performs an engagement to estimate the value of a business, business ownership interest, security, or intangible asset. The Statement identifies these members as "valuation analysts."

Valuation analysts must comply with the Statement whenever they perform a valuation engagement involving a conclusion of value or a calculated value. The only exceptions are: (1) when the valuation is part of an attest engagement; (2) when a client or third party has provided a subject value, and the analyst does not apply any independent analysis; (3) engagements to determine economic damages (unless inclusive of an estimation of value); and (4) jurisdictional exceptions for governmental, judicial, or accounting authorities. The Statement is effective for all applicable engagements after January 1, 2008, but earlier adoption is encouraged.

Parties who rely on valuation reports—including
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attorneys, bankers, and transaction principals—will now be able to define alternative levels of valuation services and reports. They will benefit from increased transparency, consistency, and reliability of valuation reports. What follows are the key points regarding the effect and application of the new Standard:

1. Competency. The Statement requires the analyst to possess a level of knowledge sufficient to identify, gather, and analyze valuation data; consider and apply appropriate valuation approaches and methods; and use professional judgment.

2. Objectivity. “Objectivity is a state of mind.” The Statement defines objectivity as imposing the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest.”

3. Independence. If the valuation analyst also performs an attest engagement, then the analyst must meet the requirements of Rule 101 of the AICPA Professional Standards (“Independence”) and Rule 102 (“Integrity and Objectivity”).

4. Types of engagements. The Statement permits: (i) a valuation engagement, expressed as a conclusion of value, with applied methods and approaches selected by the analyst; and (ii) a calculation engagement, for which the analyst and client agree on the methods and extent of procedures, resulting in a calculated value.

5. Factors to consider. In a valuation engagement, the Statement lists eight factors:

- i. the nature of the subject interest, including financial and non-financial data; and type of ownership interest
- ii. the scope of the valuation engagement
- iii. the valuation date
- iv. the intended use of the valuation
- v. the applicable standard of value
- vi. the applicable premise of value
- vii. any assumptions and limiting conditions
- viii. any applicable governmental regulations or other professional standards

6. Valuation approaches and methods. In a business or security valuation, the valuation analyst should consider: the income, market, and asset-based approaches. The income, market and cost approaches apply to an intangible asset valuation.

7. Rules of thumb. The Statement permits rules of thumb and/or industry benchmarks as reasonableness checks but discourages their use as the only method

to value a subject interest.

8. Valuation adjustments. The analyst should consider whether valuation adjustments should be made; e.g., price premiums or price discounts (lack of control and/or marketability).

9. Conclusion. In determining the conclusion of value, the analyst should: (i) assess the reliability of results under different valuation approaches and methods using the information gathered in the valuation engagement; (ii) correlate and reconcile the results gathered from the different valuation approaches and methods; and (iii) determine whether the conclusion of value should reflect (a) the result of one valuation approach and method or (b) a combination of results.

10. Subsequent events. In most cases, the analyst should consider only those events existing prior to and at the valuation date. Should a “subsequent event” (after the valuation date but before the report is issued) impact value, the analyst should consider only those events “known or knowable” at the valuation date.

11. Documentation. The Statement requires the valuation analyst to apply professional judgment to determine the type, quantity, and content of documentation. These may include information gathered and analyzed to understand value, assumptions and limiting conditions, restrictions on scope, etc.

12. Calculation engagement. At a minimum, the analyst should consider: (i) the client; (ii) the subject interest; (iii) the degree of ownership control and marketability; (iv) the purpose and intended use of the calculated value; (v) the intended users; (vi) the valuation date; (vii) the applicable premise and standard of value; (viii) the sources of information used; (ix) the agreed-upon valuation approaches and methods; and (x) any subsequent events.

13. Valuation report. The Statement defines a valuation report as a “written or oral communication to the client about the conclusion of value or the calculated value of the subject interest.” Exceptions include reports for “controversy” proceedings, unless the analyst forms a conclusion of value or calculated value. The report should identify any use restrictions.

14. Written reports. For a valuation engagement, the Statement permits a “detailed” report and a “summary” report; the distinction is the level of reporting detail. The detailed report should enable intended users to understand the information, reasoning, and analyses

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underlying the conclusion of value and should include these sections:

- i. Letter of transmittal
- ii. Table of contents
- iii. Introduction, including an overall description of the valuation engagement
- iv. Sources of information
- v. Analysis of the subject entity and related non-financial information
- vi. Financial statement/information analysis
- vii. Valuation approaches and methods considered
- viii. Valuation approaches and methods used, identifying each method used and the reason(s) for their use, including rules of thumb
- ix. Valuation adjustments (if any)
- x. Non-operating assets, non-operating liabilities, and excess or deficient operating assets
- xi. Representation of the valuation analyst, including eight specific statements
- xii. Reconciliation of estimates and conclusion of value, including specific disclosures
- xiii. Professional qualifications of the valuation analyst
- xiv. Appendices and exhibits, including examples, assumptions, and limiting conditions

The summary report provides an abridged version of a detailed report and does not require the same level of detail. At a minimum, it should include the subject interest, the valuation date, the purpose of the valuation, and the premise and standard of value.

For a calculation report, the analyst should identify: (i) any hypothetical conditions used in the calculation agreement (including the basis for their use); (ii) any assumptions and limiting conditions of the engagement; (iii) how a specialist's work was used; (iv) any application of the jurisdictional exception; (v) any subsequent events (in certain circumstances); and (vi) the calculated value.

Lastly, an oral report may be used in a valuation engagement or in a calculation engagement. The valuation analyst should document in working papers the substance of the oral report that was communicated to the client.

Note: A complete copy of the Statement, presentations, and an FAQ are available at <http://bvfls.aicpa.org>.

Divorce Court Accepts Double-Dipping Argument From Valuation Analyst

In re Marriage of Porter, 2007 Wash. App. LEXIS 1161 (May 21, 2007)

The Porter husband owned a successful radiology practice and imaging services. His trial expert, a certified business appraiser, valued the businesses at \$1.5 million, including an assessment of goodwill at \$500,000. The expert used an excess earnings method to arrive at the goodwill value, which the trial court adopted in its determinations regarding property distributions and maintenance.

In particular, the expert testified that because goodwill was based on the income stream from the doctor's businesses, and because it was included in the property distribution, it should not be counted again in any maintenance determinations. Doing so would be "double-dipping," he explained. To use his analogy, this would be tantamount to the court requiring the physician to "buy" his practice (from the non-owning spouse) based on the income stream it generates, and then using that same income stream as the basis for determining maintenance to the non-owning spouse.

The husband's attorney cited the expert's analysis in his closing argument, urging the trial court to base maintenance on the "reasonable compensation" of \$368,000 per year (gross). Although projections forecasted the husband as earning \$430,000 in wages and \$510,000 in income from his businesses during the year of the divorce, there was also testimony that he was going to cut back his workload due to health concerns. After considering all the evidence, the trial court awarded the wife two years of maintenance at \$8,000 per month and four years at \$6,000 per month.

Wife wanted \$15,000 per month

In her appeal, the wife contested the award. She claimed \$15,000 in monthly expenses—and that the \$8,000 maintenance amounted to only 15% of the doctor's projected monthly income of \$54,000. But on review of the trial record, the appeals court confirmed that the husband's estimated net income would likely decline because of his health. Further, the projections included business income that the trial court already accounted for in its property distribution. "To consider that income stream twice would, according to [the doctor's] expert, amount to double dipping." The trial court was entitled to rely on that testimony and to base maintenance on the doctor's reasonable replacement compensation of \$20,800 per month.

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Expert Testimony

Business Valuations

Litigation Support

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