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The Finger Approach

We are sure that our readers have a solid overview understanding of the three approaches to valuation - cost, income and market. However, there is kind of a fourth approach, which we refer to in the title as the finger approach - or more commonly referred to as the Rule of Thumb (ROT). Actually, the ROT approach tends to be a derivative of the market approach, and sometimes mixes in elements of the income approach. However, the major point to keep in mind is that the ROT is not a good approach for valuation, and probably should never stand on its own. Any kind of ROT approach, any kind of use of a ROT, must be done very cautiously, and with multiples of the proverbial grain of sand. It would be, stated as an understatement, highly unusual for a ROT to be used as the exclusive measure of value, and not much better if it were to be used as the main approach to value. Rather, a ROT is more appropriate as a kind of rough sanity test, as little more than a sense of what one (or sometimes several) stream of thought believes the so-called average company in that field is worth.

Note a very important word in the previous sentence - average. A ROT typically gives some form of a multiple (for instance one time sales, five times net income, $10 for every hour of service, etc.) to measure value, and sometimes also gives a range rather than a specific number - i.e. between 4 and 6 times net. Assuming that these ROT are more than one person's guestimate of what the market will bear, ROT has been developed typically based on historical situations involving, at least in theory, actual transactions. The number, or the range, is for determining a normal or average situation. It is questionable whether you would really know, as to the subject company being valued, if that company is about average, considerably better or considerably worse. To know that, you would have to know what is average for the industry - and usually that information is not available. ROT provides no better than a rough sense of what a so-called average company might be worth - and you do not know if your company is average, or how much better or worse than average.

When a substantial volume of transactions exist, it is possible that what might otherwise have been simply a ROT becomes more meaningful, in the form of a transactional database. By way of illustration, there is a crude ROT for accounting practices (subject to many weaknesses) that they are worth between 75% and 150% of (between 3/4 and 1 1/2 times) annual gross revenues. The merit of this approach is

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Calendar

Recent and Upcoming Speeches Include:

September 2004
29 CPA Club of New Jersey - Business Valuation (West Orange)

October 2004
27 ICLE – Divorce Taxation (Mt. Laurel)

December 2004
9 CPA Club of New Jersey - Business Valuation (Saddlebrook)

January 2005
8 - ICLE - Divorce Taxation (New Attorneys Skills Set) (New Brunswick)
13 - Florida Institute CPAs - Forensic Accounting - Advanced (Ft. Lauderdale)
28 - ICLE - Determination of Income (Iselin)

February 2005
11 - - Family Law Section - Looking Past the Date of Complaint (New Orleans)

April 2005
02 & 20 - ICLE - Unreported Income (Mt. Holly; Fairfield)

May 2005
07 - NJSCPA/Family Law Section - Cutting Edge Issues in Business Valuation (Iselin)

December 2005
09 - Florida Institute CPAs - Proving & Challenging Unreported Income (Ft. Lauderdale) (full day course)

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Divorce Taxation: The Basics - our new book, 40 pages explaining Divorce Taxation in layman's terms, is available - complimentary copies for the asking. Contact us if you haven't received your copy.

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that there have been a sufficient volume of transactions, of accounting firms actually changing hands, that ROT databases have been developed, and a reasonable range of the average sales transaction established. In that sense, what was perhaps a ROT has evolved into something more reliable. Even then it is still a range, and in this case that range for say a $1 million grossing accounting practice would put the value between $750,000 and $1.5 million - a rather substantial spread. Further, you still need to know where in the continuum of superior to average to inferior the subject firm is positioned. Thus, even where a ROT has evolved because of the volume of transactions to a more reliable type market approach, many questions remain. We most strongly caution our readers to look askance where a ROT forms the foundation for valuation, and to take a most jaundiced eye to a valuation calculation that relies to any significant degree on a ROT.

The following is a real life example of the dangers of a ROT, and how we succeeded in countering a report which relied upon a ROT. We were involved in a valuation involving a pool service business located in New Jersey. The other expert relied very heavily on a ROT, derived from a well-known source/book which provided these types of benchmarks. There was no question but that the subject business fit into the category being used, and there was no question but that the other expert read/interpreted the ROT numbers correctly and applied them correctly - within the limits of what a ROT truly entails. Thus, anyone looking at the same numbers, and using a ROT, would come up with the same conclusion. Of course, that is only valid if in fact the ROT is valid. We were asked to review that expert's report and see if it had any weaknesses.

We were able to satisfy ourselves that, as far as it could be relied upon, the other expert correctly applied the ROT from the source material. However, the conclusion of value struck us as illogical under the circumstances, and we felt that the ROT simply did not appear to be what we would have expected. What we did was to contact the publisher of the text in which the subject ROT (along with many other ROTs) was printed. We asked the publisher to put us in touch with or provide us with the names of the various sources (usually these are business brokers) who supplied the information that enabled the publisher to consider that to be a useful ROT for that type of business (pool service). The publisher was most cooperative - and two critical items became immediately apparent. First, it was not several sources that provided this ROT - it was just one. Thus, the so-called ROT had only one allegedly authoritative source. That potentially is a serious shortcoming - just how authoritative, how involved in that field, is this one source, how many transactions constituted the base for making that ROT. The second critical aspect revealed to us through the publisher was that this one source happened to be located in Arizona. This now becomes far more than merely a geographical issue - Arizona has year-round outdoor swimming. Most of us would instinctively recognize that New Jersey (even if we were to go to south New Jersey) does not lend itself to year-round outdoor swimming. Our season is more like three months. Therefore, the use of a ROT, even if it were a valid one with multiple sources, when that ROT relies upon a climate that provides for year-round swimming as contrasted with New Jersey's, clearly cannot be considered relevant to a New Jersey business. Thus, the ROT used was… ROT-ten.

Calendar

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Ongoing

The BARSON GROUP CLE Series

- October 2, 2004
- October 5, 2004
- October 6, 2004
- November 1, 2004
- November 2, 2004
- November 8, 2004
- November 17, 2004

Recent and Upcoming Media Situations:

- ***Book - Second edition of Investigative Accounting in Divorce*** by Kal Barson, published by John Wiley and Sons
- ***Book - Divorce Taxation: The Basics*** - by the Staff of The BARSON GROUP
- ***Chapter - Divorce Taxation - NJ Family Law*** by Lexislaw (Scheduled for April 2005)
- ***Article - Value to the Holder - Valuation's Nadir?*** - American Journal of Family Law (Summer 2004)
- ***Article - The Elements of a Business Valuation Report*** by Marshall A. Morris - American Journal of Family Law (Fall 2004)
- ***Article - The CPA's Role in Estimating Business Damages*** by Marshall A. Morris - Middlesex County Bar Newsletter (January 2005)
- ***Article - Divorce Taxation*** - New Jersey Lawyer (January 24, 2005)
- ***Article - Forensic Accounting - A Force for Good*** - to be in New Jersey Family Lawyer (late 2005)

A ROT tries to make a "one-size fits all" approach toward business valuation. It cannot - there are many variances from one business to another, and indeed every business is different. While there may be a merit to looking at a ROT, and perhaps benchmarking against the specific company at hand, it would truly be a rare situation where a ROT could fairly and properly be used for more than a crude sense of whether the value conclusion derived from other more reliable type sources and approaches is consistent with what appears to be a rough sense of value for that type of business. Even then, as indicated, there are issues as to how the subject entity compares to the so-called average (which you will almost never really know), how many sources make up the ROT, how reliable are those sources, and are there significant shortcomings in comparing the ROT to the subject company (i.e. geography).

To Value or Not to Value

Don't take our word for it, you need a valuation. Now that we have caught your attention, let us address why in the world anybody would want to have a business, or an interest in a business, valued. Actually, there are many good reasons, and only some of them are litigation oriented. There is a whole panoply of reasons and purposes for a business valuation. These include:

- ***Divorce*** - if a business is an asset in a marital estate subject to a divorce action, that business needs to be valued. Without a value, how would you know what figure to use in balancing the litigants financial interests?
- ***Shareholder suit (or partner dissolution)*** - essentially, this is a commercial divorce. The reasons are the same - someone needs to buy out someone, and there is likely no way to do it other than by having the business valued.
- ***Electing S corporation status*** - if a business is already in existence in the form of a C corporation, and elects to convert to S corporation status, it needs to be valued, for determination of possible built-in gains. This is potentially very significant, and should not be downplayed.
- ***Gifting*** - usually driven for tax purposes, but possible simply to try to balance family/sibling treatment. An often used vehicle for transferring interests in a business to the next generation is the gifting of an interest. That requires a valuation, if for no other reason, than the proper disclosure of same on a gift tax return.
- ***Estate returns*** - tied into the preceding, if someone dies owning an interest in a business, that interest needs to be valued so the value can be expressed on Form 706, the Estate tax return. Depending on the magnitude of the value at hand, this can be a very significant item, and a very expensive mistake if not done correctly.
- ***Shareholder or buy-sell agreements*** - people in business together will often enter into an agreement between them, so as to provide for a buy-out of one or more interests, protection from family members if one of the business owners were to die, provide a retirement vehicle, etc. While sometimes the approach to value in these agreements is done either through life insurance (which is hardly a valuation approach) or some form of simplistic formula (which is fraught with problems, particularly after a few years), some actually go through the process of a real valuation - which is strongly recommended for everyone's mutual interests.
- ***Buy-in or bringing in of a partner, or the buying out of a partner*** - particularly if there is no partner or buy/sell agreement, it may be important to establish the appropriate value when an owner/shareholder of a business is looking to be bought out. Also when someone is looking to buy in and it is going to be more formal than perhaps a sweat equity type of consideration.
- ***Life insurance*** - this may be tied to a buy-sell agreement; the need to value a business to justify a large amount of life insurance.
- ***Breach of contract*** - there very well may be damage issues, and a question as to value before and after an alleged breach or wrongdoing. What was the value of that business at one or more points in time?
- ***Fraudulent conveyance*** - another aspect of a damages claim, it is possible that an interest in a business, perhaps even the entire business, was sold - conveyed - and the concern is that it was for less than adequate value.
- ***Mergers and acquisitions*** - similar in many ways to dealing with a buy-in or buy-out, but in this circumstance it might, for instance, involve the merger of two companies, and the need to determine the differential in value between them so as to provide for a disproportionate ownership of the merged entity, or to provide for some financial leveling, one party contributing additional capital or paying the other party directly for a differential in values.
- ***ESOPs*** - these are popular financial and tax vehicles, and require annual valuations. There is a need for an annual valuation so as to protect everyone's interests - generally thought of as the interests of the various minority shareholders, but at the same time it is also needed to protect what is often the founding owners, or the majority shareholders who can be at great risk without a proper valuation.
- ***Purchase price allocation*** - when there is an asset sale of a business, which is a very common situation (as contrasted with a stock sale), the pieces being sold/bought need to be valued. The largest piece might very well be the goodwill - which requires the valuation of the business for allocation purposes. This is often a very tax important matter.

The above provides you with an understanding as to the wide range of areas where business valuations play an important role. Frankly, the cost of not doing a valuation - or, potentially far worse, the cost of doing it improperly - is usually far more costly than doing a valuation properly in the first place.

FOCUS ON FUN

Accountants & Humor – a Sociological Fable

1. An accountant could not deduct the cost of exercise equipment that he purchased to help maintain his stamina for long hours in the office. Interestingly, negligence penalties were not imposed because the language of the statute was broad enough to encompass the deduction.

2. An ice cream vendor who preached the gospel from his ice cream truck was liable for self-employment tax. The IRS didn't take his approach with the intended good humor. He was not exempt as a member of any recognized religious sect that opposes accepting the benefits of insurance, nor was he eligible for the exemption allowed certain ordained ministers. You might say that the IRS gave him the cold shoulder. The failure to file penalty was also imposed because his return was untimely, and he offered no explanation for the delay. His excuses just kind of melted away.

3. An accountant and treasurer of a university who argued that he had acted as a mere conduit for the channeling of funds to third parties was taxable on the amounts that he had misappropriated from his employer and used for the companionship of women. Surprisingly, the Court felt that an accountant should be able to secure the companionship of women without embezzling funds to do so. He clearly had unrestricted control over those funds (at least he did until he gave them to those women), and the Court further held that the mental illness that the taxpayer might have had (I guess it wasn't clear) did not interfere with his ability to recognize taxable income.

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