



INSIGHTS ON

# VALUATION

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## Edward Giardina

MSA CPA/ABV CVA

In professional practice since 1983, providing income and estate tax planning, tax preparation, financial statement reporting and business valuation services to business and individuals.

Member of the American Institute of Certified Public Accountants

Massachusetts Society of Certified Public Accountants

National Association of Certified Valuation Analysts

NACVA - Massachusetts Chapter

Braver Valuation Services, LLC.  
2 Liberty Square  
Boston, MA 02109  
(617) 235-5000  
egiardina@thebravergroup.com

## Fair Value Litigation

The Financial Accounting Standards Board issued a new definition of “Fair Value” for purposes of financial reporting. The new definition and application of the definition are now components of Generally Accepted Accounting Principles (GAAP). The statement containing the new definition is known as FAS 157. It is part of a series of pronouncements that are slowly moving the accounting profession towards reporting assets and liabilities at “fair value” rather than historic cost basis. This is consistent with international standards for reporting.

Rather than discuss the definition and the technicalities of the application of FAS 157, this article will summarize some of the expected consequences of this pronouncement and others leading to fair value accounting.

The first consequence is that audit firms and internal accounting management must have the skills and education necessary to prepare financial statements as well as determine fair value of certain assets and liabilities. Historic cost basis has been relatively easy to determine and verify. Fair value requires subjective judgments and assumptions. These types of judgment calls involve quantification of adjustments to asset values as well as the timing of the adjustments.

In the public company market, significant fluctuations in balance sheet valuations are expected to result in more stock price volatility. Stock prices are reflective of earnings. Accounting changes that affect earnings will also, therefore, affect market valuations. Additional volatility results in higher risk and, over the long run, suppressed stock values.

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For public and private companies the cost of preparing GAAP financial statements has increased significantly as specialized valuation knowledge is needed to comply with the requirements of mandatory disclosures. Additionally, the new requirements to write investments up and down to fair value will affect loan covenants as ratios will fluctuate with some degree of volatility.

The obvious result of these changes is the prospect of much more accounting litigation. Trial attorneys have already begun to warn that they anticipate filing litigation to challenge:

- Qualifications and experience of accountants and auditors
- Legitimacy of accounting entries that result in stock price fluctuations
- Judgment exercised by those preparing financial statements
- Methodology used to determine fair value
- Comparability of financial statement presentation

Financial statement preparers and the users of those financial statements will be increasingly reliant on financial experts with the expertise of valuing businesses, intangible assets, and derivative instruments. Lawyers who already deal with legal matters involving complex financial matters will see the issues increase in complexity and, consequently, their reliance on valuation professionals increase. A Certified Valuation Analyst/ Accredited Valuation Analyst is uniquely qualified to assist in the implementation of Fair Value Accounting. They are CPAs or experienced financial professionals with specialized training and education in the valuation of intangible assets.

## Topping Off the Discount Rate— Specific Company Risk

The present value of an investment in an established firm can be determined by applying a discount rate to its expected future cash flows. In a single period earnings capitalization, the divisor is the discount rate less the expected long-term growth rate of the cash flows. The discount rate is, therefore, a key determinant of value. The discount rate for an investment represents the level of risk of that investment: the higher the risk, the higher the discount rate, giving a lower current value, and a greater potential reward for making the investment.

The discount rate for any particular investment represents the level of risk of that investment, compared

investment by comparison to the publicly traded companies that are most similar in size to the subject company. At this point in the process the question becomes, “does the discount rate so far built up appropriately match the risk of the subject investment?” Asked another way, “Is the level of risk of the subject company equal to the level of risk of the publicly traded companies so far used in the build up?”

Additional adjustments to the discount rate are usually necessary. First, if the subject company is much smaller than the smallest publicly traded group for which we have data, an increment to the discount rate is made for its size.



to the next available opportunity. The valuation professional has hard data from the public stock markets showing the average discount rates for thousands of companies, sorted by size, even very small companies. Using public data, we can “build up” a discount rate for a particular

Finally, the valuation professional has to make a judgment about the strengths, weaknesses, opportunities, and threats of the subject company, compared to the average company of its size. This is called the specific company risk premium (SCRIP).

SCRP is almost always an increase, but on rare occasion can be a decrease. In making this adjustment, one must keep in mind that even the size adjusted average from the publicly traded company data has an inherent assumption that the investor is making a diversified investment. The data presents the results of both winners and losers. There is safety in numbers, but this comfort is not present when investing in a single business entity. For any single investment, one must judge how much the discount rate should be increased to make the potential for gain worth the risk of the particular investment.

There are no widely accepted methods as yet for quantifying the SCR. The valuator must judge how much is warranted on a case-by-case basis, based on his or her assessment of the strengths, weaknesses, opportunities, and threats facing the company. Most valuers would site a range of -2% to 8%. If you are further interested in learning about the SCR, please feel free to call us.



## The Role of a Non-Compete Agreement in a Valuation for Divorce Purposes

Valuation analysts doing divorce work often find themselves following Alice down the rabbit hole into Wonderland, where the Red Queen has her own special rules concerning valuation that are found nowhere else. One of those areas where special rules are enforced only in the Wonderland of the divorce arena is that concerning non-compete agreements. In certain jurisdictions (check with a divorce attorney), the assumption of a non-compete agreement that underlies a conclusion of value may trigger argument over whether the value attributable to the non-compete represents personal goodwill, and is therefore excludable from the marital estate. The idea behind this exclusion is that since the non-compete agreement restricts the post-marital activity of the

spouse who would sign it, its value is his personal, non-marital asset. This idea should not apply in most situations for three basic reasons.

First, a non-compete agreement is essential to maximizing the selling price that the seller obtains, as no willing buyer would ever pay for a business without assurances that the seller would not compete with him by soliciting either his customers or employees. Therefore, a willing seller, in order to obtain the highest price possible for his business, will gladly sign a non-compete agreement. By doing so, he agrees to transfer to the buyer not only the business' enterprise goodwill, but his personal goodwill as well, "putting paid" to the idea that personal goodwill is not transferable, and therefore non-marital. No business has ever

been sold that had a carve-out for certain customers, clients, or patients who insisted on staying with the seller, as this would be impracticable since he would be unable to service them without the business he had just sold.

Second, a non-compete agreement protects and is associated with not only personal goodwill, but enterprise goodwill as well. Without a non-compete agreement, the seller would be allowed to make suicidal solicitation calls on all his former customers, clients, or patients, not just those who had some kind of personal bond with him. These solicitation calls, if effective, would result in the destruction of not only the seller's personal goodwill, but also the business' enterprise goodwill, both of which he just sold to the buyer. Therefore, the non-compete agreement

protects all the goodwill associated with the business, not just the seller's personal goodwill.

Third, the restriction on the selling spouse is one he gladly entered into to maximize his economic return, and therefore should not be seen as restricting the seller's right to earn a living in some essential way. This type of restriction is not for a lifetime nor does it cover the continental United States. It is typically for no more than three to five years and covers a limited geographic area, usually up to a 25 mile radius of the city or town wherein the business is located. It is a minimal

imposition on the seller and in no fundamental way restricts his right to earn a living by practicing his chosen profession or craft.

For these three reasons, divorce courts should not be carving out as a non-marital asset the value associated with a non-compete agreement, as the agreement both maximizes the seller's economic self interest and protects the business' enterprise goodwill. If you find yourself in the Wonderland of divorce court, make sure your valuation analyst is familiar with the local rules.

*If you have any questions,  
please contact our office . . .*



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**Edward Giardina**  
2 Liberty Square  
Boston, MA 02109  
(617) 720-5520  
eggiardina@thebravergroup.com