

Step 2. Estimate Associated Costs (Saved Expenses)

Variable costs during other periods are usually the best evidence of the saved or incremental costs to the firm of not receiving the “lost” revenues claimed in step 1. Regression models can be useful here to determine how certain types of costs vary with levels of service or production. Those costs that vary with production or sales should be included in determining lost profits, while those that do not vary with production (i.e., fixed, or continuing, costs) should be excluded in this computation. An example of a variable, or saved, cost is the accounting category called “cost of goods sold.” Some or the entire amount of selling expense may be variable, and therefore saved, as well. Because accounting definitions do not uniquely identify which costs are variable and which are not, the CVA/AVA must often use considerable judgment and statistical expertise to make the separation.

Step 3. Examine Continuing Expenses Patterns for Extra Expense

It is sometimes the case that certain typical overhead costs may increase during or after the business interruption period as a result of the injury. Detecting these increased costs is easier when management of the business is consulted concerning cost trends. For example, management may incur overtime expense to make up lost production. Examining any month-to-month changes in overhead can also identify these costs.

Step 4. Compute Lost Profits

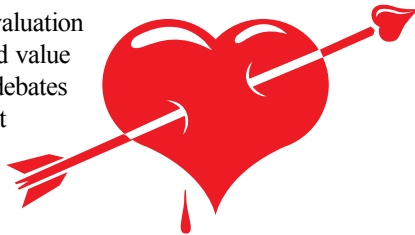
Lost profits are the “but for” additional revenues that would have been attained, less associated saved expenses related to those lost revenues, plus any additional overhead costs incurred by the damaged party resulting from the interruption.

Conclusion

We have now seen that in computing lost profits, net profits are the appropriate measure of the loss; the definition of net profits that is used, however, may not correspond to the net profits figure that appears at the bottom of an income statement. It may be equal to or lower than the gross margin, but more often is higher than the net margin, as the injured party’s loss includes the net profit it would have earned plus those costs and expenses that continue during the period of interruption.

Valuing Professional Goodwill *In re Marriage of Ackerman*

An ongoing debate in the valuation community is how to identify and value professional goodwill. These debates stem from and lead to significant court cases where the issue is placed before a judge to decide. In January, 2007 a significant case was decided by the California Court of Appeals and the results of the case have attracted national attention. It has become known as “The Ackerman Decision.” (California Court of Appeal, 4 Civil G034582, G034259, 146 Cal.App.4th 191, 52 Cal.Rptr.3d 744) Contrary to previous court decisions in California, and other states, the courts did not question whether professional goodwill existed. By virtue of that alone, this was an important case establishing—or reaffirming—that professional goodwill is a factor in the valuation of professional practices.



Beyond that, the relevance of this case is the method the court used to value the goodwill. Boris (plastic surgeon) and Ann Ackerman were married in 1991. Before they were married a prenuptial agreement was signed placing a value on Boris’ medical practice of \$162,000. The agreement stated that any increase in value would be community property and that, in the event of divorce, a forensic accountant would be hired to place a value on the business. The couple separated in 2001. Among the issues litigated as a result of the divorce was the valuation of the practice.

When valuing a professional practice there are two key elements. The first is profit as in any other business. The second is goodwill. This factor is unique in family court since there are parallel calculations being done: income for the purpose of establishing support and income for the purpose of establishing the value of an asset. The greatest concern is that the same income is not used for both purposes—double dipping. In Ackerman, the court adopted the capitalization of excess earnings method. In simple terms, this method requires that the earnings from a business are capitalized only to the extent that the earnings exceed the earning power of the professional. For example, if the medical practice for a doctor generates \$350,000 annual income and the earning power of the doctor in another place of employment is \$275,000, then only \$75,000 is capitalized to determine the value of a business.

This scenario, then, makes the analysis of earning power and/or reasonable compensation a central issue. The wife’s expert opined that reasonable compensation was from \$291,000 to \$355,000. The husband’s expert opined that reasonable compensation was \$551,000. In effect, the wife’s expert was saying that more of the income was due to the goodwill value of the practice and the husband’s expert was saying that the income was due more to the personal efforts of the husband.

The court decided that the reasonable compensation amount was \$544,000. The final result was in the husband’s favor—there was minimal value to the practice outside the personal goodwill of Mr. Ackerman.

Several other issues were decided by the court in the Ackerman case but from a valuation standpoint several points were reinforced as it relates to valuation of professional practices:

- One of the experts based reasonable compensation conclusions on “regional” studies. The court was astute enough to identify that a survey of the western states will produce a low result when analyzing the income of a doctor in a high-income wealthy area such as where Dr. Ackerman practiced.
- One of the experts based his reasonable compensation opinion on, among other sources, personal interviews with plastic surgeons in the immediate geographical area. While this seems to be a reasonable approach, the court disregarded it.
- Once again a court has established that value is based on historical earnings not projected earnings. While this is contrary to how business is valued in virtually every other venue, it seems to be the law of the land in family courts around the country.
- The value of the professional goodwill continues to be linked to the earning power (reasonable compensation) of the individual doctor. The remaining income generated by the business is then relevant to determine the goodwill value of the business.
- The value of a well written prenuptial agreement is highlighted once again. Establishing, in advance, the method and procedure of valuation in the pre-nuptial could have saved both sides a lot of legal fees.

Involving valuation professionals “up-front” in prenuptial or buy-sell agreements is a smart way to reduce conflict, uncertainty, and expense at the “back end” when everyone is already unhappy.

Start-Up Company Stock and Options

New ventures go through stages as they progress toward an IPO or acquisition. There is the start up phase, the angel stage, the venture capital stage, the mezzanine or bridge stage, and finally, the exit event. The exit can take several forms, including an IPO or an acquisition by a publicly held company.

During these stages of development, companies typically issue common stock and stock options to employees. When stock is issued, taxation is determined under Section 83 of the Internal Revenue Code. The general rule is that the value of the stock is ordinary income when all restrictions on the employee's ability to receive or resell the stock have lapsed. This could be years after the grant of the stock award, if for example, the employee must work for the company for a few years before he is entitled to keep the stock, or resell it. The stock could be near to worthless now, but worth a significant amount later if the company succeeds.

Legal counsel usually recommends that the employee recipient file what's known as an "83(b) election." The election causes the employee to be taxed on the value of the stock when received, instead of later when the restrictions lapse. The value of the stock must be determined in accordance with the rules of that section. These rules generally require that any restrictions on the receipt or resale of the stock be ignored, except a restriction which by its terms will never lapse. Companies are wise to document the value of the stock for Section 83 purposes with a written valuation report.

Stock options (excluding statutory plan options and ESPP shares) are taxed in accordance with a different set of rules. These rules are the recently enacted "deferred compensation" rules of Section 409A. The rules require the inclusion in ordinary income of the value of the stock, even before exercise, as soon as all risks of forfeiture lapse. Typically, a ten-year option becomes exercisable after two years of continued employment, but the employee waits as long as possible after that before actually exercising. Nevertheless, Section 409A would tax the employee on the value of the stock at the two year mark when his right to exercise and retain the stock vests. And furthermore, the continuing increase in value of the stock will also be taxed annually. And furthermore to that, there is a 20% tax penalty imposed.

There is an exception to this rule. If the exercise price of the option is at or above the fair market value of the stock at the date of grant, then the



stock option is exempt from the Section 409A rules. Thus, for start up companies as well as any closely held company issuing stock options to its employees, it is essential to obtain a written valuation of the stock subject to the option. Again, the value is determined without regard to any restrictions that will lapse.

The regulations provide a few avenues by which a closely held company can determine the value of its common stock. Each avenue requires the skill and knowledge of a valuation professional. The preferred course is to obtain a written valuation report from a professional who takes into account the tangible and intangible assets of the company, its projected cash flows, similar publicly traded companies, lack of control and lack of marketability, and all other factors affecting the value of the stock. The valuation methodologies used for compliance with generally accepted accounting principals are most frequently used for Section 409A compliance. Valuations as of a specific date are generally valid for Section 409A purposes for up to one year, or until the company experiences a significant growth event, such as the achievement of its first sale, or a new round of financing.

Please contact us to discuss the valuation of your company's common stock before implementing a stock or stock option award plan. The consequences of not addressing value are too ominous to ignore.

Fair Market Value



When a valuation expert prepares a valuation of a business, the standard of value is based upon the purpose of the valuation. The most widely used standard of value related to business valuations is Fair Market Value. Fair Market Value, is

the standard of value utilized by the Internal Revenue Service and Courts in valuations for federal income and estate tax purposes. It is also the legal standard of value in many other valuation situations.

The technical standard for determining Fair Market Value has remained unchanged for more than 35 years. The Internal Revenue Service definition is:

"Fair market value is the price that property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts." (I.R.S. Revenue Ruling 59-60).

The best way to understand the meaning of fair market value is to break down the definition into its five major components:

- 1) price,
- 2) property,
- 3) willing buyer and willing seller,
- 4) no compulsion to buy or to sell, and
- 5) having reasonable knowledge of relevant facts.

The first component, "price," in various regulations and cases, is defined as "adequate and full consideration in money and money's worth" for the subject interest being valued. This is the market price. How this "price" is determined, for valuation purposes, depends on certain characteristics including if it is publicly traded, if there are any prior transactions which indicate a "price," or if there are markets that determine the price.

The second component, "property," is the entity or interest that is to be valued.

The third component, the "willing buyer and willing seller" are hypothetical persons, dealing at arm's length, and dedicated to achieving maximum economic advantage. In other words, if a willing buyer would buy at that price, would a willing seller really sell at that price?

The fourth component, "no compulsion to buy or to sell," implies that prices that the property would bring in a sale that was forced upon the seller or the buyer would not indicate Fair Market Value. Financial pressures may cause a seller to act more hastily and accept a price lower than Fair Market Value, or a buyer forced to purchase may pay a price higher than Fair Market Value.

The fifth component, "having reasonable knowledge of relevant facts," assumes a value is

determined based on facts that are reasonably available at the valuation date. These facts include marketplace data as well as company information and general economic information.

A standard of value addresses the questions “value to whom?” and “under what circumstances?” In certain instances, other standards of value are appropriate, whether determined by the purpose of the valuation, statute or case law. Other standards of value include:

- Fair Value—a legally created standard of value that applies in certain transactions and situations including cases of stockholders’ dissent and oppression matters, corporate dissolution, and valuations of a company going private. The definition of Fair Value refers to an equitable, just and reasonable value for property, without reference to a market transaction. This differs from Fair Market Value by assuming the property holder has no interest in entering the market. Fair value is also the standard used for financial reporting purposes.
- Investment value—“the specific value of an investment to a particular investor or class of investors based on individual investment requirements,” rather than the unspecific buyer or seller assumed in the definition of Fair Market Value.
- Intrinsic or fundamental value—an analytical judgment of value perceived to be a “true” or “real” value by an investor based on the investor’s perception of the characteristics of the investment.
- Synergistic Value—the highest value that would be paid for control shares, generally if the purchase was made for a specific purpose of the buyer.

While there are many standards of value, including those discussed above, Fair Market Value remains the most well known and widely used standard of value related to business valuations. A Certified Valuation Analyst is trained in business valuation and is qualified to assist you in performing valuations for these different standards of value.



If you have questions, please contact our office.

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