Valuing Small Businesses in Divorce Cases

The number of self-employed Americans is increasing. The divorce rate is high. I would not venture to speculate whether all those self-employed couples are the ones getting divorced, but I have observed that the convergence of these two trends means that more small businesses require valuations in family court.

The jurisdiction in which a case is being tried usually sets the standard of value to be used in the case, although there are often variations within jurisdictions as to the application of a standard. "Value" is a relative term that must be explicitly defined. The two most common standards of value used in divorce cases are Fair Market Value and Fair (intrinsic) Value.

Fair Market Value is defined by the Internal Revenue Service in Revenue Ruling 59-60 as *the amount at which the property would change hands between a willing buyer and a willing seller when the former is not under a compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.*

Fair Value is statutorily or judicially defined, and usually considers all elements of a business's value (benefit streams, assets, etc.) except for its investment value in the marketplace. Unlike Fair Market Value, Fair Value does not assume that there is a willing buyer and seller, nor that all parties have reasonable knowledge. The concept of "fairness" replaces the assumption of an arm's-length transaction that is used in Fair Market Value.

Professional practices

Medical practices and professional service firms are often valued using intrinsic value, as they often have no market value without the current owner. The value of a business for divorce purposes can be very different from its value in the marketplace. A buyer's opinion of value is usually based on the future benefits stream of a business, while post-divorce earnings generally are not divisible upon divorce. Practice goodwill is often treated as a distributable marital asset, while personal goodwill is not.

Small business difficulties

Even if a clear standard of value is set, each divorce valuation may generate a unique set of circumstances for the valuator. Small business owners often seek to minimize the profits and value of the business each accounting period, as part of their on-going tax

minimization strategy. Our income tax laws favor the self-employed more than almost any other group of taxpayers, and American ingenuity continually develops new ways to avoid taxes as a national pastime. Small businesses are notoriously weak in accounting and administrative skills, and the desired information -- such as cash sales, non-recurring expenses, non-operating assets, inventory quantities, and owner's compensation -- often is difficult to extract even when the owner wants complete transparency. Mix in the usually strong emotions that a divorce case generates, and the motivations not to cooperate on the part of the business owner, and the situation becomes difficult.

The tendencies of small business owners to either undermine the value of their business (usually to minimize income tax), to push towards maximizing the value of their business (generally if they are preparing it for sale), or to consistently make the same types of accounting errors tend to place a larger than usual emphasis on normalization adjustments. Normalization adjustments are used to make the business being valued more favorably comparable to other companies of the same size and circumstances and in the same industry.

Here are some examples of common normalization adjustments made to businesses being valued in a divorce setting:

- Unrecorded revenue – businesses that take cash sales may understate revenues.
- Understated inventory – companies with poor accounting systems or a desire to minimize income and property taxes may understate inventory values or quantities.
- Overstated expenses – small businesses often expense tools or equipment that should be capitalized, commingle personal and business expenses, or incur other types of expenses that are not ordinarily incurred in that type of business and are not necessary for the operation of the business. Expenses that have been accelerated should also be adjusted.
- Excess assets – small businesses often hold more assets than they need, usually cash or real estate, for future expansion, investment, or other personal financial planning purposes. This can also include non-operating assets such as boats or vacation homes.
- Owner's compensation – some people pay themselves much more than is justified, while others pay themselves far below their personal market value.
- Non-recurring items – such as litigation expenses or windfall gains, should not be factored into the value of the business.
- Related party transactions – these should be adjusted to market rates of interest or cost of capital.
- Unrecorded liabilities – businesses with poor accounting systems often fail to capture all of their accounts payable, accrued wages and taxes, etc.
- Overvalued assets – fixed assets and inventory past its prime should be written down to reflect its market value. Accounts receivable should be evaluated for collectability.

Determining what normalization adjustments are appropriate requires a detailed review of the accounting and financial records that is often similar to a forensic review. Curiosity, business and financial experience, and an understanding of the individual business are significant factors in being able to evaluate the normalization adjustments that could be significant determinants of value in a small business divorce case.

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