

A GOING CONCERN: HOW LEGAL AND FINANCIAL PROFESSIONALS WILL BE DEALING WITH BUSINESS VALUATIONS GOING FORWARD

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Brisbane Consulting Group, LLC

Louis J. Cercone, Jr., CPA/ABV/CFF, ASA

Douglas P. Sosnowski, CPA/ABV/CFF, ASA

William P. Allen, CPA/ABV, CFE

Klein Liebman & Gresen, LLC

Glenn S. Liebman, CPA/ABV

David L. Gresen, CPA/ABV/CFF, CFE

Schlissel Ostrow Karabatos, PLLC

Joseph A. DeMarco, ESQ

PRESENTATION OVERVIEW

1. COVID-19 Timeline of Critical Events
2. Disclosure of Subsequent Events – AICPA Guidance
3. Determination of the Valuation Date – Relevant Case Law
4. Economic Outlook
5. COVID-19 Impact on Financial Markets
6. Valuation Issues & Considerations
7. Three Approaches To Value
 1. Asset Approach
 2. Market Approach
 3. Income Approach

TIMELINE OF EVENTS

11/17/2019: Earliest confirmed case of COVID-19 - not recognized as a new virus at the time.

12/31/2019: China contacts World Health Organization (WHO) to inform that cases of pneumonia of unknown cause were detected in Wuhan.

1/8/2020: Scientists in China announce the discovery of a new coronavirus.

1/21/2020: The CDC confirms the first case of 2019 Novel Coronavirus in the U.S., Washington.

1/30/2020: The WHO director-general declares the coronavirus outbreak a “public health emergency of international concern.”

2/7/2020: The Federal Reserve Bank warns that the virus is a potential threat to the growth of the U.S. economy.

2/24/2020: S&P 500 falls 3.4%, worst single day in two years. Death toll surpasses 2,600. US cases reach 53. Start of the massive decline in US stock markets. President Trump tweets: “The Coronavirus is very much under control in the USA.” and “Stock Market starting to look very good to me!”

TIMELINE OF EVENTS

CONTINUED

2/29/2020: Washington state governor declares state of emergency after a man dies of COVID-19, the first such reported death in the US.

3/11/2020: NBA suspends all games starting Thursday after a player for the Utah Jazz tests positive for COVID-19. WHO declares outbreak a pandemic after cases outside China increased thirteenfold.

3/12/2020: Stock markets worldwide suffer greatest single-day fall since 1987.

3/13/2020: Donald Trump declares a national state of emergency, allocating about \$50 billion of federal government money for relief efforts.

3/20/2020: NY Gov. Andrew Cuomo issues statewide order that all nonessential workers must stay at home.

SUBSEQUENT EVENTS

For Valuations as of December 31, 2019 (OR BEFORE)

AICPA's Statement on Standards for Valuation Services (SSVS No.1 Paragraph 43)

- ▶ The valuation conclusion is applicable to a specific date
- ▶ Analyst considers only those circumstances existing as of the valuation date-
"known or knowable"
- ▶ An event that could affect value after the valuation date is known as a
"subsequent event".
- ▶ In certain situations where a valuation **is meaningful beyond the valuation date;**
the events may be of such nature as to warrant disclosure.
- ▶ **However, the analysis and conclusion therein is not updated to reflect the
change in circumstances or for events that occurred subsequent to the valuation
date.**

SUBSEQUENT EVENTS

CONTINUED

AICPA Valuation Services Section Subsequent Event Toolkit

- ▶ Released on April 15, 2020
- ▶ Focus on paragraph 43 of VS section 100 – Subsequent Events
- ▶ Provides Frequently Asked Question (FAQ) and sample disclosures

KEYS TO A PROPER DISCLOSURE

- ▶ Disclosure is an option; not a requirement
- ▶ Should clearly state:
 - ▶ that the subsequent event is presented for informational purposes only and
 - ▶ does not affect the analyst's determination of value as of the valuation date.
- ▶ The disclosure should be in a section of the report that is separate from the analysis and value conclusion.

SUBSEQUENT EVENTS

CONTINUED

PURPOSE OF A DISCLOSURE

- ▶ Provide meaningful information to the intended user as of the valuation date
- ▶ Confirm to the intended user information that was not “known” or “knowable” as of the valuation date , or
- ▶ Identify circumstances that have changed between the valuation date and the date of issuance of the report
- ▶ Disclosure of such a change in condition may inform the intended user that the analyst’s determination of value **may no longer be relevant** as of the date of issuance of the valuation report

SUBSEQUENT EVENTS

CONTINUED

THE DISCLOSURE CANNOT

- ▶ Identify the impact of the subsequent on value

DEFINITION OF KNOWN OR KNOWABLE

- ▶ Consider only facts or circumstances existing at the valuation date or those facts that could have been reasonably known, foreseen, understood or comprehended
- ▶ **Known Example:** A sales agreement with a customer executed weeks after the valuation date could be “knowable” because negotiations would have occurred prior to the valuation date.
 - ▶ Consider in Valuation
- ▶ **Not Knowable Example:** A natural disaster that occurs just after the valuation date and causes major damages to business and facilities.
 - ▶ Cannot be considered in Valuation

SUBSEQUENT EVENTS

CONTINUED

For Valuations as of December 31, 2019 (OR BEFORE)

- ▶ Revenue Ruling 59-60 (Section 3, Paragraph .03)
 - ▶ *“Valuation of securities is, in essence, a prophesy as to the future and must be based on facts available at the required date of appraisal.”*
- ▶ When were the effects of the pandemic known or knowable (Refer to Timeline):

<u>Valuation Date</u>		<u>Date of Report</u>
10/31/2019	SUBSEQUENT EVENT DISCLOSURE	4/30/2020
12/31/2019	SUBSEQUENT EVENT DISCLOSURE	4/30/2020
1/31/2020	GREY AREA ON "KNOWABLE"	4/30/2020
2/28/2020	"KNOWABLE" HEATING UP	????
3/31/2020	IT'S GETTING HOT IN HERE	????

VALUATION DATES

DETERMINATION OF THE VALUATION DATE: NY DRL Section 236 B(4)(b)

- ▶ “As soon as practicable after a matrimonial action has been commenced, the Court shall set the date or dates the parties shall use for the valuation of each asset.”
- ▶ “The valuation date or dates may be anytime from the date of commencement of the action to the date of trial.”

CASE LAW

Wegman v. Wegman 123 A.D. 2d 220 (2d Dept. 1986)

- ▶ Date of commencement – July 1981 / Date of trial – March 1985
- ▶ S.J. Wegman Company began as some type of mail order business.
- ▶ In 1957 S.J. Wegman Corp formed a wholly-owned subsidiary called Advance Biofactures Corporation (ABC)
 - ▶ Profits from the mail order business were used by ABC to develop *Collagenase*, a product used to treat bedsores and skin ulcers.

VALUATION DATES

CONTINUED

Wegman v. Wegman 123 A.D. 2d 220 (2d Dept. 1986) Continued

- ▶ The product was not actively marketed until 1972 and by the time of trial, accounted for 95% of ABC's income.
 - ▶ It also became very successful and profitable.
- ▶ Trial Court Findings:
 - ▶ Wife Expert valued businesses at \$10 million as of 12/1/1984 and Husband's interest was worth \$6.5 million.
 - ▶ Wife's expert said value of business 6 months after DOC was \$7.2 million and husband's share was \$4.75 million.
 - ▶ Husband's expert was his accountant who applied a liquidation value as of DOC and testified there would not be significant change in value between DOC and DOT.

VALUATION DATES

CONTINUED

Wegman v. Wegman 123 A.D. 2d 220 (2d Dept. 1986) Continued

- ▶ Appellate Division Ruling on Valuation Date:
 - ▶ one of “the most perplexing and difficult problems created by the Equitable Distribution Law”
 - ▶ “There can be no strict rule mandating the use of a particular valuation date and that a trial court must have the discretion or select a date appropriate to the case before it in light of the particular circumstances presented.”
 - ▶ “Flexibility rather than rigidity is essential for the fair disposition of a given case”
 - ▶ “If an asset increases in value due to market forces or inflation, valuation as of the date of commencement of the action would result in a windfall to the titled spouse and injustice to the other. If the asset greatly decreased in value, as would be the case, for example, if a closely held corporation lost a major customer, a Court which values assets at the date of commencement of the action might make a distributive award that is beyond the owner spouse’s ability to pay.
 - ▶ Court used DOT valuation because of wife contribution’s during the marriage

VALUATION DATES

CONTINUED

Schacter v Schacter, 151 A.D.3d 422 (1st Dept. 2017)

- ▶ Valuation of plaintiff husband's law firm interest
 - ▶ DOC - October 2007 (value = \$5,032,000)
 - ▶ DOT - September 2012 (value - \$1,660,000)
- ▶ Trial Court used DOC value; 2nd Dept. reversed and remanded for determination of the wife's distributive share of the asset as of the DOT valuation.
- ▶ Appellate Court Decision: By using a DOC valuation date, "the trial court failed to factor sufficiently the roles that the 2007-2008 financial crisis and the defendant's conduct in generating negative publicity about plaintiff played in the decline in the value of the plaintiff's partnership interest by the time of trial".
- ▶ On remand, the Trial Court used the DOT valuation but increased the wife's share from 17% to 40%. Second Department later affirmed this award. See 176 A.D.3d 536 (2019).

VALUATION DATES

CONTINUED

Sagarin v. Sagarin, 251 A.D.2d 396 (2d Dept. 1998)

- ▶ Appellate Division held that the trial court did not improvidently exercise its discretion in valuing the husband's corporation as of the date of trial instead of the date of commencement.
- ▶ Adverse economic forces outside of the husband's control caused the value of the husband's corporation to decline.
- ▶ There was no evidence of misconduct or dissipation on the part of the husband.

Giallo-Uvino v. Uvino, 165 A.D.3d 894 (2d Dept. 2018)

- ▶ DOT valuation for Defendant's law practice.
- ▶ No proof that the Defendant, who was disbarred during the pendency of the action, intentionally lost his license to devalue his business.

VALUATION DATES

CONTINUED

Breese v. Breese, 256 A.D.2d 433 (2d. Dept. 1998)

- ▶ Husband moved to set valuation date of his real estate holding company as of date of commencement. Trial court granted his motion, setting valuation date as of DOC.
- ▶ Second Dept. reversed, finding that husband failed to provide evidence to support claim that change in value was due solely to his efforts, rather than market forces. Trial date valuation is appropriate date.
- ▶ “This does not preclude either party from presenting evidence at trial of any efforts which affected the value of [the company] for purposes of equitable distribution.”

Heine v. Heine, 176 A.D.2d 77 (1st Dept. 1992)

- ▶ DOC valuation date for husband’s stock in a company in which he was the director. He was involved in making the decision to take the company private, which resulted in an increase in value post-commencement.
- ▶ Wife’s claim on appeal that the increase in value was passive was rejected.

VALUATION DATES

CONTINUED

Morton v. Morton, 69 A.D.3d 693, 892 N.Y.S.2d 518 (2nd Dept., 2010)

- ▶ DOT valuation for Husband's businesses.
- ▶ Owned commercial real estate properties and acted as the landlord for industrial and manufacturing tenants in the Detroit, Michigan area.
- ▶ The decrease in value of the assets since the DOC was attributable to market forces and was thus passive in nature.
- ▶ **No evidence that the decline in the Husband's business was due to dissipation or wasteful conduct on the part of the husband.**

Daniel v. Friedman, 22 A.D.3d 707 (2d Dept. 2005)

- ▶ DOC valuation for Husband's business even though there was an economic downturn between DOC and DOT which had an effect on the value of the business.
- ▶ There was evidence at trial that "the business had rebounded significantly and that there were signs of potential positive growth for the future."

VALUATION DATES

CONTINUED

M.M. v. D.M., 159 A.D.3d 562 (1st Dept. 2018)

- ▶ Appellate Court affirmed Referee's decision to use a valuation date *between* the date of commencement date and trial date.
- ▶ Appellate Court reasoning that "at around that time defendant was forcibly hospitalized and diagnosed with temporal lobe epilepsy, and subsequently had very little involvement in his family's business. We decline to disturb the Referee's determination on the ground that the value of the business continued thereafter to rise "passively," i.e., through no efforts of defendant, since defendant had been actively involved in the business before he became ill"

VALUATION DATES

CONTINUED

VALUATION IS A MOVING TARGET – ON ONE DAY \$X, NEXT DAY \$Y

- ▶ Google (Internet)
 - ▶ \$1,524.87 on February 26, 2020
 - ▶ \$1,206.57 on April 9, 2020 (down 21%)
 - ▶ \$1,410.42 on May 22, 2022 (down 7.5%)

- ▶ Marriott (Hotels)
 - ▶ \$150.78 on February 12, 2020
 - ▶ \$81.31 on April 10, 2020 (down 46%)
 - ▶ \$91.05 on May 22, 2020 (down 40%)

- ▶ Bed Bath & Beyond (Retail)
 - ▶ \$14.85 on February 11, 2020
 - ▶ \$5.58 on April 9, 2020 (down 62%)
 - ▶ \$6.70 on May 22, 2020 (down 55%)

- ▶ Dave & Busters (Restaurant and Entertainment – all locations closed)
 - ▶ \$46.30 on February 20, 2020
 - ▶ \$14.68 on April 9, 2020 (down 68%)
 - ▶ \$12.03 on May 22, 2020 (down 74%)

ECONOMIC OUTLOOK

INTERNATIONAL MONETARY FUND (IMF)

- ▶ COVID-19 Pandemic inflicting high human costs worldwide
- ▶ Necessary protection measures are severely impacting economic activity
- ▶ Worldwide economy expected to contract by 3% in 2020, much worse than the 2008-2009 financial crisis
- ▶ Extreme uncertainty around the global growth forecasts. The economic fallout depends on factors that interact in ways that are hard to predict such as:
 - ▶ Intensity and efficacy of containment efforts
 - ▶ Extent of further supply disruptions
 - ▶ Tightening of global financial markets
 - ▶ Shifts in spending habits
 - ▶ Behavioral changes (did this destroy brick and mortar shopping?)

Source: World Economic Outlook, April 2020: The Great Lockdown; Executive Summary. www.imf.org

ECONOMIC OUTLOOK

IMF CONTINUED

Prepared April 2020	Projection		
	2019	2020	2021
World Output	2.9	(3.0)	5.8
Advanced Economies	1.7	(6.1)	4.5
Emerging & Developing Markets	3.7	(1.0)	
United States	2.3	(5.9)	4.7
China	6.1	1.2	9.2

Note: real GDP, annual percent change

- Even with expected growth in 2021, U.S. Economy will not reach pre-COVID-19 levels until 2022
- Advanced Economies (United States, Germany, United Kingdom, etc.) will experience more contraction than Emerging Markets
- It goes without saying, but a second outbreak would be devastating to economies worldwide

ECONOMIC OUTLOOK

FINANCIAL MARKETS

- ▶ Insight from Financial Market Analysis
 - ▶ Ninety day decrease in S&P 500 index was as much as 30.8% due to the COVID-19 Pandemic
 - ▶ Price as of 4/28/2020 is \$2,864 which represents a loss in value of (11.4%)
 - ▶ Ninety day decrease in S&P 500 index was as much as 35.1% during 2008 Financial crisis.
 - ▶ It took the S&P 500 38 months to recover its losses from the 2008 financial crisis
 - ▶ S&P 500 did not exist in 1929
 - ▶ The Dow Jones Industrial Average lost 87% of its value in 34 months!
 - ▶ It took the Dow Jones 25 years to recover all its losses from the Great Depression
- ▶ How long will it take the financial markets to recover from the COVID-19 PANDEMIC ??
- ▶ **Panel Discussion:**
 - ▶ Can we infer anything from the financial markets during economic uncertainty in the past ?

ECONOMIC OUTLOOK

INDUSTRIES HARDEST HIT

- ▶ Hospitality
- ▶ Airlines
- ▶ Restaurants
- ▶ Healthcare (providers of non-elective procedures)
- ▶ Brick & Mortar non-grocery retail

VALUATION ISSUES

SEVERAL CONSIDERATIONS

- ▶ Macro (overall economic concerns)
- ▶ Micro (factors impacting a specific business)
 - ▶ Not all businesses will be impacted equally
- ▶ Length of business interruption
 - ▶ Amount of time to reopen
 - ▶ Amount of time to re-staff
- ▶ Increase in unemployment costs because of lay-offs
- ▶ How much working capital will be used to facilitate the re-growth of the company?
- ▶ Loan proceeds and forgiveness options
- ▶ Virus recurrence

THREE APPROACHES TO VALUE

▶ **Market**

- ▶ Transaction method
- ▶ Guideline company method

▶ **Income**

- ▶ Capitalization of income methods
- ▶ Discounted future returns method

▶ **Asset-based**

- ▶ Net asset value method

MARKET APPROACH

TRANSACTION METHOD

► Overview

- The transaction method is based on the premise that actual transactions of similar business entities can provide a relevant benchmark for value.
- Under this method, a valuation multiple based on actual sales is applied to a specific stream of economic income to determine the operating value of a company.

MARKET APPROACH

GUIDELINE PUBLIC COMPANY METHOD

► Overview

- The guideline company method is based on the premise that the prices observed in the public stock market of comparable business entities can provide a relevant benchmark for value.
- Under this method, a valuation multiple based on the ratio of the stock price to the public company's earnings or earnings before interest, taxes, depreciation and amortization (EBITDA) is developed and applied to the same level of income of the subject company.

MARKET APPROACH

CONTINUED

▶ Panel Discussion:

- ▶ What is the relevance of the Market Approach in the face of Covid-19?
- ▶ Do market multiples fluctuate during times of economic uncertainty?
 - ▶ How is the impact Covid-19 different versus other economic downturns that would limit the relevance of the Market Approach?

INCOME APPROACH

COVID-19 CONSIDERATIONS

▶ **Applicability of Methods**

- ▶ Capitalization of Income Method focuses on a single-stream of economic income. This method may be inappropriate in many instances
 - ▶ Historical operations may be of little relevance even to businesses that were able to maintain some form of operations during the pandemic
- ▶ Discounted Cash Flows Method is a multi-period methodology that will likely be more applicable in the wake of Covid-19

DISCOUNTED CASH FLOW METHOD

▶ DCF Overview

- ▶ The worth of a business is equal to the present value of all projected future cash flows added together
- ▶ The income stream is discounted to present value using a discount rate.
- ▶ The discount rate reflects the expected risk in achieving the prospective future cash flows
- ▶ Key consideration: multiple alternatives (i.e. high and low value) might be most applicable given the economic uncertainty
 - ▶ Assumptions made today are fraught with uncertainty and subject to challenge

DISCOUNTED CASH FLOW METHOD

CASH FLOW ANALYSIS

- ▶ Are forecasts and budgets available?
 - ▶ How accurate have they historically been compared to actual results
- ▶ Analysts might need to get into the “weeds”
 - ▶ Monthly sales by segments in 2020 v. historical monthly sales by segment
 - ▶ Changes to cost structure; i.e. payroll, shipping, fuel and utility prices
- ▶ Negative cash flows in the short-term may not be uncommon before profits return
- ▶ Need to account for the Payroll Protection Plan loans
- ▶ Assumptions on economic improvement
- ▶ Susceptibility to other industries and economic sectors

ASSET BASED APPROACH

- ▶ Based on the balance sheet of the business
- ▶ Applicable when there is little if any intangible value
- ▶ Used for holding companies and asset intensive companies

ASSET BASED APPROACH

CONTINUED

- **Panel Discussion:**
- Will there be an increased reliance on the asset approach ??
 - Might be most applicable for businesses most impacted by social distancing measures
 - Restaurants & Bars
 - Airlines
 - Hotels
 - Brick & Mortar Retail
 - Oil & Gas Sector
 - Barber shops / Beauty Parlors
 - Some Healthcare Sectors

FINAL THOUGHT

- ▶ In the context of fair market value, does a hypothetical buyer exist today?

A Going Concern: How Legal and Financial Professionals will be Dealing with Business Valuations Going Forward



Louis J. Cercone, Jr., CPA/ABV/CFF, ASA | lcercone@BrisCon.com

Douglas P. Sosnowski, CPA/ABV/CFF, ASA | dsosnowski@BrisCon.com

William P. Allen, CPA/ABV, CFE | wallen@BrisCon.com



Glenn S. Liebman, CPA/ABV | gliebman@goklg.com

David L. Gresen, CPA/ABV/CFF, CFE | dgresen@goklg.com



Joseph A. DeMarco, ESQ | jdemarco@soklaw.com