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# Litigation & Valuation REPORT

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# Quantifying the value of customer relationships

Customer relationships often are a key component of a business's value. In recent years, however, the methods used to value these relationships have become more sophisticated.

Why all the complexity? For the most part, the increasing use of fair value standards in financial reporting has put a spotlight on the accuracy of different valuation methods. The method a valuator uses can have a significant impact on the determined value of the customer relationships, so it's important to understand their nuances.



## Distinguished from goodwill

The *International Glossary of Business Valuation Terms* defines goodwill as “that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.” At one time, goodwill was treated as a “wasting asset” for financial reporting purposes. In other words, it was assumed that goodwill's value deteriorated over time. Thus, companies would capitalize goodwill and amortize it over a period of up to 40 years.

Under current accounting rules, however, goodwill is tested annually for impairment and recorded only if its fair value has dipped below its carrying amount. The value of goodwill is the portion of a business's value that's left over after determining the value of its tangible assets and identifiable intangible assets. It's critical, therefore, to determine the value of identifiable intangibles, which generally are amortized over their useful lives.

Customer relationships are related to goodwill, but they are recognized as separate, depreciable assets if they have 1) an ascertainable value separate and distinct from goodwill and 2) a limited useful life that can be determined with reasonable accuracy. According to Accounting Standards Codification (ASC) 805, *Business Combinations*, an intangible asset is “identifiable” if either:

- ◆ It's separable, meaning that it's capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, or
- ◆ It arises from contractual or other legal rights — regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

Typically, customer relationships that can be valued separately from goodwill involve contractual rights, such as subscriptions, service agreements, supplier agreements, distribution agreements, licenses, leases and certain banking relationships.

### It comes down to attrition

In the past, some valuers used a cost approach to value customer relationships. This means that the value was based on the cost of acquiring a new customer. Today, most valuers rely on the discounted cash flow or other income-based method to measure the future economic benefits a customer relationship is expected to produce.

One of the keys to estimating future income from existing customer relationships is to account for expected attrition over time. Several methods can be used when forecasting attrition. More sophisticated methods generally produce more accurate attrition rates and, therefore, may yield substantially different valuation results than simpler methods. Whether a more sophisticated analysis is appropriate depends on the level and detail of historical customer purchase data available.

### Calculating CRA

The simplest method of forecasting attrition is constant rate attrition (CRA) analysis. The valuator analyzes historical customer purchase information, calculates an attrition rate for each period for which data is available and then develops a single, constant attrition rate for use throughout the forecast period. To develop a more accurate forecast — provided the data is available — the valuator could identify different attrition rates depending on the size of the customer relationship. For example, a bank may experience higher attrition rates for customers with smaller deposit account balances.

A more sophisticated approach involves actuarial attrition analysis, in which the valuator measures the impact of the age of a customer relationship on attrition. Like CRA analysis, actuarial analysis may also break down attrition rates by size. To develop meaningful correlations between customer ages and

attrition rates, the valuator needs a significant amount of historical purchase data — generally going back at least five years.

### Beyond financial reporting

Financial reporting requirements have elevated the importance of valuing customer relationships, but their value may be relevant in many contexts, including business acquisitions, tax litigation and shareholder disputes.

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In addition to representing a significant component of business value, the nature and quality of customer relationships can affect business risk. For example, if a company relies on a few customers for the bulk of its revenues, the loss of just one could put it out of business. There may also be greater risk if a company's clients are heavily concentrated in one industry or geographical area.

Valuators can take these risks into account in different ways. They might reduce income forecasts or increase the discount rate used to calculate present value.

### Assessing reliability

In cases where the value of customer relationships is a significant component of business value, attorneys need to be familiar with the various valuation methods and their limitations. Even relatively small variations in attrition rates can have a big impact on value.

More sophisticated methods are generally more precise, but whether these methods are appropriate depends on the availability of historical data in sufficient volume and detail to produce reliable results. ♦

# Active vs. passive appreciation

## A deceptively complex issue in divorce cases

In divorce cases, it's common for an interest in a closely held business or professional practice to be the marital estate's most valuable asset. In many states, when the owner-spouse brings this asset to the marriage, a valuator may be called upon to distinguish between active appreciation in the business's value (which is subject to division) and passive appreciation (which isn't).

### Appreciating the difference

Typically, when a spouse owns an interest in a closely held business before marriage, that interest is considered his or her separate property. In many states, appreciation in the value of the interest during the life of the marriage due to the owner-spouse's efforts is considered marital (or community) property. Thus, it's subject to division. Passive appreciation in the interest's value during the marriage retains its character as separate property. (It's critical that state law also be accounted for.)

Passive appreciation may result from a variety of market forces and other external factors, including:

- ◆ General economic growth,
- ◆ Industry growth,
- ◆ Financial changes, such as in interest rates, markets or credit policies,
- ◆ Legislative or regulatory changes,
- ◆ Demographic trends, and
- ◆ Consolidations and other changes in the competitive landscape.

Active appreciation, on the other hand, is attributable to the owner-spouse's active management of the business.

### Picture this

Here's a simple example to illustrate the difference between active and passive appreciation. When Michelle married Pete, she owned a parcel of undeveloped land worth \$300,000. When they divorced ten years later, the land remained undeveloped, but its value had increased to \$1.3 million as a result of changes in the local real estate market. The \$1 million in growth during the marriage is passive appreciation and, therefore, isn't subject to division.

But what if Michelle had built an office building on the property and marketed the space to local businesses, so that when she and Pete divorced the property was worth \$4 million? Clearly, a significant portion of the property's increase in value would be attributable to Michelle's efforts, constituting active appreciation that's subject to division.



In the case of real estate, allocating the growth in value between active and passive appreciation may be relatively straightforward. In this case, if undeveloped land in the same location would be worth \$1.3 million,

then arguably the additional \$2.7 million in appreciation would be attributable to Michelle's active efforts.

### Blurred line

The line between active and passive appreciation becomes blurred, however, when a business is involved. After determining the value of the business at the beginning and end of the marriage, a valuator might use econometrics or other statistical methods to analyze and quantify the impact of various passive factors on business growth.

Among other aspects, the valuator will consider:

1. Whether property subject to passive appreciation changes its character,
2. The degree of the success of management efforts by an owner-spouse, and
3. The record of business growth and the level of growth attributable to management efforts.

The remaining appreciation in value is classified as active, but the valuator's job isn't done yet. Depending on the nature of the business, the valuator may also need to determine how much of that active appreciation is attributable to the owner-spouse's efforts and how much, if any, is attributable to the efforts of others.

## Just awards

### Construct a framework when assessing damages

**A**lmost daily, jurors award huge damages to plaintiffs. But are these jurors making informed decisions? In many cases they aren't provided with full and accurate information, which is a significant problem.

One of the most important contributions a financial expert can make in damages litigation is to construct a framework the jury can use when assessing the damages.

### The inflation myth

Owner-spouses sometimes argue that a business's growth during marriage is attributable primarily or exclusively to inflation and, therefore, is passive. Suppose, for example, that a business is valued at \$5 million at the beginning of a marriage and at \$10 million when the marriage ends 25 years later. Assuming a 3% inflation rate, \$5 million would be worth more than \$10 million at the end of the marriage by virtue of inflation alone. Therefore, an owner-spouse might argue, the entire amount of appreciation is passive.

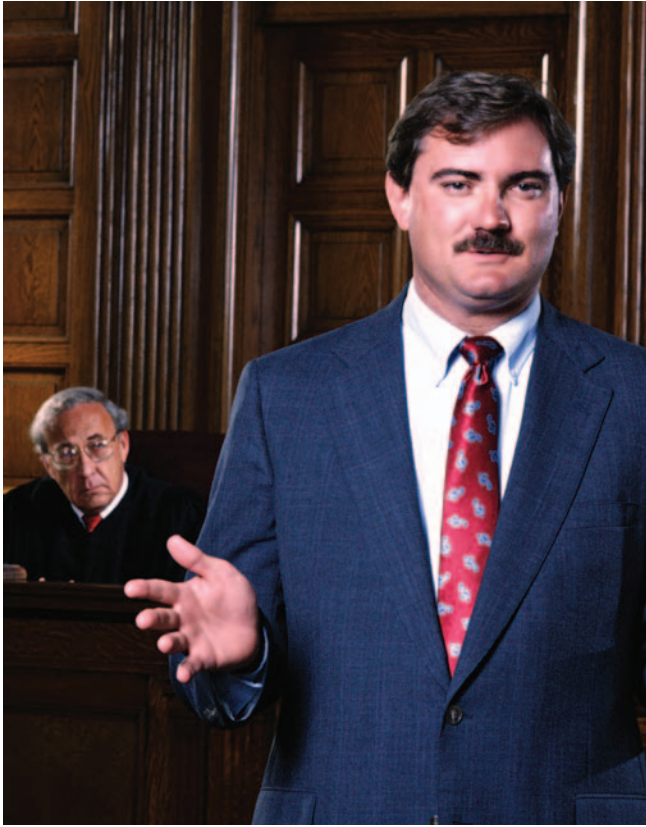
The fallacy of this argument is apparent when you consider that, if it were valid, *all* businesses would grow at least at the rate of inflation. In the real world, of course, many businesses experience stagnant growth or fail. Indeed, studies of public company stock prices show that in most cases there is little, if any, correlation between inflation and business growth.

### A critical distinction

Distinguishing between a business's active and passive appreciation can have an enormous impact on how property is distributed in a divorce. It's important for attorneys to understand the need for sophisticated valuation techniques in making this distinction. Valuers also are instrumental in challenging simplistic arguments such as the inflation theory. ♦

### Getting a proper perspective

A CPA expert can break a company down into its components to give jurors the proper perspective regarding the responsible division or department. Jurors should understand that the specific division can be sufficiently punished even if the award won't significantly affect the overall company.



By breaking a company down, jurors may be more likely to look at the defendant as a business composed of many individual employees, rather than viewing it as an unfeeling, monolithic entity. This approach can also be used to identify other individuals who will be hurt by a disproportionate award, such as a company's stockholders.

### Understanding profits

Profits realized as a result of the defendant's misconduct will be integral in determining an appropriate damages award. The financial expert's role is to clearly establish actual or expected profits from such conduct. In addition, the jury must understand that actual profits constitute a small percentage of total revenues or total sales. A company's historic net profits, for example, might be 3% of total revenues.

As part of this, the expert must take into account any expenses incurred as a result of claims that grew out of the transgression, including those associated with recalls or redesigns. Jurors need to understand that revenues or sales are *not* the same as profits.

### Comparing apples to apples

Many times, a plaintiff will point to the defendant's net worth as an indication of how large an award must be to be truly punitive. Net worth can give a broad idea of the defendant's ability to pay, but, as with profits, total assets are only part of the picture.

It's important to consider the "form" of a company's assets. For example, are they in a liquid form? A company's assets may be fixed or in another form not easily converted to cash. In fact, converting some assets to cash can make it difficult, if not impossible, to continue operating.

Both plaintiffs and defendants will also want to examine the fair market value (FMV) of assets vs. their book value. Assets typically are recorded at book value, but FMV can vary substantially, and such changes in value are rarely reflected in financial statements.

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### Other considerations

The defendant's ability to access cash should be considered when awarding punitive damages. After all, the harder it is to put together funds to pay an award, the more punitive it will be.

When examining a company's cash flow, the financial expert looks at the business's ability to generate cash

in the future. Companies with a current high net worth may not be able to generate strong earnings in the future, whereas companies with a current negative net worth due to high initial costs may be positioned to garner impressive profits in the future.

Finally, the expert can explain to the jury how liabilities affect a defendant's financial statements, as well as its overall financial status. Many times, conduct that precipitates punitive damages claims also triggers

multiple claims against the defendant, as in mass torts or class actions. By the time a particular claim reaches the punitive award stage, the defendant may already have been found liable for significant claims.

### Knowing when to call in an expert

Before you head into the courtroom, work with a financial expert. He or she will play a critical role in determining just damages and, as a witness, can explain to jurors why certain amounts are fair or unfair. ♦

## IS THE PRICE RIGHT? ASK AN EXPERT

As the economy continues to recover, merger and acquisition (M&A) activity is picking up steam. In the current environment, however, making or evaluating an offer can be challenging. Obtaining a fairness opinion from an objective, independent valuation expert can help M&A participants and their management defend themselves against shareholder claims.

### What is it?

A fairness opinion is a statement by a financial expert that a proposed transaction's terms are fair to the company's shareholders from a *financial* perspective. It doesn't provide an opinion on whether the transaction is legally sound or a good business strategy.

### Why get one?

Fairness opinions often are obtained in connection with M&As, particularly when public companies are involved. But they can be valuable — for both public and private companies — whenever minority shareholders claim that a transaction is unfair to them or that the company's directors or officers are engaged in self-dealing.

In addition to M&As, situations that may call for a fairness opinion include:

- ◆ Management buyouts,
- ◆ Recapitalizations and restructurings,
- ◆ "Going private" transactions,
- ◆ Related-party or "insider" transactions,
- ◆ Stock buybacks,
- ◆ Employee stock ownership plan (ESOP) transactions,
- ◆ Bankruptcy reorganizations, and
- ◆ Liquidations.

A fairness opinion can help avert shareholder lawsuits by assuring them that the transaction's financial terms are fair. It also can help ensure that directors and officers are protected by the "business judgment rule." Provided they've acted in good faith, the rule shields them from liability for decisions made on an informed basis and in a manner they believe is in the best interests of the company and its shareholders.

### Who should prepare it?

M&As historically have a high failure rate — at least from the buyer's side. A fairness opinion is an important first step in bringing to light certain factors that might help address these important issues.

