The importance of business valuations on divorce

As businesses differ, it is important to ascertain their value with care to ensure a fair division of the family wealth, advises **Rakesh Kapila**

Rakesh Kapila is a principal at Sim Kapila, Chartered Accountants, and a member of the Academy of Experts and the Expert Witness Institute
www.simkapila.co.uk

The value of a family business or business interest is included in the matrimonial pot to be distributed when it comes to negotiating a financial settlement on divorce. Since the business valuation may be the most significant component of the total matrimonial assets, it needs to be ascertained with care, normally with expert assistance, in order to achieve a fair division of the family wealth.

What needs to be valued?

In order to value a party's 'stake' in a business, it is necessary to value the business as a whole. A business with a consistent history of profits expected to continue as a going concern is generally valued on the basis of its maintainable earnings stream.

In order to determine the 'value' attributable to the annual maintainable earnings of a business, it is normal practice to apply a 'price' to such earnings – in other words, the amount payable in the market for buying an earnings stream either by reference to 'price/earnings' ratios applicable to actual transactions or by reference to the 'average' ratio applicable to the industry sector concerned for companies quoted on the Stock Exchange.

For a business with a patchy history of profits and with an uncertain future, albeit with a relatively healthy asset base, it may be more appropriate to consider the net assets rather than the earnings stream in valuing the business. It may also be appropriate to consider net assets for sectors in which assets can be realised with relative ease and within which earnings may be less of a driving force than asset appreciation (for example the property sector).

Why are valuations important?

Proper account needs to be taken of various aspects which can affect the valuation, including whether both parties are involved; whether the business owner is a sole trader, a partner, or a shareholder; whether one or both parties own all or only a percentage of the business; whether the business owns property; and whether the business is merely an income-producing vehicle. For instance, a business which is an income-producing vehicle reliant upon one or two individuals may have little value as a going concern.

If the valuation of the business interest is a relatively significant proportion of the total family wealth of the parties, it may be necessary for value to be realised from the business. It may either be appropriate for a partner or shareholder to divest a proportion of his or her interest or to release funds from the business.

As the principle of sharing has evolved, the courts may consider making an order which requires a business to be restructured or possibly sold to implement the terms of any settlement. As an example of restructuring, a family court may order a transfer of shares to the other spouse so that a financial settlement can be arranged in a tax-efficient way. It is vital, therefore, that the valuation of the business represents a true reflection of its worth.

A clean break terminating the financial obligations of the parties to each other may need to be deferred if the business is either too difficult to value or in such a state of flux that justice can only be done by allowing each party to retain a stake. Postponement may also be necessary if assets are illiquid or the business's borrowing power is limited.

If a relatively low value is 'incorrectly' attributed to a business, the matrimonial pot would be undervalued so that the party running the business would get the asset 'on the cheap'. Important implications may include the business being deemed to have insufficient assets for use in settlement proposals and the business being considered to have inadequate profits to provide a healthy income stream for the party continuing with the business.

If a business is valued at an 'unjustifiably' high amount, the matrimonial pot would be overvalued so that the party running the business would get an inadequate share of the overall assets. It may be concluded incorrectly that the business has sufficient assets to assist in settlement proposals or that it can sustain a healthy income stream for the party continuing with the business. Proposals based on such conclusions may jeopardise the future of the business as a going concern.

Appropriate methodology

As businesses differ and valuations are critical, it is important to avoid a mechanistic approach to work on valuations and to ensure that they are independent, based on the best available information and prepared on the basis of the most appropriate methodology. **SJ**