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BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Vol. 18, No. 5, May 2012

Valuation and Forensics: Economic Benefit Streams

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Despite the attention focused on financial forensics in recent years, virtually nothing has been published on how to use these techniques in valuation. The primary impediment has been one of *misunderstanding.* That is, valuators unconsciously (or even purposely) equate the term "forensics" with "fraud." That posture somehow distances them from a perceived liability associated with financial forensics and the need for a codified body of knowledge.

The valuation profession rests upon only three essential components: an economic benefit stream, a required rate of return, and secondary adjustments, all represented by the following formula:

$$V = \left[\frac{EBS}{R}\right] S_a$$

V	Value
EBS	Economic Benefit Stream
R	Required Rate of Return
S_a	Secondary Adjustments

The derivation of an economic benefit stream is a forward-looking concept, which can be determined through a wide variety of quantitative and qualitative forecasting techniques. The techniques can generally be categorized as historically driven, management-driven, or independent-variable-driven to derive the outlook for the subject business.

The required rate of return and secondary adjustment components can be exceedingly complex and thus require considerable deliberation. Nonetheless, one would be hard-pressed to find substantive guidance for constructing an economic benefit stream.[1] For example, assuming six years of financial statement history, valuation reports will often contain some weighted-average calculation intended to represent the near-term outlook of the stream. That is, a 3-2-1 (or other) weighting of the recent historical stream may be the only "science" applied. Worse, the report's supporting rationale may be nothing more than a statement that such method was used by the appraiser. Surprisingly, even a highly regarded and very recent valuation book recommends the same tired, stale approach.

Economic benefit streams in damages calculations fare no better. While the literature and related technical guidance typically address issues regarding ex post[2] and ex ante[3] matters, very little practical substantive guidance for economic benefit stream construction can be found.

Therefore, this section delivers logical, practical, and defensible guidance for the forensic operator striving to develop a representative economic benefit stream in either valuation or damages matters. Furthermore, it provides a foundation upon which the forensic operator can continuously build and refine economic benefit streams.

1 One notable exception is *Quantitative Business Valuation: A Mathematical Approach for Today's Professionals*, by Jay B. Abrams; McGraw-Hill, 2001.

2 Refers to past events when uncertainties have been eliminated.

3 Refers to future, unknown events.

BUSINESS VALUATION UPDATE

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Business Valuation Update™ (ISSN 1088-4882) is published monthly by Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035. Periodicals Postage Paid at Portland, OR, and at additional mailing offices. Postmaster: Send address changes to ***Business Valuation Update***™, Business Valuation Resources, LLC, 1000 SW Broadway, Suite 1200, Portland, OR, 97205-3035.

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A valuation premise is used for the section, but the same principles and techniques apply to economic damages calculations.

The economic benefit stream technique is outlined in the following seven steps and is summarized as follows:

1. Array historical financial statements in both schedule and visual formats.

2. Array historical economic benefit stream(s) in both schedule and visual formats.

3. Identify historical benefit stream(s) comparison sources from three categories of independent variables as available:

   d. The subject entity's financial history, that is, itself.

   e. Management-prepared financial estimates (if any) such as business plans, budgets, forecasts, and projections.

   f. Independent variables such as GDP[4] or GDP-derived measures, GSP,[5] or GSP measures, industry sector measures, and so forth.

7. Illustrate and quantify as available the relationships for each of the three categories listed in Step 3.

8. Estimate and visually array as available the history, planned, and correlated measures for each of the three categories listed in Step 3. Anything prepared by XYZ is considered a "dependent" variable, while GDP, GSP, and related sources are considered "independent" variables.

9. Compare and contrast the respective strengths and weaknesses of the quantitative and visual relationships.

4 Gross domestic product—The total annual value of all goods and services produced by labor and capital within a country's borders.

5 Gross state product—The total annual value of all goods and services produced by labor and capital within a state's borders.

10. Conclude upon a stream that reflects the strongest quantitative and/or visual representations from the preceding steps. The selected stream may be best represented by a convergence of streams.

The preceding steps outline the reasoning applied to the respective assignment, which in aggregate are persuasive in their simplicity, defensibility, and logic. More important, for most audiences, the visualization of the history and alternative outlooks leads to the same logical and empirical conclusion reached by the forensic operator.

This article is excerpted from Dorrell and Gadawski's Financial Forensics Body of Knowledge*, just published by John Wiley & Sons.*