Valuation vs. Calculation – Which Product is Right for You?

The first contract has grown to thirty, two employees have multiplied to a hundred and revenue conversations that once discussed thousands of dollars now contemplate hundreds of thousands or millions of dollars. The satisfaction of becoming a successful business owner who has grown a construction company into a thriving enterprise is accompanied by the realization that there is significant value in the fruits of the labor. The reasons are varied and numerous, but at some point in time it will be necessary to know how much the business is worth.

The purpose of the valuation will ultimately determine the appropriate level of service required. Some common purposes include:

- Business and succession planning
- Mergers and acquisitions
- Litigation (including the possibility of shareholder disputes)
- Marital dissolution
- Estate and gift tax.

There are different levels of service available in the market to help estimate the value of a business. Certified Public Accountants who provide business valuation services offer either a valuation engagement or a calculation engagement as defined by the Statement on Standards for Valuation Services ("SSVS") No. 1 issued by the American Institute of Certified Public Accountants ("AICPA"). SSVS No. 1 was issued in June 2007 and AICPA members are required to adhere to this standard when providing such services.

A valuation engagement requires more procedures than a calculation engagement, results in a conclusion of value and is generally more expensive to prepare. SSVS No. 1 states that a valuation engagement is performed when (1) the engagement calls for the valuation analyst to estimate the value of the subject interest and (2) the valuation analyst estimates the value and is free to apply the valuation approaches and methods deemed circumstantially appropriate. The results of the valuation are expressed as a conclusion of value as either a single amount or a range.

A calculation engagement allows for fewer procedures than a valuation engagement, leads to a calculated value and is usually less costly. SSVS No. 1 explains that a calculation engagement is performed when (1) the valuation analyst and the client agree on the valuation approaches and methods the analyst will use as well as the extent of procedures the analyst will perform in the process of calculating the value of a subject interest and (2) the valuation analyst calculates the value in compliance with the agreement. The results of these procedures are expressed as a calculated value as either a single amount or a range.

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Let’s look at a few examples to gain a better understanding of when a valuation engagement and a calculation engagement may or may not be appropriate. In the first case, assume the purpose of the valuation is preliminary business planning to determine if selling the company might result in the ability to retire. A calculation of value might be perfectly acceptable as the goal is to estimate the value of the company to get an approximate idea of what a hypothetical willing buyer might pay. Any buyer that comes along would likely do their own due diligence to ascertain their own estimate of value. Thus, the calculation of value would essentially be a negotiating tool. As discussions become more serious with an actual buyer, escalating the calculation of value to a conclusion of value may be a warranted consideration. However, for initial business planning, the calculation engagement is typically an appropriate and cost effective option.

In the next example, the business owner finds himself or herself involved in divorce proceedings that will require a division of marital assets. One of the significant assets is the company and a value needs to be determined. If it is early on in the process and an estimate of the value is needed to settle the matter, a calculation of value may be an option. Yet, in proceedings that will likely end up in a courtroom, it is critical to understand that the selected business valuation should attain the standards level of a valuation engagement and the analyst opining on a conclusion of value.

A calculation engagement results in a calculated value, which does not provide the valuation analyst’s opinion or conclusion. In fact, SSVS No. 1 explicitly states that an appraiser should disclose that a calculation engagement does not include all the procedures required for a valuation engagement and had a valuation engagement been performed, the results may have been different. Most valuation analysts will not testify in court proceedings without having completed a valuation engagement resulting in a conclusion of value, which he or she can use as a professional opinion. Although it may save money up front, a calculation engagement applied to the above example of divorce is not likely to be sufficient when litigation is involved. Nonetheless, a calculation of value can be effective for purposes of mediating a settlement outside of the courtroom by providing the business owner with at least some calculations to assist in negotiating a settlement.

The final scenario considers the business owner who would like to gift minority interests in his or her company to family members. The values of the gifts need to be determined so that the appropriate filings can be made with the Internal Revenue Service (“IRS”). In this case, the values that are determined are subject to the scrutiny of the IRS. As opposed to a calculated value, a conclusion of value that is obtained through a valuation engagement and provides an opinion of a valuation professional is a much stronger position to have when facing questions that may arise in an audit by the IRS.

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While the terms conclusion of value and calculated value sound similar, it is important for business owners to understand the differences between a valuation engagement and a calculation engagement before deciding on the appropriate level of service. Discussing the options available with a qualified valuation professional will help deliver the appropriate product for the engagement. Consulting with one’s legal counsel is always recommended to determine the appropriate level of engagement.

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