

# BUILDING VALUE

## SUCCESS THROUGH COLLABORATION

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A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them



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### MEASUREMENT-MANAGED COMPANY: TO BE OR NOT TO BE?

Most executives would publicly support the use of performance measures in their companies, but few have implemented a strategic performance measurement (management) program. This is the “Measurement Paradox.”

Many forces have combined to cause the failure of companies to implement a strategic measurement system. However, a recent study by Lingle and Schiemann of the Metrus Group ([www.metrus.com](http://www.metrus.com)) shows that companies adopting strategic measurement systems are more likely to be perceived as industry leaders, to be financially ranked in the top third of their industry, have a three-year return on their investment, and were moderately-to-very successful in their last major cultural or operational change. With these results, every company should at least consider becoming a measurement managed company.



#### What is a measurement-managed company?

Measurement-managed organizations have identified their customer related critical success factors (CSFs) and have developed a strategic plan to satisfy those CSFs. They also have adopted a holistic set of strategy supporting key performance indicators allowing the company to plan its future; operate

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### DOUBLE DIPPING – GOOD FOR ICE CREAM, BAD FOR POTATO CHIPS AND DIVORCE

“Double dipping” or “double counting” refers to using the same dollar of income twice in a financial calculation. When an income stream is converted to a single value, it no longer represents future income comprised of ongoing payments. Instead, it is an asset with a value at a single point in time. There is either an asset or income – not both. Double dipping can occur in either a divorce situation or other litigation, but this article will focus solely on marital disputes.

Consider the simple example of a marital estate that consists of a \$250,000 personal residence and \$250,000 portfolio of marketable securities. Assume that the marketable securities generate income of \$15,000 per year. Double dipping occurs if one spouse is awarded the marketable securities, the other spouse the house, and then the income from the marketable securities is split between the spouses. Since the financial marketplace takes the level of interest and dividends into account when valuing marketable securities, the income generated by the portfolio was already counted in arriving at the \$250,000 value. In addition, the spouse receiving the house could sell it and invest the proceeds in a manner that would provide the same \$15,000 of income, leaving both spouses with a \$250,000 investment portfolio, but one spouse would have \$7,500 of income while the other would have \$22,500 of income.<sup>1</sup>

A more subtle and less-often recognized problem with double dipping exists when a closely held business is valued by reference to an income or cash flow measure. It may also include calculations under the market approach, depending on

*Double dipping may be a trap for unwary business appraisers, even those with a financial background.*

how the calculation is done. This article will focus solely on the income approach, although a properly done excess earnings analysis should yield a similar result.

Before an appraiser can begin to determine the value of a company using the income approach, the company’s earnings and cash flow must be analyzed. One of the most common normalizing adjustments is changing owner’s compensation to an arms-length or market rate of pay. This means that the appraiser must separate the payment for the owner’s services as an employee from a disguised return on investment or tax minimization strategy.

Consider the following example of a business valuation where over-compensation of the owner spouse occurred. Assume that a closely held business has an after-tax cash flow to equity of \$30,000 after an owner salary of

<sup>1</sup> This analysis assumes that the tax basis is equal to the market value for the house and the investment portfolio. Problems created by unequal tax bases is a topic for another issue.

<sup>2</sup> This article assumes a 40 percent tax rate throughout.

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effectively; and to monitor strategies, systems and changes in customer satisfaction.

**Why are these companies more successful?**

Compared to their competitors, there are six primary reasons contributing to their success:

**1. Measurement provides a common language for communication.** Using an understandable measurement system creates a common language within the company as people begin to discuss how they are measured. Since the measures should be linked to strategy and customer-related CSFs, employees and managers will be communicating about issues important to the company.

**2. Measurement reduces ambiguity about the company’s strategy.** Developing strategic-related performance measures

forces management to agree on the company’s strategy in order to determine the measures and make the most effective allocation of the company’s tangible and intangible resources.

**3. Measurement improves organizational alignment.** Using “cascading” measurements that tie individual performance (via personal scorecards) to the company’s strategy, makes objectives relevant to each employee’s departmental and individual responsibilities.

**4. Measurement improves the ability to anticipate the future.** Using leading indicators as performance measures significantly increases management’s ability to “see” the future. Companies are able to predict the effect of internal and external changes, to the customer and to the company’s financial returns.

**5. Measurement provides a holistic view of the company.** Using a balanced system of measures reflects the company’s strategy as it is implemented throughout the company. This also provides the

management team a comprehensive view of how actions taken in one area of the company can affect performance in other areas.

**6. Measurement forces employees to deal with specific problem areas.** People respond to areas that are targeted by management for attention. Measuring the items of strategic importance to the company in each performance area forces employees to find methods to improve performance and to understand why these areas must be improved.

With the many benefits of being a measurement-managed company, why wait? Check with your Financial Consulting Group member firm for more information about value creation ideas available for your company or organization.

— Michael Mard, CPA/ABV, ASA, and  
James S. Rigby Jr., CPA/ABV, ASA

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\$125,000. Applying a 20 percent capitalization rate arrives at an entity fair market value of \$150,000 ( $\$30,000/.2$ ) if owner’s salary is not adjusted. If the market rate of pay for the owner is \$100,000, adjusting the cash flow to remove the excess salary would increase the capitalizable cash flow by \$15,000 [ $(\$125,000 - \$100,000) * (1 - .40^2)$ ] to \$45,000. Applying the same 20 percent capitalization rate to the cash flow results in an entity level value of \$225,000 ( $\$45,000/.2$  percent). Double dipping occurs when the marital estate includes a value for the business of \$225,000 and the actual salary of \$125,000 is used in the calculation of spousal support. The proper salary to be considered in the spousal support calculation is the \$100,000.

The value of the business increased from \$150,000 to \$225,000 as a result of removing the \$25,000 excess salary. The difference between the \$125,000 salary being paid and the \$100,000 market rate of pay has been fully captured in the \$75,000 increase in fair market value. As an additional proof of the increase in business value, dividing the \$15,000

after tax excess salary by the 20 percent capitalization rate results in the same \$75,000 increase in value.

It is clear from a financial point of view that the \$75,000 difference between the \$125,000 actual salary and the \$100,000 market salary has been fully captured in the value of the business and it cannot be used again in the spousal support calculation.

Double dipping becomes more complicated when the business owner spouse is under-compensated. Consider the same facts as above except that the owner’s actual salary is only \$40,000. The normalization adjustment to the cash flow to increase the salary to a market rate would decrease the original \$30,000 capitalizable cash flow by \$36,000 [ $(\$40,000 - \$100,000) * (1 - .40)$ ] to MINUS \$6,000. This suggests that the business has a negative value under the income approach when a market rate of pay is used. The answer to this problem is to limit the salary to the amount that would not cause a negative cash flow since this negative cash flow would eventually cause the business to fail. In this example, the salary to be used in the spousal support calculation would be \$90,000 [Proof:  $\$30,000 - (\$40,000 - \$90,000) * (1 - .40) = \$0$ ].

Double dipping may be a trap for unwary business appraisers, even those

with a financial background. It’s always best to check with your valuation professional to seek counsel and advice.

— John R. Gilbert, CPA/ABV, ASA, Cr. FA, and  
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