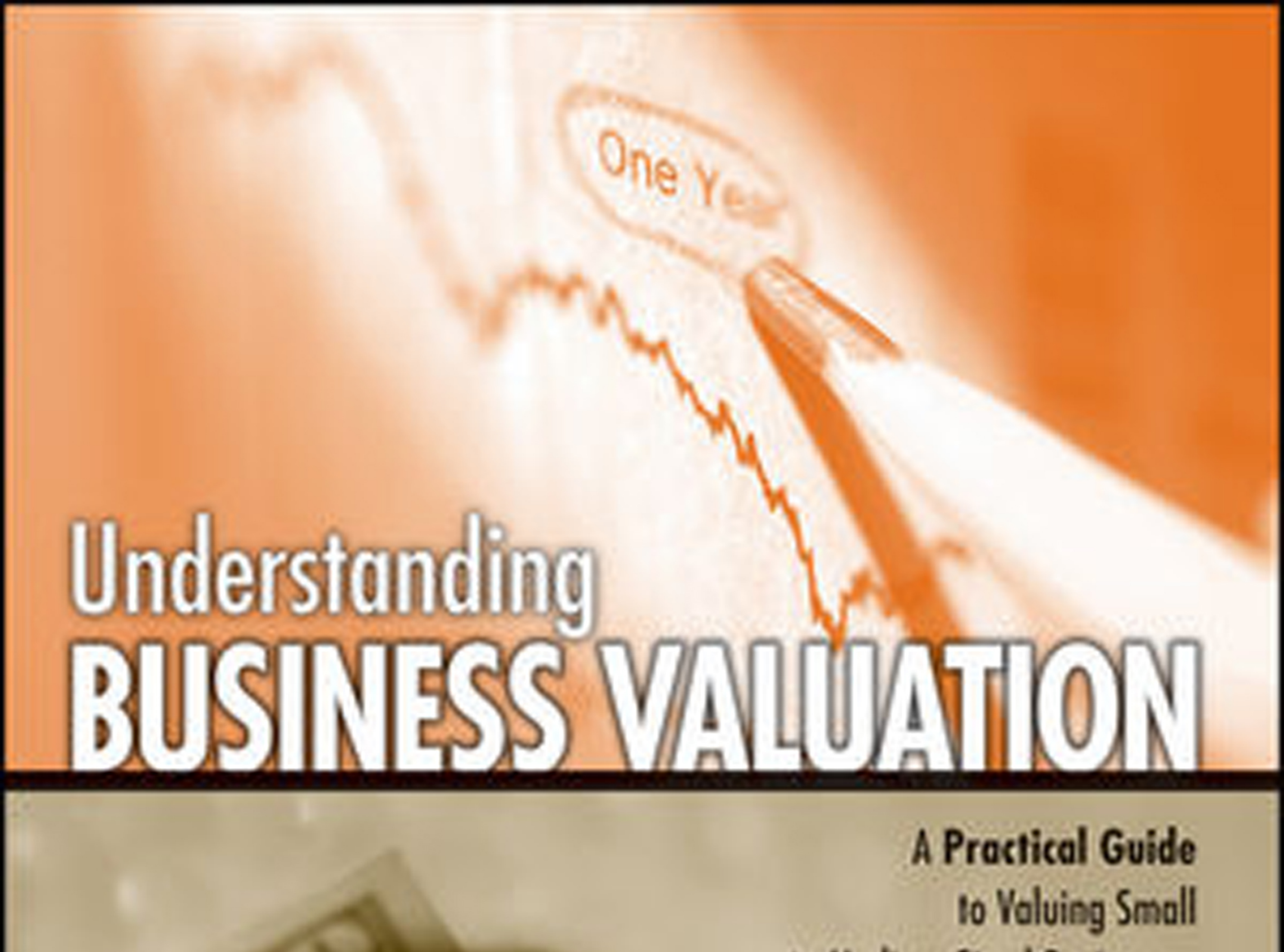

Understanding BUSINESS VALUATION

A **Practical Guide** to Valuing Small to Medium Sized Businesses

FOURTH EDITION

AICPA

Gary R. Trugman

WILEY

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Notice to Readers

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Dedication

To Linda, my wife and business partner

Each edition of this book is like our life…it just keeps getting better

Thanks for being you. None of this would be worthwhile by myself!!!

Preface

This is really hard to believe. This time, it's the fourth edition. A lot has happened since 1998 when the first edition of this book was published. I was going to say that I am like a bottle of fine wine that keeps getting better with age, but those of you who know me or have bought earlier editions of this book know that I keep getting older. I will leave it for you to decide if I am getting any better with age. In the meanwhile, since you purchased this book, keep reading.

I may sound like a broken record (or I guess for those of you who are too young to know what a record is, a scratched CD), but I keep saying, "This is just what we need, another book on business valuation." Years ago, there were only a limited number of books on this topic—mostly finance texts. Today, you cannot read everything that is being published unless you have no life. Oh gee, that's me. Anyway, for those of you with a limited life, there are definitely some books on this topic that are worth reading. I can no longer list only two or three books that are my favorites because so many good books on this topic have been published over the last several years that the list has grown too much. I have included many references to these books throughout this edition, so you should have no problem figuring out which ones I like.

Okay, so why did I do this again, and what is new in this edition? I did it again because I find that there is still a need for this stuff to be explained in plain, uncomplicated English in a manner that helps apply appraisal theory to real-world practice. Please don't get me wrong! I am not claiming to know everything. In fact, I am afraid of what I don't know. But I also finally realize that there are things in this world we may never understand. As to the new stuff in this edition and from the weight of this book, you can tell that there is a lot; I will tell you about it soon.

The purpose of this book is to provide some guidance on the theory, as well as on how to apply it in a meaningful fashion. Whether or not I'm successful is up to you. First, some basic ground rules:

1. To get the most out of this book, you must read it, not only in its entirety but also in the sequence in which it is written. Don't go to the chapter on capitalization rates without reading the earlier sections of the book. Otherwise, you may not understand what you are capitalizing and why. It is also important to make sure that you read the exhibits and the appendices at the time they are referenced. The exhibits have been included as an integral part of this book. If you skip over them or go back to them later, you may miss a valuable point I am trying to make.
2. In general, I do not think in terms of complex mathematical formulas. I do not like equations with lots of parentheses nor do I like formulas that have Greek letters in them. Therefore, if you really get off on mathematical equations, this book is not for you. Believe it or not, I want readers to understand this stuff! In certain sections of this book, you will see some mathematical formulas. You will even see some Greek letters. The notation may be different from that found in other books. Concentrate on the concepts, not the letters and symbols used.
3. I am a firm believer of the KISS theory (keep it simple, stupid). This does not mean, however, that business valuations are simple. Quite the contrary! If you are at all like me, after reading this book, you will never feel comfortable doing a business valuation again. This can be an extremely subjective process. For the accountants out there, this is not at all like accounting in which the debits have to equal the credits. What you will learn is that there is no black and white answer. There are a million shades of gray. To quote a good friend of mine, the answer to most questions is, "It depends."
4. The concepts discussed in this book cannot be read and applied as if they were in a vacuum. Many of the items discussed will directly or indirectly affect other parts of the valuation process. You must be a big-picture type of person.
5. In some of the exhibits, I cheated. They were so good in the last edition that I decided to merely update the dates to freshen them up. If I messed up because the interest rates are not from that exact period, please forgive me. I am much more concerned with the concepts than the dates. In some instances when I

felt the exhibit was date sensitive, I did not change the dates. In some cases, I also changed the location of the business to protect the confidentiality of the client, so here, too, if it is a little inconsistent, please forgive me.

6. This book is not intended to present every alternative to every situation. Just because I have included something in this book, please do not rely solely on my writings. There may be facts and circumstances that could negate my opinion. You will find that there is no substitute for common sense in this process.
7. In some instances, I will be illustrating points from the negative. Several of the exhibits contain sections of actual reports critiquing someone else's work. Learn from what they may have done wrong.
8. Please don't shoot the messenger! Throughout this book, several topics will be discussed that are controversial. Some may not even have a definitive answer, but you must think about these issues when you do a business valuation.
9. While reading this book, you are going to be exposed to my own form of humor. This is not intended to insult anyone but, rather, to add a little levity to what can be a very dry and technical topic. Although business valuation tends to be extremely complex, let's have some fun while we learn. You just can't take this stuff too seriously.
10. And finally, in much of what I am trying to teach, I have made many of the mistakes that I am trying to prevent you from making. Someone once told me I will learn from my mistakes. By now, I am a genius!

With that stuff out of the way, please enjoy my attempt to explain what little I know about business valuation.

Acknowledgments

I must acknowledge several people for their contributions to this book. These people are not listed in any special order, but they are all very important to me. The first person is admittedly the most important. First and foremost, I have to thank Linda Trugman, CPA/ABV, MCBA, ASA, MBA. As you can see, she is much more qualified than merely being my wife. She is my business partner of 28 years, and I have to thank her for her countless hours in assisting me to make this book more readable, logical, and technically accurate. She also is one heck of an editor. She makes this kid from the Bronx sound like I am from Manhattan while keeping my Bronx accent intact. She is also the primary author of the chapter on estate and gift valuations. This is clearly her area of specialty, and there is no reason to try to produce a chapter on this topic without her significant input.

Next, my special thanks to Mark Zyla, CPA/ABV, CFA, ASA, who was the primary author of the new chapter on valuations for financial reporting. This is one of Mark's areas of expertise, and I was delighted to have him participate in this book. I also want to thank two of my staff members, William Harris, MA, CFA, AM, and Ray Bratcher, for their significant contribution to updating many of the chapters with new content.

Other individuals who were kind enough to perform a technical review on either the entire book or large parts of the book include William Quackenbush, ASA, MCBA; Ed Dupke, CPA/ABV, ASA; and Harold Martin, CPA/ABV, ASA. Special thanks also go to some individuals who were kind enough to review specific sections of this book that I thought deserved some special expertise on the given topics: Michael Crain, CPA/ABV, ASA, CFA (chapter on statistics); Roger Grabowski, ASA; and James Harrington (chapter on discount rates and capitalization rates); and Lance Hall, ASA (chapters on valuation adjustments). I cannot begin to express my gratitude to them for lending their vast levels of expertise to this book. Another group of folks who deserve a thank you , and I apologize for not listing everyone by name, is the group of individuals who sent me various e-mails about either corrections that needed to be made to the book or items they felt needed additional clarification. You are the folks who bought this book and actually took the time to go through it and provided comments to make it better. I hope we fixed all the typos and clarifications. In fact, one person actually added up all of the tables in this book and pointed out that there were a few addition errors. Wow, what an attention to detail! All I can say is thank you, thank you, and thank you again.

And one more special thanks to a group of folks I could not have done without—the group at the AICPA who made this book what it is: Robert Fox, acquisitions editor; Whitney Woody, associate developmental editor; Michelle Partridge-Doerr, copyeditor; Laura S. LeBlanc, copyeditor; Amy Sykes, production manager; and Nancy Karmadi, graphic designer. These folks had to put up with my writing style and the many mistakes I made throughout the manuscript. This group of folks is my dream team. I could not have done this without you all!

I also cannot forget my editor from the last edition and friend, Andrew Grow. Andrew was the person who I called whenever I got frustrated. Even though he was not assigned to the book this time, he was there for me, and I have to thank him. If he sends me a bill for psychological counseling, I will owe him a fortune. Thanks. Thank you so very much.

And finally, one more thank you goes to two different groups of practitioners. The first group consists of the many practitioners I have taught with over the years who have taught me so much. This list goes on and on and just keeps getting longer as I get older. You know who you are. The second group of practitioners consists of all the students who have attended my classes, participants at conferences who have attended the sessions I have spoken at, and all my colleagues who have had such flattering things to say to me over the years about my teaching; my writings; and, particularly, the first three editions of this book. It is hard to make me humble, but you have succeeded.

Contents

Introduction

This book has been methodically organized to help you get the most you possibly can out of it. Each chapter contains lots of new stuff since the last edition, and there are many new chapters; therefore, you might want to go through all the chapters in sequence. The chapters are set up as follows:

- Chapter 1 provides background stuff regarding why businesses are appraised, who appraises them, and the various appraisal organizations. Although you probably fit into one of the categories discussed, you should be aware of the other types of valuation analysts and their standards because you will most likely run across them in your endeavors.
- Chapter 2 consists of an annotation of the AICPA business valuation standard. Other standards are also covered in this chapter. This chapter is so important (and also so long) that I made it into its own chapter.
- Chapter 3 gets you started in the appraisal process. In this chapter, I discuss the things you must know to start an assignment. Chapter 3 includes information about engagement letters, conflicts of interest, internal work programs, and the initial document request.
- Chapter 4 takes you through the basic appraisal principles and theory behind the stuff that we are trying to figure out how to do. We will learn that the term *value* has many different meanings in business valuation, and we will discuss some of the more important meanings. Because so much of the valuation work we do involves taxes, this chapter will also point out the influence of the Internal Revenue Service on what we do.
- Chapter 5 includes a discussion of internal and external sources of information that will be gathered by the appraiser. Numerous references are provided as to where you can locate information. This chapter lists all types of neat websites on the Internet for doing the required research.
- Chapter 6 walks you through the process of what to do with the data that was gathered during the appraisal process. This chapter includes a discussion of economic, industry, company, and financial analysis. This is one of the most important chapters in the valuation process. It will help you arrive at the numbers needed to apply valuation methodologies to, as well as help you assess the riskiness of the income stream of the appraisal subject. This edition even includes a discussion of Porter's five forces.
- Chapter 7 is a new chapter. It covers statistics for business valuation and economic damages. Don't worry; I kept it relatively basic because I could not make it complex. Keeping it simple is a good thing! If you are going to do this work, don't skip this chapter.
- Chapter 8 is another new chapter that addresses forecasts. So much of what we do involves working with forecasts that I decided to dedicate a separate chapter to this topic. The intention is to keep the reader out of trouble. Various forecasting techniques are discussed.
- Chapter 9 presents the first part of the market approach to valuation. The underlying theory for the market approach is presented in this chapter. The balance of the chapter concentrates on the guideline public company method, including more detail on how to perform the analysis involving publicly traded companies. You will have to read this chapter to find out about size, growth, leverage, performance, turnover, and liquidity. You will also learn how to size adjust your multiples.
- Chapter 10 presents the second half of the market approach. This chapter includes a detailed discussion of the guideline transaction method, including a description of the various databases available to find merger and acquisition information involving closely held businesses. This chapter takes you step by step through the process of using this method, including making you aware of the potential pitfalls. Using internal transactions and rules of thumb are also discussed in this chapter.
- Chapter 11 presents the asset-based approach to valuation. Here, also, several methods are explored, and there is a discussion of how to find and communicate with other types of appraisers.
- Chapter 12 presents the income approach to valuation. For small and medium sized businesses, this chapter may be one of the most important. Single period and multiperiod models are presented. Forecasting financial information is also included in this chapter because it is the very essence of this approach to valuation.

- Chapter 13 is the chapter everyone will want to turn to! Discount rates and capitalization rates are discussed. Lots of theory and, hopefully, practical guidance have been included in this chapter. This chapter has been significantly changed and expanded from the last edition. An in-depth discussion about the equity risk premium and the small stock premium have been added to this chapter. Discussions about Morningstar's *SBBI Yearbook*, Duff & Phelps Risk Premium Report, and the Butler Pinkerton Model are included in this chapter. I have also included a discussion about private equity cost of capital. This may cause even the experienced valuation analysts to change the manner in which they do things.
- Chapter 14 includes the first part of my discussion on valuation premiums and discounts. This chapter got so large that I split it into two chapters. In this chapter learn when to use different premiums and discounts, as well as how to support your opinion. This chapter includes a discussion on valuation premiums and discounts, in general, control premiums, lack of control (minority) discounts and discounts from net asset value. This revised chapter includes a discussion on some of the more controversial issues still being debated among practitioners.
- Chapter 15 is the second part of my discussion on valuation premiums and discounts. This chapter includes everything that you want to know about discounts for lack of marketability. I have added a lot of new stuff to this chapter including a separate discussion on quantification techniques of this discount. I have an expanded discussion about QMDM and the FMV Opinions DLOM Calculator. I went so crazy in this chapter that I even discuss stock option models. Other discounts and premiums discussed in this chapter include private company discounts, key person discounts, nonhomogeneous (portfolio) discounts, blockage discounts, and more. I even explain how to apply these discounts.
- Chapter 16 contains an annotated version of Revenue Ruling 59-60. This revenue ruling is so important that I decided to include it as a separate chapter. You can never get enough of a Revenue Ruling that is over 50 years old but has the makings of being the best writing in business valuation of all time (maybe with the exception of my book).
- Chapter 17 addresses the appraisal report. Learn how to prepare and defend the report and learn some tips regarding presentation techniques. This chapter includes the reporting requirements of the AICPA's business valuation standard.
- Chapter 18 is brand new. I pulled it out of the income approach chapter from the last edition. In this new chapter, I discuss Pass-Through Entities. Besides having a discussion about the tax issues of these types of entities, I have included a discussion about all of the leading models being used to calculate the impact on value. This chapter is a dandy!
- Chapter 19 is also a new chapter. This one covers valuations for financial reporting. While it is intended to be basic, if you do valuations for financial reporting purposes, you know that this work is anything but basic. The new chapter discusses the basic rules and pronouncements in this area of practice.
- Chapter 20 is a basic chapter on intangible assets. There are several examples to help you learn how to value different types of intangibles. There are some really good reference materials cited in this chapter as well.
- Chapter 21 addresses valuation assignments that are performed for estate and gift tax purposes. Learn about the Chapter 14 (of the Internal Revenue Code) requirements, the adequate disclosure requirements, and family limited partnership valuations. Also, learn about the new appraiser penalties if you mess up.
- Chapter 22 covers issues involved in divorce valuations. Valuations performed as part of a divorce assignment entail very unique considerations for the appraiser.
- Chapter 23 contains a discussion on unique aspects of valuing professional practices. Learn what factors should be considered in valuing different types of professional practices, making these assignments different from valuing an operating company. Also included in this chapter is a detailed analysis on the valuation of work in process for a contingent fee law firm.
- Chapter 24 addresses valuation assignments for shareholder disputes, including issues involving the fair value standard of value. There are some new exhibits in this chapter that address very significant issues regarding fair value.
- Chapter 25 is a discussion of some of my favorite court cases. In fact, the name of this chapter is "My Favorite Court Cases." Pretty catchy, isn't it? This chapter has a few really good court cases that will help you understand some important issues regarding valuation.

- Chapter 26 contains a discussion about economic damages. There are several new exhibits addressing different types of damages issues in this chapter.
- And finally, the accompanying CD-ROM contains appendixes 1-18 as well as some reports for you to plagiarize. I only hope that you will give our firm proper attribution. Several new sample reports are included so that you can see the difference between the different types of reports.

While the material in this book is not necessarily unique, it has been organized in a manner that is intended to provide you with a logical analysis of the appraisal process. Many of the exhibits contain actual sections of appraisal reports to help emphasize the subject matter. Make sure you read them!

STEPS OF AN APPRAISAL

This book proceeds in a sequence that resembles the steps of performing an appraisal. The chapters will address these steps in detail. Because you are probably dying to know what these steps are, I list them here:

1. Define the appraisal engagement.
2. Gather the necessary data to perform the engagement.
3. Analyze the data that you gathered.
4. Estimate the value of the interest being appraised.
5. Write the report to communicate the value.

NOTATION SYSTEM USED IN THIS BOOK

A source of confusion for those trying to understand financial theory and methods is the fact that financial writers have not adopted a standard system of notation. While I have attempted to follow the most common notation system, I may have deviated along the way. This should not concern you.

Following are the symbols used in this book:

- Value at a point in time:

PV = Present value

FV = Future value

- Cost of capital and rate of return variables:

k = Discount rate (generalized)

k_e = Discount rate for common equity capital (cost of common equity capital); unless otherwise stated, it generally is assumed that this discount rate is applicable to the net cash flow available to common equity

k_d = Discount rate for debt (*Note:* for complex capital structures, there could be more than one class of capital in any of the above categories, in which case expanded subscripts would be required.)

c = Capitalization rate

$\mathrm{C_{pt}}$ = Capitalization rate for a pretax benefit stream

$\mathrm{C_{at}}$ = Capitalization rate for an after tax benefit stream

CP = Control premium

t = Tax rate (expressed as a percentage of pretax income)

R_f = Rate of return on a risk free security

β = Beta (a coefficient, usually used to modify a rate of return variable)

$(R_m - R_f)$ = Risk premium for the "market" (usually used in the context of a market for equity securities such as NYSE or S&P 500)

SCA = Specific company adjustment

SCP = Small company premium

WAAC = Weighted average cost of capital

- Income variables:
  - E = Expected economic income (in generalized sense [i.e., could be dividends], any of several possible definitions of cash flow, net income, and so on; also called a benefit stream)
  - EBIT = Earnings before interest and taxes
  - EBITDA = Earnings before depreciation, interest, and taxes ("depreciation" in this context usually includes amortization)
- Periods or variables in a series:
  - i = The *i*th period, or the ith variable in a series (may be extended to the *j*th variable, the *k*th variable, and so on)
  - n = The number of periods or variables in the series, or the last number in the series
  - ∞ = Infinity
  - 0 = Period, the base period, usually the latest year immediately preceding the valuation date
- Weightings:
  - W = Weight
  - W_e = Weight (percentage) of common equity in capital structure
  - W_p = Weight (percentage) of preferred equity in capital structure
  - W_d = Weight (percentage) of debt in capital structure

  Note: For purposes of computing a weighted average cost of capital (WAAC), it is assumed that the above weightings are at market value.
- Growth:
  - g = Rate of growth
- Mathematical functions:
  - Σ = Sum of (add up all the variables that follow)

Chapter 1

Overview of Business Valuation

Chapter Goals

Business valuation is process oriented. As such, I thought that I should start the process at the beginning. Therefore, this chapter is designed to do the following:

- Give you a very brief history about the valuation profession
- Explain why businesses are appraised
- Provide some background about who values businesses
- Familiarize you with the professional appraisal organizations

What did you expect at this point, the complicated stuff? Be patient, and we will get there.

Introduction

Business valuations are performed for companies and interests in companies of all sizes and types. The conceptual principles are the same for companies of different sizes, but very often, the manner in which these principles are applied varies greatly. The quantity and quality of data available for the appraisal of small and mid-sized companies tends to be considerably lower than that which is available for larger businesses. Just for the record, having a greater amount of data for larger companies is not always better. Sometimes, the quality of the data is awful, even for larger companies. When there is a lack of data available for the smaller companies, either certain methodologies cannot be used, or the result should be considered less reliable. The valuation analyst must be more careful in circumstances where less data is available because having less data creates a larger risk of not being able to interpret the existing data properly. The valuation analyst should understand the business valuation process from the large company, more theoretical basis, in order to adapt these concepts properly to its smaller counterparts. This means that the same theory that applies to the valuation of large companies may have to be adapted for the valuation of small companies. However, valuing smaller businesses can be extremely challenging because most of the empirical data that is regularly used by a valuation analyst applies to larger companies and only tangentially to smaller ones.

A Brief Walk Down Memory Lane

Let's take a couple of giant steps to cover this material. If you are looking for a longer history about the profession, consider getting a life! Over the last few decades, the business valuation industry has gone through staggering changes. We have seen the following occur:

- 1987—Establishment of the Appraisal Foundation. This organization was set up by seven real estate organizations and the American Society of Appraisers in response to the growing problem facing the real estate appraisal world. This organization is the creator of the *Uniform Standards of Professional Appraisal Practice* (USPAP). The provisions of the USPAP include Standards 1 through 6 that pertain to real estate appraisal, Standards 7 and 8 that pertain to personal property appraisal, and Standards 9 and 10 that pertain to business valuations. Standard 3, Appraisal Review, also now applies to business valuation.

Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses, Fourth Edition. Gary R. Trugman.

- 1989—Passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Among other provisions, this law requires all who perform real estate appraisals involving a *federally related transaction* to follow the USPAP. There was quite a bit of confusion when this law was first passed because the business valuation profession thought that it would also be subject to this act. However, it is pretty clear now that it was only real estate appraisers who were subject to the federally related transaction portion of the legislation. However, many of the appraisal organizations have encouraged all appraisers to follow the USPAP as a "best practices" technique.
- 1991—Formation of the National Association of Certified Valuation Analysts. This organization initially targeted CPAs who were looking to gain a credential in business valuation. It has since expanded its membership base to include non-CPAs and government employees. This organization was the fastest growing of all business valuation organizations and has made significant strides in becoming a major player in our field.
- 1997—The American Institute of CPAs Executive Board passes a specialty designation known as *Accredited in Business Valuation* (ABV). The first examination was given in November 1997. This designation, especially because it is appended to the CPA (CPA/ABV), gains immediate recognition in the marketplace among all of the credentials available in our field.
- 1998—The American Institute of Certified Public Accountants (AICPA), through great insight and foresight, published the first edition of my book. (Hey, don't laugh—it could not have been that bad—this is the fourth edition and you either bought it or it was given to you as a birthday present!)
- 2005—The AICPA sent out an exposure draft of the first business valuation standard in its history.
- 2006—The AICPA sent out a second exposure draft of its business valuation standard.
- 2007—The AICPA sent out a third exposure draft of its business valuation standard. This time it was approved and passed. This is so important an event in our history that I have devoted a complete chapter to this standard (see chapter 2).
- 2012—The fourth edition of my book gets published. And it keeps getting bigger and (hopefully) better!

Why Are Businesses Appraised?

Business valuation assignments will vary depending on their purpose. Therefore, it is imperative that the valuation analyst understand the purpose of the assignment before the process can begin. More often than not, the purpose will influence the standard of value, the methodologies used, the level of research performed, and possibly the date of the valuation. This does not mean that the valuation analyst takes shortcuts or aims for a high or low value. Examples of how these items can impact the assignment can be demonstrated by understanding that certain types of business valuations are guided by specific sets of rules, such as state statutes, IRS regulations, or Department of Labor regulations, or if a minority interest is being valued, certain adjustments may not be made to the company's financial statements because the minority interest cannot legally effectuate such adjustments. Valuations performed for divorce purposes may have case law restrictions that must be considered (for example, separating professional goodwill from the goodwill of the enterprise). If you have never done a business valuation, this stuff probably has you wondering what I am talking about. Be patient, this will start to make more sense as we proceed. Box 1.1 explains the variety of reasons that business valuation engagements are performed.

Mergers, Acquisitions, Reorganizations, Spin-offs, Liquidations, and Bankruptcy

Business valuations are frequently performed when one company acquires another company, when a company is targeted for an acquisition, when a company's capital structure is reorganized, when a company splits up, or when a company enters bankruptcy in liquidation or reorganization. The transactions may include entire or partial acquisitions, divestitures, liquidation, or recapitalization. Mergers will generally require both companies to be valued, while an acquisition may require only a single valuation. The terms of the transaction generally include cash, notes, stock, or a combination of these forms of payment.

In bankruptcy, in addition to the involvement of the different classes of creditors and the shareholders, the approval of the bankruptcy court is usually required. Closely held companies with two or more definable divisions may be split up or spun off into separate corporations. Reasons for doing this can include estate tax considerations, family conflict, or sale of only part of the total business. In the liquidation of a corporation, the valuation analyst's allocation of the assets distributed to the stockholders may be required to substantiate subsequent depreciation and other deductions claimed. Many publicly traded companies have acquired closely held businesses by using restricted stock (Rule 144 stock) as the form of payment. Restricted stock is discussed in chapter 15. The advantage of using stock as a form of payment is that the acquirer does not have to use cash to make the acquisition. Frequently, the transaction can also provide the seller with a tax-free transaction under Internal Revenue Code (IRC) section 1031. It also provides the seller with the opportunity to take advantage of the tax deferred appreciation of owning the acquirer's stock. This can be a good or bad thing. This can also create work for the valuation analyst.

Box 1.1 Reasons for a Business Valuation Engagement

- Mergers, acquisitions, reorganizations, spin-offs, liquidations, and bankruptcy
- Allocation of purchase price (tax and financial reporting)
- Estate, gift, and income taxes
- Marital dissolution
- ESOPs
- Buy-sell agreements
- Stockholder disputes
- Financing
- Ad valorem taxes
- Incentive stock option considerations
- Initial public offerings
- Damages litigation
- Insurance claims
- Charitable contributions
- Eminent domain actions
- Fairness opinions

Allocation of Purchase Price

An allocation of purchase price may be performed for either tax or financial reporting purposes. Each of these assignments will be accomplished based on the applicable set of rules for the intended purpose. The tax rules have been around longer, so I am going to start with them. The current financial reporting rules were codified since the last edition of this book and continue to evolve.

Years ago, both the purchaser and seller would determine their own values and treat the purchase and sale of the assets differently. The purchaser did not want to buy goodwill because it was not tax deductible, and the seller wanted to sell goodwill because it was subject to lower capital gains tax treatment. This created some very interesting allocations between the buyer and the seller. The all around loser was Uncle Sam. However, the Tax Reform Act of 1986 changed all of that. IRC section 1060 requires that when a business is acquired, a valuation must be performed to support the allocation of the total purchase price to the component parts for income tax purposes. The law requires a uniform allocation of the purchase price based on an appraisal of the underlying assets. The IRS now pays more attention to these transactions to ensure that the purchase price allocation is reasonable and is treated consistently by both the purchaser and the seller. An inappropriate or inconsistent allocation of the purchase price can result in an increased tax liability and, in some instances, penalties.

In 1993, the tax law changed, providing for intangible assets to be amortized over 15 years. This change reduced the necessity for valuation analysts to allocate the purchase price between different classes of intangible assets that had different amortization periods, or no amortization period (for example, goodwill) under the old law. Allocation of purchase price continues to be a required service, although the tax law has made it a little easier.

Not all allocations of purchase price are performed for income tax purposes. In some instances, an allocation may be performed when it is necessary to value certain components (assets or liabilities) of a company and not the entire equity of an enterprise. This can be illustrated by the following situation. A company was sold, and the value of the transaction was known. However, the $17 million sales price was problematic because our client thought that her husband's business was worth $5 million. After all, he told her this when they settled their divorce action based on this value. To say the least, she was not happy when she found out that the business was sold for $17 million, with the transaction closing about two weeks after the divorce was finalized. The court decided that she was entitled to her equitable share of the excess (due to the husband's fraud), but, because the divorce was in a state that did not consider personal goodwill or personal covenants not to compete as part of equitable distribution, she was entitled to the nonpersonal portion (See chapter 22 for an extensive discussion about *personal goodwill*).

The valuation analyst representing the husband allocated a large portion of the purchase price to personal goodwill or a personal covenant not to compete, or both. We had to allocate the purchase price to support the value of what our client was entitled to receive. This is an example of a nontax allocation of purchase price.

In addition to allocating the purchase price for tax purposes, generally accepted accounting principles (GAAP) also require these types of valuations. The valuation analyst is frequently being called on to provide valuation services with respect to pronouncements made by the Financial Accounting Standards Board (FASB). They include, but are not necessarily limited to, FASB *Accounting Standards Codification* (ASC) 805, *Business Combinations* (formerly FASB Statement No. 141); FASB ASC 350, *Goodwill and Other Intangible Assets* (formerly FASB Statement No. 142); FASB ASC 360, *Long Lived Assets* (formerly FASB Statement 144); and FASB ASC 820, *Fair Value Measurements* (formerly FASB Statement No. 157), all of which deal with issues such as the determination of the fair value of assets acquired and impairment of goodwill. These topics will be covered in more detail in chapter 19.

Estate, Gift, and Income Taxes

The valuation of a closely held business or business interest is important to estate planners as they consider the effect of the unified estate and gift tax credit on lifetime transfers of property. Although this is not a tax book, valuation analysts working in this area are urged to consult the appropriate IRC sections and regulations for specifics on the unified estate and gift tax requirements. If you think that finance books on business valuation are fun reading, try the tax code. You will never have so much fun!

IRC section 2036(c), relating to estate freeze techniques, was repealed and superseded by a new, complex set of rules in Chapter 14 of the IRC (sections 2701–2704). These rules can be advantageous to the client, but the IRC and IRS regulations include strict provisions for compliance. Valuation analysts, therefore, should familiarize themselves with these tax provisions. Chapter 21 of this book contains specific information about estate and gift tax valuations. Also included in that chapter are the rules that pertain to defining a *qualified appraiser*, as well as penalties if you get caught!

In addition to these items, the IRC contains special rules for the redemption of stock in a closely held company when the owner dies and the value of the stock represents more than 35 percent of the gross estate. Valuation analysts need to be aware of the alternatives under IRC section 303.

Valuations performed for income tax purposes may include S corporation conversions due to the built-in gains tax issues that arise if a sale occurs before the required holding period established by the IRC. Although these assignments do not occur as often as they did a few years ago, valuation analysts are still being approached to perform this assignment, especially in circumstances where the client did not listen to its tax accountants when he or she said that the client needed to do the appraisal at the time of the conversion. Clients frequently said, "I have no intention of selling my business during the next few years, so I am not worried about it." Guess what? The built-in gains tax kicked in when the client received an offer to sell that was too good to pass up. Valuation analysts should consult applicable sections of the tax law to properly understand the unique requirements of S corporation valuations performed for a conversion. S corporation and other pass-through entity valuation issues are discussed further in chapter 18.

Another practice opportunity that we are seeing show up is the allocation of purchase price for tax purposes. Although I discussed this before, we are starting to see more and more valuations arise when the seller of a business is attempting to allocate part of the sales price of a corporate entity to personal goodwill. We are talking about the difference between income taxes at about 35 percent and capital gains taxes at 15 percent. That 20 percent can be a big number in tax savings!

Marital Dissolution

In a marital dissolution, most of a couple's assets and liabilities are valued, regardless of whether their state follows equitable distribution or community property rules. Frequently, one of the assets included in the marital estate is an interest in a closely held business. It is typical to have the business valued in its entirety if it is a small business, but sometimes only a portion of the business (for example, a minority interest) is valued in a large business. Usually the business is not divided between the spouses. Instead, one spouse keeps the business, and the other receives different assets of equal value. Because marital dissolution laws vary significantly from state to state, the valuation analyst must be aware of the rules of the state in which the divorce takes place. For example, in some states, goodwill associated with a professional is excludable from distribution, while in other states, it is includable. Another item that the valuation analyst must be aware of is the standard of value (covered in chapter 4) used in the jurisdiction of the marital dissolution. Frequently, fair market value is the standard of value discussed, but the application from state to state varies greatly from the definition found in the tax laws. This can be illustrated by reviewing cases from various states. For example, in Florida, fair market value has been interpreted to be the value of the business, assuming that the business owner walks away without a covenant not to compete. In most instances, fair market value assumes a covenant not to compete. Logically, what willing buyer would purchase a business if the seller could open up next door and compete with him or her? In Pennsylvania, fair market value excludes personal goodwill. Clearly, the valuation analyst cannot be expected to know every state law, but he or she should ask the client's attorney for information before proceeding in a direction that may have his or her report thrown out for failure to comply with the rules of the jurisdiction. Chapter 18 contains specific information about divorce valuations.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) is an incentive ownership arrangement funded by the employer. In general, employer stock is contributed instead of cash. ESOPs provide capital, liquidity, and certain tax advantages for private companies whose owners do not want to go public. An independent valuation analyst must value the employer's securities, at least annually, and must determine the price per share supporting transactions with participants, plan contributions, and allocations within the ESOP. Valuation analysts are urged to become familiar with the rules promulgated by the IRS and the Department of Labor before they begin an ESOP engagement.

Buy-Sell Agreements

A buy-sell agreement allows a partner or stockholder in a closely held business to acquire the interest of a partner or stockholder who withdraws from the business. The agreement may contain a designated price or a formula to determine the price that the remaining owners of the entity will pay to acquire the interest. The price, or the formula, needs to be updated periodically. Payment terms and conditions of sale are also generally provided. A client may ask a valuation analyst to assist in determining which valuation method is appropriate in such an agreement.

Buy-sell agreements are also used frequently to establish a value for a transaction between the partners or stockholders in the event of death, disability, or retirement. It is common to see different formulas for each event. The valuation analyst must be aware of IRC section 2703 and its effect on valuations when there is a buy-sell agreement in effect.

In working with the client, the valuation analyst should caution him or her, and possibly the entity's legal counsel, about the use of a single formula. Formulas do not always appropriately consider the economic and financial climate at the valuation date, stand the test of time, or achieve the parties' intentions. Therefore, their usage should be limited. Instead, the basis of a buy-sell agreement should be a valuation. If an extensive valuation is required, it should be performed by a qualified valuation analyst.

Stockholder Disputes

Stockholder disputes can range from breakups of companies resulting from disagreements between stockholders to stockholder dissent relating to mergers, dissolutions, and similar matters. Because many states allow a corporation to merge, dissolve, or restructure without unanimous stockholder consent, many disputes have arisen over the years because minority stockholders have felt that the action of the majority had a negative impact on them. Dissenting stockholders have filed lawsuits to allow their shares to be valued as if the action never took place.

In such cases, the value of the stockholder's interest is what it was immediately before the change; it does not reflect the impact of the proposed change on the value of the corporation. In these instances, the value is generally determined according to the standard of fair value, based on either statute or the case law within the state of incorporation. When a valuation analyst accepts an engagement relating to a stockholder action, it is advisable for him or her to request the client's legal counsel to clarify the value definition used in the particular state. The valuation analyst cannot address such issues as control premiums, minority discounts, and discounts for lack of marketability without adequate legal information about the value definition to be used.

Many states also have statutes to protect minority shareholders from being "oppressed" (abused) by the controlling shareholder(s). This is another instance where the valuation analyst must become familiar with the statutes and case law of the jurisdiction in which the legal action is pending. Chapter 24 contains some specific information about shareholder dispute valuations.

Financing

A valuation of the business may provide lenders or potential investors with information that will help the client obtain additional funds. Financial statements present information about a business based on historical amounts. For a new business, the traditional statement may closely reflect the estimated current value. However, this is generally not the case for an established business that has developed intangible value over the years. Assets with intangible value (such as special trademarks, patents, customer lists, and goodwill) may not be reflected in the financial statements. Furthermore, other assets and liabilities of the business (such as real estate and equipment) may be worth significantly more or less than the book value as recorded under GAAP.

Ad Valorem Taxes

In some jurisdictions, ad valorem taxes are based on the value of property used in a trade or business. Various entities are subject to ad valorem taxation, and, therefore, the fair market value of such properties must frequently be determined to ascertain the amount of tax. Regulations and case law differ significantly from jurisdiction to jurisdiction. To determine the appropriate standard of value for these properties, the valuation analyst needs to consult the client's lawyer.

Incentive Stock Option Considerations

Many large companies provide fringe benefits in the form of incentive stock option plans that allow their employees to purchase the company's stock at a certain point in time and at a stated price. Employees pay no taxes when the incentive stock option is granted or when the stock option is exercised. Employees do pay tax, however, when they sell the stock received through the exercise of the option. To qualify as an incentive stock option, a stock's option price must equal or exceed its fair market value when the option is granted. Accordingly, the valuation of a closely held company has a significant effect on its incentive stock option plan.

Over the past decade, stock options have become a major component of employee compensation packages. This is especially true for start-up companies that may not have the cash flow to pay market rates of compensation to its employees. Instead, the employee works for the company for a lower salary but a very generous stock option plan. The computer industry has produced many millionaires as a result of these programs. Oh, to be a geek!

Initial Public Offerings

A substantial amount of legal and accounting services must be rendered to bring a private business to the public marketplace. From a financial standpoint, the corporation's accounting records and statements are carefully reviewed and amended, if necessary. The capital structure may need enhancement, and executive benefit plans may need revisions. More important, the corporation's stock is valued for the initial offering.

The underwriter must exercise a great deal of judgment about the price the public may be willing to pay for the stock when it is first offered for sale. Such factors as prior years' earnings, potential earnings, general stock market conditions, and the stock prices of comparable or guideline companies need to be considered to determine the final offering price. The client may ask the valuation analyst to support the offering price by performing a valuation or a fairness opinion.

Damages Litigation

Many court cases involve damages. Some cases relate to compensation sought for patent infringements, illegal price fixing, breaches of contract, lost profits, or lost business opportunities, while others relate to lender liability, discrimination, and wrongful death actions. The valuation analyst may also be asked to perform hypothetical valuations of a company to determine the amount of damages resulting from the loss of business value (i.e., diminution of value) to the stockholders. These types of valuations generally require the valuation analyst to value the company twice. The first valuation determines the value of the company at the present time. The second valuation is based on what the company would have been worth had a certain action taken place or not taken place. The difference is generally a measure of damages.

Practitioners are cautioned to be aware of such court decisions as *Daubert*[1] and *Kumho Tire*[2] to ensure that the methodologies employed in these and other types of litigation are generally accepted in the literature. Using methods that are not generally accepted can result in the expert's disqualification in a litigation. This is sure to make for unhappy clients and attorneys. Keep in mind that these cases also apply to more than just damages litigation. They are applicable to all types of litigation assignments. Chapter 26 contains specific information pertaining to economic damages.

Insurance Claims

Cases involving risk insurance claims focus on the loss of income because of business interruptions and the value of such separate business assets as inventory and equipment. A valuation may be required to support the owner's position or the insurer's position. The loss of income would be determined based on documentable lost profits. The value of individual business assets, such as inventory and equipment, would be based on the replacement cost of these assets.

Charitable Contributions

Owners of closely held businesses may wish to give all or part of their interest in a business to a favorite charity. Although shares of stock in a closely held business are donated to charity infrequently, this option exists, and the valuation analyst must be aware of the income tax rules concerning the necessary documentation to be included in a valuation report for the deductibility of such gifts. Current tax laws encourage charitable donations by permitting a tax deduction equal to the fair market value of certain appreciated capital gains property. For gifts of property in excess of $500, the IRS requires that donors provide documentation to support the deduction for the year in which the gift was given. If the amount of the tax deduction warrants the expense, donors can obtain a valuation of the gift. If the value of the gift exceeds $5,000, a qualified appraisal is required. I will discuss what makes a qualified appraisal in chapter 21.

Eminent Domain Actions

An eminent domain action takes place when the government exercises its right to take over property and must compensate the owner for any resulting reduction in the value of the property. For example, a business may have to forfeit a prime location to accommodate the widening of a street. Although the business can relocate, its value may be adversely affected during the period of the move or as a result of changing locations. An expert opinion on the monetary effect of the condemnation may be necessary to support the business owner's claim or the government's offer. As part of the business valuation, the valuation analyst should become familiar with the demographics of the area and should assess the impact of the change in location. In assessing the impact, the business valuation analyst needs to remember that real estate valuation analysts have often said that the key to a business's success is "location, location, location." Projections may be required to calculate the losses. A valuation of the business, both before the condemnation and after the move, may be required. The expenses of the actual move need to be considered in the valuation.

[1] *William Daubert, et al. v. Mzw Pharmaceuticals, Inc.*, 509 U.S. 579, 113 S. Ct. 2786, 125 L.Ed.2d 469 (1993).

[2] *Kumho Tire Company, Ltd., et al. v. Patrick Carmichael, et al.,* 119 S. Ct. 1167, 143 L.Ed.2d 238 (1999).

Fairness Opinions

A service that is very closely related to business valuation is the fairness opinion. A fairness opinion is generally required when a corporation is involved in a merger, acquisition, going private, or other type of transaction where the board of directors wants to have an independent valuation analyst give its blessing to the transaction. This is a high risk type of service, and it should not be performed by a valuation analyst unless he or she really understands the nuances of the fairness opinion.

This service is frequently provided by investment bankers (with deep pockets). However, many appraisal firms also offer this service. After the Sarbanes-Oxley Act of 2002[3] legislation was passed, many smaller publicly traded companies have gone private, requiring fairness opinions. The purpose of the fairness opinion is for the valuation analyst to opine that the transaction is fair to the stockholders from a financial point of view. The valuation analyst does not determine value because there is already an agreed upon price for the transaction. The valuation analyst should read many other publications, including actual fairness opinions, before even thinking about doing one. Think liability!

Who Values Businesses?

There is a considerable amount of competition among business valuers. There are a growing number of full time valuation analysts in the business, but they are outnumbered by the part time valuation analysts, who spend much of their time in other areas. It is important to understand who the other players in the field are because you will come across them if your practice is anything like mine. Understanding the strengths and weaknesses of your opposition, particularly in a litigation engagement, will allow you to properly assist the attorney with whom you are working so that he or she can cross examine the other expert more thoroughly. Among the groups providing business appraisal services are the following:

- Business valuation analysts
- Accountants (CPAs)
- Business brokers
- College professors (finance and economics)
- Commercial real estate appraisers
- Investment bankers
- Industry experts
- The Internet (the newest entry into our field!)

Each group of professionals brings something unique to the practice of business valuation. Each group has its advantages and disadvantages, although the better business valuation analysts have crossed over boundaries and obtained some of the advantages of the other groups. Each of these groups is discussed in the following sections.

Business Valuation Analysts

Professional business valuation analysts are those individuals who provide business appraisal services as their main area of focus. They are generally well educated in business valuation, and this includes having an understanding of issues involved in the fields of finance, economics, security analysis, and accounting, among others. Most of these individuals either have received some form of accreditation from a professional appraisal organization or are currently pursuing these credentials (credentials are discussed later in this chapter).

Many of these individuals work in an environment where they are exposed to businesses of a particular type (for example, professional practices, large companies, small companies, or a particular industry). One difficulty that these individuals may encounter is trying to value a company that is not in their area of specialization. For example, a valuation analyst who is accustomed to using public stock market information to value large closely held companies may have a difficult time valuing the small hardware store (not The Home Depot).

[3] *Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745).*

Accountants (CPAs)

Over the past few decades, the number of accountants performing business valuations has grown exponentially. An accountant's background and training provide both advantages and disadvantages with regard to being a business valuation analyst.

Accountants have several advantages in rendering business valuation services. They are educated in financial concepts and terminology. This gives the accountant a distinct advantage in understanding financial statements. It also may give the accountant the ability to analyze the financial statements using the same analytical tools (for example, ratio analysis) that he or she employs to perform other types of accounting services.

Working with numbers is another clear advantage for the accountant. We bean counters can count beans better than anyone else. Accountants are also frequently exposed to revenue rulings and tax laws. This can represent a significant advantage over other types of valuation analysts, especially when tax related appraisals are being performed. To illustrate this point, our firm performed a valuation assignment for the IRS (I know, the so-called bad guys! They really are not a bad group to work for once you get to know them.) where the subject of the valuation was a 1.6 percent beneficial interest in a trust. The taxpayer's valuation analyst took a discount for lack of marketability, which we pointed out as being incorrect because of specific IRS regulations that pointed to mortality tables that took this into consideration. Don't try to figure out all of the details; suffice it to say that our awareness of the tax laws gave us a distinct advantage over the non-CPA valuation analyst.

However, there are disadvantages as well. Accountants are used to working with financial statements and concepts that are either GAAP oriented or tax oriented. These concepts deal with book value rather than market value. Accountants are also frequently uncomfortable working with forecasts of the operating performance of the business being valued. Accountants are historians by nature. Financial statements generally report the past, not the future.

Over the years, accountants have been exposed to a large number of malpractice lawsuits, particularly in the audit area. Recently, the lawsuits have gone beyond the audit arena into litigation support engagements. As a result, accountants tend to be concerned with malpractice exposure because of the subjective nature of business valuation. The debits do not equal the credits; therefore, is the answer correct? Accountants also have to be concerned with potential conflicts of interest (for example, preparing tax returns for the business and then adjusting the officer's compensation in the appraisal as being excessive). Even if there is not a conflict of interest, there can be a perceived bias in certain types of assignments.

Business Brokers

Business brokers have a distinct advantage as business valuation analysts because they are involved with actual transactions in the marketplace. Because fair market value comes from the market, the business broker is frequently more familiar with the market for the business being appraised.

However, many business brokers do not complete appraisal training. They are generally salespeople as opposed to valuation analysts. They will tell you that a similar business sold for $1 million and that the appraisal subject is, therefore, also worth $1 million, but they may not understand the effect on value that the terms of the transaction can have. What if the similar business sold with terms of 20 percent down, with the balance being paid off over 10 years with no interest? The present value of this transaction would be quite a bit less than $1 million. Business brokers are generally involved in the investment value standard and often have trouble switching to fair market value due to their lack of appraisal training.

Business brokers are also very quick to value a business based on "rules of thumb." Rules of thumb can be dangerous. They are discussed in chapter 10. It has also been my experience that some brokers tend to sell the same type of business for the same multiple of earnings or gross revenues, over and over again, which tends to make them market makers instead of interpreters of the market—which is actually the role of the valuation analyst. Frequently, the business broker also lacks training in financial statement analysis.

College Professors

Another group of valuation analysts who are visible in the field are college professors with backgrounds in economics and finance. Many professors are entering this field because they have time after school or as a means to supplement their income (not a bad part time job). Sometimes these folks even have Ph.D.s. Almost every time I have a Ph.D. on the opposite side of a case, it reminds me that Ph.D. stands for *philosophically different*. Sometimes these guys are out in left field with their theory of the universe. There is no doubt that the vast majority of these individuals understand the theory, but some (not all) demonstrate two shortcomings: first, they try to apply some very complex formulas to simple little businesses, and second, they cannot explain what they did in language that most regular people can understand. Many of these individuals are very strong in their comprehension of financial modeling and formulas. Although the mathematical formula may be correct, the answer may still be wrong.

Commercial Real Estate Appraisers

Every time that we see the real estate market suffer, we have seen a growing number of commercial real estate appraisers entering the field of business valuation. Included among the students of courses that I have taught are members of this profession who are trying to expand their businesses. During the slow times in the real estate world, many appraisers look to fill up their work week with business valuation assignments. And often, the pay is better for business valuation assignments.

Although real estate appraisers understand the valuation process and principles, they often have a difficult time with the accounting aspects of financial reporting. They also have some difficulty making the transition into business valuation, where the ability to verify comparables is not always possible. Finally, although many real estate appraisals involving a capitalization of income use capitalization rates between 8 percent and 12 percent, real estate appraisers have a difficult time understanding the substantially higher capitalization rates used to appraise small businesses.

Investment Bankers

Investment bankers are frequently employed to perform valuations for a wide variety of assignments, including estate and gift tax valuations, initial public offerings, and going private, as well as for other purposes. More often than not, the investment bankers perform pretty large valuation assignments. They are brought into assignments for reasons that come before the issue of the fee. It is much different from the local hardware store.

Industry Experts

Industry experts are being called upon more often these days to provide valuation opinions regarding businesses in their industry. Many of these individuals are familiar with what is going on in the industry, but they rarely have the qualifications of a business valuation analyst. However, the courts are paying a lot of attention to these individuals, rightfully or wrongfully, because they are believed to understand the mechanics of the industry. My own experience is that many of these industry experts are more expert from the operational side of the business than from the valuation side. Sometimes, you may want to team up with someone who has the industry know-how to strengthen your valuation.

The Internet

Did you know that you can get a business valuation done on the Internet? There are websites that allow you to put in your credit card number, some financial data about a company, and out comes a business valuation. Some sites even claim that the report is in compliance with standards! We actually had one prospective client ask us how we differentiate ourselves from an Internet site, particularly because our fee quote was considerably higher. The question just did not deserve an answer. We told the prospect that you get what you pay for! We also told her that she can talk to us and get an answer (rather than talk to the computer and get no response). For that matter, my name does not start with "www."