

CONTENTS

Introduction.....	xix
Steps of an Appraisal	xxi
Notation System Used in This Book.....	xxi
Chapter 1 Overview of Business Valuation.....	1
Chapter Goals.....	1
Introduction.....	1
A Brief Walk Down Memory Lane.....	1
Why Are Businesses Appraised?	2
Mergers, Acquisitions, Reorganizations, Spin-offs, Liquidations, and Bankruptcy	2
Allocation of Purchase Price	3
Estate, Gift, and Income Taxes.....	4
Marital Dissolution.....	4
Employee Stock Ownership Plans.....	5
Buy-Sell Agreements.....	5
Stockholder Disputes	5
Financing.....	6
Ad Valorem Taxes	6
Incentive Stock Option Considerations	6
Initial Public Offerings.....	6
Damages Litigation.....	7
Insurance Claims.....	7
Charitable Contributions.....	7
Eminent Domain Actions	7
Fairness Opinions	8
Who Values Businesses?.....	8
Business Valuation Analysts.....	8
Accountants (CPAs)	9
Business Brokers	9
College Professors.....	10
Commercial Real Estate Appraisers.....	10
Investment Bankers	10
Industry Experts.....	10
The Internet.....	10
Professional Appraisal Organizations	11
The AICPA.....	11
The American Society of Appraisers.....	11
The Institute of Business Appraisers, Inc.	14
The National Association of Certified Valuation Analysts	14
The CFA Institute	15
The Appraisal Foundation.....	15
Conclusion	15
Chapter 2 Business Valuation Standards.....	17
Chapter Goals.....	17
Introduction.....	17
AICPA Statement on Standards for Valuation Services No. 1	17
Foreword	18
Why Issued	18
Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset	19
Introduction and Scope	19
Overall Engagement Considerations.....	21
Development	24
The Valuation Report	34
Effective Date.....	43
Interpretation No. 1-01, "Scope of Applicable Services" of Statement on Standards for Valuation Services No.1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset	44
Background	44
General Interpretation	44
Specific Illustrations	45
Illustrations Relating to Litigation Engagements and Certain Controversy Proceedings	45
Illustrations Relating to Tax Engagements	46
Illustrations Relating to Other Engagements	54
Illustrations for PFP-Specific Engagements	55
AICPA Statement on Standards for Consulting Services No. 1	57
AICPA Code of Professional Conduct— Rule 102	57
Professional Competence.....	57
Due Professional Care	57
Planning and Supervision	57
Sufficient Relevant Data.....	58
Client Interest	58
Understanding With the Client	58
Communication With the Client	59
IBA Standards	59
ASA Standards	59
Uniform Standards of Professional Appraisal Practice	59
NACVA Standards	59
Glossary of Business Valuation Terms	60
Conclusion	60

Chapter 3 Getting Started.....	61
Chapter Goals.....	61
Introduction.....	61
Learning About the Engagement	61
Deciding Whether to Accept the Engagement	62
Conflicts of Interest	62
Purpose and Function of the Engagement.....	70
Amount of Time Required to Do the Job	71
The Scope of the Assignment	71
The Type of Report to Be Issued.....	74
Engagement Letters	74
Description of the Scope of the Assignment	86
Detailed Description of the Appraisal Subject.....	88
Standard of Value That Will Be Used, Including the Definition of That Standard.....	88
Effective Date(s) of the Valuation	89
Type of Report That Will Be Issued to Communicate the Value Estimate	89
Client Responsibilities	89
Method of Determining Fees and the Terms of Payment	89
Five Steps of an Appraisal Assignment	90
Engagement Letter Considerations for Litigation Reports	90
The Initial Document Request	90
Using a Standard Checklist	94
Setting Up Multiple Checklists	94
Conclusion	99
Chapter 4 Appraisal Principles and Theory.....	101
Chapter Goals.....	101
Introduction.....	101
Principles of Appraisal.....	101
Principle of Alternatives.....	101
Principle of Substitution	102
Principle of Future Benefits.....	102
Standards of Value	103
Fair Market Value	103
Fair Value.....	107
Investment Value.....	108
Intrinsic Value.....	109
How the Purpose of the Valuation Influences the Standard of Value.....	110
Subsequent Events (Known or Knowable)	111
IRS Influence on Appraisals	113
Revenue Ruling 59-60.....	113
Revenue Ruling 65-192.....	114
Revenue Ruling 65-193.....	114
Revenue Procedure 66-49.....	114
Revenue Ruling 68-609.....	114
Revenue Procedure 77-12.....	115
Revenue Ruling 77-287.....	115
Revenue Ruling 83-120.....	115
Revenue Ruling 85-75.....	115
Revenue Ruling 93-12.....	115
Technical Advice Memorandum 94-36005.....	116
Chapter 14 of the IRC	116
Conclusion	116
Chapter 5 Data Gathering.....	117
Chapter Goals.....	117
Introduction.....	117
What Items Affect Value?.....	117
Internal Information	117
Nonfinancial Information	117
Financial Information	127
External Information.....	128
Economic Data	128
Industry Data	136
Publicly Traded Guideline Company Data.....	143
The Old Days (When the Dinosaurs Roamed the Earth).....	143
Other Sources of Data	146
The On-Site Interview	149
Conclusion	155
Chapter 6 Data Analysis	157
Chapter Goals.....	157
Introduction	157
Economic Analysis.....	157
Industry Analysis	161
Porter's Five Forces	161
Other Considerations	166
Subject Company Analysis	173
SWOT (Strengths, Weaknesses, Opportunities, and Threats) Analysis	173
Financial Analysis.....	176
Comparative Company Analysis	176
Common Size Financial Statements	176
Financial Ratios.....	179
Comparative Industry Analysis	183
Trend Analysis.....	194
Operational Analysis	195
Financial Statement Adjustments.....	197
Conversion of Cash or Income Tax Basis to GAAP	197
Tax Return Adjustments.....	198
Understanding Financial Statements for Valuation Purposes	198
Analysis of Historical Balance Sheets	201
Analysis of Historical Income Statements	201
Bardahl Analysis	201

Normalization Adjustments.....	204	Statistical Trend Models.....	250
Comparability Adjustments.....	207	Monte Carlo Simulation	260
Nonoperating and Non-Recurring Adjustments	208	Projecting Sales for a New Business.....	260
Discretionary Adjustments	208	Cost of Goods Sold	270
Minority Interest Valuations.....	213	Operating Expenses.....	273
Conclusion	221	Depreciation and Capital Expenditures	273
Chapter 7 Statistics for Valuation and Economic Damages	223	Interest Expense and Borrowing Needs.....	274
Chapter Goals.....	223	Balance Sheet Forecast	277
Introduction.....	223	Applicable Standards for Forecasts in Business Valuation and Economic Damage Assignments.....	281
Population and Sample: Descriptive and Inferential Statistics	223	Court Acceptance.....	282
Discrete and Continuous Variables	224	Conclusion	284
Frequency Distributions and Measures of Variation	224	Chapter 9 The Market Approach—Part I	285
Central Tendency (Mean, Median, Mode, and So Forth).....	224	Chapter Goals.....	285
Relation Between Mean, Median, and Mode.....	225	Introduction.....	285
Relation Between Arithmetic, Geometric, and Harmonic Means	226	Guideline Public Company Method	286
Quartiles, Deciles, and Percentiles	226	Creating a List of Potential Guideline Companies	294
Variation.....	227	Industry Research	300
Correlation.....	228	Get the Business Description	300
Let's Do Some Number Crunching.....	231	Size Criteria.....	301
Calculation of the Mean	232	Active Trading and Penny Stocks	301
Calculation of the Harmonic Mean	232	Stock Pricing Reports and Active Trading	302
Calculation of the Standard Deviation.....	232	For Those That Pass Muster	304
Calculation of the Coefficient of Variation	232	Using Valuation Multiples	316
Calculation of Median and Percentile	232	Price to Net Earnings	317
Be Careful Not to Drink the Statistics Kool-Aid: This Stuff Can be Misleading.....	232	Price to Pretax Earnings.....	317
Conclusion	236	Price to Cash Flow	317
Chapter 8 Developing Forecasts for Business Valuations and Economic Damages	237	Price (MVIC) to Sales	318
Chapter Goals.....	237	Price to Dividend or Dividend Paying Capacity	318
Introduction.....	237	Price to Book Value	318
Forecast Versus Projection	237	Valuing Invested Capital Instead of Equity.....	319
Management's Forecast.....	238	Adjusting Public Company Multiples for Risk.....	319
Factors to Consider When Evaluating Management's Forecast.....	239	Economic Risk.....	320
Company Specific Factors	239	Business Risk	320
Economic Conditions	242	Operating Risk.....	320
Industry Trends	246	Financial Risk.....	320
Preparing the Forecast.....	247	Asset Risk	321
The Sales Forecast	248	Product Risk	321
Revenue Factors for Certain Industries	249	Market Risk	321
Sales Forecasting Techniques.....	249	Technological Risk	321
Average Historical Growth Rate	249	Regulatory Risk	321
		Legal Risk	321
		Valuation Considerations	322
		What Price Do We Use in the Multiples?.....	323
		Regression Analysis	324
		Adjusting Multiples Based on SGLPTL	324
		Making Quantitative Adjustments to Multiples	330

Adjusting the Market Multiple for Size Risk	331	Chapter 12 The Income Approach	409
Adjusting the Market Multiple for Growth Risk	332	Chapter Goals	409
How to Calculate the Present Value Weighted Perpetual Growth Rate	333	Introduction	409
Advantages of Using the Guideline Public Company Method	335	Value Is From an Investor's Viewpoint	410
Disadvantages of Using the Guideline Public Company Method	336	Advantages and Disadvantages of the Income Approach	411
So Let's Be Honest	336	Advantages	411
Let's Demo Pitchbook	337	Disadvantages	411
Conclusion	346	Selecting Benefit Streams	411
Chapter 10 The Market Approach—Part II	347	The Nature of the Business and Its Capital Structure	411
Chapter Goals	347	The Purpose and Function of the Appraisal	412
Introduction	347	The Particular Subject of the Valuation	412
Merger and Acquisition (Transaction) Method	347	Using Pretax or After Tax Information	412
IBA Market Database	349	Valuing Invested Capital Instead of Equity	413
BizComps	353	Using Cash Flow Instead of Earnings	413
Pratt's Stats	358	Defining Cash Flow	414
Done Deals	366	Forecasting Future Benefit Streams	415
Public Stats	367	Income Approach Methods	421
Mergerstat/BVR's Control Premium Study	368	Capitalization of Benefits Method	421
Thomson Financial Mergers & Acquisitions (TF Mergers & Acquisitions)	368	Discounted Future Benefits Method	427
Business Brokers	370	The Excess Earnings (Formula) Method	430
Transaction Analysis	372	Conclusion	439
Qualitative Analysis	373	Chapter 13 Discount and Capitalization	441
Quantitative Analysis	378	Rates	441
Let's Get Back to Valuation Theory	379	Chapter Goals	441
Advantages of Using the Merger and Acquisition Method	379	Introduction	441
Disadvantages of Using the Merger and Acquisition Method	382	Discount Rates	443
Internal Transactions	383	Factors That Affect the Selection of a Discount Rate	444
Industry Method	384	Components of a Discount Rate	444
Conclusion	385	Comparing the Subject Company	461
Chapter 11 The Asset-Based Approach	387	Application of the Discount Rate	472
Chapter Goals	387	When All Else Fails, Go Back to the Theory	472
Introduction	387	The Build Up Method	472
Common Applications of the Asset-Based Approach	387	Capital Asset Pricing Model (CAPM)	472
Advantages and Disadvantages of the Asset-Based Approach	388	Other Methods for Estimating a Discount Rate	479
Valuation Methods	389	Capitalization Rates	486
Adjusted Book Value Method	389	Factors Affecting the Selection of the Capitalization Rate	487
Liquidation Value Method	401	Sources of Data on Capitalization Rates	488
Cost to Create Method	405	Deriving Discount and Capitalization Rates Applicable to Net Income Directly From the Market	489
Working With Other Appraisers	406	Back to the Real World	490
How to Locate and Recognize Specialists	406	Using Pretax or After Tax Rates	491
Conclusion	407	Discount Rates for Economic Damages	498

Chapter 14 Premiums and Discounts	
(Valuation Adjustments)—Part I	501
Chapter Goals	501
Introduction	501
Types of Discounts	503
Levels of Value	504
Valuation Adjustment—Control Premium	504
Protecting the Minority Owner with Rights and Restrictions Through Agreements	505
Legal Remedies	507
More Control Premium Issues	507
Lack of Control (Minority) Discounts	515
Discount From Net Asset Value	519
Discount for Embedded Capital Gains	525
The Embedded Capital Gain Problem	526
Court Case Precedents on Embedded Capital Gains Tax with C Corporations	526
Embedded Capital Gains in Pass-Through Entities	527
Court Decisions on Embedded Capital Gains in Pass-Through Entities	528
Nonvoting Stock Discount	528
Conclusion	530
Chapter 15 Premiums and Discounts	
(Valuation Adjustments)—Part II	531
Chapter Goals	531
Introduction	531
Discount for Lack of Marketability (Illiquidity)	531
DLOM for Control	532
DLOM—The Qualitative Stuff	533
Private Company Discount	606
Some More Empirical Data	608
Key Person Discount	609
Quantifying the Magnitude of the Key Person Discount	610
Court Cases Involving Key Person Discount	610
Blockage Discount	611
How About Some Court Cases?	616
Other Premiums and Discounts	616
Application of Valuation Adjustments	618
Conclusion	619
Chapter 16 Revenue Ruling 59-60	621
Chapter Goals	621
Introduction	621
Revenue Ruling 59-60	621
Conclusion	631
Chapter 17 The Valuation Report	633
Chapter Goals	633
Introduction	633
Components of a Valuation Report	633
Letter of Transmittal	634
Table of Contents	634
Introduction	634
Description of the Assignment	635
Scope of Work	635
Assumptions and Limiting Conditions	635
Sources of Information	636
Analysis of Subject Entity and Related Nonfinancial Information	636
Financial Statement/Information Analysis	637
Valuation Approaches and Methods Considered	637
Valuation Approaches and Methods Used	638
Valuation Adjustments	638
Nonoperating Assets, Nonoperating Liabilities, and Excess or Deficient Operating Assets	638
Representation of the Valuation Analyst	638
Reconciliation of Estimates and Conclusion of Value	638
Qualifications of the Valuation Analyst	638
Appendices and Exhibits	638
Types of Valuation Reports	639
Detailed Reports	640
Summary Reports	640
Calculation Reports	641
Oral Reports	641
Preparing the Business Valuation Report	641
Federal Rules of Civil Procedure	642
Using Your Report as a Selling Tool	642
Using the Other Side's Report to Help Sell Your Opinion	645
Understanding the Weaknesses in the Valuation Process	654
Valuation Analyst, Protect Yourself!	655
Defending the Business Valuation Report	655
Common Errors in Business Valuation Reports	656
The Reconciliation Process	657
Conclusion	660
Chapter 18 Valuation of Pass-Through Entities	661
Chapter Goals	661
Introduction	661
What is an S Corporation?	661
Key Court Cases	663
So Where Do We Go From Here?	664
Valuation Issues	664
Standard of Value	665
Control Versus Minority	666

Distributing Versus Nondistributing	666
Corporate or Personal Income Tax Rates.....	671
Holding Period of the Investment.....	672
Timing of the Valuation.....	672
So, What Do We Do?	672
Back to the Future.....	674
S Corporation Models	675
How Our Firm Handled the S Corporation Issue.....	687
How Do the Models Compare?.....	688
Some Points to Consider	688
Other Pass-Through Entities	690
Conclusion	690
Chapter 19 Valuation in Financial Reporting ...	691
Chapter Goals.....	691
Introduction.....	691
Background of Valuation in Financial Reporting.....	691
FASB ASC 820, <i>Fair Value Measurement</i>	692
Definition of <i>Fair Value</i>	692
Example of Principal and Most Advantageous Markets.....	694
Market Participants Assumptions.....	694
Highest and Best Use Application Criteria Applied in Fair Value Measurements.....	695
FASB ASC 805, Business Combinations	696
Recognizing Identified Assets in Business Combinations.....	696
Fair Value Measurements in Impairment Testing.....	705
When to Test for Ongoing Impairment.....	706
Developing Best Practices in Valuation for Financial Reporting.....	707
Valuation Resource Group	707
AICPA	707
Working With Your Client's Outside Auditing Firm.....	707
Identification of Intangible Assets for Financial Reporting	708
Conclusion	709
Chapter 20 Valuing Intangible Assets:	
An Overview	711
Chapter Goals.....	711
Introduction.....	712
What Is Intellectual Property?	716
Conducting a Valuation of Intangible Assets	717
Market Approach	718
Income Approach	718
Cost Approach.....	719
What Is a Remaining Useful Life Analysis?	720
What Is a Reasonable Royalty Rate and Where Do I Get This Stuff?.....	721
What Is an <i>Amortization Benefit</i> ?	726
How About Some More Examples.....	728
Create a Lead Schedule for Your Analysis.....	728
Fair Value of the Customer List.....	728
Fair Value of Acquired Software	730
Fair Value of Customer Related Intangibles with an Excess Earning Model	730
Fair Value of Noncompete Agreements Using a "With and Without" Model	731
Fair Value of the Assembled Workforces	732
Personal Goodwill.....	735
Conclusion	749
Chapter 21 Estate and Gift Valuations.....	751
Chapter Goals.....	751
Introduction.....	751
Penalties for Undervaluation on Estate and Gift Tax Returns	751
2006 Pension Protection Act.....	752
Revenue Ruling 59-60	753
Chapter 14 Guidelines.....	753
Case Law	753
The Valuation Report	753
The FLP Report	753
What Is an FLP?	754
Why Are FLPs Attractive?.....	754
What Exactly Is the Assignment?.....	755
What Documents Are Necessary for Preparing the Appraisal Report?	755
How Does Revenue Ruling 59-60 Help?.....	756
What Is Chapter 14?.....	756
How Does All This Affect the Valuation Assignment?	758
Section 2036	758
More Court Cases.....	760
Things to Consider in the Appraisal Process	760
What About Methodology?	761
Valuation Adjustments	762
The FLP Written Report.....	768
As Valuation Analysts, Do We Go for the Big Discounts?	773
Conclusion	773
Chapter 22 Divorce Valuations	775
Chapter Goals.....	775
Introduction.....	775
The Role of the Valuation Analyst	775
Definition of Value.....	776
Fair Market Value	777

Intrinsic Value	777	Cash Versus Accrual Accounting	876
Fair Value	777	Valuation Calculations—Unique Aspects	
What do the Definitions Really Mean		of the Calculations	901
in a Divorce Context?	777	Rules of Thumb	901
Valuation Dates	778	Statutory Rule Value	902
Date of the Marriage	779	Asset-Based Approach	903
Date of Gift or Inheritance	779	Conclusion	905
Date of the Separation	779		
Date of the Divorce Complaint	779	Chapter 24 Shareholder Disputes	907
Date Agreed to by the Parties	779	Chapter Goals	907
Date of the Trial	779	Introduction	907
Valuation Methods	780	Dissenting Shareholder Matters	910
Valuation as of a Specific Date	780	Oppressed Shareholder Matters	911
Data Gathering and Analysis	780	Fair Value	912
Gathering Financial Data	781	The Valuation Date	917
The Valuation Process	781	Fair Value Methodology	923
Normalizing Financial Statements	781	Conclusion	964
Unreported Revenues	782		
Stockholder Loans	782	Chapter 25 My Favorite Court Cases	965
Income Taxes	783	Chapter Goals	965
Explaining the Valuation	783	Introduction	965
Reaching a Conclusion of Value	783	<i>Estate of Joyce C. Hall v. Commissioner</i>	
Divorce Valuations of Professional Practices	783	Issue: What Makes a Guideline Company?	965
Professional Practices Differ From Regular		<i>Estate of Samuel I. Newhouse v. Commissioner</i>	
Business Enterprises	783	Issue: Different Classes of Willing Buyers	
Divorce Valuations and the Market Can Be		Result in Different Values	967
Very Different	784	<i>Charles S. Foltz v. U.S. News & World Report, Inc.</i>	
Financial Information	784	Issue: Excess Asset and the Minority Interest	969
Professional Versus Practice Goodwill	785	<i>Bernard Mandelbaum, et al. v. IRS Commissioner</i>	
Noncompete Agreements	787	Issue: Discount for Lack of Marketability	972
Valuation of Other Marital Assets	839	<i>Mad Auto Wrecking Inc v. Commissioner</i>	
Professional Licenses	839	Issue: Reasonable Compensation	976
Celebrity Goodwill	839	<i>Delaware Open MRI Radiology Associates P.A. v.</i>	
Conclusion	840	Howard B. Kessler, et al.	
Chapter 23 Professional Practice Valuations	841	Issue: Treatment of S Corporation Taxes	
Chapter Goals	841	in Fair Value	992
Introduction	841	Conclusion	999
Why Are Professional Practices Values?	841		
Characteristics of the Professional Practice	842	Chapter 26 Economic Damages	1001
Professional Practice Versus Other Business		Chapter Goals	1001
Valuations	842	Introduction	1001
Buy-Sell Agreements	842	Lost Profits	1001
Internal Transactions	844	Elements of a Lost Profits Claim	1001
External Transactions	844	Types of Damages	1003
Subsequent Events	846	The Lost Profits Analysis	1003
More About Professional Practice Versus Other		Meet With the Client and Client's Attorney	
Business Valuations	847	to Determine the Objectives	
The Valuation Process	848	of the Assignment	1003
History of the Practice	868	Plaster Your Files With Support	1004
Economy and Industry Information	876	Obtaining Documents and Records From	
		the Opposing Side	1005

Should You Work With Original Documents or Copies?.....	1005	Appendix 2 ASA Standards
Get Information From the Client and the Other Side.....	1005	Appendix 3 NACVA Professional Standards
Performing the Lost Profits Computation	1006	Appendix 4 International Glossary of Business Valuation Terms
Mitigation of Damages.....	1020	Appendix 5 SSVS 1 Appendix C
Period of Recovery	1020	Appendix 6 Revenue Ruling 59-60
Variable Cost of Lost Revenues.....	1020	Appendix 7 Revenue Ruling 65-192
Incremental Revenues and Expenses— Not Fixed or Variable	1021	Appendix 8 Revenue Ruling 65-193
Should Lost Net Earnings Be Reduced for Income Taxes?	1021	Appendix 9 Revenue Procedure 66-49
Prejudgment Interest	1021	Appendix 10 Revenue Ruling 68-609
Projected Lost Revenues After Trial	1021	Appendix 11 Revenue Procedure 77-12
Discounting Projected Lost Profits After Trial to Present Value	1034	Appendix 12 Revenue Ruling 77-287
Ex-Ante Versus Ex-Post	1034	Appendix 13 Revenue Ruling 83-120
Don't Forget to Check the Lost Profits Computation for Reasonableness.....	1041	Appendix 14 Revenue Ruling 85-75
Other Situations	1041	Appendix 15 Revenue Ruling 93-12
Lost Profits or Lost Business Value?	1087	Appendix 16 Technical Advice Memorandum 94-36005
Other Types of Damages Measurements	1088	Appendix 17 Private Letter Ruling 91-50001
Plaintiff or Defense?.....	1090	Appendix 18 Business Valuation Resources
Common Mistakes Made By Damages Experts	1090	
Conclusion	1116	
Index.....	1117	

CD-ROM

Overview

Appendix 1 AICPA Statement on Consulting Services
Standards 1

Sample Reports
 Calculation of Value
 Family Limited Partnership
 Large Company Valuation
 Shareholder Oppression Report
 Small Company Valuation
 Summary Report