Contents

About the Editor	XXİ
About the Authors	xxiii
Acknowledgments	xxxvii
Preface	xvii
CHAPTER 1	
Introduction to Financial Valuation	1
Who Values Businesses?	1
Purpose of a Valuation	2
Professional Valuation Organizations	2 3
Standards of Value	3
Premise of Value	6
Principles of Appraisal Practice	7
Dates	8
Approaches to Value	8
Valuation Procedures	9
Summary	9
Addendum 1—Valuation Checklist/Ready Reference	
(Revenue Ruling 59-60)	10
Addendum 2—International Glossary of Business	4.0
Valuation Terms	18
Addendum 3—AICPA Glossary of Additional Terms, Statements on Standards for Valuation Services VS Section 100	26
CHAPTER 2 Standards of Value	29
Introduction	29
How the Standard of Value Can Affect the Final "Number"	31
Premises of Value	32
Common Standards of Value	33
Common Operational Premises Underlying the Standard of Value	39
Application of Specific Standards of Value	40
Fair Value in Shareholder Dissent and Oppression	44
Control Premiums	46
Immediately Before	46
Unless Exclusion Would Be Inequitable	47
Extraordinary Circumstances	48
Current and Customary Techniques	48

Standard of Value in Divorce	50
Fair Value in Financial Accounting	55
Measurement	56
Conclusion	57
CHAPTER 3	
Research and Its Presentation	59
Obtaining Internal Information	59
External Sources of Data	60
Research Techniques and Planning the Search	61
Information Sources: Business Financial Databases	65
Economic Research	66
Selected Sources of Economic Information	67
Industry Research	68
Selected Sources of Industry Information	68
Guideline Public Company and Guideline Company Transactions Research	70
Sources for Guideline Public Company Data	70
Guideline Company Transactions Databases	70
Presenting Research in a Report	72
Cost of Capital Research	72
Other Sources of Information	74
Summary	75
•	
CHAPTER 4 Financial Statement and Company Risk Analysis	77
Historical Financial Statement Analysis	77
Length of Financial History to be Used	78
Spreading Financial Statements in Columnar Format	78
Adjustments to Financial Statements	81
Normalization of Historical Financial Statements	81
Unusual, Nonrecurring, and Extraordinary Items	82
Nonoperating Items	83
Changes in Accounting Principle	84
Nonconformance with GAAP	84
Tax-Affecting the Earnings of Subchapter S Corporations an	
Other Adjustments	85
Degree of Ownership Interest	86
Normalization Adjustments	86
Common Sizing Normalized Financial Statements	90
Ratio Analysis (Quantitative Analysis) Comparative Analysis	97 98
	102
Risk Analysis (Qualitative Analysis) Macroenvironmental Analysis	102
Addendum 1—Commonly Used Financial Ratios:	100
Application to Ale's Distributing	109
CHAPTER 5 Income Approach	117
Fundamental Theory	117
Basics of Income Approach—"A Fraction"	118
**	

<u>Contents</u> ix

Income Approach Methodologies	119
Normalization Process	120
Adjustments for Ownership Characteristics	120
Adjustments for GAAP Departures and Extraordinary,	
Nonrecurring, and/or Unusual Items	123
Adjustments for Nonoperating Assets and Liabilities	
and Related Income and Expenses	124
Adjustments for Taxes	125
Adjustments for Synergies from Mergers and Acquisitions	126
Determination of Future Benefit Stream (Cash Flows)	127
Defining the Benefit Stream	127
Defining Net Cash Flow	127
Use of Historical Information	129
The Capitalized Cash Flow Method	135
The Discounted Cash Flow Method	138
Terminal Value	145
Capitalized Cash Flow Method (Revisited)	151
Excess Cash Flow Method	153
Best Practices	162
Conclusion	163
Addendum 1—Application of the Direct Equity Method (DEM)	103
and the Invested Capital Method (ICM)	164
Addendum 2—Dealing with Debt	171
Addendum 3—Best Practices: The Terminal Year of a	1/1
Discounted Cash Flow Model	177
Discounted Cash Flow Model	1//
CHAPTER 6	
Cost of Capital/Rates of Return	185
Value Drivers	185
Relationship between Risk and Return	187
Characteristics of Cost of Capital	190
Weighted Average Cost of Capital	190
The Cost of Debt	192
The Cost of Equity	193
Risk-Free Rate (R _f)	197
Equity Risk Premium (RP _m or ERP)	200
Beta	206
Industry Risk Premium	214
Size Premium (RP _s)	217
Company-Specific Risk	222
Issues in Cost of Capital Application	231
Cost of Equity Case Study	232
Implied Returns from Market Data	232
Emerging Equity Models	241
Legacy Valuations: Using Ibbotson Data	244
Venture Capital Returns	245
Addendum 1—SPARC: Strategy/People/Architecture/Routines/Culture	250
Addendum 2—Twenty Ways to Calculate the Cost of Equity Capital:	230
A Case Study	261
11 Case study	201

K CONTENTS

CHAPTER 7	
International Cost of Capital	271
Background	271
Estimating the Cost of Equity	274
Developing the WACC (Appreciating the Differences between	
Debt and Equity)	278
Analysis of Multinational Corporations	280
Due Diligence: Company-Country-Currency-Sector Framework	282
Case Study	286
Technique for Considering a Large Portfolio of Countries	288
Conclusion	289
CHAPTER 8	
Market Approach	291
Overview	291
Level of Value	295
Advantages and Disadvantages of the Market Approach	296
Understanding the Subject Company	298
Finding Guideline Companies	298
Sources of Transaction Data	300
The Direct Market Data Method	303
Guideline Company Transactions Method	304
Selecting Guideline Public Companies	306
Basic Financial Indicators	312
Comparing Guideline and Subject Data	313
Adjustments to the Guideline and Subject Companies	316
Concluding Remarks on Choosing Guideline Companies	323
Calculating Standard Pricing Multiples	323
Equity versus Invested Capital	324
Financial Statement Measures	325
Computing Multiples	328
Matching Price to Parameter	328
Dispersion of Pricing Multiples	329
Applying the Valuation Multiples	331
Adjusting Pricing Multiples for Differences in Growth	333
Adjusting the Guideline Multiples for Size	337
Summary	341
CHAPTER 9	
Asset Approach	343
Theory	343
Application	344
Premise of Value	346
Control versus Minority	346
Built-In Gains Taxes	347
General Steps in the Asset Approach	352
Case Study	353
Best Practices	363
Addendum 1—Understanding Real Estate Appraisals	364
Addendum 2—Understanding Machinery and Equipment Appraisals	375

Contents Xi

CHAPTER 10	
Valuation Discounts and Premiums	391
Levels of Value	392
Liquidity versus Marketability	395
Entity-Level versus Shareholder-Level Discounts	396
Controversial Issues	398
Discounts for Lack of Control	398
Levels of Noncontrolling Interests	401
Control Premiums	404
Alternative View on Premium for Control	408
Conclusion	409
Control and the Market Approach	410
Discounts for Lack of Marketability	411
DLOM on a Controlling Interest	412
Tax Court Cases	420
Empirical Evidence of Marketability Discounts	422
Applying Study Data	466
Quantitative Tools	468
Factors Influencing Marketability	481
Other Discounts	485
Premiums Accorded Voting versus Nonvoting Stock	491
Summary	493
CHAPTER 11	
Report Writing	495
Valuation Engagements	495
USPAP Engagements	496
Types of Valuation Engagements and Related Reports	496
Detailed Valuation Report	497
Analysis of Risk	502
Other Business Valuation Reports	505
Addendum—Sample Valuation Report	507
History and Nature of Business	513
General Economic and Industry Outlook	516
Book Value and Financial Position	523
Projections	532
Approaches to Value	532
Income Approach	534
Cost of Capital	545
Market Approach	554
Guideline Public Company Method	554
Guideline Company Transactions Method	572
Reconciliation of Valuation Methods	575
Conclusion of Value	576
Appendix A—Assumptions and Limiting Conditions	576
Appendix B—Valuation Representation/Certification	580
Appendix C—Professional Qualifications of the Appraiser	581
Appendix D—Other Sources Consulted	582
Appendix E—Exhibits	582

Xİİ CONTENTS

CHAPTER 12	
Business Valuation Standards	583
History of Valuation Standards	583
Government Action	584
Organization of the USPAP Standards	585
USPAP Business Valuation Standards (2016–2017)	586
Other Business Valuation Standards and Credentials	593
Summary	597
Addendum 1—Standards: A Summary of the AICPA'S BV Standards	598
CHAPTER 13	007
Valuation of Pass-Through Entities	607 607
Introduction Background	608
Standard of Value	620
Controlling Interests in Pass-Through Entities	622
Applicable Tax Rates	635
Noncontrolling Interests in Pass-Through Entities	639
Treharne Model	640
Van Vleet Model	646
The S Corporation Economic Adjustment	648
The S Corporation Equity Adjustment Multiple	651
Mercer Model	655
Grabowski Model	664
Summary: Noncontrolling Interest in Pass-Through Entity Theory	674
Bibliography	677
CHAPTER 14	001
Estate, Gift, and Income Tax Valuations	681
Valuations in Estate and Gift Taxes	681
Selected Internal Revenue Code Provisions	682 683
Selected Treasury Regulations Selected Revenue Rulings	686
Valuations for Income Taxes	716
	710
CHAPTER 15	705
Valuation of Family Limited Partnerships	725
Family Limited Partnership Uses	726 727
Tax Advantages How Family Limited Partnerships Are Formed	727
Other Characteristics of Family Limited Partnerships	728
State Law, Property Rights, and Their Importance to the	720
Valuation Process	729
Improper Formation can Create Problems for Partners	731
Valuation of Family Limited Partnership Interests	732
Preliminary Considerations	733
Valuation Process	750
Illustrative Case Study	762
Court Cases	769

Contents

CHAPTER 16 Summony of Toy Count Coop Voluction Issues	779
Summary of Tax Court Case Valuation Issues Tax Court Opinions	77 9
Tail Court of mone	
CHAPTER 17	
Shareholder Disputes	783
History of Shareholder Disputes	783
Causes of Action	784
Standard of Value	786
Valuation Date	789
Entire Fairness	790
Valuation Methodology	791
Valuation Adjustments	793
Some Relevant Court Cases	796
Court Case Caveats	799
Conclusion	800
CHAPTER 18	
Employee Stock Ownership Plans	801
Introduction	801
Purposes	801
Requirements	802
Tax Considerations	802
Need for Valuation Services	804
Adequate Consideration and Standard of Value	805
Feasibility of Formation	807
ESOP Share Ownership Characteristics	811
Ongoing Operations	812
Accounting Standards for ESOP Companies with Acquisition Debt	816
ESOP Valuation Engagements	818
Regulatory Environment	825
Demand for Review Appraisal Services	826
Additional Information	826
CHAPTER 19	
Valuation in the Divorce Setting	831
Standards of Value	831
Premise of Value	833
Goodwill—The Battleground for Divorce Valuations	834
Defining Goodwill	834
State Interpretations on Inclusion of Goodwill in the	0.2.5
Marital Estate	835
Personal versus Entity (Enterprise) Goodwill	836
Allocation of Goodwill as Personal or Entity	837
Applying the Factors to Separate Goodwill	838
Role of Noncompete Agreements in Determining Personal versus	0.15
Entity Goodwill	842
Trifurcation of Goodwill and the Concept of Tradeable	0.42
Personal Goodwill	843

XÎV CONTENTS

Personal Goodwill in Commercial Businesses	844
Double Dipping in Divorce Cases	845
Valuation of the S Corporation and Other Pass-Through Entities	846
Restrictions on Data	847
Range versus Specificity	847
Professional Standards	847
Valuation Methodology and the Application of Discounts	849
Liquidity Myth in Pass-Through Entities	852
Divorce Valuation and Bankruptcy	852
Summary	852
CHAPTER 20	
Valuation Issues in Small Businesses	853
Common Characteristics	853
Financial Statement Adjustments	856
Qualitative Factors Affecting Value	859
Valuation Methods	860
Reasonableness Tests	865
Summary	866
CHAPTER 21	
Valuation Issues in Professional Practices	867
Types of Practices	868
Purpose of Valuation	871
Professional Goodwill and Practice Goodwill	871
Select Case Law for Marital Dissolution	873
Factors Affecting Value	875
Financial Statement Adjustments	879
Valuation Methods Summary	883 887
CHAPTER 22	
Reasonable Compensation	889
Purposes for Analysis	890
Types of Compensation	893
Assessing Compensation	896
Methods of Calculating Reasonable Compensation	900
Divorce and the "Double Dip"	904
Personal Goodwill	906
Reasonable Compensation Job Aid for IRS Valuation Professionals	907
Conclusion	910
CHAPTER 23	
The Valuator as Expert Witness	911
Introduction	911
Pre-Engagement Considerations	913
United States Requirements and Procedures Applicable to	
Expert Witnesses	914
Daubert Motion	916
The Ikarian Reefer	919

<u>Contents</u> XV

Canadian Requirements Applicable to Expert Witnesses	920
"Rules" for the Testifying Expert When on the Witness Stand	922
Conclusion	929
CHAPTER 24	
Fair Value Measurement and the Valuation of Intangible Assets	931
Introduction	931
Nature of Intangible Assets	932
Reasons to Value Intangibles	934
Fair Value Measurement	934
Business Combinations	939
Intangibles: Risk and Return	944
Valuation Approaches to Intangibles	945
Cost Approach	946
Market Approach	949
Income Approach	952
Amortization Benefit	957
In-Process Research and Development	959
Goodwill	960
Financial Reporting Disclosures	967
Statements on Standards for Valuation Services VS Section 100	968
Case Study: Determining the Value of Goodwill and Other	0.70
Intangible Assets in a Business Combination	970
CHAPTER 25	
Marketing, Managing, and Making Money in a Valuation Services Group	1007
Purpose and Overview	1007
CHAPTER 26	
Business Damages	1009
General Considerations in Damages Calculations	1009
Legal Principles Governing Damages	1010
Measurement of Damages	1016
Can Lost Profits Exceed the Fair Market Value of the Business?	1028
Considerations in Intellectual Property Damages	1029
Considerations in Securities Class Action Litigation	1036
Conclusion	1040
CHAPTER 27	
Other Valuation Service Areas	1043
A: Valuation for Public Companies and/or Financial Reporting	1043
B: Valuation Issues in Buy-Sell Agreements	1043
C: Valuing Debt	1044
D: Valuation Issues in Preferred Stock	1044
E: Restricted Stock Valuation	1044
F: Valuation of Early-Stage Technology Companies	1044
G: Valuation Issues Related to Stock Options and Other	
Share-Based Compensation	1044
H: Real Option Valuations	1045
I: Maximizing Shareholder Value	1045

XVI CONTENTS

CHAPTER 28	
Valuation of Healthcare Service Businesses	1047
Background	105
Industry Factors	1054
Standard of Value	1066
Considerations for Valuing Healthcare Entities	1067
Valuation Process	1068
Control Premiums and Minority Discounts	1074
Discounts for Lack of Marketability	1073
Valuation Issues for Specific Healthcare Industry Niches Public and Private Healthcare Services Companies by Niche	1076 1087
CHAPTER 29	
Determination of Compensation in the Healthcare Industry	1089
Background on Drivers of Compensation Assignments	1089
Regulatory Guidance	1090
Applicable Valuation Standards	1092
Compensation Elements	1092
Sources of Data	1096
Documentation	1097
Conclusion	1097
CHAPTER 30	
Special Industry Valuations	1099
Construction	1099
Oil and Gas Exploration and Production Valuations	1111
Radio	1124
Cable TV	1132
Restaurants	1144
Bars and Nightclubs	1162
Addendum 1—An Interview with a Business Broker-Valuator	1168
CHAPTER 31	447
Valuation Views and Controversial Issues: An Illustration	1179
The Report	1179
Introduction	1182
Regional Economic Data (as of September 1, 20X5)	1189
Local Economy	1189
Industry Outlook	1190
Financial Analysis of the Company	1192
Appraisal of Fair Market Value	1200
Reconciliation of Valuation Methods	1223
About the Website	122
Index	1229