CHAPTER 1

Introduction to Financial Valuation

There is an ever-increasing need for financial valuation services pertaining to ownership interests and assets in non-public companies and subsidiaries, divisions, or segments of public companies. Many textbooks discuss valuation issues pertaining to public companies and their stock prices. Much of that information also can be used to value nonpublic companies. However, over the past 25 years or so, specific techniques, methods, applications, and models applicable to nonpublic entities and assets have emerged. This text addresses this body of knowledge.

Valuation has many subjective factors, and this leads to many differences of opinion. This book presents the consensus view of 30 of the leading valuation analysts (analysts) in the country.

Much of the notation system used in this text is that used by Shannon Pratt in his various publications,[1] a system adopted by the American Institute of Certified Public Accountants (AICPA), the National Association of Certified Valuation Analysts (NACVA), and the American Society of Appraisers (ASA) in their business valuation courses.

As a quick reference guide to important factors and concepts, numerous "ValTips" are found throughout the volume. These ValTips are intended to provide guidance and insight on handling key issues as well as to provide practice ideas.

WHO VALUES BUSINESSES?

Many providers and/or users of business valuation services exist. The AICPA unofficially estimates that tens of thousands of Certified Public Accountants (CPAs) perform business valuations on at least a part-time basis. Many of these are also full-time valuation practitioners. Several of the national accounting firms also have valuation services groups. There are also analysts and appraisers who practice out of various types of organizations, including appraisal companies, valuation boutiques, and consulting firms. Valuations are also performed by investment bankers, usually as part of a transaction. Owners and financial executives also participate in valuations of their companies or segments of their companies. This book attempts to provide a sound understanding of financial valuation for all users and providers of valuation services and to advance consensus views on some of the more troublesome aspects of valuation science.

[1] Shannon P. Pratt, *Cost of Capital: Estimation and Applications, Second Edition* (New York: John Wiley & Sons, Inc., 2002), pp. xxviii–xxx.

PURPOSE OF A VALUATION

Businesses or their assets are valued for a variety of reasons. Some of the more common purposes for valuation are:

- Mergers and acquisitions
- Litigation and ownership disputes
- Estate, gift, and income tax
- Marital dissolution
- Dissenters' rights cases
- Shareholder oppression cases
- Employee Stock Ownership Plans (ESOPs)
- Financial reporting
- Allocation of purchase price
- Goodwill impairment
- Buy/sell agreements
- Family limited partnerships
- Reorganizations and bankruptcies
- Recapitalizations
- Business planning
- Stock option plans
- Compensation

Various types of businesses can be valued:

- C corporations
- S corporations
- Limited liability companies
- Limited liability partnerships
- Limited partnerships
- General partnerships
- Trusts
- Sole proprietorships
- Undivided interests

The types of interest within each of the organizational structures can vary as well. The types of interest that can be valued include:

- 100 percent controlling interest
- Majority interests that possess control
- Majority interests that do not possess control
- 50 percent interest
- Dominant minority interest
- Nondominant minority interest

The individual ownership characteristics of any interest in a company being valued must also be evaluated. As such, it is important for an analyst to review corporate documents, including articles of incorporation, by-laws, buy/sell agreements, restrictive agreements, and the like. A review of these documents, along with an understanding of state rights, will indicate any particular rights that the interest enjoys.

PROFESSIONAL VALUATION ORGANIZATIONS

Four U.S. professional organizations, listed alphabetically below, provide assistance to their members in valuing businesses, particularly closely held business interests:

1. American Institute of Certified Public Accountants (AICPA)
2. American Society of Appraisers (ASA)
3. Institute of Business Appraisers (IBA)
4. National Association of Certified Valuation Analysts (NACVA)

Each of these organizations is briefly described in Chapter 10.

STANDARDS OF VALUE

Before analysts can attempt to value a business, they must fully understand the standard of value that applies.

ValTip

> Relying on the wrong standard of value can result in a very different value and, in a dispute setting, the possible dismissal of the value altogether.

There are five main standards of value:

1. Fair market value (FMV)
2. Investment value
3. Intrinsic value
4. Fair value (state rights)
5. Fair value (financial reporting)

FAIR MARKET VALUE

The U.S. Treasury regulations define fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[2]

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[2] Treasury Regulation 20.2031-1.

Fair market value for tax purposes also assumes a hypothetical willing buyer and a hypothetical willing seller. This is in contrast to investment value, which identifies a particular buyer or seller and the attributes that buyer or seller brings to a transaction. Fair market value also assumes an arm's-length deal and that the buyer and seller are able and willing. This is not the same as the definition of market value, an often-used real estate term. For example, the Uniform Standards of Professional Appraisal Practice (USPAP) defines market value as "a type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal."

Internal Revenue Service Revenue Ruling 59-60 (see Addendum 1 at the end of this chapter for a checklist summary for Revenue Ruling 59-60) defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property."[3]

ValTip

Although many states use the term "fair market value" in their marital dissolution cases, the definition of fair market value may vary from state to state and will not necessarily be the same definition as in the tax area.

The *International Glossary of Business Valuation Terms (International Glossary)* represents the collective wisdom of the American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts, and the Institute of Business Appraisers. See Addendum 2 at the end of this chapter for the complete *International Glossary*. Its definition of fair market value reads: "The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms-length in an open and unrestricted market, where neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

This is obviously very similar to the definition of fair market value in the tax area. Fair market value is used most often in tax situations. It is also used in many buy/sell agreements and marital dissolution situations. Unless otherwise noted, the standard of value discussed throughout this text is fair market value.

[3] Rev. Rul. 59-60,59-1 CB 237.

INVESTMENT VALUE

The *International Glossary* defines investment value as "The value to a particular investor based on individual investment requirements and expectations." Investment value is the value to a particular investor, which reflects the particular and specific attributes of that investor. The best example would be an auction setting for a company in which there are five different bidders attempting to purchase the company. More than likely each of the bidders will offer a different price because the prices are based on the individual outlook and synergies that each bidder brings to the transaction. Investment value may also reflect more of the risk of a particular investor than the market consensus of the risk of the investment.

INTRINSIC VALUE

Intrinsic value is based on fundamental analyses of companies, particularly publicly traded companies. It is often what is taught in university financial courses and presented in finance textbooks. Jeffrey C. Hooke, in his text *Security Analysis on Wall Street: A Comprehensive Guide to Today's Valuation Methods,* states that "Under the intrinsic value method, future dividends are derived from earnings forecasts and then discounted to the present, thereby establishing a present value for the stock. If the stock is trading at a price lower than this calculation, it is a 'buy'; if the market price is higher than the intrinsic value, the stock is a 'sell.'"[4]

Others define intrinsic value as the "true" or "real" worth of an item, based on an evaluation of available facts. It is sometimes called *fundamental value*. It is an analytical judgment of value based on perceived *characteristics inherent in the investment* (not characteristic peculiar to any one investor). Intrinsic value is not applied often in valuations of nonpublic companies.

FAIR VALUE (STATE RIGHTS)

The common definition of fair value is that from the Uniform Business Corporation Act, which defines it as "the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action."[5] Fair value is the standard of value for state actions, including dissenting rights cases and shareholder oppression cases. Its definition and application can vary from state to state. As such, the definition of fair value in one state may be quite different from the definition of fair value in another state. Analysts must understand both the definition and the application of fair value in the particular state in which the action is taking place. A discussion with an attorney familiar with a state's statutes and case law is very helpful.

FAIR VALUE (FINANCIAL REPORTING)

Fair value has been the standard of value for financial reporting for many years. It is the standard of value in many Statements of Financial Accounting Standards (SFAS) as issued by the Financial Accounting Standards Board (FASB). The most recent defi-

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[4] Jeffrey C. Hooke, *Security Analysis on Wall Street: A Comprehensive Guide to Today's Valuation Methods* (New York: John Wiley & Sons, Inc., 1998), p. 14.

[5] Georgia Dissenters Right Statute.

nition of fair value is from SFAS 141 and 142: "The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."[6]

Fair value for financial reporting purposes often has been equated with fair market value. However, in certain situations, e.g., purchase of a business, fair value for a company or a segment of a company would include synergies within a transaction, if present. As such, in those situations, the purchase price may have more aspects of investment value than fair market value. In other situations, such as the value of certain individual assets, synergies may not be included, and fair value would be more similar to fair market value. It is important for the analyst to look for guidance from FASB and the Securities and Exchange Commission (SEC) in terms of their views on fair value and its applications.

As of the writing of this book, the Fair Accounting Standards Board (FASB) had issued the exposure draft "Proposed Statement of Financial Accounting Standards, Business Combinations, a Replacement of FASB Statement No. 141." This proposed statement includes many changes in the area of fair value. There is an FASB SFAS fair value measurements draft (3/15/06) that has the latest definition of fair value as ". . . the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date." This new definition gives recognition to the concept of "market participant" in a "hypothetical transaction." This sounds similar to the traditional definition of fair market value (see Chapter 21).

PREMISE OF VALUE

There are two main premises of value in a business valuation, going-concern value and liquidation value. *The International Glossary* defines premise of value as "An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation, e.g., going concern, liquidation." It defines going-concern value as "The value of a business enterprise that is expected to continue to operate into the future. The intangible elements of going-concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place."

ValTip

Some companies are worth more dead than alive. It is important for the analyst, particularly when valuing an entire company, to determine if the going-concern value exceeds the liquidation value. For a minority interest, there are situations where the going-concern value is less than the liquidation value. However, the minority shareholder cannot force a liquidation if the controlling shareholder desires to continue the business as a going concern.

[6] Statements of Financial Accounting Standards No.142, "Goodwill and Other Intangible Assets," Financial Accounting Standards Board of the Financial Accounting Foundation, June 2001, p. 117.

There are two types of liquidation value, orderly liquidation and forced liquidation. *The International Glossary* defines orderly liquidation value as "Liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received." It defines forced liquidation value as "Liquidation value at which the asset or assets are sold as quickly as possible, such as at an auction." It also defines liquidation value as "The net amount that can be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either 'orderly' or 'forced.'"

PRINCIPLES OF APPRAISAL PRACTICE

The modern financial valuation body of knowledge is based to some extent on the evolution of appraisal practices. The ASA's seminal text, *Appraisal Principles and Procedures,* discusses the general characteristic of value.

> It is a characteristic of *value,* in the sense that the word is understood in appraisal practice, that it is expressible in terms of a single lump sum of money considered as payable or expended at a particular point in time in exchange for property, i.e., the right to receive future benefits as at that particular time – point. The amount of the lump sum of money, in any particular instance, is exactly equivalent to the right to receive the particular future benefits encompassed in the property under consideration. In this, *value* differs from *price* or *cost.* Price and cost refer to an amount of money asked or actually paid for a property, and this may be more or less than its value.[7]

ValTip

> Price and cost *can* equal value but don't necessarily *have to* equal value. Furthermore, value is future-looking. Although historical information can be used to set a value, the expectation of future economic benefits is the primary value driver. Investors buy tomorrow's cash flow, not yesterday's or even today's.

DATES

All valuations are done as of a single date. It is important that the users of valuations understand this fact. *The International Glossary* defines the valuation date as, "The specific point in time as of which the valuator's opinion of value applies (also referred to as 'Effective Date' or 'Appraisal Date')."

[7] Henry A. Babcock, *Appraisal Principles and Procedures* (Washington, DC: American Society of Appraisers, 1994), p. 95.

APPROACHES TO VALUE

There are only three approaches to value any asset, business, or business interest:

1. The income approach
2. The market approach
3. The asset approach

There are no other approaches to value. However, there are numerous methods within each one of the approaches that the analyst may consider in performing a valuation. For example, under the income approach, the analyst can use a discounted cash flow method or a capitalized cash flow method. Each of these methods also can be prepared on a direct equity method or an invested capital method. In the market approach, the analyst can apply guideline public company multiples or multiples derived from transactions both public and private. In the asset approach, the analyst often must choose between valuing just tangible assets, individual intangible assets, or all intangible assets as a collective group. Various methodologies exist for each one of these choices.

All three approaches should be considered in each valuation. However, it is not common to use all three approaches in each valuation. For example, the asset approach is used less often in valuing operating companies, since the time and cost involved in performing valuations of intangible assets do not warrant the increased level of accuracy, if any, provided by the cost approach. Specific intangible asset values are often excluded due to the fact that intangible asset values are captured in the proper application of the income and market approaches, which would provide, in most circumstances, the aggregate intangible asset values.

VALUATION PROCEDURES

Numerous procedures and factors must be considered in performing a business valuation. However, they can generally be classified into the following areas:

- Understand the purpose of the engagement
- Understand who the client is
- Understand the client's use of the valuation
- Determine the standard of value and its definition
- Determine the premise of value
- Determine the users of the value
- Determine the interest or assets to be valued
- Ascertain whether discounts and/or premiums are to be considered
- Analyze the company's financial information
- Gather information about the company or assets
- Gather information about the industry and economy
- Consider all approaches of value and select the most appropriate
- Apply the approaches to value through the various methodologies
- Reconcile the values
- Apply discounts and premiums if applicable
- Write the report if applicable

All of these steps are discussed throughout the book.

SUMMARY

Valuation, by its very nature, contains many controversial issues. We address many of these issues throughout this book, highlighting them through the ValTips. These issues are further addressed in Chapter 27, which presents these issues as "Valuation Views" (VV) in the sequence of an actual abbreviated report.

The valuation of business enterprises and business assets is well founded in academic publications and empirical studies. The use of public company information has provided the foundation for the analysis of business valuation. The biggest difference between valuing investments in public companies and nonpublic businesses is the lack of information. The application of recognized valuation methodologies combined with rigorous analysis of the private entity provides the foundation for business valuation. This book presents state-of-the-art methods for the valuation of closely held businesses and other assets as they have evolved.

ADDENDUM 1—VALUATION CHECKLIST/READY REFERENCE (REVENUE RULING 59-60)

Introduction

Revenue Rulings provide useful guidance in various valuation situations. Revenue Ruling 59-60 is applicable to many types of valuation engagements. Revenue Ruling 77-287 applies to restricted securities, such as private placements, investment letter stock, control stock, or unregistered securities. Revenue Ruling 93-12 applies to valuing minority interests in closely held companies for intrafamily transfers. See Chapter 12 for checklists for revenue rulings 77-287 and 93-12.

A valuation checklist/ready reference has been created for each of these revenue rulings to assist in a quick review of their key points as well as for the practical application of these rulings to an actual valuation.

Although Revenue Ruling 59-60 and others provide excellent guidance, they are often cumbersome to apply. The checklists are designed to make it easier to apply these rulings.

Keep in mind that many valuation analysts disagree with various components of the revenue rulings. However, a thorough understanding of these revenue rulings is essential to prepare valuations for tax and other purposes. See Chapter 12 for a detailed discussion of these revenue rulings.

Revenue Ruling 59-60

Revenue Ruling 59-60 contains a wealth of information. It has also stood the test of time and is often quoted in various valuation situations. However, many analysts feel that it is poorly organized and hard to follow. This checklist presents the ruling in an easy-to-follow format.

The primary information concerning discounts and premiums is highlighted by an asterisk (*).

1. *Purpose*

______ Estate tax

______ Gift tax

______ Income tax (as amplified by Revenue Ruling 65-192)

______ *Value of closely held corporations

______ *Value of thinly traded stock

______ Value of other business entities such as partnerships, proprietorships, etc. (as amplified by Revenue Ruling 65-192)

2. *Background Definitions*

Dates of Valuation

______ Date of death

______ Alternate date (6 months after date of death)

Definition of Fair Market Value

______ “The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

______ “The hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”

3. *Approach to Valuation*

______ Facts and circumstances

______ No general formula applicable

______ Wide difference of opinion as to fair market value

______ Valuation is not an exact science

______ Sound valuation:

    ______ Relevant facts

    ______ Common sense

    ______ Informed judgment

    ______ Reasonableness

______ Future outlook:

    ______ Value varies as general economic conditions change

    ______ Optimism versus pessimism

    ______ Uncertainty as to the stability or continuity of future income

    ______ Risk of loss of earnings and value

    ______ Highly speculative value to very uncertain future prospects

    ______ Valuation is a prophecy as to the future

______ Use of guideline public companies

4. *Factors to Consider*

Nature of the Business and History of the Enterprise from Inception

______ Past stability or instability

______ Growth or lack of growth

______ *Diversity or lack of diversity of its operations

______ *Degree of risk in the business

______ Study of gross and net income

______ *Dividends history

______ Nature of the business

______ Products or services

______ Operating and investment assets

______ *Capital structure

______ Plant facilities

______ Sales records

______ *Management

______ Due regard for recent significant changes

______ Discount events of the past that are unlikely to recur in the future

______ Value has a close relation to future expectancy

______ Recent events are of greatest help in predicting the future

Economic Outlook in General and Condition and Outlook of the Specific Industry in Particular

______ Current and prospective economic conditions

______ National economy

______ Industry or industries

______ More or less successful than its competitors; stable with competitors

______ Ability of industry to compete with other industries

______ Prospective competition

______ Price trends in the markets for commodities and securities

______ *Possible effects of a key person or thin management/lack of succession

______ Effect of the loss of the manager on the future expectancy of the business

______ *Key person life insurance could be partially offsetting

Book Value of the Stock and the Financial Condition of the Business

______ Two historical fiscal year-end balance sheets

______ Balance sheet as of the end of the month preceding the valuation date

______ *Liquid position (ratio of current assets to current liabilities)

______ Gross and net book value of principal classes of fixed assets

______ Working capital

______ Long-term indebtedness

______ *Capital structure

______ Net worth

______ *Revalued nonoperating assets (i.e, investments in securities and real estate) on the basis of their market price

______ Generally, nonoperating assets command lower rates of return

______ Acquisitions of production facilities or subsidiaries

______ Improvements in financial position

______ *Recapitalizations

______ *Changes in capital structure

______ *Classes of stock

______ *Examine charter or certificate of incorporation for rights and privileges of the various stock issues including:

- ______ Voting powers
- ______ Preference as to dividends
- ______ Preference as to assets in the event of liquidation

The Earning Capacity of the Company

______ Preferably five or more years of detailed profit and loss statements

______ Gross income by principal items

______ Deductions from gross income:

- ______ Operating expenses
- ______ Interest and other expense on each item of long-term debt
- ______ Depreciation and depletion
- ______ *Officers' salaries in total if reasonable and in detail if they appear excessive
- ______ Contributions based on nature of business and its community position
- ______ Taxes

______ *Net income available for dividends

______ *Rates and amounts of dividends paid on each class of stock

______ Remaining amount carried to surplus

______ Adjustments to, and reconciliation with, surplus as stated on the balance sheet

______ Separate recurrent from nonrecurrent items of income and expense

______ *Distinguish between operating income and investment income

______ Ascertain whether or not any line of business is operating consistently at a loss and might be abandoned with benefit to the company

______ *Note percentage of earnings retained for business expansion when considering dividend-paying capacity

______ Secure all information concerning past income that will be helpful in predicting the future (potential future income is a major factor in many valuations)

______ Prior earnings records are usually the most reliable guide as to future earnings expectancy

______ The use of arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation

______ If a record of progressively increasing or decreasing net income is found, consider according greater weight to the most recent years' profits in estimating earning power

______ Look at margins and percentages of sales to assess risk:

    ______ Consumption of raw materials and supplies for manufacturers, processors, and fabricators

    ______ Cost of purchased merchandise for merchants

    ______ Utility services

    ______ Insurance

    ______ Taxes

    ______ Depreciation and depletion

    ______ Interest

Dividend-Paying Capacity

______ *Primary consideration to dividend-paying capacity rather than dividends actually paid

______ *Recognition of the necessity of retaining a reasonable portion of profits to meet competition

______ *When valuing a controlling interest, the dividend factor is not a material element, since the payment of such dividends is discretionary with the controlling stockholders

______ *The individual or group in control can substitute salaries and bonuses for dividends, thus reducing net income and understating the dividend-paying capacity of the company

______ *Dividends are a less reliable factor for valuation than dividend paying capacity

Whether the Enterprise Has Goodwill or Other Intangible Value

______ Goodwill is based on earning capacity

______ Goodwill value is based on the excess of net earnings over and above a fair return on the net tangible assets

______ Factors to consider to support intangible value:

- ______ Prestige and renown of the business
- ______ Trade or brand name
- ______ Record of success over a prolonged period in a particular locality

______ Sometimes it may not be possible to make a separate valuation of tangible and intangible assets

______ Intangible value can be measured by the amount that the value of the tangible assets exceeds the net book value of such assets

Sales of the Stock and the Size of the Block of Stock to Be Valued

______ Prior sales should be arm's length

______ Forced or distressed sales do not reflect fair market value

______ Isolated sales in small amounts may not control as a measure of value

______ *Blockage is not an issue since the stock is not publicly traded

______ *Size of the block of stock is a relevant factor

______ *A minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock

______ *Control of a corporation, either actual or in effect, may justify a higher value for a specific block of stock since it is an added element of value

Market Price of Stocks of Corporations Engaged in the Same or a Similar Line of Business Having Their Stocks Actively Traded in a Free and Open Market, Either on an Exchange or Over-the-Counter

______ *Must be evidence of an active free public market for the stock as of the valuation date to be used as a comparable company

______ Use only comparable companies

______ The lines of business should be the same or similar

______ A comparable with one or more issues of preferred stock, bonds, or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding

______ A comparable with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion

5. *Weight to Be Accorded Various Factors*

______ Certain factors carry more weight than others because of the nature of the company's business

______ Earnings may be the most important criterion of value in some cases, whereas asset value will receive primary consideration in others

______ Give primary consideration to earnings when valuing stocks of companies that sell products or services to the public

______ Give greatest weight to the assets underlying the security to be valued for investment or holding-type companies

______ Closely held investment or real estate holding company:

- ______ Value is closely related to the value of the assets underlying the stock
- ______ The appraiser should determine the fair market values of the assets of the company
- ______ *Operating expenses of such a company and the cost of liquidating it, if any, merit consideration
- ______ The market values of the assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the valuation date
- ______ Adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not it is family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend-paying capacity

6. *Capitalization Rates*

______ Capitalize the average or current results at some appropriate rate

______ One of the most difficult problems in valuation

______ No ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling price of corporate shares listed on the major exchanges

______ Wide variations will be found even for companies in the same industry

______ The ratio will fluctuate from year to year depending upon economic conditions

______ No standard tables of capitalization rates applicable to closely held corporations can be formulated

______ Important factors to consider:

 ______ Nature of the business

 ______ Risk

 ______ Stability or irregularity of earnings

7. *Average of Factors*

______ Valuations cannot be made on the basis of a prescribed formula

______ There is no means whereby the various applicable factors in a particular case can be assigned mathematical weights to derive the fair market value

______ No useful purpose is served by taking an average of several factors (e.g., book value, capitalized earnings, and capitalized dividends) and basing the valuation on the result

______ Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance

8. *Restrictive Agreements*

______ *Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price usually is accepted as the fair market value for estate tax purposes

______ *The option price is not determinative of fair market value for gift tax purposes

______ *Where the option or buy and sell agreement is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending on the circumstances of each case, fix the value for estate tax purposes

______ *Such restrictive agreements are a factor to be considered, with other relevant factors, in determining fair market value

______ *Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his or her death, the fair market value is not limited to the option price

______ *Determine whether the agreement represents a bona fide business arrangement or is a device to pass the decedent's shares for less than an adequate and full consideration in money or money's worth:

 ______ Relationship of the parties

 ______ Relative number of shares held by the decedent

 ______ Other material facts

ADDENDUM 2—INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS

To enhance and sustain the quality of business valuations for the benefit of the profession and its clientele, the below-identified societies and organizations have adopted the definitions for the terms included in this glossary.

The performance of business valuation services requires a high degree of skill and imposes upon the valuation professional a duty to communicate the valuation process and conclusion in a manner that is clear and not misleading. This duty is advanced through the use of terms whose meanings are clearly established and consistently applied throughout the profession.

If, in the opinion of the business valuation professional, one or more of these terms needs to be used in a manner that materially departs from the enclosed definitions, it is recommended that the term be defined as used within that valuation engagement.

This glossary has been developed to provide guidance to business valuation practitioners by further memorializing the body of knowledge that constitutes the competent and careful determination of value and, more particularly, the communication of how that value was determined.

Departure from this glossary is not intended to provide a basis for civil liability and should not be presumed to create evidence that any duty has been breached.

American Institute of Certified Public Accountants
American Society of Appraisers
Canadian Institute of Chartered Business Valuators
National Association of Certified Valuation Analysts
The Institute of Business Appraisers

Adjusted Book Value Method—a method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent) are adjusted to their fair market values (*Note:* In Canada on a going concern basis).

Adjusted Net Asset Method—see **Adjusted Book Value Method.**

Appraisal—see **Valuation.**

Appraisal Approach—see **Valuation Approach.**

Appraisal Date—see **Valuation Date.**

Appraisal Method—see **Valuation Method.**

Appraisal Procedure—see **Valuation Procedure.**

Arbitrage Pricing Theory—a multivariate model for estimating the cost of equity capital, which incorporates several systematic risk factors.

Asset (Asset-Based) Approach—a general way of determining a value indication of a business, business ownership interest, or security using one or more methods based on the value of the assets net of liabilities.

Beta—a measure of systematic risk of a stock; the tendency of a stock's price to correlate with changes in a specific index.

Blockage Discount—an amount or percentage deducted from the current market price of a publicly traded stock to reflect the decrease in the per share value of a block of stock that is of a size that could not be sold in a reasonable period of time given normal trading volume.

Book Value—see **Net Book Value**.

Business—see **Business Enterprise**.

Business Enterprise—a commercial, industrial, service, or investment entity (or a combination thereof) pursuing an economic activity.

Business Risk—the degree of uncertainty of realizing expected future returns of the business resulting from factors other than financial leverage. See **Financial Risk**.

Business Valuation—the act or process of determining the value of a business enterprise or ownership interest therein.

Capital Asset Pricing Model (CAPM)—a model in which the cost of capital for any stock or portfolio of stocks equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the stock or portfolio.

Capitalization—a conversion of a single period of economic benefits into value.

Capitalization Factor—any multiple or divisor used to convert anticipated economic benefits of a single period into value.

Capitalization of Earnings Method—a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate.

Capitalization Rate—any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.

Capital Structure—the composition of the invested capital of a business enterprise, the mix of debt and equity financing.

Cash Flow—cash that is generated over a period of time by an asset, group of assets, or business enterprise. It may be used in a general sense to encompass various levels of specifically defined cash flows. When the term is used, it should be supplemented by a qualifier (for example, "discretionary" or "operating") and a specific definition in the given valuation context.

Common Size Statements—financial statements in which each line is expressed as a percentage of the total. On the balance sheet, each line item is shown as a percentage of total assets, and on the income statement, each item is expressed as a percentage of sales.

Control—the power to direct the management and policies of a business enterprise.

Control Premium—an amount or a percentage by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise, to reflect the power of control.

Cost Approach—a general way of determining a value indication of an individual asset by quantifying the amount of money required to replace the future service capability of that asset.

Cost of Capital—the expected rate of return that the market requires in order to attract funds to a particular investment.

Debt-Free—*we discourage the use of this term.* See **Invested Capital.**

Discount for Lack of Control—an amount or percentage deducted from the pro rata share of value of 100 percent of an equity interest in a business to reflect the absence of some or all of the powers of control.

Discount for Lack of Marketability—an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

Discount for Lack of Voting Rights—an amount or percentage deducted from the per share value of a minority interest voting share to reflect the absence of voting rights.

Discount Rate—a rate of return used to convert a future monetary sum into present value.

Discounted Cash Flow Method—a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.

Discounted Future Earnings Method—a method within the income approach whereby the present value of future expected economic benefits is calculated using a discount rate.

Economic Benefits—inflows such as revenues, net income, net cash flows, etc.

Economic Life—the period of time over which property may generate economic benefits.

Effective Date—see **Valuation Date**.

Enterprise—see **Business Enterprise**.

Equity—the owner's interest in property after deduction of all liabilities.

Equity Net Cash Flows—those cash flows available to pay out to equity holders (in the form of dividends) after funding operations of the business enterprise, making necessary capital investments, and increasing or decreasing debt financing.

Equity Risk Premium—a rate of return added to a risk-free rate to reflect the additional risk of equity instruments over risk-free instruments (a component of the cost of equity capital or equity discount rate).

Excess Earnings—that amount of anticipated economic benefits that exceeds an appropriate rate of return on the value of a selected asset base (often net tangible assets) used to generate those anticipated economic benefits.

Excess Earnings Method—a specific way of determining a value indication of a business, business ownership interest, or security determined as the sum of a) the value of the assets derived by capitalizing excess earnings and b) the value of the selected asset base. Also frequently used to value intangible assets. See **Excess Earnings**.

Fair Market Value—the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. (*Note:* In Canada, the term "price" should be replaced with the term "highest price.")

Fairness Opinion—an opinion as to whether or not the consideration in a transaction is fair from a financial point of view.

Financial Risk—the degree of uncertainty of realizing expected future returns of the business resulting from financial leverage. See **Business Risk**.

Forced Liquidation Value—liquidation value, at which the asset or assets are sold as quickly as possible, such as at an auction.

Free Cash Flows—*we discourage the use of this term.* See **Net Cash Flows**.

Going Concern—an ongoing operating business enterprise.

Going-Concern Value—the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.

Goodwill—that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

Goodwill Value—the value attributable to goodwill.

Guideline Public Company Method—a method within the market approach whereby market multiples are derived from market prices of stocks of companies that are engaged in the same or similar lines of business, and that are actively traded on a free and open market.

Income (Income-Based) Approach—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount.

Intangible Assets—non-physical assets such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities, and contracts (as distinguished from physical assets) that grant rights and privileges, and have value for the owner.

Internal Rate of Return—a discount rate at which the present value of the future cash flows of the investment equals the cost of the investment.

Intrinsic Value—the value that an investor considers, on the basis of an evaluation or available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price or strike price of an option and the market value of the underlying security.

Invested Capital—the sum of equity and debt in a business enterprise. Debt is typically a) all interest-bearing debt or b) long-term interest-bearing debt. When the term is used, it should be supplemented by a specific definition in the given valuation context.

Invested Capital Net Cash Flows—those cash flows available to pay out to equity holders (in the form of dividends) and debt investors (in the form of principal and interest) after funding operations of the business enterprise and making necessary capital investments.

Investment Risk—the degree of uncertainty as to the realization of expected returns.

Investment Value—the value to a particular investor based on individual investment requirements and expectations. (*Note:* in Canada, the term used is "Value to the Owner.")

Key Person Discount—an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise.

Levered Beta—the beta reflecting a capital structure that includes debt.

Limited Appraisal—the act or process of determining the value of a business, business ownership interest, security, or intangible asset with limitations in analyses, procedures, or scope.

Liquidity—the ability to quickly convert property to cash or pay a liability.

Liquidation Value—the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced."

Majority Control—the degree of control provided by a majority position.

Majority Interest—an ownership interest greater than 50 percent of the voting interest in a business enterprise.

Market (Market-Based) Approach—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

Market Capitalization of Equity—the share price of a publicly traded stock multiplied by the number of shares outstanding.

Market Capitalization of Invested Capital—the market capitalization of equity plus the market value of the debt component of invested capital.

Market Multiple—the market value of a company's stock or invested capital divided by a company measure (such as economic benefits, number of customers).

Marketability—the ability to quickly convert property to cash at minimal cost.

Marketability Discount—see **Discount for Lack of Marketability**.

Merger and Acquisition Method—a method within the market approach whereby pricing multiples are derived from transactions of significant interests in companies engaged in the same or similar lines of business.

Mid-Year Discounting—a convention used in the Discounted Future Earnings Method that reflects economic benefits being generated at midyear, approximating the effect of economic benefits being generated evenly throughout the year.

Minority Discount—a discount for lack of control applicable to a minority interest.

Minority Interest—an ownership interest less than 50 percent of the voting interest in a business enterprise.

Multiple—the inverse of the capitalization rate.

Net Book Value—with respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise.

Net Cash Flows—when the term is used, it should be supplemented by a qualifier. See **Equity Net Cash Flows** and **Invested Capital Net Cash Flows**.

Net Present Value—the value, as of a specified date, of future cash inflows less all cash outflows (including the cost of investment) calculated using an appropriate discount rate.

Net Tangible Asset Value—the value of the business enterprise's tangible assets (excluding excess assets and nonoperating assets) minus the value of its liabilities.

Nonoperating Assets—assets not necessary to ongoing operations of the business enterprise. (*Note:* in Canada, the term used is "Redundant Assets.")

Normalized Earnings—economic benefits adjusted for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons.

Normalized Financial Statements—financial statements adjusted for nonoperating assets and liabilities and/or for nonrecurring, noneconomic, or other unusual items to eliminate anomalies and/or facilitate comparisons.

Orderly Liquidation Value—liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.

Premise of Value—an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation.

Present Value—the value, as of a specified date, of future economic benefits and/or proceeds from sale, calculated using an appropriate discount rate.

Portfolio Discount—an amount or percentage deducted from the value of a business enterprise to reflect the fact that it owns dissimilar operations or assets that do not fit well together.

Price/Earnings Multiple—the price of a share of stock divided by its earnings per share.

Rate of Return—an amount of income (loss) and/or change in value realized or anticipated on an investment, expressed as a percentage of that investment.

Redundant Assets—see **Nonoperating Assets**.

Report Date—the date conclusions are transmitted to the client.

Replacement Cost New—the current cost of a similar new property having the nearest equivalent utility to the property being valued.

Reproduction Cost New—the current cost of an identical new property.

Required Rate of Return—the minimum rate of return acceptable by investors before they will commit money to an investment at a given level of risk.

Residual Value—the value as of the end of the discrete projection period in a discounted future earnings model.

Return on Equity—the amount, expressed as a percentage, earned on a company's common equity for a given period.

Return on Investment—see **Return on Invested Capita**l and **Return on Equity**.

Return on Invested Capital—the amount, expressed as a percentage, earned on a company's total capital for a given period.

Risk-Free Rate—the rate of return available in the market on an investment free of default risk.

Risk Premium—a rate of return added to a risk-free rate to reflect risk.

Rule of Thumb—a mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay, or a combination of these; usually industry specific.

Special Interest Purchasers—acquirers who believe they can enjoy post-acquisition economies of scale, synergies, or strategic advantages by combining the acquired business interest with their own.

Standard of Value—the identification of the type of value being used in a specific engagement; e.g. fair market value, fair value, investment value.

Sustaining Capital Reinvestment—the periodic capital outlay required to maintain operations at existing levels, net of the tax shield available from such outlays.

Systematic Risk—the risk that is common to all risky securities and cannot be eliminated through diversification. The measure of systematic risk in stocks is the beta coefficient.

Tangible Assets—physical assets (such as cash, accounts receivable, inventory, property, plant and equipment, etc.).

Terminal Value—see **Residual Value**.

Transaction Method—see **Merger and Acquisition Method**.

Unlevered Beta—the beta reflecting a capital structure without debt.

Unsystematic Risk—the risk specific to an individual security that can be avoided through diversification.

Valuation—the act or process of determining the value of a business, business ownership interest, security, or intangible asset.

Valuation Approach—a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more valuation methods.

Valuation Date—the specific point in time as of which the valuator's opinion of value applies (also referred to as "Effective Date" or "Appraisal Date").

Valuation Method—within approaches, a specific way to determine value.

Valuation Procedure—the act, manner, and technique of performing the steps of an appraisal method.

Valuation Ratio—a fraction in which a value or price serves as the numerator and financial, operating, or physical data serves as the denominator.

Value to the Owner—see **Investment Value**.

Voting Control—*de jure* control of a business enterprise.

Weighted Average Cost of Capital (WACC)—the cost of capital (discount rate) determined by the weighted average, at market value, of the cost of all financing sources in the business enterprise's capital structure.