

Chapter 1

Overview of Business Valuation

Learning Objectives

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

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

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

Introduction

Business valuations are performed for companies and interests in companies of all sizes and types. The conceptual principles are the same for companies of different sizes, but very often, the manner in which these principles are applied varies greatly. The quantity and quality of data available for the valuation of small- and mid-sized companies tends to be considerably lower than what is available for larger businesses. Just for the record, having a greater amount of data for larger companies is not always better. Sometimes, the quality of the data is awful, even for larger companies. When there is a lack of data available for the smaller companies, either certain methodologies cannot be used or the result should be considered less reliable. However, there can be a lack of data for larger companies, as well. The valuation analyst¹ must be more careful in circumstances in which less data is available because having less data creates a larger risk of not being able to interpret the existing data properly. The valuation analyst should understand the business valuation process from the large company, more theoretical basis, in order to adapt these concepts properly to its smaller counterparts. This means that the same theory that applies to the valuation of large companies may have to be adapted for the valuation of small companies. However, valuing smaller businesses can be extremely challenging because most of the empirical data that a valuation analyst regularly uses applies to larger companies and only tangentially to smaller ones.

A Brief Walk Down Memory Lane

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

- 1987—Establishment of the Appraisal Foundation. This organization was set up by seven real estate organizations and the American Society of Appraisers, a multidiscipline body, in response to the growing problems facing the real estate appraisal world. The Appraisal Foundation is the creator of the *Uniform Standards of Professional Appraisal Practice* (USPAP). The provisions of the USPAP include Standards 1 and 2 that pertain to real estate appraisal, Standards 7 and 8 that pertain to personal property appraisal, Standard 6 that pertains to mass appraisals, whether real estate or personal property, and Standards 9 and 10 that pertain to business valuations. Standard 3, Appraisal Review, applies to business valuation as well as real estate and personal property. You are probably wondering about Standards 4 and 5. They used to pertain to real estate, but they are now retired.

¹ In this book, I will be referring to the business or intangible asset appraiser as the *valuation analyst*. This is the wording used in the AICPA Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (AICPA, *Professional Standards*, VS sec. 100) that I will be discussing throughout this book. We might as well be consistent!

- 1989—Passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Among other provisions, this law requires all who perform real estate appraisals involving a *federally related transaction* to follow the USPAP. There was quite a bit of confusion when this law was first passed because the business valuation profession thought that it would also be subject to this act. However, it is pretty clear now that it was only real estate appraisers who were subject to the federally related transaction portion of the legislation. Yet, several of the appraisal organizations have encouraged all appraisers to follow the USPAP as a “best practices” technique, although the American Society of Appraisers is the only organization with a business valuation discipline that mandates adherence to these standards.
- 1997—The American Institute of Certified Public Accountants (AICPA) Executive Board passes a specialty designation known as Accredited in Business Valuation (ABV). The first examination was given in November 1997. This designation, especially because it is appended to the CPA (CPA/ABV), gains immediate recognition in the marketplace among all of the credentials available in our field.
- 1998—The AICPA, through great insight and foresight, published the first edition of my book. (Hey, don’t laugh—it could not have been that bad—this is the fifth edition, and you either bought it or it was given to you as a birthday present!)
- 2007—The AICPA’s business valuation standard was approved and passed. It became effective January 1, 2008. This is such an important event in our history that I have devoted a complete chapter to this standard (see chapter 2).
- 2017—The fifth edition of my book gets published. Based on its popularity, it is now being used in the academic market as well as the professional market. That, my friends, is a very cool thing!

Why Are Businesses Valued?

Business valuation assignments will vary depending on their purpose. Therefore, it is imperative that the valuation analyst understand the purpose of the assignment before the process can begin. More often than not, the purpose will influence the standard of value, the methodologies used, the level of research performed, and possibly the date of the valuation. This does not mean that the valuation analyst takes shortcuts or aims for a high or low value. Examples of how these items can affect the assignment can be demonstrated by understanding that certain types of business valuations are guided by specific sets of rules, such as state statutes, IRS regulations, or Department of Labor (DOL) regulations, or, if a minority interest is being valued, certain adjustments may not be made to the company’s financial statements because the minority interest cannot legally effectuate such adjustments. Valuations performed for divorce purposes may have case law restrictions that must be considered (for example, separating personal or professional goodwill from the goodwill of the enterprise). Business valuations of closely held companies will fall into one of three categories: 1) as part of an arm’s-length, negotiated sale or acquisition of a company, 2) as part of a statutory or legal action, such as a dissenting shareholder suit, fairness opinion, or marital dissolution, and 3) as part of a hypothetical sale, when no actual transaction takes place (such as fair market value for income, gift, and estate tax purposes and fair value reporting for financial reporting purposes). If you have never performed a business valuation, this stuff probably has you wondering what I am talking about. Be patient, this will start to make more sense as we proceed. Box 1.1 explains the variety of reasons that business valuation engagements are performed.

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

Business valuations are frequently performed when one company acquires another company, when a company is targeted for an acquisition, when a company’s capital structure is reorganized, when a company splits up, or when a company enters bankruptcy in liquidation or reorganization. The transactions may include entire or partial acquisitions, divestitures, liquidation, or recapitalization. Mergers will generally require both companies to be valued, whereas an acquisition may require only a single valuation. The terms of the transaction generally include cash, notes, stock, or a combination of these forms of payment. Sometimes, the valuation analyst has to calculate the cash equivalent value of the payment terms when the terms include payments in stock or notes that may not reflect market rates. This will be further explained in chapter 10.

In bankruptcy, in addition to the involvement of the different classes of creditors and the owners,² the approval of the bankruptcy court is usually required. Closely held companies with two or more definable divisions may be split up or spun off into separate entities. Reasons for doing this can include estate tax considerations, family conflict, or sale of only part of the total business. In the liquidation of a business enterprise, the valuation analyst's allocation of the assets distributed to the owners may be required to substantiate subsequent depreciation and other deductions claimed. Many publicly traded companies have acquired closely held businesses by using restricted stock (Rule 144 stock) as the form of payment. Restricted stock is discussed in chapter 15. The advantage of using stock as a form of payment is that the acquirer does not have to use cash to make the acquisition. Frequently, the transaction can provide the seller with a tax-free transaction under IRC Section 1031. It also provides the seller with the opportunity to take advantage of the tax-deferred appreciation of owning the acquirer's stock. This can be a good or bad thing. This can also create work for the valuation analyst.

BOX 1.1**Reasons for a Business Valuation Engagement**

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

Allocation of Purchase Price

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

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

In 1993, the tax law changed, providing for intangible assets to be amortized over 15 years. This change reduced the necessity for valuation analysts to allocate the purchase price between different classes of intangible assets that had different amortization periods or no amortization period (for example, goodwill) under the old law. In more recent times, an allocation of purchase price for income tax purposes has become important because many sellers are trying to allocate a certain portion of a corporate sale as the personal goodwill of an owner. This is intended to create capital gain treatment for a portion of the sale that might otherwise be subject to ordinary income tax rates (for non-tax people, ordinary tax rates are higher).

² In this book, I will be referring to the terms *owner* or *owners* because of the different types of ownership interests that may exist for a business. A sole proprietorship or a single-member limited liability company may only have a single owner; a partnership will have partners, generally two or more; a limited liability company may have anywhere from one to numerous "members" that own the equity of the enterprise; and a corporation will have one or more stockholders (with the possibility of multiple classes of stock) that own the equity of the enterprise. I am going to keep it simple, but the type of owner will depend on the type of entity that is being addressed.

In addition to allocating the purchase price for tax purposes, generally accepted accounting principles (GAAP) also require these types of valuations. The valuation analyst is frequently being called on to provide valuation services with respect to pronouncements made by FASB. They include, but are not necessarily limited to, FASB *Accounting Standards Codification* (ASC) 805, *Business Combinations*; FASB ASC 350, *Intangibles—Goodwill and Other*; FASB ASC 360, *Property, Plant, and Equipment*; and FASB ASC 820, *Fair Value Measurement*, all of which deal with issues such as the determination of the fair value of assets acquired and impairment of goodwill. These topics will be covered in more detail in chapter 19.

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

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

Estate, Gift, and Income Taxes

The valuation of a closely held business or business interest is important to estate planners as they consider the effect of the unified estate and gift tax credit on lifetime transfers of property. Although this is not a tax book, valuation analysts working in this area are urged to consult the appropriate IRC sections and regulations for specifics on the unified estate and gift tax requirements. If you think that finance books on business valuation are fun reading, try the tax code. You will never have so much fun! Chapter 21 of this book contains specific information about estate and gift tax valuations. Also included in that chapter are the rules that pertain to defining a *qualified appraiser*, as well as penalties if the valuation prepared is determined to be substantially outside of the final determined value.

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

Marital Dissolution

In a marital dissolution, most of a couple's assets and liabilities are valued, regardless of whether their state follows equitable distribution or community property rules. Frequently, one of the assets included in the marital estate is an interest in a closely held business. Usually, the business or business interest is not divided between the spouses because that would defeat the idea of them getting divorced. Instead, one spouse keeps the business, and the other receives different assets of equal value. Because marital dissolution laws vary significantly from state to state, the valuation analyst must be aware of the rules of the state in which the

divorce takes place. For example, in some states, goodwill associated with a professional is excludable from distribution, whereas in other states, it is includable. Another item that the valuation analyst must be aware of is the standard of value (covered in chapter 4) used in the jurisdiction of the marital dissolution. Frequently, fair market value is the standard of value discussed, but the application from state to state varies greatly from the definition found in the tax laws. This can be illustrated by reviewing cases from various states. For example, in Florida, fair market value has been interpreted to be the value of the business, assuming that the business owner walks away without a covenant not to compete. In most instances, fair market value assumes a covenant not to compete. Logically, what willing buyer would purchase a business if the seller could open up next door and compete with him or her? In Pennsylvania, fair market value excludes personal goodwill. Clearly, the valuation analyst cannot be expected to know every state's law, but he or she should ask the client's attorney for information before proceeding in a direction that may have his or her report thrown out for failure to comply with the rules of the jurisdiction. Chapter 18 contains specific information about divorce valuations.

Employee Stock Ownership Plans

An employee stock ownership plan (ESOP) is an incentive ownership arrangement funded by the employer. In general, employer stock is contributed instead of cash. ESOPs provide capital, liquidity, and certain tax advantages for private companies whose owners do not want to go public. An independent valuation analyst must value the employer's securities, at least annually, and must determine the price per share supporting transactions with participants, plan contributions, and allocations within the ESOP. Valuation analysts are urged to become familiar with the rules promulgated by the IRS and the DOL before they begin an ESOP engagement. Although I am not going to spend time on these types of engagements in this book, there are entire books devoted to this topic. If you plan to value an ESOP, I suggest that you track down the appropriate literature before you begin.

Buy-Sell Agreements

A buy-sell agreement allows an owner in a closely held business to acquire the interest of another owner who withdraws from the business. The agreement may contain a designated price or a formula to determine the price that the remaining owners of the entity will pay to acquire the interest. The price, or the formula, needs to be updated periodically. Payment terms and conditions of sale are also generally provided. A client may ask a valuation analyst to assist in determining which valuation method is appropriate in such an agreement. Buy-sell agreements are also used frequently to establish a value for a transaction between the owners or the entity, or both in the event of death, disability, or retirement. It is common to see different formulas for each event. Unfortunately, there are so many poorly written and outdated agreements that this area of practice has evolved in the litigation arena, where the parties are fighting over the intent of the agreement. It is part of the full-employment act for business valuers.

The valuation analyst must be aware of and understand IRC Section 2703 and its effect on valuations when there is a buy-sell agreement in effect. This is discussed in chapter 21.

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

Ownership Disputes

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

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

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

Financing

A valuation of the business may be necessary to provide lenders or potential investors with information that will help the business enterprise obtain additional funds. Financial statements for an established business present information about that enterprise based on historical amounts, but rarely reflect the current values of the assets and liabilities that are contained in the balance sheet.

For a new business, the traditional balance sheet may closely reflect the estimated current value since the assets and liabilities were recently acquired. However, this is generally not the case for an established business that has developed intangible value over the years. Assets with intangible value (such as special trademarks, patents, customer lists, and goodwill) will most likely not be included in a balance sheet at current value unless it was recently acquired. Furthermore, other assets and liabilities of the business (such as real estate and equipment) may be worth significantly more or less than the book value as recorded under GAAP.

Ad Valorem Taxes

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

Incentive Stock Option (Equity) Considerations

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

Stock options have become a major component of employee compensation packages, especially for start-up companies that may not have the cash flow to pay market rates of compensation to its employees. Instead, the employee works for the company for a lower salary but a very generous stock option plan. The computer industry has produced many millionaires as a result of these programs. Maybe I should have considered a different profession!

Initial Public Offerings

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

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

Damages Litigation

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

When you work in this area of practice, you need to be aware of such court decisions as *Daubert*³ and *Kumho Tire*⁴ to ensure that the methodologies employed in these and other types of litigation are generally accepted in the literature. Using methods that are not generally accepted can result in the expert's disqualification from a litigation. This is sure to make for unhappy clients and attorneys. Keep in mind that these cases also apply to more than just damages litigation. They are applicable to all types of litigation assignments. Chapter 26 contains specific information pertaining to economic damages.

Insurance Claims

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

Charitable Contributions

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

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

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

Eminent Domain Actions

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

Fairness Opinions

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

This service is frequently provided by investment bankers (with deep pockets). However, many valuation firms also offer this service. After the Sarbanes-Oxley Act of 2002⁵ was passed, many smaller publicly traded companies have gone private, requiring fairness opinions. The purpose of the fairness opinion is for the valuation analyst to opine that the transaction is fair to the stockholders from a financial point of view. The valuation analyst does not determine value because there is already an agreed upon price for the transaction. Fairness opinions also arise in the context of an ESOP. Frequently, a valuation firm is asked to opine that an ESOP transaction is fair. This can present an area of danger to the valuation analyst if the analyst is also the consultant to the ESOP who establishes the initial purchase price for the transaction. How can the analyst opine that the transaction that was based on his or her valuation was anything but fair? This is a potential conflict of interest that has apparently been below the radar of the DOL. The question is can the analyst stay lucky for an unlimited amount of time? The valuation analyst should read many other publications, including actual fairness opinions, before even thinking about doing one. Think liability!

Who Values Businesses?

There is a considerable amount of competition among business valuers. There is a growing number of full-time valuation analysts in the business, but they are outnumbered by the part-time valuation analysts, who spend much of their time in other areas. It is important to understand who the other players in the field are because it will help you to assess the qualifications of the individual whose report you may be reading. Understanding the strengths and weaknesses of a valuation analyst, particularly in a litigation engagement, will allow you to properly assist the attorney with whom you are working so that he or she can cross-examine the other expert more thoroughly. Among the groups providing business valuation services are the following:

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

⁵ Sarbanes-Oxley Act of 2002 (Pub. L. No. 107-204, 116 Stat. 745).

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

Business Valuation Analysts

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

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

Accountants (CPAs)

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

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

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

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

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

Business Brokers

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

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

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

College Professors

Another group of valuation analysts who are visible in the field are college professors with backgrounds in economics, finance, and accounting. Many professors are entering this field because they have time after school or as a means to supplement their income (not a bad part-time job). There is no doubt that the vast majority of these individuals understand the theory, but some (not all) demonstrate two shortcomings: First, they try to apply some very complex formulas to simple little businesses, and second, they cannot explain what they did in language that most regular people can understand. Many of these individuals are very strong in their comprehension of financial modeling and formulas. Although the mathematical formula may be correct, the answer may still be wrong.

Commercial Real Estate Appraisers

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

Although real estate appraisers understand the valuation process and principles, they often have a difficult time with the accounting aspects of financial reporting. They also have some difficulty making the transition into business valuation, where the ability to verify comparables is not always possible. Finally, although many real estate appraisals involving a capitalization of income use capitalization rates between 7 percent and 12 percent, real estate appraisers have a difficult time understanding the substantially higher capitalization rates used to value small businesses.

Investment Bankers

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

Industry Experts

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

The Internet

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

There are many websites available to have a business valuation done. Many of them seem to be designed and administered by college professors (or, for all I know, their graduate students). The fees range from as low as \$99 to a high of \$6,000. By the time you finish reading this book and realize how much work you need to do to produce a credible valuation, you may wonder how these fees are possible!

Professional Valuation Organizations

When one thinks of business valuation, several organizations⁶ come to mind, including the following:

- The AICPA
- The American Society of Appraisers
- The National Association of Certified Valuation Analysts/The Institute of Business Appraisers
- The CFA Institute
- The Appraisal Foundation

The AICPA

The AICPA is not a valuation organization, but its members probably provide the largest percentage of business valuations performed because of their sheer numbers. In 1981, the AICPA established a membership section for CPAs who provide management advisory services, recognizing that AICPA members provide services other than audit and tax. Today, that section is divided into multiple member sections, including the Forensic and Valuation Services (FVS) section. The AICPA recognizes business valuation services as an important component of CPA services.

The ABV designation was approved by the AICPA Council in the fall of 1996, and the first examination was given in November 1997. This has been an area of specialization recognized by the accounting profession. To obtain this accreditation, a candidate must meet the following requirements:

1. Be a member in good standing of the AICPA
2. Hold a valid and unrevoked CPA certificate or license issued by a legally constituted jurisdictional authority (50 states plus 6 territories)
3. Pass a comprehensive business valuation examination
4. Have the appropriate education and experience
5. Pay the required fee

⁶ There are also international organizations, such as the Canadian Institute of Chartered Business Valuers (CICBV), our friends to the north, that participate with the American organizations in conferences, standards, education, and so on.

Box 1.2 describes additional requirements that must be completed before the ABV certificate is awarded, but may be completed at any time within 24 months of passing the AICPA ABV examination. The ABV credential is required to be recertified every 3 years. This may seem like a lot, but it can't be that bad. After all, I am an ABV! For more information about obtaining the credential, go to the following website: www.aicpa.org/Membership/Join/Pages/credentials.aspx.

Because the requirements change from time to time, you should visit this site for the most current requirements.

BOX 1.2**Additional Requirements to Become an ABV****THE BUSINESS EXPERIENCE REQUIREMENT***

There are two ways an ABV credential candidate may successfully fulfill the business experience requirement:

1. A credential candidate will successfully complete the requirement by serving as a full-time instructor, who has taught at least four accredited college courses covering at least 50 percent of the material included in the business valuation body of knowledge indicated in the ABV Exam Content Specification Outline.
2. A credential candidate will also successfully complete the requirement by completing at least 150 hours of or 6 business valuation engagements in which the valuation analyst must use professional judgment, and the engagement results in the estimation of value, culminating in the expression of either a conclusion of value or a calculated value (see paragraph .21 of Statement on Standards of Valuation Services [SSVS] No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* [AICPA, *Professional Standards*, VS sec. 100]). Examples of methods used on such engagements include, but are not limited to the following:
 - **Cash flow valuation**—Analyze the historical performance of the business; estimate the cost of capital; calculate the value of the cash flow stream; and interpret the results
 - **Specialized valuation skills and training**—Security market options; research techniques and research tools; company, industry, and economic data analysis; valuation calculations and conclusions; engagement reporting; and the AICPA Code of Professional Conduct and AICPA *Professional Standards*
 - **Analysis of financial information**—Linkage between purpose for the valuation, standard of value and ownership, and sources and uses of industry financial and operating data
 - **Financial forecasting**—Statistical techniques: simple and multiple regressions, time series analysis, AICPA Prospective Financial Reporting Guidelines, determining and documenting significant forecast assumptions, company and industry data, and sources and uses of economic data
 - **Estimating cost of capital (discount and capitalization rates)**—Understanding the sources and limitations of data; security market line; market efficiency, theoretical underpinning of discount and capitalization rates—capital asset pricing model (CAPM), multifactor models, difference and similarities of CAPM and the build-up method; sources of small firm risk premiums, firm-specific risk premiums and other adjustments to cost of capital (when and how); Beta—understanding the sources and calculations, R-squared and other potential limitations; estimating Beta for privately owned companies, including guideline companies' levered Beta (bL) and Guideline Companies' Proxy unlevered Beta (bu)
 - **Selecting and evaluating guideline company data**—Screening and selection process; goodness of fit issues; guideline companies; data to use and the proper use of the data; linkages between the Standard of Value, purpose for the valuation, selection of guideline companies and specific data; court cases involving acceptance and rejection of guideline company data
 - **Determining the proper valuation discounts or premiums**—Reasons for discounts and premiums such as marketability and control issues; Standard of Value, purpose for the valuation, ownership issues, and the proper usage of discounts; sources for estimating discounts such as identifying and understanding the empirical research of liquidity and control issues; and methods used to select and apply proper discounts and premiums
 - **Linkages between approaches, standards of value**—Purpose of Valuation and Discounts Income methods; market methods; asset-based methods; liquidity and marketability issues; control and minority ownership positions; fair market value, investment value, and fair value
 - **Entity and specialized industry issues**—ESOP plans; family limited partnerships; medical practices; professional service businesses; other service businesses; start-ups, research and development, or technology-based businesses; initial public offering (IPO) candidates; merger and acquisition valuation engagements; real estate or other holding companies; and specialized industries (construction, retail, restaurants, and so on)
 - **Report preparation and engagement administration**—Awareness of appropriate SSVS No. 1 and USPAP reporting standards, proper documentation of research, presentation of and support for the valuation conclusion, sufficient and competent evidential matter, guidelines for working paper and supporting documentation, and engagement letters and letters of representation
 - **Litigation and dispute resolution services**—Rules of evidence, qualifications of experts, roles of the consulting expert and the testifying expert, and depositions and court testimony

* www.aicpa.org/InterestAreas/ForensicAndValuation/Membership/Pages/default.aspx.

BOX 1.2**Additional Requirements to Become an ABV (continued)****THE EDUCATION REQUIREMENT**

An ABV candidate must have a minimum of 75 hours of business valuation-related education. The objectives of the Education component of the program are as follows:

- Maintain competency by requiring timely updates of valuation knowledge and skills
- Provide a mechanism for monitoring maintenance of competency

In order to maintain the ABV credential, ABVs must comply with continuing professional education (CPE) standards issued by the AICPA and NASBA. It is suggested ABV credential candidates and members visit aicpa.org/cpe to become familiar with these standards, the CPE requirements for AICPA members, and the specific CPE requirements for each state board and society.

The following are examples of education related to business valuation:

- **Cash flow valuation**—Analyze the historical performance of the business, forecast future performance, estimate the cost of capital, estimate the continuing value, calculate and interpret the results
- **Specialized valuation skills and training**—Security market options; research techniques and research tools; company, industry, and economic data analysis; valuation calculations and conclusions; engagement reporting; and the AICPA Code of Professional Conduct and AICPA *Professional Standards*
- **Analysis of financial information**—Linkage between purpose for the valuation, standard of value and ownership, characteristics and normalized earnings, normalizing earnings, sources and uses of industry financial and operating data
- **Financial forecasting**—Statistical techniques: simple and multiple regressions, time series analysis, exponential smoothing, AICPA Prospective Financial Reporting Guidelines, determining and documenting significant forecast assumptions, company and industry data, and sources and uses of economic data
- **Estimating cost of capital (discount and capitalization rates)**—Understanding the sources and limitations of data; security market line; market efficiency, theoretical underpinning of discount and capitalization rates—CAPM, multifactor models, difference and similarities of the CAPM and the build-up method; sources of small firm risk premiums, firm-specific risk premiums, and other adjustments to cost of capital (when and how); Beta—understanding the sources and calculations, R-squared and other potential limitations; estimating Beta for privately owned companies, including guideline companies' levered Beta (bL) and Guideline Companies' Proxy unlevered Beta (bu)
- **Selecting and evaluating guideline company data**—Screening and selection process; goodness of fit issues; guideline companies; data to use and the proper use of the data; linkages between the Standard of Value, purpose for the valuation, selection of guideline companies and specific data; court cases involving acceptance and rejection of guideline company data
- **Determining the proper valuation discounts or premiums**—Reasons for discounts and premiums such as marketability and control issues; Standard of Value, purpose for the valuation, ownership issues, and the proper usage of discounts; sources for estimating discounts such as identifying and understanding the empirical research of liquidity and control issues; and methods used to select and apply proper discounts
- **Linkages between approaches, standards of value, purpose of valuation and discounts**—Income methods, market methods, asset-based methods, liquidity and marketability issues, control and minority ownership positions, fair market value, investment value, and fair value
- **Entity and specialized industry issues**—ESOP companies; family limited partnerships; medical practices; professional service business, other service businesses; start-up, research and development, or technology-based businesses; initial public offering (IPO) candidates; merger and acquisition valuation engagements; real estate or other holding companies; and specialized industries (construction, retail, restaurants, and so on)
- **Report preparation and engagement administration**—USPAP reporting standards, proper documentation of research, presentation of and support for the valuation conclusion, sufficient and competent evidential matter, guidelines for working paper and supporting documentation, and engagement letters and letters of representation
- **Litigation and dispute resolution services**—Rules of evidence, qualifications of experts, roles of the consulting expert and the testifying expert, and depositions and court testimony
- **Attendance at annual AICPA conferences and conferences of other professional organizations focusing on valuation-related topics**

The American Society of Appraisers

The American Society of Appraisers (ASA) is a multidisciplinary organization specializing in all types of appraisals. The organization was founded in 1936, but by 1981, there was a growing need within the organization (which was primarily a real estate dominated professional appraisal organization) to recognize business valuation as a specialty. In 1981, ASA established a business valuation committee after recognizing the business valuation discipline as a separate specialization.

ASA accredits its members by requiring candidates to pass an extensive series of written examinations, usually given at the end of four, three-day training courses. The alternative is to pass an examination that is administered in one day without taking the various training courses. Candidates are also required to submit one valuation report that the International Board of Examiners must approve and that demonstrates knowledge and compliance with valuation theory and standards.

ASA has two levels of accreditation based on the experience of the applicant. First, a designation of Accredited Member (AM) is granted to those individuals who meet the other requirements and have greater than two years, but less than five years, of full-time experience. ASA gives credit for partial years for those applicants who do not perform appraisals on a full-time basis. CPAs are given one year of valuation experience for being a CPA for five years. Financial Analysts (CFAs) are given full-time equivalent experience and are exempt from taking the examinations. Second, those applicants with five or more years of experience are granted the Accredited Senior Appraiser designation.

The National Association of Certified Valuation Analysts/The Institute of Business Appraisers, Inc.

Founded in 1991, the National Association of Certified Valuation Analysts (NACVA) is one of the newer organizations accrediting business appraisers. This organization has one designation. To become a Certified Valuation Analyst (CVA), the applicant must be a member in good standing with NACVA, successfully demonstrate that he or she meets NACVA's experience threshold requirement by completing a sample case study (or submitting an actual and sanitized fair market value report prepared in the last 12 months) for peer review, attend a 5-day training program, submit 3 personal and 3 business references, and pass a comprehensive examination.

Although considered a separate organization, The Institute of Business Appraisers (IBA) is effectively being run as a parallel organization to NACVA. IBA's assets were acquired several years ago, and both organizations are run under one roof. In the past, new and non-certified appraiser candidates for the Certified Business Appraiser (CBA) accreditation must have possessed a four-year college degree or equivalent; successfully completed both the written examination and the submission of two demonstration reports demonstrating a high degree of skill, knowledge, and judgment as a business appraiser; be a member in good standing of the IBA; submit an official CBA application form and fee; and provide four satisfactory references: two personal character references and two references regarding professional competence as a business appraiser.

Candidates for the CBA designation were exempt from the education and examination requirements if they were accredited by ASA, NACVA, the AICPA, the Canadian Institute of Certified Business Valuators, the CFA Institute, or if they hold the IBA's junior accreditation: Accredited by IBA.

IBA also has a Master Certified Business Appraiser (MCBA) designation, which is given to individuals who have held the CBA designation for no less than 10 years and who have 15 years of full-time experience as a business appraiser. That individual must have been endorsed by senior business appraisers as leading contributors to the profession's body of knowledge. I don't know how, but I am an MCBA. However, at the time of the writing of this chapter, NACVA sent out a notice informing the members that they would support existing accredited members, but they were discontinuing all of IBA's accreditations.

The CFA Institute

The CFA Institute is not really a valuation organization. This organization grants the CFA designation after an applicant passes three extensive annual examinations. The CFA designation has more of a public company orientation (mostly portfolio and asset management) than the designations of the valuation organizations that primarily deal with closely held companies. There is no report requirement, and the experience level needed for one to obtain this designation is four years.

The Appraisal Foundation

Established in 1987, The Appraisal Foundation is not a valuation organization. This organization was set up by seven real estate organizations and ASA, which was the only multidisciplinary organization, in response to a growing problem facing the real estate appraisal world. Real estate appraisers lacked standards to provide consistency in their work product. As a result, relying on these real estate appraisals caused bad bank loans to be made, creating severe problems for lending institutions. Facing some form of regulation in the near future, The Appraisal Foundation promulgated a set of standards relative to appraisals. These standards are the USPAP. Although these were primarily intended to cover real estate appraisals, ASA used its influence to have standards included for its other disciplines as well: personal property and business valuation. The USPAP is discussed in greater detail throughout this book.

Conclusion

Because this was only the first chapter of the book, you are probably starting to doze off. What did you expect? This is introductory stuff. It gets better. By now, you are at least familiar with some history of the profession, who values businesses, why businesses are valued, and valuation organizations. You also were told many times to consult with an attorney about certain issues. In fact, I said this many, many times. I know the suspense of the next chapter is probably killing you, so let's move on.

