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Companion to PPC's Guide to

Business Valuations

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Interactive Self-study CPE

Companion to PPC's Guide to Business Valuations

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To enhance your learning experience, the examination questions are located throughout the course reading materials. Please look for the exam questions following each lesson.

EXAMINATION INSTRUCTIONS, ANSWER SHEETS, AND EVALUATIONS

INTRODUCTION

Business Valuations consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to Business Valuations* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at **OnlineGrading.Thomson.com** or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **March 31, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

Taking the Courses

Each course is divided into lessons. Each lesson addresses an aspect of business valuations. You are asked to read the material and, during the course, to test your comprehension of each of the learning objectives by answering self-study quiz questions. After completing each quiz, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. References are also cited so you can go back to the text where the topic is discussed in detail. Once you are satisfied that you understand the material, **answer the examination questions which follow each lesson**. You may either record your answer choices on the printed **Examination for CPE Credit Answer Sheet** or by logging on to our Online Grading System.

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COMPANION TO PPC'S GUIDE TO BUSINESS VALUATIONS

COURSE 1

Overview of a Business Valuation Engagement Including Valuation Terms and Methodology (VALTG101)

OVERVIEW

COURSE DESCRIPTION:	Lesson 1 of this interactive self-study course covers overview of a business valuation engagement. Lesson 2 covers valuation terms and methodology.
PUBLICATION/REVISION DATE:	March 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Business Valuations*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	6 QAS Hours, 6 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Specialized Knowledge and Applications
EXPIRATION DATE:	Postmark by **March 31, 2011**
KNOWLEDGE LEVEL:	Overview

Learning Objectives:

Lesson 1—Overview of a Business Valuation Engagement

Completion of this lesson will enable you to:
- Identify the characteristics of a closely held company and its differences from a publicly traded company.
- Determine the importance of objectivity and independence in business valuation engagements.
- Recognize the professional standards that valuation consultants must comply with in performing valuation engagements.
- Summarize education, experience and training requirements for those who perform valuation services and describe the steps involved in conducting a business valuation engagement.

Lesson 2—Valuation Terms and Methodology

Completion of this lesson will enable you to:
- Identify terms applicable to business valuations.
- Summarize the basic valuation approaches and methods used to value future earnings.
- Recognize the valuation method selection process and determine the approach or method to use utilizing industry and company factors and identify valuation methods relating to very small businesses and when they are used.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

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Tax & Accounting—R&G
VALTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

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Lesson 1: Overview of a Business Valuation Engagement

INTRODUCTION

Learning Objectives:

Completion of this lesson will enable you to:

- Identify the characteristics of a closely held company and its differences from a publicly traded company.
- Determine the importance of objectivity and independence in business valuation engagements.
- Recognize the professional standards that valuation consultants must comply with in performing valuation engagements.
- Summarize education, experience and training requirements for those who perform valuation services and describe the steps involved in conducting a business valuation engagement.

What Is a Closely Held Business?

The valuation methods discussed in this Course focus on valuing closely held businesses. Generally the term *closely held business* issued to refer to a business that is owned by relatively few stockholders (or partners) and is not publicly held, i.e., not traded on a national or local stock exchange or in the over-the-counter market.

How Does Size Affect the Definition? There is a natural inclination when one hears the term *closely held business* to envision a relatively small company when measured in terms of total revenue or total assets. However, a closely held business can range in size from a relatively small corner business to an extremely large, complex entity with sales in excess of $1 billion. Again, the common denominator of this wide size range of companies is that they are owned by a relatively small number of stockholders (or partners), and their stock is not publicly traded.

Does the Approach Used to Value a Publicly Traded Company Differ? The honest answer to this question is no. The methodology used to value a publicly held company follows very closely that used to value a closely held company. In fact, valuation consultants who value publicly held companies, or financial vice-presidents, controllers, and accountants involved with the merger/acquisition activities of a public company, will find the guidance presented in this book very helpful. However, despite the similarity in approaches, a number of practical considerations or distinctions should be considered in valuing a closely held company. Those distinctions are as follows:

a. *Emphasis on Earnings versus Other Benefits.* Closely held companies are often managed directly by their shareholders, whereas publicly traded companies are usually not. A primary goal of management of a public company is to maximize the wealth of the company's shareholders through the payment of dividends or through capital appreciation. Earnings per share is a commonly used standard by which to evaluate the success of a public company's management. The owner/operators of private companies, however, can often maximize their benefits through salaries and other perquisites without regard to earnings, although earnings are still important to bankers, outside shareholders, and other third parties. For privately held companies, the primary emphasis is usually on net cash flow to the owners rather than net income.

b. *Quality and Availability of Financial Information.* Because publicly held companies are required by the Securities and Exchange Commission (SEC) to file periodic financial statements, there is a readily available data base of audited financial information that can be used to assist in arriving at value. Such a reliable and sophisticated data base does not exist for closely held companies. Consequently, the valuation consultant who deals with closely held companies often encounters situations where there is a lack of formal financial statements, or where numerous analytical tests must be performed to establish the reasonableness of financial information.

c. *Requirement for Specialized Knowledge.* The ability to value a public company often requires a knowledge of foreign operations (laws, economic conditions, etc.), a very large valuation staff, a diverse expertise in a variety of industries, and some knowledge of securities laws. In reality, such an engagement may be beyond the scope of the typical valuation consultant whose experience is primarily with small to medium-size companies. However, if a private company is a candidate to be sold to a public company, some understanding of the public company perspective is necessary.

What Is a Valuation Engagement?

A valuation engagement involves arriving at an opinion regarding the estimated value of an ownership interest in a business entity (company) as of a given point in time. The ownership interest valued may be the company's common equity or its total capital, which includes both interest-bearing debt and equity.

Reasons for Valuation. Business valuations are performed for a variety of reasons, including the following:

a. Selling all or a partial interest of a business.

b. Buying all or a partial interest of a business.

c. Mergers.

d. Corporate or partnership dissolution or recapitalization.

e. Divorce.

f. Buy-sell agreements.

g. Gift, estate, inheritance, and income taxes.

h. Charitable contributions.

i. Estate planning.

j. Determining the need for life insurance.

k. Obtaining financing.

l. Preparing personal financial statements.

m. Employee Stock Ownership Plans (ESOPs).

n. Determining damages:

   (1) Breach of contract suits.

   (2) Antitrust suits.

   (3) Lender liability suits.

   (4) Condemnation (eminent domain).

   (5) Lost business opportunity.

   (6) Business interruption.

o. Allocation of total value:

   (1) Among classes of ownership interests.

   (2) Among classes of assets.

p. Ad valorem taxes (property taxes).

q. Dissenting stockholder and shareholder oppression suits (and other stockholder disputes).

r. Financial reporting.

(1) Measuring identifiable assets acquired (including research and development assets and intangible assets), liabilities assumed, goodwill, and any noncontrolling interest resulting from a business combination.

(2) Asset impairment analysis, including goodwill and acquired research and development assets.

(3) Stock options.

As discussed earlier in item r., valuation engagements can be performed to assist companies and their auditors in complying with the FASB's increased reliance on fair value reporting. For example, FASB ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*), provides a framework for measuring fair value in GAAP and modifies disclosures about fair value measurement, and FASB ASC 825 (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*), permits entities to choose to measure many financial instruments and certain other items at fair value. Also, FASB ASC 805 (formerly SFAS No. 141(R), *Business Combinations*), and FASB ASC 350 (formerly SFAS No. 142, *Goodwill and Other Intangibles*), require most assets and liabilities to be recorded at fair value during the initial business combination and subsequent impairment reviews.

Scope of Service. In responding to a client's needs, the valuation professional may prepare anything from an oral discussion of reasonable ranges of value to a comprehensive, fully documented written report that would be defensible in court.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Distinctions involved in valuing a closely held company when placing an emphasis on earnings versus other benefits includes which of the following?

   a. Closely held companies are usually not managed directly by their shareholders.

   b. Earnings per share is a commonly used standard by which to evaluate the success of a closely held company.

   c. Closely held companies primary emphasis is usually on net cash flow.

   d. Maximization of wealth through capital depreciation.

2. Which of the following best defines a *closely held business*?

   a. A local printing shop in a downtown area.

   b. A clothing manufacturer with sales up to $250 million.

   c. A large, multi-state distributor with sales in excess of $1 billion.

   d. A non publicly traded toy store with few stockholders.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

1. Distinctions involved in valuing a closely held company when placing an emphasis on earnings versus other benefits includes which of the following? **(Page 3)**

   a. Closely held companies are usually not managed directly by their shareholders. [This answer is incorrect. Closely held companies *are* often managed directly by their shareholders since they are owned by a relatively small number of shareholders whereas publicly traded companies are usually not.]

   b. Earnings per share is a commonly used standard by which to evaluate the success of a closely held company. [This answer is incorrect. A closely held company's success can be evaluated through salaries and other perquisites without regard to earnings, although earnings are still important to bankers, outside shareholders, and other third parties.]

   c. Closely held companies primary emphasis is usually on net cash flow. [This answer is correct. For closely held companies, the primary emphasis is usually on net cash flow to the owner's rather than net income since closely held companies are often managed directly by their shareholders and a closely held company would not have as many resources at their disposal as a public company.]

   d. Maximization of wealth through capital depreciation. [This answer is incorrect. A primary goal of management of a public company is to maximize the wealth of the company's shareholders through the payment of dividends or through capital *appreciation* not capital *depreciation*.]

2. Which of the following best defines a *closely held business*? **(Page 3)**

   a. A local printing shop in a downtown area. [This answer is incorrect. A closely held business can be a relatively small corner business. However, it can also be an extremely large, complex entity. The size of the business is not a factor in a closely held business.]

   b. A clothing manufacturer with sales up to $250 million. [This answer is incorrect. A closely held business can have sales much greater than $250 million. The sales revenue does not define a closely held business.]

   c. A large, multi-state distributor with sales in excess of $1 billion. [This answer is incorrect. A closely held business can range in size from a relatively small corner business to an extremely large, complex entity with sales in excess of $1 billion. However, this is still not the best definition of a closely held business.]

   d. A non publicly traded toy store with few stockholders. [This answer is correct. The common link that allows entities of widely varying sizes to be classified as closely held businesses is that they are owned by a relatively small number of stockholders (or partners), and their stock is not publicly traded.]

THE ROLE OF THE CONSULTANT IN A BUSINESS VALUATION ENGAGEMENT

The Role of Objectivity and Independence in a Valuation Engagement

Regardless of the background of the consultant or the unique requirements of his or her profession, one of the most critical professional and ethical decisions the valuation consultant must make involves the issue of objectivity. On any engagement, a valuation consultant must assume one of the following roles:

a. The consultant serves as an independent consultant, performing an objective valuation of the company (or a specific interest in the company), or

b. The consultant serves as an advisor, determining and negotiating a value that is most beneficial to the client's position.

The consultant must define his or her role before beginning an engagement and should clearly communicate that role to the client in a signed engagement letter.

There Is Normally a Presumption of Objectivity. Just as an auditor is presumed to be independent with respect to an audit client, a consultant is normally presumed to be independent and objective with respect to a business valuation. The AICPA's *Code of Professional Conduct* states the following:

> **Rule 102—Integrity and objectivity.** In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

The AICPA Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, further states in paragraph 14 (VS 100.14):

> Objectivity is a state of mind. The principle of objectivity imposes the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest. If necessary, where a potential conflict of interest may exist, a valuation analyst should make the disclosures and obtain consent as required under Interpretation No. 102-2. . .

Although Rule 102 and SSVS No. 1 relates specifically to CPAs, the concept of objectivity is important to any consultant who performs valuation services.

In performing an independent valuation of a company, a consultant should objectively interpret accumulated data in a reasonable and accurate manner. The consultant's opinion of value should not be compromised by external factors such as the wishes of the client or the amount of the fee. In the absence of any disclosure to the contrary, the appraised value of a company is presumed to represent the impartial, unbiased judgment of the appraiser.

Protecting the Appearance of Objectivity. In addition to being objective in providing valuation services, the consultant needs to maintain the *appearance* of objectivity. The consultant's professional reputation can be irreparably harmed whenever an actual or apparent compromise of objectivity or integrity occurs. The following practices should be considered in order to maintain the appearance of objectivity:

a. The consultant should be independent of the company being valued, i.e., there should be no ownership or other financial interest or family relationship.

b. Contingent fee arrangements, whereby the amount of the consultant's fee is based in whole or in part on the outcome of the valuation engagement, must be avoided. Instead, the consultant should price his or her services based on standard hourly or per diem rates or agree on a fixed sum before beginning the project.

c. Progress bills should be rendered and collected in a timely manner as the project progresses. This will reduce a client's ability to exert undue influence on the outcome of the valuation engagement by threatening to withhold payments unless the value is either raised or lowered.

Objectivity of Consultants Who Perform Litigation Support Services. Valuation consultants are frequently engaged to perform appraisals to assist in the resolution of civil or tax disputes. In fact, it is not unusual for both the plaintiff and the defendant in a lawsuit to engage valuation consultants as expert witnesses. It is important to stress the importance of objectivity when providing expert witness testimony in legal disputes. In a litigation engagement, it is especially important to render and collect progress bills regularly to keep the opposing side from trying to imply that the outcome of the engagement may affect the fee.

Independence. A consultant is normally presumed to be independent and objective with respect to a valuation engagement. The Professional Ethics Executive Committee (PEEC) issued a Conceptual Framework for AICPA Independence Standards (Conceptual Framework) (ET 100.01) which describes the risk-based approach used by PEEC to determine whether a member's relationship with a client poses an unacceptable risk to the member's independence.

In situations where there are no independence interpretations or rulings that address an accountant's particular independence circumstance, CPAs must refer to the risk-based approach described in the Conceptual Framework Interpretation to evaluate whether the particular independence situation would lead a reasonable person who is aware of all of the facts to conclude that the CPA is not independent.

The Introduction to the Conceptual Framework indicates that under a risk-based approach to analyzing independence, a member's relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member's independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising) the member's professional judgment when rendering an attest service to the client.

The Conceptual Framework discusses factors that influence independence risk and categorizes these factors as either threats or safeguards to independence. Threats to independence are circumstances that could impair independence. Many individual circumstances (or combinations of circumstances) can create threats to independence. Some examples include the following:

- *Self-review Threat.* Reviewing your own nonattest work, or that of your team, as part of the attest engagement.

- *Familiarity Threat.* Accountants who have close or longstanding relationships with attest clients.

- *Undue Influence Threat.* Attempts by an attest client's management to exercise influence over the CPA, such as pressure to reduce audit procedures for the purpose of reducing audit fees.

- *Management Participation Threat.* Performing management functions on behalf of an attest client, such as making hiring decisions.

Safeguards are controls that mitigate or eliminate threats to independence to an acceptable level. Safeguards are generally created or implemented by (a) the CPA profession, legislation, or regulation through continuing education requirements on independence and ethics and external review of a firm's quality control system, (b) the attest client through an attitude that emphasizes its commitment to fair and ethical policies and procedures, and (c) the CPA through rotation of senior personnel assigned to the attest engagement team and the involvement of another firm to perform part of an audit.

When threats to independence are not at an acceptable level and safeguards are required, the CPA should document the identified threats to independence and the safeguards applied to eliminate the threats or reduce them to an acceptable level. A copy of the Conceptual Framework can be found on the AICPA's website at **www.aicpa.org**.

<u>Ethics Interpretation 101.3.</u> Interpretation 101-3, *Performance of Nonattest Services*, covers the practitioner's responsibilities for maintaining independence when providing nonattest services, including valuation services, to attest clients. Note that this Interpretation is based on the independence of the firm when providing attest services. However, paragraph 15 of SSVS No. 1 (VS 100.15) also states that the requirements of Interpretation 101-3 should be met to avoid impairing independence of the valuation analyst.

The Interpretation provides that a CPA's independence would be impaired if he performs an appraisal, valuation, or actuarial service for an attest client that involves a *significant degree of subjectivity* and is material, individually or in the aggregate, to the client's financial statements. Thus, most valuations for business acquisition or sale purposes would violate the CPA's independence rule and preclude the CPA valuator from performing audit or review services for the valuation client. However, business valuations performed for nonfinancial statement purposes, such as valuations for estate and gift tax planning or divorce proceedings, may not impair the CPA valuator's independence.

If a valuation engagement does not involve a significant degree of subjectivity or is not material, individually or in the aggregate, to the client's financial statements, to comply with the requirements of Interpretation 101-3, a CPA must obtain a written understanding with the client regarding the following:

a. Objectives of the valuation.

b. Services to be performed.

c. Client's acceptance of its responsibilities.

d. CPA's responsibilities.

e. Any limitations of the engagement.

The client's responsibilities noted in item c. include (a) making all management decisions and performing all management functions, (b) designating an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management, to oversee the valuation, (c) evaluating the adequacy and results of the services performed, and (d) accepting responsibility for the results of the valuation. In cases where the client is unable or unwilling to assume all of these responsibilities, the practitioner's performance of the valuation services would impair independence.

Valuation engagements are, by their very nature, subjective and require numerous judgments to be made by the appraiser. In addition, the client's responsibilities (such as evaluating the adequacy and results of the services, and accepting responsibility for the results of the valuation) are often difficult for the client to achieve. Thus, CPAs deciding whether to perform valuation services for an attest client should carefully consider all of the requirements of this Interpretation before accepting the engagement.

The Interpretation does not specify how the written understanding is to be documented, so the practitioner has flexibility. For example, the understanding might be documented in a separate engagement letter, or in the workpapers, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

Advisory Engagements

As previously discussed, a valuation consultant should normally perform valuation engagements in an objective, impartial manner. This is not to say, however, that a valuation consultant should never serve as an advisor to a client. Consultants often assist buyers and sellers of companies throughout the negotiation process. In this role, the consultant will typically assist the buyer or seller in establishing a range of acceptable values. The buyer will then usually offer an amount at the lower end of the range while the seller will hold out for an amount closer to the upper end of the range. The consultant can provide invaluable assistance by actively participating in the negotiations, pointing out factors that should lower the seller's expectations or raise the buyer's offering price.

Some clients believe that whenever they hire a consultant to perform a business valuation, they are hiring an advisor who will support the client's best interests and render a value acceptable to the client. The consultant must ensure that the client is aware of the distinction between an objective appraisal and an advisory service before accepting the engagement. The role of the consultant should be specifically addressed in the engagement letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

3. Which of the following situations best maintains the appearance of objectivity and independence in a valuation engagement?

   a. When performing a current business valuation engagement, the partner of ABC Accounting Firm realized that his sister-in-law is a significant stakeholder in the client's business.

   b. When determining the fee for ABC Accounting Firm's business valuation engagement, the partner and client agreed upon a fixed sum before beginning the engagement.

   c. Although ABC Accounting Firm agreed upon a standard hourly rate, the client insisted on paying at the close of the engagement.

   d. A CPA performed a valuation for an attest client that involved a significant degree of subjectivity and is material to the client's financial statements.

4. Consultants providing nonattest services could encounter threats to their independence on an engagement. Which of the following is an example of a familiarity threat?

   a. Sarah has presented to her client the proposal for the audit. Her client has refused the proposal because they feel too many hours are required to get the job done, making the fee too high.

   b. Steve has been engaged to value the business of Frank, the best friend of Steve's dad, so that he can put his business on the market for retirement.

   c. All of the partners in Jim's firm are busy on other engagements, so Jim's team decides to review each other's work on their current engagement.

   d. Lynn has been asked by her client to interview the candidates for the controller position that the client is hiring. The controller will be the position interacting with the firm.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

3. Which of the following situations best maintains the appearance of objectivity and independence in a valuation engagement? **(Page 9)**

   a. When performing a current business valuation engagement, the partner of ABC Accounting Firm realized that his sister-in-law is a significant stakeholder in the client's business. [This answer is incorrect. The consultant should be independent of the company being valued. There should be no ownership or other financial interest or family relationship.]

   b. When determining the fee for ABC Accounting Firm's business valuation engagement, the partner and client agreed upon a fixed sum before beginning the engagement. [This answer is correct. Contingent fee arrangements, whereby the amount of the consultant's fee is based in whole or in part on the outcome of the valuation engagement, must be *avoided*. Instead, the consultant should price his or her services based on standard hourly or per diem rates or agree on a fixed sum before beginning the project.]

   c. Although ABC Accounting Firm agreed upon a standard hourly rate, the client insisted on paying at the close of the engagement. [This answer is incorrect. Progress bills should be rendered and collected in a timely manner as the project progresses. This will reduce a client's ability to exert undue influence on the outcome of the valuation engagement by threatening to withhold payments unless the value is either raised or lowered.]

   d. A CPA performed a valuation for an attest client that involved a significant degree of subjectivity and is material to the client's financial statements. [This answer is incorrect. The AICPA revision to Interpretation 101-3, *Performance of Nonattest Services*, provides that a CPA's independence would be impaired if he performs a valuation service for an attest client that involves a *significant degree of subjectivity* and is material to the client's financial statements.]

4. Consultants providing nonattest services could encounter threats to their independence on an engagement. Which of the following is an example of a familiarity threat? **(Page 10)**

   a. Sarah has presented to her client the proposal for the audit. Her client has refused the proposal because they feel too many hours are required to get the job done, making the fee too high. [This answer is incorrect. This is an example of undue influence threat. When an attempt by an attest client's management is made to exercise influence over the CPA, such as pressure to reduce audit procedures for the purpose of reducing audit fees is made, the threat is considered undue influence.]

   b. Steve has been engaged to value the business of Frank, the best friend of Steve's dad, so that he can put his business on the market for retirement. [This answer is correct. When accountants have a close or longstanding relationship with the attest client, it could impair the independence of the engagement due to a familiarity threat.]

   c. All of the partners in Jim's firm are busy on other engagements, so Jim's team decides to review each other's work on their current engagement. [This answer is incorrect. When a team reviews their own nonattest work as part of the attest engagement, this threat to independence is called self-review.]

   d. Lynn has been asked by her client to interview the candidates for the controller position that the client is hiring. The controller will be the position interacting with the firm. [This answer is incorrect. When the accountant has been asked to perform management functions on behalf of the attest client, such as making hiring decisions, there is a threat of management participation and independence could be impaired.]

Other Professional Standards

In addition to the general issue of objectivity, valuation consultants must comply with certain additional professional standards. The remainder of this lesson summarizes the unique standards that may apply in a valuation engagement.

Uniform Standards of Professional Appraisal Practice of the Appraisal Foundation. In 1987, nine professional appraisal organizations formed The Appraisal Foundation, which in turn established the Appraisal Standards Board (ASB) and the Appraiser Qualifications Board (AQB). The Foundation, through its Appraisal Standards Board, has developed *Uniform Standards of Professional Appraisal Practice* (USPAP). Standards 9 and 10 relate specifically to performing and reporting on business valuation engagements. Various federal and state regulatory agencies (including the Federal Deposit Insurance Corporation and the Office of Thrift Supervision) have adopted guidelines that require adherence to USPAP.

USPAP consists of five sections: Definitions, Preamble, Rules, Standards and Standards Rules, and Statements on Appraisal Standards. USPAP Definitions are included at the beginning so the reader has a clear understanding of the multitude of terms used in the document. The Preamble expresses the goal of the document which is to promote and maintain a high level of public trust in appraisal practice by establishing requirements for appraisers. USPAP contains four overarching Rules covering ethics, competency, scope of work, and jurisdictional exception. Each Rule applies to all appraisal disciplines and set the framework for the conduct of the assignment. The ten Standards and Standards Rules establish requirements for appraisal, appraisal review, appraisal consulting service, and the manner in which each is communicated. One group establishes requirements for the development of an opinion while the other group establishes requirements for the manner in which the opinion is communicated. Statements on Appraisal Standards (Statements) are issued for the purpose of clarification, interpretation, explanation or elaboration of USPAP. They have the full weight of a Standards Rule. Each statement is labeled as to its applicability to the various appraisal disciplines. Currently, there are ten Statements of which five are retired. Of the remaining Statements, only Statement 9 (concerning the identification of Intended Use and Intended Users) is applicable to business valuation.

USPAP also includes guidance in the form of Advisory Opinions (AO) to illustrate the applicability of USPAP in specific situations for the resolution of appraisal issues and problems. Guidance provided in AOs does not establish new standards or interpret existing standards. There have been 32 advisory opinions issued of which 5 have been retired. Like the Statement on Appraisal Standards each opinion is labeled as to its applicability to the various disciplines. Of the 27 active AOs, only nine are applicable to business valuation as they are applicable to all appraisal disciplines. The ASB also publishes monthly questions and answers concerning USPAP, which are compiled in its "USPAP Q&A" located at **www.appraisalfoundation.org**.

<u>Recent Changes to USPAP.</u> In November 2009, the Appraisal Standards Board issued the 2010–2011 USPAP. Effective January 1, 2010 through December 31, 2011, the 2010–2011 USPAP contains many minor updates, including revisions to the definitions of "Signature", "Jurisdictional Exception", and "Assignment". Specifically, the definition of "Assignment" was changed from "a valuation service provided as a consequence of an agreement between an appraiser and a client to provide a valuation service" to "1) an agreement between an appraiser and a client to provide a valuation service; 2) the valuation service that is provided as a consequence of such an agreement". This change was done to recognize that USPAP often refers to the agreement itself as an assignment.

With two notable exceptions, most of the changes to the 2010–2011 USPAP were done for clarity and do not alter the intent or general requirements. The changes that do impact requirements deal with the Conduct Section of the Ethics Rule and changes to Standard Rule 3, *Appraisal Review, Development and Reporting*. The change to the Conduct Section of the Ethics Rule is particularly significant. Prior to accepting an assignment, and if discovered at any time during the assignment, an appraiser must disclose to the client and in the report certification:

> Any services regarding the subject property performed by the appraiser within the prior three years, as an appraiser or in any other capacity.

The intent of this requirement is to allow a perspective client or existing client to know whether the appraiser is performing or has performed services with regard to the property. The requirement is premised on the concept that the client should have the opportunity to evaluate this information before or during the period the appraiser is engaged to determine any conflict of interest or potential conflict of interest by the appraiser. This change has been incorporated throughout this *Guide*.

The second significant change, revisions to Standard 3, was made to update and clarify the requirements for appraisal review. Specifically, there have been differences in practice regarding the requirements that apply to reviewers who are providing their own opinion of value related to the subject of an appraisal, an appraisal review, or an appraisal consulting problem addressed in the work under review. The 2010–2011 USPAP clarifies that, in an appraisal review assignment, the reviewer can provide an opinion of value for the subject property if the reviewer complies with the requirements of the respective development Standards 1, 6, 7, and/or 9.

It is believed that USPAP reflects good appraisal practice and recommended that appraisers agree with their clients to conform to USPAP when performing a complete appraisal. Copies of these standards may be ordered directly from The Appraisal Foundation at the following phone number and website:

The Appraisal Foundation
(800) 348-2831
www.appraisalfoundation.org

Cost for a complete set of the USPAP is $75. Exhibit 1-1 lists the 10 USPAP standards, the ten Statements on Appraisal Standards, and the related Advisory Opinions.

Proposed Changes to USPAP. The Appraisal Standards Board (Board) is already addressing potential changes to the 2012—2013 edition of USPAP. In December 2009, the Board issued an initial exposure draft. The exposure draft contained a proposed COMMUNICATIONS RULE dealing with the appraiser's responsibilities in communicating with the client, including drafts and/or preliminary reports. Other changes in the initial draft do not have a direct impact on performing and reporting on business valuation engagements. A second exposure draft is expected to be issued in March 2010. A third exposure draft is also expected to be issued before the projected November 2011 final version is issued.

Exhibit 1-1

2010–2011 Uniform Standards of Professional Appraisal Practice

INTRODUCTION
STANDARDS AND STANDARDS RULES
Standard 1—Real Property Appraisal, Development
Standard 2—Real Property Appraisal, Reporting
Standard 3—Real Property and Personal Property Appraisal Review, Development, and Reporting
Standard 4—Real Property/Appraisal Consulting, Development
Standard 5—Real Property/Appraisal Consulting, Reporting
Standard 6—Mass Appraisal, Development and Reporting
Standard 7—Personal Property Appraisal, Development
Standard 8—Personal Property Appraisal, Reporting
Standard 9—Business Appraisal, Development
Standard 10—Business Appraisal, Reporting
STATEMENTS ON APPRAISAL STANDARDS
SMT-1 Clarification of Comment on Standards Rule 3-1(g) (Retired 1/1/00)
SMT-2 Discounted Cash Flow Analysis
SMT-3 Retrospective Value Opinions
SMT-4 Prospective Value Opinions
SMT-5 Confidentiality Section of the Ethics Rule (Retired 7/1/01)
SMT-6 Reasonable Exposure Time in Real Property and Personal Property Market Value Opinions
SMT-7 Permitted Departure from Specific Requirements for Real Property and Personal Property Appraised Assignments (Retired 7/1/06)
SMT-8 Electronic Transmission of Reports (Retired 1/1/02)

SMT-9 Identification of the Client's Intended Use in Developing and Reporting Appraisal, Appraisal Review, or Appraisal Consulting Assignment Opinions and Conclusions

SMT-10 Assignments for Use by a Federally Insured Depository Institution in a Federally Related Transaction (Retired 1/1/08)

ADVISORY OPINIONS

AO-1 Sales History
AO-2 Inspection of Subject Property Real Estate
AO-3 Update of an Appraisal
AO-4 Standards Rule 1-5(b)
AO-5 Assistance in the Preparation of an Appraisal (Retired 1/1/08)
AO-6 The Appraisal Review Function (Retired 1/1/05)
AO-7 Marketing Time Opinions
AO-8 Market Value vs. Fair Value in Real Property Appraisals (Retired 7/1/06)
AO-9 Responsibility of Appraisers Concerning Toxic or Hazardous Substance Contamination
AO-10 The Appraiser-Client Relationship (Retired 1/1/04)
AO-11 Content of the Appraisal Report Options of Standards Rule 2-2 and 8-2
AO-12 Use of the Appraisal Report Options of Standards Rule 2-2 and 8-2
AO-13 Performing Evaluations of Real Property Collateral to Conform with USPAP
AO-14 Appraisals for Subsidized Housing
AO-15 Using the DEPARTURE RULE in Developing a Limited Appraisal (Retired 7/1/06)
AO-16 Fair Housing Laws and Appraisal Report Content
AO-17 Appraisals of Real Property with Proposed Improvements
AO-18 Use of an Automated Valuation Model (AVM)
AO-19 Unacceptable Assignment Conditions in Real Property Appraisal Assignments
AO-20 An Appraisal Review Assignment That Includes The Reviewer's Own Opinion of Value
AO-21 When Does USPAP Apply in Valuation Services?
AO-22 Scope of Work in Market Value Appraisal Assignments, Real Property
AO-23 Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment
AO-24 Normal Course of Business
AO-25 Clarification of the Client in a Federally Related Transaction
AO-26 Readdressing (Transferring) a Report to Another Party
AO-27 Appraising the Same Property for a New Client
AO-28 Scope of Work Decision, Performance, and Disclosure
AO-29 Acceptable Scope of Work
AO-30 Appraisals for Use by a Federally Regulated Financial Institution
AO-31 Assignments Involving More than One Appraiser
AO-32 Ad Valorem Property Tax Appraisal and Mass Appraisal Assignments

* * *

Standards of the American Society of Appraisers. The American Society of Appraisers (ASA) was formed in 1936 and, with over 5,000 members worldwide, is a major appraisal testing/certifying organization representing all major disciplines of appraisal specialists, including those who specialize in business valuation. To ensure that professional appraisers adhere to the highest technical and ethical standards in performing valuation projects, ASA has prepared a comprehensive set of *Principles of Appraisal Practice and Code of Ethics* for its members. These standards are appropriate for business valuation specialists as well as appraisers of real estate, machinery and equipment, personal property, and other valuation disciplines. Among other topics, the standards address the following major issues:

a. Objectivity in the performance of appraisal work.

b. The appraiser's obligations to his or her client.

c. The appraiser's obligations to other appraisers and to ASA.

d. General guidance on the application of various appraisal methods and practices.

e. Unethical and unprofessional appraisal practices.

f. Guidance on certain specific explanations, descriptions, and statements that should be included in appraisal reports.

Standards of the Business Valuation Committee of the ASA. Beyond the preceding general standards, the Business Valuation Committee has adopted standards that relate specifically to business valuation engagements. These standards currently include eight Business Valuation Standards, Definitions, two Statements of Business Valuation Standards, one Advisory Opinion, and one Procedural Guideline.

Standards of the National Association of Certified Valuation Analysts. The National Association of Certified Valuation Analysts (NACVA) was formed in 1991 and is an association focused on training, accrediting, and serving business valuation and litigation support professionals. Current membership is approximately 6,600. Membership is open to interested professionals.

Standards of the Institute of Business Appraisers. The Institute of Business Appraisers (IBA) is a testing and certifying organization for appraisers who perform valuations of small closely held businesses. Formed in 1978, the IBA has over 3,000 members, half of whom are CPAs. In late 2009, the IBA announced that it was significantly revising its standards. Those revisions will be put out for comment and are expected to be approved and issued as final sometime in late 2010.

Guidelines of the Internal Revenue Service. In 1998, the Internal Revenue Service began to examine and comment on its existing valuation practices and policies. Through this process, the IRS established a National Valuation Policy Council (VPC) to set direction and oversee the implementation of valuation policies and utilization of IRS resources.

In 2002, the IRS business valuation guidelines were issued. In 2006, the guidelines were revised and incorporated into the Internal Revenue Manual (beginning at IRM §4.48.3). The revised IRS business valuation guidelines also include valuation policies and procedures of personal property, intangible property, and real (tangible) property. The business valuation guidelines are a synthesis of USPAP, Revenue Ruling 59-60, and other similar standards. The guidelines relate to the development, resolution, and reporting of business valuation issues and are applicable to IRS and taxpayers' valuators. In addition, the guidelines require certain content included in a signed statement attached to business valuation reports.

The VPC has subsequently been disbanded. The IRS has indicated it will be replaced by a larger council encompassing all field specialists and will seek external stakeholder participation at some time in the future.

Standards of the American Institute of Certified Public Accountants (AICPA). The AICPA's Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*, is similar to the standards of other business valuation organizations. For example, the Statement upholds the "known or knowable" concept as of the valuation date. The Statement is also supportive of the three primary valuation approaches: the income approach, the market approach, and the asset-based approach. Valuation approaches and methods unique to valuation of intangible assets are separately identified in the Standards. However, there are slight terminology differences particular to the CPA profession. For example, instead of an appraiser's *certification*, the Standard uses the term appraiser's *representation*. The difference in terms is necessary because the term *certification* holds a unique financial statement meaning to a CPA that is different than the type of certification presented by other business valuation standards.

The Statement allows for two types of engagements—a valuation engagement and a calculation engagement. The valuation engagement results in a *conclusion of value* while the calculation engagement results in a *calculated value*. The estimate of value computed under either analysis may be expressed as an individual number or as a range. SSVS No. 1 also provides guidance for writing the valuation report, including suggested wording for the conclusion paragraph and representation of the valuation analyst of both types of engagements. SSVS No. 1

allows oral reports as long as certain reporting requirements are properly communicated to the client and properly documented in the workpapers.

The AICPA Valuation Standards Subcommittee. The AICPA's Business Valuation Committee is overseen by the Forensic and Valuation Services Executive Committee (FVSEC), which has been designated as a senior committee reporting directly to the AICPA Board of Directors (Board). The FVSEC also has the ability to set standards without prior clearance of the Board or the AICPA Governing Council. Subsequent to the issuance of SSVS No. 1, the AICPA's Business Valuation Committee established the AICPA Valuation Standards Subcommittee (VSS). The VSS was established to monitor the business valuation environment for necessary changes to SSVS No. 1, to recommend new topics for potential future standards, and to provide implementation guidance for SSVS No. 1 and any future Standards. As for providing implementation guidance, the VSS established presentation materials and training courses, wrote magazine articles, and responded to specific questions from practitioners. Some of the questions that have been non-authoritatively answered by the VSS are as follows:

- Are fairness opinions covered by SSVS No. 1? No. Because no conclusion of value is offered in a fairness opinion, SSVS No. 1 does not apply.

- Are solvency opinions subject to SSVS No. 1? It depends. SSVS No. 1 does not apply when a CPA is retained to complete the solvency analysis and issue a solvency opinion, even if the CPA performs some valuation-related work as part of the analysis. However, if the CPA is retained as a valuation analyst to perform a valuation analysis and issue a valuation opinion, the CPA must follow the requirements of SSVS No. 1.

- Is an engagement to only provide an estimate of a valuation discount or control premium subject to SSVS No. 1? No, SSVS No. 1 does not apply because the valuation analyst is not providing a conclusion of value or a calculated value.

- Are critiques of opposing expert's valuations subject to SSVS No. 1? Generally no. If the CPA performs a review and critique engagement, even a review appraisal under USPAP Standards Rule 3, and does not reach an independent valuation conclusion, then SSVS No. 1 does not apply. Thus, the CPA may critique and correct the opposing expert's analysis (sources, research, approaches and methods, mathematics, logic, etc.) and indicate the corrected values. However, if the CPA also concludes that the corrected values represent the CPA's value conclusion, SSVS No. 1 would apply. The same logic applies if the CPA is serving as a trier of fact in litigation matters, such as serving as an arbitrator.

- Are executive compensation "valuations" covered by SSVS No. 1? No. Because there is no engagement to value a business, an interest in a business, a security or an intangible asset, SSVS No. 1 does not apply.

- Is the determination of an owned undivided interest in real estate covered by SSVS No. 1? No, because there is no engagement to value.

- Is the preparation of an intangible asset royalty analysis subject to SSVS No. 1? No, SSVS No. 1 does not apply because the valuation analyst is not preparing a conclusion of value.

At the request of the AICPA Business Valuation Committee, the VSS is currently working on two projects for future SSVSs. Broad outlines have been developed for the following valuation topics: (1) the applicability of SSVS No. 1 to review appraisal assignments similar to USPAP Standards Rule 3 and (2) the impact on valuing intangible assets for the guidance in FASB ASC 805 (formerly SFAS No. 141(R), *Business Combinations*;) FASB ASC 350 (formerly SFAS No. 142, *Goodwill and Other Intangible Assets*;) and FASB ASC 820 (formerly SFAS No. 157, *Fair Value Measurements*). However, in 2009 work was delayed on these projects until FVSEC completes a forensic and valuation services (FVS) standards manual which is intended to formalize the AICPA procedures for issuing future FVS professional standards, including SSVSs. The FVSEC standards manual is expected to be completed and approved in 2010. Upon approval, the VSS will continue work on the two existing projects and initiate others as needed.

Other AICPA Standards that Apply to All CPAs. The AICPA has established other professional standards that generally apply to all services provided by CPAs. Some of the AICPA standards relate to business valuation engagements and others do not. For example, standards on attestation engagements are normally not applicable because of the nature of a valuation engagement. Other standards, such as those relating to forecasts and projections and those relating to reports on historical financial statements, may or may not be applicable to a particular valuation engagement depending on the type of information contained in the valuation report. The following AICPA standards may apply to CPAs who perform valuation services:

a. Standards That Apply to All Valuation Engagements.

   (1) Standards for Consulting Services.

   (2) Standards of Professional Conduct.

b. Standards That May Apply to Valuation Engagements, Depending on the Circumstances.

   (1) Standards on Reporting on Historical Financial Information.

   (2) Standards on Financial Forecasts and Projections.

   (3) Quality Control Standards.

The AICPA Consulting Services Special Report (CSSR) 03-1, *Litigation Services and Applicable Professional Standards*, includes business valuations as a type of service included under the definition of "litigation services." CSSR 03-1 is available from the AICPA at **www.aicpa.org**.

How These Requirements Affect Exempt Consultants

Obviously, the previously mentioned professional standards do not apply to every user of this lesson. Attorneys who often serve their clients in an advocacy role, for example, would probably not be concerned with the preceding objectivity issues. Likewise, CPAs employed in industry, under certain circumstances, may not need to comply with those AICPA standards that are designed for public practitioners. It is believed, however, that the standards of each professional group complement each other and provide a logical foundation for delivering valuation services.

It is recommended that all valuation consultants be aware of both the unique standards of their profession and the standards of related professions and incorporate them into their philosophy of service. The basic valuation standards of each professional organization have been incorporated into the engagement approach presented in this lesson.

Impact of Accounting Guidance

FASB ASC 820, *Fair Value Measurements* and Disclosures (formerly SFAS No. 157, *Fair Value Measurements*), provides a framework for measuring fair value in GAAP and modifies disclosures about fair value measurement. The guidance provides the definition and measurement process of fair value used in existing accounting literature.

FASB's Future Role in the Valuation Field. Although the FASB's emphasis on fair value reporting is expected to be beneficial to the valuation industry, the FASB recognizes that existing accounting literature does not address many valuation issues encountered by financial statement preparers and auditors, as well as valuation professionals. Due to the fragmented nature of the valuation profession and no one source of valuation standards, the FASB is considering its role in the valuation field as it applies to financial reporting and best valuation practices for measuring fair value.

To help define its role, the FASB solicited opinions concerning how issues related to value determination should be addressed within the current FASB framework. From the comments received, the FASB decided to form a resource group. The Valuation Resource Group (VRG) provides the FASB staff with information and alternative viewpoints on implementation issues surrounding fair value measurements used in financial statements reporting purposes. Because the VRG does not make any authoritative decisions, VRG meetings are closed to the public and minutes are not distributed. Since its inception, VRG discussions have helped initiate and provide input for various FASB projects concerning fair value, including improving disclosures about fair value measurement and the guidance issued in response to the SEC study on mark-to-market accounting. Further information on the VRG is available on the FASB's website at **www.fasb.org**.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. The *Uniform Standards of Professional Appraisal Practice* (USPAP) is comprised of five sections. If an appraiser was searching for information regarding the scope of work of an appraiser, which section would he want to reference?

   a. Standards and Standards Rules.

   b. Definitions.

   c. Rules.

   d. Statements on Appraisal Standards.

6. Which of the following AICPA standards are applicable to *all* valuation engagements?

   a. Quality Control Standards.

   b. Standards on Financial Forecasts and Projections.

   c. Standards for Consulting Services.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

5. The *Uniform Standards of Professional Appraisal Practice* (USPAP) is comprised of five sections. If an appraiser was searching for information regarding the scope of work of an appraiser, which section would he want to reference? **(Page 15)**

   a. Standards and Standards Rules. [This answer is incorrect. The Standards and Standards Rules of the USPAP establish requirements for appraisal, appraisal review, appraisal consulting service, and the manner in which each is communicated. One group establishes requirements for the development of an opinion while the other group establishes requirements for the manner in which the opinion is communicated.]

   b. Definitions. [This answer is incorrect. The definitions are included at the beginning of the USPAP so that the reader has a clear understanding of the multitude of terms used in the document. While they are helpful terminology, they would not provide the information regarding the appraisers scope of work.]

   c. Rules. [This answer is correct. The USPAP contains four overarching Rules covering ethics, competency, scopes of work, and jurisdictional exception. The appraiser could locate the information that he was searching for in this section of the USPAP.]

   d. Statements on Appraisal Standards. [This answer is incorrect. The Statements are issued for the purpose of clarification, interpretation, explanation, or elaboration of the USPAP. They have the full weight of a Standards Rule. There are currently 10 Statements, with only Statement 9 being applicable to business valuations.]

6. Which of the following AICPA standards are applicable to *all* valuation engagements? **(Page 19)**

   a. Quality Control Standards. [This answer is incorrect. Quality Control Standards *may* apply to valuation engagements, depending on the type of information contained in the valuation report, but do not apply to all valuation engagements.]

   b. Standards on Financial Forecasts and Projections. [This answer is incorrect. Standards on Financial Forecasts and Projections *may* apply to valuation engagements, depending on the type of information contained in the valuation report, but do not apply to all valuation engagements.]

   c. Standards for Consulting Services. [This answer is correct. Standards for Consulting Services apply to all valuation engagements. Standards of Professional Conduct also apply to all valuation engagements.]

Impact of Federal Legislation on Business Valuers

FIRREA. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) requires that each state establish a licensing or certification for real estate appraisers. At first glance, this Act would not appear to be relevant to business valuers; however, the laws enacted by several states are so broad that a valuation of a business that owns real estate would require the involvement of a state-licensed real estate appraiser. Accordingly, business valuers should review the laws of their states dealing with licensing or certifying real estate appraisers to ensure that their work as business appraisers is not also covered by the licensing requirements. The ASA has taken an active role by urging states that have adopted licensing rules that appear to have gone beyond the original intent of FIRREA to amend those rules to exclude business valuations.

Unless required by an overly restrictive state law, the need to employ an appropriately licensed real estate appraiser will depend on the nature of the entity and the interest to be valued. The ASA has prepared a release titled *Business Appraiser or Real Property Appraiser—Determining Which to Use*, to help valuation consultants identify situations when a real estate appraiser should be involved in a valuation engagement.

Gramm-Leach-Bliley Act. The Financial Services Modernization Act of 1999, commonly referred to as the Gramm-Leach-Bliley Act (the GLB Act), was enacted to to, among other items, protect the privacy and security of nonpublic personal financial information that consumers provide to financial institutions. In the same manner that the IRS issues regulations interpreting the tax law, the Federal Trade Commission (FTC) is responsible for promulgating the rules on the privacy of consumer financial information under the GLB Act. The FTC's regulations significantly expand the definition of financial institutions and include within this definition businesses such as tax preparers and financial planners not traditionally thought of as financial institutions.

The Financial Services Regulatory Relief Act of 2006 includes an exemption for CPAs from the privacy disclosure provisions of the GLB Act, since the AICPA Code of Professional Conduct already protects the confidentiality of client information. As a result of this exemption, CPAs are no longer required to send out annual privacy disclosure statements to each of their clients detailing the financial information they retain and what disclosures of that information they are allowed to make. The legislation, however, does not exempt CPAs from the requirements that they secure client information and have written procedures to protect client financial information. The following discussion focuses on the impact of the GLB Act to non-CPA business valuation professionals.

Real estate and personal property appraisal firms are considered "nontraditional financial institutions" based on an earlier and unrelated regulatory determination by the Federal Reserve Board that stated "performing appraisals of real estate and tangible and intangible personal property, including securities . . . are usual activities related to extending credit." Although the FTC has not been asked, nor has it ruled, whether business valuation services are considered in this definition, it would appear that they may, in fact, be included. In addition, valuation firms may obtain nonpublic financial information about consumers when performing valuation services for a traditional financial institution. For example, a bank may engage a valuation consultant to value a business in connection with granting or extending a loan.

Another important term is *nonpublic personal information* which is defined as "any personally identifiable financial information that a financial institution collects about an individual in connection with providing a financial product or service, unless that information is otherwise publicly available." Thus, a valuation consultant that deals only with business clients presumably would not be affected by the new disclosure rules unless some of those business clients were sole proprietors or single-member LLCs owned by an individual. Valuation services provided to individual clients in connection with business valuation engagements appear to be subject to the disclosure rules unless they are specifically exempted, as discussed in the following paragraph.

<u>Exceptions and Exemptions.</u> The FTC's rules provide various exemptions from its rules related to the GLB Act, including the following:

- Appraisal services provided for business purposes. Thus, if the services are *not* performed for a client's personal, family, or household purposes, then they are not covered by the FTC rules. However, business valuations services performed for personal estate planning or divorce purposes may be subject to the rules unless they are exempted by other factors.

- Appraisal services where a "customer relationship" does not exist between the appraiser and a consumer. A customer relationship is defined as "a continuing relationship between a consumer and a financial institution", and according to the rule, "a consumer does not . . . have a continuing relationship with you if . . . (D) The consumer obtains one-time personal or real property appraisal services from you ...." Thus, any one-time valuation engagement would appear to be exempt from the Act. In addition, the "Supplementary Information" section of the FTC rule states that, "Real estate appraisers who perform services for a financial institution, but do not provide financial products or services to individuals, will not be required to make the disclosures mandated by the rule because they do not have 'consumers' or 'customers' as defined in the rule."

- The disclosure of nonpublic personal information to a nonaffiliated third party when that disclosure is necessary to effect or administer a transaction requested by the consumer. For example, an appraisal firm performing services for a nonaffiliated financial institution may, without incurring any privacy responsibilities, receive nonpublic personal information from that institution when disclosure is necessary to effect or administer a transaction that a consumer requests. However, the FTC's rule makes it clear that the appraisal firm would still be required to observe the rule's limitations on reuse and redisclosure of that information.

Requirements. Those entities that are considered "traditional or nontraditional financial institutions" under the FTC's rules have three basic disclosure duties to their customers (as well as, of course, a duty to adhere to the substantive limitations on disclosure):

- To provide both an initial notice about their privacy policies and a subsequent annual privacy notice at least once in each 12-consecutive-month period;

- To describe the conditions under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties; and,

- To provide a method for their customers to "opt-out" of such otherwise permissible disclosures, or provide a statement that their firm does not disclose nonpublic personal information about clients or former clients except as authorized by law.

In addition, those entities covered by the GLB Act must also develop and implement written policies and procedures for safeguarding customer records and information.

If the engagement to be performed by a valuation consultant is covered by the GLB Act, sending a privacy notice to the new client along with the initial engagement letter is recommended. The FTC rule requires that these initial and annual notices to clients be clear and conspicuous and accurately reflect the firm's privacy policy and practices. In addition, the notices normally must be in writing and they must be mailed to a client's last known address (unless hand-delivered). The AICPA issued a practice guide that provides a sample disclosure notice, which is available at **http://ftp.aicpa.org/public/download/news/ftc.doc**.

The GLB Act specifically permits states to enact privacy protections for nonpublic financial information that may give individuals greater protections than are currently available under the federal law. Thus, valuation consultants should be alert for any state laws that may be enacted related to privacy issues.

Treasury Department Circular No. 230. Treasury Department Circular No. 230 (Circular 230) governs the right of CPAs, attorneys, and other tax professionals to practice before the IRS. As a response to the explosive growth of what it considers questionable tax avoidance schemes, the IRS has amended Circular 230. The amendments establish standards of practice for written advice that *tax practitioners* give to their clients, preventing the clients from using the advice they receive to avoid tax penalties from IRS disputes. While appraisers are not presently included in Circular 230's definition of *tax practitioner*, advice involving appraisals and material valuation issues are covered by its provisions.

Many practitioners rely on the provision in Circular 230 that gives the practitioner the option, in lieu of issuing a reliance opinion, to include a disclaimer in the written advice that clearly states that the written advice is not intended by the practitioner to be relied on by the taxpayer to avoid penalties resulting from taxpayer's federal tax positions. The following is an illustrative example of such language:

> IRS Circular 230 Disclosure: To ensure compliance with the requirements imposed by the IRS, we advise you that if this communication or any related attachment contain U.S. federal tax advice, it is not

> intended or written to be used, and cannot be used, for the purpose of (a) avoiding federal tax penalties under the Internal Revenue Code or (b) promoting, marketing or recommending to another party any transaction or matter addressed herein.

The IRS is now singling out appraisals for special scrutiny and has begun a Compliance Initiative Project that seeks a better understanding of patterns of appraisal usage in the tax system, including the use of valuation discounts. Appraisers whose valuations improperly support an understatement of tax liability may incur Internal Revenue Code (IRC) Section 6701 fines for knowingly aiding and assisting such understatement. In addition, if an IRC Section 6701 violation is found, referrals will be made to the IRS's Office of Professional Responsibility for the purpose of initiating proceedings to disqualify the appraiser from practicing before the IRS.

Pension Protection Act of 2006 (PPA). The PPA introduced extensive changes for tax-related appraisal practices as part of a general and ongoing attempt by Congress and the IRS to tighten the qualification requirements for those who provide tax-related valuations and increase a valuator's accountability for their valuation conclusions. Specifically, the PPA's appraisal provisions contain the following:

a. A revised definition of the term *qualified appraiser*, enhancing the valuation qualifications individuals must possess to be eligible to perform tax-related appraisals.

b. A requirement that the appraisal is considered a *qualified appraisal* according to U.S. Treasury regulations.

c. Smaller thresholds for triggering "substantial" and "gross" valuation misstatements to improve valuation accuracy. Specifically, the PPA reduced the triggering threshold for substantial valuation misstatements to differences of at least 150% (previously 200%) of the amount determined to be the correct value. For gross valuation misstatements, the triggering threshold was reduced to differences of at least 200% (previously 400%) of the amount determined to be the correct value.

d. Increased monetary penalties on valuators that provide substantial or gross misstatements through a new civil penalty (in addition to the IRC Section 6701(a) and Circular 230 penalties) on any person who prepares a valuation in connection with a return or refund claim that results in a substantial or gross valuation misstatement. Other late 2007 Tax Acts clarified this provision to state that a substantial estate or gift tax valuation understatement is also grounds for the new civil penalty.

e. The possibility of disbarment or suspension of appraisers from practice before IRS for violating Circular 230 standards of appraisal practice and due diligence or for a pattern of valuation misstatements.

The valuation analyst acknowledges some of these PPA appraisal provisions by completion of the Declaration of Appraiser, which is part of Form 8283 and required for noncash charitable contributions over a minimal amount. The Declaration contains the following representations:

> "I understand that a substantial or gross valuation misstatement resulting from the appraisal of the value of the property that I know, or reasonably should know, would be used in connection with a return or claim for refund, may subject me to the penalty under section 6695A. I affirm that I have not been barred from presenting evidence or testimony by the Office of Professional Responsibility."

Transitional Guidelines. In November 2006, the Treasury Department and IRS issued transitional guidance (Notice 2006-96) relating to PPA's appraisal provisions. According to the transitional guidance, a qualified appraiser (a) has earned an appraisal designation from a recognized appraisal organization, (b) regularly performs appraisals for compensation, and (c) meets such other requirements as may be prescribed in regulations or other guidance. The transitional guidance also states that an individual will *not* be treated as a qualified appraiser unless that individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal and has not been prohibited from practicing before the IRS for violations of Circular 230 requirements during the 3-year period ending on the date of the appraisal.

Also, according to the transitional guidance, a *qualified appraisal* is conducted by a qualified appraiser in accordance with generally accepted appraisal standards, such as the Uniform Standards of Professional Appraisal Practice (USPAP). While much attention has focused on the use of USPAP as an example of generally accepted appraisal standards, it is clear from the guidelines that other standards which are consistent with the substance of USPAP will be acceptable as well.

Until recently, there was some speculation that PPA appraisal provisions applied only to valuations performed in connection with non-cash charitable contributions. However, in November 2007, the Office of Chief Counsel of the Internal Revenue Service published a memorandum (AM 2007-0017) stating that the valuation misstatement and penalty provisions of new Code section 6695A apply to any appraiser for valuations prepared after May 25, 2007 that are used in connection with an estate or gift tax return or claimed refund or credit. Thus, the PPA's appraisal provisions apply to all tax-related valuations and those who prepare them.

Proposed Regulations. As of January 2010, the IRS has not issued final regulations implementing the PPA's appraisal provisions, so Notice 2006-96 and AM 2007-0017 continue to apply. In August 2008, the IRS and Treasury published proposed regulations implementing a number of the PPA's appraisal provisions (see REG-140029-07). As drafted, proposed Reg. 1.170A-17(a)(2) states that "generally accepted appraisal standards means the substance and principles of the Uniform Standards of Professional Appraisal Practice, as developed by the Appraisal Standards Board of the Appraisal Foundation."

The IRS has held public hearings on various aspects of the proposed regulations, including one in January 2009, which covered the IRS's proposed rules concerning (a) who is qualified to perform appraisals in connection with valuing noncash charitable contributions and (b) how such appraisals should be performed. This hearing should help the IRS and Treasury define the terms *qualified appraisal* and *qualified appraiser* as they are used in IRC Section 6695A.

Potential Practice Issues under the Proposed Regulations. There has been criticism of the proposed regulations and the related IRC Section 6695A penalties. Some have indicated that the percentage approach used in the regulations to determine valuation misstatements demands false precision for certain categories of valuations. Critics point out that different asset classes are subject to different valuation variances. For example, the valuation of financial derivatives could be subject to greater valuation variances than the valuation of commercial real estate.

Another criticism is the timeframe within which such penalties can be assessed. For example, in 2006, the Fifth Circuit Court of Appeals overturned the Tax Court's 2003 opinion. The gifts that were the subject of this decision were made in 1996. In the lower court case, the court rejected the valuation expert's use of restricted stock studies as the basis for the discount for lack of marketability. If a similar fact pattern occurred, according to the proposed regulations, would the taxpayer's appraiser be subject to the appraiser penalties under IRC Section 6695A years before final resolution of the valuation conclusion? If, after final resolution in favor of the taxpayer (and the appraiser), would the appraiser receive a refund (with interest) of previously paid penalties?

Although critics use *McCord* as an example of the difficulties in practically applying the assessment of penalties under IRC Section 6695A and the proposed regulations, the IRS is likely to propose additional regulations to implement other provisions of the PPA. It is expected that future regulations will address the imposition of monetary penalties (and other sanctions) against appraisers, standard of care issues, and other due process issues.

Small Business and Work Opportunity Tax Act of 2007. The Small Business and Work Opportunity Act of 2007 (2007 Act) makes the penalties for valuation misstatements applicable to a broader range of tax returns and claims for refund. Previously, such penalties were restricted to income tax return preparers. However, the definition now includes preparers of other types of tax returns, including estate, gift, employment, and excise tax. The 2007 Act also increased the IRC Section 6694 penalties for tax preparer understatements due to unreasonable positions and due to willful or reckless conduct.

In December 2008, the IRS and Treasury Department issued final regulations implementing amendments to the tax return preparer penalties under IRC Sections 6694 and 6695. These final regulations in Rev. Proc. 2009-11 are applicable to returns and claims for refunds filed after December 31, 2008. The final regulations change the standards of conduct that tax return preparers must meet to avoid the imposition of penalties in the event that a prepared tax return results in an understatement of tax. The final regulations also expand the scope of penalty provisions of IRC Section 6695 beyond income tax returns.

Perhaps the most important issue is that, for the first time, the IRS and Treasury Department have explicitly addressed the issue of whether valuation professionals are within the definition of practitioners considered to be defined as tax return preparers and subject to penalties under IRC Section 6694. The following is a reprint of the section of the final regulations in Treasury Decision (TD) 9436 that specifically deals with appraisers.

> Under Treasury Regulations in place since 1977 and the proposed regulations, an appraiser might be subject to penalties under section 6694 as a nonsigning tax return preparer if the appraisal is a substantial portion of the return or claim for refund and the applicable standards of care under section 6694 are not met. Several commentators have stated that appraisers should not be subject to penalties under section 6694 because they are subject to new, higher standards of conduct under section 6695A as set out in the Pension Protection Act of 2006, Public Law No. 109-280. The commentators have also urged that the assessment of penalties under section 6694 against appraisers would result in the imposition of a gratuitous and unnecessary layer of requirements and sanctions without any additional public policy benefit.
>
> After consideration of the comment, the Treasury Department and the IRS continue to include appraisers in the definition of both signing and non-signing preparers, thereby providing the IRS with discretion to impose the section 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under sections 6694 and 6695A with respect to the same conduct. A separate regulation will provide guidance under section 6695A.

With the clarification that valuation analysts are specifically included in the definition of both signing and non-signing preparers and subject to the penalties under IRC Sections 6694 and 6695, practitioners should know these regulations in detail.

While these new standards of care have been applied in other contexts, they have never been addressed in the context of valuations or valuation practitioners. For example, one standard of care is "reasonable basis" for disclosed positions. The term might mean one thing for a preparer who is interpreting tax law but quite another thing for an appraiser who is determining value. The IRS will need to address how these tests should be applied to valuation practice.

Tax Extenders and Alternative Minimum Tax Relief Act of 2008. As discussed beginning at paragraph 1001.49, The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 (2008 Act) further amended IRC Sec. 6694 (and IRC Sec. 7701) with respect to the definition of a tax preparer and the standards of conduct that tax return preparers must meet in order to avoid imposition of penalties. The Treasury and IRS issued final regulations reflecting these amendments.

Treasury Reg. 301.7701-15 clarifies who, as a return preparer, is subject to preparer penalties and provides definitions of tax return preparer, signing preparer, and nonsigning preparer. When the IRS issued the final regulations, it stated that it would "continue to include appraisers in the definition of both signing and non-signing preparers, thereby providing the IRS with discretion to impose the section 6694 and 6695A penalties in the alternative against an appraiser depending on the facts and circumstances of the appraiser's conduct. The IRS, however, will not stack the penalties under sections 6694 and 6695A with respect to the same conduct."

Treasury Reg. 1.6694-2 reflects the changes to IRC Sec 6694 made by the 2008 Act with respect to the definition of unreasonable position for determining tax preparer penalties. In general a position is unreasonable unless there is substantial authority for the position. For a disclosed position (that is not a reportable transaction or tax shelter as defined in IRC Sec. 6662), the position is unreasonable unless there is a reasonable basis for the position. For an undisclosed position that is a tax shelter or reportable transaction, a position is unreasonable unless it is reasonable to believe that the position will more likely than not be sustained on its merits.

Interim Guidance for Assessing Civil Penalties Under IRC Sec. 6695A. In August 2009 the Small Business Self Employed division of IRS issued SBSE Memorandum 04-0809-015, Penalty for Valuation Misstatements Attributable to Incorrect Appraisals, which provides interim guidance to all IRS examiners, Revenue Agents, and Tax Compliance Officers for assessing IRC Sec 6695A civil penalties for valuation misstatements. The memo deals with examination procedures including who can assert the penalty, the procedure used to assert such penalty, and the role in this process of Field Specialists with valuation training.

There have been strong objections to the penalty assessment procedures described in the Memorandum because of a belief that the procedures lack adequate due process safeguards for appraisers and because they fail to define "safe harbor" terms without which a valuation misstatement finding cannot be made. The valuation practitioner who performs tax-related assignments should monitor this situation closely before completing their work.

Standards of Practice. To more effectively and consistently enforce the valuation related provisions of Circular 230 and recent laws, the IRS and its Office of Professional Responsibility are currently developing the Standards of Practice for Appraisers. The term *standards of practice* refers to the demonstration of professional competence, the exercise of due diligence, and the adherence to ethical behavior. These Standards will be a benchmark against which the performance of appraisers in tax-related valuations will be measured. While still in the drafting stage, the Standards are expected to make reference to "adherence to USPAP," meet the applicable laws, regulations and/or procedures for the type of property appraised, and prohibit the assessment of a valuation related 6701(a) or 6695A ("substantial" and "gross" valuation misstatements) penalty if the Standards are followed. It is expected that the Standards of Practice will be finalized in 2010.

Sarbanes-Oxley Act of 2002. The Public Company Accounting Reform and Investor Protection Act of 2002, commonly referred to as Sarbanes-Oxley, contains a number of key provisions that require the Securities and Exchange Commission (SEC) to strengthen independence requirements for auditors of public companies. Specifically, Title II of Sarbanes-Oxley requires the SEC to adopt new rules that:

a. Prohibit certain nonaudit services.

b. Strengthen conflict of interest standards.

c. Strengthen audit partner rotation and second partner review requirements.

d. Enhance and clarify the relationship between the independent auditor and the audit committee.

Section 201(a) of Sarbanes-Oxley added Section 10A (g) to the Securities Exchange Act of 1934 to prohibit all registered public accounting firms from providing an audit client certain nonaudit services while named as the accountant of record. One of the nine prohibited nonaudit services specifically emphasized is appraisal or valuation services, including fairness opinions and contribution-in-kind reports. However, Sarbanes-Oxley does not prohibit an accounting firm from utilizing its own valuation specialist to review work done by the audit client or an independent, third-party specialist engaged by the audit client.

A number of states have adopted, or are considering adopting, certain rules similar to those of the Sarbanes-Oxley Act that are applicable for small and midsized nonregistered accounting firms. However, much of the state legislative activity to date has focused on areas such as the limitation or disclosure of non-audit services for an audit client and retention of audit workpapers. For example, the National Association of State Boards of Accountancy (NASBA) amended the Uniform Accountancy Act—UAA Model Rules to include a seven-year record retention requirement. The UAA rules are intended to provide guidance to state boards of accountancy in the form of a single uniform standard. Practitioners should be alert for changes in legislation in the states in which they operate.

Public Company Accounting Oversight Board (PCAOB). The Public Company Accounting Oversight Board (PCAOB) is under the supervision of the SEC to set auditing, quality control, ethics, independence, and other standards relating to the audits of public companies. The PCAOB has the authority to set standards governing the audits of public companies only; the AICPA continues to have the authority to set standards governing the audits of nonpublic companies and has actively developed and issued standards since the establishment of the PCAOB.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Federal legislation impacts business valuers in a variety of ways. Which of the following federal legislation protects the privacy and security of nonpublic personal financial information provided by consumers to financial institutions?

   a. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

   b. The Financial Services Modernization Act of 1999.

   c. Treasury Department Circular No. 230.

8. Various exemptions related to the Gramm-Leach-Bliley (GLB) Act are provided by the Federal Trade Commission's (FTC's) rules including which of the following?

   a. Appraisal services provided for household purposes.

   b. Appraisal services where a "customer relationship" exists between the appraiser and a consumer.

   c. The disclosure of nonpublic personal information to a nonaffiliated third party when that disclosure is necessary to effect or administer a transaction requested by the consumer.

9. A personal property appraisal is required to follow which disclosure requirements for a nontraditional financial institution under the Gramm-Leach-Bliley Act?

   a. To describe the conditions under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties.

   b. To provide a method for their customers to "opt-out" of such otherwise permissible disclosures *and* provide a statement that their firm does not disclose nonpublic personal information about clients or former clients except as authorized by law.

   c. To provide an initial notice about their privacy policies and a subsequent privacy notice at least once in each 24-consecutive-month period.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

7. Federal legislation impacts business valuers in a variety of ways. Which of the following federal legislation protects the privacy and security of nonpublic personal financial information provided by consumers to financial institutions? **(Page 23)**

   a. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). [This answer is incorrect. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) requires that each state establish a licensing or certification for real estate appraisers. Business valuers should review the laws of their states dealing with licensing or certifying real estate appraisers to ensure that their work as business appraisers is not also covered by the licensing requirements.]

   b. The Financial Services Modernization Act of 1999. [This answer is correct. The Financial Services Modernization Act of 1999, commonly referred to as the Gramm-Leach-Bliley Act (the GLB Act), was enacted to, among other items, protect the privacy and security of nonpublic personal financial information that consumers provide to financial institutions. In the same manner that the IRS issues regulations interpreting the tax law, the Federal Trade Commission (FTC) is responsible for promulgating the rules on the privacy of consumer financial information under the GLB Act.]

   c. Treasury Department Circular No. 230. [This answer is incorrect. Treasury Department Circular No. 230 (Circular 230) governs the right of CPAs, attorneys, and other tax professionals to practice before the IRS. Effective June 21, 2005, the amendments establish standards of practice for written advice that tax practitioners give to their clients, preventing the clients from using the advice they receive to avoid tax penalties from IRS disputes. While appraisers are not presently included in Circular 230's definition of tax practitioner, advice involving appraisals and material valuation issues are covered by its provisions.]

8. Various exemptions related to the Gramm-Leach-Bliley (GLB) Act are provided by the Federal Trade Commission's (FTC's) rules including which of the following? **(Page 23)**

   a. Appraisal services provided for household purposes. [This answer is incorrect. Appraisal services are provided for *business* purposes. Thus, if the services are not performed for a client's personal, family, or household purposes, then they are *not* covered by the FTC rules. However, business valuations services performed for personal estate planning or divorce purposes may be subject to the rules unless they are exempted by other factors.]

   b. Appraisal services where a "customer relationship" exists between the appraiser and a consumer. [This answer is incorrect. Appraisal services where a "customer relationship" does *not* exist between the appraiser and a consumer is an exemption of the GLB Act. If there is no relationship, then according to the FTC, "Real estate appraisers . . . who do not provide financial products or services to individuals, will not be required to make the disclosures. . . ."]

   c. The disclosure of nonpublic personal information to a nonaffiliated third party when that disclosure is necessary to effect or administer a transaction requested by the consumer. [This answer is correct. The FTC's rule makes it clear that the appraisal firm would still be required to observe the rule's limitations on reuse and redisclosure of that information.]

9. A personal property appraisal is required to follow which disclosure requirements for a nontraditional financial institution under the Gramm-Leach-Bliley Act? **(Page 24)**

   a. **To describe the conditions under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties. [This answer is correct. Entities that are considered "traditional or nontraditional financial institutions" under the FTC's rules have three basic disclosure duties to their customers. One such duty is to describe the conditions under which they may disclose nonpublic personal information about consumers to nonaffiliated third parties.]**

   b. To provide a method for their customers to "opt-out" of such otherwise permissible disclosures *and* provide a statement that their firm does not disclose nonpublic personal information about clients or former clients except as authorized by law. [This answer is incorrect. One of the three basic disclosure duties is to provide a method for their customers to "opt-out" of such otherwise permissible disclosures, *or* provide a statement that their firm does not disclose nonpublic personal information about clients or former clients except as authorized by law. Both actions are not required, just one or the other.]

   c. To provide an initial notice about their privacy policies and a subsequent privacy notice at least once in each 24-consecutive-month period. [This answer is incorrect. Another of the basic disclosure duties is to provide both and initial notice about the entity's privacy policies and a subsequent annual privacy notice at least once in each *12*-consecutive-month period, not 24 months.]

EDUCATION AND EXPERIENCE

Although many consultants already possess many of the skills needed to practice business valuation, additional training, experience, and support resources may be needed before the consultant can practice successfully on a wide array of valuation engagements. Before expanding into business valuation, the consultant should consider the following factors:

a. The consultant's existing capabilities.

b. Additional training that is needed.

c. How relevant experience will be gained.

d. What additional resources are needed.

e. How the new service will be marketed.

Evaluate Capabilities

A consulting firm may expand its practice to include business valuation services in one of three primary ways:

a. Develop the expertise in-house;

b. Hire an experienced appraiser from the outside; or

c. Form a strategic alliance with an existing valuation firm.

Developing the Expertise without Prior Experience. Even though this approach obviously requires a long lead time, a medium-size or large firm may develop a successful valuation practice in-house by designating someone in-house to become proficient and experienced in the subject. Ideally, the person chosen should be an experienced practitioner with sound business judgment and a strong knowledge of the tax and financial accounting issues faced by small businesses.

The probability of success of an internally developed valuation practice is greatly enhanced when the individual chosen to head up the practice is committed to its success and when the venture has the full support of the firm. The firm will usually invest significant sums in training costs and unassigned time during the development phase of a new practice, and it will often be several months before any revenues are generated. The partners should not expect a new practice to be profitable immediately.

After mastering the basic concepts of business valuation the leader of the new practice should:

a. Recruit valuation staff either from within the firm or from the outside.

b. Develop firm policies and procedures regarding valuation engagements as well as a comprehensive system of quality control.

c. Obtain library, computer, and other resources, and train the staff in their uses.

d. Develop and institute a marketing plan.

PPC's Guide to Small Business Consulting Engagements contains several chapters devoted to the development and administration of a new consulting practice. Consultants who wish to start a valuation practice will find this book to be an invaluable resource.

Hiring an Experienced Valuation Consultant from the Outside. Many firms feel that the easiest, most economical way to offer a new service is to hire experienced people from the outside. If the new consultant is able to bring new valuation clients to the firm, the service can have a more immediate impact on fee income. There are many variations of this approach, but two of the most popular are as follows:

a. The firm can hire an experienced appraiser at the partner or manager level and let that person develop the valuation department. This person may be able to quickly develop policies and procedures manuals and other materials that will allow the department to become productive within a short period of time.

b. The firm can purchase an existing business valuation company. This turnkey approach can be very efficient for accounting and other firms that want to begin offering this service immediately.

Forming a Strategic Alliance with an Existing Valuation Consultant. This approach is popular for small firms or for consultants that want to be able to offer valuation services without having to develop and maintain all of the required expertise in-house. Under this approach, a valuation consultant with a good reputation is identified. After performing extensive due diligence procedures on the experience and capabilities of the valuation consultant, an alliance is structured. There are many ways to structure such an alliance, but some of the more common include the following:

a. *Complete Referral.* The engaging consultant merely refers the valuation work to the valuation consultant and has no further involvement in the project. Since accountants and other professionals are often not able to receive commissions for business referrals, however, this method provides no direct monetary benefits to the CPA.

b. *Have the Valuation Consultant Issue the Report.* The project is staffed by the engaging consultant, but all work is reviewed and the report is actually issued by the valuation consultant. This method allows the engaging consultant to gain valuation experience while working under the direction of an experienced valuator.

c. *The Firm Issues the Report Using the Consultant's Staff.* Under this method, the valuation consultant's staff performs the valuation, and their work is reviewed by the engaging consultant, who issues the completed report. In effect, the accounting firm uses the valuation firm as a subcontractor. This method also allows the CPA to remain involved with the project while gaining additional valuation experience. This method is generally advisable only if the firm has an experienced staff or management member who can supervise and direct the outside consultant's staff. The legal liability issues of relying on another party's work should also be considered, along with the consequences of being asked to deliver expert witness testimony.

d. *As-needed Assistance.* The engaging consultant may only use the valuation consultant to review complex engagements or to provide guidance or insight whenever specialized industries are involved.

The AICPA has ethics rules for CPAs who outsource professional services to third parties. The rules apply to consulting services, such as business valuation engagements, and include related clerical and data-entry functions. Under the rules, the CPA must do the following before disclosing confidential client information to the third party:

- Inform the client, preferably in writing, that the CPA consultant may use a third-party service provider to assist in providing the service to the client. If the client objects to the use of a third party, the CPA consultant must either provide the service without using the third party or decline the engagement.

- Enter into a contractual agreement with the third-party service provider requiring the party to maintain the confidentiality of the information and to have procedures in place to prevent unauthorized release of confidential information. If such an agreement is not obtained, the CPA must obtain the client's consent to disclose the client's confidential information to the third party.

The ethics rules also require the CPA consultant to do the following:

- Adequately plan and supervise the services provided by the third party.
- Obtain sufficient relevant data to support the work product.
- Comply with all technical standards applicable to the services.

Training Requirements

Consultants who perform valuation services must be properly trained in this specialized field, even if the service is only offered part-time during a firm's slow seasons. Since many business valuators come from different professional backgrounds, a number of organizations offer business valuation courses and, as indicated in Exhibit 1-2, award professional business valuation designations, some specifically developed for CPAs, attorneys, examiners, and other professionals. The following paragraphs discuss the major certifying organizations.

Exhibit 1-2

Business Valuation Designations

Abbreviation	Name of Designation	Awarding Organization
ABV	Accredited in Business Valuation	American Institute of Certified Public Accountants (AICPA)
AIBA	Accredited by IBA	Institute of Business Appraisers (IBA)
AMPI	Accredited Member	American Society of Appraisers (ASA)
ASA	Accredited Senior Appraiser	American Society of Appraisers (ASA)
AVA	Accredited Valuation Analyst	National Association of Certified Valuation Analysts (NACVA)
BVAL	Business Valuator Accredited for Litigation	Institute of Business Appraisers (IBA)
CBA	Certified Business Appraiser	Institute of Business Appraisers (IBA)
CFA	Chartered Financial Analyst	Association for Investment Management and Research
CFE	Certified Fraud Examiner	Association of Certified Fraud Examiners
CPA	Certified Public Accountant	American Institute of Certified Public Accountants
CVA	Certified Valuation Analyst	National Association of Certified Valuation Analysts (NACVA)
CBI	Certified Business Intermediary	International Business Brokers Association
CFM	Certified in Financial Management	Institute of Management Accountants
CFP	Certified Financial Planner	College of Financial Planning
CMA	Certified Management Accountant	Institute of Management Accountants
EA	Enrolled Agent or Enrolled to Practice Before the IRS	Internal Revenue Service
FASA	Fellow of the American Society of Appraisers	American Society of Appraisers (ASA)
FIBA	Fellow of the Institute of Business Appraisers	Institute of Business Appraisers (IBA)
FCBI	Fellow Certified Business Intermediary	International Business Brokers Association
JD	Juris Doctor	Law schools around the country
MBA	Master of Business Administration	Various universities
MCBA	Master Certified Business Appraiser	Institute of Business Appraisers (IBA)
PhD	Doctor Philosophy	Various universities

[SOURCE: Excerpt from "Explaining the Alphabet Soup: Business Appraisal Designation—What They Mean and How Difficult They Are to Obtain" by Paul R. Hyde. *Business Appraisal Practice*, Spring 2002. Reprinted with permission from The Institute of Business Appraisers, Inc.]

* * *

American Society of Appraisers. The ASA offers a series of four three-day core courses in business valuation, each followed by an exam. The ASA also offers advanced courses such as options valuation, cost of capital, and valuation principles for transfer pricing. A description of each of these courses is included on the ASA's website at **www.appraisers.org**. The ASA also publishes the quarterly professional journal *Business Valuation Review* and provides a variety of other services to its members. Members who are engaged in the valuation profession can earn the following professional designations:

a. An Accredited Member (AM) has at least two years of full-time or full-time equivalent valuation experience and a college degree (or equivalent experience). Full-time equivalent experience is based on the time spent on business valuation engagements. For example, if the consultant works on business valuation engagements 20% of the time, it will take five years to reach one year of full-time equivalent experience. In addition, the candidate must pass comprehensive written exams and submit acceptable appraisal reports.

b. An Accredited Senior Appraiser (ASA) has at least five years of full-time or full-time equivalent valuation experience (one of which may be fulfilled by five years of CPA experience) and has fulfilled the educational/examination/ appraisal report requirements.

c. The designation of Fellow (FASA) may be bestowed on an Accredited Senior Appraiser in recognition of outstanding service to the appraisal profession or the American Society of Appraisers.

Reaccreditation rules for ASA designations require the designees to complete 100 hours of continued professional education and/or organizational participation in professional activities every five years. (If less than 100 hours is obtained, reaccreditation for periods of two–four years may be obtained, depending on the number of CPE/participation hours completed during the current accreditation period.) Of the 100 hours, continuing education must comprise at least 40 hours. Continuing education may also include speeches, instruction, or other participation in an appraisal profession educational program, as well as published articles and other appraisal profession literary contributions.

The ASA and the AICPA have an education equivalency program that allows AICPA members with an Accredited in Business Valuation (ABV) credential to receive credit for the ASA's four three-day core courses in business valuation. Thus, for an ABV to receive the American Society of Appraisers' AM or ASA designation, the ABV must satisfy the ASA's experience and membership requirements, successfully pass two appraisal reports through the peer review process, and pass an ASA ethics exam and the USPAP exam.

Information about the ASA and its courses can be obtained at the following phone number and website:

American Society of Appraisers
(800) 272-8258
www.appraisers.org

Institute of Business Appraisers. The Institute of Business Appraisers (IBA) also conducts seminars on business valuation. The IBA's phone number and website are as follows:

Institute of Business Appraisers
(800) 299-4130
www.go-iba.org

The IBA awards the following professional designations:

a. An Accreditation as Accredited-IBA (AIBA) is for members who have a 4-year college degree or equivalent, complete an 8-day workshop training program in *Valuing Closely Held Businesses*, pass a written examination, pass a character screening, and submit an acceptable demonstration appraisal report.

b. A Certified Business Appraiser (CBA) is for members who have a 4-year college degree or equivalent, successfully completed 90 classroom hours of upper-level course work or demonstrate 5 years full-time experience, complete an IBA report writing course, pass a written examination, and submit two acceptable demonstration appraisal reports. Applicants that hold another business valuation credential may be exempt from the written exam.

c. A Master Certified Business Appraiser (MCBA) designation is awarded through a review process. Applicants must have a 4-year college degree and 2-year post-graduate degree or equivalent, hold the CBA designation for at least 10 years, have 15 years of business appraisal experience, hold a professional designation from at least one other business valuation organization, and provide acceptable references from at least three other MCBA's.

d. A Business Valuator Accredited for Litigation (BVAL) is for members who have either a business appraisal designation from the IBA, AICPA, ASA, or NACVA and complete a workshop and exam. Also, applicants must provide two letters of recommendation from attorneys who have witnessed the candidates work in deposition and trial, or complete 16 hours of education in areas of law for cases in which the appraiser will provide testimony.

e. An Accredited in Business Appraisal Review (ABAR) is for members who have a 4-year college degree or equivalent, successfully completed 90 classroom hours of appraisal education or demonstrate 5 years full-time experience, complete an IBA valuation report critiquing course, pass an examination on appraisal concepts and report review techniques, submit two appraisal reviews for peer review, and have a business appraisal designation from the IBA, AICPA, ASA, or NACVA.

To retain accreditation for IBA designations, designees must obtain 24 hours of continued professional education every two years. Acceptable development includes attending classes or conferences sponsored by any business appraisal organization or by attending IBA's national conference; volunteering for technical IBA activities, including mentoring, reviewing articles for the IBA's bibliographic database, and providing technical assistance to other IBA members; writing business appraisal articles for publication; and lecturing on business appraisal issues.

National Association of Certified Valuation Analysts. The National Association of Certified Valuation Analysts (NACVA) provides education programs in business valuation and litigation support leading to the designation of Certified Valuation Analyst (CVA) or Accredited Valuation Analyst (AVA). To qualify, an individual must be a CPA or have sufficient business valuation experience. Individuals must be a member of NACVA, submit personal and business references, and complete a 5-hour proctored exam and a take-home exam, which includes a standardized case study.

NACVA also provides a financial forensic that leads to the designation of Certified Forensic Financial Analyst (CFFA). The CFFA is for members who have either a NACVA, AICPA, ASA, IBA, CPA, or certain other listed designations; a bachelor's degree in a business field, or a master's degree or doctorate in a field of business. The CFFA designation can be obtained by specializing in one of six different areas of training: financial litigation, forensic accounting, fraud prevention and detection, economic damages, valuing intangible assets and intellectual property, and matrimonial litigation support.

CFFA applicants must show proof of providing services in one of six training areas, but the experience requirements differ among the training areas. For example, the financial litigation experience requirement requires involvement in 8 different litigation matters of which a minimum of 3 resulted in providing deposition or expert witness testimony (but can also be met if the applicant attends a three-day NACVA course on expert witness testimony), but the forensic accounting experience requirement is involvement in 10 engagements or 1000 hours of forensic accounting experience. In addition to the experience requirement, CFFA candidates must complete a four or five-day NACVA training program for the specific area of training selected and, for most training areas, a three-day NACVA litigation training course; complete a two-part, eight-hour proctored exam; and submit one business and two professional references, substantiating the applicant's community involvement and quality of work. There are some experience waivers for these CFFA requirements.

NACVA designations discussed in the previous paragraphs must be recertified every three years. Recertification requires the NACVA designees to obtain 36 hours of continued professional education (CPE) every three years, of which at least 18 hours must be in the areas of valuation and/or litigation. NACVA adheres to a "100-point system" that requires credentialed members to obtain at least 100 points every three years. In addition to the 50 points received for the 36 hours of CPE, members may obtain additional points through the following:

a. Additional CPE over the 36-hour minimum qualifies at the rate of 1 point per hour—up to a maximum of 25 additional points.

b. Participation in either of two NACVA programs, Knowledge of Current Development and Knowledge of Quality Issues, qualifies as 25 points per program and also provides hours towards the CPE requirement.

c. Professional development through authoring (books, articles, or instructional courses) or teaching/presenting valuation, litigation, or fraud related subjects qualifies for up to 25 points.

d. Experience gained through either performing valuation engagements or tasks/services that are characteristic to the valuation of an entity qualifies for up to 25 points. (A minimum of 1,500 hours in a three-year cycle is required.)

Additional information may be obtained at the following phone number and website:

National Association of Certified Valuation Analysts
(801) 486-0600
www.nacva.com

American Institute of Certified Public Accountants. The AICPA has an accreditation program for CPAs performing business valuation services. The program results in the Institute granting an Accredited in Business Valuation (ABV) designation. To apply for the ABV program, an individual must be a member in good standing with the AICPA and hold a valid, unrevoked CPA certificate or license issued by a legal state authority. To qualify for the designation, a CPA must satisfy a "100-point system" by completing the following requirements:

a. Provide evidence of performing at least six and up to fourteen business valuation engagements or at least 150 and up to 350 business valuation hours that demonstrate substantial experience and competence.

b. Complete at least 45 and up to 105 hours of CPE related to business valuations, which may include up to 45 hours in the form of lecturing or up to 30 hours in the form of writing articles or publications.

c. Pass a two-part written exam which is offered twice a year. [Candidates that hold the Accredited Senior Appraisers (ASA) are exempt from the exam requirements. Candidates that hold any of the following credentials automatically satisfy the second part of the examination requirement: Certified Valuation Analyst (CVA) of NACVA, Certified Business Appraiser (CBA) of the Institute of Business Appraisers, or the Chartered Financial Analyst (CFA) of the Association for the Investment Management and Research.]

To maintain the ABV accreditation, a CPA must complete 60 hours of related CPE during the same three-year period, of which only 24 hours may be in the form of writing articles and 36 hours may be in the form of lecturing. CPAs interested in participating in the program should contact the ABV Member Service Center at (888) 777-7077, or its website at **http://fvs.aicpa.org**.

The AICPA and the American Society of Appraisers agreed to an education equivalency program that allows ABVs to receive credit for the ASA's four, three-day core courses in business valuation. Thus, for an ABV to receive the American Society of Appraisers' AM or ASA designations, the ABV must satisfy the ASA's experience and membership requirements, successfully pass two appraisal reports through the peer review process, and pass an ASA ethics exam and the USPAP exam.

Obtaining Relevant Experience

A valuation consultant needs both training and experience to become proficient. Generally speaking, in business valuation, as in accounting, law, and other professions, the best experience is gained by working under the direction of a competent professional. This can be easily accomplished if a strategic alliance has been formed with a valuation firm or if the consultant has hired an experienced appraiser to head up the valuation practice. It can be difficult, however, if the valuation practice is started in-house without the assistance of any outside professionals.

Although all valuation engagements are complex and require a great deal of judgment, some have more exposure to criticism or liability than others. For example, an engagement to value an ownership interest for ESOP purposes involving complex valuation issues may have more exposure than an engagement to serve as an advisor for the seller of a business. A consultant should generally start with less complex engagements that have lower levels of exposure. A CPA firm that is already offering estate planning services, for instance, may begin performing the required estate tax valuations on small, less complex businesses in-house, then progress to more complex engagements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

10. A consultant should consider a number of factors before expanding into business valuation. Which of the following factors should have little or no impact on that decision?

    a. The educational background of a local valuation consultant.

    b. The consultant's existing capabilities and talents.

    c. Any needed training.

    d. Any needed additional resources.

11. William Mays Consulting is a consulting firm that wants to expand its practice to include business valuation services as soon as possible in order to expand its business base. Which of the following three primary ways will allow them to accomplish this most efficiently?

    a. Develop the expertise using existing staff.

    b. Hire an experienced appraiser from outside the firm.

    c. Form a strategic alliance with another firm offering valuation services.

12. To perform valuation services with a professional business valuation designation as an Accredited Valuation Analyst (AVA), a consultant must be a CPA or have sufficient valuation experience and complete a course provided by which of the following organizations?

    a. Institute of Business Appraisers (IBA).

    b. American Society of Appraisers (ASA).

    c. National Association of Certified Valuation Analysts (NACVA).

    d. International Business Brokers Association (IBBA).

13. If a CPA performing business valuation services wishes to earn an AICPA Accredited in Business Valuation (ABV) designation, he or she must meet several requirements. Which of the following are required for this designation?

    a. Be a CPA or have sufficient business valuation experience.

    b. Complete at least 45 and up to 105 hours of CPE related to business valuations.

    c. Have a 4-year college degree or equivalent, complete an 8-day workshop training program in *Valuing Closely Held Businesses*, pass a written examination, pass a character screening, and submit an acceptable demonstration appraisal report.

    d. Pass a three-part written exam which is offered throughout the year.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

10. A consultant should consider a number of factors before expanding into business valuation. Which of the following factors should have little or no impact on that decision? **(Page 32)**

    a. The educational background of a local valuation consultant. [This answer is correct. Knowledge of the competition is valuable; however, more relevant information about the competition would have a larger impact on the decision (i.e. customer base, years of experience, etc.).]

    b. The consultant's existing capabilities and talents. [This answer is incorrect. It is important for the consultant to consider his or her existing capabilities and talents in order to know what else will be needed to be effective in performing business valuations.]

    c. Any needed training. [This answer is incorrect. The consultant needs to know what additional training he or she will need before expanding into business valuation to ensure he or she has the skills and competence to handle all types of business valuations.]

    d. Any needed additional resources. [This answer is incorrect. Consideration of additional resources needed is imperative when considering expanding into business valuation to maximize successful performance of valuations.]

11. William Mays Consulting is a consulting firm that wants to expand its practice to include business valuation services as soon as possible in order to diversify its services. Which of the following will allow them to accomplish this most efficiently? **(Page 32)**

    a. Develop the expertise using existing staff. [This answer is incorrect. Although designating someone in-house to become proficient and experienced in business valuation may prove highly successful in the long run, this approach requires a long lead time and, therefore, would not be the best approach for William Mays Consulting since they want to add business valuation services to their firm as soon as possible.]

    b. Hire an experienced appraiser from outside the firm. [This answer is correct. Many firms have found that the easiest, most cost effective way to offer a new service such as business valuation is to hire an experienced appraiser from outside the firm. In addition to acquiring immediate expertise, the new consultant may be able to bring new valuation clients to the firm thereby making it possible for valuation services to have an immediate impact on revenue.]

    c. Form a strategic alliance with another firm offering valuation services. [This answer is incorrect. Under this approach, a well-respected valuation consultant is identified. Subsequent to accomplishing extensive due diligence procedures on the valuation consultant's experience and capabilities, an alliance is formed and structured. This method is effective, but may be time-consuming.]

12. To perform valuation services with a professional business valuation designation as an Accredited Valuation Analyst (AVA), a consultant must be a CPA or have sufficient valuation experience and complete a course provided by which of the following organizations? **(Page 34)**

    a. Institute of Business Appraisers (IBA). [This answer is incorrect. The IBA awards the following professional designations: (a) An Accredited-IBA (AIBA), (b) A Certified Business Appraiser (CBA), (c) A Master Certified Business Appraiser (MCBA), and (d) A Business Valuator Accredited for Litigation (BVAL).]

    b. American Society of Appraisers (ASA). [This answer is incorrect. The ASA awards the following professional designations: (a) An Accredited Member (AM), (b) An Accredited Senior Appraiser (ASA), and (c) The designation of Fellow (FASA) on an Accredited Senior Appraiser in recognition of outstanding service to the appraisal profession or the American Society of Appraisers.]

c. National Association of Certified Valuation Analysts (NACVA). [This answer is correct. The NACVA awards the following professional designations: (a) Certified Valuation Analyst (CVA), and (b) Accredited Valuation Analyst (AVA).]

d. International Business Brokers Association (IBBA). [This answer is incorrect. The International Business Brokers Association awards the following professional designations: (a) Certified Business Intermediary (CBI), and (b) Fellow Certified Business Intermediary (FIBA).]

13. If a CPA performing business valuation services wishes to earn an AICPA Accredited in Business Valuation (ABV) designation, he or she must meet several requirements. Which of the following are required for this designation? **(Page 37)**

a. Be a CPA and have sufficient business valuation experience. [This answer is incorrect. These two qualifications are not sufficient to be considered for the designation of ABV. Additional requirements must also be met as dictated by the AICPA.]

b. Complete at least 45 and up to 105 hours of CPE related to business valuations. [This answer is correct. A CPA must complete at least 45 and up to 105 hours of CPE related to business valuations, which may include up to 45 hours in the form of lecturing or up to 30 hours in the form of writing articles or publications. This is one of the requirements the AICPA has designated for a CPA to earn an ABV designation.]

c. Have a 4-year college degree or equivalent, complete an 8-day workshop training program in *Valuing Closely Held Businesses*, pass a written examination, pass a character screening, and submit an acceptable demonstration appraisal report. [This answer is incorrect. These are valid requirements for earning Accredited-IBA (AIBA) from the Institute of Business Appraisers, but not for the designation of ABV.]

d. Pass a three-part written exam which is offered throughout the year. [This answer is incorrect. A three-part written exam is not required. Passing a two-part written exam which is offered twice a year is required by the AICPA for an ABV designation.]

OVERVIEW OF A VALUATION ENGAGEMENT

This lesson introduces the approach to conducting business valuation engagements. The approach is intended to provide a framework for the important engagement activities that are common to all valuation engagements. Exhibit 1-3 presents an overview of a typical business valuation engagement.

Exhibit 1-3

Overview of a Business Valuation Engagement

Recommended Quality Control Steps to Be Applied to a Valuation Engagement:

1. Evaluate whether to accept the engagement.
2. Prepare a detailed work program.
3. Develop a time and fee estimate.
4. When appropriate, obtain approval of the work program, staff assignments, and fee estimate.
5. When necessary, prepare a proposal letter or oral presentation.
6. Obtain an engagement letter.
7. Collect and adjust the data appropriate for the valuation methods used.
8. Perform the valuation methods under the supervision of an experienced individual.
9. Determine the final estimate of value. This usually involves the following procedures:
    a. Weighting of methods (whether quantitative or qualitative).
    b. Applying "sanity checks" to the estimates of value.
    c. Applying premiums and/or discounts.
10. Document all work performed and conclusions reached.
11. Consider obtaining a representation letter, if possible.
12. Draft the valuation report.
13. Perform a detailed review of the workpapers and report draft.
14. If practical, obtain an independent internal review of the workpapers and report draft.
15. Resolve any professional disputes.
16. Discuss engagement findings and report draft with the client.
17. Determine that all review points and open items have been cleared.
18. Prepare the final report.
19. Sign the report or transmittal letter.
20. File the workpapers.
21. Evaluate the staff's performance.

Note: It is recommended that the above procedures be considered when developing a firm's system of quality control. The firm's quality control system and the unique aspects of each engagement should dictate the specific procedures to be applied in an individual engagement.

* * *

The specific procedures to be applied in a given valuation engagement will depend on two primary factors:

a. The firm's quality control system.

b. The unique aspects of each individual engagement.

There is little definitive guidance as to what specific procedures should be performed in a valuation engagement. Each firm generally has a great deal of flexibility in designing the procedures that will accomplish the valuation objectives of an individual engagement while conforming with the firm's quality control system. The suggested procedures listed in Exhibit 1-3 are often used by business valuation consultants in the order given and should be considered in designing work programs for valuation engagements.

Overall Engagement Approach

Business valuation engagements, like many services offered by accountants and other consultants, are conducted in the following three primary phases:

a. Pre-engagement and planning activities.

b. Data gathering, analysis, and valuation procedures.

c. Reporting and wrap-up.

Each of the recommended quality control steps listed in Exhibit 1-3 falls into one of these three primary engagement phases. The remainder of this lesson presents an overview of the suggested steps and how they fit into the three phases of a typical valuation project.

Pre-engagement and Planning Procedures

Pre-engagement and planning activities include those procedures which are performed before the valuation fieldwork actually begins. The quality control steps that are usually performed during this phase include the following:

Step 1 Evaluate whether to accept the engagement.

Step 2 Prepare a detailed work program.

Step 3 Develop a time and fee estimate.

Step 4 When appropriate, obtain approval of the work program, staff assignments, and fee estimate.

Step 5 When necessary, prepare a proposal letter or oral presentation.

Step 6 Obtain an engagement letter.

Evaluate Whether to Accept the Engagement. A consultant should generally only accept engagements that can be completed professionally, within a reasonable time period, and for a reasonable fee. Before accepting a new valuation engagement, the consultant should, therefore, evaluate the client and the specific project. Among the factors that should be evaluated during this process are the following:

a. The consultant's professional competence.

b. The nature, risks, and requirements of the engagement

c. Whether there are conflicts of interest that might impair the consultant's (1) objectivity or (2) credibility as an expert witness.

d. Whether the consultant is independent with respect to the client and subject business.

e. Other factors regarding the engagement, client, or the subject company.

In deciding whether to accept an engagement, the consultant should obtain a basic understanding of the subject company, its industry, its operations, and its historical operating results. At this stage, it is also important to obtain information regarding the valuation date or dates, the interest being valued, the reason for the valuation, and other information that will be required to understand the appropriate definition of value. Some of this background information may already be available if the consultant has historically provided other services to the client.

Based on the information gathered during this phase, the consultant should be able to make a preliminary assessment of possible valuation methods to be used and any obvious difficulties in applying those methods. The consultant normally does not make a final selection of valuation methods until after all the data has been collected and analyzed. However, the experienced consultant can anticipate which methods are likely to be used and what problems, if any, there may be in applying those methods.

Prepare a Detailed Work Program. Once the necessary background information has been obtained and the overall valuation approach has been developed, the consultant should normally prepare a detailed work program. Although the work program should be tailored to the unique circumstances of each engagement, many procedures will be performed on virtually all valuation projects.

Develop a Time and Fee Estimate. After the detailed work program has been prepared, a consultant can usually develop a fairly accurate budget for a valuation project. The budget should normally summarize the number of hours expected to be incurred for each staff level (staff, partner, reviewer, etc.). A fee estimate can be calculated by applying the appropriate hourly billing rates to the budgeted hours. The "Fee Estimate Worksheet" can be adapted for use on most valuation engagements.

When Appropriate, Obtain Approval of the Work Program, Staff Assignments, and Fee Estimate. The planning and budgeting procedures of a valuation engagement are often performed by staff or manager level consultants. Before beginning the fieldwork, many firms, especially larger firms with more than one experienced valuation professional on staff, have a requirement that the work programs, staffing assignments, and time estimates prepared during the planning phase be reviewed and approved by a partner or other responsible party. Since the partner is usually the most experienced member of the engagement team, this review ensures that the valuation approach to be used will be the most effective and efficient.

When Necessary, Prepare a Proposal Letter or Oral Presentation. A consultant may occasionally have to compete with one or more other firms to obtain a valuation engagement. When this occurs, the engagement is typically awarded based in part on a written or oral proposal. Such proposals should stress the firm's qualifications, the expertise of the firm's personnel, the firm's ability to comply with completion deadlines, and a host of other matters.

Obtain an Engagement Letter. By obtaining an engagement letter for each project, a valuation consultant can often avoid disputes resulting from client misunderstandings about the scope, timing, and cost of an engagement. A properly drafted engagement letter will also explain the extent of responsibility the consultant takes for historical and projected financial information supplied by the company being valued. If the appraisal ultimately may involve litigation, the attorney may want to engage the consultant in order to protect his work product until the attorney can decide whether or not to name the consultant as an expert witness.

Data Collection, Analysis, and Valuation Procedures

During this phase, the consultant should perform the procedures outlined in the detailed work program previously discussed. In general terms, these procedures require the consultant to perform the following steps from Exhibit 1-3:

Step 7 Collect and adjust the data appropriate for the valuation methods used.

Step 8 Perform the valuation methods under the supervision of an experienced individual.

A brief overview is presented in the following paragraphs.

Collect Data Appropriate for the Valuation Methods Used. In order to establish a value for a company, a consultant must generally gather a great deal of information about the company, its industry, the economy in which the company operates, and other guideline companies. To be useful, the information must be timely, accurate, and comparable to similar companies against which comparisons will be made. This information is usually gathered during the early stages of the valuation engagement.

The specific types of information needed will vary from engagement to engagement and are primarily based on the valuation methods that are appropriate for a particular project. The data gathering process usually involves an analysis of historical financial information, interviews with company management, and extensive research on guideline companies, economic and industry trends, and market price data. Financial information must often be adjusted and analyzed before it can be used in the valuation process.

Perform the Valuation Methods under the Supervision of an Experienced Individual. To ensure that the valuation procedures are performed effectively and efficiently, the valuation staff must be properly supervised throughout this phase of the engagement. This supervision should extend to staff members employed directly by the consultant, subcontractors who perform certain portions of a valuation engagement, and employees of valuation firms with which the consultant works under a strategic alliance.

Reporting and Wrap-up Procedures

The final phase of an engagement involves the preparation and issuance of the valuation report and completion of a number of administrative items. The procedures normally performed during this phase as listed in Exhibit 1-3 include:

Step 9 Determine the final estimate of value. This usually involves the following procedures:

a. Weighting of methods (whether quantitative or qualitative).

b. Applying *sanity checks* to the estimates of value.

c. Applying premiums and/or discounts.

Step 10 Document all work performed and conclusions reached.

Step 11 Consider obtaining a representation letter, if possible.

Step 12 Draft the valuation report.

Step 13 Perform a detailed review of the workpapers and report draft.

Step 14 If practical, obtain an independent internal review of the workpapers and report draft.

Step 15 Resolve any professional disputes.

Step 16 Discuss engagement findings and report draft with the client.

Step 17 Determine that all review points and open items have been cleared.

Step 18 Prepare the final report.

Step 19 Sign the report or transmittal letter.

Step 20 File the workpapers.

Step 21 Prepare staff evaluations.

The following paragraphs provide a brief overview of these steps.

Determine the Final Estimate of Value. This step usually involves the following procedures:

a. A valuation consultant often uses two or more valuation methods to estimate a company's value. This usually results in a range of possible values, which the consultant must often narrow down to a single value. This is normally accomplished by subjectively or mathematically weighting the values computed using the different valuation methods.

b. The value estimate should be tested for reasonableness using one or more *sanity checks.*

c. The consultant should *fine-tune* the resulting value by applying any appropriate premiums and/or discounts. These typically may include minority interest discounts, control premiums, and discounts for lack of marketability.

Document Work Performed and Conclusions Reached. A consultant should prepare a set of workpapers for each valuation engagement. The workpapers should include not only the completed work programs, but also all data, calculations, and key assumptions made by the engagement team, as well as all conclusions reached.

Consider Obtaining a Representation Letter (If Possible). Auditing standards require that CPAs obtain representation letters from audit clients. In such letters, the companies being audited make various statements (representations) regarding the accuracy and completeness of company information used by the auditor. It is sometimes useful to obtain similar representation letters during business valuation engagements. Although this is not a required step on all valuation engagements, the consultant may desire to obtain such written representations in some situations. Paragraph 66 of SSVS No. 1 (VS 100.66) addresses representation letters.

Draft the Valuation Report. The results of a valuation project are usually communicated to the client in a written report.

Perform a Detailed Review of the Workpapers and Report Draft. All workpapers used to document a valuation engagement and the report draft should be reviewed for accuracy and compliance with firm and professional standards. Completion of the review should be documented either by initials on the workpapers or by completion of a reviewer's checklist or memo.

If Practical, Obtain an Independent Internal Review of the Workpapers and Report Draft. Many consultants have a requirement that the engagement workpapers and final report draft be reviewed by a member of the firm who has no other responsibility for the engagement. An independent review helps ensure that the engagement team has followed the firm's quality control procedures and provides an additional check for errors or inconsistencies in the valuation report.

Resolve Any Professional Disputes. A great deal of judgment must be exercised in conducting a business valuation engagement. This sometimes leads to professional disputes between staff members over the interpretation of some of the data used in the valuation process. Each consulting firm should design procedures to follow when professional disputes occur.

Discuss Engagement Findings and Report Draft with the Client. Before concluding an engagement and issuing the final report, the consultant should usually meet with or talk to the client to discuss the engagement findings and report draft. Such a meeting can be helpful both for the client and the consultant. The client can often obtain a better understanding of the engagement findings by asking the consultant questions during this face-to-face meeting or phone conversation. The client may also be able to provide additional information to the consultant that can be useful in further supporting or, in some cases, if appropriate, modifying the valuation conclusion.

Determine That All Review Points and Open Items Have Been Cleared. Review comments and pending notes are often written throughout an engagement. An engagement cannot be considered completed until all such matters have been addressed by the engagement team to the satisfaction of all parties. A completed valuation report should never be issued until all comments and pending notes have been cleared.

Prepare the Final Report. At this point, the consultant should be able to prepare the final valuation report. Obviously, information that was obtained from the meeting with the client and during the workpaper and report reviews should be properly addressed in the final report.

Sign the Report or Transmittal Letter. Most consulting firms specify that a partner or other responsible party sign all final reports or transmittal letters. Before signing the report or transmittal letter, the partner should determine that all required engagement procedures have been completed, that all review comments and pending notes have been cleared, and that the independent review, if practical, has been performed.

File the Workpapers. At this point, the consulting project has been completed, and the workpapers should be filed for future reference. Some firms have procedures that require the engagement workpapers to be filed in a standard sequence. Also, some firms (based on advice from their legal counsel) have policies requiring that all review points on the engagement be discarded before the workpapers are filed.

Evaluate the Staff's Performance. The performance of the consulting staff should be evaluated at the end of each engagement. The evaluation may be communicated orally or in writing to the individual staff member(s). However, if the evaluation is in writing, the completed form should be discussed with the staff member before being filed in the employee's personnel file.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. The consultant generally needs to assess certain information about the client and the specific project prior to accepting a new valuation engagement. Which of the following information should have no bearing on whether to accept the engagement?

    a. The requirements of the engagement.

    b. Whether there are conflicts of interest that might impair the consultant's objectivity.

    c. Whether the consultant is independent with respect to the client.

    d. The anticipated outcome of the valuation.

15. The president of Bluetip Match Company calls his consultant and indicates that the company may be sold and asks for a rough estimate of its value by 5:00PM today. Which of the following factors should the consultant consider in deciding whether to accept the engagement?

    a. Whether the consultant can meet the 5:00PM deadline.

    b. Whether the consultant can provide an estimate the president will accept.

    c. Whether the consultant has an understanding of the company and its operations.

    d. Whether the consultant has performed valuations of similar companies in the past.

16. A consultant may occasionally have to compete with one or more other firms to obtain a valuation engagement. When this occurs, the engagement is typically awarded based in part on which of the following engagement activities?

    a. Preparing a detailed work program.

    b. Developing a time and fee estimate.

    c. Proposal letter or oral presentation.

    d. Engagement letter.

17. The data gathering process for the valuation method used usually involves, among other things, an analysis of historical financial information. Which of the following financial information is normally unnecessary on valuation engagements?

    a. Historical financial statements.

    b. Municipal tax returns.

    c. Economic trends.

    d. Research on guideline companies.

18. Determining the final estimate of value involves several procedures. Which one of the following would be an inaccurate representation of a procedure used?

    a. Often two or more valuation methods are used to estimate a company's value.

    b. The consultant must often narrow down a range of possible values to a single value.

    c. The value estimate should be tested for reasonableness using only one *sanity check*.

    d. The consultant should refine the resulting value by applying any appropriate premiums and/or discounts.

19. The preparation and issuance of the valuation report and completion of a number of procedures is the final phase of an engagement. Which of the following is **not** a required step on all valuation engagements?

    a. Document all work performed and conclusions reached.

    b. Obtain a representation letter.

    c. Resolve any professional disputes.

    d. Prepare staff evaluations.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

14. The consultant generally needs to assess certain information about the client and the specific project prior to accepting a new valuation engagement. Which of the following information should have no bearing on whether to accept the engagement? **(Page 43)**

    a. The requirements of the engagement. [This answer is incorrect. The nature, risks, and requirements of the engagement will have a significant impact on the consultant's decision regarding whether to accept the engagement. If any of those factors are not reasonable for the consultant, then they may not decide to accept the engagement.]

    b. Whether there are conflicts of interest that might impair the consultant's objectivity. [This answer is incorrect. The consultant will want to consider whether there are conflicts of interest that might impair the consultant's objectivity or credibility as an expert witness prior to accepting the engagement.]

    c. Whether the consultant is independent with respect to the client. [This answer is incorrect. Another factor to be considered by the consultant prior to acceptance of the engagement is whether the consultant is independent with respect to the client and the subject business to be valued. If independence will be impaired, the consultant must decline the engagement.]

    d. The anticipated outcome of the valuation. [This answer is correct. The outcome of the valuation cannot be accurately anticipated and, therefore, should have no bearing on the assessment of the proposed engagement.]

15. The president of Bluetip Match Company calls his consultant and indicates that the company may be sold and asks for a rough estimate of its value by 5:00PM today. Which of the following factors should the consultant consider in deciding whether to accept the engagement? **(Page 44)**

    a. Whether the consultant can meet the 5:00PM deadline. [This answer is incorrect. Simply being able to meet the deadline established should not be a factor in deciding whether to accept the engagement since being able to complete the engagement in a reasonable time period is important to the engagement. Rushing the valuation might compromise the quality of work by the consultant.]

    b. Whether the consultant can provide an estimate the president will accept. [This answer is incorrect. The goal of any valuation is to produce an accurate and honest assessment, not to produce what the client wants the end result to be.]

    c. Whether the consultant has an understanding of the company and its operations. [This answer is correct. There are several important assessments that need to be made when deciding whether to accept an engagement. One such assessment is to gain a basic understanding of the company and its operations. Another assessment is to understand the purpose and requirements of the engagement.]

    d. Whether the consultant has performed valuations of similar companies in the past. [This answer is incorrect. The decision about whether to accept an engagement should be solely based on the specifics of the company and the valuation to be performed. Prior valuations of similar companies in the past should not be taken into account.]

16. A consultant may occasionally have to compete with one or more other firms to obtain a valuation engagement. When this occurs, the engagement is typically awarded based in part on which of the following engagement activities? **(Page 44)**

    a. Preparing a detailed work program. [This answer is incorrect. Once the necessary background information has been obtained and the overall valuation approach has been developed, the consultant should normally prepare a detailed work program, although not until the engagement has been awarded to the consultant. Although the work program should be tailored to the unique circumstances of each engagement, many procedures will be performed on virtually all valuation projects.]

    b. Developing a time and fee estimate. [This answer is incorrect. After the detailed work program has been prepared, a consultant can usually develop a fairly accurate budget for a valuation project. The budget should normally summarize the number of hours expected to be incurred for each staff level (staff, partner, reviewer, etc.). A fee estimate can be calculated by applying the appropriate hourly billing rates to the budgeted hours.]

    c. Proposal letter or oral presentation. [This answer is correct. A consultant may occasionally have to compete with one or more other firms to obtain a valuation engagement. When this occurs, the engagement is typically awarded based in part on a written or oral proposal. Such proposals should stress the firm's qualifications, the expertise of the firm's personnel, the firm's ability to comply with completion deadlines, and a host of other matters.]

    d. Engagement letter. [This answer is incorrect. By obtaining an engagement letter for each project, a valuation consultant can often avoid disputes resulting from client misunderstandings about the scope, timing, and cost of an engagement. A properly drafted engagement letter will also explain the extent of responsibility the consultant takes for historical and projected financial information supplied by the company being valued.]

17. The data gathering process for the valuation method used usually involves, among other things, an analysis of historical financial information. Which of the following financial information is normally unnecessary on valuation engagements? **(Page 45)**

    a. Historical financial statements. [This answer is incorrect. Historical financial statements, both annual and interim, for a relevant period, are normally used on valuation engagements to see the past financial status of the company being valued.]

    b. Municipal tax returns. [This answer is correct. State and federal tax returns are normally used on valuation engagements, but municipal tax returns are not since municipal taxes are not included in the valuation process.]

    c. Economic trends. [This answer is incorrect. The process of gathering data usually involves an analysis of economic and industry trends since these factors will affect the valuation results.]

    d. Research on guideline companies. [This answer is incorrect. One key element in the data gathering process is extensive research on guideline companies so that a general guideline for the value of companies in the same line of business can be established.]

18. Determining the final estimate of value involves several procedures. Which one of the following would be an inaccurate representation of a procedure used? **(Page 46)**

    a. Often two or more valuation methods are used to estimate a company's value. [This answer is incorrect. By using two or more valuation methods to estimate a company's value, the valuation consultant has a greater likelihood of arriving at the most accurate value possible. This is a step that the valuation consultation would use to arrive at the final estimate.]

    b. The consultant must often narrow down a range of possible values to a single value. [This answer is incorrect. By using two or more valuation methods, a range of possible values usually results that the consultant must many times narrow down to a single value. This can be accomplished by weighting the values computed using the different valuation methods.]

    c. The value estimate should be tested for reasonableness using only one *sanity check*. [This answer is correct. The value estimate should be tested for reasonableness using one or more sanity checks. The test for reasonableness need not be limited to the use of only one *sanity check*.]

    d. The consultant should refine the resulting value by applying any appropriate premiums and/or discounts. [This answer is incorrect. The consultant should fine-tune the resulting value by applying any appropriate premiums and/or discounts. This will help the consultant arrive at the most accurate value for the company's value. Examples of such discounts may include: control premiums, minority interest discounts, and discounts for lack of marketability.]

19. The preparation and issuance of the valuation report and completion of a number of procedures is the final phase of an engagement. Which of the following is **not** a required step on all valuation engagements? **(Page 46)**

    a. Document all work performed and conclusions reached. [This answer is incorrect. A consultant should prepare a set of workpapers for each valuation engagement. The workpapers should include not only the completed work programs, but also all data, calculations, and key assumptions made by the engagement team, as well as all conclusions reached.]

    b. Obtain a representation letter. [This answer is correct. Auditing standards require that CPAs obtain representation letters from audit clients. In such letters, the companies being audited make various statements (representations) regarding the accuracy and completeness of company information used by the auditor. It is sometimes useful to obtain similar representation letters during business valuation engagements. *Although this is not a required step on all valuation engagements, the consultant may desire to obtain such written representations in some situations*.]

    c. Resolve any professional disputes. [This answer is incorrect. A great deal of judgment must be exercised in conducting a business valuation engagement. This sometimes leads to professional disputes between staff members over the interpretation of some of the data used in the valuation process. Each consulting firm should design procedures to follow when professional disputes occur.]

    d. Prepare staff evaluations. [This answer is incorrect. The performance of the consulting staff should be evaluated at the end of each engagement. The completed form should be discussed with the staff member before being filed in the employee's personnel file. This will help employees perform more efficiently and accurately on the next engagement.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (VALTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook.

1. Andy Smith is in the process of valuing a closely held company. There are a number of practical considerations or distinctions that he should consider when performing his valuation. Which of the following is one of them?

   a. A working knowledge of how foreign operations work.

   b. Thorough knowledge of how to value securities.

   c. The availability of information to value the company.

   d. Diverse experience in a multitude of industries.

2. Which of the following is a recent development driving the need for valuation engagements?

   a. Charitable contributions.

   b. Buying and/or selling all or partial interest of a business.

   c. Divorce.

   d. Fair value reporting.

3. A CPA's independence would be impaired if he or she performs any of several services for an attest client that involves a *significant degree of subjectivity* and is material, individually or in the aggregate, to the client's financial statements. Which of the following would **not** result in a CPA's independence being impaired?

   a. Appraisal of the client's fixed assets.

   b. Divorce proceedings for a company executive.

   c. Valuation of a planned acquisition.

   d. Actuarial service to calculate annuity premiums.

4. For purposes of independence, Jack Walsh, CPA must obtain a written understanding with his client regarding the client's acceptance of its responsibilities. As a part of such agreement, Jack should include a statement in the agreement stating that:

   a. The CPA will be responsible for making all management decisions/performing all management functions.

   b. The CPA will oversee the valuation.

   c. The client will evaluate the adequacy and results of the service performed.

   d. The client is not responsible for the results of the valuation.

5. Which of the following statements is **inaccurate** concerning valuation engagements performed under Ethics Interpretation 101.3, *Performance of Nonattest Services*?

   a. Valuation engagements require numerous judgments to be made by the appraiser.

   b. The client's responsibilities are frequently difficult for the client to achieve.

   c. All of the requirements of Interpretation 101.3 should be considered prior to accepting an engagement with an attest client.

   d. Interpretation 101.3 gives the practitioner precise instructions regarding how to document the written understanding.

6. The Uniform Standards of Professional Appraisal Practice (USPAP) is proposing changes to the 2012–2013 edition of the standards. Which of the following is a change that will have a direct impact on performing and reporting on business valuation engagements?

   a. A rule permitting appropriate access of a work file by other valuation practitioners with obligations to the assignment.

   b. A rule indicating that an appraiser would be responsible for personally signing their report.

   c. A communications rule addressing the appraiser's responsibilities in communicating with the client.

   d. A rule addressing the jurisdictional exceptions when compliance with the USPAP is precluded by law.

7. Which of the following would be considered a consultant exempt from the AICPA standards?

   a. A professional on a business valuation engagement making an oral report to the client.

   b. A professional engaged in a calculation engagement.

   c. An attorney serving as a client advocate.

   d. Do not select this answer choice.

8. Gerry is an auditor of public companies on a regular basis. Title II of the Sarbanes-Oxley Act of 2002 requires the SEC to adopt new rules to improve independence requirements that affects Gerry's audits of public companies. Which of the following is one such rule established for that purpose?

   a. Relax second partner review requirements.

   b. Allow all nonaudit services.

   c. Relax conflict of interest standards.

   d. Clarify the relationship between the audit committee and the independent auditor.

9. Harry is the leader of a new valuation practice and has gained a full understanding of the basic concepts of valuing a business. Subsequently, Harry should then take a number of actions. Which of the following statements is **inaccurate** regarding those actions?

   a. Develop/implement a marketing plan.

   b. Always recruit valuation staff from outside the firm.

   c. Develop a comprehensive system of quality control.

   d. Obtain computer resources and train staff in their uses.

10. Organizing an alliance with an existing valuation consultant is a great way for a small firm to leverage services and provide a broader range of assistance to their clients. There are many different ways for an accountant to form a union with a valuation consultant. In which option does the engaging consultant use the valuation firm as a subcontractor, allowing the engaging consultant to gain valuation experience?

    a. The valuation consultant reviews the engagement when there are complex issues.

    b. The valuation consultant is referred the engagement by the engaging consultant and then the engaging consultant is no longer involved.

    c. The report is issued by the engaging consultant, using the valuation consultant's staff to perform the valuation.

    d. The engaging consultant's firm completes the work and has the valuation consultant review it and issue the report.

11. Robert Smith, CPA, performs business valuation services and holds the designation of Accredited-IBA (AIBA). Which of the following is required in order to receive AIBA designation?

    a. Be a CPA.

    b. Have a 4-year college degree or equivalent.

    c. Be a member in good standing with the AICPA.

    d. Successfully complete 90 classroom hours of upper-level course work.

12. There is variety of quality control steps that Sarah should apply to the valuation engagement she is currently performing for Blue Chip Micro Instruments, Inc. Which of the following is one of the quality control steps that are recommended?

    a. Obtain approval of the work program.

    b. Prepare a proposal letter or oral presentation.

    c. Obtain a representation letter.

    d. Find solutions to professional disputes.

Lesson 2: Valuation Terms and Methodology

INTRODUCTION

A discussion of valuation terms and methodology is at once academic and practical. The natural tendency is to skim through this chapter or to skip it entirely. To make sound valuation decisions and to prepare credible valuation reports, consultants must understand certain basic business valuation terms and principles. Remember, a valuation report may be challenged by an opposing party, especially in a divorce or other litigation case. The consultant will need to support the valuation conclusion and explain how the engagement followed accepted valuation principles.

This lesson discusses basic valuation terms and methods. Also included is a discussion on how to select appropriate valuation methods and a discussion of valuation methods that are appropriate for very small businesses.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify terms applicable to business valuations.
- Summarize the basic valuation approaches and methods used to value future earnings.
- Recognize the valuation method selection process and determine the approach or method to use utilizing industry and company factors and identify valuation methods relating to very small businesses and when they are used.

VALUATION TERMS

What Is an Appraisal?

The term *appraisal* is defined as:

> The act or process of determining the value of a business, business ownership interest, security, or intangible asset. It is synonymous with valuation.

Accordingly, an appraisal is an opinion of the value of an asset or an ownership interest of a business enterprise. However, a business can have many values, depending on the circumstances. Thus, an appraisal must have a specific definition of value.

Appraisal versus Valuation. Some consultants use the terms *appraisal* and *valuation* synonymously. Others, including the Appraisal Foundation, reserve the term *appraisal* for a set of procedures that conforms to appraisal standards (such as USPAP or ASA standards), using the term *valuation* for any less formal exercise that results in a value opinion but that would not meet appraisal standards. Throughout this lesson, terms *appraisal* and *valuation* are used synonymously.

What Is Value?

Value is an imprecise term because it varies with the situation. The following are some common definitions of value:

a. Fair market value.

b. Fair value.

c. Investment value.

d. Intrinsic value.

e. Going concern value.

f. Liquidation value.

g. Book value.

Fair Market Value. This is probably the most common definition of value and the definition discussed most often in this book. Revenue Ruling 59-60 defines fair market value as:

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

That definition is commonly used by the IRS, the courts, and valuation consultants. It assumes a hypothetical arm's length sale without regard to a specific buyer or seller.

Fair Value. The term used here is not the same as that used in accounting literature. This term is a court-determined value provided for under some states' laws. In those states, if a corporation agrees to a merger, sale, or other action and the minority stockholders believe they will not get adequate consideration for their stock, those stockholders have the right to have their shares appraised and get fair value in cash. The consultant in such cases considers the factors established by relevant statutes and case law, which may include market values, individual asset values, methods commonly used in the financial community, and other factors. It is important to obtain legal direction when performing a fair value assignment.

In some states, case law has established precedent as to whether minority interest or marketability discounts will be allowed in the determination of fair value. In other states, the determination of fair value is left to the discretion of the courts. An example of the court using its discretion is the case of *Weigel Broadcasting Company v. Smith, et. al*, [682 N.E.2d 745, 289 Ill. App. 3d 602 (Ill. Ct. App. 1996)]. At issue in the case was the fair value assigned to the dissenting shareholders' common stock. The company's expert valued the stock at $115 per share using a discounted cash flow and market approach and applied a 50% discount for minority interest and lack of marketability. On the other hand, the dissenting shareholders' expert determined that the fair value of the stock should be a prorata division of corporate assets without any discounts. That expert determined the fair value of the stock to be $578.44 per share.

In the end, the appellate court upheld the trial court's fair value determination of $126 per share by stating "there is no precise method for determining fair value." In its decision, the appellate court listed the following factors considered by the trial court:

- Nature and history of the business.
- Economic outlook of the industry.
- Book value of the stock.
- Financial condition and earning capacity of the company.
- Dividend paying capacity of the company.
- Goodwill.
- Previous stock sales.
- Market price of similar corporations.

After citing case law, which supports the consideration of minority interest and marketability discounts, the appellate court decided that "applying such discounts is left to the trial court's discretion."

Fair Value in Accounting Literature. In the context of accounting literature, FASB ASC 820, *Fair Value Measurements and Disclosures* (formerly SFAS No. 157, *Fair Value Measurements*), defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." Fair value is measured for a particular asset or liability, which may be a stand-alone asset or liability or a group of assets or liabilities. FASB ASC 820 requires consideration of attributes that are specific to the asset or liability, such as its condition or location, when measuring fair value. Although FASB ASC 820 focuses on assets and liabilities, it also applies to instruments that are measured at fair value and classified in stockholders' equity.

A fair value measurement assumes that an asset or liability is exchanged in an orderly transaction. That means the hypothetical transaction to sell the asset or transfer the liability is assumed to be usual and customary for the type of asset or liability and not a forced liquidation or distress sale. The hypothetical transaction is also assumed to occur in the principal market for the asset or liability or, if a principal market does not exist, the most advantageous market for the asset or liability. The transaction is considered from the perspective of the entity holding the asset or liability, with the objective of determining the price that would be received or paid to sell the asset or transfer the liability at its highest and best use. That is, fair value is based on an exit price, which may differ from the price paid to acquire the asset or received to assume the liability (i.e., an entry price).

Fair value should be measured using consistently applied valuation techniques based on the market, income, or cost (asset) approaches. Each of these approaches includes different measurement techniques that rely on judgment and assumptions, including assumptions about risk. The assumptions used should be those that market participants would use in pricing the asset or liability. FASB ASC 820 refers to these assumptions as inputs and establishes a fair value hierarchy to prioritize fair value inputs from highest to lowest reliability as follows:

a. *Level 1 Inputs.* Level 1 inputs consist of quoted prices in active markets for identical assets or liabilities (such as the quoted stock price for a public company).

b. *Level 2 Inputs.* Level 2 inputs consist of observable inputs other than Level 1 inputs. Such inputs include (1) quoted market prices for similar assets or liabilities in active markets; (2) quoted prices for identical or similar assets or liabilities in markets that are not active (few transactions, prices are not current or are volatile over time or between markets, or limited public information is released); (3) interest rate and yield curves observable at commonly quoted intervals, prepayment speeds, credit risks, default rates; and (4) market-corroborated inputs (such as sales price per square foot for Class A office buildings in Fort Worth, Texas).

c. *Level 3 Inputs.* Level 3 inputs are considered unobservable inputs. Unobservable inputs should be used when there is little (or no) market activity for the asset or liability. Such inputs are generally the entity's own assumptions about the assumptions that market participants would use to price the asset or liability, which might include the entity's own data. Examples include whether to apply a discount for lack of marketability to the stock price of a privately-held entity in a non-active market and the entity's estimated rate of return required by market participants.

Almost all business valuation engagements involve privately held entities, and, thus, quoted prices (Level 1 inputs) are rarely available. Consequently, Level 2 and Level 3 inputs must generally be used to estimate fair value for valuation engagements related to financial reporting.

In April 2009, the FASB issue FSP SFAS No. 157-4, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly," which amended SFAS No. 157 to address valuation difficulties resulting from recent market gridlock within many historically active markets. Thus, in certain market conditions, assets and liabilities previously valued using Level 1 or Level 2 inputs, may require Level 2 or Level 3 inputs to determine a proper fair value for financial reporting purposes. This may increase the need for valuation consultants to provide services for financial reporting purposes. The FASB subsequently codified this guidance into FASB ASC 820.

FASB ASC 825, *Financial Instruments*, (formerly SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*), permits entities to choose, at specified election dates, to measure many financial assets and liabilities at GAAP fair value for which fair value measurement was previously prohibited. The objective of the Statement is to provide more uniform measurements of related assets and liabilities.

FASB ASC 825 excludes the following types of financial assets and liabilities: (a) investments in subsidiaries or interests in VIEs that the entity is required to consolidate; (b) employers' and plans' obligations for pension benefits, postretirement benefits, employee stock option and stock purchase plans, and other forms of deferred compensation; (c) financial assets and financial liabilities recognized under leases; (d) deposit liabilities of deposit institutions that are withdrawable on demand; and (e) financial instruments classified by the issuer as a component of stockholder's equity. With the abundance of assets and liabilities that can now be measured at fair value for financial reporting purposes, the introduction of these standards may create new engagement sources for valuation consultants, further enhancing the status of the discipline within the business community.

Investment Value. Investment value is the value of an asset or business to a specific owner or prospective owner. Accordingly, this type of value considers the owner's or prospective owner's knowledge, abilities, expectations of risks and earning potential, and other factors. An example of investment value is when a transaction provides unique motivators or synergies to a particular buyer that is unavailable to the typical buyer. In this situation, the transactions usually include a synergistic or acquisition premium that reflects additional value to a particular buyer.

Intrinsic Value. Some consultants use this term interchangeably with investment value. Other consultants consider intrinsic value to be value based on the analysis and judgment of an independent security analyst, investment banker, or financial manager. In valuation engagements, the term is ambiguous. In court cases, the term often is not defined clearly and may refer to fair market value, fair value, or some other type of value. Thus, consultants who are engaged to determine a company's intrinsic value should obtain a clear definition of the term from the client or attorney before starting work.

Going Concern Value. Sometimes this term refers to a company's value as a going concern. In this sense, it is a premise of value, not a distinct definition of value. In some instances, this term refers to the intangible elements of a business arising from such factors as having in place a trained qualified workforce; an operating plant; and the required licenses, systems, and procedures.

Liquidation Value. Liquidation value assumes that a company's operations are expected to cease and that its individual assets will be sold (or otherwise disposed of). Liquidation value is usually determined using one of the following premises:

a. *Orderly Liquidation.* Selling the assets over a reasonable time period to get the highest price for each.

b. *Forced Liquidation.* Selling the assets as quickly as possible, such as at an auction. (Forced liquidation value is sometimes called auction value.)

Liquidation value considers not only the proceeds from selling the assets, but also the selling costs, the costs to hold the assets until their sale, and other expenses. Typically, although not always, when valuing an interest with absolute control, a company's net liquidation value represents the lower limit of value.

Book Value. Book value is an accounting term that refers to one of the following:

a. For an asset, its historical cost reduced by any allowances for unrealized losses or depreciation, impairment, and amortization.

b. For a company, its stockholders' equity, that is, the excess of total assets over total liabilities as presented on the balance sheet.

How Does the Definition of Value Affect a Valuation Engagement?

The definition of value, purpose of the valuation, and type of ownership interest will affect the selection of valuation methods. For example, in a divorce engagement, the company will be valued based on relevant statutes and case law. That value may be equivalent to fair market value, investment value, or some other definition. Thus, the definition of value used is especially critical to the valuation process.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. When considering the terms *appraisal* and *valuation*, what is the opinion of the Appraisal Foundation?

    a. The terms are considered synonymous in application to the USPAP and ASA standards.

    b. *Appraisal* includes procedures that conform to the appraisal standards, while a *valuation* does not.

21. Regarding valuation terminology, which of the following definitions of *value* is the correct use of the term when describing the value of an asset or business to a specific owner or prospective owner?

    a. Fair Market Value.

    b. Fair Value.

    c. Investment Value.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

20. When considering the terms *appraisal* and *valuation*, what is the opinion of the Appraisal Foundation? **(Page 59)**

    a. The terms are considered synonymous in application to the USPAP and ASA standards. [This answer is incorrect. The Appraisal Foundation does not feel that these two terms are synonymous with each other, while other consultants use them interchangeably. The Appraisal Foundation does not think that a valuation meets the standards for an appraisal.]

    b. *Appraisal* includes procedures that conform to the appraisal standards, while a *valuation* does not. [This answer is correct. The Appraisal Foundation reserves the term appraisal for a set of procedures that conforms to appraisal standards (such as USPAP or ASA standards), using the term valuation for any less formal exercise that results in a value opinion that would not meet appraisal standards.]

21. Regarding valuation terminology, which of the following definitions of *value* is the correct use of the term when describing the value of an asset or business to a specific owner or prospective owner? **(Page 62)**

    a. Fair Market Value. [This answer is incorrect. The amount at which the property would change ownership between a willing buyer and a willing seller when the former is not under any pressure to buy and the latter is not under any pressure to sell, and both parties have adequate knowledge of the pertinent facts is the Fair Market Value.]

    b. Fair Value. [This answer is incorrect. Fair Value is a value provided for under some states' laws by the courts. In those states, if a corporation agrees to a merger, sale, or other action minority stockholders have the right to have their shares appraised and receive fair value in cash if they believe they will not receive adequate consideration for their stock. When this happens, the consultant in such cases should consider the factors established by relevant statutes and case law, which may include market values, individual asset values, methods commonly used in the financial community, and other factors. When performing a fair value assignment, an attorney should be consulted.]

    c. Investment Value. [This answer is correct. The value of an asset or business to a specific owner or prospective owner is investment value. As a result, this type of value takes into consideration the owner's or prospective owner's knowledge, abilities, expectations of risks and earning potential, and other factors.]

VALUATION APPROACHES AND METHODS

A company's value is derived from its future benefits. However, those benefits cannot be measured with certainty. Companies have different risks and earnings characteristics. Their owners' goals and expectations vary. No single formula can be used to determine the value of every company in every situation. Therefore, different approaches and methods have evolved for estimating future benefits and companies' values.

Valuation Approaches

The major professional business appraisal organizations classify valuation methodology into three basic approaches. The three approaches are:

a. Income approach.

b. Market approach.

c. Asset based approach.

Income Approach. This approach is the closest to the basic valuation principle. The term income does not refer to income in the accounting sense, but to the future benefits accruing to the owner. Under the income approach, the consultant estimates the future ownership benefits and discounts those benefits to present value using a rate suitable for the risks associated with realizing those benefits. As a *shortcut* method under the income approach, the consultant may capitalize some normalized level of ongoing benefits.

Market Approach. This approach assumes that value can be estimated from analyzing recent sales of comparable assets. This approach is commonly used to value single-family homes, where the appraiser estimates a house's value by comparing it to similar houses recently sold or offered for sale. In business valuations, the consultant analyzes guideline public companies (and private companies, whenever possible) and/or guideline transactions to determine a company's value. Using this approach requires a thorough search for guideline companies and thorough analysis and adjustment of the guideline data, both public and private. There are two distinct valuation methods based on guideline company data—the guideline public company method and the guideline transaction method.

Asset Based Approach. This approach assumes that an asset's value is indicated by the cost of reproducing or replacing it, less an allowance for physical deterioration and obsolescence. The approach is commonly used for assets that are not sold on an active market, such as land improvements and special purpose equipment. For business valuations, the approach generally applies to companies with little value beyond the value of their tangible assets, such as holding companies. It is also used when valuing individual components of a business enterprise for certain purposes, such as financial reporting.

Approaches versus Methods. To apply the valuation approaches discussed above, the consultant may use one or more valuation methods, depending on the benefit stream used to estimate value. Exhibit 2-1 illustrates the differences between approaches and methods.

The International Glossary of Business Valuation Terms, developed jointly by the AICPA, ASA, CICBV, IBA, and NACVA, establishes collective terminology relating to approaches and methods. This course is in general conformity with the International Glossary.

Types of Valuation Methods. The following valuation methods are discussed in this course:

- *Methods Using the Income Approach*
  - Discounted future returns methods.
  - Capitalized returns methods.

- *Methods Using the Market Approach*
    - Value multiples involving guideline public company data.
    - Value multiples involving guideline transactions.
- *Methods Using the Asset Based Approach*
    - Underlying asset methods.
    - Excess earnings method.

These methods are discussed briefly in the following paragraphs.

Exhibit 2-1

Valuation Approaches and Methods

Approaches	**Methods**	
Income	Discounted future returns	• Discounted net cash flow • Discounted future earnings
	Capitalized returns	• Capitalization of net cash flow • Capitalization of earnings
Market	Value multiples using guideline data[a] (The same valuation multiples can be used for guideline public companies and guideline transactions.)	• Price/earnings • Price/dividends • Price/gross cash flow • Price/book value • Price/revenues • Price/net asset value • Multiple of discretionary earnings • Rules of thumb • Company specific methods
Asset based	Underlying assets	• Net asset value • Liquidation value • Excess earnings[b]

Notes:

[a] "Price" can be either price of equity or the market value of invested capital (MVIC).

[b] Excess earnings is arbitrarily classified under the asset approach because it consists of adjusting tangible assets to current market values and adding an estimate of intangible asset value.

* * *

Discounted Future Returns and Capitalized Returns Methods

The discounted future returns and capitalized returns methods are similar because both rely on estimating future benefits, that is, both use a company's operating results in estimating value. These methods can be used whenever a company's future returns can be reasonably estimated.

Discounted Future Returns Methods. Discounted future returns methods may be used when the company's future returns (a) can be reasonably estimated and (b) are expected to differ significantly from its current operations because of factors such as changes in business structure or expected changes in economic conditions. To apply these methods, the consultant estimates the company's future returns until they reach a stabilized level. Then the consultant determines a terminal value of the company based on its stabilized net cash flow or earnings. Finally, the company's estimated future returns, including the terminal value, are then discounted to present value using a market discount rate.

Capitalized Returns Methods. Capitalized returns methods may be used when a company's future operations are not expected to change significantly from its current normalized operations or where future returns are expected to grow at a somewhat predictable rate. To apply these methods, a company's current operations (either net cash flow or earnings) are divided by a capitalization rate to estimate value.

Discount and Capitalization Rates. The discounted future returns methods and the capitalized returns methods use the following rates:

a. *Discount Rate.* This rate is used to convert a company's future returns to present worth. It represents the rate of return that investors would require given the risk involved.

b. *Capitalization Rate (Cap Rate).* This rate is used to convert a single benefit stream into value, as follows:

   Value = expected returns ÷ cap rate

   Expected returns may be measured in terms of either net cash flow or earnings of a company.

Cap rates generally differ from discount rates because of factors such as the company's expected growth, the expected life of the business, and the potential for fluctuation in the company's growth rate.

Income Approach Valuation Methods. There are various discounted future returns and capitalized returns methods. The methods differ primarily in the benefit streams used and the rates relating to those benefit streams. These valuation methods are as follows:

a. *Discounted Future Returns Methods.*

   (1) Discounted net cash flow.

   (2) Discounted future earnings.

b. *Capitalized Returns Methods.*

   (1) Capitalization of net cash flow.

   (2) Capitalization of earnings.

The methods most commonly used are the discounted net cash flow and capitalization of net cash flow methods.

Value Multiples Involving Guideline Data

What Are Value Multiples? Value multiples are market-derived factors used to determine the value of a business or ownership interest (or fractional interest therein). The concept is similar to the capitalization rates discussed previously. For example, a price/earnings multiple of 4 would be equivalent to an earnings capitalization rate of

25%. Value multiples can be based on several different benefit streams or other variables. Common multiples include:

a. Price/earnings.

b. Price/dividends.

c. Price/gross cash flow.

d. Price/book value.

e. Price/revenues.

f. Price/net asset value.

Note that each of the items listed above constitutes a separate valuation method. Note also that, although net cash flow is preferred in the income approach, net cash flow is normally not used in the market approach because of the difficulty of measuring justifiable net cash flow for guideline companies.

Applying Value Multiples Methods. Value multiples are determined based on guideline company data or guideline transactions. To apply value multiples methods, the consultant first identifies guideline companies or guideline transactions and then develops a value multiple. That multiple is applied to the appropriate benefit stream or other variable for the business (or ownership interest) being valued. For example, the consultant may identify a list of guideline public companies and determine a price/earnings multiple. That multiple would then be applied to the company's earnings to estimate its value. It is important that the earnings be measured in the same way and using the same time period for both the company being valued and guideline companies (or guideline transactions). That time period could be the latest 12 months, latest fiscal year, estimate of the next 12 months, or average or weighted average of some number of past years.

Price of Equity versus Market Value of Invested Capital (MVIC). If valuing equity directly, the numerator used in deriving the valuation multiple is the price received by common equity owners and the denominator is the return to common equity owners. If valuing invested capital, the numerator used in deriving the valuation multiple is the amount received by all invested capital owners (equity and long-term debt) and the denominator is the return to all equity and long-term debt holders.

In practice, true guideline public companies and guideline transactions are difficult to find. Generally, value multiples derived from guideline data must be adjusted for differences in size, expected growth, financial risk, and many other factors.

Multiple of Discretionary Earnings. This method can be a good way to value a small, owner-managed business, such as a single-store ice cream shop. The method assumes that a buyer would be purchasing both a business and a job. Discretionary earnings is most typically defined as the company's pretax earnings plus owners' compensation and benefits, interest expense, and noncash expenses (such as depreciation and amortization). To determine the company's value, the consultant would multiply discretionary earnings by a value multiple derived from sales in the market or developed from various risk characteristics. The value indicated by this method generally represents the value of the business to a prospective owner/manager.

Rules of Thumb. Rules of thumb are formulas that sometimes are used to value companies in certain industries. For example, a rule of thumb for a casualty insurance brokerage might be 1–2 times retained gross commission income, plus net tangible assets. Rules of thumb may be useful in evaluating the reasonableness of the values indicated by other methods. However, they have many limitations.

Company Specific Methods. In some cases, the consultant may find information about the company that can indicate its value. For example, transactions involving the company's stock may provide an indication of its value. Usually such transactions are among family members, but sometimes those are arm's length transactions. Another example of a company specific method is using enforceable contracts such as buy-sell agreements. If any such transactions are the result of negotiations between independent parties, the consultant should consider whether they provide any indications of the company's worth.

Underlying Asset Methods

Underlying asset methods determine a value for a business based on individual asset values. To apply these methods, the consultant adjusts the company's assets and liabilities to either fair market value or liquidation value, depending on the method used. There are three underlying asset methods:

a. Net asset value method.

b. Liquidation value method.

c. Excess earnings method.

Net Asset Value Method. The company's assets and liabilities are adjusted to their appraised values (usually fair market values) to determine the value of the business. This method assumes that the value of the business will be realized as part of a going concern. Generally, the net asset value method is appropriate only in limited circumstances.

Liquidation Value Method. The net proceeds from liquidating the company's assets and paying off its liabilities are discounted to present value using a suitable rate of return. This method assumes that the value of the business will be realized through either a forced or orderly liquidation of its assets, instead of as a going concern.

Excess Earnings Method. The excess earnings method is a common method for valuing small businesses or professional practices. The method was developed by the Treasury Department and is outlined in Revenue Ruling 68-609. First, the consultant determines a fair rate of return on the company's tangible assets. Then, the consultant computes the company's excess earnings, which is the difference between the company's net earnings and a fair return on its tangible assets. To compute the value of intangibles, the excess earnings are capitalized using a cap rate suitable for intangible assets. To determine the value of the company, the value of the intangibles is added to the value of the company's tangible net assets (determined using the net asset value or another suitable method).

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Valuation methodology is classified by the major professional business appraisal organizations into three basic approaches. Which approach is commonly used to value single-family homes?

    a. Income approach.

    b. Market approach.

    c. Asset based approach.

23. Which of the following methods is used with the Asset Based valuation approach?

    a. Capitalization of earnings.

    b. Liquidation value.

    c. Price/revenues.

    d. Price/dividends.

24. When should a consultant consider using the discounted future returns method for estimating a company's valuation?

    a. When the company cannot logically estimate the future returns based on net cash flows or earnings.

    b. When a company's future returns are not expected to vary drastically from its current operations.

    c. When the economy is expected to significantly change the company's future returns from its current operations.

    d. The future returns of the company are expected to grow at a conventional rate that are predictable.

25. There are three underlying asset methods. Which of the following is **not** one of those methods?

    a. Capitalized return method.

    b. Net asset value method.

    c. Liquidation value method.

    d. Excess earnings method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

22. Valuation methodology is classified by the major professional business appraisal organizations into three basic approaches. Which approach is commonly used to value single-family homes? **(Page 65)**

    a. Income approach. [This answer is incorrect. The income approach refers to the future benefits accruing to the owner. Under the income approach, the consultant estimates the future ownership benefits and discounts those benefits to present value using a rate suitable for the risks associated with realizing those benefits. As a *shortcut* method under the income approach, the consultant may capitalize some normalized level of ongoing benefits.]

    b. Market approach. [This answer is correct. The market approach makes the assumption that value can be estimated from analyzing recent sales of comparable assets. This approach is frequently used to value single-family homes. In such cases, the appraiser will estimate a house's value by comparing it to similar houses recently sold or offered for sale.]

    c. Asset based approach. [This answer is incorrect. An asset's value is indicated by the cost of reproducing or replacing it, less an allowance for physical deterioration and obsolescence under the asset based approach. The approach is often used for assets that are not sold on an active market, such as land improvements and special purpose equipment. For business valuations, the approach usually applies to companies with minimal value beyond the value of their tangible assets, such as holding companies. It can also be used when valuing individual components of a business enterprise for certain purposes such as financial reporting.]

23. Which of the following methods is used with the Asset Based valuation approach?**(Page 66)**

    a. Capitalization of earnings. [This answer is incorrect. Capitalization of earnings is a method used under the *income* valuation approach since this approach uses the future benefits accruing to the owner.]

    b. Liquidation value. [This answer is correct. Liquidation value is one of three methods used under the asset based approach since this approach assumes that an asset's value is indicated by the cost of reproducing or replacing it. Other methods include the net asset value and excess earnings methods.]

    c. Price/revenues. [This answer is incorrect. The price/revenues method is a market approach, not an asset based approach. This approach assumes that the value can be estimated from analyzing recent sales of comparable assets and is commonly used for valuing single-family homes.]

    d. Price/dividends. [This answer is incorrect. In business valuations, the price/dividends method is used in the market approach. The consultant analyzes guideline public companies (and private companies, whenever possible) and/or guideline transactions to determine a company's value. The asset based valuation approach does not use price/dividends.]

24. When should a consultant consider using the discounted future returns method for estimating a company's valuation? **(Page 67)**

    a. When the company cannot logically estimate the future returns based on net cash flows or earnings. [This answer is incorrect. To use the discounted future returns method, a company must be able to reasonably estimate their future returns. The consultant must estimate the company's future returns until they reach a stabilized level.]

    b. When a company's future returns are not expected to vary drastically from its current operations. [This answer is incorrect. If the company's future operations are not expected to change significantly from its current normalized operations, then the company should use the capitalized returns method, not the discounted future returns method.]

    c. When the economy is expected to significantly change the company's future returns from its current operations. [This answer is correct. The discounted future returns method may be used when the company future returns can be reasonably estimated and when the results are expected to differ significantly from its current operations because of factors such as changes in business structure or expected changes in economic conditions.]

    d. The future returns of the company are expected to grow at a conventional rate that are predictable. [This answer is incorrect. When using the capitalized returns method, not the discounted future returns method, the company should expect that the future returns are expected to grow at a somewhat predictable rate. To apply this method, a company's current operations (either net cash flow or earnings) are divided by a capitalization rate to estimate value.]

25. There are three underlying asset methods. Which of the following is **not** one of those methods? **(Page 69)**

    a. Capitalized return method. [This answer is correct. When a company's future operations are not anticipated to change significantly from its current normalized operations or where future returns are expected to grow at a fairly predictable rate, the capitalized return methods may be used. It is not considered an underlying asset method since it is not based on assets for value. To apply these methods, a company's current operations (either net cash flow or earnings) are divided by a capitalization rate to estimate value.]

    b. Net asset value method. [This answer is incorrect. To determine the value of the business, the company's assets and liabilities are adjusted to their appraised values (usually fair market values). This method is based on the premise that the value of the business will be realized as part of a going concern. Generally, the net asset value method is appropriate only in certain circumstances and is an underlying asset method.]

    c. Liquidation value method. [This answer is incorrect. The net proceeds from liquidating the company's assets and paying off its liabilities are discounted to present value using a suitable rate of return. The liquidation value method is an underlying asset method and assumes that the value of the business will result from either a forced or orderly liquidation of its assets, instead of as a going concern.]

    d. Excess earnings method. [This answer is incorrect. This is a common method for valuing professional practices or small businesses and considered an underlying asset method. The method was developed by the Treasury Department and is outlined in Revenue Ruling 68-609.]

SELECTING VALUATION METHODS

In most valuation engagements, two or more valuation methods are selected, if applicable. The actual number depends on the purpose of the engagement, definition of value, type of company, available data, and other factors. Since consultants obviously will not use every method on every engagement, they need a way to narrow the list of methods to those most appropriate for each situation. The selection process is important because consultants may be asked to defend their choices of methods if the valuation is challenged. This lesson discusses both the professional and practical aspects of selecting valuation methods.

Authoritative Literature

The following sources provide guidance regarding the selection of valuation methods:

a. Uniform Standards of Professional Appraisal Practice (USPAP).

b. Revenue Ruling 59-60.

Uniform Standards of Professional Appraisal Practice. Standard 9 of the *Uniform Standards of Professional Appraisal Practice* discusses selection of business valuation methods. However, the guidance is very broad and general. The rules relating to Standard 9 state that:

a. The appraiser must be aware of, understand, and correctly use the recognized methods and techniques that are needed to produce a credible appraisal. (Rule 9-1)

b. In determining the value of a majority interest, the appraiser must investigate the possibility that the company may be worth more in liquidation than as a going concern. If liquidation is the indicated valuation premise, then real estate and personal property should be valued using the appropriate standard. (Rule 9-3)

c. The appraiser must value the company using an appropriate method or technique. (Rule 9-4)

d. The appraiser must (1) select one or more approaches that apply to the specific engagement and (2) assess the quality and quantity of data available to apply the applicable approaches. (Rule 9-5)

Generally, those rules do not impose any additional requirements beyond those for a typical valuation engagement.

Revenue Ruling 59-60. Revenue Ruling 59-60 provides guidance on several aspects of business valuations for tax purposes. Its guidance may also be used for other fair market value appraisals because it combines the operating characteristics that buyers and sellers normally consider. Section 4 of the revenue ruling lists eight factors, which "although not all-inclusive are fundamental and require careful analysis in each case":

a. The nature of the business and the history of the enterprise from its inception.

b. The economic outlook in general and the condition and outlook of the specific industry in particular.

c. The book value of the stock and the financial condition of the business.

d. The earning capacity of the company.

e. The company's dividend-paying capacity.

f. Whether or not the enterprise has goodwill or other intangible value.

g. Sales of the stock and the size of the block of stock to be valued.

h. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

The following paragraphs discuss other factors to consider in the selection process.

The Selection Process

As previously discussed, consultants normally select two or more valuation methods on each engagement. Selecting valuation methods is a very complex, judgmental process. The consultant considers several factors in determining which methods are most appropriate for each specific engagement. The general steps involved in selecting valuation methods are outlined below.

Step 1 Consider the requirements of the engagement.

Step 2 Consider industry and company factors, including common valuation practices for the particular industry.

Step 3 Decide whether asset-based methods and/or earnings-based methods are appropriate for the valuation.

Step 4 Consider whether adequate guideline data is available.

Step 5 If asset-based methods are used,

a. Determine whether the company is a going concern and whether it is worth more in liquidation.

b. Based on the determination in 5a and the considerations in Steps 1–4, select appropriate valuation methods.

Step 6 If earnings-based methods are used,

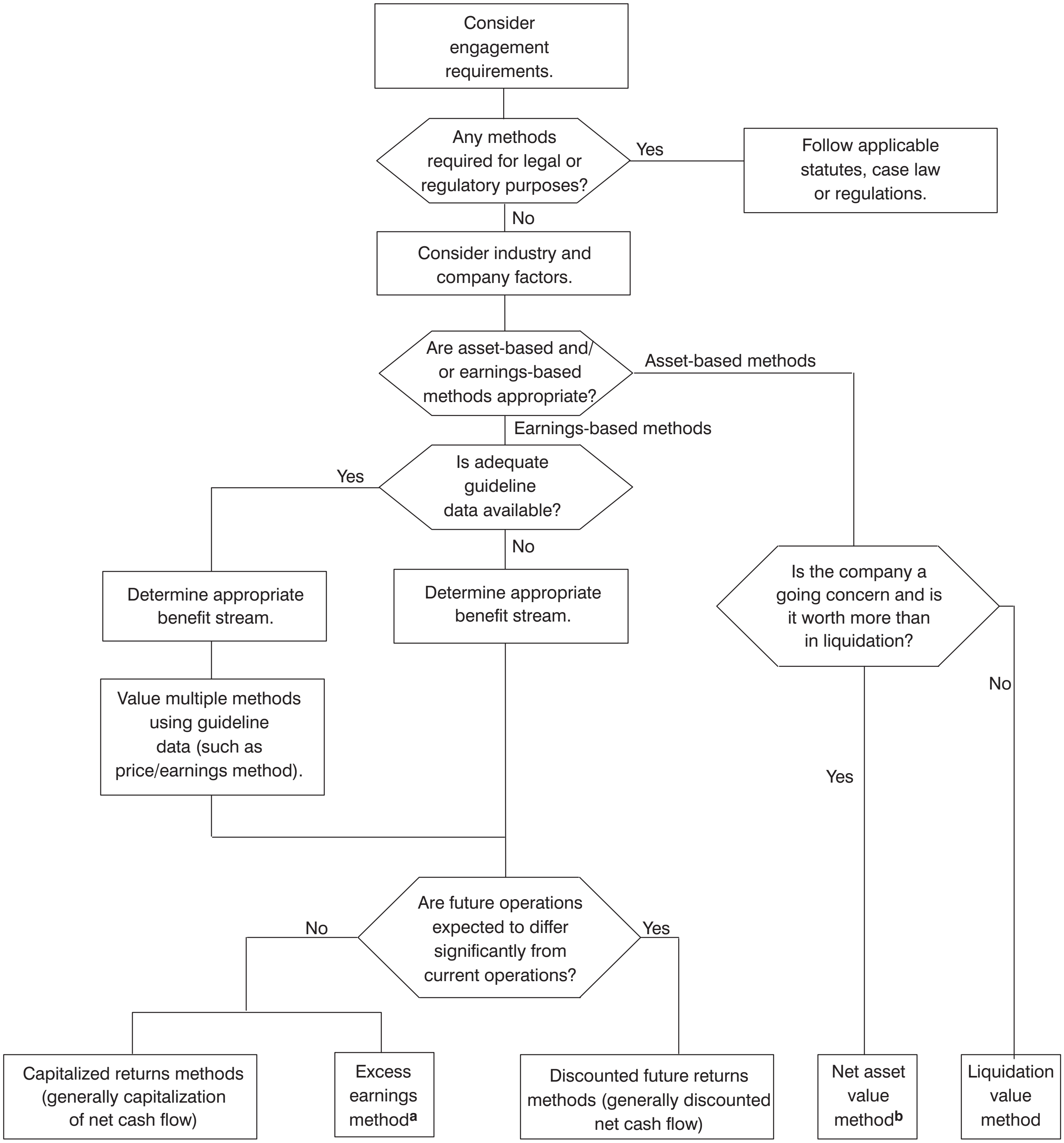
a. Identify the benefit stream or streams to be used in the valuation.

b. Assess whether future cash flow/earnings is expected to differ significantly from current or historical cash flow/earnings.

c. Based on the considerations in Steps 1–4 and 6a–6b, select appropriate valuation methods.

These steps are illustrated in the diagram at Exhibit 2-2.

Exhibit 2-2
Example Approach to Selecting Valuation Methods



Notes:

[a] Although classified in this Exhibit as an earnings-based method, throughout the lesson excess earnings is arbitrarily classified under the asset approach because it consists of adjusting tangible assets to current market values and adding an estimate of intangible asset value. Generally, the excess earnings method is only suited to small businesses.

[b] If the ownership interest is a minority interest and adequate guideline data is available, then price/net asset value method or price/book value method often should be considered.

* * *

It should be noted that this is only one technique to selecting valuation methods. The selection process varies among different consultants. Whatever technique is followed, it is important for the consultant to use judgment and consider all the relevant factors when selecting valuation methods.

The case of *Nathan and Geraldine Morton v. Commissioner* [TC Memo 1997-166 (1997)] provides an example of the importance of using good judgment when selecting valuation methods. At issue in the case was the fair market value of stock purchased by an employee and the resulting reportable amount of taxable income. The taxpayer's expert used only the discounted cash flow method to arrive at a value of $55 per share. In comparison, the IRS expert used four methods of valuation, all of which led to a mutually supportive value of $1,798 per share. As a result, the court rejected the taxpayer's valuation and accepted the IRS expert's valuation in its entirety.

The following paragraphs outline key considerations in the process of selecting valuation methods.

Step 1—Consider the Requirements of the Engagement

The first step in the selection process is to consider the requirements of the valuation engagement, including:

a. Purpose of the engagement.

b. Definition of value used.

c. Type of ownership interest being valued.

d. Legal or regulatory requirements, if any.

e. Data availability.

Purpose of the Engagement and Definition of Value. The purpose of the valuation can significantly affect the definition of value used, which in turn may affect the selection of valuation methods. Exhibit 2-3 illustrates some typical definitions of value and valuation methods based on the purpose of the engagement. It is important for consultants to obtain the definition of value before beginning the assignment.

Legal Requirements. Depending on the purpose of the engagement, the consultant may need to consider applicable legal requirements in selecting valuation methods. Legal requirements may apply in situations related to litigation (such as divorces or dissenting shareholder suits) or in meeting the requirements of a governmental agency (such as the IRS or Department of Labor). On those types of engagements, applicable statutes, regulations, or case law normally are an important, maybe the most important, factor to consider when selecting valuation methods. For example, if the court will not accept a discounted future returns method, the consultant should consider other methods instead, or in addition to, that method.

Exhibit 2-3

Examples of How the Purpose of the Engagement Can Affect the Selection of Valuation Methods

Purpose of the Engagement	Definition of Value	Possible Effect on Selection of Valuation Methods
Estate and gift tax	Fair market value	Emphasis on methods using data derived from market, especially guideline public companies
Dissenting shareholder lawsuit	Fair value	Selection of methods depends on case law in applicable state jurisdiction and methods commonly used in the financial community
Potential acquisition	Investment value or fair market value	Emphasis on discounted cash flows
Marital dissolutions	Fair market value or other definition of value, depending on case law in the applicable state jurisdiction	Selection of methods depends on the definition of value, which may vary based on case law in applicable state jurisdiction
Financial reporting	Fair value	Selection of methods depends on the consultant's judgment and assumptions. GAAP refers to these assumptions as inputs and uses a three-level hierarchy of value to assist in selecting the methods.

* * *

Type of Ownership Interest. The essence of valuation may be described as "What's in it for me?" Accordingly, valuations for controlling interests tend to focus on methods that reflect the benefit stream a controlling stockholder (or group) might receive by exercising its control. On the other hand, valuations for minority interests tend to focus on methods that reflect their current benefit streams, given their lack of control. Those benefit streams may differ from the benefit streams the controlling shareholder receives. Exhibit 2-4 illustrates how different methods may be used based on whether a controlling or minority interest is being valued.

Data Availability. Another factor which can affect the methods used on an engagement is the availability of useful data. If consultants are unable to obtain enough guideline data, then they cannot use methods based on value multiples. Similarly, if consultants cannot obtain reliable earnings or cash flow data for their subject companies, then they may need to use methods based on assets. When consultants cannot apply a method that is otherwise considered to be relevant to their engagements, they should consider disclosing that fact in their valuation reports.

Step 2—Consider Industry and Company Factors

It is important for consultants to consider industry and company factors in selecting valuation methods. To do that, the consultant will need to obtain and evaluate relevant company, industry, and economic data. Consequently, the consultant's selection of valuation methods will not be finalized until after the data gathering phase.

Exhibit 2-4

Examples of How Controlling versus Minority Interest Can Affect Valuation Methods

Valuation Method	Controlling Interest	Minority Interest
Discounted net cash flow	Typically, important to controlling shareholder, often reflecting benefit streams assuming exercise of control	Can be useful if it reflects the benefit stream currently receivable by the minority interests.
Capitalized net cash flow	Same as discounted net cash flow	Same as discounted net cash flow
Price/earnings (or other equity multiples)	Use control transactions, or minority transactions plus a control premium, when appropriate	Use minority transactions or control transactions, less a minority discount, when appropriate.
Market value of invested capital (MVIC) or other return to invested capital	Use control transactions and subtract long-term debt	Use minority transactions with consideration of a minority discount.
Net asset value	Generally suitable for controlling interests	Generally suitable for minority interests with minority interest discount.
Excess earnings method	Use control transactions if cash flows are adjusted	Use minority transactions if cash flows are unadjusted.

* * *

Industry Considerations. Some industries place emphasis on specific characteristics in determining value. For example, for accounting practices, the client base is an important consideration, and value is normally measured using parameters relating to the firm's client base, such as multiples of revenues, etc. The use of certain methods tends to result from common characteristics of the industry and companies in it, such as:

a. The amount of current and potential competition (and ease of entry into the industry).

b. Degree of financial risk (including leverage) of companies in the industry.

c. Historical and expected profitability, considering both revenues and cost structures.

d. Growth and development trends.

e. Length of product life cycle, and the industry's current status within that cycle.

f. Effects of current and expected economic conditions.

g. The market's perception of value based on a certain benefit stream or indicator.

h. Predictability of benefit streams.

The consultant should ascertain whether there are any standard practices for valuing businesses in the subject company's industry.

Company Factors. While industry factors can help guide the consultant to certain approaches or methods, the actual selection of methods may depend more on the characteristics of the company being valued. Even companies in the same industry may differ with respect to factors such as:

a. Financial condition.

b. Earnings history and growth trends.

c. Competitive strengths.

d. Depth and quality of management.

e. Dependence on key managers, customers, or suppliers.

f. Litigation or other contingencies.

g. Owner compensation arrangements.

Accordingly, the consultant generally needs an understanding of both the company and industry.

Step 3—Determine Whether Asset-based Methods and/or Earnings-based Methods Are Appropriate

After considering engagement requirements and company and industry factors, the next step is to determine whether the business should be valued based on its assets or its earnings. It is not uncommon for consultants to use both asset-based and earnings-based methods on the same engagement (e.g., using an asset-based method to set the lower limit on the value estimate). However, in such cases, the consultant may give greater weight to either the asset-based or the earning-based methods. The net asset value and liquidation value methods generally are considered asset-based methods. Sometimes, primarily in cases involving minority interests, the price/net asset value or price/book value methods may be used as asset-based methods. Generally, the other valuation methods discussed herein are considered earnings-based methods. In the sense used here, earnings-based methods also include cash flow, dividends, or similar benefit streams based on the company's operations.

If there are no legal or regulatory requirements affecting the engagement, the decision between asset-based and earnings-based methods should be made considering the operating characteristics of the company and industry. Exhibit 2-5 presents examples of conditions that may influence the degree of emphasis on asset-based methods versus earnings-based methods. Generally, the smaller and less predictable the return on the owner's investment, the more likely that the company has little goodwill value and the more likely that asset-based methods are appropriate. Accordingly, when valuing many small businesses, this step may be expressed as follows:

a. Determine the value of the business using an appropriate asset-based method.

b. Consider whether there is any goodwill or other intangible value.

Exhibit 2-5

Examples of Some Conditions That May Influence the Degree of Emphasis on Earnings-based versus Asset-based Valuation Methods[a]

Earnings-based Methods	Asset-based Methods
The company's future or normal operations can be estimated reliably.	The company has no earnings history, or its operations cannot be reliably estimated.
The company has a consistent, predictable customer base.	The company depends heavily on competitive contract bids, and there is no consistent, predictable customer base.
The company has distinctive products, services, or processes that might indicate intangible value.	The company has little or no value from labor or intangible assets.
The company's assets are primarily production assets, such as machinery and equipment.	A significant portion of the company's assets are composed of liquid assets or other investments (such as marketable securities, real estate investments, mineral rights, etc.).
There are significant barriers to entering the industry, such as high capital requirements.	It is relatively easy to enter the industry.
The company is likely to retain key personnel, or those individuals can be readily replaced without negatively affecting the business.	There is a significant chance of losing key personnel, which could have a substantial negative effect on the company.

Note:

[a] The consultant may use both earnings-based and asset-based methods on the same engagement. In such cases, greater weight is normally given to one of the two types of methods based on the circumstances.

* * *

Step 4—Consider Whether Guideline Data Is Available

The next step is to decide whether guideline data might be available. If adequate guideline data is available and earnings-based valuation methods are appropriate, then the consultant should consider methods involving value multiples (such as a price/earnings) based on guideline data items. If good guideline data items are available, they normally provide the best indicators of value. Although this step is more important when earnings-based methods are appropriate (see Step 3), it may also be important when valuing minority interests using asset-based methods. In recent years, there has been a proliferation of information on transactions.

Generally, the consultant must perform a search for guideline data (either public companies or private company transactions) before deciding whether value multiple methods can be used on an engagement. However, that should not be cause for concern to many consultants for two reasons:

a. The consultant normally selects more than one valuation method. Accordingly, even if suitable guideline data items are found, the consultant normally will select at least one other valuation method anyway.

b. The consultant may be able to make a preliminary search for guideline data items before beginning the engagement by searching on-line databases, calling business brokers, etc. Based on that preliminary search, the consultant may be able to determine whether suitable guideline data is likely to be available.

Step 5—Choosing Asset-based Valuation Methods

If the consultant decides that asset-based valuation methods are appropriate (Step 3), then the next step is to consider whether:

a. the company is likely to continue as a going concern, and

b. the company is worth more as a going concern than in liquidation.

If both criteria are met, then the company should be valued using the net asset value method or price/net asset value method (assuming benefit streams sustain the asset values), depending on the type of ownership interest. If the company is unlikely to continue as a going concern or if the company is worth more *dead than alive*, then the liquidation value method should be considered.

Step 6—Choosing Earnings-based Methods

Earnings-based valuation methods include all the methods except asset-based methods. Thus, earnings-based methods include:

a. Discounted future returns methods.

b. Capitalized returns methods.

c. Most value multiples methods using guideline data.

Selecting earnings-based methods depends on:

a. Expected future net cash flow/earnings.

b. Other considerations from Steps 1–4.

c. The benefit stream to be used in the valuation.

Considering Expected Future Net Cash Flow or Earnings. Discounted future returns methods may be used when the company's future operations (a) can be reasonably estimated and (b) are expected to differ significantly from current operations. If future operations are not expected to change significantly, then capitalized returns methods, value multiples methods, or other methods should be considered instead.

Guideline Data and Other Considerations. Value multiples generally should be considered whenever there is adequate guideline data, especially when earnings-based methods are appropriate. Another important consideration is whether there is any market data on prevailing units of comparison commonly used for valuing companies in the industry (such as using multiples of revenues, commission income, etc.). The other factors discussed in Steps 1–4 (such as, purpose of the valuation, type of ownership interest, legal or regulatory requirements, etc.) are also important.

Benefit Streams. Several different types of benefit streams may be used in valuing a company, including:

a. Net cash flow.

b. Earnings.

c. Dividends.

d. Revenues.

(With underlying asset methods, benefit streams are based on amounts realized from the sale of assets.)

The process of selecting earnings-based valuation methods also involves selecting an appropriate benefit stream. For example, if the consultant decides that a capitalized returns method is appropriate and that net earnings is an appropriate benefit stream, then the capitalization of earnings method will be selected.

Choosing a Benefit Stream. Generally, for a benefit stream to be suitable for valuation purposes, it should meet the following criteria:

a. *It Reasonably Reflects the Economic Benefits of Ownership.* An important consideration for methods that use net cash flow or earnings is that the owner's economic benefits should be quantifiable, especially owner's salary and perquisites. Some owners receive part of their ownership benefits through excess compensation or perquisites. When valuing controlling interests, failure to properly adjust for excess owner's compensation can result in inappropriate value estimates. If there is inadequate data regarding owner's compensation and perquisites, the consultant generally should consider another benefit stream instead of net cash flow or earnings.

b. *It Can Be Reliably Estimated.* Obviously, the consultant cannot use a benefit stream to value the business if the company data relating to it is known to be inaccurate. Thus, if net cash flow or earnings cannot be reliably estimated, then another benefit stream (such as revenue) should be considered.

c. *It Can Be Reasonably Compared to Market Data.* The consultant should be able to reasonably relate market rates of return and value multiples to the appropriate benefit stream. For example, to use revenue as the benefit stream, the consultant should be able to reasonably relate guideline price/revenue data to the business being valued. Since most companies are sold assuming some level of profitability (or profit capacity), the consultant needs to be able to determine some relationship between revenue and profitability among the guideline data items and the business being valued before developing an appropriate value multiple. If that relationship cannot be determined, then other benefit streams may need to be considered or the valuation method may be given less weight in arriving at a final value estimate.

d. *The Benefit Stream Is Neither Negative Nor Marginally Positive for the Company Being Valued or Guideline Data Items.* To develop and apply appropriate capitalization rates or value multiples, the consultant needs a benefit stream that is neither negative nor marginally positive. Sometimes if the current period benefit stream is negative or marginal, it may be appropriate to use average benefit streams for a period of years as an estimate of future benefit streams. However, in such cases the average cannot be negative or marginally positive. This guidance applies for both the company being valued and guideline data items.

Also, the consultant should consider prevailing units of comparison in the industry.

Benefit Stream with Net Normalized Losses. If a benefit stream is negative after normalization adjustments are made, the valuation consultant should consider the following options:

- Convert to a *discretionary earnings* benefit stream. Discretionary earnings is most commonly defined as the company's pretax earnings plus owners' compensation and benefits, interest expense, and noncash expenses (depreciation, amortization, and impairment), less any recurring capital expenditures. By adding back these expenses, the benefit stream is less likely to remain negative.

- Perform the valuation using the market approach with a price/revenue multiple.

- Perform the valuation using an asset-based approach. With this approach, the use of a benefit stream is eliminated. However, this approach generally applies to companies with little value beyond the value of their tangible assets. In many instances, this option is not applicable or only used as a last resort, if neither discretionary earnings nor revenues can be estimated.

Case Study—Selecting Valuation Methods

The following case study illustrates how various factors may affect the selection of valuation methods. This case study presents one approach to selecting valuation methods. However, many other approaches to selecting valuation methods may be used, depending on the circumstances.

Background. WGM Distributors, Inc., a New Jersey corporation, is a wholesale produce company owned equally by three brothers—Will, Gary, and Mike Jones. Mike is planning to leave the business, and the other brothers have agreed to buy Mike's stock for its fair market value as of December 31, 20X1. WGM is a profitable company with an established earnings history, and its earnings are expected to grow at a stable rate for the next few years. (Note that in this case study there are no legal or regulatory requirements to consider.)

Asset-based versus Earnings-based Methods. After obtaining information regarding the definition of value, valuation date, and ownership interest, the consultant must decide whether asset-based or earnings-based valuation methods should be used primarily on the engagement. Exhibit 2-5 discusses factors to consider in making that decision. Based on the WGM's industry and history of profitability, earnings-based valuation methods generally would be more appropriate for valuing WGM.

Considering Value Multiples Methods Based on Guideline Data. The next step in the selection process is to decide whether adequate guideline data items might be available. This decision generally cannot be made until a search for guideline data is performed. Assuming adequate guideline data is available, the consultant also must choose an appropriate benefit stream to use in valuing the company. If reliable earnings data is available, then net earnings is generally the preferred benefit stream for many companies, including WGM, when using a value multiples method. Accordingly, if suitable data is available, the consultant should consider using the price/earnings method.

Considering Expected Future Net Cash Flow or Earnings. In addition to a value multiples method (which is based on the market approach), the consultant also should consider using a second method to value WGM. Accordingly, the next step in the selection process is to consider whether future net cash flow/earnings is expected to change significantly from current levels. Since WGM's earnings are expected to grow at a stable rate, the consultant should consider using the capitalization of net cash flow method or the excess earnings method. If only one method will be used, the capitalization of net cash flow method generally is preferred over the excess earnings method. However, sometimes the consultant may decide to use both the capitalization of net cash flow method and the excess earnings method on the same engagement, especially when valuing small businesses.

Based on the preceding paragraphs, the primary valuation methods that should be considered for valuing the one-third interest in WGM are as follows:

a. Price/earnings multiple method using guideline data items.

b. Capitalization of net cash flow method.

c. Excess earnings method.

Always Use Judgment

This lesson provides some general guidance regarding selecting valuation methods. Sometimes there may be exceptions or cases when the choice of valuation methods is not clear. Besides possible legal requirements, there are few, if any, absolute criteria for selecting valuation methods. Accordingly, the consultant must use judgment in weighing the relevant factors and selecting appropriate valuation methods.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. Bill, CPA, should follow several general steps in determining which valuation method is most appropriate for a specific engagement. Which of the following is the first step in the selection process?

    a. Consider industry and company factors, including common valuation practices for the particular industry.

    b. Decide whether asset-based methods and/or earnings-based methods are appropriate for the valuation.

    c. Consider the requirements of the engagement.

    d. Consider whether adequate guideline data is available.

27. In which of the following situations would a valuation consultant be most likely to consider the legal requirements in a valuation engagement?

    a. Purchasing all or partial interest in a business.

    b. Selling all or partial interest in a business.

    c. Dissenting shareholder suits.

    d. Preparing personal financial statements.

28. If the purpose of the engagement is a dissenting shareholder lawsuit, the definition of value is:

    a. Fair market value.

    b. Fair value.

    c. Investment value.

    d. State-specific definition of value.

29. The third step Bill, CPA, should follow in applying the valuation method selection process is to:

    a. Consider whether guideline data is available.

    b. Choose asset-based valuation methods.

    c. Choose earnings-based methods.

    d. Determine whether asset-based methods and/or earnings-based methods are appropriate.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

26. Bill, CPA, should follow several general steps in determining which valuation method is most appropriate for a specific engagement. Which of the following is the first step in the selection process? **(Page 75)**

    a. Consider industry and company factors, including common valuation practices for the particular industry. [This answer is incorrect. This is general Step 2 in selecting valuation methods based on the general steps most valuation consultants follow.]

    b. Decide whether asset-based methods and/or earnings-based methods are appropriate for the valuation. [This answer is incorrect. This is general Step 3 in selecting valuation methods that valuation consultants follow.]

    c. Consider the requirements of the engagement. [This answer is correct. The first step in the selection process is to consider the requirements of the engagement. Subsequent steps are based on the requirements of the engagement.]

    d. Consider whether adequate guideline data is available. [This answer is incorrect. Using the guidelines that most consultants follow, this is general Step 4 in selecting valuation methods.]

27. In which of the following situations would a valuation consultant be most likely to consider the legal requirements in a valuation engagement? **(Page 77)**

    a. Purchase of all or partial interest in a business. [This answer is incorrect. Considering the legal requirements would generally not be necessary when purchasing all or partial interest in a business since purchase of interest in a business is considered a normal business transaction not involving the courts.]

    b. Selling all or partial interest in a business. [This answer is incorrect. When selling all or partial interest in a business, it would not normally be necessary to consider the legal requirements of such action unless such sale involves legal disputes.]

    c. Dissenting shareholder suits. [This answer is correct. Considering legal requirements would be a must in the case of lawsuits by dissenting shareholders since there will be enforceable applicable statues, regulations and case law.]

    d. Preparing personal financial statements. [This answer is incorrect. Preparing personal financial statements does not necessitate that legal requirements be considered since no litigation is involved.]

28. If the purpose of the engagement is a dissenting shareholder lawsuit, the definition of value is: **(Page 78)**

    a. Fair market value. [This answer is incorrect. Fair market value is generally used as the definition of value in estate and gift tax engagements since the emphasis would be on methods derived from the market.]

    b. Fair value. [This answer is correct. If the purpose of the engagement is a dissenting shareholder lawsuit, the definition of value is fair value of the shares of the company. This is how the company would be valued.]

    c. Investment value. [This answer is incorrect. Investment value is generally used as the definition of value if the purpose of the engagement is a potential acquisition based on what investors would be willing to pay for the company.]

    d. State-specific definition of value. [This answer is incorrect. Generally in engagements involving marital dissolution, the definition of value is fair market value or other definition of value, depending on case law in the applicable state jurisdiction situations can differ in these instances, which would changes the definition of value.]

29. The third step Bill, CPA, should follow in applying the valuation method selection process is to: **(Page 80)**

   a. Consider whether guideline data is available. [This answer is incorrect. Considering whether guideline data is available is Step 4. A consultant will generally perform a search for guideline data before deciding whether value multiple methods can be used on an engagement.]

   b. Choose asset-based valuation methods. [This answer is incorrect. Choosing asset-based valuation methods is Step 5. An additional step is required before choosing asset-based valuation methods.]

   c. Choose earnings-based methods. [This answer is incorrect. Choosing earnings-based methods is Step 6. Additional steps are required before choosing earnings-based methods.]

   d. Determine whether asset-based methods and/or earnings-based methods are appropriate. [This answer is correct. Step 3 is to determine if a business should be valued on its assets or earnings. Both asset-based and earnings-based methods may be used on the same engagement and is not uncommon. When both methods are used, a consultant may give greater weight to one method or the other.]

VALUATION METHODS RELATING TO VERY SMALL BUSINESSES

This lesson discusses valuation approaches and methods applicable to businesses of all types and sizes. However, because of the number of very small businesses, it is likely that valuation consultants will primarily be called upon to value small businesses. This lesson will provide some guidance into the methods used for valuing very small businesses.

What Is a Very Small Business?

No research exists that would serve to categorize small businesses by size of revenue, numbers of employees, or number of locations. Although a small business is generally closely held, a closely held business is not necessarily a small business. Within the realm of small businesses, there are those enterprises that are especially small, such as a single store pizza parlor. Because these businesses are usually owner operated, they are often referred to as *Mom and Pop* or *Main Street* businesses. This lesson refers to these enterprises as very small businesses.

Very small businesses tend to have certain common characteristics. The following are some of the more important characteristics:

a. The owners are usually the managers of the business. Therefore, the viability of a proposed purchase of a very small business considers both return on labor (the owner's salary) and return on capital.

b. Absent any need for third-party review, the financial reporting emphasizes minimization of the business's taxable income. Therefore, earnings may tend to be understated.

c. Accounting records are generally on the cash basis and are typically not very detailed.

d. The legal form of entity is relatively unimportant. Many very small businesses are sole proprietorships, though many elect S or C corporation status due to a desire to limit liability or reduce taxes.

One of the most important distinguishing features of a very small business is that the owners are involved in the day-to-day operations of the business. Thus, the buyers of such businesses are often motivated by the desire to purchase a job or career.

Purchase and Sale Characteristics of Very Small Businesses. Since very small businesses involve buyers and sellers who are motivated by the purchase of a job, these owner/operators often measure their total return based on salary, benefits, and profits. Therefore, the purchase and sale of very small businesses have some of the following characteristics:

a. The buyer's perception of the business's potential is a key factor in its marketability.

b. These businesses are usually sold via an asset purchase.

c. The terms of the sale and collateral are key components of the price eventually paid.

d. Buyers and sellers may be ruled by emotion.

Valuation Methods Relating to Very Small Businesses

It should be evident that small businesses are risky. Many of these businesses fail within the first year of their existence. Some of the reasons are as follows:

a. Lack of capital.

b. Poor management.

c. No business experience.

d. Inadequate planning.

In view of the above characteristics, there are certain valuation methods that are more appropriate to these businesses than other valuation methods. The following is a brief discussion of the applicability of certain valuation methods to very small businesses.

Multiple of Discretionary Earnings Method. The multiple of discretionary earnings method is a valuation method that is often used to value very small businesses. This method may produce the investment value of the business rather than the fair market value. However, this method has been used so frequently to value very small businesses that it may constitute an industry norm.

Excess Earnings Method. The excess earnings method is also frequently used to value very small businesses. It may be considered a combination of an asset-based approach, in which an amount is paid for tangible assets of a business, plus a negotiated amount for intangible assets based on capitalized *excess earnings* (if there are any).

Guideline Transaction Method. Valuation methods using guideline transactions are also useful. In this sense, we are not referring to the price of guideline publicly traded enterprises, but sales of actual very small businesses. In this instance, the practitioner should contact business brokers, business owners, and other professionals in an effort to develop transaction information. Sometimes, this is reduced to a rule of thumb in an industry. This can be useful if the rule of thumb is based on actual transaction information.

Guideline transaction data for very small businesses is not widely available. However, *Done Deals®*, *BIZCOMPS®*, the IBA Market Data File, and *Pratt's Stats™* are four sources of guideline information that may be useful as references in valuing very small businesses.

a. *Done Deals.* Done Deals is a computerized database of over 8,900 mid-market transactions that provides data such as price, term, and seller financials and ratios for every transaction reported. Approximately 50% of the deals are under $15 million, and approximately 75% of the selling companies are privately owned. The online version of Done Deals is updated weekly and may be purchased at **www.donedeals.com** or by calling (800) 323-8724.

b. *BIZCOMPS.* BIZCOMPS is a study of recent small business sales compiled by a business broker. The studies have been published for over fifteen years, and the data is divided into Western, Central, Eastern, and National Industrial editions. The database currently includes information on over 10,250 actual sales.

c. *IBA Market Database.* IBA Market Database is a computerized database compiled by the Institute of Business Appraisers. The database contains information on over 34,000 sales of both mid-sized and small closely held companies.

d. *Pratt's Stats.* Pratt's Stats is an online database that is updated monthly. The database provides up to 88 data points on over 14,600 private and closely held company transactions. Many of the transactions in the database include a detailed balance sheet, income statement, transaction terms, purchase price allocation, noncompete and employment agreement terms, and other data.

Because of the limited sample size and other data limitations, it is recommended that the above resources be used only as references. The data is not a substitute for in-depth research.

In the valuation of very small businesses, it is important that comparable information be timely, relevant, and sufficiently detailed to allow meaningful comparison. When relevant data about the transaction and the buyer and seller is available, the guideline transaction method can be used as a primary valuation method. Additionally, the data may be useful as a *sanity check*.

Methods That May Not Be Particularly Useful in Valuing Very Small Businesses

Stock prices of guideline publicly traded corporations are usually not helpful in valuing very small businesses. The differences between the publicly traded firms and the very small businesses are usually too great to allow meaningful comparison. The practitioner should look for guideline transactions, but will usually not find them in the sales price of publicly traded guideline companies.

Since very small businesses are usually risky, their future performance is somewhat uncertain. The mortality rate of very small businesses is such that a prediction of an entity's long-term performance may not be possible. Accordingly, a discounted cash flow or discounted future earnings method using a specific five-year or ten-year time horizon often is not appropriate.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

30. Which of the following valuation methods used to value very small businesses may produce the investment value of the business?

    a. Multiple of Discretionary Earning Method.

    b. Excess Earnings Method.

    c. Guideline Transaction Method.

31. There are four sources of guideline transaction data that may be useful as references in valuing very small businesses. Which of those sources has a database with many transactions that include a detailed balance sheet, income statement, transaction terms, and other data?

    a. *Done Deals*.

    b. BIZCOMPS.

    c. IBA Market Data File.

    d. *Pratt's Stats*.

32. Which of the following methods is useful in valuing very small businesses?

    a. Stock prices of guideline publicly traded corporations.

    b. Excess Earnings Method.

    c. Discounted Cash Flow Method.

    d. Discounted Future Earnings Method.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this course. **(References are in parentheses.)**

30. Which of the following valuation methods used to value very small businesses may produce the investment value of the business? **(Page 89)**

    a. Multiple of Discretionary Earnings Method. [This answer is correct. This method may produce the investment value of the business rather than the fair market value. It should be noted, however, that this method has been used so frequently to value very small businesses that it may constitute an industry norm.]

    b. Excess Earnings Method. [This answer is incorrect. The Excess Earnings Method may be considered a combination of an asset-based approach, in which an amount is paid for tangible assets of a business, plus a negotiated amount for intangible assets based on capitalized *excess earnings* (if there are any).]

    c. Guideline Transaction Method. [This answer is incorrect. When using the Guideline Transaction Method, the practitioner should contact business brokers, business owners, and other professionals in an effort to develop transaction information. In some cases, this is reduced to a rule of thumb in an industry. This can be useful if the rule of thumb is based on actual transaction information.]

31. There are four sources of guideline transaction data that may be useful as references in valuing very small businesses. Which of those sources has a database with many transactions that include a detailed balance sheet, income statement, transaction terms, and other data? **(Page 89)**

    a. *Done Deals*. [This answer is incorrect. Done Deals is a computerized database of over 8,900 mid-market transactions that provides data covering things such as price, term, and seller financials and ratios for every transaction reported.]

    b. BIZCOMPS. [This answer is incorrect. BIZCOMPS is a study of recent small business sales assembled by a business broker. The studies have been published for more than a decade, with the data being divided into Western, Central, Eastern, and National Industrial editions.]

    c. IBA Market Data File. [This answer is incorrect. IBA Market Database is database that has been compiled by the Institute of Business Appraisers for IBA members. The database contains information on over 34,000 sales of both small, closely held and mid-sized companies.]

    d. *Pratt's Stats*. [This answer is correct. Pratt's Stats is an online database that is updated monthly. The database provides a wide array of data points on over 14,600 private and closely held company transactions. Numerous transactions in the database include a detailed balance sheet, income statement, transaction terms, purchase price allocation, noncompete and employment agreement terms, among other data.]

32. Which of the following methods is useful in valuing very small businesses? **(Page 89)**

    a. Stock prices of guideline publicly traded corporations. [This answer is incorrect. In valuing very small businesses, stock prices of guideline publicly traded corporations are generally not helpful. The differences between the publicly traded firms and the very small businesses are usually too great to allow meaningful comparison.]

    b. Excess Earnings Method. [This answer is correct. The excess earnings method is many times used to value very small businesses. It may be considered a combination of an asset-based approach, where an amount is paid for tangible assets of a business, plus a negotiated amount for intangible assets based on capitalized *excess earnings*, if there are any.]

c. Discounted Cash Flow Method. [This answer is incorrect. Because very small businesses are usually risky, their future performance many times cannot be determined. The failure rate of very small businesses indicates that a prediction of an entity's long-term performance maybe difficult at best. Therefore, a discounted cash flow method using a specific five-year or ten-year time horizon often is not appropriate.]

d. Discounted Future Earnings Method. [This answer is incorrect. Because very small businesses have a high risk factor, their future performance is often unpredictable. The failure rate of very small businesses highlights that a prediction of an entity's long-term performance may not be possible. Accordingly, a discounted future earnings method using a specific five-year or ten-year time horizon often is not appropriate.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (VALTG101)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook.

13. Bill is attempting to ascertain value in a variety of engagements he is seeking to complete. Which of the following would **not** be a definition of value that Bill could rely on in performing his valuation engagements?

    a. Intrinsic value.

    b. Perceived value.

    c. Fair value.

    d. Book value.

14. When performing business valuations, which of the following statements best represents the definition of value?

    a. Going concern value is commonly used by the IRS.

    b. Fair value is used in the same context as that used in accounting literature.

    c. Value is a precise term easily defined in all situations.

    d. Fair market value is the most common definition of value.

15. Selling a company's assets over a reasonable time period to get the highest price for each is described by which of the following definitions of *value*?

    a. Intrinsic Value.

    b. Going Concern Value.

    c. Liquidation Value.

    d. Book Value.

16. Which of the following methods would be used with the Market Valuation Approach?

    a. Rules of thumb.

    b. Net asset value.

    c. Liquidation value.

    d. Excess earnings.

17. Which of the following valuation methods is used with the income approach?

    a. Excess earnings method.

    b. Capitalized returns methods.

    c. Value multiples involving guideline public company data.

    d. Value multiples involving guideline transactions.

18. Which of the following two valuation methods are similar?

    a. Discounted future returns and value multiples involving guideline transactions methods.

    b. Discounted future returns and underlying asset methods.

    c. Discounted future returns and capitalized returns methods.

    d. Discounted future returns and excess earnings methods.

19. Which of the following methods uses a company's operating results in estimating value?

    a. Discounted future returns and capitalized returns methods.

    b. Net asset value method.

    c. Liquidation value method.

    d. Excess earnings method.

20. Patty is attempting to determine what requirements should apply in selecting valuation methods for the engagement she is currently working on. All of the following requirements should be considered by Patty except:

    a. The definition of value.

    b. The engagement's purpose.

    c. Certifications held by the valuation consultant.

    d. The type of company being valued.

21. Once Patty has determined which requirements to consider, her next step should be to:

    a. Determine whether asset-based methods and/or earnings-based methods are appropriate.

    b. Consider company and industry factors.

    c. Choose asset-based valuation methods.

    d. Determine whether guideline data is available.

22. Which of the following valuation methods for valuing minority interest can be useful if it reflects the benefit stream currently receivable by the minority interests?

    a. Price/earnings (or other equity multiples).

    b. Discounted net cash flow.

    c. Net asset value.

    d. Excess earnings method.

23. Valuations for controlling interest that use control transactions, or minority transactions plus a control premium, when appropriate, should use which valuation method?

    a. Capitalized net cash flow.

    b. Market value of invested capital (MVIC) or other return to invested capital.

    c. Price/earnings (or other equity multiples).

    d. Net asset value.

24. Valuations for minority interest that use minority transactions or control transactions, less a minority discount (when appropriate), should use which of the following valuation methods?

    a. Capitalized net cash flow.

    b. Net asset value.

    c. Excess earnings method.

    d. Price/earnings (or other equity multiples).

25. Which of the following valuation methods should be used for valuing controlling interest using control transactions and subtracting long-term debt?

    a. Net asset value.

    b. Discounted net cash flow.

    c. Market value of invested capital (MVIC) or other return to invested capital.

    d. Excess earnings method.

26. For minority interests with minority interest discount, which valuation method should be used?

    a. Price/earnings (or other equity multiples).

    b. Net asset value.

    c. Excess earnings method.

    d. Capitalized net cash flow.

27. When considering a valuation engagement where there is minority interest and the discounted net cash flow reflects the benefit stream currently receivable by the minority interests, which other valuation method could be considered?

    a. Capitalized net cash flow.

    b. Price/earnings (or other equity multiples).

    c. Net asset value.

    d. Excess earnings method.

28. In cases where there are no legal or regulatory requirements affecting the engagement, deciding between asset-based and earnings-based methods should include considering the operating characteristics of the company and industry. As a result, which situation below describes the decision to choose an appropriate valuation method?

    a. In most cases, the smaller and less predictable the return on the owner's investment, the more likely that the company has little goodwill value and more likely that earnings-based methods are appropriate.

    b. In most cases, the smaller and less predictable the return on the owner's investment, the more likely that the company has little goodwill value and the more likely that asset-based methods are appropriate.

    c. In most cases, the smaller and less predictable the return on the owner's investment, the more likely that the company has greater goodwill value and the more likely that earnings-based methods are appropriate.

    d. In most cases, the larger and more predictable the return on the owner's investment, the more likely that the company has little goodwill value and the more likely that asset-based methods are appropriate.

29. There are a number of criteria that should be met by a benefit stream in order for it to be deemed suitable for valuation purposes. Which of the following is not one of those criteria?

    a. The owner's economic benefits should be determinable.

    b. Company data related to a benefit stream must be accurate.

    c. It can stand on its own merit and does not need to be compared to market data.

    d. It is neither marginally positive nor negative for the company being valued, or guideline data items.

30. Which of the following characteristics can be used to categorize a company as a very small business?

    a. Size of revenue.

    b. Typically, owners are the managers of the business.

    c. Number of employees.

    d. Number of locations.

GLOSSARY

Appraisal: An opinion or estimate of the value of a property or business.

Audit Evidence: The term evidential matter has been replaced by audit evidence. Auditing theorists drew a distinction between the things the auditor obtained, such as supporting source documents and confirmation responses, which were evidential matter, and their significance to the auditor's judgment. Evidential matter became evidence after being evaluated by the auditor. This theoretical distinction has been discarded. SAS No. 106, paragraph 2, states:

> Audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based and includes the information contained in the accounting records underlying the financial statements and other information.

Audit Plan: The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members to obtain sufficient appropriate evidence. The audit plan is commonly referred to as the audit program.

Audit Strategy: The audit strategy (previously called the audit plan) is the auditor's operational approach to achieving the objectives of the audit. It is a high-level determination of the audit approach by audit area. It includes the identification of audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the general approach to each audit area as being substantive procedures or a combined approach of substantive procedures and tests of controls. The risk assessment standards require that the auditor establish the overall strategy for the audit.

Closely Held Business: A business that is owned by relatively few stockholders (or partners) and is not publicly held, i.e., not traded on a national or local stock exchange or in the over-the-counter market.

Further Audit Procedures: Further audit procedures are procedures an auditor performs in response to the assessed risks to reduce the overall audit risk to an appropriately low level. They consist of substantive procedures, tests of controls, and other procedures, sometimes referred to as general procedures.

Reasonable Assurance: The scope paragraph of the auditor's report includes a statement that generally accepted auditing standards (GAAS) require audits to be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement. That statement introduces the concept of materiality to the audit report and the auditor's responsibility for detecting errors or fraud. SAS No. 104 amends paragraph 10 of SAS No. 1 to expand the definition of reasonable assurance. SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of audit assurance.

Relevant Assertions: The assertions that are relevant for a particular class of transactions, account balance, or disclosure are those that have a meaningful bearing on whether the item is fairly stated. A routine example is that the valuation assertion is usually not relevant to the cash account unless currency translation is involved. Another example is that the valuation assertion is usually not relevant to the gross amount of the accounts receivable balance, but is usually relevant to the related allowance for doubtful accounts.

> Auditors have generally focused on those assertions that have some realistic chance of being misstated for a particular item. The risk assessment standards give prominent recognition to the idea of relevant assertions. References to "decisions made at the relevant assertion level" mean decisions made about the relevant assertions within a class of transactions, account balance, or disclosure.
>
> Under the risk assessment standards, the auditor assesses risks of material misstatement at the relevant assertion level and designs audit procedures to mitigate that assessed risk.

Risk Assessment Procedures: According to SAS No. 106, paragraph 20, risk assessment procedures are a defined category of audit procedures performed near the beginning of an audit to obtain an understanding of the entity and its environment, including its internal control, for the purpose of assessing the risks of material misstatement at the financial statement and relevant assertion levels. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures. Risk assessment procedures consist of inquiry, observation, inspection, and analytical procedures.

Risk of Material Misstatement: The risk of material misstatement is the likelihood of a misstatement of the financial statements of a material amount. The auditor should assess this risk at both the financial statement level and at the relevant assertion level. At the financial statement level, it is an overall assessment. At the relevant assertion level, it is the combination of the auditor's assessment of inherent risk and control risk. The auditor can make a combined assessment of inherent and control risk or assess the component risks separately and then combine them.

Significant Risks: A risk is a significant risk if an analysis of inherent risk indicates that the likely magnitude of the potential misstatement and the likelihood of the misstatement occurring are such that they require special audit consideration. The determination of whether a risk requires special audit consideration is based on an assessment of inherent risk and does not include consideration of controls. Significant risks generally relate to nonroutine transactions (i.e., transactions that are unusual due to their size or nature) and complex or judgmental matters. Transactions that are routine, noncomplex, and subject to systematic processing have lower inherent risks and are less likely to involve significant risks. Identified fraud risks are significant risks.

Sufficient, Appropriate Evidence: The term sufficient, competent evidence has been replaced by sufficient, appropriate evidence. Appropriate has essentially the same meaning as competent, and the change was made only to achieve compatibility with International Standards of Auditing (ISA) issued by the International Auditing and Assurance Standards Board. ISAs use the term sufficient, appropriate evidence. Similarly, ISAs use the term substantive procedures rather than substantive tests, and this convention has been adopted in the risk assessment standards.

Those Charged with Governance: Another change made to achieve compatibility with the terms used in ISAs is the change from audit committee to those charged with governance. The reference to those charged with governance is more general and encompasses those situations in which an entity does not have an audit committee, but has a group responsible for oversight of financial reporting.

Valuation: Estimated worth or price.

Valuation Engagement: A valuation engagement involves arriving at an opinion regarding the estimated value of an ownership interest in a business entity (company) as of a given point in time. The ownership interest valued may be the company's common equity or its total capital, which includes both interest-bearing debt and equity.

Value: The worth of all the rights arising from ownership.

Value Multiples: Value multiples are market-derived factors used to determine the value of a business or ownership interest (or fractional interest therein).

INDEX

COMPANION TO PPC'S GUIDE TO BUSINESS VALUATIONS

COURSE 2

Data Gathering and Analysis and Various Business Valuation Methods (VALTG102)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course covers various topics related to business valuations, including data gathering and analysis, as well as a variety of methods of business valuation.
PUBLICATION/REVISION DATE:	March 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Business Valuations*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	7 QAS Hours, 7 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Specialized Knowledge and Applications
EXPIRATION DATE:	Postmark by **March 31, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Gathering and Analyzing Data

Completion of this lesson will enable you to:
- Describe data gathering and how internal company information is used in business valuations.
- Identify economic, industry, and market data and their impact on valuations.
- Describe the review, adjustment, and analysis of financial statements.

Lesson 2—Business Valuation Methods

Completion of this lesson will enable you to:
- Identify the various underlying assets methods and when they should be applied.
- Describe the multiple of discretionary earnings method and to what businesses it is best suited.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

> **Thomson Reuters**
> **Tax & Accounting—R&G**
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Lesson 1: Gathering and Analyzing Data

INTRODUCTION

After the consultant completes the pre-engagement procedures, the focus of the work shifts to the data gathering and analysis stage. There is a natural temptation to skim over this phase of the engagement because the fun part (performing the valuation calculations) is yet to come. However, much like a house painter who must spend hours scraping, sanding, caulking, and priming before applying the paint, the valuation consultant also must spend enough time and attention to data gathering and analysis to develop a proper valuation conclusion.

This lesson first discusses what information is needed and how to obtain it; second, how to analyze and adjust the data; and third, introduces a case study that illustrates the types of adjustments typically made to financial statements during a valuation engagement.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe data gathering and how internal company information is used in business valuations.
- Identify economic, industry, and market data and their impact on valuations.
- Describe the review, adjustment, and analysis of financial statements.

DATA GATHERING

By the time the data-gathering phase begins, the consultant often has made a preliminary assessment of possible valuation methods that may be used on the engagement. That preliminary assessment is made during the pre-engagement phase based on the consultant's cursory knowledge of the business, the definition of value used, the size of the ownership interest being valued, and other factors. Now the consultant should gather as much meaningful data as possible (or practical) to perform the valuation.

What Type of Data Should Be Gathered?

Depending on the valuation methods selected, the valuation consultant would want to gather some or all of the following data about the company being valued:

a. Financial information.

b. Legal documents concerning ownership information.

c. Operational data.

d. Economic and industry information.

e. Market data.

The preceding list of data is what the consultant would hope to obtain on every engagement. However, rarely will all that data be available. Thus, the consultant should approach each engagement pragmatically—knowing that some data may not be available and looking for creative alternatives to compensate for missing data.

Collect Data That Is Available or Determinable as of the Valuation Date

It is important to note that valuation consultants should only gather data that was available or discernable as of the valuation date. Although the valuation process is concerned with the future benefits of ownership, the consultant must approach the engagement from the perspective of the valuation date. That means the consultant can only use information that was available or determinable as of the valuation date. However, this may not be entirely true in estate and gift tax matters.

Use a Checklist to Determine What Is Available

One technique that can improve the efficiency and effectiveness of data gathering is the use of a data-gathering checklist. The checklist can be especially useful for engagements relating to litigation. The consultant can indicate on the checklist those items that are needed, give a photocopy to the owner or company management to use as a "to do" list, and file the original in the workpapers. On more formal engagements, the consultant may wish to request the data in a formal letter.

INTERNAL COMPANY INFORMATION

Financial Information

The financial information that is normally used on valuation engagements includes:

a. Historical financial statements, both annual and interim, for a relevant period.

b. Federal and state tax returns.

c. Prospective financial statements, when available.

d. Other accounting data, if needed.

Historical Financial Statements for Five Years

Historical financial statements are important for identifying key variables and trends for valuation analysis. Accordingly, complete financial statements (including footnotes and any supplemental data) should be obtained for a sufficient, relevant period to allow reliable analysis. Generally, the consultant should obtain year-end financial statements for the most recent five years preceding the valuation date. A longer period may be needed if (a) significant changes such as technological trends, product shifts, or environmental changes have occurred or (b) the five-year period is not long enough to assess the company's performance during changes in its business cycle or economic conditions. Sometimes a period less than five years may be appropriate if the company's operations have changed significantly in recent years, such as through mergers, divestitures, or changes in product lines.

What If Financial Statements Have Not Been Prepared for the Last Five Years? If financial statements for the most recent five years are not readily available, the consultant should try to improvise to overcome the lack of data. The following considerations may be helpful when this situation arises:

a. *Use Tax Returns for the Missing Years*. If financial statements are not available for some years, the consultant may be able to use financial data from tax returns. However, several adjustments may be needed to the tax financial data to permit comparable, meaningful analysis. If the analyst (or the analyst's firm) did not audit, review, compile, or attest to the financial information in the tax return, the analyst should state that fact and should also (1) identify the tax returns used and any existing relationship between the valuation analyst and the tax preparer and (2) state that the analyst assumes no responsibility for the derived financial information. This is generally disclosed in the assumptions and limiting conditions section of the valuation report.

b. *Prepare a Working Trial Balance for the Missing Years*. Another approach to compensate for the lack of financial statement data is to develop trial balances from prior years' general ledgers. Each trial balance can be used in place of formal financial statements for the missing years to identify trends.

c. *Reevaluate Whether Prior Years' Financials Are Needed*. In some valuation engagements, a lack of some financial data may not be a major handicap. For example, the consultant may not need five years' financials to value businesses that have experienced rapid growth recently. Instead, only the most recent year's financial statements may be used. In another case, only current financial statements may be needed if the consultant has previously determined that an underlying asset method is most appropriate for valuing the company.

What If the Company Changed Its Legal Status during Recent Years? Sometimes the consultant may find that the company has changed its legal status during recent years, that is, from a proprietorship to a corporation, from a corporation to an S corporation, etc. In such cases, the consultant should still try to obtain relevant years' financial statements and adjust those statements, if necessary, to develop a picture of what the company's operations would have been if it always had its current legal status.

What If the Company Being Valued Has Ownership Interests in Other Companies? Occasionally, the consultant will find a complex valuation situation where the company being valued has major ownership interests in several other companies. In those cases, the consultant may also need to request financial statements of the related companies to get a true picture of the company being valued. The consultant should be cautious in such situations about relying on consolidated tax return data instead of financial statements, because the consolidation rules for income tax returns often differ from those for financial statements.

Interim Financial Statements. Besides annual financial statements, the consultant should also consider obtaining interim statements. Interim statements are helpful or necessary in the following situations:

a. *Valuing at a Date Other Than Year End*. If the valuation date is a date other than the company's fiscal year end, the consultant should obtain financial statements as of that interim date or, more typically, the month or quarter ended immediately prior to or closest to the valuation date. Preferably, the consultant should obtain statements for the most recent 12 months and the preceding 12 months.

b. *Identifying Trends within the Fiscal Year*. Even when the valuation date is the company's year end, the consultant should consider obtaining interim statements for each of the 12 months comprising the fiscal year if it would be useful to identify seasonal changes and market trends.

As a final caution, it should be noted that the accounting principles applied to interim statements often are not consistent with those applied to annual statements. This is a limitation associated with using interim statements.

Subsequent Events

Business valuations often occur well after the established valuation date. This time lag increases the probability for notable events, additional financial information, comparable transactions, or even the sale of the subject business to occur. Should these subsequent events affect the subject entity's value as of the valuation date?

Paragraph 43 of SSVS No. 1 (VS 100.43) states that subsequent events "are indicative of conditions that were not known or knowable at the valuation date, including conditions that arose subsequent to the valuation date." Because valuation analysts should consider only circumstances existing at the valuation date and events occurring up to the valuation date, SSVS No. 1 states that subsequent events should not affect the conclusion of value. (However, in certain circumstances, subsequent events may be disclosed in the valuation report, but the disclosure must be included in a separate section of the report and clearly state that the subsequent event is for informational purposes only and does not affect the conclusion of value.)

Known or Knowable. Generally, fair market value should include information that is known by any party to the transaction, as well as any information that may not be apparent at the valuation date but would have been knowable at the time by those involved. What is knowable at the valuation date is not always clear. In some instances, the courts have gone to great lengths to show that something may have been knowable at the valuation date. Michael Mard of the Financial Valuation Group produced a compendium of cases spanning the 1929 to 2005 period dealing with the issue of what was known or knowable.

Subsequent Period Financial Statements. Business valuations should be based on information that is available or determinable as of the valuation date. Accordingly, financial statements for periods ending after the valuation date generally are not used as direct evidence in a valuation engagement. However, the consultant may use some subsequent period financial statements in certain limited instances. For example, suppose the consultant were valuing a company as of September 30 and that company has a calendar year end. In such cases, the consultant might use annual or fourth quarter financial statements as a basis for asking about such matters as whether there were any known GAAP errors in the first three quarters that were corrected in the fourth quarter. Note that in this case, the consultant obtains the data primarily through inquiry of management. The subsequent financials were merely a tool in the discussion process. If consultants use subsequent period financials, they must be very careful to ensure that the information they use was truly knowable as of the valuation date and does not reflect subsequent events. Generally, it is inappropriate to use subsequent financial statements to prepare a forecast of "future" (i.e., after the valuation date) operations or to determine the outcome of contingencies existing at the valuation date.

Tax Returns

Consultants typically obtain tax returns to understand the company's tax position and to obtain additional financial data. The returns provide a summary of significant tax policies and elections that affect the company's tax expense and net income. They also present the company's operations in a different format and provide additional financial data. For example, nontaxable income or nondeductible expense items may include nonoperating revenues or expenses that must be considered in valuation calculations.

As previously noted, some small businesses do not prepare financial statements and the consultant must obtain most of the financial data from the company's tax returns. In those cases, the consultant should adjust the tax return data to a GAAP basis.

Prospective Financial Information

The consultant should request copies of any types of prospective information (that is, forecasts, budgets, or projections) maintained by the company, because that data can provide a revealing picture of the company's opinion of its earnings potential. Also, such data may be needed if the consultant plans to apply a valuation method based on future net cash flows or earnings. However, in many engagements, the owners or management may not prepare formal prospective information. When that occurs, the consultant (with some ingenuity) may be able to develop the information from interviews with management and from data maintained by the company.

Other Financial Information

Historical financial statements often are presented in a summarized form that does not allow meaningful analysis of key assets, liabilities, revenues, and expenses. In those cases, the consultant should request additional schedules that list the components of the captions on the financial statements. Additional financial information that may be needed includes:

a. Aged listing of accounts receivable as of the valuation date.

b. List of cash accounts and cash investments, if significant.

c. List of property and equipment (depreciation schedule).

d. List of items comprising inventory (noting quantity, description, and cost).

e. List of items comprising significant other asset balances.

f. List of accounts payable (preferably aged) as of the valuation date.

g. Analyses of significant accrued liabilities as of the valuation date.

h. List of notes payable.

i. List of items comprising significant other liability balances.

j. Information on owners' compensation, including benefits and personal expenses.

k. Information on key man (or officer's) life insurance.

l. Details regarding advantageous or disadvantageous contracts.

m. List of contingent or off-balance sheet assets or liabilities.

n. List of prior sales of company stock.

o. Schedule of sales by product for each period that an income statement is requested, unless that data is presented on the income statements.

p. List of accounts comprising the major expense captions on each income statement requested, unless a detailed income statement is presented.

Preliminary Analysis of the Financial Information

After obtaining the appropriate financial information, the consultant should review it briefly to determine:

a. If it is complete, that is, if it contains all the information requested.

b. If it is usable, that is, if it provides sufficient information in a form that can be compared to market data.

c. Whether there are obvious departures from generally accepted accounting principles (GAAP).

Completeness of the Information

When several pages of data are requested from a client, it is easy to omit a key page or include a poor copy in the mass of data. Also, sometimes the data must be requested from an uncooperative source, such as an opposing party in a divorce engagement, and key pages of financial statements may be intentionally withheld. A good habit for all consultants is to compare the data received to a checklist of data requested and to scan the data for obvious page omissions. If the engagement relates to litigation, the consultant should go a step further and log in the data for later reference during the trial. Ideally, the consultant should obtain copies of the information so that a permanent record can be maintained in the workpapers. However, if the data is too long to copy or if the company will not allow it to be copied, a brief memo can be prepared that highlights the key considerations found in that data. If the consultant performs the photocopying or reviews the client's permanent records, it is generally good practice to obtain a receipt confirming the return of the data to the client.

Usability of the Data

During the cursory review for the completeness of data, the consultant should assess whether the data is in a usable format or whether more data is needed. For example, if the company provides consolidated financial statements, those statements may not provide enough information to be useful (as discussed in the next paragraph). Sometimes it takes several discussions with management to get useful data.

Consolidated Financial Statements May Be Inadequate. Consolidated financial statements alone may not be useful for performing a valuation. Generally, the consultant will need separate financial statements for the parent company and each subsidiary because each entity may be valued separately and then combined in determining a value for the group.

What If the Financial Information Is Incomplete or Unusable? If the data is incomplete or unusable and a suitable alternative source of data is not readily available, the consultant should consider the following options:

a. Ask the client to provide the missing information or to revise the format of the information to make it more usable.

b. Make arrangements with the client for an agreeable amendment to the fee estimate for the consultant or a third party to develop complete, usable information.

c. If the client does not agree to either alternative a. or b., the consultant should tell the client that the valuation report may have to be qualified. If the missing financial information is extremely important, the consultant should consider resigning from the engagement.

Apparent Departures from GAAP

During the preliminary analysis of the financial statements, the consultant should read the statements for any obvious departures from generally accepted accounting principles (GAAP) that might adversely affect the consultant's ability to develop a valuation conclusion. This preliminary step raises an important question that all consultants should be concerned about, which is, "What is the consultant's responsibility on a valuation engagement for detecting GAAP adjustments?"

The Consultant's Responsibility for Detecting GAAP Errors. Most consultants (regardless of their background or professional affiliation) agree that the answer to the previous question is, "The consultant's responsibility on a valuation engagement does not, and should not, extend to detecting GAAP errors unless those errors are expressly noted on the accountant's report on the financial statements, or unless the consultant is expressly made aware of such errors by the client, owner, or management of the company being valued." Despite this widely held view, the client's or the public's perception of the consultant's responsibilities for detecting GAAP errors may extend beyond the shared opinion of those within the profession. Therefore, the consultant should take certain precautionary steps to reduce the exposure of making a valuation conclusion based in part on incorrect financial statements and to clear up any confusion about the consultant's responsibilities. Normally, the precautionary steps would include:

a. Reviewing the accountant's report on the financial statements for obvious GAAP departures.

b. Communicating clearly, in both the engagement letter and valuation report, the consultant's responsibility for detecting GAAP adjustments.

The drafting forms for both the engagement letter and the valuation report include language that specifies the consultant's responsibilities for client financial data.

Reviewing the Accountant's Report for GAAP Errors. If the financial statements have been compiled, reviewed, or audited by an independent CPA, the financial statements should be accompanied by an accountant's report that describes the CPA's level of service and indicates whether the financial statements contain departures from GAAP. For non-CPAs, the following brief description of a compilation, review, and audit may be helpful:

a. *Compilation*. In a compilation engagement, the CPA is merely putting information supplied by the client in proper financial statement form (that is, in accordance with GAAP) without attempting to express any assurance on those statements. In a compilation, the CPA is not required to make inquiries of management or perform other procedures to verify, corroborate, or review information supplied by the client.

b. *Review*. In a review engagement, the CPA goes beyond putting client information together. The CPA also makes certain inquiries of management and performs analytical procedures. However, in a review, the CPA is not required to understand the company's internal control, test the accounting records, observe inventory, confirm receivables, or obtain other corroborating evidence, as is required during an audit.

c. *Audit*. In an audit engagement, the CPA goes beyond a review, and, on a test basis, examines evidence supporting the amounts and disclosures in the financial statements.

What If a CPA Has Not Been Associated with the Financial Statements? If the financial statements are prepared solely by the client without independent CPA involvement, a non-CPA consultant may wish to have those statements compiled by a CPA. In a compilation, the CPA is putting the financial statements into a format that complies with GAAP. If the client prepared the financial statements from tax returns or on a cash basis, those statements probably do not conform to GAAP. Even if the financial statements were prepared from traditional general ledger sources, they may still contain material presentation or measurement errors that could adversely affect the accuracy of the valuation. It should be noted that engaging a CPA to perform a compilation does not ensure that all departures from GAAP will be detected. In performing a compilation a CPA does not perform any inquiries or procedures to verify that the information provided by the client is accurate. Therefore, if the client's accounting procedures were flawed such that, for example, inventory was misstated, it is possible that the accountant performing the compilation would not detect any errors in the inventory balances. Non-CPA consultants may be hesitant to enlist the services of a CPA to compile the financial statements, primarily because of concerns about controlling the fees on the engagement. However, an arrangement with a CPA can be structured where the financial statements are compiled without the added cost of footnote disclosures, which should hold the cost to a reasonable level.

The discussion later in this lesson provides additional guidance about the types of GAAP errors common to closely held businesses. However, remember that the consultant is not responsible for detecting GAAP errors unless those errors are expressly noted on the accountant's report on the financial statements, or unless the consultant is expressly made aware of such errors by the client, owner, or management.

Legal Documents Concerning Ownership Information

The consultant should review the company's significant legal documents of ownership information concerning the subject interest. If applicable and available, review of ownership information generally enables the analyst to gain a deeper understanding of the following characteristics as required by SSVS No. 1:

a. The type of ownership interest being valued and whether the interest reflects control characteristics.

b. The ownership interests of other owners (to assess any potential effects on the value of the subject interest).

c. The classes and associated rights of equity ownership interests.

d. Rights included or excluded for each intangible asset.

e. Other matters that may affect the value of the subject interest (e.g., voting trust agreements, loan covenants, operating agreements).

Some of the documents that might be reviewed include:

a. *Articles of Incorporation, Stockholder, or Partnership Agreements*. Those agreements indicate ownership interests and the owners' rights and obligations. Also, any stock option agreements should be considered. This review will help the consultant determine or verify the type of interest to be valued, such as whether it is a controlling or minority interest.

b. *Stock Books*. Reviewing stock books can help the consultant ascertain the relative size of various ownership interests and identify transactions in the company's stock.

c. *Existing Buy-sell Agreements*. Such agreements may be indicators of the company's value or the value of an ownership interest in the company. However, such agreements are often structured based on factors other than the company's value.

d. *Key Managers' Employment Contract and Non-compete Agreements*. Those agreements may contain provisions for compensation in excess of a reasonable level, golden parachute provisions in case the business is sold, or commitments by employees not to compete against the company if they leave, which can significantly affect the value determination. These contracts may also be used in determining possible risk of losing key personnel, which could negatively affect the business.

e. *Loan and Lease Agreements*. Those agreements may contain restrictive covenants, special demand clauses, or working capital requirements that affect the value of the company. The length and terms of lease agreements also may be important. Lease and loan agreements with related parties may not be on arm's length terms.

f. *Sales and Purchase Contracts*. Those agreements may contain special terms that affect value, such as the nontransferability of the contract to a new owner. Also, if the company has any government contracts, they may be subject to renegotiation. In addition, reviewing those agreements may reveal that the company is dependent on a few specific customers or suppliers.

g. *Documents Relating to Any Current, Pending, or Threatened Litigation*. Those documents may indicate major contingent liabilities that may affect the company's value.

h. *Patent or Trademark Documents*. Those documents may indicate the existence of valuable intangible assets, or the absence of those documents could indicate the absence of a value consideration claimed by the client.

i. *Purchase and Sale Agreements Involving the Company's Stock*. Such agreements may provide indications of the company's value. Also, the consultant should review any offers or letters of intent to sell or purchase the company's stock.

Besides those documents or summaries thereof, the consultant should review contracts or legal documents (or summaries thereof) on any other obvious matters that may significantly affect value, such as warranties, guaranties, employee benefit plan agreements, union contracts, major insurance policies, and notes receivable agreements. The consultant also should consider reviewing the reports of any examinations by government agencies such as OSHA, EPA, IRS, and EEOC. Another good source of information is minute books for board of directors meetings.

Operational Data

Business valuation procedures should encompass more than reviewing documents and crunching numbers. Consultants should also gain an understanding of the company's operations and key people. This can be accomplished by visiting the company's website, touring the company's facilities, interviewing its key managers, and obtaining additional operational data.

The Company's Website. Because of the increased awareness and use of the Internet by consumers, many companies now have their own website to describe their company nature, background, and history and their products or services. A great deal of information may be obtained about a company and its operations without ever leaving the office. Thus, one of the first steps a consultant should take to obtain operational data is to visit the company's website. This visit to the company's website often makes the site visit and interviews more productive due to the base of knowledge gained about the company, its management, operations, and products.

Site Visits. Whenever practical, the consultant should visit the company's facilities. However, in certain litigation proceedings, interrogation, deposition, or previous trial transcripts can produce important information. The 1994 IRS *Valuation Training for Appeals Officers Coursebook* notes:

> It is suggested that whether the asset to be appraised is real estate, closely held stock or some other asset with specific and/or unique characteristics, that the appraisal include a statement that the appraiser did make a personal inspection of the property to familiarize himself with specific problems involved in appraising the asset involved.

Courts properly tend to give more creditability to experts who have performed site visits.

Site visits can provide insights into a company's operations and its strengths and weaknesses. For example, a site visit may indicate or confirm how a particular location may affect value. If the success of the operation is due greatly to its location, special emphasis should be given to a review of lease documents or deeds evidencing legal rights to the property. Obviously, if the lease on a prime location will expire soon, the company's ability to renew that lease and the expected new lease terms could have a material effect on value. Likewise, if a company is locked into a site or building that is too large, too small, without ample parking, or with poor access, the company's value could be greatly affected. If a site visit is impractical, the reason for being unable to visit the company's facilities should be documented in the workpapers.

During the site visit, the consultant should tour the company's operating facilities to gain an understanding of its manufacturing or service process. For example, in a manufacturing facility, the consultant would observe the process of receiving and storing raw materials, converting them into finished products, and shipping them to customers. During this visit, the consultant should be alert for idle or damaged machinery or equipment; obvious excess or damaged inventory; or obvious environmental contingencies such as illegal dumping, toxic wastes, or pollution.

Interviews. During the site visit, the consultant typically will interview key management personnel. Most small businesses have only one or two key managers, but some companies have more. The consultant should ask questions to obtain a further understanding of the company's history, customer base, geographical markets, product mix, business risks, the governmental or regulatory environment, strategy and future plans, and other matters. The consultant should prepare a list of questions for the interviews or refer to a "Data Collection Checklist". That form addresses basic data that should be obtained on most engagements, and it can be modified to address the unique circumstances of each engagement.

Other Documents. Either before or during the interview process, the consultant should also be aware of other operational data or contracts that may obviously affect value. Examples of such documents include:

a. *Corporate Documents.* These documents help identify key managers and affiliates and other important information. They also may provide data that may be used in the valuation process. Examples include:

   (1) Management team list (which may include officers, directors, and key employees).

   (2) Stockholder and director lists.

   (3) Officers and directors compensation schedule.

   (4) Schedule of key man life insurance policies.

   (5) Organization charts.

b. *Operations Documents.* These documents help the consultant understand the company's business and identify significant assets. Examples include:

   (1) Business plans.

   (2) Brochures, price lists, catalogs, and other product information.

   (3) Sales forecasts.

   (4) Data on customers and suppliers.

   (5) Capital budgets.

   (6) Lists of major competitors.

c. *Reports of Other Professionals.* These reports may highlight information that is useful in the valuation process. Examples include:

   (1) Appraisals on specific assets.

   (2) Reports of other consultants.

   (3) Reports of independent auditors or accountants.

d. *Other Internal Information.* Other information that may provide insight into value includes:

   (1) Details concerning transactions in the company's own stock.

   (2) Offers that were received for the company.

   (3) Documents or details relating to potential public offerings for debt or equity, venture capital prospectus or similar information.

This list is not all-inclusive. For example, sometimes employee handbooks or minutes of board of directors meetings are useful. The key is to obtain enough information to have a thorough understanding of the company, its operations, and its environment. It should be emphasized, however, that thoroughly reviewing every possible document and interviewing every employee is impractical and beyond the scope of the data-gathering and analysis phase of the engagement. Accordingly, the consultant should rely on judgment and experience to determine the extent of documents needed. Furthermore, the consultant must rely on the accuracy of the data being reviewed and the representations of management. The consultant is not engaged to perform procedures to verify or test the accuracy of the data or representations.

Get a Receipt for the Return of Client Documents

One important step that is often overlooked during the data-gathering phase is obtaining a signed receipt from the client confirming that all original documents have been returned. Such a receipt can be very important in a judicial proceeding to protect against charges that the consultant lost a key piece of evidence. However, this step is unnecessary if the consultant obtains copies of documents instead of originals.

Assessing the Data Obtained

After obtaining and reviewing the company's documents, the consultant can begin to analyze and assess how that data will affect the valuation. Factors to consider include:

a. The company's financial condition.

b. Company earnings history and growth trends.

c. The company's competitive strengths.

d. Depth and quality of management.

e. Dependence on key managers.

f. Size of the ownership interest being valued.

g. Potential legal exposure from pending litigation or contingencies such as product liability, warranties, environmental hazards, government fines, etc.

h. Dependence on key customers or suppliers.

i. Company goals and expectations.

j. The company's location and its effect on sales, future expansion, access to customers and raw materials, etc.

k. Existing buy-sell agreements or compensation agreements with management.

l. The possibility of labor disputes and union contract renegotiations.

Exactly how those factors affect the value determination depends on the valuation methods used. For example, many of those factors are considered when determining the discount rate, capitalization rate, or value multiple for a specific company.

The discussion in this section has focused on gathering and assessing internal information that may affect the value of a company. The discussion now moves into assessing how external variables may affect the value of a business.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following financial information is **not** used on valuation engagements?

   a. Employee compensation.

   b. Interim historical financial statements.

   c. Prospective financial statements.

   d. State tax returns.

2. When the valuation date is a different date than the company's fiscal year end, which of the following financial statements is recommended?

   a. Interim financial statements.

   b. Annual financial statements.

   c. Prospective financial statements.

3. If a business valuation occurs significantly after the established valuation date, which of the following actions by the valuation analyst is appropriate?

   a. Inclusion of additional financial information in the report that comes to light after the valuation date.

   b. Consideration of comparable transactions in the valuation that the analyst becomes aware of after the valuation date.

   c. Inclusion in the valuation report of the impact of the sale of the subject business subsequent to the valuation date.

   d. Disclosure in the valuation report that unexpected subsequent events are for informational purposes only and did not affect the determination of value.

4. When financial data is incomplete or unusable and an acceptable alternate source for the data cannot be easily obtained, a number of options are available to the consultant. Which of the following options is **not** an option?

   a. Ask the client for an agreeable amendment to the fee estimate.

   b. Request that the client provide the missing information.

   c. Consider qualifying the report if missing information or an agreeable amendment is not provided.

   d. Continue the engagement, but disclose that extremely important information was not available.

5. When an accountant assembles client information and makes specific inquiries of management, he or she is performing which of the following levels of service?

   a. Audit.

   b. Review.

   c. Compilation.

6. Which of the following documents indicate ownership interests and the owners' rights and obligations?

   a. Sales and purchase contracts.

   b. Articles of incorporation.

   c. Existing buy-sell agreements.

   d. Patent or trademark documents.

7. In deciding divorce cases, courts tend to place more importance on information obtained from which of the following sources to determine which consultant has provided the most accurate valuation?

   a. Previous trial transcripts.

   b. Site visits.

   c. Interrogation.

   d. Litigation proceedings.

8. Business plans help the consultant understand the company's business and are an example of which of the following type of document?

   a. Corporate documents.

   b. Operations documents.

   c. Reports of other professionals.

   d. Other internal information.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following financial information is **not** used on valuation engagements? **(Page 106)**

   a. Employee compensation. [This answer is correct. Regular employee compensation is not normally used in valuation engagements. However, information on owners' compensation may be used due to the fact that owner's compensation may affect value, whereas employee compensation may not. Owner's compensation may need to be adjusted to a reasonable level.]

   b. Interim historical financial statements. [This answer is incorrect. Historical financial statements, both interim and annual, (for a relevant period) are financial information that generally is used on valuation engagements to identify key variables and trends.]

   c. Prospective financial statements. [This answer is incorrect. Prospective financial statements are usually used on valuation engagements, when such statements are available, because they provide a revealing picture of the company's opinion of its earnings potential.]

   d. State tax returns. [This answer is incorrect. Both state and federal tax returns are typically used on valuation engagements because they provide a summary of significant tax policies and elections that affect the company's tax expense and net income.]

2. When the valuation date is a different date than the company's fiscal year end, which of the following financial statements is recommended? **(Page 107)**

   a. Interim financial statements. [This answer is correct. In cases where the valuation date is a date other than the company's fiscal year end, the consultant should obtain financial statements as of that date or, the month or quarter ended just prior to or closest to the valuation date.]

   b. Annual financial statements. [This answer is incorrect. Annual financial statements are recommended when the valuation date is the same as the company's fiscal year end.]

   c. Prospective financial statements. [This answer is incorrect. Prospective financial statements are helpful for valuation engagements; however, they are not recommended to specifically address valuing at a date other than year end.]

3. If a business valuation occurs significantly after the established valuation date, which of the following actions by the valuation analyst is appropriate? **(Page 107)**

   a. Inclusion of additional financial information in the report that comes to light after the valuation date. [This answer is incorrect. Even if additional financial information becomes available after the valuation date, it should not impact the analyst's determination of value.]

   b. Consideration of comparable transactions in the valuation that the analyst becomes aware of after the valuation date. [This answer is incorrect. Only consideration of comparable transactions that are known prior to the valuation date should be considered by the analyst in the conclusion of value.]

   c. Inclusion in the valuation report of the impact of the sale of the subject business subsequent to the valuation date. [This answer is incorrect. Unless the subject business is sold prior to the valuation date, the impact of such sale should not be taken into account when determining value.]

   d. Disclosure in the valuation report that unexpected subsequent events are for informational purposes only and did not affect the determination of value. [This answer is correct. Per SSVS No. 1, subsequent events should not affect the conclusion of value. Therefore valuation analysts should only consider circumstances existing at the valuation date and events occurring up to the valuation date. Any events subsequent to the valuation date may be disclosed in a separate section of the valuation report, but must clearly indicate that the subsequent event(s) is informational in nature only, and does not have a bearing on the conclusion of value.]

4. When financial data is incomplete or unusable and an acceptable alternate source for the data cannot be easily obtained, a number of options are available to the consultant. Which of the following options is **not** an option? **(Page 109)**

   a. Ask the client for an agreeable amendment to the fee estimate. [This answer is incorrect. One option the consultant should consider is to ask the client for an agreeable amendment to the fee estimate so that the consultant or a third party can develop complete and usable information.]

   b. Request that the client provide the missing information. [This answer is incorrect. In situations where the data is incomplete or unusable and a suitable alternative source of data cannot be readily obtained, the consultant should consider asking the client to provide the missing information or to revise the format of the information to make it more usable.]

   c. Consider qualifying the report if missing information or an agreeable amendment is not provided. [This answer is incorrect. Another option the consultant may consider when information is missing or an agreeable amendment has not been provided, is to qualify the valuation report. A qualified report cannot be given if financial data is missing or unusable.]

   d. Continue the engagement, but disclose that extremely important information was not available. [This answer is correct. In cases where the missing financial information is critical, it is appropriate for the consultant to consider resigning from the engagement. A disclosure would not be sufficient.]

5. When an accountant assembles client information and makes specific inquiries of management, he or she is performing which of the following levels of service? **(Page 110)**

   a. Audit. [This answer is incorrect. In an audit engagement, the accountant examines evidence on a test basis that supports the amounts and disclosures in the financial statements.]

   b. Review. [This answer is correct. In a review engagement, the accountant puts client information together, makes specific inquiries of management, and performs analytical procedures.]

   c. Compilation. [This answer is incorrect. In a compilation engagement, the accountant organizes the information supplied by the client in accordance with GAAP but does not attempt to express any assurance on such information.]

6. Which of the following documents indicate ownership interests and the owners' rights and obligations? **(Page 111)**

   a. Sales and purchase contracts. [This answer is incorrect. Sales and purchase contracts may contain special terms that impact value, such as the nontransferability of the contract to a new owner. Sales and purchase contracts involve customers or suppliers, not the owners.]

   b. Articles of incorporation. [This answer is correct. Articles of incorporation, stockholder, or partnership agreements indicate ownership interests and the owners' rights and obligations. In addition, any stock option agreements should be considered. Such review will assist the consultant in determining or verifying the type of interest to be valued (i.e., controlling or minority interest).]

   c. Existing buy-sell agreements. [This answer is incorrect. Existing buy-sell agreements may be indicators of value; the company's value, or the value of an ownership interest in the company.]

   d. Patent or trademark documents. [This answer is incorrect. Patent or trademark documents may indicate that valuable intangible assets exist, or if such documents do not exist, the absence of a value consideration claimed by the client.]

7. In deciding divorce cases, courts tend to place more importance on information obtained from which of the following sources to determine which consultant has provided the most accurate valuation? **(Page 112)**

   a. Previous trial transcripts. [This answer is incorrect. Even though previous trial transcripts can contain important information, they are not the most important source of information from the courts point of view in determining the most accurate valuation.]

   b. Site visits. [This answer is correct. Courts appropriately give more creditability to consultants who have performed site visits since such visits produce valuable information about the company, its management, operations, and products.]

   c. Interrogation. [This answer is incorrect. Interrogation is an example of important information that can be used in valuations; however, it is not viewed by the courts as the most important factor in determining the accuracy of a valuation.]

   d. Litigation proceedings. [This answer is incorrect. Litigation proceedings are another example of information that can prove valuable in performing valuations. Courts do not give the most creditability to experts who have relied on litigation proceedings in performing a valuation.]

8. Business plans help the consultant understand the company's business and are an example of which of the following type of document? **(Page 113)**

   a. Corporate documents. [This answer is incorrect. Examples of corporate documents include organization charts, officers/directors compensation schedule, stockholder and director lists, management team list, and a schedule of key man life insurance policies. These documents help identify key managers and affiliates and other important information.]

   b. Operations documents. [This answer is correct. Examples of operations documents include business plans, capital budgets, lists of major competitors, sales forecasts, data on customers and suppliers, and brochures, price lists, catalogs, and other product information.]

   c. Reports of other professionals. [This answer is incorrect. Examples of reports of other professionals include reports of other consultants, appraisals on specific assets, and reports of independent auditors or accountants. These reports may highlight information that is useful in the valuation process.]

   d. Other internal information. [This answer is incorrect. Examples of other internal information include offers that were received for the company, details concerning transactions in the company's own stock, and documents or details relating to potential public offerings for debt or equity, venture capital prospectus or similar information. This may provide insight into value.]

ECONOMIC, INDUSTRY, AND MARKET DATA

A company does not exist in a vacuum. It is affected by economic conditions, industry trends, and other external factors. Similarly, a company's value is rarely determined from its financial statements alone. The consultant usually must consider relevant economic, industry, and market conditions.

However, the consultant should focus entirely on information that is available or determinable as of the valuation date. Although economic, industry, or market conditions may subsequently change, that data is not relevant to the estimate of value at the valuation date, unless there is evidence that such changes were expected as of the valuation date.

What Type of Data Is Needed?

There is a vast body of economic and industry data available from a long list of financial newspapers, government publications, and trade associations, as well as the news media in general. Consequently, it is easy for the valuation consultant to become overwhelmed with the prospects of considering all this data. To be efficient in this facet of the engagement, the consultant must identify (a) which external factors appear to be most important and (b) what external data is necessary to perform the valuation methods the consultant expects to use. Then the consultant can focus the data-gathering attention on those factors.

Relating the Need for External Data to the Method to Be Used. The amount of economic, industry, and market data needed and the extent of the analysis of that data, depend on the valuation methods the consultant expects to use. For example, valuation methods that are based only on the value of a company's net tangible assets normally will not require an extensive evaluation of economic data. On the other hand, valuation methods that are based on discount rates or capitalization rates normally require a more sophisticated assessment of external factors to:

a. *Assist with the Financial Analysis.* Part of financial analysis is comparing the subject company's financial ratios and data to industry data.

b. *Help the Consultant Quantify Risks Associated with the Company's Operations.* Risk assessment is an important step in determining discount and capitalization rates and in applying several valuation methods.

However, the consultant's analysis of industry factors and other external data can affect the selection of valuation methods. For example, after reviewing the company's internal data and certain initial external data, the consultant may decide that using public company data is unnecessary and that the business is so small that local or regional data is more important than national industry data. Thus, consultants generally should obtain at least a basic understanding of key external factors on all valuation engagements.

Identifying Key External Factors. During the cursory review of the company's financial statements and while learning about the internal factors that affect the company, the consultant will start to identify a pattern of key external factors (such as interest rates; inflation; competition, both domestic and international; technological changes; and dependence on natural resources) that may have a direct effect on the company's value.

Relating Key External Factors to Data Requirements. After identifying key external factors, the consultant should determine what external data will be needed on the engagement. This decision typically occurs in two stages. First, the consultant normally needs to have a basic understanding on each engagement of relevant economic and industry conditions, and how the company has performed relative to its industry. Exhibit 1-1 presents suggested data sources to use in obtaining that basic understanding of economic and industry factors. After that initial data gathering, the consultant can decide whether his or her knowledge needs to be expanded to select and apply appropriate valuation methods.

Exhibit 1-1

Suggested Sources of Basic Economic and Industry Data

Publication	Description
Federal Reserve Bulletin Supplement	Provides money market and capital market data, which can be helpful in assessing the monetary environment at the valuation date. This bulletin also provides basic business statistics.
First Research	Updated on a quarterly basis. First Research provides analysis, statistics, and forecasts covering over 700 industry sectors.
Economic Outlook Update	Published quarterly by Business Valuation Resources. It presents the general economic climate that existed at the end of the respective quarter and contains short-term and long-term forecasts for major economic indicators.
Standard & Poor's *Industry Surveys*	Published weekly and annually by Standard and Poor's. Provides data on industry structure, trends, and outlook for over 50 broad industry groups, subdivided into approximately 500 subgroups and 115 market sectors.
Integra Information	Integra provides extensive information through data that is derived from 33 different proprietary and government data sources. Integra covers more than 900 industries with data from over 4.5 million privately held businesses.
RMA Annual Statement Studies	Published annually by RMA—The Risk Management Association. Probably the best-known source of industry ratio data. Collected from bank loan officers. Covers more than 700 industries.
Trade Associations	Can be a good source of general industry data.

* * *

Major Sources of External Data. Consultants may consult some or all of the following sources of data:

a. National economic data.

b. Regional and local economic and demographic data.

c. Industry information.

d. Guideline company data.

National Economic Data

Some companies are more sensitive to general economic conditions than others. For example, interest rates typically affect the demand for housing, which in turn affects home builders.

To assess how economic conditions affect a company, the consultant should consider relevant economic trends including:

a. GNP.

b. Inflation rates.

c. Unemployment rates.

d. Consumer spending levels.

e. Orders for durable goods.

f. Levels of business investment.

g. Interest rates.

h. Specific industry statistics (such as housing starts for certain construction contractors).

Also, the consultant may need to consider trends in the financial markets, such as:

a. U.S. Treasury bill (T-bill) and bond (T-bond) rates.

b. Market-generated required rates of return on equity and related factors.

c. Other financial market data.

Possible Sources of National Economic Data. The federal government publishes several sources of statistical data. The *Federal Reserve Bulletin* is particularly useful in obtaining a basic understanding of general economic conditions. For more information on general economic conditions, the consultant may wish to consult one of the following sources:

a. *The Survey of Current Business.* Contains a broad range of business information such as business indicators, price data, and employment data. Includes the "Business Situation," a review of recent economic developments and articles about the national, regional, and international economic accounts and related topics. The survey is published by the U.S. Bureau of Economic Analysis.

b. *Consensus Forecasts USA.* Contains detailed forecasts for 20 U.S. economic and financial variables, including historical data, graphs, commentary, and special surveys.

c. *Economic Report of the President.* Contains trends and annual numerical goals on topics such as employment, production, real income, and Federal budget outlays, and a five-year outlook on the U.S. economy. The report is published by the U.S. Council of Economic Advisors.

Financial market data affects the value of virtually all companies. This information includes stock price levels, price/earnings multiples, preferred stock yields, and interest rates. To apply the income or market valuation approaches, it is important to have an understanding of the financial markets as of the valuation date. For financial market information, the following sources may be useful:

a. *U.S. Financial Data.* A convenient source of information on T-bill and T-bond rates and other commercial interest rates. It is published weekly by the Federal Reserve Bank of St. Louis.

b. *Wall Street Journal.* The recognized source for stock and bond prices. Also, it contains data on money market rates.

c. *Barrons.* A respected source of information on capital markets that includes T-bill, T-bond, and commercial paper rates and prices. It also includes prices on futures, options, and international securities.

When valuing a business, Rev. Rul. 59-60 indicates:

> . . . a sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of the appraisal, both in the national economy and in the industry or industries with which the corporation is allied.

As discussed later in this lesson, national, regional and local economic data is also available through numerous electronic sources.

Regional and Local Economic and Demographic Data

Besides national trends, the consultant may need to consider regional and local factors. For a small business, local or regional economic data are typically more important than national economic data. Information about demographics, sales, current and projected employment rates, and other information is often available on state, regional, and local levels. That data helps the consultant understand a company's regional and local environment. Sources of such information include federal government studies and state, regional, and local governments and agencies. Chambers of commerce and regional economic development agencies are two good sources. Also, consultants can consult the following:

a. *Census of Retail Trade, Census of Service Industries, Census of Wholesale Trade, and Census of Manufacturers.* Excellent sources of regional data on sales volume, number of businesses, and employment trends. These censuses are conducted every five years by the U.S. Census Bureau.

b. *Sales and Marketing Management Survey of Buying Power.* An excellent source of data on retail sales, personal income, population, and demographics for metropolitan areas and counties of all 50 states.

c. *County and City Data Book*. Official population and housing data from the 2000 Census plus business and other data for all 50 states, all counties, and cities with a population of at least 25,000 inhabitants. Available from the U.S. Census Bureau (through the Government Printing Office) in print, CD-ROM, or online.

Industry Data

Industry data consists of the following types:

a. *General industry data* helps the consultant understand growth and development trends.

b. *Comparative financial data* allows the consultant to compare a company's financial condition and performance against industry averages.

To use industry data, the consultant should classify the company's business activity. One common classification method is using the Standard Industrial Classification (SIC) system, which assigns numeric codes to various business types. (The codes are published in the *Standard Industrial Classification Manual*.) Once the company's business activity is classified, the consultant can research data for companies or industries in the same category.

General Industry Data. One source of basic industry data is *Business Statistics*, published annually by Bernan Press. Another good source is Standard and Poor's *Industry Surveys*.

Trade associations are another possible source of industry information. They typically compile information such as sales volume, shipment totals, employment data, and other statistics related to supply and demand trends. Trade associations often develop industry data for smaller groups than the industry categories in the SIC codes or S&P. For example, trade groups may be organized for a geographic region or company size. Thus, they can sometimes provide more relevant data than other sources. Consultants should ask company management whether any trade associations exist and consider whether those trade associations can provide information that will assist in the valuation. The following resources also may be useful:

a. *Encyclopedia of Associations.* The largest compilation of nonprofit associations and organizations available. Contains descriptions of professional associations, trade and business associations, labor unions, chambers of commerce, and groups of all types in virtually every field. Published by Gale Research, Inc.

b. *National Trade and Professional Associations of the United States.* An excellent source book for trade and industry sources of industry information. Restricted to trade and professional associations and labor unions with national memberships. Published annually by Columbia Books, Inc.

c. *The American Society of Association Executives' & The Center for Association Leadership* (**www.asaenet.org**). This website allows you to search their database of associations and also provides links to each association's individual website.

Each of those sources lists trade and professional associations, classified by industry, with addresses, phone numbers, and a brief description of each group's activities.

Comparative Financial Data. Comparative financial data is typically presented as average or aggregate financial statement data or ratios. Probably the best known source of that type of information is RMA—The Risk Management Association *Annual Statement Studies*. Also, Integra Information has a wealth of information available on comparative industry data. Integra's varied line of products include the *Industry Profiler*, *Comparative Profiler*, *Valuation Profiler*, and *5 Year Industry Data*. As discussed in Exhibit 1-1, a majority of the data is derived from 33 different proprietary and government data sources and covers more than 900 industries from over 4.5 million privately held businesses. Other sources include:

a. *The Almanac of Business and Industrial Financial Ratios* (CCH).

b. *Key Business Ratios* (Dun & Bradstreet).

c. *IRS Corporate Financial Ratios* (Schonfeld & Associates).

Many trade associations also provide comparative financial data. Also, many computer information services, such as the *Dialog, LEXIS/NEXIS*, and *CompuStat* services, contain industry studies from various financial analysts.

Assessing Economic and Industry Data

After obtaining the economic and industry data, the consultant should consider its effects on the company's financial condition and earnings potential as of the valuation date. Questions to consider include:

a. How has the company performed relative to its industry?

b. Are current economic conditions (such as inflation, interest rates, etc.) favorable or unfavorable to the company?

c. Is the industry growing or declining?

d. How do current demographic and competitive conditions and trends affect the company?

How Do Those Assessments Affect the Valuation? The valuation can be affected in two ways. First, the data may affect the selection of valuation methods. Second, those assessments can affect how valuation methods are applied. For example, understanding the company's prospects for growth is important in applying a discounted future returns method. Also, if the company's industry is depressed, that may be a factor in determining an appropriate discount or capitalization rate.

Market Data

The type of market data that a consultant needs depends on the valuation methods selected. For example, if underlying asset methods are used, the market data will be limited primarily to information on specific assets, such as securities or real estate investments. In discounted returns methods, the market data may consist of information on rates of return. Several valuation methods use market data on guideline companies or transactions involving similar companies, including data from business brokers.

Electronic Resources

Economic, industry, and market data is now available through many electronic sources, including CD-ROM, on-line services and the Internet. These sources allow the valuation consultant the convenience of performing research at his or her desk with access to an almost unlimited amount of information.

Applying Economic, Industry, and Market Data to the Valuation

A vast amount of external data is available to the consultant. Although this amount of information can be overwhelming, selection of relevant information allows the consultant to:

a. Estimate how economic forces will affect a company's net cash flow and earnings.

b. Determine appropriate valuation multiples.

c. Determine relevant discount rates.

Best practices indicate that relevant economic, industry, and market data be included in the written valuation report, along with an explanation of how it impacts the company being valued. If the information is extensive, it may be clearer to mention the data in the report and refer the reader to an attached appendix that contains the actual information.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. Generally, an extensive evaluation of economic data is unnecessary for valuation methods that are based on:

   a. Net tangible assets.

   b. Capitalization rates.

   c. Discount rates.

10. Of the following sources of basic economic and industry data, which one would help the consultant in assessing the monetary environment at the valuation date?

    a. Economic outlook update.

    b. Business statistics.

    c. Federal Reserve bulletin supplement.

    d. Integra information.

11. If a consultant is seeking financial market information, which of the following sources could prove useful?

    a. Wall Street Journal.

    b. Consensus Forecasts USA.

    c. The Survey of Current Business.

12. Bill is a consultant performing a business valuation on Sally's Dress Shop, a small business. Which of the following would be of least importance to Bill in performing this valuation?

    a. Local economic data.

    b. Regional economic data.

    c. National economic data.

    d. Local demographic data.

13. Which of the following is an excellent source of data on demographics for metropolitan areas?

    a. Census of Wholesale Trade, Census of Retail Trade, Census of Manufacturers, and Census of Service Industries.

    b. County and City Data Book.

    c. Sales and Marketing Management Survey of Buying Power.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. Generally, an extensive evaluation of economic data is unnecessary for valuation methods that are based on: **(Page 120)**

   a. Net tangible assets. [This answer is correct. Since the amount of economic data needed and the extent of the analysis of that data are based on the valuation methods anticipated by the consultant, valuation methods that are based only on the value of a company's net tangible assets normally will not require extensive evaluation of economic data.]

   b. Capitalization rates. [This answer is incorrect. Valuation methods that are based on capitalization rates generally require a more sophisticated assessment of external factors for reasons such as to assist with the financial analysis.]

   c. Discount rates. [This answer is incorrect. Valuation methods that are based on discount rates usually require a more sophisticated assessment of external factors for various reasons. One such reason is to help the consultant quantify risks associated with the company's operations.]

10. Of the following sources of basic economic and industry data, which one would help the consultant in assessing the monetary environment at the valuation date? **(Page 121)**

    a. Economic Outlook Update. [This answer is incorrect. The Economic Outlook Update presents the general economic climate that existed at the end of the respective quarter and contains both short-term and long-term forecasts for major economic indicators.]

    b. Business Statistics. [This answer is incorrect. The Business Statistics publication provides more than 4,000 data series of economic and industrial statistics for several industries.]

    c. Federal Reserve Bulletin Supplement. [This answer is correct. The Federal Reserve Bulletin Supplement provides capital market and money market data, which can be useful in assessing the monetary environment at the valuation date. It also provides basic business statistics.]

    d. Integra Information. [This answer is incorrect. Integra Information is a publication that provides extensive information through data derived from 33 different proprietary and government data sources. It covers more than 900 industries with data from over 4.5 million privately held businesses.]

11. If a consultant is seeking financial market information, which of the following sources could prove useful? **(Page 122)**

    a. Wall Street Journal. [This answer is correct. The Wall Street Journal is a good source of financial market information. It is the industry source for stock and bond prices, and also contains data on money market rates.]

    b. Consensus Forecasts USA. [This answer is incorrect. Consensus Forecasts USA is a source of information on general economic conditions and contains detailed forecasts for 20 U.S. economic and financial variables, including historical data, graphs, commentary, and special surveys.]

    c. The Survey of Current Business. [This answer is incorrect. The Survey of Current Business is a source of information on general economic conditions and contains a wide range of business information including business indicators, price data, and employment data.]

12. Bill is a consultant performing a business valuation on Sally's Dress Shop, a small business. Which of the following would be of least importance to Bill in performing this valuation? **(Page 123)**

    a. Local economic data. [This answer is incorrect. Local economic data would be of considerable value in valuing Sally's Dress Shop, a small business.]

    b. Regional economic data. [This answer is incorrect. Regional economic data could prove valuable in comparing other similar businesses in the region to Sally's Dress Shop for valuation purposes.]

    c. National economic data. [This answer is correct. Because Sally's Dress Shop is a small business, national economic data would have less relevance and prove less useful in performing this valuation.]

    d. Local demographic data. [This answer is incorrect. Local demographic data helps the consultant understand the company's local environment.]

13. Which of the following is an excellent source of data on demographics for metropolitan areas? **(Page 123)**

    a. Census of Wholesale Trade, Census of Retail Trade, Census of Manufacturers, and Census of Service Industries. [This answer is incorrect. These censuses are sources of regional data on sales volume, number of businesses, and employment trends.]

    b. County and City Data Book. [This answer is incorrect. The County and City Data Book are comprised of official population and housing data from the 2000 Census plus business and other data for all 50 states.]

    c. Sales and Marketing Management Survey of Buying Power. [This answer is correct. The Sales and Marketing Management Survey of Buying Power is an excellent source of data on demographics for metropolitan areas and counties of all 50 states, retail sales, personal income, and population which helps the consultant understand a company's regional and local environment. For a small business, local or regional economic data are typically more important than national economic data.]

REVIEW AND ADJUSTMENT OF THE FINANCIAL STATEMENTS

Consultants may review a company's financial statements at different times and for different reasons during a valuation engagement. For example, financial statements may be reviewed—

a. In the preliminary data-gathering phase, to determine if the financial data is complete and usable.

b. After the data-gathering phase, to determine what adjustments might be needed to create a normalized, comparative data base.

c. After the data has been adjusted, to assess trends and relationships within the financial statements and among different periods.

The different types of review referred to in the preceding paragraph are discussed as separate topics to allow the users of this course to conceptualize the phases of the review process. In practice, the process of reviewing financial statements occurs throughout the engagement, and procedures often overlap. For example, the consultant may identify financial statement adjustments during the preliminary review or while analyzing trends.

Also, CPAs should be aware that these types of review are different from the procedures a CPA would perform to issue a SSARS review report on financial statements. The former is designed to help the consultant value the company, and the financial statement data is a tool used in the valuation. The latter is intended to allow a CPA to give some degree of assurance to third party users that the financial statements are in accordance with GAAP.

A General Discussion about Adjustments

The process of identifying and making financial statement adjustments is discussed in greater detail below. Financial statements in a valuation engagement may be adjusted for different reasons and in a different manner than in a normal financial statement preparation engagement. The adjustments:

a. Provide the consultant with a consistent, reasonable starting point for the valuation decision.

b. Give the consultant an insight into:

   (1) what prior operations might have looked like under normal conditions (and on a consistent basis with guideline companies), or

   (2) what a prospective buyer might reasonably be expected to obtain from the company in the future, using history as a guide.

The adjustments described in Point a. are GAAP adjustments. The adjustments described in Point b. are referred to as normalization adjustments. The type of ownership interest, type of entity, definition of value, and purpose of the valuation also may determine the nature of certain normalization adjustments.

How Are Adjustments Posted and Presented? While this issue may sound minor and mechanical, posting adjustments can be a time-consuming process, especially considering that five years of data often require adjustment. There are two common techniques for making adjustments:

a. Adjusting each account balance and presenting new, restated financial statements.

b. Presenting the original, unadjusted financial statements; then, separately presenting statements summarizing the adjustments to the original statements.

While the first technique allows for an easier comparison among years, it can be very time-consuming and even confusing if there is no trail showing the before and after balances. Accordingly, consultants may prefer to follow technique b. and present a summary of adjustments.

Adjustments to the Balance Sheet and Income Statement May Not Be Linked. Another aspect of adjusting financial statements that may be confusing to accountants is that many normalization adjustments are made to the balance sheet or income statement alone. A normalization adjustment made to the income statement does not necessarily mean that the balance sheet is adjusted, and vice versa. This may sound like heresy to accountants trained in double entry bookkeeping. To understand this seeming accounting violation, it is necessary to consider how financial statements are used in a valuation engagement.

The balance sheet in a valuation engagement can be viewed as only a starting point in determining a company's net worth (that is, the difference between its assets and liabilities), and a company may have a value exceeding its stated net worth. However, the consultant generally should spend some time assessing whether the starting point, the assets and liabilities, are properly stated. Depending on the valuation method used, a balance sheet adjustment may not have a corresponding effect on the income statement (or may not be needed to assess the prior trend of earnings).

Likewise, many normalization adjustments may be made to the income statement that have no corresponding effect on the balance sheet. Normalization adjustments may be made to the income statement to allow the consultant to assess what past operating results and trends would be under different conditions. Examples include adjustments to reflect compensation at reasonable levels; adjustments for owners' personal expenses; and, adjustments to apply current income tax rates to prior periods.

On the other hand, some matters require adjustment of both the balance sheet and income statement. Examples include GAAP adjustments and many adjustments for nonoperating or excess assets.

GAAP Adjustments

As stated previously, it is recommended that the consultant perform a cursory review of the financial statements during the data-gathering stage to determine if there are any apparent GAAP departures.

The consultant usually begins modifying the financial statements by making any obvious GAAP adjustments, especially if the business will be valued based on its net cash flow or earnings. Some small businesses maintain their financial records on a cash or tax basis. The owner may not even prepare formal financial statements. Instead, the owner may use tax returns or schedules of cash receipts and disbursements. If the company cannot provide GAAP financial statements, the consultant may need to prepare them or ask the company to engage an accountant to prepare them or qualify the valuation report.

Common GAAP Departures. While this course is not intended to be a treatise on generally accepted accounting principles, there are recurring GAAP departures common to the financial statements of nonpublic companies, especially those statements prepared from tax returns or statements that have not been compiled, reviewed, or audited by a CPA. Some of the more common GAAP departures are listed in Exhibit 1-2.

Exhibit 1-2

Common GAAP Departures

Type of Departure	Explanation
Financial statements prepared on a tax or cash accounting basis	The rules for tax return financial statements may differ significantly from GAAP. This is especially true in the timing of recognition of revenue and expenses. Sometimes, it is acceptable for tax purposes to recognize revenue and expenses on a cash basis (when cash is received or paid) rather than on the accrual method required by GAAP.
Unrecorded revenue	In some industries, there is a tendency for the owner to understate cash sales.
Inadequate allowances for bad debts	Companies with a large volume of credit sales may have exposure in this area. Owners tend to be overly optimistic about the collectibility of their accounts receivable. This could also be true of employee or related party receivables.
Failure to write down obsolete, slow-moving, or damaged inventory	Especially common with manufacturers, retailers, or distributors with large inventories of numerous products.

Type of Departure	Explanation
Understated inventories	Some small businesses may try to understate inventories to reduce income taxes. This is especially true for companies without perpetual inventory systems.
Unrecorded prepaid expenses	Prepaid items are sometimes expensed to save income taxes. Such items should be added back for valuation purposes to get a true picture of the company's assets.
Obsolete, damaged, or abandoned equipment still shown in the financial statements	Companies with large investments in fixed assets are more likely to have this problem, especially if they have not inventoried those assets recently.
Small tools that have been expensed	Manufacturing companies may have large numbers of small tools or supplies that were expensed when purchased. Those items should be added back, if material.
Unrecorded liabilities	This is a common problem with interim financial statements when late bills are not recorded in the correct accounting period.
Failure to record capital lease obligations	Certain leases, especially those involving large trucks or heavy equipment, should normally be classified as capital leases under GAAP. In those cases, both the asset and lease obligation would be recorded on the balance sheet.
Failure to accrue for wages, employee benefits, and vacation/sick pay	This can be a material liability if the company has a large workforce.
For construction contractors, failure to use percentage of completion accounting	This is a common problem for small contractors who keep their general ledger on a completed contract basis for tax purposes.

*   *   *

Adjusting Tax Returns. As discussed previously, consultants sometimes use tax returns for valuation purposes when financial statements are not available. In those cases, consultants should remember that tax returns typically use accounting conventions that differ from GAAP. Those accounting methods include:

a. *Revenue Recognition.* Some small businesses recognize revenue on a cash basis.

b. *Depreciation Methods.* The IRS prescribes specific allowable depreciation methods and lives, which may differ from those used under GAAP.

c. *Inventory Valuation.* The IRS requires capitalization of some indirect and administrative costs that are expensed under GAAP. Also, the IRS typically does not allow writedowns of obsolete inventory.

d. *Cost Capitalization.* Many companies write off costs such as prepaid expenses that should be capitalized under GAAP.

e. *Consolidation.* IRS consolidation rules may differ from GAAP.

A Special Problem—Unrecorded Revenue. One of the GAAP errors noted in the list at Exhibit 1-2 is unrecorded revenue. The consultant may become aware of this problem, not from reviewing the financial statements, but instead from a candid discussion with the owner of the company. The financial statements may not disclose this problem because there is no documentation in the company's accounting and tax records. Furthermore, such an error may be almost impossible to detect even if normal audit procedures are performed. The owner may decide that it is now in his or her best interest to disclose this activity based on the assumption that a truer picture of the income potential of the business will enhance its value. Obviously, such a revelation can create problems for the valuation consultant, especially for a CPA who has previously filed tax returns for the company or been associated with the company's published financial statements.

When a problem like unrecorded revenue is encountered, the consultant should proceed very cautiously with the engagement. Steps that should be considered include:

a. *Evaluating the Effects of the Error.* First, the consultant should determine whether the unrecorded revenue materially affects the financial statements or tax returns. For example, the consultant may decide that the effect of the error was to understate sales and owner's salary expense, which would not affect pretax accounting income. However, tax authorities may consider such transactions to be unrecorded sales and dividends, which could result in additional tax liability to a corporation. Also, the company could be subject to penalties for filing improper tax returns or statements (such as forms W-2, 941, etc.).

b. *Deciding to Withdraw from the Engagement because of Questions Regarding Management Integrity and the Reliability of Company Data*. For example, if the owner has misrepresented the company's revenues and only now acknowledges an understatement, the consultant must decide whether there is any evidence to support the owner's acknowledgement. Otherwise, the consultant would have to base any adjustments on the owner's word alone. In such cases, it may be preferable to withdraw from the engagement.

c. *Proceeding with the Engagement, But Adjusting the Financial Statements That Will Be Presented in the Valuation Report.* In this instance, it is important to consider the effects of the potential adjustments on the valuation process. An unrecorded revenue adjustment also may lead to an owner's compensation adjustment. In this instance, it is important to note the source of the information leading to the adjustment and consider the additional revenue in the context of all the other adjustments (such as, officers' compensation, perquisites, bad debts, etc.).

d. *Complying with Professional Standards That Govern the Consultant's Profession.* The applicable standard depends on the specific services that were performed.

    (1) *Financial Reporting Services.* A CPA who becomes aware that financial statements he/she previously reported on (compilation, review, or audit) contain a material error should refer to SAS No. 1 (AU 561) and SSARS No. 1 (AR 100), as appropriate.

    (2) *Tax Services.* A CPA who becomes aware that prior tax returns contain a material error should consult the AICPA Statements on Standards for Tax Services Nos. 6 and 7 (TS 600 and TS 700, respectively).

If the consultant issues a report on a valuation engagement where material unrecorded revenue was discovered, it may be prudent to seek the advice of legal counsel before issuing that report.

Comparability of Accounting Principles. In some cases, a company may use accounting methods that are acceptable under GAAP, but are not consistent with industry practices or those used by guideline companies. For example, a company that uses a LIFO inventory method normally should be adjusted to be comparable with other companies if that industry primarily relies on FIFO. Revenue recognition policies and depreciation lives and methods also can affect the comparability of financial statements.

Normalization Adjustments

Normalization adjustments are unique to business valuation engagements. As previously discussed, the purpose of normalization adjustments is to give the consultant an insight into:

a. what prior operations might have looked like under normal conditions (and on a consistent basis with guideline companies), or

b. what a prospective buyer might reasonably be expected to obtain from the company in the future, using history as a guide.

Normalization adjustments may be affected by the size of the ownership interest, type of entity, definition of value, and purpose of the valuation. Exhibit 1-3 presents some common normalization adjustments.

Exhibit 1-3

Common Normalization Adjustments for Closely Held Companies

Type of Adjustment	Explanation
Balance Sheet Adjustments	
Nonoperating assets and excess assets	For valuation purposes, the company's balance sheet should present the assets and liabilities of its core operations, assuming a normal capital structure. Thus, adjustments often should be made to remove nonoperating or excess assets, along with any related debt. These adjustments are more often appropriate when valuing controlling interests than when valuing minority interests. However, some analysts will use a discounted value when valuing a minority interest.
Loans to/from related parties	Loans to affiliates may be nonoperating assets. Loans from affiliates may need to be reclassified as long-term debt or equity.
Income Statement Adjustments	
Compensation of owner or family members that exceeds or is less than reasonable levels	Profitable companies may pay part of their profits to owners as excess compensation, or they may pay family members who are no-show employees. Marginal companies may underpay their owners to improve their bottom lines. When valuing majority interests, the income statement may need to be adjusted to reflect owner's compensation at a reasonable level.
Fringe benefits	Similar to the owner's compensation issues discussed above.
Nonrecurring income and expenses	Nonrecurring income and expenses should be excluded from the income statement. Examples include moving expenses, gains or losses on sales of fixed assets, and extraordinary items.
Income and expenses related to excess assets, nonoperating assets, and asset shortages	If the balance sheet was adjusted for excess assets, nonoperating assets, or asset shortages, the income statement should be adjusted for any related income and expenses.

Type of Adjustment	Explanation
Related party revenues or expenses	Closely held companies often have arrangements with related parties, such as leases, management fee arrangements, etc. If any such arrangements are unrelated to the company's core business and a controlling interest is being valued, income or expenses relating to those arrangements should be eliminated. If those arrangements do relate to core operations but are not on arm's length terms, they should be adjusted to market rates.
Income taxes	Income statement adjustments are normally made on a pretax basis. After making those adjustments, income taxes should be recomputed based on normalized pretax income and the tax rates at the valuation date.

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Adjustments Related to the Balance Sheet

Many consultants start the normalization process by looking at the balance sheet. The consultant should scan the balance sheet for items such as nonoperating assets, excess assets, asset shortages, and related party loans.

Nonoperating Assets, Excess Assets, and Asset Shortages. In normalizing the balance sheet, the consultant makes adjustments to present the assets and liabilities of the company's core business, assuming a normal operating structure. Adjustments may be needed for some or all the following:

a. *Nonoperating Assets*. Nonoperating assets are those unrelated to the company's primary operations. Examples of such assets include:

   (1) Nonbusiness assets, that is, assets that have no specific business purpose. For example, if a New York City garment manufacturer company had bought a Hilton Head condominium for the owner's personal use, that asset would be a nonoperating asset.

   (2) Unrelated business assets, that is, business assets that are unrelated to the company's core business. For example, if a soft drink bottler had an investment in an outdoor nursery, that investment would be a nonoperating asset.

b. *Excess Assets.* Some companies have more assets than they need to operate their businesses. Examples of such assets include excess cash and land held for future expansion.

c. *Asset Shortages.* A company may lack sufficient assets or have too many liabilities to operate normally. For example, a company may not maintain adequate inventories or may incur excessive accounts payable liabilities.

If a company has significant nonoperating or excess assets, the consultant normally should adjust the balance sheet for the excess. Also, the income statement should be adjusted for any related income or expenses. For example, in the case of the garment manufacturer in the preceding paragraph, the cost of the Hilton Head condo, less any related accumulated depreciation should be removed from the company's balance sheet, together with any related debt. Also, any rent, depreciation expense, taxes, utilities, or other income or expenses should be removed from the income statement. In the case of the nursery investment, that investment and the nursery income or losses should be removed from the bottling company's financial statements. The objective is to present the financial statements without any nonoperating or excess assets. The nonoperating or excess assets are valued separately and added to the value associated with the company's core operations.

Some companies have asset shortages that can significantly reduce their values if not corrected. Such companies may have inadequate cash, inventory, or other current assets to support a normal level of operations. They may also have inadequate plant capacity or have a high level of deferred maintenance that needs to be funded in the future. Unlike nonoperating or excess assets, the consultant should usually not adjust a company's balance sheet to reflect normalization adjustments for asset shortages. When the consultant is using a net cash flow or earnings based valuation method to develop an equity value estimate, however, it may be appropriate to reflect the impact of significant asset shortages in the valuation process. This can normally be accomplished in one of two ways:

a. The income or cash flow statements used in the valuation process can be adjusted to reflect the impact of correcting the asset shortage. For example, if a discounted future returns method is used to value a company that has a severe shortage of cash and warehouse space, the consultant may assume in preparing the forecast of future operations that the company will borrow the needed cash (if possible) and will rent the needed warehouse space. When this approach is used, the resulting value estimate will reflect the impact of the asset shortages and no further adjustment is needed for these items.

b. In some cases, the consultant may choose not to include the effect of an asset shortage in the income or cash flow statements used in the valuation process. Instead, the consultant can reduce the value estimate determined using a net cash flow or earnings based valuation method by the amount that would need to be borrowed in order to cure the asset shortage. In other words, if a company needs to fund $150,000 of deferred maintenance in order to keep its assembly line going, the consultant can determine the company's value without considering the asset shortage, and then reduce the value by the required expenditure of $150,000.

Related Party Loans. The company may have loaned or borrowed funds from affiliates. Such loan arrangements may require adjustment. Uncollectible loans receivable should have been written off as a GAAP adjustment. Collectible loans receivable may still be considered nonoperating assets and evaluated separately. Loans payable to related parties may be structured as demand notes, but there may be little chance that such loans will be repaid. In those cases, the loans may be classified either as long-term debt or a form of owners' equity.

Income Statement Adjustments

Income statement adjustments are made to present the results of the company's operations as they might have been under conditions similar to what a prospective buyer might expect in the future. Common adjustments relate to owner's compensation and benefits that exceed or are less than a reasonable level, nonoperating income and expenses, nonrecurring income and expenses, and other items. In general, the consultant should consider the factors in the following paragraphs.

Owner's Compensation. Since most closely held businesses are managed by their owners, some of the companies' profits may be included in owners' salary expenses. As shown in Exhibit 1-4, owners may pay themselves excessive salaries instead of dividends to reduce their total tax liability. On the other hand, owners of marginally profitable companies may pay themselves unreasonably low salaries to enhance net income. Thus, owner's compensation may need to be adjusted to a reasonable level.

Exhibit 1-4

Tax Effects of Salaries versus Dividends

Assumptions:		
C Corporation's earnings before taxes and owner's salary	$	500,000
Total payments to owner (salaries and/or dividends)	$	250,000
Effective income tax rates—Corporate		39 %
Individual		33 %

Case 1			Case 2		
Salary	$	150,000	Salary	$	250,000
Dividends	$	100,000	Dividends	$	0
Corporate income taxes .39 × ($500,000 – $150,000) =	$	136,500	Corporate income taxes .39 × ($500,000 – $250,000) =	$	97,500
Individual income taxes .33 × $250,000 =		82,500	Individual income taxes .33 × $250,000 =		82,500
Total tax liability	**$**	**219,000**	**Total tax liability**	**$**	**180,000**

* * *

Although compensation adjustments are needed in many valuation engagements, they are not always required. Consultants should consider whether such adjustments are needed based on the circumstances. Factors to consider include:

a. *Size of the Ownership Interest Being Valued.* Compensation adjustments generally are not needed for valuing minority interests because the minority owner cannot control the salary levels and thus cannot benefit from any adjustments. However, such adjustments may be needed for minority interests in cases when:

   (1) The minority investor receives excess compensation.

   (2) There is reason to believe the minority investor will receive a pro rata share of the proceeds from selling the business, and those proceeds will include the present worth of those extra benefits.

   (3) The valuation engagement assumes that all stockholders, including minority stockholders, will be treated fairly (pro rata). This type of engagement assumes that all employees, including the owners, receive fair salaries with any remaining benefits going equally to all the stockholders. Situations where this assumption generally applies are fairness opinions and dissenting shareholder suits.

b. *The Amount of Compensation Considered above or below a Reasonable Level.* Obviously, adjustments are only needed when the amount of the compensation adjustment will materially affect the valuation.

c. *The Valuation Methods to Be Used.* Compensation adjustments are only needed if net income or cash flow is relevant to the valuation methods to be used.

d. *The Purpose of the Valuation.* If the owner/manager is selling the business, compensation adjustments are appropriate. If the company is establishing an ESOP and the owner/manager intends to remain with the company, those adjustments usually are not needed.

A consultant who decides that a compensation adjustment may be appropriate should estimate a reasonable salary level for the owner or owners based solely on the services performed. The objective is to determine what the owner should be paid if that person did not own the company. Several factors should be considered, including:

a. The owner.

   (1) Education.

   (2) Experience.

   (3) Knowledge and skills.

(4) Duties and responsibilities.

(5) Time and effort devoted to the business.

b. The company and industry.

(1) Nature of business and organization structure. (Does it depend heavily on the owner's abilities?)

(2) Industry practices.

(3) Financial performance.

(4) Historical compensation practices.

(5) Depth and abilities of others in management.

(6) Pension plans, profit-sharing plans, perquisites, or other employee benefits.

After obtaining an understanding of the factors listed above, the consultant may need to obtain comparative data on salaries paid by the company's peers. One common source is *RMA's Annual Statement Studies*, which provides data on officer salaries as a percentage of sales for different industries. Although the RMA data is useful, it has the following limitations:

a. It does not disclose the number of officers in each category.

b. It does not identify how many officers in each category, if any, are owner/managers.

c. Its ratios and percentages may not be statistically valid.

The Almanac of Business and Industrial Financial Ratios presents data similar to the RMA data, and it has similar limitations.

Besides the general financial statement sources, there are other sources of compensation data. In complex engagements, consultants may obtain information from trade associations, employment agencies, or other human resource specialists. However, no matter what salary data is used, the consultant should consider the factors listed above in relation to the common characteristics of and practices in the industry.

Benefits. Some small business owners receive special company benefits such as auto allowances or use of company cars by family members. The consultant should review the benefits the owner receives to determine if they are reasonable. Life and health insurance and auto allowances are common benefits. But receiving auto allowances for three cars would probably be excessive. The consultant should make adjustments for all excess automobile expenses. The same principle applies to travel and entertainment and promotion expenses.

Family Members. Another area to consider is salary and benefits for members of the owner's family. Family members who work for the company are clearly entitled to be paid. However, their salary and benefits should be consistent with their contribution to the business. Otherwise, the consultant should make adjustments for those expenses.

Nonoperating Income and Expenses. The operating results of the company's primary recurring operations generally should exclude any income and expenses relating to nonoperating assets. The same principle applies to income and expenses for excess assets.

Nonrecurring Income and Expenses. In addition to nonoperating items, the consultant also should look for nonrecurring income and expenses. Examples of nonrecurring income include:

a. Gain on sale of property or equipment.

b. Income from settlement of a lawsuit.

c. Income classified as an extraordinary item on the income statement.

Examples of nonrecurring expenses include:

a. Loss on disposal of a line of business.

b. Moving expenses.

c. Losses from strikes or casualties.

d. Losses from floods or other acts of God.

Nonrecurring revenues and expenses should be excluded from net income for valuation purposes.

Related Party Leases. The company may rent property or equipment from affiliates at terms significantly different from (either above or below) market terms. If the company has significant leases with affiliates, the consultant should consider whether adjustments are needed to adjust net income to reflect lease expense at market rates.

Fee Arrangements. Affiliated companies or persons may provide management, accounting, or other services to small businesses and receive fees for such services. The consultant should consider the nature of those services and the level of fees charged to the business. Similar to assessing owners' compensation, the consultant should determine what those services would cost if they were performed on an arm's length basis and make adjustments, if appropriate. However, if those fee arrangements are, in essence, nonoperating income and expenses, they should be eliminated.

Income Taxes

The preceding income statement adjustments ordinarily should be recorded on a pretax basis. Accordingly, the consultant should add back the company's historical income tax expense to its net income, record the adjustments, and compute normalized pretax income. Then, if the valuation methods to be used are based on after-tax net cash flow or earnings, the consultant should compute a revised income tax provision.

If the company will be valued under a method that uses company earnings (such as the capitalized earnings method), the consultant should compute the revised tax provision using the following steps:

a. Determine normalized pretax income.

b. Subtract any significant tax-exempt income included in Item a. Examples of tax-exempt income include interest income on tax-exempt bonds and a portion of dividend income on U.S. corporation stocks.

c. Add back any significant nondeductible expenses included in Item a. Examples of nondeductible expenses include officer's life insurance expense, goodwill impairment, and interest incurred to purchase tax-exempt securities.

d. The net total of Items a., b., and c. is normalized taxable income.

e. Compute a tax provision based on normalized taxable income and the tax rates in effect at the valuation date. The federal corporate income tax rates for 1988 through 2010 are summarized in Exhibit 1-5. State income tax rates vary from state to state and should also be considered.

Many types of tax-exempt income and nondeductible expenses may be eliminated with normalization adjustments, because many of those items relate to nonoperating assets. In those cases, normalized taxable income will be approximately equal to normalized pretax income.

Exhibit 1-5

Federal Corporate Income Tax Rates for 1988 through 2010[a]

Tax Rates in Effect for 1988 through 1992:

Taxable income is over	But not over	Tax rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	—	34%

Tax Rates in Effect for 1993 through 2010:

Taxable income is over	But not over	Tax rate
$ 0	$ 50,000	15%
50,000	75,000	25%
75,000	100,000	34%
100,000	335,000	39%
335,000	10,000,000	34%
10,000,000	15,000,000	35%
15,000,000	18,333,333	38%
18,333,333	—	35%

Note:

[a] These are the tax rates in effect as of the date of this course. The consultant should be alert for any subsequent changes in tax laws that might affect tax rates.

* * *

The steps outlined above determine a company's total tax provision, including both current and deferred taxes. That approach generally is appropriate when determining a value using the company's net income (such as the capitalization of earnings method). It may not be necessary to provide deferred taxes when determining values based on cash flow. In those cases, the consultant should compute a tax provision based on normalized taxable income, which considers all book/tax differences (such as book/tax depreciation, etc.).

Determining the Company's Taxes Based on the Tax Rates of a Known Purchaser. As discussed in the preceding paragraph, the consultant normally should determine a company's tax provision as if it were a stand alone company, using the rates that apply to that company. However, if a valuation engagement relates to a pending purchase transaction, and the consultant knows who the likely purchaser is, the consultant may be requested to compute taxes based on the prospective buyer's effective tax rate. (In these cases, the definition of value may be investment value, not fair market value.) For example, if the purchaser is in the 34% tax bracket, the earnings of the company being purchased would be taxed at 34% after the acquisition. Accordingly, even if the company's earnings were less than $100,000, the consultant may be asked to compute taxes using the 34% rate. In such cases, the tax rate assumptions should be disclosed in the valuation report. Also, if the consultant is engaged as an advisor (instead of an independent valuator) for a client who is considering buying a business, the client may wish to determine the after-tax earnings of the company based on several "what if" tax assumptions.

Determination of Tax Provisions for Partnerships, Proprietorships, and S Corporations. Sometimes the consultant may be engaged to value a partnership, sole proprietorship, or S corporation. Those entities may be referred to as *pass through* or nontaxable entities because federal income taxes (and in some cases state income taxes) are not paid at the entity level. The income generated by these entities is passed through to their owners, who are responsible for the tax. As a result, many have argued that the savings from double taxation (entity and owner's tax on dividends) for interests in pass through entities makes them worth more than their C corporation counterparts. In addition, market data on rates of return or value multiples typically used in valuing a business is often derived from after-entity tax data. Thus, many consultants believe that, when appropriate, some level of adjustment should be made to account for this seeming inconsistency. A number of techniques for estimating the premium, if any, and resolving this conflict have evolved over the years. Some are more sophisticated than others. The following techniques are often used to ensure that state and federal income taxes are properly treated in valuing pass-through entities:

a. *Determine a Pretax Cap Rate Based on Nontaxable Public Entities*. This technique is applied by dividing the cash flow (or earnings) of a nontaxable entity by a cap rate that is based on the earnings of nontaxable public companies. Unfortunately, there are not many public companies that are exempt from federal income taxation. This technique has theoretical support, but it can only be used in those rare instances when the nontaxable entity that is being valued is comparable to a number of nontaxable public entities such as master limited partnerships.

b. *Using the Effective Tax Rate of a Known Purchaser.* Under this technique, the earnings of an S corporation, partnership, or proprietorship are tax-effected at the effective income tax rate of a known purchaser under the assumption that the purchaser will have to provide those taxes after the acquisition closes. Obviously, this technique can only be used when a known purchaser has been identified.

c. *Tax Effecting Earnings of the Nontaxable Entity Using Either Corporate or Personal Rates and Calculating a Premium (Discount) When Appropriate.* Another technique is to tax effect the nontaxable entity's earnings by the prevailing corporate or personal rates. Similar to the above, the consultant would tax effect the nontaxable entity's earnings at the prevailing corporate rates if the most likely pool of buyers include C corporations. Tax effecting recognizes those buyers as the most likely purchasers of the nontaxable entity. This technique is most useful when the most likely pool of buyers would potentially include publicly-traded companies or companies in an industry that is going through a period of consolidation.

   When the most likely pool of buyers include those who may not change the tax status of the company, the consultant should consider tax effecting the nontaxable entity's earnings at the prevailing personal tax rate. This technique recognizes that, through the use of various deductible expenses, closely-held C corporations will have the same after-tax cash flows as S corporations. That is, under the same operating circumstances, the closely-held C corporation structures payments to shareholders so that the amount of cash flow retained, after considering all applicable taxes including personal taxes, is the same as the net cash flow available to the S corporation shareholder.

   There have been a number of recent variations of this method that attempt to measure an appropriate premium, if any, for minority interests in certain pass thru entities depending on their particular characteristics, such as distributions, holding period, and pool of buyers. This approach generally revolves around the avoidance of dividend and capital gains tax.

   The selection of an appropriate method depends on the facts and circumstances in each assignment. All of the above methods require judgments that may or may not be feasible in any given circumstance.

d. *Tax-effecting Earnings of the Nontaxable Entity at a Hypothetical C Corporation Tax Rate.* A variation of the technique in item c. is to tax effect the nontaxable entity at a rate that equals the post tax distribution amount of return for an S corporation minority shareholder. In other words, the tax-effecting rate is the "hypothetical pre-dividend C-corporation tax rate" that provides a distribution amount (after personal taxes on dividends) equivalent to an S-corporation distribution after personal taxes.

e. *Capitalizing the Company's Earnings after Personal Tax Rates by A Cap Rate Adjusted for the S Corp Status.* Using this technique, the discount rate determined using the build-up method and CAPM can be adjusted to reflect the additional risks, if any, associated with the company's status as a pass through entity, as well as any premium due to a savings of the dividend tax and increased basis. The following discusses the risks factors inherent in nontaxable entities:

(1) The owners of partnerships and proprietorships have unlimited liability for loss.

(2) The number of shareholders that S corporations can have is limited (100-shareholder limit).

(3) S corporations' shares cannot be owned by a C corporation.

FINANCIAL STATEMENT ANALYSIS

After normalizing financial statements as discussed above, the consultant should analyze the financial statements to identify and assess trends and relationships. Financial statement analysis generally involves:

a. Comparing financial statement amounts.

b. Analyzing financial ratios.

c. Making comparisons with peer groups, that is, industry or guideline company data.

d. Reviewing prospective information.

Financial statement analysis may also reveal GAAP or normalization adjustments. Accordingly, financial analysis and adjustment normally will be performed together to some extent.

Comparing Financial Statement Data

Comparing financial statement data reveals trends and highlights major strengths and weaknesses. It also can reveal areas requiring adjustment. Specific areas to consider include:

a. *Current Assets.* When analyzing financial statements, the consultant should consider the value of all significant current assets. The value of accounts receivable depends on their collectibility. Consultants typically look at accounts receivable aging and write offs to assess their recoverability. Inventory is another consideration. The consultant also should consider whether there may be large amounts of obsolete or excess inventories.

b. *Property and Equipment.* Consultants should consider asset lives, depreciation methods, and the net realizable value of property and equipment. They also should consider the replacement cost of those assets. Some businesses are valued in part based on asset value or comparison of market to book value. In those cases, the consultant should compare the company's fixed asset levels to those of its peers. Sometimes it may be appropriate to obtain appraisals of fixed assets.

c. *Current Liabilities.* Consultants should consider the age of accounts payable and the companies' payment practices. They should also note whether there is any dependence upon one or a small group of suppliers.

d. *Debt-financing.* Consultants should consider the companies' financing arrangements, such as: short-term versus long-term collateral; rates; terms; covenants; unused lines of credit; or additional borrowing capacity.

e. *Equity Capital.* Consultants should obtain an understanding of the companies' equity capital structures. If the company is a partnership, the consultant should consider the number of limited partners versus general partners, as well as their respective ownership interests. If the company is a corporation, the consultant should consider how much of the equity capital is preferred stock versus common as well as the features of each equity security and, dividend practices and requirements. Any convertible notes, warrants, options, or similar arrangements should be identified. Such factors can affect marketability and minority interest discounts.

f. *Off Balance Sheet Financing.* The consultant should determine if the company has any off balance sheet financing arrangements, such as leases and letters of credit.

g. *Revenues.* Revenue growth or decline is often an excellent sign of a company's ability to produce profits. The consultant should review sales by product, preferably in both units and dollars. Many of those areas will be covered when the consultant reviews the company's pricing policies, marketing strategy, and market share.

h. *Nonoperating Income and Nonrecurring Expenses*. When the consultant assesses a company's earnings trend, it is important to consider the effects of nonoperating income (e.g., income from unrelated investments) and nonrecurring expenses (e.g., losses from closing a business segment). Such items are not part of the company's normal operating results and should be excluded from valuation calculations.

i. *Significant Variations.* If significant variations are found in the analysis, the consultant should investigate the causes. Such variations may result from seasonal or cyclical factors, unusual circumstances, industry or company volatility, or other factors. The consultant should consider the effects of such factors on the company's operations. Also, the consultant should consider whether variations arose from errors that should be corrected in the adjusted financial statements.

That list of considerations is not all-inclusive. It should also be noted that the consultant's analysis will consider trends over the periods reviewed and relationships within each period.

Ratio Analysis

Ratios can be an effective part of financial analysis. Ratios can highlight trends and allow comparisons with industry peers. In a valuation engagement, ratio analysis is used in many ways. For example, consultants may use ratio analysis to assist in:

a. *Identifying Financial Statement Adjustments.* Comparing the company's ratios to industry or guideline company data often reveals areas that may need adjustment, such as excess assets, asset shortages, unrecorded revenues, and compensation above or below a reasonable level.

b. *Identifying Key Variables.* Consultants often use ratios to identify key factors that may affect a company's value. For example, the pretax profit margin (pretax earnings divided by sales) highlights the relationship between sales and expenses. Pretax return on equity (pretax earnings divided by equity) highlights the pretax profits generated by equity invested. Compound growth rates provide a historical perspective of revenue or profit growth. Those ratios can be useful in estimating future earnings capacity.

c. *Assessing Financial Risk.* Financial risk is an important consideration in determining discount rates.

d. *Applying Certain Valuation Techniques.* Some valuation methods use ratio data in their calculations. For example, the excess earnings method sometimes uses return on equity or return on assets data.

Exhibit 1-6 presents some suggested financial ratios. Also, consultants might refer to the nonauthoritative guidance included in the AICPA's Forensic and Valuation Services Section Practice Aid 06-3, *Analyzing Financial Ratios*, which provides definitions and interpretations of common ratios.

Exhibit 1-6

Suggested Financial Ratios

RATIO	FORMULA	USE
Liquidity		
Current Ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Commonly used liquidity ratio.
Acid Test (Quick) Ratio	$\frac{\text{Total cash, cash equivalents, and accounts receivable}}{\text{Current liabilities}}$	More conservative because it only considers assets that can be readily liquidated.
Activity		
Age of Inventory	$\frac{365 \times \text{Average inventory}}{\text{Cost of sales}}$	Indicates average number of days to sell inventory.
Age of Receivables	$\frac{365 \times \text{Average accounts receivable}}{\text{Net credit sales}}$	Estimates average collection period for credit sales.
Total Asset Turnover	$\frac{\text{Net sales}}{\text{Total assets}}$	Indicates how efficiently those assets are producing sales.
Sales/Working Capital	$\frac{\text{Net sales}}{\text{Current assets minus current liabilities}}$	Indicates efficiency of current asset use.
Sales/Net Fixed Assets	$\frac{\text{Net sales}}{\text{Net fixed assets}}$	Indicates how efficiently net fixed assets are producing sales.
Sales/Gross Fixed Assets	$\frac{\text{Net sales}}{\text{Gross fixed assets}}$	More conservative ratio because it excludes accumulated depreciation.
Leverage		
Long-term Debt/ Equity	$\frac{\text{Long-term debt}}{\text{Total equity}}$	Indicates the extent of debt financing used to fund company assets.
Times Interest Earned	$\frac{\text{Earnings before interest and taxes}}{\text{Interest expense}}$	Indicates ability of company operations to cover interest expense.
Profitability		
Gross Profit Margin	$\frac{\text{Gross Profit}}{\text{Net sales}}$	Indicates the average percentage of profit generated from each sale.
Pretax Earnings/Sales	$\frac{\text{Earnings before income taxes}}{\text{Net sales}}$	Indicates the average percentage of pretax income generated from each sale.

RATIO	FORMULA	USE
Pretax Earnings/ Total Equity	$\dfrac{\text{Earnings before income taxes}}{\text{Total equity}}$	Indicates the pretax return on equity to the stockholders.
Pretax Earnings/ Total Assets	$\dfrac{\text{Earnings before income taxes}}{\text{Total assets}}$	Indicates the pretax return on total assets.
Growth		
Compound Growth Rate	$\left[\left(\dfrac{\text{Amount, Year N}}{\text{Amount, Year 1}}\right)^{\frac{1}{(N-1)}} - 1\right]$	Indicates compound growth rate of sales, net income, etc. Expressed in percent.

*   *   *

One common form of analysis is using comparative common-size statements, which present balance-sheet and income-statement data as percentages of total assets and total revenues, respectively. As with analyzing historical financial statements, common-size data should be reviewed for trends among the various periods and relationships within each period.

Peer Comparisons

Peer comparisons are common in financial statement and ratio analysis. The company's financial data is compared to specific similar companies or total industry data to determine the company's strengths and weaknesses relative to the industry group. Common sources for data on industry averages and guideline companies are discussed previously. However, before making such comparisons, the consultant must ensure that:

a. The industry or companies are truly comparable (type of business, size, markets served, etc.).

b. The company data is presented on a comparable basis to the peer data (that is, the entities used similar accounting principles, and the ratios were computed the same way).

Those two criteria are critical for making a valid analysis. Many valuation errors result from using peer data that is not truly comparable, such as comparing pretax ratios to after-tax ratios. The company's financial data will often require adjustment before meaningful comparisons can be made.

Reviewing Prospective Information

The preceding paragraphs discussed analysis of historical financial data. Consultants also should review any available company budgets or forecasts. Prospective financial data is used to apply discounted future returns methods and to identify future company goals and trends. Before using the data, the consultant should determine:

a. *What accounting principles were used.* The accounting principles used to prepare the prospective data should be consistent with those used in the historical statements.

b. *Whether the assumptions are reasonable.* The consultant should consider whether the assumptions in the prospective data are reasonable, based on the consultant's knowledge of the company and discussions with management.

Even if the consultant finds inconsistent accounting principles, unreasonable assumptions or other errors, it is possible that no formal adjustments may be needed. The steps to be taken depend on the valuation methods used.

If a discounted future returns method is used, the prospective statements may need to be restated. For other methods, the consultant may only use prospective data for qualitative analysis, and no formal adjustment may be needed.

PROCEDURES FOR INDUSTRY ANALYSTS AND ACCOUNTANTS

The objectives for data gathering and analysis in an internal valuation are similar to those of the independent valuation consultant. The difference is mainly a matter of degree.

Data Gathering

The industry analyst or accountant is already familiar with the company, its business, its strategy, its financial performance, and its accounting policies. Thus, the internal analyst will focus primarily on obtaining the external data discussed previously. Of course, sometimes additional internal data is needed to perform the valuation or to understand some specific aspects of the business. Then the analyst would need to spend some time in those areas.

Data Analysis and Adjustment

Likewise, the industry analyst usually needs less time to analyze and adjust the company's financial data. The basic procedures outlined above apply to both external and internal valuations.

CASE STUDY ON BUSINESS VALUATION

This section introduces a case study of a business valuation engagement to illustrate the valuation process.

Background

SJM Restaurants, Inc., a Missouri corporation, operates a small chain of 15 casual dining, Italian theme restaurants in the Midwest. The company has been in business for almost 30 years and is run by the company president and 50% shareholder, Robert Eaton. Bill Thompson, Vice President of Operations, and Suzanne Madison, Vice President of Finance and Controller, are the other two shareholders—each owning a 25% interest in SJM. Eaton has engaged Collinsworth and Company to perform a business valuation as of August 14, 20X3.

During the data-gathering process, John Collinsworth, valuation consultant, obtained the following information:

a. Mr. Eaton was paid $850,000 in salary during the last twelve months ended July 31, 20X3. After reviewing his activities, management and organization structure, industry practices, and other relevant factors, John believes that a compensation adjustment may be needed. After checking with executive recruiters and industry sources, John determines that a reasonable salary would be $350,000. Similar adjustments are needed for 19Y8–20X2.

b. John's review of travel and entertainment expenses for the five-year period indicated that personal expenses were included in the company's expenses.

c. John's review of operating expenses reveals that selling expenses include various discretionary promotional expenses related to contests and trade outs that a new owner would probably eliminate.

d. The other income in 20X2 represents the settlement of a lawsuit in favor of the Company that is considered non-operating income.

e. The other assets on the historical balance sheets consist of artwork and a boat originally costing $1,128,946. Based on conversations with the controller, John determines that expenses relating to the boat, including depreciation, were incurred by the company. John considers the boat and painting to be nonoperating assets. Accordingly, John plans to evaluate those separately from the company's normal operations. Both assets will be valued by qualified appraisers.

Financial Statement Adjustments

Income Statement Adjustments. Based on the information obtained, John determined that the following income statement normalization adjustments were necessary:

a. Compensation for Mr. Eaton.

b. Personal expenses and travel and entertainment.

c. Nonrecurring income related to the lawsuit settlement.

d. Boat expenses (relate to a nonoperating asset).

e. Discretionary promotional expenses related to contests and trade outs.

Balance Sheet Adjustments. John determined that the following balance sheet normalization adjustment was needed:

a. Nonoperating assets (boat and artwork).

After the financial statements have been adjusted, John can begin performing ratio analysis and making comparisons with guideline company and industry data.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

14. A consultant may review a company's financial statements to determine what modifications may be needed to create a normalized, comparative data base at what phase of the valuation engagement?

    a. After the data has been adjusted.

    b. After the data-gathering phase.

    c. In the preliminary data-gathering phase.

15. A nonpublic company has large investments in fixed assets and has not inventoried those assets recently. What type of potential GAAP departure does this indicate?

    a. Understated inventories.

    b. Obsolete, damaged, or abandoned equipment still shown in the financial statements.

    c. Unrecorded prepaid expenses.

    d. Unrecorded liabilities.

16. A consultant who becomes aware that previously reported-on financial statements contain a material error, should comply with which of the following standards?

    a. The AICPA Statements of Responsibilities in Tax Practice Nos. 6 (TS 600) and 7 (TS 700).

    b. SAS No. 1 (AU 561) and SSARS No. 1 (AR 100) and its interpretation (AR 9100.13-.15), as applicable.

17. Owners' salaries and dividends are often manipulated to reduce the total tax liability. Use the following assumptions and calculate the total tax liability (individual and corporate combined) for a closely held business:

C Corporation's earnings before taxes and owner's salary	$	500,000
Total salaries	$	125,000
Total dividends	$	75,000
Effective corporate income tax rate		39%
Effective individual income tax rate		33%

    a. $66,000.

    b. $183,000.

    c. $212,250.

    d. $261,000.

18. Compensation adjustments generally are needed in valuation engagements due to which of the following circumstances?

    a. The company is establishing an ESOP and the owner/manager is remaining with the company.

    b. Compensation adjustments are at a reasonable level.

c. Valuing minority interests.

d. Net income is relevant to the valuation methods to be used.

19. A consultant has determined that a C corporation being valued using the capitalized earnings method has normalized taxable income for 2009 of $350,000. What is the company's incremental income tax rate for 2009?

    a. 15%.

    b. 25%.

    c. 34%.

    d. 39%.

20. Which of the following statements is true regarding S corporations?

    a. S corporations cannot have C corporations as shareholders.

    b. The owners of partnerships and proprietorships have limited liability for loss.

21. Of the following activity financial ratios, which one indicates efficiency of current asset use?

    a. Sales/Net Fixed Assets.

    b. Total Asset Turnover.

    c. Sales/Gross Fixed Assets.

    d. Sales/Working Capital.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

14. A consultant may review a company's financial statements to determine what modifications may be needed to create a normalized, comparative data base at what phase of the valuation engagement? **(Page 130)**

    a. After the data has been adjusted. [This answer is incorrect. Financial statements may be reviewed after the data has been adjusted to assess trends and relationships within the financial statements and among different periods.]

    b. After the data-gathering phase. [This answer is correct. After the data-gathering phase is the appropriate time to review financial statements to determine what adjustments might be needed to create a normalized, comparative data base.]

    c. In the preliminary data-gathering phase. [This answer is incorrect. Financial statements may be reviewed in the preliminary data-gathering phase to determine if the financial data is complete and usable.]

15. A nonpublic company has large investments in fixed assets and has not inventoried those assets recently. What type of potential GAAP departure does this indicate? **(Page 131)**

    a. Understated inventories. [This answer is incorrect. The explanation for a GAAP departure involving understated inventories is that some small businesses may attempt to understate inventories to reduce income taxes.]

    b. Obsolete, damaged, or abandoned equipment still shown in the financial statements. [This answer is correct. Companies with large investments in fixed assets, especially those that have not inventoried those assets recently, are likely to have obsolete, damaged, or abandoned equipment that is still shown in the financial statements.]

    c. Unrecorded prepaid expenses. [This answer is incorrect. When the type of GAAP departure is unrecorded prepaid expenses, the correct explanation is that prepaid items are occasionally expensed to save income taxes.]

    d. Unrecorded liabilities. [This answer is incorrect. Unrecorded liabilities are a common problem with interim financial statements when late bills are not recorded in the correct accounting period.]

16. A consultant who becomes aware that previously reported-on financial statements contain a material error, should comply with which of the following standards? **(Page 133)**

    a. The AICPA Statements of Responsibilities in Tax Practice Nos. 6 (TS 600) and 7 (TS 700). [This answer is incorrect. A consultant should consult the AICPA Statements of Responsibilities in Tax Practice Nos. 6 and 7 when performing tax services and becomes aware that prior tax returns contain a material error.]

    b. SAS No. 1 (AU 561) and SSARS No. 1 (AR 100) and its interpretation (AR 9100.13-.15), as applicable. [This answer is correct. A consultant should consult SAS No. 1 and SSARS No. 1 when performing financial reporting services and becomes aware that financial statements previously reported on such as a compilation, review, or audit, contain a material error, should refer to SAS No. 1 and SSARS No. 1 and its interpretation, as applicable.]

17. Owners' salaries and dividends may be manipulated to reduce the total tax liability. Use the following assumptions and calculate the total tax liability (individual and corporate combined) for a closely held business: **(Page 136)**

C Corporation's earnings before taxes and owner's salary	$	500,000
Total salaries	$	125,000

Total dividends	$	75,000
Effective corporate income tax rate		39%
Effective individual income tax rate		33%

a. $66,000. [This answer is incorrect. $66,000 is the individual income tax. Corporate income taxes should be included.]

b. $183,000. [This answer is incorrect. Do not deduct dividends from corporate earnings when calculating corporate income taxes.]

c. $212,250. [This answer is correct. Using the tax liability formula indicated in the text and applying the assumptions listed above, the total tax liability is $212,250 ($146,250 corporate tax plus $66,000 individual tax).]

d. $261,000. [This answer is incorrect. The owner's salary must be deducted before calculating the corporate income taxes.]

18. Compensation adjustments generally are needed in valuation engagements due to which of the following circumstances? **(Page 137)**

a. The company is establishing an ESOP and the owner/manager is remaining with the company. [This answer is incorrect. If the owner/manager is remaining with the company, compensation adjustments generally are not needed. However, if the owner/manager is selling the business, compensation adjustments are appropriate.]

b. Compensation adjustments are at a reasonable level. [This answer is incorrect. Compensation adjustments are not needed in cases where compensation adjustments are reasonable. However, compensation adjustments are needed in cases where the amount of the compensation adjustment will materially impact the valuation.]

c. Valuing minority interests. [This answer is incorrect. Valuing minority interests generally are not needed since the minority owner cannot control the salary levels and, therefore, cannot benefit from any adjustments.]

d. Net income is relevant to the valuation methods to be used. [This answer is correct. Compensation adjustments are warranted if net income or cash flow is relevant to the valuation methods to be used.]

19. A consultant has determined that a C corporation being valued using the capitalized earnings method has normalized taxable income for 2009 of $350,000. What is the company's incremental income tax rate for 2009? **(Page 140)**

a. 15%. [This answer is incorrect. The Federal corporate income tax rate for 2009 would be 15% for a company with taxable income of $50,000 or less.]

b. 25%. [This answer is incorrect. The Federal corporate income tax rate for 2009 would be 25% for a company with taxable income over $50,000 but less than $75,000.]

c. 34%. [This answer is incorrect. The Federal corporate income tax rate for 2009 would be 34% for a company with taxable income over $75,000 but less than $100,000.]

d. 39%. [This answer is correct. The Federal corporate income tax rate for 2009 would be 39% for a company with taxable income over $100,000 but not over $335,000.]

20. Which of the following statements is true regarding S corporations? **(Page 140)**

    a. S corporations cannot have C corporations as shareholders. [This answer is correct. C corporations cannot be shareholders in S corporations per the Internal Revenue Code.]

    b. The owners of general partnerships and proprietorships have limited liability for loss. [This answer is incorrect. The owners of partnerships and proprietorships have *unlimited* liability for loss. Partners in a general partnership can act as agents for the partnership and have liability for partnership obligations. However, in limited partnerships, limited partners will usually only risk their contributed capital.]

21. Of the following activity financial ratios, which one indicates efficiency of current asset use? **(Page 144)**

    a. Sales/Net Fixed Assets. [This answer is incorrect. Sales/Net Fixed Assets ratio indicates how efficiently net fixed assets are producing sales.]

    b. Total Asset Turnover. [This answer is incorrect. Total Asset Turnover ratio indicates how efficiently those assets are producing sales.]

    c. Sales/Gross Fixed Assets. [This answer is incorrect. Sales/Gross Fixed Assets ratio indicates how efficiently gross fixed assets are producing sales and excludes accumulated depreciation.]

    d. Sales/Working Capital. [This answer is correct. The activity financial ratio that indicates efficiency of current asset use is called the Sales/Working Capital ratio. Net sales are divided by current assets minus current liabilities.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (VALTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. There is a basic list of data the valuation consultant hopes to obtain about any company being valued. According to the text, when some of the desired data is unavailable, which of the following actions by the consultant is recommended?

   a. Wait for the unavailable data to become available before performing the engagement.

   b. Look for creative alternatives to compensate for the data that is not included.

   c. Substitute comparable data for the data that has been determined to be unavailable.

   d. Give serious consideration to withdrawing from the engagement.

2. Year-end financial statements generally should be obtained by the consultant for which years preceding the valuation date?

   a. The most recent three years.

   b. The most recent four years.

   c. The most recent five years.

   d. The most recent six years.

3. Of the following statements, which one is accurate regarding accounting principles applied to interim statements compared to those applied to annual statements?

   a. They are always consistent.

   b. They are usually consistent.

   c. They often are not consistent.

   d. They are never consistent.

4. When performing a business valuation, which of the following regarding the use of financial statements is true?

   a. Consolidated financial statements alone are never sufficient.

   b. Financial statements for the parent company alone generally are all that the consultant needs.

   c. Separate financial statements for each subsidiary are rarely required.

   d. Separate financial statements for the parent company and each subsidiary generally are necessary.

5. Which of the following is true regarding the consultant's responsibility for detecting GAAP errors in a valuation engagement?

   a. The consultant has no responsibility for detecting GAAP errors in any valuation engagement.

   b. Generally, the consultant is only responsible for detecting GAAP errors if those errors are noted on the accountant's report on the financial statements.

c. Generally, the consultant is only responsible for detecting GAAP errors in cases where those errors are noted on the accountant's report on the financial statements, or such errors are identified by an appropriate party related to the company being valued.

d. The consultant is always responsible for detecting GAAP errors in any valuation engagement.

6. Which of the following is **not** identified in the text as something the consultant can do when performing a valuation to gain an understanding of the operations and key people in the company being valued?

   a. Talk to predecessor consultants.

   b. Visit the company's website.

   c. Tour the company's facilities.

   d. Obtain additional operational data.

7. A number of actions are valuable when performing a valuation. Of the following actions, which one is **false**?

   a. Occasionally, minutes of board of directors meetings or employee handbooks may be useful.

   b. The consultant is often times engaged to perform procedures to verify the accuracy of the data.

   c. The consultant should rely on judgment/experience in determining what documents are needed.

   d. The consultant must rely on the accuracy of the data being reviewed and management representations.

8. During the data-gathering phase of a valuation, which of the following is true regarding requesting a signed receipt from the client which states that all original documents have been returned?

   a. It would be of little or no importance.

   b. It would be important in judicial proceedings.

   c. It would be insulting to a client to request a signed receipt.

   d. Do not select this answer choice.

9. Once the consultant has identified the key external factors, he or she should determine what external data will be needed on the engagement. There are typically two stages involved in this decision. What does the consultant do first?

   a. The consultant should decide whether his or her knowledge should be expanded to select and apply the appropriate valuation methods.

   b. The consultant generally needs to have a basic understanding of relevant economic and industry conditions.

   c. Do not select this answer choice.

   d. Do not select this answer choice.

10. Probably the most popular source of industry ratio data is:

    a. Trade Associations.

    b. Standard & Poor's Industry Surveys.

c. RMA Annual Statement Studies.

d. Do not select this answer choice.

11. Which of the following sources would a consultant want to use for information on national financial conditions?

    a. Economic Report of the President.

    b. U.S. Financial Data.

    c. Barrons.

    d. Do not select this answer choice.

12. Rev. Rul. 59-60 indicates that, when valuing a business, a sound appraisal of a closely held stock must consider which of the following?

    a. Only current economic conditions as of the date of the appraisal in the industry/industries the corporation is allied with.

    b. Current and prospective economic conditions as of the date of the appraisal only in the industry/industries the corporation is allied with.

    c. Current and prospective economic conditions as of the date of the appraisal only in the national economy.

    d. Current and prospective economic conditions as of the date of the appraisal, both in the national economy and in the industry/industries with which the corporation is allied.

13. Which of the following is probably the best known source of comparative financial data?

    a. IRS Corporate Financial Ratios (Schonfeld & Associates).

    b. Annual Statement Studies (RMA–The Risk Management Association).

    c. Key Business Ratios (Dun & Bradstreet).

    d. Financial Studies of the Small Business (Financial Research Associates).

14. When financial statements in a valuation engagement are adjusted to provide the consultant with a consistent and reasonable starting point for the valuation decision, the adjustments are:

    a. GAAP adjustments.

    b. Normalization adjustments.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

15. Which of the following techniques makes a comparison among several years of data easier?

    a. Presenting the original (unadjusted) financial statements and subsequently separately presenting statements that summarize the adjustments to the original statements.

    b. Adjusting each account balance and presenting new financial statements that are restated.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

16. When there is a GAAP departure involving the failure to record capital lease obligations, which of the following should be recorded on the balance sheet?

    a. The asset and a lease expense.

    b. Inventory and a lease obligation.

    c. The asset and a lease obligation.

    d. Either inventory, or the asset, and a lease obligation.

17. The consultant should usually avoid adjusting a company's balance sheet to reflect normalization adjustments for which of the following?

    a. Asset shortages.

    b. Nonoperating assets.

    c. Excess assets.

    d. Do not select this answer choice.

18. Use the following assumptions and calculate the total tax liability (individual and corporate) for a closely held business:

C Corporation's earnings before taxes and owner's salary	$	500,000
Total salaries	$	200,000
Total dividends	$	0
Effective corporate income tax rate		39%
Effective individual income tax rate		33%

    a. $66,000.

    b. $117,000.

    c. $183,000.

    d. $261,000.

19. A consultant determined that a company that was valued using the capitalized earnings method had normalized taxable income for 2009 of $70,000. What was the company's incremental Federal corporate income tax rate for 2009?

    a. 15%.

    b. 25%.

    c. 34%.

    d. 39%.

20. The maximum number of shareholders a corporation can have and still qualify for S corporation status is:

    a. 50.

    b. 75.

    c. 100.

    d. 150.

21. Of the following profitability financial ratios, which one indicates the average percentage of profit generated from each sale?

    a. Pretax Earnings/Sales.

    b. Gross Profit Margin.

    c. Pretax Earnings/Total Assets.

    d. Pretax Earnings/Total Equity.

Lesson 2: Business Valuation Methods

INTRODUCTION

This lesson discusses the following valuation methods:

a. Underlying assets methods.

(1) Net Asset Value.

(2) Liquidation Value.

(3) Excess Earnings.

b. Other methods.

(1) Multiple of Discretionary Earnings.

(2) Rules of Thumb.

(3) Company-specific methods.

Learning Objectives:

Completion of this lesson will enable you to:
- Identify the various underlying assets methods and when they should be applied.
- Describe the multiple of discretionary earnings method and to what businesses it is best suited.

UNDERLYING ASSETS METHODS

What Are Underlying Assets Methods?

In applying underlying asset valuation methods, the company's assets and liabilities are adjusted to their appraised values, and the net result is an indication of the value of the company's equity. The three primary underlying asset methods are:

a. *Net Asset Value (NAV) Method.* Under this method, the company's assets and liabilities are adjusted to appraised values to determine the value of the company's equity.

b. *Liquidation Value (LV) Method.* Under this method, the net proceeds from liquidating the company's assets and paying off liabilities are discounted to present value.

c. *Excess Earnings Method.* Under this method, the company's tangible assets and liabilities are adjusted to appraised values and an estimate of intangible asset values is added to that amount to determine the value of the company's equity.

When Should Underlying Assets Methods Be Applied?

As previously discussed, underlying assets methods focus on the value of a company's assets under hypothetical sale conditions instead of its earnings potential. Thus, the underlying assets methods are generally used in one of the following situations:

a. The company's value depends heavily on the value of its tangible assets, and there is little or no value added to its products or services from labor or intangible assets (such as a real estate investment company).

b. The company has no established earnings history, a volatile cash flow/earnings history, or a questionable ability to continue as a going concern (such as a start-up company or troubled business).

Sometimes an underlying asset method may be used even when the above conditions are not met, but the method will normally receive less weight than an earnings-based method.

NAV Method. The NAV method presumes that the subject company's value will be realized by the hypothetical sale of its assets as part of a going concern. Thus, the NAV method generally should be considered only if all the following criteria are met:

a. The subject company holds significant tangible assets.

b. There is little or no value added to the company's products or services from labor. Labor-intensive businesses generally are not suited to the NAV method.

c. The company has no significant intangible assets. (However, some companies in extractive industries—that is, mining or oil and gas production companies—may be suited to the NAV method, even though they have significant intangible assets, such as mineral rights.)

d. The balance sheet reflects all the company's tangible assets, that is, the company has not expensed any tangible assets that continue to benefit the company. (However, sometimes the consultant may be able to adjust the balance sheet to record those assets and still apply this method.)

If the consultant plans to value a partial interest in the subject company using the NAV method, there is another important consideration. The subject ownership interest should be able to cause the sale of the company's assets. Most states require a minimum ownership percentage (at least a majority) to cause sale of a company's assets. Accordingly, the NAV method is more appropriate for valuing controlling interests than for minority interests. If the subject interest is a minority interest, the consultant should consider using the price/net asset value method instead of the NAV method. However, some state laws, called shareholder oppression statutes, allow certain minority interests to petition the court for dissolution of the corporation, thereby causing the sale or distribution of company assets. In those states, if a minority interest has begun or threatened to begin a shareholder oppression action, the consultant may be able to apply the NAV method to value the minority interest. In such instances, the consultant should seek legal advice regarding the appropriate premise of value.

Examples of companies that may be valued using the NAV method include:

- Real estate investment companies.
- Holding companies and other investment companies.
- Some natural resources (oil and gas, mining, timber, etc.) companies.
- Start-up businesses.
- Small businesses that are easy and relatively inexpensive to start (small machine shops, small retail stores, etc.).

LV Method. The LV method should be considered when:

a. The company is in liquidation, such as Chapter 7 bankruptcy.

b. The company's current and projected net cash flows from continuing operations are low compared to net assets, and the company is worth more *dead* than *alive*. Then, the company's LV might be its maximum potential value and the only usable indicator of value to the owners.

c. The company's current and projected cash flows from continuing operations are low enough that its liquidation value is almost equal to its going concern value. Some owners may prefer liquidation, while others may prefer continued operation. Then, both the LV method and going-concern methods may be considered in valuing the business.

d. The company is a multi-division or multi-subsidiary holding company where some divisions are profitable and others are not.

Also, as noted above, the LV method may be applicable in minority oppression situations if the value realized through the dissolution of the business would be the orderly liquidation value of the assets rather than the going concern value of the assets.

Excess Earnings Method. The excess earnings method is similar to the NAV method except it also adds an additional amount for intangible assets based on its "excess earnings." The excess earnings method should be considered when:

a. The company has an established earnings history and its value is derived primarily from earnings.

b. Current earnings are expected to approximate future earnings.

c. Adequate reliable data is available to reasonably estimate expected normal earnings.

Engagement Considerations When an Underlying Assets Method Is Used

Use of an underlying assets method may require the consultant to make several engagement decisions that may not be required for other valuation methods. These decisions or considerations relate to:

a. Deciding whether an asset appraiser may be needed.

b. Determining the qualifications for an asset appraiser.

c. Defining the premise of value for the asset appraiser.

d. Determining whether special procedures (such as physical inventories or analysis of certain assets) are required.

Deciding Whether an Asset Appraiser Is Needed. Several factors affect the decision about when an asset appraiser may be needed when an underlying assets method is used. Some of the more obvious factors are:

a. *An Asset Appraiser Is Usually Needed When the LV Method Is Used*. Qualified asset appraisers generally are better informed about market conditions for certain assets than valuation consultants. Thus, an asset appraiser is recommended when the LV method is used.

b. *An Asset Appraiser May Be Needed If There Are Large Amounts of Inventory or Property and Equipment.* A company's balance sheet normally presents inventory and property and equipment at their book values, which may be significantly different from their market values. Accordingly, an asset appraiser may be needed to determine the market value of significant assets, especially real estate and equipment. Values of fixed assets are normally expressed based on one of the following premises—value in use, orderly liquidation, or forced liquidation (auction).

c. *An Asset Appraiser May Be Needed for Companies in Certain Industries.* Some asset-intensive companies in specialized industries are more likely to require asset appraisers. For example, a real estate investment company with large inventories of undeveloped properties probably will require appraisals from a qualified real estate appraiser. Likewise, an oil and gas production company will normally require a reserve report of developed and undeveloped oil and gas reserves as of the valuation date.

Determining the Qualifications of an Asset Appraiser. Although the client typically hires the asset appraiser, the consultant probably will recommend the appraiser to be used. Accordingly, the consultant should consider what qualifications the appraiser should have to perform a competent appraisal. Factors to consider include:

a. *Professional Certifications.* Obviously, the asset appraiser should have appropriate professional certifications. For example, real estate appraisers preferably should have an ASA, MAI, or SREA certification. Oil and gas appraisers should be petroleum engineers.

b. *Relevant Experience.* The asset appraiser should have appropriate experience for the services needed. The appraiser should be familiar with the specific types of assets to be valued, especially if they are unique.

c. *Ability to Support the Opinion.* The asset appraiser should be able to provide a clear, sound explanation of the asset appraisal and conclusions reached. The appraiser also should provide reference material, market data, and other information to support the analyses, opinions, and conclusions.

What If the Client Will Not Hire an Appraiser? If the client refuses to hire an appraiser, the consultant should:

a. *Reconsider Using An Underlying Asset Method.* The consultant should assess whether using an underlying asset method is essential to valuing the company or merely helpful. If the consultant decides that the underlying asset method is not essential, it can be omitted. However, depending on the circumstances, it may be appropriate to put a qualification in the valuation report to the effect that asset appraisals were not obtained, perhaps indicating that this was a client decision.

b. *Consider Alternative Sources.* If the consultant considers the underlying asset method essential, then he or she should consider whether there are suitable alternative sources of information. For example, previous appraisals may be usable if the consultant can make reasonable adjustments for the time period, changes in economic conditions and other factors. Also, the consultant may rely on management's written representation about its asset values. However, that runs a risk as to the degree of confidence that can be placed in the valuation conclusion.

If an underlying asset method is essential and there are no satisfactory alternative sources, the consultant should consider withdrawing from the engagement.

Defining the Premise of Value. The consultant, in conjunction with the asset appraiser, should define the premise of value that the asset appraiser will use so that it will be consistent with that in the company's valuation. In defining the appraiser's premise of value, the consultant should remember that different appraisers may use slightly different terminology. Thus, the consultant should not only specify the premise of value but also obtain from the appraiser a clear definition of that premise. The definition should include the time available to sell the assets, and the consultant may request that the period be stated in the appraiser's reports. Using the NAV or excess earnings method, the premise normally will be *value in use*. Using the LV method, the consultant typically should select one of the following premises of value:

a. *Forced Liquidation Value.* Value realized from selling the assets as quickly as possible, such as at an auction.

b. *Orderly Liquidation Value.* Value realized from selling the assets over a reasonable period, typically six to nine months, to get the best price for each.

The most common LV premise is the orderly liquidation value. However, if lack of funds or other factors are likely to keep the company from holding its assets for a reasonable period, then the forced liquidation value premise may be more appropriate.

If the consultant is uncertain of what period the appraiser should use in a given situation, the appraiser may be requested to use "an appropriate time period for sale" for the specific premise. If the consultant is uncertain of the premise to be used, then the appraiser potentially could be requested, at least on a preliminary basis, to provide values under as many premises as necessary to determine the appropriate one.

Determining Whether Special Procedures Are Required. Since the underlying asset methods rely on the existence and value of the company's assets as of the valuation date, a physical count or inspection as of the valuation date may be needed if there are significant amounts of inventory or property and equipment. Physical counts will generally be conducted by the client, sometimes under the supervision of the asset appraiser or valuation consultant. The consultant should consider whether such inventories are needed and what individuals should participate in them. In making that decision, the consultant also should be aware that a company may have significant amounts of supplies or parts on hand that are not reflected in the balance sheet, and those items should be counted and valued.

Besides the assets that may require physical inventories, there may be special groups of assets that need detailed analysis. For example, if a company has significant accounts receivable, the consultant may need to obtain an aged listing of those receivables to properly value the collectibility of each account.

If the balance sheet has numerous assets and liabilities, but has not been subjected to a compilation, review, or audit by a CPA, the consultant may conclude that further procedures may be warranted, especially for interim financial statements.

Reporting Considerations

When reporting on valuations that used an underlying asset method, many consultants present a statement of assets and liabilities based on the estimated values. For CPAs, that raises some unusual reporting considerations, such as whether such statements are subject to SSARS.

NET ASSET VALUE METHOD

Overview of the Method

The steps to apply the NAV method are as follows:

Step 1 Obtain the balance sheet as of or as near as possible to the valuation date.

Step 2 Adjust the balance sheet, if necessary, for known missing assets or liabilities, or to update the balance sheet to the date of the valuation.

Step 3 Adjust each tangible asset and identifiable intangible asset to its appraised value, which is generally fair market value. (Exhibit 2-1 presents some common adjustments.)

Step 4 Adjust liabilities to their appraised (market) values, if different from their book values.

Step 5 If appropriate, make adjustments for income taxes and interest-bearing liabilities.

Step 6 The amount of total equity after completing Steps 1–5 is the value of total stockholders' equity. If the company has preferred stock or other senior equity securities, then the equity value must be reduced by the value of those securities to determine the value of common equity.

Step 7 Perform "sanity checks" to determine the reasonableness of the value computed in Steps 1–6.

Step 8 Determine if the value computed in Steps 1–6 should be adjusted for applicable discounts.

Step 1—Obtain the Company's Balance Sheet

The starting point for the NAV method should be obtaining the company's balance sheet at or as near as possible (but not after), the valuation date. The consultant theoretically could use either a GAAP balance sheet or a tax basis balance sheet, but one may be more appropriate than the other depending on the circumstances. The consultant also should determine if the balance sheet should be compiled, reviewed, or audited by an independent CPA.

When a Tax Basis Balance Sheet May Be More Appropriate. If the company is a C corporation, the company's tax basis balance sheet (if available as of the valuation date) may be the most efficient starting point because the consultant may need to compute taxes on the difference between the tax basis of the company's assets and liabilities and their corresponding fair market values. However, the tax basis balance sheet may not reflect all the company's assets and liabilities at the valuation date.

When the GAAP Basis Balance Sheet May Be More Appropriate. If the business being valued is a nontaxed entity (S corporation, partnership, or sole proprietorship), the best starting point normally is the company's GAAP basis balance sheet, if GAAP statements are available as of the valuation date. Those types of entities may not have a tax liability associated with the difference between the fair market values of their assets and their tax bases.

Exhibit 2-1

Common Net Asset Value Adjustments

Asset/Liability	Commonly Adjusted to:
Certificates of deposit and money market funds	Face amount plus accrued interest at the valuation date.
Marketable securities	Closing price at the valuation date; or, if the valuation date is a weekend or holiday, the closing price on the last trading day before the valuation date.
Accounts receivable	Outstanding receivables balance at the valuation date, less an appropriate allowance for bad debts.
Inventory	Replacement cost. (The lower of FIFO cost or market may approximate replacement cost if inventory turnover is relatively high and product cost has been relatively constant throughout the last 12 months.)
Related party receivables and payables	Discount them to market value or eliminate them, depending on their economic substance.
Furniture, equipment, and other fixed assets	Fair market value based on asset appraisals or suitable alternatives.
Intangible assets	Eliminate goodwill and reflect identifiable intangibles (patents, copyrights, leasehold interests, etc.) at their fair market values.
Accounts payable and other noninterest-bearing liabilities	Their outstanding balances as of the valuation date.
Notes payable and other interest-bearing debt	Their outstanding balances, with discounts or premiums to reflect market rates, if needed.

*   *   *

Step 2—Adjusting the Balance Sheet for Omitted Assets and Liabilities or When the Balance Sheet Date and the Valuation Date Differ

Omitted Assets and Liabilities. Applying the NAV method involves adjusting the company's assets and liabilities to their fair market values. Before this can be accomplished, the consultant should inquire whether the balance sheet represents a complete listing of all the company's assets and liabilities as of the valuation date. In some instances, the company may have expensed (for both GAAP and tax purposes) supplies, small tools, prepaid insurance, deposits, etc. The fact that those items may have been expensed might not be disclosed in the notes to the financial statements because they were considered to be immaterial when they were originally acquired. However, previously expensed assets may have significant value, especially if they are made up of large stockpiles of supplies or numerous hand tools. The important point is that the balance sheet may not reflect all the company's assets, and thus the consultant should make a special point to ask management whether large amounts of previously expensed assets exist. A physical inventory of supplies or hand tools may be necessary to determine the quantity of the assets and their fair market value.

The balance sheet also may need to be adjusted to an accrual basis if the company uses the cash basis of accounting for tax purposes. In such cases, the balance sheet may not reflect the accounts receivable or payable. Also, if the balance sheet date is different from the valuation date, the consultant may need to obtain the balance sheet closest to (but usually not after) the valuation date and make appropriate adjustments to reflect the assets and liabilities as of the valuation date. If there is a significant period of time between the balance sheet date and the valuation date, non-CPA consultants may need to consider whether a CPA should be engaged to compile, review, or audit the financial statements as of the valuation date.

Intangible Assets and Contingent Liabilities. Sometimes the company may have significant intangible assets or contingent liabilities that are not reflected on the balance sheet. Those assets or liabilities could significantly affect the value of the business. Therefore, the consultant should ask management about the possibility of unrecorded intangible assets and contingent liabilities. Examples of the types of intangible assets that may not be reflected on the company's balance sheet include:

a. *Leasehold Interest.* Leasehold interests may have value if the company has a favorable leasing arrangement for facilities or equipment, assuming the lease can be assigned. The general method for determining leasehold value is to compute the present value of the difference between the lease payments under the lease and a market lease payment over the remaining term of the lease agreement. For example, if a company had 20 months remaining on a lease that required monthly payments of $200, and a market lease rate would be $500 per month, then the leasehold value would be as follows (assuming a discount rate of 12%):

Monthly difference in lease payments	$ 300
Present value factor for an annuity of 20 months at 12%	× 18.0456
Value of leasehold interest	$ 5,414

The discount rate to be used should be the company's weighted average cost of capital (WACC) adjusted for the risks associated with the leasehold interest relative to the risks of the business as a whole, or another suitable market rate of return. Similar principles can be applied to other favorable contract rights, especially if they are assignable.

b. *Internally Developed Intangibles.* Sometimes companies develop intangible assets for which the company has expensed all the costs associated with their development. Examples of such intangibles may include customer lists, patents, or copyrights. The balance sheet may or may not be adjusted for such items.

Unrecorded liabilities may exist because of legal claims (either asserted or unasserted), potential assessments or fines from government agencies (OSHA, EPA, EEOC, IRS, etc.), product warranty obligations, unfavorable long-term leases, etc. If the consultant can reasonably estimate the amount the company is likely to pay to settle such liabilities, that amount generally should be accrued, even if it is at the low end of a range (e.g., "I know the liability will be at least . . ."). If the amount of the company's contingent or unrecorded liabilities cannot be estimated, if the exposure beyond the low-end accrual cannot be determined, or if the likelihood of a loss cannot be determined, the consultant may need to consider discounting the estimated value of the company because of the potential associated with the unrecorded liabilities.

Steps 3 and 4—Adjusting Assets and Liabilities to Appraised Value

The consultant should adjust each tangible asset and each liability to its appraised value based on reports from asset appraisers or suitable alternative sources. Also, in some cases, identifiable intangible assets, such as patents, copyrights, mineral rights, and customer lists, may be adjusted to their appraised values depending on the availability of appraisals and other factors. However, in other cases, adjustments are only made for tangible assets and, possibly, very clearly identifiable intangible assets such as leasehold interests. Unidentifiable intangible assets such as goodwill should be removed. Equity should be increased for increases in assets and reductions in liabilities. Similarly, equity should be reduced for any reductions in assets or increases in liabilities.

Step 5—Make Income Tax Adjustments (If Appropriate)

Valuation consultants generally must consider several different income tax issues relating to the NAV method, including the following:

a. When an interim period is used, whether income taxes should be accrued for the period between the last fiscal year end and the valuation date.

b. Whether the adjustments in Steps 3 and 4 listed in the overview of the Net Asset Value Method should be tax-effected (that is, whether income taxes should be provided on the difference between the fair market value of the company's assets and liabilities and their tax bases).

c. How to deal with deferred income taxes under the NAV method. (This issue generally applies to C corporations only.)

Regarding item a., if the valuation date is a date other than year-end and the company is a C corporation, the consultant should record a liability for taxes for the period between the last fiscal year end and the valuation date. Obviously, if the company is a nontaxed entity (S corporation, partnership, or sole proprietorship), a tax provision would not be necessary.

Regarding item b. (tax effecting the adjustments in Steps 3 and 4), valuation consultants differ on whether income taxes should be considered under the NAV method. Some consultants believe that the assets are valued *as if* put up for sale, without assuming that a sale will occur. Since there is no sale, no taxes will be incurred on any gains on asset sales (or benefits from losses on those sales), and no tax adjustments are needed. Other consultants believe that tax adjustments are needed because gains and losses on asset sales and the related tax expense are recognized in the ongoing net income amounts used in other going concern methods. Thus, they believe that it would be inconsistent not to provide for tax effects on the appraisal adjustments.

Generally, when adjusting asset values on the balance sheet for C corporations, unless specifically directed by law, taxes generally should be provided for the difference between the market values of net assets and their tax bases. The Tax Reform Act of 1986 repealed the "General Utilities Doctrine," which allowed corporations to avoid capital gains taxes at the corporate level by liquidating the corporation within one year. After the Tax Reform Act of 1986, most sales involving C corporations are structured as sales of stock, with the buyer retaining the seller's old basis. That means the buyer does not receive the additional tax deductions associated with stepping up the basis in appreciated assets acquired in the purchase. Since the buyer's tax deductions are reduced, the total benefits from purchasing the company are reduced. Tax-effecting the NAV adjustments recognizes those reduced owner benefits.

If tax adjustments are considered appropriate, the consultant should compute them based on the difference between the market value and the tax basis of the company's assets and liabilities. For example, if the appraised values of the company's assets exceed their tax bases, the consultant would compute a tax provision on that excess. If the appraised values of liabilities are less than their tax bases, that difference should also generate a tax provision. However, tax benefits related to asset writedowns or writeups of liabilities generally should be used only to offset tax provisions on corporate level gains. Otherwise, the benefits will probably be lost. A net tax benefit may be provided if it is probable that those benefits will be realized, but such cases are unusual.

For nontaxed entities, the answer is less clear, and there is no consensus among valuation consultants. Following the reasoning discussed above, tax adjustments generally would not be needed when valuing interests in sole proprietorships and partnerships (assuming that a buyer could step up the basis in partnership assets to market value). However, when valuing S corporations, the consultant should consider the need to provide for built-in gains taxes or state taxes.

Regarding Item c. above, the treatment of deferred income taxes generally depends on the answer to Item b. If the adjustments made in Steps 3 and 4 will be tax-effected, then deferred taxes generally should be eliminated because the effects of book/tax differences, such as book/tax depreciation, generally would be reflected in the tax basis of the assets. Thus, keeping the deferred taxes that were previously recorded would be double counting. However, if the consultant does not tax-effect the adjustments in Steps 3 and 4, the consultant should determine to what book/tax differences the deferred tax liability (or asset) relates. If those differences are likely to result in future tax liability or reductions in future taxes, the deferred taxes should be retained. However, deferred taxes may need to be adjusted to reflect the tax rates in effect at the balance sheet date. Also, if deferred taxes are retained, the tax provision discussed in Item a. should include both deferred taxes and current income taxes.

Special Considerations If There Is a Known Buyer. The discussion above applies to appraisals based on a hypothetical sale between an unknown buyer and seller. If there is a known buyer, the consultant should consider the structure of the proposed transaction (for example, whether it is a stock sale or an asset sale). After the Tax Reform Act of 1986, most sales involving C corporations are structured as sales of stock, with the buyer retaining the seller's old basis. However, sometimes the buyer may wish to structure the transaction as a purchase of assets, primarily to limit the buyer's exposure to significant contingent liabilities. In such cases, the buyer could receive a step-up in basis of the assets and could thus receive more of the tax benefits associated with those assets. However, the seller would be subject to taxes (a) at the corporate level on the gain on selling those assets, and (b) at the individual level on the distribution of the net proceeds to the shareholders. Accordingly, if the valuation relates to a proposed or potential sale, the consultant may wish to make tax adjustments from the client's perspective (depending on whether the client is the buyer or the seller) so the valuation report reflects the benefits accruing to the client based on the structure of the proposed transaction. Note that the definition of value that usually applies when a specific buyer or seller is considered is investment value instead of fair market value.

Disclose Tax Assumptions in the Valuation Report. Since income taxes can significantly affect the estimate of value, consultants should disclose the key tax assumptions made in developing the estimate of value, such as, whether a tax adjustment was made and why, the methods used to determine the tax adjustment, and the structure of the hypothetical (or proposed) sale, if applicable. If those assumptions are disclosed, the users of the valuation report can evaluate the reasonableness of the assumptions and consider the effects, if any, of alternate scenarios.

Step 6—Adjusting for Senior Equity Securities

Steps 1–5 above determine the value of total stockholders' equity. If the company has preferred stock or other senior equity securities and the consultant is valuing the common stock alone, then the equity value must be reduced by the value of senior securities. The value of the senior securities should be determined using one of the following methods:

a. *Dividend Yield.* The stock value is derived primarily from its dividend yield. This procedure involves comparing the yield on the company's preferred stock to yields on publicly traded preferred stocks with similar features. If the company's preferred stock has a lower yield than the publicly traded preferred stocks, its indicated value may be less than par.

b. *Liquidation Preference Value.* The stock value is based upon its liquidation preference, which is usually stated in the stock agreement, articles of incorporation, or other corporate legal documents.

There is no authoritative guidance that specifies which method should be used to value senior securities. The consultant may use the method that is best suited to the circumstances. For example, it may be more appropriate to use the liquidation preference method for a valuation in connection with the sale or liquidation of a business. But, the dividend value method may be more appropriate for a going concern scenario, such as a valuation for an ESOP.

Step 7—Perform "Sanity Checks" to Determine the Reasonableness of the Estimated Value

At first, it may seem unnecessary to perform sanity checks on a value estimate based on the NAV method. The first reaction may be that a company must be at least worth the value of its assets. However, it is important that the consultant consider whether:

a. The estimated values of the assets and liabilities are appropriate based on the definition of value, purpose of the engagement, and other factors.

b. The overall estimate of value of the ownership interest is reasonable, that is whether a buyer is likely to purchase the company at the estimated value, considering the risks associated with ownership and other factors.

Step 8—Adjust for Applicable Discounts

If the NAV method is used to value a minority interest for minority oppression statute purposes, a minority interest discount may be needed, depending on the definition of value and relevant state law. A discount also may be needed for lack of marketability, again depending on the definition of value and relevant state law. The consultant may need to provide a discount for administrative or other costs during the asset sale period or for possible contingent liabilities.

Invested Capital versus Equity

Valuation consultants normally are engaged to value the stockholders' equity of a company. This type of value may be referred to as an *equity* value or *net-of-debt* value. Sometimes, it is useful to value a company's total invested capital (both debt and equity). This type of value may also be referred to as *debt-free* value. Invested capital valuations are sometimes used in cases involving a known buyer who wishes to buy assets instead of company stock.

The steps listed above determine an equity value, unless they are modified. To determine the value on an invested capital basis, the consultant should add the total market value of the company's interest-bearing liabilities to its equity in Step 5 above, or simply not subtract those liabilities in the initial calculations. If the valuation relates to a proposed asset purchase transaction, the consultant may also need to make an income tax adjustment, depending on the purpose of the engagement and the proposed transaction.

Case Study

SJM Restaurants, Inc., is a profitable business with significant value added from both labor and intangible assets. Thus, SJM is not suited to the NAV or LV methods. Another company, XYZ Company (a C corporation), is used to illustrate the NAV method. XYZ's balance sheet at the valuation date and related appraised values are presented at Exhibit 2-2. To simplify the example, the tax bases of the company's assets are assumed to be equal to their book values. The company's value using the NAV method is the difference between the appraised values of XYZ's assets and liabilities. In this example, XYZ's value is an equity value. Fixed asset values were determined by recent asset appraisals. Income taxes were provided on asset value adjustments based on a 40% effective tax rate (includes both federal and state taxes).

Exhibit 2-2

XYZ Company (a C Corporation)
Net Asset Value Method

	Book Value & Tax Basis 12/31/X1	Appraised Value 12/31/X1
Cash	$ 128,000	$ 128,000
Accounts receivable	256,000	256,000
Inventory	900,600	900,600
Other current assets	7,000	7,000
Total current assets	1,291,600	1,291,600
Property, plant, and equipment	1,020,000	1,310,000
Accumulated depreciation	(278,000)	
TOTAL ASSETS	$ 2,033,600	$ 2,601,600
Current maturities of long-term debt	$ 66,000	$ 66,000
Notes payable	266,000	266,000
Accounts payable	227,600	227,600
Accrued liabilities	44,000	44,000
Income taxes payable	46,000	46,000
Total current liabilities	649,600	649,600
Long-term debt net of current maturities	384,000	384,000
Estimated taxes on the difference between appraised value and tax basis of assets		227,200 [a]
Stockholders' equity	1,000,000	1,340,800
TOTAL LIABILITIES & EQUITY	$ 2,033,600	$ 2,601,600
Value indicated by the NAV method		**$ 1,340,800**

Note:

[a] Taxes were computed as follows:

Appraised value of assets	$ 2,601,600
Tax basis of assets	2,033,600
Difference	568,000
Tax rate	× 40 %
Estimated taxes	$ 227,200

Appraised value of liabilities is same as tax basis. Thus, no tax adjustment needed for liabilities.

* * *

LIQUIDATION VALUE METHOD

Overview of the Method

The LV method generally involves several steps and complex analyses. Also, a qualified asset appraiser is needed more often when the LV method is required.

The LV method typically consists of the following basic steps:

Step 1 Obtain the balance sheet as of or as near as possible to the valuation date.

Step 2 Adjust the balance sheet, if necessary, for known missing assets or liabilities, or to update the balance sheet to the date of the valuation.

Step 3 Determine the approach to liquidate the company's assets.

Step 4 Determine the gross amount (before selling costs, taxes, etc.) of proceeds from liquidation.

Step 5 Reduce gross proceeds for applicable direct and indirect expenses.

Step 6 Add or subtract operating profits or losses during the liquidation period.

Step 7 Subtract the liquidation value of all liabilities.

Step 8 Subtract a provision for any additional income tax liabilities from operations or gains on asset sales, if applicable. If losses from sales or operations produce tax benefits, they may be added back in some limited cases.

Step 9 Subtract the liquidation preference of any senior equity securities.

Step 10 Discount to present value the amounts in Steps 4–9 from the dates the net proceeds are received.

Step 11 Determine if the value computed in Steps 1–10 above should be adjusted for a minority interest discount and/or a discount for lack of marketability.

Steps 1 and 2—Obtain the Company's Balance Sheet and Adjust It (If Necessary)

The first two steps of the LV method are the same as the NAV method. However, it should be noted that omitted intangible assets should only be recorded if they can be sold apart from the business.

Step 3—Determining the Approach to Liquidation

Computing liquidation values involves making judgments about how the company's assets should be liquidated. The consultant should determine the best way to liquidate the company's assets, that is the practical way to get the maximum net proceeds from liquidation. This determination is based on several factors, including:

a. Applicable legal restrictions, if any.

b. Potential impact of using an orderly versus forced liquidation premise.

c. The company's ability to liquidate its assets in an orderly manner.

d. Potential liquidation value of intangible assets, if any.

This assessment is the basis for the estimate of the liquidation period.

Step 4—Determine the Gross Proceeds from Liquidation

This determination will depend on the premise of value used in the liquidation (that is, orderly or forced). Also, this step normally requires the use of asset appraisers or other specialists.

In determining gross proceeds from liquidation, the consultant also should consider the nature of any intangible assets. Most intangibles, such as goodwill and most noncompete agreements, have little or no liquidation value because they cannot be sold separately from the business. However, the consultant should be aware of any identifiable intangibles such as mineral rights, patents, customer lists, or other intangibles that might be saleable.

Step 5—Reduce Gross Proceeds for Direct and Indirect Expenses

The gross proceeds in Step 4 should be reduced for direct and indirect expenses. Examples include:

a. *Direct Expenses.* Selling commissions and other fees or taxes related to the specific sales.

b. *Indirect Expenses.* Legal expenses, other professional fees, and any holding costs (interest, taxes, insurance, repairs and maintenance, etc.) not included in the interim results of operations (Step 6 below).

Step 6—Add or Subtract Operating Profits or Losses during the Liquidation Period

Net proceeds should be increased by the amount of any operating profits and reduced for operating losses during the liquidation period. However, defining operations during the liquidation period is not always easy. For example, if the company is conducting normal operations (that is, purchasing, manufacturing, etc.), how does the consultant consider those activities in estimating liquidation operations? Generally, the best approach is to estimate operations based on the presumption that the company began liquidating on the valuation date. Accordingly, purchases, sales, or other operating activities occurring after the valuation date would be considered only in the context of the company winding down its operations. The consultant should review several possible scenarios with management to determine an appropriate estimate of operating profits and losses during the liquidation period.

In determining the expected operations during the liquidation period, the consultant should also consider whether the company may incur contingent losses in a liquidation scenario that it might not otherwise incur. For example, the company may have additional costs associated with terminating a noncancelable lease. The company also may have losses associated with fulfilling other commitments, such as purchase or sales commitments. It should be noted that sometimes those contingent losses can be settled at reduced amounts. However, as discussed in the following paragraph, such settlements should be assumed only in limited circumstances.

Step 7—Subtract the Liquidation Values of Liabilities

In many cases, the liquidation values of liabilities will equal their book values. However, in some cases, such as a bankruptcy liquidation, there may be an agreement between the company and some or all creditors to settle liabilities at less than book value. Consultants should consider such agreements in estimating liability liquidation values, but they normally should not assume any settlements unless (a) there is evidence that such agreements existed at the valuation date, or (b) the valuation is a hypothetical appraisal.

Step 8—Add or Subtract Income Tax Provision or Benefit

If the company is a C corporation, income taxes should be provided for any gains on sales of assets, operating profits, or gains on settlement of liabilities. Tax benefits may be provided only in limited cases for operating losses, losses on asset sales, etc.

If the company is a sole proprietorship, no tax provision or benefit is needed. Likewise, no tax provision may be needed for partnerships; but, special tax considerations may apply depending on the type of partnership interest. For S corporations, tax provisions may be required if the company is subject to built-in gains tax.

Step 9—Subtract the Liquidation Preference Value of any Senior Equity Securities

The liquidation preference value of any preferred stock or other senior equity securities should be subtracted from the net proceeds. Note that only the liquidation preference value, not the dividend yield value, should be used to value senior equity securities using the LV method.

Step 10—Discount the Net Proceeds to Present Value

The amounts determined in Steps 4–8 should all be discounted to present value. The discount rate to be used depends on the circumstances. In a few cases, a typical going concern discount rate generally may be used. However, going concern rates should only be used if:

a. The company's assets are highly liquid, that is, they can easily be sold for an established market price.

b. The period needed to liquidate the company's assets and settle its debts is short.

c. There are no significant contingent liabilities.

Frequently, the criteria in the preceding paragraph will not be met, and the consultant typically will use a higher rate than the normal going concern discount rate. Then, the discount rates may be similar to required return rates on venture capital investments or even on highly leveraged LBOs. Such rates may range from 35%–60% or more. In selecting a discount rate, the consultant should consider the following risks:

a. *Risk that projected cash flows will be less than expected,* because of lower gross proceeds, higher liquidation costs, worse-than-expected interim operations, or other factors.

b. *Risk of contingent liabilities,* that is, potential liabilities that cannot be reasonably predicted or estimated. Examples include unanticipated lawsuits and unexpected bankruptcy claims.

When assessing the risks involved in liquidation, the consultant should consider the following factors:

a. *Liquidity of the Company's Assets.* The more liquid the assets, the easier to sell them and to reasonably estimate gross proceeds.

b. *Liquidation Period.* The longer the liquidation period, the greater the risk of (1) incurring more expenses and contingencies and (2) needing to reduce the selling prices of the assets to attract buyers.

c. *Company's Leverage.* The more leveraged the company is, the smaller its net proceeds and the greater the risk of volatility in cash flows.

Step 11—Determine the Need for Discounts

Like the NAV method, the LV method assumes that the subject ownership interest can cause the sale of the company's assets. If the subject interest is a minority interest that is unable to cause the sale of company assets, the consultant should consider that action in choosing a minority discount. Special rules on discounts may apply in minority oppression situations, depending on the definition of value and relevant state law.

Adjustments for Invested Capital Valuations

If the consultant applies the LV method on an invested capital basis, the steps above should be modified as follows:

Steps 5 and 6	Add back interest expense during the liquidation period. (Note that the interest expense adjustment will be tax-effected through this procedure, if the company is a C corporation with taxable ordinary income.)
Step 7	Do not subtract the value of interest-bearing liabilities.
Step 9	Omit this step.

Case Study

Exhibit 2-3 and Exhibit 2-4 illustrate the application of the liquidation value method to XYZ company. This example assumes the following:

a. It will take 24 months to liquidate the company's assets and settle its liabilities. Equipment will be liquidated in 9 months, and real estate will be sold in 18 months. The other assets can be liquidated within 90 days.

b. The company's operations, aside from liquidation activities, have ceased.

c. Estimated gross liquidation proceeds are equal to the company's NAV value. (This assumption is for illustration purposes only. In practice, gross liquidation proceeds may differ significantly from NAV value. The amount of those proceeds generally should be determined by asset appraisals based on the relevant definition of value.)

d. An appropriate discount rate was determined to be 48%.

e. The company will be unable to carry over or carry back the losses resulting from selling its assets and expenses during the liquidation period.

f. As mentioned in the NAV case study, the tax bases of the company's assets are approximately equal to their book values.

Using the LV Method in Going Concern Situations

While it may appear that the LV method is only usable for troubled businesses, the method can actually be very helpful in valuing companies with several divisions or subsidiaries, some of which are profitable and others of which are not. If consolidated income and cash flow were used for valuation purposes, the loss from the unprofitable operations would make the entity appear much less profitable, and thus would make the company appear much less valuable than it really is. In such cases, it may be appropriate to value the unprofitable operations on a liquidation value basis and the profitable operations on a going-concern basis. Then, the liquidation value of the unprofitable operations can be added to the value of the profitable operations, thereby producing a higher value that is more reflective of the true fair market value of the business.

Exhibit 2-3

XYZ Company
Liquidation Value Calculation

	Book Value (and Tax Basis) 12/31/X1	Liquidation Value 12/31/X1	
Cash	$ 128,000	$ 128,000	
Accounts receivable	256,000	256,000	
Inventory	900,600	596,000	(Exhibit 2-4)
Other current assets	7,000	7,000	
Total current assets	1,291,600	987,000	
Property, plant, and equipment	1,020,000	522,000	(Exhibit 2-4)
Accumulated depreciation	(278,000)		
TOTAL ASSETS	$ 2,033,600	$ 1,509,000	
Current maturities of long-term debt	$ 66,000	$ 66,000	
Notes payable	266,000	266,000	
Accounts payable	227,600	227,600	
Accrued liabilities	44,000	44,000	

	Book Value (and Tax Basis) 12/31/X1	Liquidation Value 12/31/X1
Income taxes payable	46,000	46,000
Total current liabilities	649,600	649,600
Long-term debt net of current maturities	384,000	384,000
Estimated direct and indirect liquidation costs:		
Asset holding costs		43,000 [a]
Severance and benefits		55,000 [b]
Management expenses		175,000 [c]
Stockholders' equity	1,000,000	202,400
TOTAL LIABILITIES & EQUITY	$ 2,033,600	$ 1,509,000
Value Indicated by LV Method		$ 202,400

Notes:

[a] Expenses (taxes, insurance, etc.) relating to holding assets until liquidation, discounted at 48% as follows:

Holding costs for:	Amt/month		PV factor		PV amount (Rounded)
Inventory (1 month)	1,000	×	1.0000	=	1,000
Equipment (9 months)	1,800	×	7.4353	=	13,000
Real estate (18 months)	2,300	×	12.6593	=	29,000
					43,000

(PV of annuity of $1 at 4% per month.)

[b] Severance and benefits for most employees paid in 30 days. No discounting needed.

[c] Administrative expenses involved in winding down operations and liquidating assets, discounted at 48% as follows:

	Amt/month		PV factor		PV amount (Rounded)
24-month period	11,500	×	15.2470	=	175,000

(PV of annuity of $1 at 4% per month.)

* * *

Exhibit 2-4

XYZ Company Liquidation Value Adjustments

	Appraised Value	Liquidation Value	
INVENTORY		(rounded to 000s)	
Finished goods	$ 380,000	$ 285,000	*Deduct 25% for stock closeout.*
Work in-process	150,600	15,000	*Reduce to scrap value.*
Raw materials	370,000	296,000	*Discount of 20% for restocking charge and freight costs.*
Total	$ 900,600	$ 596,000	
PROPERTY, PLANT, AND EQUIPMENT			
Building and land			
Appraised value		$ 750,000	

	Appraised Value	Liquidation Value	
Less 10% for commissions and other direct costs		75,000	
		675,000	
PV factor for 18 months at 48%[a]		× 0.49363	
Present value of net proceeds (rounded to 000s)		$ 333,000	(A)
Machinery and equipment			
Appraised value		$ 560,000	
1 − Sales discount of 40%		× 60	%
Gross sales proceeds		336,000	
1 − 20% for commissions and other direct costs		× 80	%
		268,800	
PV factor for 9 months at 48%[a]		× 0.70259	
Present value of net proceeds (rounded to 000s)		$ 189,000	(B)
Liquidation value of fixed assets		$ 522,000	(A+B)

Note:

[a] Present value of $1 at 4% per month.

* * *

EXCESS EARNINGS METHOD

The excess earnings method was developed by the U.S. Treasury Department in 1920 in Appeals and Review Memorandum 34 (ARM 34). Its current version (called the *formula method*) is found in Rev. Rul. 68-609. This method may appear simple, but it is easy to misuse. Because of its relative ease of application and conceptual basis, the excess earnings method is commonly used in valuing small businesses. It can also be used to value professional practices.

Conceptual Basis for the Method

The model for the excess earnings method computes the company's equity value based on the *appraised* value of tangible assets, plus an additional amount for intangible assets. A company's tangible assets should provide a current return to the owner. Since there are risks associated with owning the company's assets, the rate of return on those assets should be commensurate with the risks involved. That rate of return should be either the prevailing rate of return required to attract capital to that industry or an appropriate rate above the risk-free rate. Any returns produced by the company above the rate on tangible assets are considered to arise from intangible assets. Accordingly, the weighted average capitalization rate for tangible assets and intangible assets should be equivalent to the capitalization rate for the entire company. This capitalization rate can also be regarded as the owner's required rate of return.

Applying the Method

The excess earnings method typically consists of the following basic steps:

Step 1 Obtain the company's financial statements. Apply necessary GAAP and normalization adjustments (including adjustments for nonoperating assets). Recompute federal and state income taxes, if necessary, based on normalized pretax earnings.

Step 2 Determine the value of the company's net tangible assets.

Step 3 Determine a reasonable rate of return (as of the valuation date) on the appraised value of the company's net tangible assets.

Step 4 Multiply the reasonable rate of return (Step 3) by the company's net tangible asset value (Step 2). That amount is the *reasonable return* on those assets.

Step 5 Subtract the calculated reasonable return (Step 4) from normalized net earnings (Step 1). That difference is the company's *excess earnings*.

Step 6 Determine an appropriate capitalization rate (as of the valuation date) for the company's excess earnings, which are assumed to be attributable to goodwill or other intangible assets.

Step 7 Capitalize the excess earnings (divide excess earnings by the capitalization rate).

Step 8 Add the amount computed in Step 7 and the value of the net tangible assets (Step 2).

Step 9 Perform "sanity checks" to determine the reasonableness of the value determined in Steps 1–8.

Step 10 Determine an appropriate value for any excess or nonoperating assets that were adjusted for in Step 1. If applicable, add the value of those assets to the value determined in Step 8. If asset shortages were identified in Step 1, determine if the value estimate should be reduced to reflect the value of such shortages. If the normalized income statement was adjusted for identified asset shortages, it is not necessary to further reduce the value estimate.

Step 11 Determine if the value of the company computed in Step 8 should be adjusted for minority interest discounts or other discounts.

Step 1—Obtain the Company's Financial Statements and Make GAAP and Normalization Adjustments

The consultant usually obtains financial statements for the five fiscal years preceding the valuation date and interim statements covering the period from the last fiscal year-end to the valuation date. The periods requiring adjustments for GAAP errors or normalization generally depend on the period of operations used in the valuation. The period of operations that is used in the valuation may be the most recent fiscal year or 12 months' operations, the next year's forecasted operations, or an average of operations for several years.

Normally, the consultant will use net cash flow in applying the excess earnings method. Analysts tend to prefer net cash flow, but many still use earnings. Occasionally, consultants use pretax earnings if the available data on reasonable rates of return and capitalization rates is derived from pretax data. However, it may be difficult to obtain suitable data regarding pretax capitalization rates. In any case, the consultant should ensure that the reasonable rate of return and the capitalization rate are expressed on the same basis as normalized earnings, that is, they should all be either pretax or after-tax.

Normalizing the balance sheet includes, among other things, removing excess assets and nonoperating assets from the balance sheet. In addition, the consultant should consider whether there are any significant omitted tangible assets, such as supplies or small tools.

Step 2—Determine the Value of the Company's Net Tangible Assets

The value of net tangible assets, as used in the excess earnings method, is the fair market value of the company's tangible assets (excluding excess assets and nonoperating assets) minus the current value of its liabilities. The value of the company's net tangible assets is similar to the company's net asset value, but net tangible asset value differs in some respects. For example, net tangible asset value:

a. Does not include the value of identifiable intangible assets. It also excludes the value of excess or nonoperating assets because those assets are considered separately in Step 10.

b. Is generally not adjusted for the difference between the appraised value of fixed assets, intangible assets, and liabilities and their tax bases. (Although tax-effecting the net tangible asset value may have some theoretical appeal, it is rarely done in practice.)

c. Is not discounted for minority interest discounts or other discounts. (Such items are considered in Step 11.)

Rev. Rul. 68-609 refers to "an average annual value" of net tangible assets. However, usually, it is impractical to estimate the fair market value (in use) of the company's net tangible assets each year over several years. Thus, many consultants use the fair market values of the company's assets at or near the valuation date. Although consultants should preferably use asset appraisals to determine the value of net tangible assets; in practice, consultants sometimes use alternative sources.

Step 3—Determine a Reasonable Rate of Return on the Company's Net Tangible Assets

Theoretically, the reasonable rate of return on net tangible assets should reflect the risk associated with investing in the company's net tangible assets. Since all business assets, other than cash and some cash equivalents, involve risk, they require returns in excess of the risk-free or so called *safe* rate. The method used to determine the reasonable rate of return depends on whether the valuation method is applied on an equity or an invested capital basis. If an equity basis is used, then the consultant generally should determine a reasonable return on tangible equity. Invested capital techniques are discussed later in this lesson.

There is no ideal source for determining reasonable rates of return on tangible net assets. As discussed in the following paragraphs, all available sources have limitations. Accordingly, the consultant must use judgment in selecting an appropriate rate of return. Two commonly used techniques for determining rates of return on net tangible assets are:

a. Building up a market rate with financial market data.

b. Using prevailing industry rates of return on tangible net assets (equity).

Building up a Market Rate with Financial Market Data. Since it is often difficult to find suitable industry data, consultants typically build up a market rate of return on tangible assets using financial market data. Consultants use many different techniques to build up market rates, and there is much diversity in practice. One technique is discussed in the following paragraph.

The rate of return on net tangible assets for smaller businesses generally should be somewhat higher than the interest rate that the company would be charged by a lender for financing those assets. Exhibit 2-5 presents a step-by-step approach for determining a reasonable rate of return on net tangible assets.

Exhibit 2-5

Approach for Determining a Reasonable Rate of Return on Net Tangible Assets

1. *Analyze the Company's Asset Composition (Using the Information Determined in Step 2) to Determine a Possible Loan Percentage for Each Asset Class*. That is, the consultant reviews the list of assets at market value (in Step 2) and decides how much the company could borrow by pledging that asset class as collateral. The possible loan amount should be expressed as a percentage of the asset's market value. Note that this is the total amount

that can be borrowed, regardless of how much might already be pledged on existing debt. Factors to consider in estimating borrowing capacity include:

a. *Existing Loan Agreements.* Some loan agreements specify how much a company can borrow against its assets. For example, an agreement might allow the company to borrow up to 75% of its accounts receivable under 90 days old. Also, the consultant may look at the amounts that the company has historically been able to borrow against its assets.

b. *Company's Bankers.* Talking to the company's bankers can be a good way to estimate the company's borrowing capacity.

c. *Asset Value and Liquidity.* Asset value and liquidity are key factors that lenders consider in deciding how much they will loan against a particular asset. Generally, the greater the value and liquidity of a tangible asset, the higher the potential loan percentage relating to that asset. Asset value may be an obvious factor, but liquidity (the ability to sell an asset or convert it to cash quickly) is also important. For example, a bank normally will lend more money for finished goods inventory than for work-in-process inventory of equal value because the finished goods are more liquid.

2. *Multiply the Market Value of Each Asset Class by Its Loan Percentage (from Item 1.).* The result is the estimated borrowing capacity in dollars for each asset class.

3. *Add the Total of the Borrowing Capacity for Each Asset Class (Item 2.).* If the purpose of the engagement is to determine an equity value, reduce the total borrowing capacity by the market value of existing interest-bearing debt. The result is the net remaining tangible borrowing capacity of the company.

4. *Divide the Amount Computed in Item 3. by the Total Market Value of the Company's Tangible Assets.* The result is the estimated remaining tangible debt capacity for the total company, expressed as a percentage.

5. *Estimate a Market Rate of Interest for Company Debt.* Generally, this step can be accomplished by looking at the rate on existing bank debt and prevailing rates on similar borrowings in the market as of the valuation date. However, in some cases, the interest rate may be higher for additional debt than for existing debt.

6. *Tax-effect the Cost of Debt, If Necessary, by Multiplying the Percentage from Item 5. by (1 − the Company's Effective Tax Rate).* The effective tax rate should be normalized income tax expense divided by normalized pretax earnings. (See paragraph in Step 1.)

7. *Multiply the Interest Rate from Item 6. by the Tangible Debt Capacity Percentage in Item 4.* That represents the pretax cost of debt.

8. *Determine an Appropriate Rate of Return on Tangible Equity Capital (Earnings Discount Rate), Using the Build-up Method or a Suitable Alternative.* For purposes of this calculation, *tangible equity capital* is the difference between the value of company assets (Item 1.) and the net borrowing capacity (Item 3.). In other words, it is 1 − the remaining tangible debt capacity (Item 4.). The rate of return should be at the low end of a reasonable range of earnings discount rates because the investment relates to tangible assets, which means there is less risk involved.

9. *Multiply the Assumed Equity Rate of Return by 1 − the Remaining Tangible Debt Capacity (Item 4.).* The result is the cost of tangible equity capital.

10. *Add the After-tax Cost of Debt (Item 7.) and the Cost of Tangible Equity (Item 9.).* That sum represents the tangible rate of return for the company.

*　　*　　*

The approach in Exhibit 2-5 determines a weighted average return on the net tangible equity capital. The reasoning behind the debt/equity weighting is that the more the company could theoretically borrow (based on its tangible asset composition and present debt level), the more its market rate of return on equity will approximate its market rate of interest on debt. Thus, a company with higher quality, more liquid assets, and less leverage generally will require a lower rate of return than a highly leveraged company with lower quality assets.

Sometimes, it may be difficult to determine appropriate loan percentages for the company's assets, especially in times of tight credit. However, the consultant normally should be able to review the company's historical borrowings against its assets (e.g., 75% of accounts receivable), read existing loan agreements, and talk to the company's bankers to determine a reasonable range of loan percentages.

Using Prevailing Industry Rates. The revenue ruling discusses using a "percentage prevailing in the industry at the date of valuation." Accordingly, the consultant should look for industry average rates of return on net tangible assets. However, finding suitable industry rates of return may be difficult for two reasons. First, industry averages typically include returns on both tangible and intangible assets. Second, industry data usually is based on companies' book values (that is, unadjusted assets or stockholders' equity) instead of their fair market values. Accordingly, some consultants use industry average rates of return on historical stockholders' equity as an approximation of a market return on tangible net assets. However, this method is valid only if historical returns for the industry approximate investors' current rates of return for that industry.

Step 5—Calculate Excess Earnings

Typically, calculating excess earnings is just a mechanical step. But, sometimes, the consultant may encounter circumstances when the reasonable return on net tangible assets exceeds normalized earnings, which results in *negative excess earnings*. In such cases, the consultant should—

a. *Review the Calculation.* The first step is reviewing the excess earnings calculation to determine whether (1) the normalized earnings amount reflects the expected future operations of the company and (2) the amount of return on net tangible assets is appropriate for the company considering the factors discussed in the preceding paragraphs.

b. *Reconsider Using This Method.* If the consultant has reviewed the excess earnings calculation and still computed *negative excess earnings*, the consultant should reconsider using the excess earnings method. That negative number indicates that the company's earnings are inadequate given the level of investment in its net tangible assets. Accordingly, the consultant should consider using the NAV method or LV method, or possibly the capitalized earnings method to value the company.

Step 6—Determine an Excess Earnings Capitalization Rate

Theoretically, the rate used to capitalize excess earnings generally will be at or above the high end of the reasonable range of earnings capitalization rates. However, in practice, many consultants determine excess earnings capitalization rates based on several factors, especially the persistence of the company's intangible assets. *Persistence* refers to the average length of time that customers can be expected to continue doing business with the company. In view of the current money and capital market rates, excess earnings capitalization rates generally range from 20% to 400%, depending on persistence. For example, a company with a very consistent, dependable customer base might have persistence of five years or more, which equates to a 20% capitalization rate. On the other hand, a new company in an intensely competitive industry may have persistence of three months maximum, which equates to a 400% capitalization rate. Some factors to consider in evaluating the company's persistence include:

a. The nature of the business.

b. Management quality and depth.

c. The company's market position.

d. The company's reputation.

e. Earnings quality and consistency.

f. The nature of related intangible assets, that is, whether there are any identifiable intangibles, their effect on the company's earnings, their estimated remaining lives, etc.

g. Historical patterns of persistence of the company's customer base.

Steps 7 and 8—Capitalize the Company's Excess Earnings and Add This Amount to Its Net Tangible Assets

The next step in the valuation process is to estimate the company's intangible (or goodwill) value by dividing the excess earnings amount from Step 5 by the capitalization rate determined in Step 6. This value should then be added to the value of the net tangible assets (determined in Step 2) to arrive at a preliminary value of the company's equity.

Step 9—Perform "Sanity Checks" to Determine the Reasonableness of the Estimated Value

Since it is so difficult to obtain precise market data on net tangible rates of return and capitalization rates, the consultant's excess earnings calculations may be somewhat more subjective than calculations based on other methods. In such cases, it is especially important for the consultant to perform "sanity checks" to determine the reasonableness of the estimated value. For example, the consultant may apply both the excess earnings method and capitalization of earnings method and compare the indicated values from both methods.

Step 10—Determine an Appropriate Value for Excess Assets, Nonoperating Assets or Asset Shortages (If Necessary)

In Step 1, any excess assets or nonoperating assets were removed with normalization adjustments. If any such assets were removed, they should be added back to determine the entire value of the company's equity. However, those assets may not be added in at their full fair market values. Asset shortages should be considered in applying Step 10 only if the normalized income statement does not fully reflect the impact of asset shortages.

Step 11—Determine the Need for Minority Interest Discounts or Other Discounts

The value determined by Steps 1–10 is a majority interest equity value. If the interest being valued is a minority interest, a discount should be provided. The consultant also should consider the need for any other discounts, such as a discount for lack of marketability.

Variation on the Excess Earnings Method

One common variation of the excess earnings method is to use *average* net tangible assets (or stockholders' equity) and *average* earnings to determine net tangible asset value and normalized earnings in Steps 1 and 2. Those averages typically cover a 5-year period.

This variation is acceptable if the period used in determining the averages represents reasonable future expectations. If this variation is used, the estimated intangible value is still added to the current value of the net tangible assets to determine the value of the subject ownership interest.

Applying the Excess Earnings Method on an Invested Capital Basis

Like most of the other methods, the steps outlined earlier in this lesson are used to apply the excess earnings method on an equity basis. However, the excess earnings method is also commonly applied on an invested capital basis. To apply the method on an invested capital basis, the following changes are needed:

Step 1 The value of net tangible assets should be determined excluding interest-bearing liabilities (i.e., interest-bearing liabilities should not be subtracted in determining net tangible assets).

Step 2 Interest expense should be added back in determining the company's normalized pretax learnings. (Note that the interest expense adjustment will be tax-effected if the company is a C corporation.)

Step 3 The reasonable rate of return should be determined using the company's market cost of capital, rates of return on individual asset classes, or industry rates of return on total assets.

Step 4 The capitalization rate for excess earnings should be based upon one of the methods referred to in the next paragraph.

To convert the invested capital value to an equity value, subtract the value of the interest-bearing debt.

Rates of Return Using the Invested Capital Basis. As previously discussed, the invested capital basis uses rates of return on total invested capital instead of equity. Some techniques commonly used to compute rates of return are:

a. *Using the Market Cost of Capital.* The company's market cost of capital is similar to the approach discussed in Exhibit 2-5, except that the borrowing capacity amount would not be reduced by the amount of existing debt. Accordingly, the weighting of the cost of borrowing would be based on the total of existing debt plus remaining borrowing capacity.

b. *Using Prevailing Industry Rates of Return on Total Tangible Assets.* This technique is similar to the one discussed earlier in this lesson, except it uses return on total capital instead of return on equity. As noted earlier, this alternative is appropriate only if historical returns are representative of current investor expectations.

Cautions about Using the Excess Earnings Method

Limitations of the Method. The excess earnings method is often criticized because it applies primarily to smaller businesses. It generally is not suited to larger or more complex businesses because of its mechanical nature.

Some consultants believe that the excess earnings method is preferred by the IRS, but even the Revenue Ruling states that:

> The *formula* approach may be used in determining the fair market value of intangible assets of a business only if there is no better basis available for making the determination.

Thus, consultants should be careful about relying too much on this method.

Common Errors in Applying the Excess Earnings Method. Valuation errors can result if Revenue Ruling 68-609 is followed thoughtlessly. Common errors include:

a. *Failure to Adjust Owner's Compensation, When Appropriate.* Both Rev. Rul. 68-609 and accepted practice require that a company's earnings be adjusted to provide a reasonable salary for the owner, when appropriate. Failure to make that adjustment can result in significant misstatement of earnings and valuation results, especially when valuing controlling interests.

b. *Mechanically Following the Rates in the Revenue Ruling.* Rev. Rul. 68-609 states that the rates of return should be "the percentage prevailing in the industry involved at the date of valuation." The revenue ruling then uses as examples 8%–10% rates of return on net tangible assets and 15%–20% rates of return on excess earnings (rates prevalent at the time the revenue ruling was issued in 1968). The revenue ruling clearly states that "the above rates are used as examples . . ." and "the capitalization rates are dependent on the facts pertinent thereto in each case." The facts are that prevailing rates are significantly higher now than they were in 1968. Consultants should try to determine actual market rates at the valuation date. If suitable industry data is not available, consultants should use the alternative techniques previously discussed.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Which of the following businesses is generally unsuited to being valued using the Net Asset Value (NAV) Method?

    a. Sally's Stylish Earrings Boutique.

    b. Pyramid Holdings.

    c. Trinity Properties Investment Group.

    d. Meter-Miser Home Builders.

23. Deciding whether special procedures, such as physical inventories, are required is a consideration for the consultant to make. That decision is generally required for any of the following valuation methods **except**:

    a. Liquidation Value.

    b. Multiple of Discretionary Earnings.

    c. Excess Earnings.

    d. Net Asset Value.

24. When using the Liquidation Value (LV) method, the most common LV premise is the orderly liquidation value. Orderly liquidation value is the value realized from selling the assets over a reasonable period of time, typically:

    a. Three to six months.

    b. Three to nine months.

    c. Six to nine months.

    d. Six to twelve months.

25. If a company is unable to hold its assets for a reasonable period of time, which of the following liquidation value premises would likely be more appropriate to use?

    a. Orderly liquidation value.

    b. Forced liquidation value.

26. A company's tax basis balance sheet may be the most efficient starting point when applying the net asset value (NAV) method if the company is which of the following?

    a. Sole proprietorship.

    b. Partnership.

    c. C corporation.

    d. S corporation.

27. Which of the following statements regarding the method to use to value senior equity securities is accurate?

a. The value of senior securities should always be determined using the dividend yield method.

b. The value of senior securities should always be determined using the liquidation preference method.

c. The circumstances should dictate which method should be used to value senior securities.

28. The Liquidation Value (LV) method consists of a number of basic steps. Which of the following actions (steps) immediately follows the step where the consultant determines the gross amount of proceeds from liquidation?

    a. Determine the approach to liquidation.

    b. Subtract the liquidation value of liabilities.

    c. Add or subtract operating profits or losses during the liquidation period.

    d. Reduce gross proceeds for indirect and direct expenses.

29. When using the LV method, gross proceeds from liquidation should be reduced for direct and indirect expenses. Which of the following is an example of indirect expenses?

    a. Selling commissions.

    b. Professional fees.

30. For invested capital valuations under the LV method, which of the following steps should be omitted?

    a. Reducing gross proceeds for direct and indirect expenses, but add back interest expense during the liquidation period.

    b. Adding or subtracting operating profits or losses during the liquidation period, but add back interest expense.

    c. Subtracting the liquidation value of all liabilities except for interest-bearing liabilities.

    d. Subtracting the liquidation preference of any senior equity securities.

31. When using the excess earnings method, what determines the company's excess earnings?

    a. Whether the value of the company should be adjusted for minority interest discounts.

    b. Multiplying the reasonable rate of return by the company's net tangible asset value.

    c. Performing "sanity checks."

    d. Subtracting the calculated reasonable return from normalized net earnings.

32. Which of the following statements is true regarding net tangible asset value under the excess earnings method?

    a. It included the value of nonoperating assets.

    b. It is not discounted for minority interest discounts.

    c. It is discounted for other discounts.

    d. It is always adjusted for the difference between the appraised value of fixed assets, intangible assets, and liabilities and their tax bases.

33. Which of the following is an accurate statement regarding determining reasonable rates of return on tangible net assets using the excess earnings method?

    a. Using prevailing industry rates of return on tangible net assets is the ideal source for determining reasonable rates of return on tangible net assets.

    b. Using financial market data to build up a market rate is the ideal source for determining reasonable rates of return on tangible net assets.

    c. No source is ideal for determining reasonable rates of return on tangible net assets.

34. When determining a reasonable rate of return on net tangible assets using the excess earnings method, the estimated remaining tangible debt capacity for the total company is the result of which of the following calculations?

    a. Multiplying the market value of each asset class by its loan percentage.

    b. Adding the after-tax cost of debt and the cost of tangible equity.

    c. Dividing the net remaining tangible borrowing capacity of the company by the total market value of the company's tangible assets.

    d. Adding the total of the borrowing capacity for each asset class.

35. Orange Widget Company has stiff competition and anticipates that the average length of time each customer will continue doing business with the company is only a couple of months. Under these conditions, and assuming that excess earnings capitalization rates generally range from 20% to 400%, which of the following excess earnings capitalization rates would be most likely to apply to Orange Widget Company?

    a. 20%.

    b. 400%.

36. The excess earnings method applies primarily to:

    a. Smaller businesses.

    b. Larger businesses.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Which of the following businesses is generally unsuited to being valued using the Net Asset Value (NAV) Method? **(Page 162)**

    a. Sally's Stylish Earrings Boutique. [This answer is incorrect. Sally's Stylish Earrings Boutique would be an example of a company that may be valued using the NAV method since this type of business is a small business that is easy and relatively inexpensive to start and there is little or no value added to the products from labor.]

    b. Pyramid Holdings. [This answer is incorrect. Holding companies and other investment companies may be valued using the NAV method.]

    c. Trinity Properties Investment Group. [This answer is incorrect. Real estate investment companies, such as Trinity Properties Investment Group, are companies that may be valued using the NAV method.]

    d. **Meter-Miser Home Builders. [This answer is correct. Since Meter-Miser Home Builders is primarily a labor-intensive business, it generally is not suited to the NAV method since there is significant value added to the company's products or services as a result of the labor involved with building homes.]**

23. Deciding whether special procedures, such as physical inventories, are required is a consideration for the consultant to make. That decision is generally required for any of the following valuation methods **except**: **(Page 163)**

    a. Liquidation Value. [This answer is incorrect. Deciding whether special procedures are required is a consideration for the consultant when using an underlying assets method. Liquidation value is one of the underlying assets methods.]

    b. Multiple of Discretionary Earnings. [This answer is correct. Multiple of discretionary earnings is not one of the underlying assets methods and, as a result, determining the need for special procedures by the consultant may not be required.]

    c. Excess Earnings. [This answer is incorrect. Excess earnings are another of the underlying assets methods and, therefore, deciding whether special procedures are required would apply to this valuation method.]

    d. Net Asset Value. [This answer is incorrect. Net asset value is one of the underlying assets methods, and may require the consultant to make engagement decisions including determining whether special procedures such as physical inventories are required.]

24. When using the Liquidation Value (LV) method, the most common LV premise is the orderly liquidation value. Orderly liquidation value is the value realized from selling the assets over a reasonable period of time, typically: **(Page 164)**

    a. Three to six months. [This answer is incorrect. The reasonable period of time for selling the assets to obtain maximum value is longer than a minimum of three months.]

    b. Three to nine months. [This answer is incorrect. The reasonable period of time in which to realize optimum value from selling the assets is typically a period of time other than a span of time from three to nine months.]

    c. Six to nine months. [This answer is correct. Using the orderly liquidation value, the best price for each asset is realized when the assets are sold over a reasonable period of time, typically six to nine months in order to get the best price for each.]

    d. Nine to twelve months. [This answer is incorrect. The typical period of time for selling the assets to maximize the price obtained for each is shorter than nine to twelve months.]

25. If a company is unable to hold its assets for a reasonable period of time, which of the following liquidation value premises would likely be more appropriate to use? **(Page 164)**

    a. Orderly liquidation value. [This answer is incorrect. The orderly liquidation value premise should be used in cases where there is not a lack of funds or other factors that would keep the company from holding its assets for a reasonable period of time and liquidation can occur in an orderly fashion.]

    b. Forced liquidation value. [This answer is correct. The forced liquidation value premise may be more appropriate in cases where a lack of funds or other factors would keep the company from holding its assets for a reasonable period of time and require a more immediate liquidation to occur.]

26. A company's tax basis balance sheet may be the most efficient starting point when applying the net asset value (NAV) method if the company is which of the following? **(Page 166)**

    a. Sole proprietorship. [This answer is incorrect. The company's GAAP basis balance sheet normally is the best starting point if the company is a sole proprietorship and GAAP statements are available as of the valuation date. This is due to the fact that a sole proprietorship is a nontaxed entity.]

    b. Partnership. [This answer is incorrect. A partnership is a nontaxed entity and may not have a tax liability associated with the difference between the fair market value of its assets and its tax basis. Therefore, the company's GAAP basis balance sheet normally is the best starting point.]

    c. C corporation. [This answer is correct. If available as of the valuation date, a C corporation's tax basis balance sheet may be the most efficient starting point since the consultant may need to compute taxes on the difference between the tax basis of the company's assets and liabilities and their corresponding fair market values.]

    d. S corporation. [This answer is incorrect. Since an S corporation is a nontaxed entity and may not have a tax liability associated with the difference between the fair market value of its assets and its tax basis, the best starting point for the NAV method normally is the company's GAAP basis balance sheet.]

27. Which of the following statements regarding the method to use to value senior equity securities is accurate? **(Page 169)**

    a. The value of senior securities should always be determined using the dividend yield method. [This answer is incorrect. The dividend value method should not always be used to determine the value of senior securities, but may be more appropriate for a going concern scenario.]

    b. The value of senior securities should always be determined using the liquidation preference method. [This answer is incorrect. The liquidation preference method should not always be used to determine the value of senior securities, but this method may be more appropriate for a valuation involving the sale or liquidation of a business.]

    c. The circumstances should dictate which method should be used to value senior securities. [This answer is correct. There is not authoritative guidance that indicates which method to use to value senior securities. Thus, the method that is best suited to the circumstances is the one that should be used.]

28. The Liquidation Value (LV) method consists of a number of basic steps. Which of the following actions (steps) *immediately* follows the step where the consultant determines the gross amount of proceeds from liquidation? **(Page 172)**

    a. Determine the approach to liquidation. [This answer is incorrect. This step occurs *prior* to the step where the consultant determines the gross amount of proceeds from liquidation.]

    b. Subtract the liquidation value of liabilities. [This answer is incorrect. This step occurs immediately following the step where the consultant adds or subtracts operating profits or losses during the liquidation period.]

c. Add or subtract operating profits or losses during the liquidation period. [This answer is incorrect. This step occurs subsequent to the step where the consultant determines the gross amount of proceeds from liquidation, but does not occur immediately following that step.]

d. Reduce gross proceeds for indirect and direct expenses. [This answer is correct. Immediately following the step where the consultant determines the gross amount of proceeds from liquidation, the consultant should take action to reduce gross proceeds for applicable indirect and direct expenses.]

29. When using the LV method, gross proceeds from liquidation should be reduced for direct and indirect expenses. Which of the following is an example of *indirect* expenses? **(Page 173)**

a. Selling commissions. [This answer is incorrect. Selling commissions and other fees or taxes related to the specific sales are examples of direct expenses, not indirect expenses.]

b. Professional fees. [This answer is correct. Professional fees, such as legal fees, and any holding costs not included in the interim results of operations (operating profits and losses during the liquidation period) are considered indirect expenses.]

30. For invested capital valuations under the LV method, all but one of the following steps should be modified. Which of the following steps should instead be omitted? **(Page 174)**

a. Reducing gross proceeds for applicable direct and indirect expenses. [This answer is incorrect. This step should not be omitted, but it should be modified as follows: "Reduce gross proceeds for direct and indirect expenses, but add back interest expense during the liquidation period".]

b. Adding or subtracting operating profits or losses during the liquidation period. [This answer is incorrect. This step should not be omitted, but it should be modified as follows: "Add or subtract operating profits or losses during the liquidation period, but add back interest expense".]

c. Subtracting the liquidation value of all liabilities. [This answer is incorrect. This step should not be omitted, but it should be modified as follows: "Subtract the liquidation value of all liabilities except for interest-bearing liabilities".]

d. Subtracting the liquidation preference of any senior equity securities. [This answer is correct. The liquidation preference of any senior equity securities should be subtracted using the LV method except in cases where the consultant applies the LV method on an invested capital basis. In those cases, subtracting the liquidation preference of any senior equity securities should be *omitted*.]

31. When using the excess earnings method, what determines the company's excess earnings? **(Page 178)**

a. Whether the value of the company should be adjusted for minority interest discounts. [This answer is incorrect. Adjusting the value of the company for discounts does not determine the company's excess earnings, which was a previous step in this method.]

b. Multiplying the reasonable rate of return by the company's net tangible asset value. [This answer is incorrect. By multiplying the reasonable rate of return by the company's net tangible asset value, the amount that results is the reasonable return on those assets.]

c. Performing "sanity checks". [This answer is incorrect. Performing "sanity checks" determines the reasonableness of the values in this method.]

d. Subtracting the calculated reasonable return from normalized net earnings. [This answer is correct. By subtracting the calculated reasonable return from normalized net earnings, the difference is the company's excess earnings based on the method of calculation detailed in the excess earnings method.]

32. Which of the following statements is true regarding net tangible asset value under the excess earnings method? **(Page 179)**

    a. It included the value of nonoperating assets. [This answer is incorrect. Net tangible asset value excludes the value of excess or nonoperating assets because those assets are considered separately in Step 10.]

    b. It is not discounted for minority interest discounts. [This answer is correct. Net tangible asset value is not discounted for minority interest discounts because those items are considered in Step 11.]

    c. It is discounted for other discounts. [This answer is incorrect. Net tangible asset value is not discounted for other discounts. Other discounts are considered in Step 11.]

    d. It is always adjusted for the difference between the appraised value of fixed assets, intangible assets, and liabilities and their tax bases. [This answer is incorrect. Net tangible asset value is generally *not* adjusted for the difference between the appraised value of assets and liabilities and their tax bases.]

33. Which of the following is an accurate statement regarding determining reasonable rates of return on tangible net assets using the excess earnings method? **(Page 179)**

    a. Using prevailing industry rates of return on tangible net assets is the ideal source for determining reasonable rates of return on tangible net assets. [This answer is incorrect. Using prevailing industry rates of return on tangible net assets is a commonly used technique for determining rates of return on net tangible assets, but it is not considered an ideal source.]

    b. Using financial market data to build up a market rate is the ideal source for determining reasonable rates of return on tangible net assets. [This answer is incorrect. Another commonly used technique for determining rates of return on net tangible assets is using financial market data to build up a market rate; however, this technique is not considered an ideal source.]

    c. No source is ideal for determining reasonable rates of return on tangible net assets. [This answer is correct. There is no ideal source for determining reasonable rates of return on tangible net assets since all available sources have certain limitations. The consultant must use professional judgment in selecting an appropriate rate of return.]

34. When determining a reasonable rate of return on net tangible assets using the excess earnings method, the estimated remaining tangible debt capacity for the total company is the result of which of the following calculations? **(Page 179)**

    a. Multiplying the market value of each asset class by its loan percentage. [This answer is incorrect. The result of this calculation is the estimated borrowing capacity in dollars for each asset class.]

    b. Adding the after-tax cost of debt and the cost of tangible equity. [This answer is incorrect. The result of this calculation is a sum that represents the tangible rate of return for the company.]

    c. Dividing the net remaining tangible borrowing capacity of the company by the total market value of the company's tangible assets. [This answer is correct. When the amount computed by adding the total of the borrowing capacity for each asset class is divided by the total market value of the company's tangible assets, the result is the estimated remaining tangible debt capacity for the total company, expressed as a percentage.]

    d. Adding the total of the borrowing capacity for each asset class. [This answer is incorrect. The result of this calculation is the net remaining tangible borrowing capacity of the company.]

35. Orange Widget Company has stiff competition and anticipates that the average length of time each customer will continue doing business with the company is only a couple of months. Under these conditions, and assuming that excess earnings capitalization rates generally range from 20% to 400%, which of the following excess earnings capitalization rates would be most likely to apply to Orange Widget Company? **(Page 181)**

a. 20%. [This answer is incorrect. If Orange Widget Company were a well-established company with a consistent and dependable customer base, the average length of time customers would likely continue doing business with the company would be significant (several years). In this instance, the excess earnings capitalization rate would be very low, such as 20%.]

b. 400%. [This answer is correct. Since Orange Widget Company is a new company in a very competitive industry, the average length of time customers may continue doing business with the company would likely be quite short (only a few months). In this instance, the excess earnings capitalization rate would be very high, such as 400%.]

36. The excess earnings method applies primarily to: **(Page 183)**

a. Smaller businesses. [This answer is correct. The excess earnings method applies primarily to smaller businesses and, therefore, is limited in its use. This is due to the fact that the excess earnings method focuses primarily on businesses where the owner is actively involved in the business. Because of its relative ease of application and conceptual basis, the excess earnings method is commonly used in valuing small business.]

b. Larger businesses. [This answer is incorrect. The excess earnings method generally is not suited to larger or more complex businesses due to the fact that this method is mechanical in nature.]

MULTIPLE OF DISCRETIONARY EARNINGS METHOD

The multiple of discretionary earnings method (also known as the seller's discretionary cash flow method) comes from the business brokerage community. It is best suited to businesses where the salary and perquisites of an owner represent a significant portion of the total benefits generated by the business and/or the business is typically run by an owner/manager. Accordingly, it is often used to value very small businesses (normally businesses with less than 20 employees and values less than $250,000).

Characteristics of the Method

The multiple of discretionary earnings method has evolved over the years from its rule-of-thumb origin of "one times owner's cash flow plus tangible assets." Despite its simplistic procedures, this method has been misnamed, misused, and misunderstood by appraisers and brokers more so than any other valuation method. Many valuation consultants do not use this method because of the difficulty involved in supporting the required multiples. However, this method is used quite frequently in the business brokerage community.

Buyers and sellers of very small closely-held businesses tend to think in terms of discretionary earnings. They put little faith in financial statements that are designed to minimize taxes. In fact, many owners of very small businesses think of earnings in terms of *net to the owner* or *net to the family* rather than *after-tax* or *pretax* earnings. The vast majority of those who acquire very small businesses are purchasing both a business and a job. These people tend to think in terms of income to replace their previous paycheck or income to support their family. They look at the total discretionary earnings to see if it is sufficient to pay all the operating expenses of the business, carry the debt structure necessary to buy and/or operate the business, and provide an adequate wage.

Many business brokers believe that most people who own or acquire these types of businesses do so for reasons that may not be limited purely to the dollar return that is generated. These other reasons include: lifestyle, geographic location, the psychological benefit of being an owner rather than an employee, and other similar considerations.

Because the rate of return required by owner/managers commingles return on labor (managers' compensation) and return on capital (distributions and appreciation), application of this method may not produce an indication of fair market value. When the multiple of discretionary earnings method is supported by a sufficient number of actual market transactions, however, it may produce an indication of fair market value. For example, if a valuation consultant is able to find information relating to the sales of 20 single-store pizza parlors, these transactions may set the market. Therefore, it is not always clear whether this method provides investment value or fair market value. The consultant is urged to use other methods and/or develop reliable market data in deciding what standard of value is produced using this method.

The multiple of discretionary earnings method, as employed by most business brokers, produces a value for certain tangible and intangible assets (operating assets) of the business. Those assets not usually included in a sale (cash, accounts receivable, prepayments, and loans receivable or payable) are excluded. Therefore, the method usually produces an *invested capital* value or, as business brokers call it, a *gross value* of the operating assets of the business. To produce an *equity* value of the operating assets, the consultant must subtract the value of the company's debt. To produce an equity value of the entire company, the consultant must add back the value of those assets that were excluded from the calculation.

Rather than using the term *discretionary earnings*, some professionals prefer to use other terms, such as *owner's discretionary cash* or *owner's cash flow*. The problem with these other titles is that they are not fully descriptive and contain terms that have different meanings in the accounting and financial professions. Thus, the Standards Committee of the International Business Brokers Association (IBBA) defined discretionary earnings as a company's earnings prior to the following items:

a. Income taxes.

b. Nonoperating income and expenses.

c. Nonrecurring income and expenses.

d. Depreciation, amortization, and goodwill impairment.

e. Interest income or expense.

f. Owners' total compensation for services that could be provided by an owner/manager.

Applying the Method

The multiple of discretionary earnings method typically consists of the following basic steps:

Step 1	Determine the company's normalized pretax earnings for an appropriate period.
Step 2	Add the owner's total compensation and benefits.
Step 3	Add interest expense and any noncash charges, such as depreciation.
Step 4	Deduct interest income. (The sum of Items 1–4 discretionary earnings.)
Step 5	Determine an appropriate valuation multiple.
Step 6	Multiply discretionary earnings by the factor in Step 5 to determine the value of the company's operating assets.
Step 7	Perform "sanity checks" to determine the reasonableness of the value determined in Step 6.
Step 8	If necessary, adjust the value determined in Step 6 for net working capital, excess assets, nonoperating assets, and debt.
Step 9	Determine if the value computed should be adjusted for minority interest discounts or other discounts.

Step 1—Determine the Company's Normalized Pretax Earnings for an Appropriate Period

The consultant usually obtains financial statements for the five fiscal years preceding the valuation date and interim statements covering the period from the last fiscal year-end to the valuation date. The periods requiring adjustments for GAAP errors or normalization generally depend on the period of operations used in the valuation. The period of operations that is used in the valuation may be the most recent fiscal year or 12 months' operations or an average of operations for several years. When weighting prior years, a higher weight is usually given to the most recent years. However, the consultant must determine the most likely occurrence of the future benefit stream and weigh the historical discretionary earnings accordingly.

After the consultant has gathered the financial statements, they should be adjusted to reflect results of operations that are realistic and representative of future operations. Some of the types of adjustments that may be required include:

a. Adjustments that are required by generally accepted accounting principles.

b. Adjustments for the impact of nonoperating assets, excess assets, or asset shortages.

c. Normalization adjustments for such items as nonoperating and non-recurring events.

It should be noted that normalization adjustments are not required for owner's compensation because those amounts will be added back in Step 2.

Step 2—Add the Owner's Total Compensation and Benefits

Discretionary earnings includes the owner's total compensation. Accordingly, the reported deductions for owner's total compensation and benefits (including bonuses, insurance, automobiles, etc.) should be added back to normalized pretax earnings.

Step 3—Add Interest Expense and Any Noncash Charges

The value of the assets of a business generally should not change due to the present or proposed debt and equity capital structure. As this method calculates an invested capital value, the consultant should add back the deduction for interest expense associated with both long-term and short-term debt. (If the value of equity capital is required, the consultant can subtract the market value of the company's debt from the value computed in Step 6.)

After adding back interest expense, the consultant should also add back any noncash charges. Noncash charges normally include such things as depreciation, impairment, and amortization expense.

Step 4—Deduct Interest Income

The purpose of this method is to determine the value of tangible and intangible operating assets of the business. Because receivables are not considered to be operating assets, related interest income should not be included in discretionary earnings. (To arrive at discretionary earnings, the consultant should total steps 1–4.)

Step 5—Determine an Appropriate Valuation Multiple

Selecting the multiple (or multiplier) is unquestionably the most difficult step in applying the multiple of discretionary earnings method. The multiple must consider both the economic limits of value and various business risk factors. In addition, it is important that the multiple be based on discretionary earnings and not on some other level of benefits (for example, net income or net cash flows).

When choosing a multiple, the consultant should keep in mind that the range of multiples is limited to the economic considerations of both the seller and potential purchaser. Generally, the multiple will normally range from one to three. While multiples of less than *one* can be supported given specific business risk characteristics, most owners will rarely sell their businesses for less than one year's discretionary earnings. In addition, a multiple of less than one will usually result in a value that is less than the market value of the company's operating assets.

Best practices indicate that the use of a multiple greater than *three* often results in a value that cannot support the cash flow necessary to pay the owner a reasonable salary after servicing the annual debt and equity capital. In fact, many brokers believe that values determined using multiples in excess of "3.5" will not even support the annual debt and equity capital.

There are two common methods for determining the multiple. These methods are:

a. Base the multiple on guideline company data.

b. Calculate a multiple based on business risk characteristics that influence the expectation of receiving future benefits.

These methods are discussed further in the following paragraphs.

Basing the Multiple on Guideline Company Data. When using guideline company data, it is important to use multiples derived from companies that are similar in size and investment characteristics to the business being appraised. Obtaining useful information on very small business sale transactions can be difficult because this information is not readily available in the public domain. However, there are several sources that the consultant can utilize. These sources include databases maintained by the Institute of Business Appraisers, *BIZCOMPS®*, *Pratt's Stats®*, and *Done Deals®*, as well as databases maintained by business brokers. When selecting a multiple, it is important that the multiple be based on discretionary earnings and not some other form of benefits (for example, net income or net cash flow).

Developing a Multiple Based on Business Risk Characteristics. When guideline company multiples are not available, the consultant may decide to develop a multiple. The consultant may also wish to develop a multiple to serve as a reasonableness check against guideline company multiples. This method is more subjective than deriving a multiple from actual transactions, and whenever possible, the resulting value should be checked against other methods through the use of "sanity checks."

When developing a multiple, the consultant should consider the risk characteristics that influence buyers' expectations of receiving future benefits. Various studies conducted by the Small Business Administration, financial analysts, appraisers, and business brokers describe those risk characteristics. The following risk characteristics, while not all inclusive, represent the primary characteristics that influence value considerations for very small businesses:

a. Stability of historical earnings.

b. Business and industry growth prospects.

c. Type of business.

d. Quality of location and facilities.

e. Stability and skills of employees.

f. Competition.

g. Diversification of products, services, and geographic markets.

h. Desirability and marketability for type of business.

i. Depth of management.

j. Availability of capital and/or terms of sale.

These risk characteristics are discussed further in the following paragraphs.

Stability of Historical Earnings. The stability of historical earnings and the expectation of their continuing into the near future is one of the most important factors considered by most buyers. If earnings are marginal, erratic, and/or have exhibited no historical pattern, there is a perception of risk. Many business brokers indicate that 50% of very small businesses fail or go out of business during their first year of existence. Some of the reasons for failure include:

a. Lack of capital.

b. Poor management.

c. No business experience.

d. Inadequate planning.

By the end of five years, nearly nine out of ten businesses are no longer in business. Companies that have been established five years or more have weathered most of the major problems of operating a business and may have a higher likelihood of continued success. In general, those businesses that have a long and stable history of earnings will be more valuable than businesses with shorter histories and erratic earnings.

Business and Industry Growth Prospects. Research into the history, background, and future trends of both the specific business and its industry will provide insight into the future prospects for the company's growth. Most people go into business for themselves to have the opportunity for future earnings growth. Accordingly, buyers will usually pay more for a business that is in a growing industry. On the other hand, owners of businesses that have slow or no growth and/or are in declining industries often find it very difficult to find buyers. In this area, the consultant should pay particular attention to local economic and demographic conditions.

Type of Business. The type of business involved also has an impact on value. In general, businesses that are easy to start and require small capital investments will be less valuable than businesses that require specialized knowledge, licensing, and/or heavy capital investments.

Quality of Location and Facilities. The attractiveness of a business' neighborhood and the appearance of its facilities can have an influence on the value of a very small business. If a business is located in a less attractive part of town (due to crime, appearance, etc.), the number of potential buyers may be limited. In addition, business owners who are unable or unwilling to maintain the appearance of their facilities can expect to get less for their businesses than those that have been well kept.

Stability and Skills of Employees. Well-trained employees are an important asset of any business, especially to a new owner who may have little or no experience in managing a very small business. It is expensive and time consuming to find, hire, and train employees. A major benefit of buying an existing business is the existence of a trained workforce. Companies with low turnover and skilled employees tend to have good track records of business success and usually are more valuable than businesses with short-term unskilled employees.

Competition. Being in a highly competitive industry can also affect value. Highly competitive markets are often unstable and can have a negative impact on a business. In some industries, however, competition is very friendly and actually stimulates business for everyone. For example, tenants in shopping malls, while competing for the same consumer dollar, often use joint advertising to promote business for the mall. In analyzing this risk, the consultant should look at the overall picture and determine whether competition appears to have a negative or positive impact on the business.

Diversification of Products, Services, and Geographic Markets. Another distinguishing characteristic between small and larger businesses is diversification. Typically small businesses have very narrow lines of products and services. In addition, they are usually restricted to limited geographic markets. Expansion of product lines, services or markets may be restricted by supplier requirements, customer limitations, and/or the owner's inability to raise additional capital. Many very small businesses are in small niche markets that do not provide significant growth potential. On the other hand, larger businesses tend to be more diversified and less vulnerable when a product line or geographic market suffers or is lost. Businesses that are able to diversify are better able to reduce risk, and therefore, increase their value.

Desirability and Marketability for Type of Business. Determining what buyers for small and very small businesses want is a very difficult task. While they are certainly interested in return on investment, other characteristics such as lifestyle, pride, and past experience play important roles in determining what buyers are willing to pay for companies. Some businesses are much more desirable than others and tend to sell fast. Most very small businesses take six months or more to sell. Many others never sell despite the fact that they are profitable.

Depth of Management. One of the distinguishing characteristics between small and larger businesses is the depth of management. Larger companies tend to have multiple layers of management. Because of this, a larger business will usually not suffer if one or two managers leave the company. On the other hand, small and very small businesses tend to have few, if any, levels of management below the owner/manager. As a consequence, the success of a very small business is often tied directly to the owner/manager. Without that owner/manager, the business may not be nearly as successful. In general, the more reliant a business is on its owner/manager, the less valuable it is to a buyer.

Availability of Capital and/or Terms of Sale. The availability of debt and/or equity capital greatly influences the value of a company. A well-known saying states that "with unlimited resources of time and money, most any problem can be overcome." Unfortunately, many small businesses suffer from a lack of both time and money. According to the Small Business Administration, approximately 45% of all new businesses are funded by the owner's own equity capital because sources of debt capital are severely limited. Public companies can attract equity capital through the sale of stock. Mid-sized companies are usually sought after by an array of debt and equity sources. For small and very small businesses, however, capital can be difficult to obtain.

Business brokers report that approximately 70% of the purchasers of small and very small businesses require at least some seller financing. If cash were to be required for the entire sales price, most of these businesses would either sell at very low prices or not sell at all. Since fair market value assumes a cash price, it is necessary to find out the terms of a proposed transaction and reduce it to a cash equivalent basis (through adjustment of the multiple).

Measuring the Risk Characteristics. When developing a value multiple, many business brokers use a worksheet to analyze the business risk characteristics. The worksheet allows the consultant to select a multiple for each of the

10 risk characteristics and then to weight each of the categories based on their significance to the business. For many small and very small businesses, the importance of each characteristic is reflected in the order in which it appears on the worksheet (that is, the more important characteristics are listed first). Exhibit 2-6 illustrates a completed worksheet.

Step 6—Multiply Discretionary Earnings by the Factor in Step 5 to Determine the Value of the Company's Operating Assets

The indication of value determined in Step 6 represents the capitalized value of the tangible and intangible operating assets necessary to generate discretionary earnings. This normally includes machinery, equipment, supplies, leasehold improvements, a normalized level of inventory, and intangible assets. This capitalized value represents the estimated value at which many very small businesses sell. It does not, however, represent the total value of the business.

Step 7—Perform "Sanity Checks" to Determine the Reasonableness of the Value Determined in Step 6

Since the process of obtaining or developing a multiple is often very subjective, it is especially important for the consultant to perform "sanity checks" to determine the reasonableness of the estimated value. For example, the consultant may apply both the excess earnings method and the multiple of discretionary earnings method.

Exhibit 2-6

Valuation Multiple Development Worksheet
Multiple of Discretionary Earnings Method

Company Name: Joe's Bakery

Completed by: Nancy Consultant Date: 3/21/X3

Instructions: The valuation consultant may use this worksheet to develop a valuation multiple when one cannot be determined from sales in the market. After selecting a multiple for each business risk characteristic, the consultant should weight each of the characteristics (using a weighting scale of 1 to 10) based on the significance of the characteristic to the business.

MULTIPLE RANGE	BUSINESS RISK CHARACTERISTICS	SELECTED MULTIPLE	WEIGHT	WEIGHTED MULTIPLE
	STABILITY OF HISTORICAL EARNINGS			
0.1 – 1.0	Marginal, erratic and/or less than 3 years history			
1.1 – 2.0	Erratic or stable, but at or near industry norm	2.5	10	25
2.1 – 3.0	Stable, above industry norm & 5 years or more history			
	BUSINESS AND INDUSTRY GROWTH			
0.1 – 1.0	Flat or declining or below industry norm			
1.1 – 2.0	Flat or slightly increasing or at or near industry norm	1.5	9	14
2.1 – 3.0	Rapid growth and above industry norm			
	TYPE OF BUSINESS			
0.1 – 1.0	Service business with few assets			
1.1 – 2.0	Service or retail with significant assets	1	8	8
2.1 – 3.0	Wholesale, distribution or manufacturing			
	LOCATION AND FACILITIES			
0.1 – 1.0	Poor neighborhood, location and/or facilities			
1.1 – 2.0	Good neighborhood, location and/or facilities	1	7	7
2.1 – 3.0	Above average location and/or facilities			

MULTIPLE RANGE	BUSINESS RISK CHARACTERISTICS	SELECTED MULTIPLE	WEIGHT	WEIGHTED MULTIPLE
	STABILITY AND SKILLS OF EMPLOYEES			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	High turnover and/or unskilled employees Low to industry norm turnover and well-trained employees Long-term, well-trained, and motivated employees	1	6	6
	COMPETITION			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	Highly competitive and/or unstable market Friendly competition and/or stable market Few competitors and/or high startup costs	1.5	5	8
	DIVERSIFICATION OF PRODUCTS, SERVICE AND GEOGRAPHIC MARKETS			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	Limited product lines, services and/or size of markets Diversification of products, services and/or markets National and/or international market diversification	2.5	4	10
	DESIRABILITY AND MARKETABILITY			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	Limited buyers and/or low esteem Respectable and challenging environment Many buyers, ease of operation and high esteem	1	3	3
	DEPTH OF MANAGEMENT			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	Owner/managers—no other levels of management More than one level of supervision Multi-layers of professional staff & line management	1	2	2
	AVAILABILITY OF CAPITAL/TERMS OF SALE			
0.1 – 1.0 1.1 – 2.0 2.1 – 3.0	All cash required and limited debt capital available Normal market terms available Normal to above market terms available	2	1	2
	OTHER RISK CHARACTERISTICS	—	—	—
	TOTALS		55	85
	WEIGHTED-AVERAGE MULTIPLE[a]			1.5

Note:

[a] After weighting the multiple for each of the business risk characteristics, the consultant should calculate a weighted-average multiple to be used in the valuation.

* * *

Step 8—If Necessary, Adjust the Value Determined in Step 6 for Net Working Capital, Excess Assets, Nonoperating Assets, and Debt

The value determined in Step 6 represents the capitalized value of the tangible and intangible operating assets necessary to generate discretionary earnings. When the engagement is to value the entire company on an equity basis, then the consultant must:

a. Add the value of net working capital.

b. Add the value of any excess assets.

c. Add the value of any nonoperating assets.

d. Subtract the value of the company's debt.

It normally is not necessary to deduct asset shortages because the impact of those shortages should have been reflected through the normalization of pretax earnings.

Step 9—Determine if the Value Computed Should Be Adjusted for Minority Interest Discounts or Other Discounts

Discounts may be required in certain instances.

Limitations of the Multiple of Discretionary Earnings Method

The primary limitations of the method are:

a. It typically does not consider a reasonable compensation for an owner who will actually work in the business.

b. It ignores asset values.

Those limits are often remedied by using the NAV method or other methods that consider asset values in addition to the discretionary earnings method.

Case Study

Exhibit 2-7 presents an example of the multiple of discretionary earnings method applied to Joe's Bakery, a one-store bakery run by Joe Smith, the owner/manager.

Exhibit 2-7

Case Study—Multiple of Discretionary Earnings Method
Joe's Bakery

Assumptions

Normalized pretax income	$	115,000
Owner's salary and benefits		77,000
Interest expense		22,500
Depreciation expense		11,000
Required capital expenditures		4,500
Book value of debt (approximates market value)		195,000
Value multiple (based on sales of guideline bakeries in the region)		1.5

Valuation Calculation

Normalized pretax income	$	115,000
Add:		
Owner's salary and benefits		77,000
Interest expense		22,500
Depreciation expense		11,000
Discretionary earnings	$	225,500
Times value multiple	×	1.5
Value of operating assets	$	338,250

Add: Working capital	50,000
Less: Value of debt	(195,000)
Value of equity capital	$ 193,250

* * *

RULES OF THUMB

Industry rules of thumb or formulas are typically expressed as multiples of gross revenues, operating income, or another factor.

Limitations of Rules of Thumb

Rules of thumb are usually derived from guideline company transactions, and like most guideline companies, those companies probably will differ from the subject company. Accordingly, those differences may need adjustment. With rules of thumb, the multiples may be known, but not the underlying transactions. Thus, the basis for adjusting the guideline companies may be obscured. Other similar limitations of using rules of thumb include:

a. *Insufficient Data to Derive a Proper Multiple.* Consultants may not be able to identify specific transactions or obtain enough guideline company data to derive a multiple. Also, there may not be enough information on the actual terms of sale. For example, there may be favorable financing terms on some guideline companies, which may require adjustment.

b. *Difficulty in Defining a "Typical" Business from Which to Make Adjustments.* A rule of thumb is assumed to apply to the valuation of a *typical* business. Obviously, no *typical* businesses exist. Thus, rules of thumb will always contain some degree of error.

Rules of thumb should not be used by themselves. However, rules of thumb may be useful in assessing the reasonableness of valuations based on other methods. For example, suppose a consultant applies a capitalization of earnings method and computes a value that would be well over a *reasonable* rule-of-thumb value. Although the earnings capitalization value still may be appropriate, the consultant should have a reasonable basis for selecting a value that differs significantly from the rule-of-thumb value.

COMPANY SPECIFIC METHODS

Sometimes, consultants use value indicators based on specific company factors. Examples include:

a. Transactions in the subject company's stock.

b. Enforceable contracts.

Such factors have their limitations, but they can be useful.

Transactions in the Company's Stock

Transactions involving closely held stock should be examined carefully. Many transactions are among family members, and thus are not arm's length. However, that is not always true. Consultants should investigate the details of the company's stock transactions to determine whether they are true indicators of value.

If certain conditions are met (that is, it can be ascertained that the transactions in the company's own stock are timely and on an arm's length basis), these transactions may provide a useful basis upon which a valuation procedure could be based.

It should be stressed, however, that the transactions should be arm's length *and* timely. Transactions in the company's stock that were arm's length but that occurred at a time when the company's operations were significantly different are not useful. Generally, transactions that are more than five years old are considered untimely. However, there may be certain exceptions.

If the consultant uses prior transactions as a valuation procedure, he or she should consider all of the terms of the transaction. For example, the seller may have been given a consulting contract that does not require the seller to perform any real consulting services. Instead, the contract may be a disguised form of additional compensation for the stock.

Like any other valuation procedure, adjustments may be necessary for changes within the company or within the industry since the date of the sale. Adjustments may also be necessary for other factors, including differences in the size of the respective blocks of stock.

Enforceable Contracts

Buy-sell agreements and similar enforceable contracts are important factors to consider. Consultants should discuss those contracts with attorneys who are familiar with them to ensure that the legal aspects are clearly understood. If the agreements are recent and arm's length, they should be considered in determining the company's value.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. Which of the following statements is accurate regarding the multiple of discretionary earnings method?

    a. The rules of thumb method has evolved from this method.

    b. It is the most understood of all valuation methods.

    c. Many valuation consultants do not use this method.

    d. Using this method will always produce an indication of fair market value.

38. When applying the multiple of discretionary earnings method, a number of basic steps should be followed. Which of the following actions should be taken?

    a. Adding interest income.

    b. Deducting interest expense.

    c. Adding the owner's total compensation/benefits.

    d. Dividing discretionary earnings by the appropriate valuation multiple.

39. When developing a multiple based on business risk characteristics, which of the following characteristics would tend to make a business more valuable?

    a. A business that is easy to start.

    b. A business in a part of town with less traffic.

    c. A business in a highly competitive market.

    d. A business with multiple layers of management below the owner.

40. Apply the multiple of discretionary earnings method to Jack's Uniform Cleaning Service using the following assumptions and information. What is the value of equity capital?

Assumptions	
Normalized pretax income	$220,000
Owner's salary and benefits	170,000
Interest expense	37,500
Depreciation expense	18,000
Required capital expenditures	8,500
Book value of debt (approximates market value)	330,000
Value multiple (based on sales of uniform cleaning services In the region)	1.0
Add: Working capital	100,000

    a. $45,500.

    b. $115,500.

    c. $215,500.

    d. $445,500.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. Which of the following statements is accurate regarding the multiple of discretionary earnings method? **(Page 193)**

    a. The rules of thumb method has evolved from this method. [This answer is incorrect. The multiple of discretionary earnings method has evolved from the rules of thumb method.]

    b. It is the most understood of all valuation methods. [This answer is incorrect. The multiple of discretionary earnings method is the most *misunderstood* method of all methods used by appraisers and brokers.]

    c. Many valuation consultants do not use this method. [This answer is correct. Many valuation consultants do not use the multiple of discretionary earnings method because of the difficulty involved in supporting the required multiples.]

    d. Using this method will always produce an indication of fair market value. [This answer is incorrect. The multiple of discretionary earnings method may not produce an indication of fair market value due to the fact that the rate of return required by owner/managers mixes return on labor and return on capital.]

38. When applying the multiple of discretionary earnings method, a number of basic steps should be followed. Which of the following actions should be taken? **(Page 194)**

    a. Adding interest income. [This answer is incorrect. Deducting interest income is a step in applying the multiple of discretionary earnings method.]

    b. Deducting interest expense. [This answer is incorrect. Adding interest expense, and any noncash charges, is a step in applying this valuation method.]

    c. Adding the owner's total compensation/benefits. [This answer is correct. Immediately following the determination of the company's normalized pretax earnings for an appropriate period, the consultant should add the owner's total compensation and benefits. This is a step in applying the multiple of discretionary earnings method.]

    d. Dividing discretionary earnings by the appropriate valuation multiple. [This answer is incorrect. Determining the appropriate valuation multiple is a step in applying the multiple of discretionary earnings method. It is then multiplied by discretionary earnings.]

39. When developing a multiple based on business risk characteristics, which of the following characteristics would tend to make a business more valuable? **(Page 197)**

    a. A business that is easy to start. [This answer is incorrect. Generally, a business that is easy to start will be less valuable than a business that requires specialized knowledge, licensing, and/or capital investments.]

    b. A business in a part of town with less traffic. [This answer is incorrect. Less traffic means less potential customers, thus a lower traffic area would have an impact on the value of a very small business.]

    c. A business in a highly competitive market. [This answer is incorrect. Highly competitive markets are many times unstable and can have a negative effect on a business.]

    d. A business with multiple layers of management below the owner. [This answer is correct. A business with multiple layers of management below the owner/manager would be less likely to suffer if a few managers were to leave the company, therefore making such a company potentially more valuable.]

40. Apply the multiple of discretionary earnings method to Jack's Uniform Cleaning Service using the following assumptions and information. What is the value of equity capital? **(Page 200)**

Assumptions	
Normalized pretax income	$220,000
Owner's salary and benefits	170,000
Interest expense	37,500
Depreciation expense	18,000
Required capital expenditures	8,500
Book value of debt (approximates market value)	330,000
Value multiple (based on sales of uniform cleaning services In the region)	1.0
Add: Working capital	100,000

a. $45,500. [This answer is incorrect. $45,500 would be the correct value of equity capital if the owner's salary and benefits were erroneously excluded from the calculation.]

b. $115,500. [This answer is incorrect. $115,500 would be the correct value of equity capital if there were no working capital.]

c. $215,500. [This answer is correct. Based on the assumptions provided above, applying the multiple of discretionary earnings method results in the value of equity capital of $215,500.]

d. $445,500. [This answer is incorrect. $445,500 is the value of operating assets. Working capital and the value of the debt must be taken into account.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (VALTG102)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

22. The Liquidation Value (LV) Method should be considered in all of the following circumstances **except**:

    a. The company is a multi-subsidiary or multi-division holding company with some profitable divisions and some unprofitable divisions.

    b. The company is in reorganization, such as Chapter 11 bankruptcy.

    c. The company's current and projected cash flows from continuing operations are a level making its liquidation value nearly equal to its going concern value.

    d. The company's current and projected net cash flows from continuing operations are low by comparison to its net assets, and the company is worth more by liquidating it than by continuing to operate.

23. The Excess Earnings Method should be considered when certain circumstances are present. Which of the following statements regarding those circumstances is **inaccurate**?

    a. Current earnings are expected to be significantly greater than future earnings.

    b. Sufficient reliable data is available to reasonably estimate expected normal earnings.

    c. The company has an established earnings history and its value is based principally on earnings.

    d. Do not select this answer choice.

24. The text indicates that an asset appraiser is usually needed when which of the following valuation methods is used?

    a. Rules of Thumb.

    b. Net Asset Value.

    c. Liquidation Value.

    d. A company-specific method.

25. Obtaining the company's balance sheet should be the starting point for the net asset value method. The company's balance sheet should **not** be obtained at which of the following points in time relative to the valuation date?

    a. Prior to the valuation date.

    b. As near as possible to the valuation date.

    c. On the valuation date.

    d. After the valuation date.

26. Bill has two executive office desks in his company offices. If a consultant is using the NAV method, Bill's desks will be commonly adjusted to:

    a. Historical cost.

    b. Fair market value based on asset appraisals.

    c. Replacement cost.

    d. Cost less accumulated depreciation.

27. Under the NAV method, dealing with deferred income taxes generally applies only to:

    a. C corporations.

    b. S corporations.

    c. Sole proprietorships.

    d. Partnerships.

28. If a buyer wants to limit exposure to significant contingent liabilities, a sale involving a C corporation should be structured as:

    a. A sale of stock.

    b. A purchase of assets.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

29. The definition of value that generally applies when a known buyer or seller is considered is:

    a. Fair market value.

    b. Investment value.

    c. Do not select this answer choice.

    d. Do not select this answer choice.

30. When will the liquidation values of liabilities equal their book values?

    a. Rarely.

    b. Never.

    c. In many cases.

    d. Usually.

31. Under the LV method, when adding or subtracting income tax provision or benefit, tax provisions may be required if which of the following type of entity is subject to built-in gains tax?

    a. Most partnerships.

b. Sole proprietorships.

c. C corporations.

d. S corporations.

32. The excess earnings method is used to value which of the following?

a. Large corporations.

b. Construction contractors.

c. Small businesses.

d. Manufacturing companies.

33. Generally, the consultant will use which of the following in applying the excess earnings method?

a. Earnings.

b. Net cash flow.

c. Pretax earnings.

d. Either earnings or pretax earnings.

34. ABC Company, a small business, has been charged an interest rate of 10% by its lender for financing their net tangible assets. Generally, which of the following would be the most likely rate of return that ABC Company would realize as a result of the 10% interest rate they were charged for financing their net tangible assets?

a. 5%.

b. 8%.

c. 10%.

d. 15%.

35. When a consultant determines that the reasonable return on net tangible assets exceeds normalized earnings, it may be advisable to avoid using which of the following valuation methods?

a. Excess earnings method.

b. Capitalized earnings method.

c. NAV method.

d. LV method.

36. A commonly used variation on the excess earnings method is to use average net tangible assets and average earnings to determine net tangible asset value and normalized earnings. Such averages generally cover a:

a. 1-year period.

b. 5-year period.

c. 6-year period.

d. 10-year period.

37. The multiple of discretionary earnings method is commonly used to value very small businesses. Which the following would be considered a very small business?

    a. X Co. has 70 employees and is valued at $475,000.

    b. X Co. has 40 employees and is valued at $325,000.

    c. X Co. has 23 employees and is valued at $240,000.

    d. X Co. has 18 employees and is valued at $225,000.

38. When selecting a valuation multiple, the multiple should be based on which of the following?

    a. Net income.

    b. Net cash flow.

    c. Discretionary earnings.

    d. Another form of benefits not listed above.

39. When developing a multiple that is based on business risk characteristics, one primary risk characteristic that influences value considerations for very small businesses is the stability of historical earnings. After five years, almost ______ of very small businesses have gone out of business.

    a. 50%.

    b. 60%.

    c. 80%.

    d. 90%.

40. Approximately what percent of all new businesses are funded by the owner's own equity capital?

    a. 40%.

    b. 45%.

    c. 50%.

    d. 55%.

GLOSSARY

Articles of incorporation; The primary rules governing the management of a corporation in the United States and Canada, and are filed with a state or other regulatory agency.

Audit: Inspection of the accounting records and procedures of a business, government unit, or other reporting entity by a trained accountant, for the purpose of verifying the accuracy and completeness of the records. It may be conducted by a member of the organization (internal audit) or by an outsider (independent audit). A CPA audit determines the overall validity of financial statements. A tax (IRS) audit determines whether the appropriate tax was paid. An internal audit generally determines whether the company's procedures are followed and whether embezzlement or other illegal activity occurred.

Business valuation: A process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to consummate a sale of a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and many other business and legal purposes.

Buy-sell agreement: A pact among partners or stockholders under which some agree to buy the interests of others upon some event, such as the death of a partner.

Capitalization rate: The ratio between the net operating income produced by an asset and its capital cost (the original price paid to buy the asset) or alternatively its current market value.

C corporation: A corporation that elects to be taxed as a corporation. A C corporation pays federal and state income taxes on earnings. When the earnings are distributed to the shareholders as dividends, this income is subject to another round of taxation (shareholder's income). Essentially, the C corporations' earnings are taxed twice. In contrast, the S corporation's earnings are taxed only once.

Compilation: Presentation of financial statement information by the entity without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP). In performing this accounting service, the accountant must conform to the AICPA Statements on Standards for Accounting and Review Services (SSARS). For guidance on issues not covered therein, reference should be made to the Statements of Auditing Standards. The engagement letter should set forth the type of services to be rendered, limitations of the service (such as nonreliance to disclose errors and irregularities), and nature of the compilation report.

Excess earnings methods: This valuation method is commonly used in valuing small businesses and computes the company's equity value based on the appraised value of tangible assets, plus an additional amount for intangible assets.

Liquidation: The dismantling of a business, paying off debts in order of priority, and distributing the remaining assets in cash to the owners.

Liquidation value (LV) method: This valuation method involves computing liquidation values by making judgments about how the company's assets should be liquidated.

Minority interest: The portion of a subsidiary corporation's stock that is not owned by the parent corporation.

Multiple of discretionary earnings method: A key income-based small business valuation method that establishes the business value as a multiple of an economic benefit adjusted for net working capital, non-operating assets and long-term business liabilities.

Net assets value (NAV) method: This valuation method presumes that the subject company's value will be realized by the hypothetical sale of its assets as part of a going concern.

Net tangible assets: Net assets minus goodwill.

Non-operating asset: Investment or other asset not used in the operations of a business, but instead is meant to generate additional income (such as interest income from a fixed deposit).

Normalization adjustments: These entries are intended to change certain financial data of a business to make the best possible estimate of the true economic earning power of the entity. Normalization adjustments often deal with items the owner or manager expends that are discretionary. These adjustments may also relate to unusual or infrequent transactions that are not typical to the business.

Partnership: An organization of two or more persons who pool some or all of their money, abilities, and skill in a business and divide profit or loss in predetermined proportions. Partners are individually responsible for debts of the partnership. However, in a limited partnership, limited partners generally assume no monetary responsibility beyond the capital originally contributed. Death of a general partner will normally terminate the partnership.

Review: Accounting service providing some assurance to the Board of Directors and interested parties as to the reliability of financial data without the CPA conducting an examination in accordance with generally accepted auditing standards (GAAS). The AICPA Auditing Standards Board formulates review standards for public companies while the AICPA Accounting and Review Services Committee provides review standards for nonpublic businesses. A limited review consists primarily of inquiry and analytical review.

Rules of Thumb: Are principles with broad application that are not intended to be strictly accurate or reliable for every situation. Easily learned and easily applied procedures for approximately calculating or recalling some value, or for making some determination.

S corporation: A corporation that elects to pass corporate income, losses, deductions and credit through to their shareholders for federal tax purposes.

Sole proprietorship: A business or financial venture that is carried on by a single person and is not a trust or corporation.

Valuation date: Date as of which a consultant's estimate of value applies.

Valuation multiple: A method for determining the current value of a company by examining and comparing the financial ratios of relevant peer groups.

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COMPANION TO PPC'S GUIDE TO BUSINESS VALUATIONS

COURSE 3

Pre-engagement Procedures and Wrapping Up the Engagement (VALTG103)

OVERVIEW

COURSE DESCRIPTION:	Lesson 1 of this interactive self-study course addresses pre-engagement procedures including assessments that need to be made before accepting a valuation engagement, basic approaches to developing a work program for a valuation engagement, and items typically included in an engagement letter. Lesson 2 covers aspects of wrapping up the engagement including the two primary types of weighting techniques, applying sanity checks, and the application of premiums and/or discounts.
PUBLICATION/REVISION DATE:	March 2010
RECOMMENDED FOR:	Users of *PPC's Guide to Business Valuations*
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of accounting
CPE CREDIT:	5 QAS Hours, 5 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at **www.nasba.org** for a listing of states that accept QAS hours.
FIELD OF STUDY:	Specialized Knowledge and Applications
EXPIRATION DATE:	Postmark by **March 31, 2011**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Pre-engagement Procedures

Completion of this lesson will enable you to:
- Recognize what assessments need to be made prior to the acceptance of a valuation engagement and describe the basic approaches to developing a work program for a valuation engagement.
- Identify the topics most often included in an engagement letter for a valuation engagement and explain why obtaining an engagement letter is recommended and classify pre-engagement procedures for internal valuations and those of independent consultants.

Lesson 2—Wrapping Up the Engagement

Completion of this lesson will enable you to:
- Define the two primary types of weighting techniques and identify advantages and disadvantages of each type.
- Recognize various types of sanity checks to test the reasonableness of the value estimate.
- Determine how and when to apply any required premiums and discounts.
- Identify a controlling and a minority interest and recognize factors that affect the degree of control that can be exercised.
- Summarize other wrap-up procedures including the representation letter, workpaper documentation, workpaper and engagement reviews, and final administrative procedures.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation,** and payment to:

Thomson Reuters
Tax & Accounting—R&G
VALTG103 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Pre-engagement Procedures

INTRODUCTION

The suggested steps of a valuation engagement can be classified into:

a. Pre-engagement procedures.

b. Performance procedures.

c. Reporting and wrap-up procedures.

This lesson discusses the first phase, pre-engagement procedures.

Pre-engagement Procedures Are Also Important for Accountants and Analysts in Industry

The term *pre-engagement* suggests that the procedures discussed in this lesson are only necessary for the professional valuation consultant. While these procedures are designed from the independent consultant's perspective, they can also benefit industry accountants or analysts who are performing valuations of their companies or potential acquisitions. Thus, this lesson also explains how the independent consultant's pre-engagement procedures can be adapted to an internal valuation.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize what assessments need to be made prior to the acceptance of a valuation engagement and describe the basic approaches to developing a work program for a valuation engagement.
- Identify the topics most often included in an engagement letter for a valuation engagement and explain why obtaining an engagement letter is recommended and classify pre-engagement procedures for internal valuations and those of independent consultants.

What Are Pre-engagement Procedures?

Exhibit 1-1 lists recommended pre-engagement procedures and shows how the procedures designed for independent consultants can be adapted for internal valuations.

Exhibit 1-1

Valuation Engagement Work Program
Pre-engagement Procedures

Procedures Recommended for Independent Valuation Consultants	Adaptation of Procedures for Industry Accountants and Analysts[a]
1. Evaluate whether to accept the engagement.	1. Evaluate whether the valuation can be performed internally.
2. Prepare a work program.	2. Same.
3. Develop a time and fee estimate.	3. Develop a time and resource budget.
4. When appropriate, obtain approval of the work program, staff assignments, and fee estimate.	4. When appropriate, obtain approval of the time and resource budget.
5. When necessary, prepare a proposal letter or oral presentation.	5. Formally or informally communicate the approach, expectations, limitations, and cost of the project to the appropriate level of management.
6. Obtain an engagement letter.	

Note:

[a] Paragraph 7 of SSVS No. 1 (VS 100.07) includes a specific exception to the standard for "internal use assignments from employers to employee members not in the *practice of public accounting*."

* * *

ENGAGEMENT ACCEPTANCE

The phone rings and at the other end is one of your largest clients. The conversation goes like this: "Say Cruncher (What the company president affectionately calls his consultant), we are thinking about selling the company and need a ball park estimate of its value. Now I don't want to spend a lot of money or have a bunch of your staff digging through my files. Just give me your best shot by 5 o'clock today. Thanks Cruncher, got to run." After your heartbeat slows down, the natural urge is to call the troops together, sharpen the pencils, and start working feverishly to generate some type of number by 5 p.m.

Phone calls like the preceding example are far too common. When those situations occur, do not be tempted to immediately begin the valuation. Call time out! This time out period is called the acceptance phase of the engagement. Engagement acceptance procedures can be critical, especially in today's litigious environment.

What Data Should Be Considered and What Assessments Should Be Made before Accepting the Engagement?

To make an informed decision about whether to accept an engagement, the consultant should obtain a basic understanding of the client, company, and proposed engagement. Based on that information, the consultant should make the following important assessments:

a. The consultant's professional competence.

b. The nature, risks, and requirements of the engagement.

c. Whether there are conflicts of interest that might impair the consultant's (1) objectivity or (2) credibility as an expert witness.

d. Whether the consultant is independent with respect to the client and subject business.

e. Other factors regarding the engagement, client, or the subject company.

Each of those items is discussed in more detail in this lesson.

Assessing Professional Competence. The valuation consultant should assess whether the engagement team has the expertise and resources, collectively referred to as professional competence, to perform the valuation. Although various business valuation standards mention professional competence, the AICPA's long-standing general standard provides the most authoritative and followed guidance. However, the AICPA Statement on Standards for Valuation Services (SSVS) No.1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (VS 100.12), currently provides professional competence guidance specific to business valuations. At a minimum, SSVS No. 1 requires valuation analysts to consider the following when assessing the professional competence of the engagement team:

a. The subject entity and its industry.

b. The purpose of the valuation.

c. The subject interest.

d. The valuation date or dates.

e. Any assumptions or limiting conditions concerning the engagement.

f. The standard of value and premise of value to be used on the engagement.

g. The type of valuation report to be issued, intended use and users of the report, and any restrictions on use of the report.

h. Government regulations or other professional standards that may apply to the valuation engagement.

Consideration of these items also helps the analyst with considering the other factors involved in the engagement acceptance decision. Although only applicable to CPAs, it is believed this guidance should generally be followed by all valuation analysts.

Understanding the Subject Entity and Its Industry. The consultant should obtain a general understanding about the subject entity and its industry during the acceptance phase. Note that this understanding does not have to be as thorough as will be required if the engagement is accepted. The objective in the pre-engagement stage is to know the company well enough to not only determine whether the consultant has enough expertise to perform the valuation, but to also:

a. Identify which valuation methods will be considered for the engagement.

b. Identify any significant matters that may affect the conduct of the engagement.

Item a. is discussed later in this lesson. The following paragraphs discuss item b.

During the acceptance phase, the consultant should look for matters that may affect the engagement. For example, can the client provide enough financial data to forecast future earnings or cash flows? Will company personnel assist in providing documents and other information needed in the engagement? Will fixed assets or any other assets need to be valued by asset appraisers? Are there other matters that may require special consideration? Those types of matters affect the types of valuation techniques that can be used. They also can affect the time it takes to value the company.

Consultants might look at the following areas to obtain their understanding:

a. *Operations.* Locations, sales volumes, market share, major customers and suppliers, and the production or service process.

b. *Organization and Management.* Principal owners, key managers, organization structure, and legal form of entity.

c. *Industry.* Products and services, competition, growth and economic trends, and specialized accounting practices.

d. *Financial Statements and Tax Returns.* Profitability, financial condition, major assets, liabilities, revenues, expenses, and unusual items.

e. *Company Expectations.* Trends, growth patterns, goals, and objectives.

The Purpose of the Valuation. There are several reasons why a client would need a business valuation. Often the purpose of the engagement and the intended use of the valuation report are obvious. But sometimes the purpose of the valuation is not clear, or clients may have other reasons for needing the valuation that they prefer not to disclose. If the purpose of the valuation is not apparent, the consultant should specifically ask the client. A clear understanding of the valuation's purpose not only helps the analyst's consideration of other professional competence factors (such as the proper standard of value and the type of report to issue), but it also helps the analyst to subsequently assess the nature and risks of the engagement and the analyst's objectivity to perform the valuation. To avoid misunderstandings, it is recommended that the purpose of the valuation be disclosed in an engagement letter.

Subject Interest. The valuation consultant should have a clear understanding of the subject interest to be valued. The subject interest is generally easy to identify, but occasionally, more effort is required due to contractual or statutory provisions. Although *subject interest* is a commonly used valuation term generally referring to a portion of the subject company that is to be valued, the term was not defined in the "International Glossary of Business Valuation Terms" or other major valuation standards prior to SSVS No. 1. SSVS No. 1 (VS 100.82) provides a definition that includes a business, business ownership interest, security, or intangible asset.

Valuation Date. The valuation date for some engagements may be obvious. For example, the business valuation date for estate tax purposes would be the date of the owner's death, or an alternate date six months after the date of death. For other valuation engagements, the valuation date may be less clear, or there may even be multiple valuation dates. Since a particular valuation is relevant only for a given point in time, it is important for the valuation date to be clearly identified before beginning the engagement. Then the consultant can determine how that date affects the time and information requirements and, ultimately, the fee.

Assumptions and Limiting Conditions. SSVS No. 1 (VS 100.82) defines assumptions and limiting conditions as:

> Parameters and boundaries under which a valuation is performed, as agreed upon by the valuation analyst and the client or as acknowledged or understood by the valuation analyst and the client as being due to existing circumstances.
>
> The valuation analyst should consider known assumptions and limiting conditions (ALC) applicable to the potential valuation engagement and any adverse impact the ALC may have on the analyst's or the consultant's professional competence.

Many assumptions and limiting conditions (ALC) are applicable to most business valuation engagements and should be considered during pre-engagement procedures. A caveat that the valuation report is only valid for the specified date and purpose is an example of general ALC. However, the valuation consultant should also consider ALC specific to the proposed engagement. For example, if the consultant is approached to be a neutral appraiser in a divorce proceeding, the consultant should consider potential differences in performing the engagement and communicating the results. Occasionally, an ALC specific to the potential engagement may impact the consultant's ability to perform the engagement with professional competence. In this case, the valuation consultant should discuss the matter with the client for further clarification of the issue before making an engagement acceptance decision.

Standard of Value and Premise of Value. Standard of value refers to the type of value to be estimated in a specific engagement, such as fair market value, fair value, intrinsic value, and investments value. For certain valuations, such as those to support divorce proceedings, the standard of value used may vary from one jurisdiction to the next. Therefore, it is important for the valuation consultant to verify with the client's attorney what standard of value should be used or to read the case law to see how the relevant court interprets the standard of value.

Premise of value is an assumption of the most likely transactional circumstances that may be applicable to a valuation subject. The most common of these are going concern value and liquidation value. For example, suppose the consultant finds out that the subject company is having extreme financial difficulties. Then, the consultant would need to consider how that might affect the engagement, such as whether liquidation values should be used and possible difficulties involved in determining liquidation values for some assets. The premise of value may impact the selection of valuation methods to be used in a valuation engagement.

Type of Valuation Report. Most clients are unfamiliar with the contents of a valuation report, so it is the responsibility of the consultant to consider the appropriate report type for the proposed engagement, adhering to any requisite professional standards and guidelines. The major valuation organizations provide their own reporting requirements to promote uniformity and confidence in the association. In addition to a comprehensive, detailed report, some valuation organizations allow for an abridged version of a detailed report. Also, SSVS No. 1 (VS 100.48) allows for both a detailed report and a summary report to support a business valuation engagement.

Intended Use and Users of the Report. Similar to the purpose of the valuation, the intended use and users of the report is usually obvious. However, in certain circumstances, these factors are not as obvious and may require the consultant to ask further questions.

Governmental Regulations or Other Professional Standards. Some valuations involve governmental regulations which apply to the subject entity, such as contingent environmental cleanup liabilities, that are unfamiliar to the consultant or increase the complexity and length of the engagement. Also, state statutory requirements, such as those involving the standard of value, may require additional knowledge or resources for the consultant to complete the valuation. These characteristics of the engagement should be considered when the consultant is assessing professional competence.

Also, the consultant should consider whether the engagement can be conducted in accordance with applicable professional requirements, such as the ASA, AICPA, IBA, NACVA, and the Appraisal Foundation. This consideration is more than looking for conflicts of interest. Professional standards may require specific procedures during the engagement. For example, the CPA valuation consultant may have additional responsibilities with respect to historical financial statements.

Other Consideration. In assessing professional competence, the consultant may conclude that the valuation team does not have the expertise or resources to adequately complete the engagement. Thus, it is believed that a valuation consultant should consider refusing the engagement or using an outside specialist. However, if a CPA decides to outsource professional services to a specialist or third-party service provider (that is, an entity not controlled by the audit firm or an individual not employed by the audit firm), Ethics Ruling No. 112 under Rule 102, *Integrity and Objectivity*, requires that the client be informed, preferably in writing, before confidential information is shared with the specialist. If the client objects, the consultant should perform the services without using the specialist or should decline the engagement.

Understanding the Nature and Risks of the Engagement. The phone call example above shows how vague and sketchy valuation engagements can be. This is often the case even when a formal request for proposal (RFP) is made because RFPs may omit facts that are critical to the engagement acceptance decision. According to SSVS No. 1 (VS 100.13), in addition to the professional competence factors previously discussed to make a thorough assessment of the engagement's nature and risks, the consultant should consider, at a minimum the following information about the proposed engagement:

a. The proposed terms of the valuation engagement.

b. The identity of the client.

c. The nature and type of interest.

d. The procedural requirements and any limitations of the valuation engagement.

e. The use and limitations of the valuation report.

f. Obligations to update the valuation.

Proposed Terms of the Valuation Engagement. The terms of the engagement are critical to the success of the engagement, and thus, should be thoughtfully considered and, if necessary, negotiated. Although some engagement terms are unique to the specific engagement, some common engagement terms include the following:

a. *Start Date.* The client often wants the valuation to start (and sometimes be finished) immediately. However, the engagement team may be currently involved on another engagement or a third-party appraisal specialist to be used is currently not available. Also, the client may need time to retrieve the necessary data and documents that the consultant will need. Thus, the consultant should obtain a clear understanding of the potential start date of the proposed engagement through discussions with the client.

b. *Deadline.* The need to understand the report deadline date seems so obvious that it probably does not need to be reemphasized. But sometimes the consultant's and the client's views of the deadline are very different. If the client sets an inflexible deadline that the consultant cannot meet, the consultant should try to renegotiate the deadline or decline the engagement. To avoid confusion, many consultants disclose their deadlines in their engagement letters whenever possible.

c. *Fees.* The estimated fees based on the time and expenses to be incurred on the engagement should be within an acceptable range. If the fees for an engagement are likely to exceed the amount the client can or will pay, obviously the engagement is not feasible. The consultant should try to find out what the client's fee expectations are and make a preliminary estimate of the fees for the engagement. Consultants who believe that their prospective clients will object to their estimated fees should consider discussing the matter with the clients and revising the terms of the engagement, if possible. If the terms cannot be revised, the consultant may decide to decline the engagement.

<u>Identity of the Client.</u> The identity of the client is usually obvious. However, if the consultant is approached by a lawyer (or other third-party representative), either the lawyer or the party the lawyer represents may be the actual client. It is important for the consultant to have a clear understanding of the client's identity for several reasons, such as potential conflict of issues.

<u>Type of Ownership Interest.</u> Many business valuation engagements cover a fractional ownership interest instead of the entire ownership interest. In such cases, the type of ownership interest to be valued—that is, whether it is a controlling or minority interest—affects many facets of the engagement. For example, the valuation methods selected, the data gathered, and how both are used may depend on whether the consultant is valuing a controlling or minority interest. Accordingly, the ownership interest should be identified in the engagement letter.

<u>Procedural Requirements.</u> Many valuation procedures are performed for all valuation engagements. However, some procedures depend on the specifics of the engagement, such as characteristics and industry of the subject entity, the type of ownership interest, and the intended use of the valuation report. The consultant should consider whether there are any client-related issues or uncontrolled circumstances that may limit the consultant's ability to complete the necessary valuation procedures. The consultant may be made aware of restrictions or scope limitations of the data available for analysis or the procedures that may be performed prior to accepting the engagement. For example, the consultant may discover that critical financial information is not readily available. The consultant should then consider whether the potential client is willing to incur additional fees to develop the missing data or, alternatively, whether the absence of that data would cause a qualification of the valuation report. Such known issues should be discussed with the client before making the acceptance decision. If the engagement is accepted and the issue warrants a restriction or scope limitation, the qualification should be disclosed in the valuation report.

<u>Use and Limitations of the Report and Conclusion of Value.</u> Unauthorized use of the valuation report or estimate of value is a risk that the consultant should consider when assessing engagement acceptance. The consultant should carefully determine use limitations applicable to the valuation report and communicate the limitations to the client, preferably in a written engagement letter.

<u>Update Obligations.</u> Many valuation engagements arise from negotiations for sales, property settlements, and similar transactions. Those negotiations can take place over a long period, especially if the valuation is involved in a litigation proceeding. Changes in economic conditions or other factors can cause the value of a business to change. Consultants should consider their availability or desire to perform an updated valuation, if requested.

<u>Other Considerations.</u> Although not specifically stated in SSVS No. 1, it is believed the valuation analyst, when assessing the nature and risks of the engagement, should consider the following issues:

a. *Identifying the Consultants Role.* One of the most important professional and ethical mandates of the valuation consultant involves the issue of objectivity versus advising. The consultant can be engaged to (a) perform an objective, independent business valuation or (b) advise the client and help negotiate a best or worst value for a company. However, remember that these roles are mutually exclusive. During the acceptance phase, consultants should obtain a clear understanding of their roles and assess how those roles affect their proposed engagements. The consultant's role should be defined in each engagement letter.

b. *The Likelihood of Expert Witness Testimony* Many valuation engagements are performed in connection with some legal action. Thus, the consultant is often asked to testify as an expert witness concerning the valuation. Other times, the valuation consultant may act only as an expert consultant, giving advice or commenting on another consultant's business valuation without providing evidence or testimony. In the acceptance phase, the consultant should evaluate whether the engagement involves any legal actions and the consultant's role in those legal actions. Such circumstances can affect staffing requirements and estimated fees.

c. *Special Reporting or Presentation Requirements* Most clients are unfamiliar with the contents of a valuation report. Accordingly, they look to the valuation consultant for advice. By understanding the purpose of the valuation, the consultant's role, and the likelihood of expert witness testimony, the consultant can make a tentative assessment of the engagement's reporting requirements. Obviously, the more formal the report, the more time-consuming and expensive the engagement will be. Also, if the report will contain complete historical or prospective financial statements, CPA valuators may have added reporting responsibilities that others do not have.

Conflicts of Interest and Independence. Part of deciding whether to accept an engagement is determining whether the consultant has any conflicts of interest. Both the ASA and the AICPA have rules regarding conflicts of interest. In both types of engagements (objectivity versus advising), valuation consultants should be free from any conflicts of interest. For example, in an advisory type of purchase engagement, the consultant should not have a financial interest in the buyer or seller. Also, in an engagement where the consultant's role is to develop an objective value, the consultant should not have any financial interest in the company nor should fees be based on the value rendered. If there is uncertainty concerning a potential conflict of interest, SSVS No. 1 (VS 100.14) states that CPAs should make the disclosures and obtain consent as required under Interpretation No. 102-2, "Conflicts of Interest." (ET 102.03)

If the consultant is a CPA that also provides attest services for the potential valuation client, the AICPA has rules addressed in Ethics Interpretation 101-3 governing whether the CPA can perform nonattest services, such as business valuations, and still remain independent to perform the attest services. In summary, the consultant should (a) be familiar with the standards of his or her profession as they relate to independence and conflicts of interest and (b) consider them before accepting an engagement.

Selecting Valuation Methods. To design an efficient valuation engagement and to properly determine a fee estimate, the consultant should make a preliminary assessment of possible valuation methods that might be used on the engagement. In making this preliminary decision, a practical technique for narrowing the list of alternative methods is to first eliminate those methods that are obviously inappropriate for the particular engagement. For example, suppose the consultant was valuing a profitable wholesale food distributor that operated in leased facilities. In that case, the consultant could probably eliminate the specific asset valuation methods and focus on methods based on earnings potential. However, it should be noted that the consultant may choose more valuation methods (or reject some methods previously chosen) during the engagement as more data is obtained about the company and its industry.

Once a preliminary list of possible valuation methods is determined, the consultant should look for potential difficulties in applying those methods on the proposed engagement. For example, if an underlying asset method was selected and the company's major asset was a unique piece of scientific equipment, the consultant may need to use a specialist to appraise it. Likewise, if the method depended on the estimated future earnings of the company, the consultant would be wise to inquire whether the company has prepared forecasts of future earnings or whether those have to be prepared as part of the engagement.

Assessing Engagement Feasibility and Acceptance Considerations. At this stage of the engagement acceptance process, the consultant has been able to gain a great deal of information about the nature of the proposed engagement, the client, and the company to be valued. The consultant should carefully weigh all of the information obtained thus far and make an informed decision regarding acceptance of the engagement. Unfortunately, this is not always an easy decision to make.

Some of the factors that may lead the consultant not to accept an engagement have been discussed in the preceding paragraphs. For example, a consultant who has no expertise in a particular specialized industry and no access to someone who does, or who does not have enough available staff members to meet a client's deadline, might decline an engagement for those reasons. Sometimes, however, the rejection decision may be based on more intangible factors that cannot be supported with an objectively determined rationale. These factors may relate to some aspect of the engagement, the client, the client's attorney, or the company to be valued, and are a matter of considerable judgment.

Consultants should trust their instincts in deciding whether to accept a valuation engagement. A valuation consultant should not feel compelled to accept every engagement opportunity.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following valuation engagement pre-engagement procedures is recommended for industry accountants and analysts?

   a. Evaluate whether to accept the engagement.

   b. Develop a time and resource budget.

   c. Obtain approval of the work program, staff assignments, and fee estimate.

   d. Prepare a proposal letter or oral presentation.

2. The independent valuation consultant would **not** need to make which of the assessments listed below when deciding whether to accept a valuation engagement?

   a. An assessment of any conflicts of interest that could impair the consultant's objectivity as an expert witness.

   b. The nature, risks, and requirements of the engagement.

   c. An assessment that the valuation will exceed $100M and, therefore, be considered a significant valuation exercise.

   d. The consultant's professional competence.

3. The AICPA Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (VS 100.12), provides guidance on professional competence related to business valuations. When considering the professional competence of the engagement team, SSVS No. 1 requires, at a minimum, that valuation analysts consider all of the following **except**:

   a. The educational background of engagement team members.

   b. The purpose of the valuation.

   c. The valuation date or dates.

   d. Assumptions or limiting conditions regarding the engagement.

4. To gain a better understanding of specialized accounting practices that could affect the valuation engagement, the consultant should examine which of the following areas?

   a. Operations.

   b. Organization and management.

   c. Industry.

   d. Financial statements and tax returns.

5. Which of the following would be classified as a premise of value?

   a. Liquidation value.

   b. Fair market value.

   c. Intrinsic value.

   d. Investments value.

6. Which of the following is **not** a factor to be considered by the consultant when determining the fee to be charged for performing a valuation engagement?

   a. The consultant's level of experience.

   b. The likelihood of expert witness testimony.

   c. The consultant's role in the engagement.

   d. Special reporting requirements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following valuation engagement pre-engagement procedures is recommended for industry accountants and analysts? **(Page 219)**

   a. Evaluate whether to accept the engagement. [This answer is incorrect. Evaluating whether to accept the engagement is one of the procedures recommended for independent valuation consultants, not for industry accountants and analysts. Industry accountants and analysts evaluate whether the valuation can be performed internally.]

   b. Develop a time and resource budget. [This answer is correct. Industry accountants and analysts should develop a time and resource budget since completing the work in-house will tie up the industry accountant's time whereas independent valuation consultants should develop a time and fee estimate.]

   c. Obtain approval of the work program, staff assignments, and fee estimate. [This answer is incorrect. When appropriate, industry accountants and analysts should obtain approval of time and resource budget, *not* the work program, staff assignments, and fee estimate that are recommended for independent valuation consultants.]

   d. Prepare a proposal letter or oral presentation. [This answer is incorrect. Industry accountants and analysts do *not* need to prepare a proposal letter or oral presentation, but rather should communicate the approach, expectations, limitations, and cost of the project to the appropriate level of management.]

2. The independent valuation consultant would **not** need to make which of the assessments listed below when deciding whether to accept a valuation engagement? **(Page 220)**

   a. An assessment of any conflicts of interest that could impair the consultant's objectivity as an expert witness. [This answer is incorrect. In order to make an educated decision concerning whether to accept an engagement, the consultant needs to make an assessment of any conflicts of interest that could impair the consultant's objectivity or credibility as an expert witness in order to gain a basic understanding of the client, company, and proposed engagement.]

   b. The nature, risks, and requirements of the engagement. [This answer is incorrect. When deciding whether to accept an engagement, the consultant should make a preliminary assessment of the nature, risks, and requirements of performing the valuation engagement to become more familiar with the company, the client, and the proposed engagement.]

   c. An assessment that the valuation will exceed $100M and, therefore, be considered a significant valuation exercise. [This answer is correct. The consultant should not consider the potential results of the valuation exercise when deciding whether to accept the engagement. It is not possible to make that determination without considering all relevant information and necessary assessments that validate the valuation results.]

   d. The consultant's professional competence. [This answer is incorrect. When a consultant is in the process of determining whether to accept an engagement, an assessment of his or her ability to perform the valuation should be made as well as an assessment of other factors concerning the engagement, the client, or the company to be valued to ensure that he/she is fully qualified to perform the engagement.]

3. The AICPA Statement on Standards for Valuation Services (SSVS) No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset (VS 100.12)*, provides guidance on professional competence related to business valuations. When considering the professional competence of the engagement team, SSVS No. 1 requires, at a minimum, that valuation analysts consider all of the following **except**: **(Page 220)**

   a. The educational background of engagement team members. [This answer is correct. Valuation analysts are not required by SSVS No. 1 to consider the educational background of engagement team members when assessing their professional competence to perform the valuation.]

   b. The purpose of the valuation. [This answer is incorrect. The purpose of the valuation may indicate that engagement team members have specific experience related to the valuation in order to be effective.]

   c. The valuation date or dates. [This answer is incorrect. The valuation date or dates may be an important consideration for engagement team members when determining engagement timing and fees.]

   d. Assumptions or limiting conditions regarding the engagement. [This answer is incorrect. Assumptions or limiting conditions regarding the engagement could have an impact on how the valuation is to be performed and the engagement team members necessary to perform the engagement.]

4. To gain a better understanding of specialized accounting practices that could affect the valuation engagement, the consultant should examine which of the following areas? **(Page 221)**

   a. Operations. [This answer is incorrect. The consultant would examine operations to gain a better understanding of things such as locations, sales volumes, major customers and suppliers, and the production or service process.]

   b. Organization and management. [This answer is incorrect. An examination of organization and management by the consultant would yield information concerning principal owners, key managers, organization structure, and legal form of entity.]

   c. Industry. [This answer is correct. By looking at the potential client's industry, the consultant could gain an understanding of specialized accounting practices, products and services, competition, and growth and economic trends affecting that industry in order to determine which valuation techniques to use.]

   d. Financial statements and tax returns. [This answer is incorrect. The consultant would look at financial statements and tax returns to learn more about financial condition, profitability, major assets, liabilities, revenues, expenses, and unusual items.]

5. Which of the following would be classified as a premise of value? **(Page 222)**

   a. Liquidation value. [This answer is correct. Premise of value is an assumption of the most likely transactional circumstances that might be applicable to a valuation subject. Liquidation value is one of the most common of these circumstances.]

   b. Fair market value. [This answer is incorrect. Fair market value is a standard of value that is to be estimated in a specific engagement rather than a premise of value.]

   c. Intrinsic value. [This answer is incorrect. One standard of value (or type of value) to be estimated in a specific engagement is intrinsic value. Intrinsic value is not a premise of value assumption.]

   d. Investments value. [This answer is incorrect. Investments value is a type of value, or standard of value, that the consultant estimates in a specific engagement and is not a premise of value assumption.]

6. Which of the following is **not** a factor to be considered by the consultant when determining the fee to be charged for performing a valuation engagement? **(Page 224)**

   a. The consultant's level of experience. [This answer is correct. The consultant's level of experience is not what the client is paying for. The client is paying the consultant for his time to perform the valuation. The consultant should base the fee to be charged on the time it will take to perform the engagement.]

   b. The likelihood of expert witness testimony. [This answer is incorrect. Any legal actions that are a part of a valuation engagement and involve the consultant can impact engagement hours and, therefore, the fees to be charged.]

   c. The consultant's role in the engagement. [This answer is incorrect. The consultant's understanding of his or her role in the valuation engagement (i.e., perform a business valuation or act as advisor to the client and assist in negotiating a value for a company) is a significant factor to be considered when determining the fee to be charged for the valuation engagement.]

   d. Special reporting requirements. [This answer is incorrect. Reporting requirements are affected by the purpose of the valuation, the consultant's role, and the likelihood of expert witness testimony and CPA reporting responsibilities if the report contains complete historical or prospective financial statements, all of which can affect the fee determination.]

PREPARING WORK PROGRAMS

What Is a Work Program?

In its simplest form, a work program is a *to do* list that guides the consultant through the valuation engagement. However, when properly designed, a work program becomes more than a *to do* list—it becomes a valuable tool that helps the consultant to:

a. Perform the valuation procedures in an efficient, sequential manner.

b. Guard against omitting an important step.

c. Assign to several consultants (when feasible) the responsibility for performing various facets of the engagement.

d. Supervise assistants' work.

e. Develop a fee estimate.

f. Gauge the progress of the engagement.

g. Ensure standardization and consistency among engagements and, in larger firms, various consulting teams.

Said differently, a work program serves as the quality control device for the engagement. Because of its valuable contribution, it is recommend that a work program, whether formal or informal be used on every engagement (regardless of the engagement size or the consultant's experience level).

How Should a Work Program Be Formatted?

Normally, the most practical way to format a work program is to develop an outline that classifies the valuation procedures under major topics and presents them chronologically or sequentially. There are three basic approaches to developing a work program. One approach is to develop from scratch a unique program for each engagement. That approach allows maximum flexibility and tailoring to the specific circumstances of each engagement. A second approach is to use a standardized work program that does not change among engagements. This approach has the advantages of minimizing program development time, but it has two major disadvantages: (a) it is practically impossible to develop a standardized work program that anticipates every problem that will be encountered; and (b) such a program tends to be very comprehensive (attempting to cover every possible situation), and that can lead to major inefficiencies. A third approach, and the one recommended, is a compromise between the other two alternatives and will be referred to for discussion purposes as a flexible standardized program (FSP).

Suggested Work Program—the FSP

Certain procedures on a valuation engagement will be the same on all engagements, regardless of complexity or reason for the engagement. Other procedures, especially those that relate to the application of valuation methods or techniques, will vary among engagements. The suggested work program, the FSP, includes specific steps or considerations for the recurring procedures and generalized steps that can be deleted or expanded for those procedures that vary among engagements. Such programs include the following major sections:

a. Pre-engagement Procedures.

b. Data Gathering and Analysis.

c. Valuation Methods.

d. Concluding Procedures.

e. Comments.

DEVELOPING TIME AND FEE BUDGETS

To properly estimate the time and fees that will be incurred on the engagement, the consultant should prepare a budget based on the procedures selected in the work program. The fee estimate can be developed on memo paper and included in the workpapers, or preferably the consultant can use a preprinted form, such as the "Fee Estimate Worksheet."

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. A work program helps the consultant do which of the following during a valuation engagement?

   a. Assign the most qualified consultant the responsibility for all facets of the engagement.

   b. Establish a plan that permits assistants to work independent of supervision.

   c. Ensure standardization and consistency among engagements.

8. When formatting a work program, which of the following approaches is recommended?

   a. Develop a unique program for each engagement.

   b. Use a standardized work program consistent among engagements.

   c. Develop a flexible standardized program.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. A work program helps the consultant do which of the following during a valuation engagement? **(Page 232)**

   a. Assign the most qualified consultant the responsibility for all facets of the engagement. [This answer is incorrect. A work program helps the consultant assign to several consultants, when appropriate, the responsibility for performing a variety of aspects of the engagement to spread out responsibility among the team.]

   b. Establish a plan that permits assistants to work independent of supervision. [This answer is incorrect. A work program helps the consultant supervise assistants' work by including review checkpoints in the work plan.]

   c. Ensure standardization and consistency among engagements. [This answer is correct. A work program helps the consultant to ensure standardization and consistency among engagements, and among various consulting teams in larger firms to guide the consultant through the valuation engagement.]

8. When formatting a work program, which of the following approaches is recommended? **(Page 232)**

   a. Develop a unique program for each engagement. [This answer is incorrect. This approach affords the greatest flexibility and tailoring to the specific circumstances of each engagement but will increase program development time and increase the cost of the valuation engagement.]

   b. Use a standardized work program consistent among engagements. [This answer is incorrect. This approach will minimize program development time but it is extremely difficult to develop a standardized work program that addresses every problem that will be encountered and, as such, due to its comprehensive structure, significant inefficiencies may result.]

   c. Develop a flexible standardized program. [This answer is correct. This approach is a compromise between developing a unique program for each engagement and using a standardized work program consistent among engagements. A flexible standardized program (FSP) includes specific steps for recurring procedures and generalized steps that can be deleted or expanded in the case of procedures that vary among engagements.]

ENGAGEMENT LETTERS

Establishing an Understanding with the Client

Establishing an understanding with the client is an important component of a valuation engagement, and is a requirement for CPAs subject to SSVS No. 1 (VS 100.16). The Standard prefers the understanding with the client to be in writing, but if the understanding is oral, the valuation consultant should properly document the understanding in the workpapers. However, if the valuation is for an attest client, Ethics Interpretation 101-3 of Rule 101 of the AICPA's *Code of Professional Conduct* requires written documentation of the understanding with the client regarding the objectives of the services, the services to be performed, responsibilities of the client and the practitioner, and any limitations of the engagement. The form of the documentation is left to the judgment of the consultant, however, the engagement letter is generally the most effective means to comply with the Interpretation's written documentation requirement.

It is believed obtaining an engagement letter is critical to minimizing possible legal risks and client misunderstandings. and recommend obtaining an engagement letter for each valuation engagement.

Content

The letter should contain the consultant's understanding about all the critical aspects of the engagement, but the exact form and content of such letters varies in practice. Some consultants prefer an extensive, detailed letter, and others prefer a broader, more concise letter. Paragraph 17 of SSVS No. 1 (VS 100.17) includes several basic valuation issues that should be communicated to the client. The matters commonly addressed in most engagement letters include the following:

a. *The Nature, Purpose, and Objective of the Engagement.* The letter should specify the following items considered during engagement acceptance:

   (1) *Subject Entity.* The letter should specify what entity will be the subject of the valuation. If that entity has significant investments in other entities, the engagement will normally include valuation of the investees. For example, a valuation of a holding company typically would involve valuation of some or all the subsidiaries. In those cases, all the entities that will be included in the valuation should be identified in the engagement letter.

   (2) *Purpose of the Valuation.* The engagement's purpose can affect the valuation engagement procedures followed. Thus, consultants should confirm their understanding of the engagement's purpose through the engagement letter.

   (3) *Identification and Type of the Ownership Interest.* The letter should identify the ownership interest to be valued, especially when valuing a fractional ownership interest or a total invested capital (that is, both equity and debt capital)

   (4) *Valuation Date.* It is important to establish the valuation date or dates to plan the engagement. Those dates should be confirmed in the engagement letter.

   (5) *Identity of Client.* The letter should specify the client for whom the valuation is performed. When dealing with a lawyer (or other third-party representative), it is important to identify whether the client is the lawyer or the party the lawyer represents.

   (6) *Proposed Terms of the Engagement.* Factors such as the timing and fees of the engagement should be communicated. Many consultants confirm their engagement deadlines in their engagement letters, especially if the engagement has a tight deadline. The consultant also may wish to confirm the start date, which may be stated to be dependent on receipt of data from the client. When describing fee arrangements, the engagement letter should include the fee and payment terms. Most firms get a retainer on all engagements to prevent fee collection problems that may arise after the report has been delivered, especially if the value conclusion does not meet the client's expectations. Retainers may range from 10% to 100% of the quoted fee.

b. *Client's Responsibilities.* The letter should specify what the consultant expects from the client to expedite the valuation engagement and avoid misunderstandings. This generally involves supplying accurate data and documents in a timely manner. If performing the valuation for an attest client, AICPA Ethics Interpretation 101-3 requires the client to assume several other responsibilities that should be included in the engagement letter.

c. *Role of the Consultant.* Is the consultant to be an objective valuer or a client adviser? That issue will directly affect the engagement, and thus the consultant's role should be confirmed.

d. *Assumptions and Limiting Conditions.* The consultant may want to include a list of the more important assumptions and limiting conditions used in arriving at the appraised value. As a suggestion, the engagement letter might list items the consultant anticipates will be included in the appraisal report addenda.

e. *Type and Distribution of Report.* Because most clients are unfamiliar with the types of valuation reports, the letter should discuss the type of report to be issued. Also, it should specify any limitations on the distribution of the report. The distribution of the report can significantly affect the reporting responsibilities of CPAs.

f. *Standard of Value.* The letter should include the standard of value to be used in the engagement.

g. *Audit or Review Services Caveat.* If applicable, CPA consultants should state that they will not be auditing, reviewing, or compiling the financial data and will not express an opinion on such data. Also, the letter should state that the engagement cannot be relied on to detect errors, fraud, or violations of laws or governmental regulations that are attributable to the company.

h. *Updating Caveat.* Many valuation engagements arise from negotiations for sales, property settlements, and similar transactions. Those negotiations can take place over a long period. Changes in economic conditions or other factors can cause the value of a business to change. Consultants should prepare for those situations by including a caveat that the firm is not responsible for updating the report and that any such updates would be considered separate engagements. Alternatively, provision for the update(s) might be included in the engagement letter.

i. *Outsourcing Caveat.* If a CPA decides to outsource professional services to a specialist or third-party service provider, the client must be informed, preferably in writing, before the specialist begins working.

j. *Litigation Support.* The letter should include a general discussion of arrangements for litigation support services. Many valuation engagements are related to legal actions. If the engagement relates to a lawsuit, the attorney may decide not to designate the consultant as an expert until the valuation report is completed. Sometimes fees are not estimated if the litigation is likely to be lengthy. In tax-related valuations, the letter should state that appearances before the IRS or other taxing authorities are excluded from the engagement, and thus those services would result in additional fees.

k. *Acknowledgment.* The letter should contain a request for a signed acknowledgment because it is, in effect, a contract. Also, if a retainer is being requested, this device is useful to ensure payment.

l. *Prior Services.* USPAP requires the valuation consultant to disclose to the client the extent to which the consultant (or anyone in the consultant's firm or business) has performed services relating to the subject property (interest), if any, within the last three years.

Other matters for consideration that sometimes are included in engagement letters include:

a. *Description of Fair Market Value.* Some letters contain a description of fair market value (or other standards of value).

b. *Financial Data Caveat.* The consultant normally relies on the client to provide accurate historical and prospective financial data. The letter can include a caveat that the valuation will be based on the presumption that the financial data is accurate. The engagement letter may also confirm the process for obtaining the client's data, such as a contact person, media of data, and delivery method. Also, the letter may serve to clarify the consequences of unavailable data or restricted access to data, such as the potential weakening of the accuracy and reliability of the valuation estimate, increase in the engagement's scope and/or costs, or inability to perform and complete the valuation.

c. *Representation Letters.* Some consultants prefer to include a statement that the client will be asked to provide written representations about the information to be furnished during the engagement. Representation letters may also be used to obtain the client's assurance that it knows of no conflict of interest. However, obtaining a representation letter is not always practical.

d. *Billable Expenses.* The letter can clarify the types of billable expenses to potentially avoid disagreements during or after the engagement. Such expenses may include computer database usage, industry research materials, messenger and delivery services, and travel and living expenses.

e. *Ownership Caveat.* The consultant may want to communicate the consultant's ultimate ownership and possession of the final valuation report and related supporting documentation. Generally, the valuation report is owned by the client, subject to restrictions on use, and the work files and supporting documentation should remain the property of the valuation consultant.

f. *Confidentiality Caveat.* Some consultants prefer to explain their professional commitment to confidentiality and the limited circumstances which may require the consultant to convey the identity of the client or other identifying information.

g. *Circular 230 Caveat.* Treasury Department Circular No. 230 (Circular 230) governs the right of CPAs, attorneys, and other tax professionals to practice before the IRS. To comply with the provisions of Circular 230, many practitioners rely on the provision in Circular 230 that gives the practitioner the option to include a disclaimer in the written advice that clearly states that the written advice is not intended by the practitioner to be relied on by the taxpayer to avoid penalties resulting from taxpayer's federal tax positions.

h. *Appraisal of Company Assets.* If the consultant expects to use a valuation method involving valuation of the company's fixed or other assets, the letter may indicate that and state whether any asset appraisers will be needed to appraise certain company assets.

i. *Neutral Valuations.* Engagement letters for neutral valuations should include additional details on the conduct of the engagement, such as how written and oral communications will be made with each party.

Engagement Letters for Litigation Support Services

When designing engagement letters for litigation support services, consultants might refer to the nonauthoritative guidance included in the Forensic and Valuation Services Section Practice Aid 04-1, *Engagement Letters for Litigation Services*. The practice aid makes the following key points:

a. If the expert acts as an expert witness, the engagement letter and work product is discoverable. If the expert serves as a consultant to the attorney, the engagement letter and work product is usually protected by the attorney work-product privilege.

b. Engagement letters that contain specific information about the services to be provided can be used by opposing counsel to challenge the expert's work product and conclusions. A detailed engagement letter may provide the opposing attorney with a road map to the client's litigation strategy. Furthermore, if the expert has not performed all the tasks defined in such a letter, the opposing attorney may use that fact to challenge the expert's credibility, opinions, and testimony.

c. To avoid the problem discussed in b. above, many experts restrict their definition of services to broad statements such as, "You have requested that we assist you with analysis and consultation with regard to the XYZ litigation matter as you may direct."

d. If engaged directly by the client, the expert's work product, even if serving as a consultant, may not be protected by the attorney work-product privilege. In this situation, the consultant may want to confirm whether the consultant's work product will be protected by the attorney work-product privilege. (Attorneys sometimes prefer to have the engagement letter addressed to them rather than the client. They do so because they wish to protect any privilege extending to the expert's workpapers and the expert's discussions with the attorney.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. When the consultant is valuing a fractional ownership interest, he or she should address that fact in which section of the engagement letter?

   a. Outsourcing caveat.

   b. Updating caveat.

   c. Litigation support.

   d. Identification and type of ownership interest.

10. Inclusion of which of the following in the engagement letter would be considered inappropriate or inadvisable?

    a. Description of fair market value.

    b. Solicitation for future valuation engagements.

    c. Appraisal of company assets.

    d. Financial data caveat.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

9. When the consultant is valuing a fractional ownership interest, he or she should address that fact in which section of the engagement letter? **(Page 237)**

   a. Outsourcing caveat. [This answer is incorrect. The outsourcing caveat is included in the engagement letter when the consultant intends to outsource professional services to a specialist or third-party service provider. This section does not include information on valuing fractional ownership interest. Prior to confidential information being shared with a specialist, the consultant is required to notify the client of such information.]

   b. Updating caveat. [This answer is incorrect. An updating caveat is included in an engagement letter to inform the client that updating the report is *not* part of the engagement. This section does not include information on valuing fractional ownership interest.]

   c. Litigation support. [This answer is incorrect. This section of the engagement letter should include information concerning arrangements for litigation support services, not valuing fractional ownership interest, since many valuation engagements deal with legal actions.]

   d. Identification and type of ownership interest. [This answer is correct. Identification and type of ownership interest to be valued should be included in the engagement letter, especially when valuing a total invested capital or a fractional ownership interest.]

10. Inclusion of which of the following in the engagement letter would be considered inappropriate or inadvisable? **(Page 238)**

   a. Description of fair market value. [This answer is incorrect. In some instances, engagement letters may include a description of fair market value or other standards of value. This would not be inappropriate in the engagement letter.]

   b. Solicitation for future valuation engagements. [This answer is correct. It is not appropriate for the valuation consultant to solicit for future business/valuations in the engagement letter for a current valuation since the purpose of the engagement letter is to establish an understanding with the client concerning how the engagement will be performed.]

   c. Appraisal of company assets. [This answer is incorrect. The engagement letter may address whether any asset appraisers will be needed to appraise certain company assets in the event the consultant intends to use a valuation method that involves valuation of the company's fixed or other assets.]

   d. Financial data caveat. [This answer is incorrect. It is appropriate for the engagement letter to include a caveat stating that the valuation will be based on the assumption that the financial data provided by the client is accurate.]

PROCEDURES FOR INDUSTRY ACCOUNTANTS AND ANALYSTS

The pre-engagement procedures for internal valuations are similar to those of independent consultants. This section discusses those procedures, specifically:

a. Evaluating whether the valuation can be performed internally.

b. Preparing work programs.

c. Developing a time and resource budget.

d. Formally or informally communicating the approach, expectations, limitations, and cost of the project to the appropriate level of management.

Evaluating Whether to Perform a Valuation Internally

The accountant/analyst should first decide whether the valuation can be performed internally or whether it requires using an independent consultant. Questions to consider include:

a. *What Is the Purpose of the Valuation?* Will the valuation report be used by third parties? Is it likely to be used in future litigation? If the valuation is performed because the company may be sold or if the valuation is of a potential acquisition, an internal valuation may be practical. However, if outside parties (such as bankers, attorneys, or underwriters) are likely to use the valuation report in providing financing, raising capital, or taking legal actions, the company probably will benefit more from an independent valuation.

b. *Does the Accountant/Analyst Have the Time and Resources to Perform the Valuation in the Time Frame Needed?*

c. *Does the Accountant/Analyst Have the Expertise to Perform the Valuation?* Are any specialized skills, such as appraisals of specific assets, needed?

Preparing Work Programs

The accountant/analyst's approach to work programs is similar to that of the independent consultant. The main difference is that the internal valuation approach is less formal in some areas, such as reporting. A work program has been prepared that is tailored for industry accountants/analysts. That work program presents a general outline of the steps involved in a typical internal valuation. It should be modified to fit the circumstances of the specific engagement.

Time and Resource Budgets

Although companies do not pay fees for internal valuations, there are still costs involved. Industry accountants/analysts must take time away from their normal duties to perform the valuations. They also may need assistants or equipment, and there may be travel costs involved. Thus, it is important for the accountant/analyst to prepare a budget of the time and resources required to perform the valuation. The process is similar to the independent consultant's, except there are no fees to compute. However, an internal budget can be expressed in terms of salary cost instead of hours, if that is appropriate.

Communicating the Engagement Plan

Although the accountant/analyst does not need to prepare an engagement letter before beginning a valuation assignment, it is still important to communicate the valuation approach, expectations, limitations, and costs of the valuation assignment to the appropriate level of management. That communication can be formal or informal, it is suggested that those matters be communicated in writing before starting the valuation.

Matters to Be Covered in the Communication. The communication should cover:

a. *Valuation Approach.* The accountant/analyst should provide a general description of the approach to the valuation project so management has a frame of reference to understand the time involved, limitations, etc.

However, as with the consultant's engagement letter, avoid discussing specific techniques, because that can lead to misunderstandings.

b. *Expectations.* Discussion of how the accountant/analyst will report the results of the valuation (report, memo, etc.) and when.

c. *Limitations.* Common limitations include:

(1) *Use of Report.* The valuation report probably will be suitable only for internal use, not those of third parties.

(2) *Financial Data.* The accountant/analyst should explain how much reliance will be placed on company financial data. This is especially important if the company is a potential acquisition. However, this topic may not be applicable if the accountant/analyst prepared the financial data as part of his or her normal duties.

(3) *Valuation Date.* The valuation will only apply to the date specified in the report. Changes in economic conditions and other factors probably will change the value of the business. Thus, sometimes it may be necessary to update the valuation. That fact should be communicated to management.

(4) *Cost.* Management should be informed of the time and resources that will be needed to complete the valuation. The accountant/analyst will generally want to get management approval of the time and resource commitment before starting the assignment.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

11. In which of the circumstances listed below would a valuation performed by an independent consultant provide the greatest benefit?

    a. Bankers are likely to use the valuation report to provide financing or raise capital.

    b. The valuation is being performed due to the fact that the company may be sold.

    c. The valuation is being performed as a result of a potential acquisition.

    d. If the valuation report will not be used in taking any legal actions.

12. When communicating the engagement plan for an internal valuation to management, the accountant/analyst should avoid:

    a. Informing management of the time and resources that will be needed to complete the valuation.

    b. Informing management of the need to update the valuation due to changes in economic conditions.

    c. Explaining to management how much reliance will be placed on company financial data.

    d. Informing management of specific techniques that will be utilized in the valuation project.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

11. In which of the circumstances listed below would a valuation performed by an independent consultant provide the greatest benefit? **(Page 243)**

    a. Bankers are likely to use the valuation report to provide financing or raise capital. [This answer is correct. An independent valuation is generally recommended when bankers will likely use the report in providing financing or raising capital. An independent valuation would be taken more seriously by a bank than one produced by the company.]

    b. The valuation is being performed due to the fact that the company may be sold. [This answer is incorrect. If the valuation is being performed because the company could be sold, an internal valuation may be a better choice than an independent valuation since internal accountants would have a better idea of the current value of the company.]

    c. The valuation is being performed as a result of a potential acquisition. [This answer is incorrect. An internal valuation may be a practical choice if the reason for the valuation is a potential acquisition due to the first-hand knowledge possessed by someone within the company being valued.]

    d. If the valuation report will not be used in taking any legal actions. [This answer is incorrect. If the valuation report will not be used in taking legal actions, an internal valuation may be appropriate. However, if legal actions are anticipated, an independent valuation will likely be more beneficial to the company since it would not be viewed as being potentially biased.]

12. When communicating the engagement plan for an internal valuation to management, the accountant/analyst should avoid: **(Page 243)**

    a. Informing management of the time and resources that will be needed to complete the valuation. [This answer is incorrect. The accountant or analyst should inform management of the time and resources that will be needed and get approval of the time and resource commitment prior to commencing the assignment.]

    b. Informing management of the need to update the valuation due to changes in economic conditions. [This answer is incorrect. Changes in economic conditions and other factors could impact the value of the business. As a result, updating the valuation may be necessary and should be communicated to management.]

    c. Explaining to management how much reliance will be placed on company financial data. [This answer is incorrect. The accountant/analyst needs to explain to management how much emphasis will be placed on company financial data. This action is particularly important if the company is a potential acquisition.]

    d. Informing management of specific techniques that will be utilized in the valuation project. [This answer is correct. A general description of the valuation approach should be provided to help management understand the limitations, the time involved in the valuation, and other factors. Informing management of specific techniques should be avoided since doing so can lead to misunderstandings.]

EXAMINATION FOR CPE CREDIT

Lesson 1 (VALTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Bill is an independent valuation consultant and his brother Tom is an industry accountant. Which of the following valuation engagement work program pre-engagement procedures is recommended for both Bill and Tom?

   a. Prepare a work program.

   b. Develop a time and fee estimate.

   c. Prepare a proposal letter or oral presentation.

   d. Acquire an engagement letter.

2. Of the following valuation engagement work program pre-engagement procedures, which one is recommended specifically for Bill, an independent valuation consultant?

   a. Evaluate whether the valuation can be performed internally.

   b. Develop a time and resource budget.

   c. Acquire approval of the work program, staff assignments, and fee estimate.

   d. Communicate the cost of the project to the appropriate level of management.

3. During the acceptance phase, Melissa is seeking information regarding market share to help her decide which valuation technique to use in performing the valuation. Which of the following areas should Melissa focus her attention on to determine market share?

   a. Operations.

   b. Organization and management.

   c. Industry.

   d. Company expectations.

4. The owner of ABC Gum Company died on December 15, 20XX. For estate tax purposes, the business valuation date would either be December 15, 20XX or an alternate date __________ after December 15, 20XX.

   a. Three months.

   b. Four months.

   c. Six months.

   d. Nine months.

5. The fee that the consultant charges to perform the valuation engagement should be based on all of the following **except**:

   a. Valuation date.

   b. The value rendered.

   c. Involvement in legal actions.

   d. Type of ownership interest.

6. Which of the following areas that must be considered when making a decision concerning the feasibility of accepting the engagement is addressed in revised Ethics Interpretation 101-3?

   a. Professional competence.

   b. Performance of nonattest services.

   c. Conflicts of interest.

   d. Availability of data.

7. Randy has decided to use a flexible standardized program (FSP) to format a work program. Which of the following is **not** one of the major sections included in a FSP?

   a. Data gathering and analysis.

   b. Comparative calculations.

   c. Comments.

   d. Concluding procedures.

8. Of the following statements, which one is accurate regarding an engagement letter?

   a. Client misunderstandings can be easily avoided without the use of an engagement letter.

   b. Possible legal risks are not affected by obtaining an engagement letter.

   c. An engagement letter must include a Circular 230 caveat.

   d. Engagement letters are not *required* by professional standards for valuation engagements.

9. Robert is writing an engagement letter and has indicated that his fee for performing the engagement is $8,000. Further, he has stipulated that payment in full is due 30 days from the date of completion of the engagement. He requires a retainer prior to commencement of the engagement. The retainer Robert requires may be from a minimum of $800 to a maximum of:

   a. $2,400.

   b. $4,000.

   c. .$4,800.

   d. $8,000.

10. Which of the following caveats sometimes included in engagement letters permits the consultant to include a disclaimer indicating to the client that written advice will not prevent the taxpayer from incurring tax penalties?

    a. Financial data caveat.

    b. Confidentiality caveat.

    c. Circular No. 230 caveat.

    d. Ownership caveat.

11. Which of the following statements accurately represents one of the key points in the Forensic and Valuation Services Section Practice Aid 04-1, *Engagement Letters for Litigation Services*?

    a. If the expert serves as a consultant to the attorney, the engagement letter and work product is *always* protected by the attorney work-product privilege.

    b. Opposing counsel *cannot* challenge the expert's work product and conclusions based on specific information provided in the engagement letter about the services to be provided.

    c. It is recommended that experts *avoid* restricting their definition of services simply to broad, general statements or information.

    d. Even when serving as a consultant and engaged directly by the client, the expert's work product may not be protected by the attorney work-product privilege.

12. Of the following, which is **not** a cost associated with performing internal valuations?

    a. Time away from normal duties.

    b. Payment of fees.

    c. Need for assistants/equipment.

    d. Travel costs that may be involved.

Lesson 2: Wrapping Up the Engagement

INTRODUCTION

The suggested steps of a valuation engagement can be classified into the following three primary phases:

- Pre-engagement procedures.
- Performance procedures.
- Reporting and wrap-up procedures.

This lesson discusses the procedures that should usually be performed during the wrap-up phase of an engagement. They include the following:

a. Arriving at a final value conclusion.

    (1) Weighting of methods.

    (2) Applying "sanity checks" to the estimates of value.

    (3) Applying premiums and/or discounts.

b. Obtaining a representation letter, if possible.

c. Performing the appropriate workpaper reviews.

d. Resolving any professional disputes.

e. Performing various administrative matters, such as staff evaluation and workpaper filing.

Learning Objectives:

Completion of this lesson will enable you to:
- Define the two primary types of weighting techniques and identify advantages and disadvantages of each type.
- Recognize various types of sanity checks to test the reasonableness of the value estimate.
- Determine how and when to apply any required premiums and discounts.
- Identify a controlling and a minority interest and recognize factors that affect the degree of control that can be exercised.
- Summarize other wrap-up procedures including the representation letter, workpaper documentation, workpaper and engagement reviews, and final administrative procedures.

Many Engagement Wrap-up Procedures Should Be Performed by Both Valuation Consultants and Analysts in Industry

Most of the procedures discussed in this lesson have been designed with the independent valuation consultant in mind. Many of the procedures, however, should also be performed by internal company analysts who perform valuations of companies for potential acquisitions, even if they perform such valuations without the aid of independent valuation consultants. These procedures may also apply to an internal valuation of an analyst's own company.

Exhibit 1-1

Recommended Engagement Wrap-up Procedures

Procedures Recommended for Independent Valuation Consultants	Adaptation of Procedures for Industry Accountants and Analysts
1. Determine the final estimate of value. This usually involves the following procedures: a. Weighting of methods. b. Applying "sanity checks" to the estimates of value. c. Applying premiums and/or discounts.	1. Same.
2. Document all work performed and conclusions reached.	2. Same.
3. Consider obtaining a representation letter, if possible.	3. Industry accountants and analysts do not have to perform this procedure for internal valuations of their own companies. They should, however, ensure that all financial and other information used during the valuation process is accurate and that all assumptions that were made regarding future operations are reasonable and achievable. In performing valuations of other companies, it is often desirable for such accountants and analysts to obtain a representation letter from the management of the company being valued.
4. Draft the valuation report.	4. Same.
5. Perform a detailed review of the workpapers and report draft by the engagement partner or other responsible party.	5. Perform a detailed review of the workpapers and report draft by the controller, chief financial officer, or other responsible party.
6. If practical, obtain an independent review of the workpapers (and report draft).	6. Same.
7. Resolve any professional disputes.	7. Same.
8. Discuss the engagement findings (and report draft) with the client.	8. Discuss the engagement findings (and report draft) with the appropriate level of management.
9. Determine that all review points and open items have been cleared.	9. Same.
10. Prepare the final report.	10. Same.
11. Sign the report or transmittal letter.	11. Formally or informally communicate engagement findings to the appropriate level of management.
12. File the workpapers.	12. Same.
13. Evaluate the staff's performance.	13. Evaluate the performance of any co-workers who participated on the valuation project.

* * *

SELECTING A SINGLE VALUE FROM A RANGE OF VALUES

Weighting of Values Determined Using Two or More Methods

Consultants often use two or more valuation methods to develop a company's value. This usually results in a range of possible values, and the consultant must determine a technique to determine where within that range the best estimate of value falls. This is normally accomplished by weighting the relative importance or applicability of each valuation method to arrive at a single weighted value.

During the planning phase of a valuation engagement, the consultant should select several appropriate valuation methods. Some of these methods will result in better indications of the company's value than others, and those should obviously be given a higher weight in determining the final estimate of the company's value. However, the determination of which value estimates should get the highest weights, and how each method should be weighted in relation to the others, can be a difficult process. As with many other steps in a valuation engagement, the weighting of values determined using two or more methods is based on many factors and requires a great deal of judgment.

Mathematical versus Subjective Weightings

Two primary techniques can be used to weight the various values on a particular engagement to arrive at an overall final value estimate.

a. Mathematical weighting technique.

b. Subjective weighting technique.

Valuation consultants can use either technique, but should be aware that there are advantages and disadvantages to each.

Description of the Mathematical Weighting Technique. Under the mathematical weighting technique, the valuation consultant assigns a percentage weight to each value, with the total percentage equal to 100%. To illustrate this technique, assume that a valuation consultant computed the following values using three different valuation methods:

Discounted future cash flow method	$ 1,472,000
Capitalized earnings method	1,145,000
Excess earnings method	1,620,000

The consultant believes that the company's value lies somewhere between $1,145,000 and $1,620,000. This is a broad range, however, and is probably not precise enough to satisfy the client. Under the mathematical weighting technique, the consultant should assign percentage weights to each of the above value estimates, with the most appropriate valuation method getting the highest percentage weight and the least appropriate method getting the lowest weight. A weighted average value should then be computed as illustrated in Exhibit 1-2.

Exhibit 1-2

Illustration of the Mathematical Weighting Technique

Method	Value	×	Weight	=	Weighted Average Value
Discounted future cash flow	$ 1,472,000	×	25 %	=	$ 368,000
Capitalized earnings	$ 1,145,000	×	60 %	=	$ 687,000
Excess earnings	$ 1,620,000	×	15 %	=	$ 243,000
Weighted average value estimate			100 %	=	$ 1,298,000

* * *

Description of the Subjective Weighting Technique. The goal of the subjective weighting technique is the same as the mathematical technique previously discussed, that is, to arrive at a single estimated company value based on the results of applying two or more valuation methods. Under the subjective technique, however, the consultant does not use percentage weights to achieve this goal. The determination of the final value is supported instead by a narrative description of the factors considered in arriving at the final value estimate. Using the information introduced in the previous paragraph, the consultant may still arrive at the same value estimate of approximately $1,300,000, using the subjective weighting technique. The reasons for arriving at this final value, however, will be explained in a narrative discussion and will not be based on a mathematical allocation like the one illustrated in Exhibit 1-2.

What Does Revenue Ruling 59-60 Say about the Mathematical Weighting Technique? Use of the mathematical weighting technique may lead the user of a valuation report to believe that the process of selecting a final value estimate is more precise than it actually is. Revenue Ruling 59-60 addresses this problem as follows:

> **Section 7. Average of Factors.**
>
> Because 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 in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, 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.

Does This Imply That Mathematical Weights Should Not Be Used? It is clear from the previous paragraph that the Internal Revenue Service is not a supporter of the mathematical weighting technique. In many instances, however, this technique can be helpful, and it is often used in practice. A significant advantage of this technique is that it assists the reader in understanding the valuer's thinking in a quantifiable way. If the consultant says, "I gave the greatest weight to the discounted cash flow method," the reader is likely to want to know, "Well, *how much* of the weight did you give to that method?" The mathematical weighting technique provides that additional information.

Special Disclosures That Should Be Made When the Mathematical Weighting Technique Is Used. Whenever mathematical weighting is used, it is recommended that it be accompanied by two disclosures:

a. That the weightings are not intended to be mathematically precise.

b. That the weightings may change over time.

These issues can be addressed by including the following paragraph in the valuation report:

> The weighting of valuation methods is not an exact science and is presented in mathematical terms only to assist the reader in interpreting the valuer's thinking as to the relative emphasis given to each method. The factors that influence the appropriate degree of emphasis for different methods may change over time and thus the methods used and the weightings to be applied to each may be different in valuing the same company at a different time and/or under different circumstances.

Which Technique Should Be Used by Valuation Consultants? As previously stated, both the mathematical and the subjective weighting techniques are generally acceptable and may be used by valuation consultants. Even though Revenue Ruling 59-60 appears to express a preference for the subjective weighting technique, mathematical weightings are often used and accepted by courts and others for a variety of valuation engagements. For example, the mathematical weighting technique may be used in dissenting stockholder disputes primarily because there is a great deal of case precedent for it. However, the more widely dispersed the individual value estimates are, the less useful the mathematical weighting technique will be. Regardless of which technique is selected, the consultant must ensure that *all* relevant factors have been considered in determining the final value estimate.

Factors That Should Be Considered in Determining the Relative Weightings of Valuation Methods

Some of the factors that could influence the relative weighting of valuation results include the following:

a. The nature of the business and its assets.

b. The purpose of the valuation and the definition of value.

c. The premise or premises of value and ownership characteristics.

d. The quantity and quality of data available.

The Nature of the Business and Its Assets. The nature of a company's business is one of the most important factors in deciding which valuation methods should receive the most weight. Revenue Ruling 59-60 discusses this factor as follows:

> **Section 5. Weight to Be Accorded Various Factors.**
>
> The valuation of closely-held corporate stock entails the consideration of all relevant factors. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:
>
> (a) Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
>
> (b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type 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 when appraising the relative values of the stock and the underlying assets. The market values of the underlying 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 date of the appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, 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 family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend-paying capacity.

Earnings-based valuation methods, such as discounted future net cash flows or capitalized earnings, are more appropriate (and should therefore be given greater weight) for some types of companies. Asset-based methods, such as price/net asset value, are more appropriate for other types of companies. Also, generally speaking, a company's book value may approximate its fair market value if its asset mix is composed of either current assets or recently purchased assets. Clearly, the nature of a company's business and its assets should be considered both in determining the valuation methods that will be applied during the planning phase of an engagement and in weighting the results of the various methods during the wrap-up phase.

The Purpose of the Valuation and the Definition of Value. The purpose of a valuation has a major influence on the choice of the definition of value. This, in turn, influences the choice of methods to be applied and the relative weightings of the results of these methods. Exhibit 1-3 provides an example of how the purpose and definition of value might influence the weightings of the various valuation methods applied on an engagement.

Exhibit 1-3

Examples of How Purpose and Definition of Value Could Influence Weightings of Valuation Methods

Purpose	Definition of Value	Potential Impact on Relative Weightings of Valuation Methods
Estate Tax	Fair Market Value	Heavy weight on methods using data derived from market, including guideline company transactions
Dissenting Stockholder Action	Fair Value	Weightings influenced by case law in relevant state jurisdiction
Strategic Acquisition (e.g., for vertical integration)	Investment Value	Emphasis on capitalized projected cash flow—buyer typically would determine maximum price based on buyer's projection of cash flow and buyer's cost of capital

* * *

The Premise or Premises of Value and Ownership Characteristics. Certain valuation premises or ownership characteristics may impact the initial choices of valuation methods during the planning phase of an engagement and the relative weights assigned to the results of those methods during the wrap-up phase. The most important of these are the following:

a. Going concern versus liquidation value.

b. Minority versus controlling interest value.

Earnings-based valuation methods are generally most appropriate for companies that are determined to be going concerns. On the other hand, companies that cannot continue as going concerns because of significant operating losses, low equity levels, declining markets, warranty or litigation contingencies, or other factors should usually be valued based on the liquidation value of their assets, less all related disposal and winding-up costs. Whether a company can be expected to continue in existence for the foreseeable future should thus be assessed in weighting value estimates.

A controlling interest in a company is usually worth more than a minority interest. Some of the valuation methods are better at determining controlling interests, and others are better at estimating minority interests. (Most of the methods can be used to determine either type of value if used correctly.) Exhibit 1-4 provides examples of how the type of interest being valued may influence the weighting of valuation results.

Exhibit 1-4

Examples of How a Controlling vs. Minority Interest Ownership Characteristic Might Influence Valuation Methods

Valuation Method or Factor	Controlling Interest	Minority Interest
Capitalization of Dividends	Capitalize dividend-paying capacity	Capitalize actual dividends
Guideline Transactions	Use control transactions (or minority transactions plus a control premium)	Use minority transactions (or control transactions less a minority discount)
Asset-Related Methods	Considerable weight if controlling stockholder in a position to liquidate them	Little weight unless some conversion that would benefit the minority stockholder appears imminent
Discounted Future Returns	Typically important to controlling stockholder often reflecting results of potential exercise of prerogatives of control	Typically less important than in control situation, and if used normally would reflect operations continuing at status quo unless changes are imminent

* * *

Quantity and Quality of Available Data. A valuation method is often selected during the planning phase or is given more weight during the wrap-up phase based on the availability of data needed to implement the method. Obviously, methods that rely on guideline transaction data should not be used (or should be accorded little weight) if there are no good guideline transactions for which reliable information can be obtained. Even when a number of guideline transactions can be found, however, the consultant should still carefully assess the quality of the available information. Certain information may provide a better indication of a company's value than other information. To illustrate this point, assume that a consultant has been able to find six guideline companies and has calculated the price/earnings ratios and price/net cash flow ratios for each as shown in Exhibit 1-5.

Exhibit 1-5

Comparison of Price/Earnings and Price/Cash Flow Ratios for an Example Company

Company	Price/Earnings Ratio	Price/Net Cash Flow Ratio
A	10.0	8.0
B	20.0	10.7
C	16.0	9.8
D	16.0	5.8
E	14.0	8.9
F	18.0	7.0

* * *

In this industry, it appears that the market pays more attention to the price/net cash flow ratios (which are fairly consistent from one company to the next) and less attention to the price/earnings ratios (which are widely scattered and provide little valuation guidance). The consultant may therefore conclude that the results of the price/net cash flow method should receive more weight in arriving at the final value estimate than the results of the price/earnings method.

Summary of Factors to Consider in Weighting the Results of More Than One Valuation Method. From the preceding discussion, it is apparent that the process of weighting the results of two or more valuation methods to arrive at a single estimate of value involves a great deal of judgment. All of the factors relating to the selection of valuation methods should be considered in determining the relative weights that should be assigned to the results of each method. Some of the specific factors that should be considered in weighting the results of two or more valuation methods include the following:

a. *Nature of the Business.* Some valuation methods are more appropriate for companies in certain industries than others. For example, real estate investment companies are more likely to be valued using asset based methods than are manufacturing companies.

b. *Purpose of the Valuation.* The purpose of the valuation will often dictate the definition of value to be determined and the valuation methods that are most appropriate.

c. *Premises of Value and Ownership Characteristics.* Some valuation methods are more appropriate for going concern values while others are most often used to determine a company's liquidation value. The valuation consultant should also ensure that appropriate methods are used to determine minority versus controlling values.

d. *Quantity and Quality of Data Available.* Most valuation methods require the consultant to obtain a great deal of accurate, objective information during the data gathering phase of the engagement. In some cases, sufficient information cannot be obtained, and this may prevent the consultant from using certain methods. For example, valuation methods that use guideline company data cannot be used if no good guideline companies can be identified.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Which of the following is one of the two primary techniques that can be used to weight the various values on an engagement to reach a final value estimate?

    a. Subjective weighting.

    b. Excess earnings.

    c. Average of factors.

14. The subjective weighting technique is characterized by which of the following elements?

    a. Percentage weights are used to arrive at an estimated company value.

    b. A narrative description of factors considered is used in determining estimated company value.

    c. Arrive at two estimated company values based on use of two or more valuation methods.

15. The mathematical weighting technique would be best suited for use by valuation consultants for which of the following valuation purposes?

    a. Estate tax.

    b. Dissenting stockholder action.

    c. Strategic acquisition.

16. When the consultant is attempting to ascertain the definition of value to be determined, which of the following factors is most likely to be considered in weighting the results of two or more valuation methods?

    a. Nature of the business.

    b. Purpose of the valuation.

    c. Premises of value and ownership.

    d. Quantity and quality of data available.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

13. Which of the following is one of the two primary techniques that can be used to weight the various values on an engagement to reach a final value estimate? **(Page 253)**

    a. Subjective weighting. [This answer is correct. There are two primary weighting techniques that can be used to help the consultant to reach a final value estimate. One of those techniques is the subjective weighting technique. The other technique is the mathematical weighting technique.]

    b. Excess earnings. [This answer is incorrect. Excess earnings are one of the valuation methods that can be used under the mathematical weighting technique where a percentage weight is assigned to each value, with the total percentage equaling 100%.]

    c. Average of factors. [This answer is incorrect. Average of factors serves no useful purpose under the mathematical weighting technique because valuations cannot be made based on a prescribed formula. This is true because applicable factors used in a particular case to assign mathematical weights excludes other important factors and prevents the end result from being supportable.]

14. The subjective weighting technique is characterized by which of the following elements? **(Page 254)**

    a. Percentage weights are used to arrive at an estimated company value. [This answer is incorrect. Percentage weights are used to arrive at a single estimated company value when using the mathematical weighting technique, not the subjective weighting technique.]

    b. A narrative description of factors considered is used in determining estimated company value. [This answer is correct. The subjective weighting technique uses a narrative description of factors considered to determine the estimated company value.]

    c. Arrive at two estimated company values based on use of two or more valuation methods. [This answer is incorrect. The subjective weighting technique is used to arrive at a single estimated company value that is based on the results of applying two or more valuation methods.]

15. The mathematical weighting technique would be best suited for use by valuation consultants for which of the following valuation purposes? **(Page 255)**

    a. Estate tax. [This answer is incorrect. The mathematical weighting technique would not be well suited for determining the final value estimate for estate tax due to the fact that heavy emphasis is placed on methods that use data derived from the market, including guideline company transactions.]

    b. Dissenting stockholder action. [This answer is correct. The mathematical weighting technique is best suited in dissenting stockholder actions because there is extensive case precedent to support such actions.]

    c. Strategic acquisition. [This answer is incorrect. The subjective weighting technique, not the mathematical weighting technique, is best suited for determining the final value estimate for strategic acquisitions because, due to emphasis on capitalized projected cash flow, the buyer generally would determine the maximum price based on the buyer's projection of cash flow and the buyer's cost of capital.]

16. When the consultant is attempting to ascertain the definition of value to be determined, which of the following factors is most likely to be considered in weighting the results of two or more valuation methods? **(Page 258)**

    a. Nature of the business. [This answer is incorrect. The nature of the business helps the consultant to determine which valuation methods are most appropriate in performing the valuation.]

    b. Purpose of the valuation. [This answer is correct. When a consultant is attempting to determine the definition of value to be determined and the best valuation methods to use, the purpose of the valuation is usually important in making that determination since this will many times dictate the definition of value and the most appropriate valuation methods to use.]

    c. Premises of value and ownership. [This answer is incorrect. This factor is used for calculating going concern values and liquidation values as well as to determine minority values versus controlling values.]

    d. Quantity and quality of data available. [This answer is incorrect. The quantity and quality of data available will often dictate the valuation methods to be used. If a particular valuation method used data from a source that cannot be identified, that valuation method cannot be used.]

APPLYING "SANITY CHECKS" TO THE ESTIMATES OF VALUE

Several Types of Sanity Checks Might Be Used

At this point in the valuation process, the consultant should have applied one or more of the valuation methods previously discussed, arriving at one or more value estimates for the ownership interest being valued. The consultant has also performed the weighting procedures to determine a single value estimate. The next step is usually to apply "sanity checks," which should be designed to test the reasonableness of the value estimate. There are a variety of such tests that may be applied, but some of the more common include the following:

a. Recheck the logic and math used in each valuation method.

b. Compare various ratios of the company being valued to those of other companies.

c. Test the reasonableness of the value from a buyer's perspective by computing a payback period.

d. Test the reasonableness of the value from an adversary perspective.

Rechecking the Logic and Math. The logic and math used in each valuation method should always be rechecked during the wrap-up phase of an engagement. Common mistakes encountered in applying the various valuation methods include the following:

a. Incorrectly commingling before-tax amounts and rates with after-tax amounts and rates.

b. Discounting or capitalizing a benefit stream using an incorrect discount or cap rate.

c. Using unrealistic net cash flows, earnings, or other amounts.

d. Failing to apply appropriate premiums and/or discounts.

Comparing the Company Being Valued to Other Companies. Some of the more effective sanity checks involve the determination of various ratios for the company being valued. For example, the consultant might determine a company's price/earnings and price/book value ratios based on each value estimate, and then compare those ratios to similar ratios of guideline companies. Such sanity checks should be performed before adding back any excess or nonoperating assets. That is, these tests should be performed on the operating value of the company. The excess or nonoperating assets previously discussed should be added back to the operating value of the company after performing these sanity checks.

Testing the Reasonableness of the Value from a Buyer's Perspective. A common sanity check used to test the reasonableness of a proposed value is to examine the value from the perspective of a prudent buyer. A value could be economically sound from a buyer's perspective if the income produced by the company is sufficient to recover the purchase price over a reasonable period of time. Such a reasonableness test is sometimes referred to as "computing the payback period."

Computing the Payback Period. There are several ways to compute a payback period. One popular method that is fairly easy to apply and can be useful as a sanity check involves determining the payback period for a partial financing of a purchase price based on the company's estimated stock value. This process is described in the following discussion.

a. There is a basic assumption that the buyer of a company will pay the estimated value of the company's stock, and will finance as much of the purchase price as possible. Very few (if any) banks will finance 100% of the purchase price of a company. Depending on a number of factors, however, it is not unusual to find a bank that will finance 75% to 80% of a company's purchase price.

b. An assumed borrowing rate is developed for the buyer based on current interest rates in the financial community. Many banks in today's market will loan such funds to a qualified buyer for 2% to 4% over the prime lending rate.

c. Next, an estimate of the company's future net cash flow should be prepared. If a discounted future returns method was used in estimating the company's value, this forecast has probably already been prepared. If such a forecast is not already available, the consultant should attempt to estimate expected net cash flow for the foreseeable future. The consultant should keep in mind that the determination of the company's payback period is only a reasonableness test. Therefore, the forecast of future net cash flow does not need to be overly detailed or complex.

d. A portion of the annual net cash flow determined in Step c. will be used to pay interest at the rate determined in Step b., and the remainder will be used to pay back the financed portion of the purchase price. The payback period can be estimated using a present value formula, table, computer spreadsheet application, or calculator. Exhibit 1-6 illustrates the keystrokes that should be used on a Hewlett-Packard HP12C calculator to determine the payback period given the following assumptions:

Purchase price of company	$ 600,000
Amount financed (80%)	480,000
Interest rate	10%
Annual cash flow	$ 100,000

Exhibit 1-6

Illustration of a Payback Period Calculation
Using a Hewlett-Packard HP12C Calculator

Procedure	**Press**	**Display**
1. Clear calculator.	f CLX	0
2. Enter interest rate per period.	10 i CLX	10
3. Enter annual cash flow.	100,000 PMT	100,000
4. Enter amount financed.	480,000 CHS PV	−480,000
5. Compute number of payments.	n	7

* * *

It would therefore take the assumed purchaser of this company approximately seven years to pay back the financed portion of the purchase price.

Also, the following Microsoft Excel spreadsheet formula will provide the same results:

=NPER(.1, − 100000,480000,0,0)

Details for this formula are in the Excel help file by searching for "nper," but basically NPER is the number of payments, then within the parenthesis are the following assumptions: interest rate per period, payment per period, present value, future value, and whether payments are at beginning or end of the period.

Arriving at a Conclusion about a Payback Period. Once the payback period has been determined for a given company value, the consultant must determine if the period is reasonable. This will often vary from company to company or from one industry to the next. Generally, the more risk an investment has, the shorter the required payback period. Investors may demand a payback period of one year or less for a very high risk investment even though they may be satisfied with payback periods of five years or more for more stable, conservative companies, or even longer for growth companies with outstanding long-term prospects. The consultant should carefully assess the reasonableness of the payback period in relation to the relative risk factors of the company. In some cases, the consultant may conclude that the payback period is too long, which implies that the estimated company value is too high. When this occurs, it may be an indication that some of the assumptions made during the valuation process were not reasonable. For example, the discount or cap rates may have been too low, or the expected growth rates may have been too high. The consultant should review all major assumptions made during the valuation process and correct those that may have been too optimistic.

Testing the Reasonableness of a Value Estimate from an Adversary Perspective. Another sanity check that is often used to test the reasonableness of a value estimate is to play the role of a potential adversary. This approach is especially useful in situations where the consultant may have to defend the value in a court of law. This technique simply requires the consultant, playing the role of an adversary, to challenge every aspect of the valuation methods and logic used to establish the value. This drill may uncover assumptions that are unrealistic or insupportable.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. The buyer of a company will generally pay the estimated value of the company's stock and will seek to finance as much of the purchase price as possible. Depending on the circumstances, a bank will often finance what percentage of a company's purchase price?

    a. 25%.

    b. 50%.

    c. 75% to 80%.

    d. 100%.

18. Computing the payback period helps the consultant to determine if the income produced by the company being valued is adequate to facilitate recovery of the purchase price over a reasonable period of time. Once the payback period has been determined based on the company value, it must be determined if the payback period is reasonable. The payback period for a reasonably stable, conservative company based on investor guidelines would generally be:

    a. Less than one year.

    b. One year.

    c. Approximately five years.

    d. A period somewhat longer than five years.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

17. The buyer of a company will generally pay the estimated value of the company's stock and will seek to finance as much of the purchase price as possible. Depending on the circumstances, a bank will often finance a percentage of a company's purchase price that will generally be no greater than: **(Page 262)**

    a. 25%. [This answer is incorrect. A bank is generally willing to finance a significantly greater percentage of a company's purchase price than just 25% since the bank's income comes from interest on loans, as long as the conditions indicate that such a purchase is low-risk.]

    b. 50%. [This answer is incorrect. If warranted by circumstances indicating that the risk of the loan is low, a bank will many times finance more than half of a company's purchase price since the bank profits from the interest on loans.]

    c. 75% to 80%. [This answer is correct. Unless circumstances indicate otherwise (i.e., significant risk factors are present), a bank will often times finance 75% to 80% of a company's purchase price.]

    d. 100%. [This answer is incorrect. It would be very rare for a bank to finance 100% of the purchase price of a company because of the added risk involved in such a loan.]

18. Computing the payback period helps the consultant to determine if the income produced by the company being valued is adequate to facilitate recovery of the purchase price over a reasonable period of time. Once the payback period has been determined based on the company value, it must be determined if the payback period is reasonable. The payback period for a reasonably stable, conservative company based on investor guidelines would generally be: **(Page 263)**

    a. Less than one year. [This answer is incorrect. Investors may demand a payback period of less than one year for a very high risk investment since investors may want their repayment quickly to avoid the potential of loss due to the very high risk involved.]

    b. One year. [This answer is incorrect. With a high risk investment, investors may demand a payback period of one year due to the level of risk involved.]

    c. Approximately five years. [This answer is correct. Investors may be content with a payback period of five years or slightly longer for lower risk, conservative companies.]

    d. A period somewhat longer than five years. [This answer is incorrect. Investors may allow a payback period of somewhat longer than five years for growth companies having outstanding long-term prospects since the investors have little or no concern regarding payback due to the long-term business model and income prospects of the borrowing company.]

APPLICATION OF PREMIUMS AND/OR DISCOUNTS

Once a weighted average value estimate has been determined, the next step in the valuation process is to apply any required premiums (which increase the estimated value) or discounts (which decrease the estimated value). The required types of premiums and discounts are usually determined based on the following factors:

a. The characteristics of the weighted average value estimate previously determined.

b. The standard of value that the consultant is trying to determine.

c. Ownership characteristics (controlling/minority interest and marketable/nonmarketable) of the subject interest that differ from the characteristics inherent in the valuation approaches and methods used.

For example, assume that a consultant used market information for public companies to build up discount and cap rates. If these rates have been applied to benefit streams that are applicable to minority interests (e.g., not adjusted for abnormal compensation and other factors), the resulting value of the company will usually represent an "as-if-freely-traded" minority ownership interest. However, if the consultant has been engaged to determine a control value of the company and the benefit stream has not been adjusted, the consultant may have to add a control premium to the value estimate and may also have to deduct a discount for lack of marketability to arrive at the appropriate value. It should be noted that control premiums do not usually apply to nonoperating assets. The premium, if applicable, applies to the operating value of the company.

Alternatively, if market information is derived from public companies and is applied to benefit streams that have been adjusted to reflect cash flows or earnings on a control basis, then the resulting value will usually represent a control value for the company (before a discount for lack of marketability, if applicable). Because discount rates are normally developed from minority trades of publicly held stock (or from minority returns reflected in Ibbotson data), some might argue the discount rate is a minority interest discount rate. However, this is not considered accurate. First, there is no empirical evidence that the rate of return differs for minority and controlling shareholders. Secondly, most, if not all, of the difference between a control value and a minority value results from differences in the potential future benefits and *not* from differences in the discount rate. Therefore, if the normalized benefit stream reflects adjustments for the prerogatives of control, it is usually not necessary to add a premium for control.

Types of Premiums and Discounts

Although many types of premiums and discounts may be encountered in performing business valuations, the most common are the following:

a. Control premium.

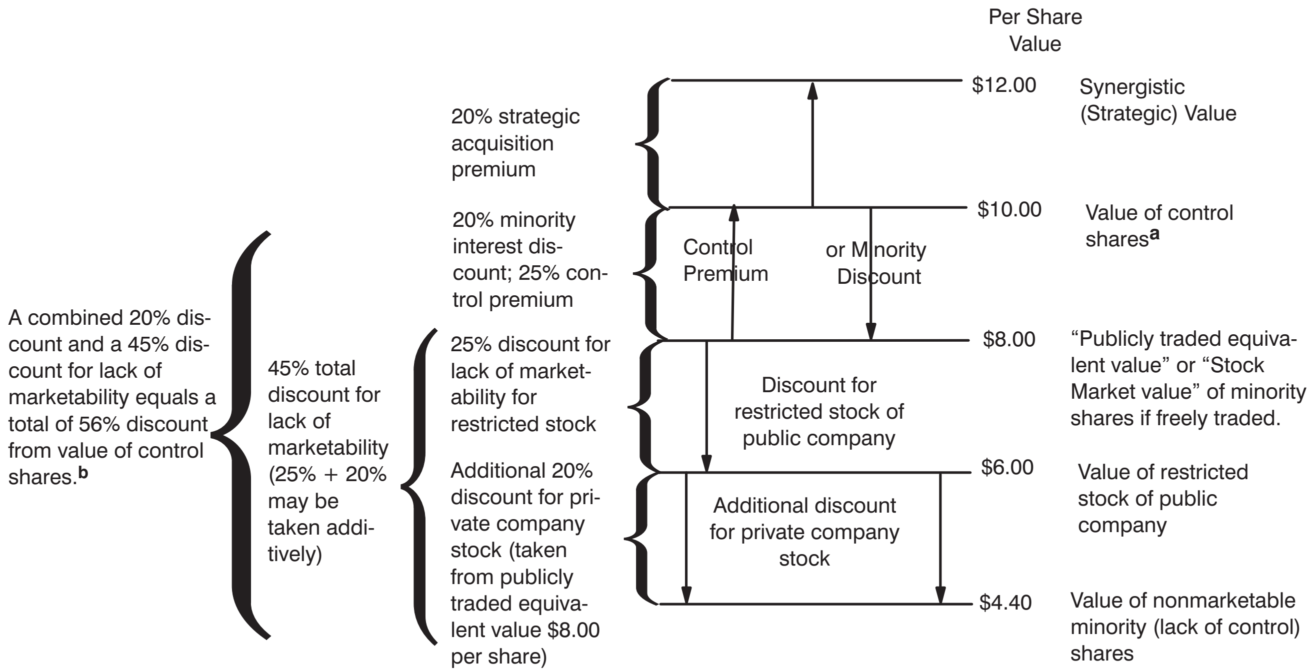
b. Minority interest discount.

c. Discount for lack of marketability.

Exhibit 1-7 illustrates the relationships between each of these premiums and discounts. As shown in this exhibit, a controlling interest in a company is usually worth more than a minority interest. In addition, an investment that is freely traded and can be easily sold is worth more than an investment that is not marketable.

Exhibit 1-7

"Levels of Value" in Terms of Characteristics of Ownership



Notes:

[a] Control shares in a privately held company may also be subject to some discount for lack of marketability, but usually not nearly as much as minority shares.

[b] Minority and marketability discounts normally are multiplicative rather than additive. That is, they are taken in sequence:.

$	10.00	Control Value
–	2.00	Less: Minority interest discount (.20 × $10.00)
$	8.00	Marketable minority value
–	3.60	Less lack of Marketability discount (.45 × $8.00)
$	4.40	Per share value of non-marketable minority shares

[c] Buyers may also pay premiums related to goodwill, such as unique customer lists and trade names; however, control premiums, minority interest discounts, and discounts for lack of marketability play the most significant role in the valuation process.

* * *

Control Premiums and Minority Interest Discounts

Controlling versus Minority Interests. Many business owners and other "informed" people believe that a minority interest in a company is worth its proportionate share of the value of the company taken as a whole. These people feel, for example, that a 15% interest in a company whose total value is $100,000 is worth $15,000. This is a dangerous misconception that can lead a valuation consultant to significantly overvalue a minority ownership interest in a company. A business valuation consultant must recognize that a controlling shareholder enjoys many benefits that are not enjoyed by minority interest owners. Minority interests are therefore usually worth less, often considerably less, than a proportionate share of the value of the total entity.

Comparison of Control Premium to Minority Interest Discount. One of the most important considerations that must be addressed during the planning phase of a valuation engagement is the ownership interest that the consultant is to value. The consultant must determine whether the client needs a control value or a minority interest value. Once this is known, the consultant can often determine the appropriate value directly. In many cases, however, the consultant determines a minority interest value even though the engagement requires a control value, or vice-versa. To arrive at the appropriate value when this occurs, the consultant should either (a) adjust the benefit stream to reflect the level of value or (b) apply a control premium or a minority interest discount. The International Glossary of Business Valuation Terms has defined these terms as follows:

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

b. *Control Premium.* An amount or 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.

Using these definitions, a minority interest discount is the opposite of a control premium. This relationship is also illustrated in Exhibit 1-7.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following statements regarding discount rates is accurate?

    a. Discount rates are *always* developed from minority trades of publicly held stock.

    b. The discount rate is a minority discount rate.

    c. Most of the difference between a control value and a minority value is due to differences in the discount rate.

    d. If the normalized benefit stream includes adjustments for the prerogatives of control, it is generally not necessary to add a premium for control.

20. Of the types of premiums and discounts listed below, which one is less common than the others?

    a. Control premium.

    b. Goodwill premium.

    c. Minority interest discount.

    d. Discount for lack of marketability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

19. Which of the following statements regarding discount rates is accurate? **(Page 267)**

    a. Discount rates are *always* developed from minority trades of publicly held stock. [This answer is incorrect. Discount rates are not universally developed from minority trades of publicly held stock, or from minority returns reflected in Ibbotson data but this is the customary way that discount rates are developed.]

    b. Even though discount rates are normally developed from minority trades of publicly held stock, the discount rate is not a minority discount rate. [This answer is correct. There is no evidence, based on observation or experience, that the rate of return differs for minority and controlling shareholders.]

    c. Most of the difference between a control value and a minority value is due to differences in the discount rate. [This answer is incorrect. All or most of the difference between a control value and a minority value results from differences in the potential future benefits.]

    d. If the normalized benefit stream includes adjustments for the prerogatives of control, adding a premium for control is required. [This answer is incorrect. It is not normally necessary to add a premium for control if the normalized benefit stream indicates adjustments for the prerogatives of control since the adjustments would preclude the need for a premium for control to be added.]

20. Of the types of premiums and discounts listed below, which one is less common than the others? **(Page 267)**

    a. Control premium. [This answer is incorrect. A control premium is among the most common premiums used in business valuations due to the fact that a controlling interest in a company is generally worth more than a minority interest.]

    b. Goodwill premium. [This answer is correct. A goodwill premium is a type of premium that may be applied in some circumstances when performing business valuations for things such as customer lists and trade names, but it is not one of the most common premiums applied since business valuations dealing with customer lists and trade names are the exception, not the rule.]

    c. Minority interest discount. [This answer is incorrect. A minority interest discount is one of the most common discounts used in business valuations since a discount will generally be applied when valuing a minority interest due to reduced value of a minority interest in comparison to a controlling interest.]

    d. Discount for lack of marketability. [This answer is incorrect. A discount is commonly applied for lack of marketability. An investment that is readily traded and is easy to sell is worth more than investment that is not marketable, thus the discount.]

Distinguishing between a Controlling and a Minority Interest. Accountants and other users of financial statements are used to using quantitative guidelines to measure an ownership interest. For example, if you were to ask a group of CPAs how they would define a controlling interest and a minority interest in a company, most of them would probably respond that a controlling shareholder owns more than 50% of the company's stock and a minority shareholder owns less than 50%. This simplistic distinction, however, is usually not acceptable for valuation purposes. The value of control depends on the shareholder's ability to exercise any or all of a variety of rights typically associated with control. Exhibit 1-8 presents a checklist of some of the more common benefits of control.

Exhibit 1-8

Common Prerogatives of Control

1. Appoint or change operational management.
2. Appoint or change members of the board of directors.
3. Determine management compensation and perquisites.
4. Set operational and strategic policy and change the course of the business.
5. Acquire, lease, or liquidate business assets, including plant, property, and equipment.
6. Select suppliers, vendors, and subcontractors with whom to do business and award contracts.
7. Negotiate and consummate mergers and acquisitions.
8. Liquidate, dissolve, sell out, or recapitalize the company.
9. Sell or acquire treasury shares.
10. Register the company's equity securities for an initial or secondary public offering.
11. Register the company's debt securities for an initial or secondary public offering.
12. Declare and pay cash and/or stock dividends.
13. Change the articles of incorporation or bylaws.
14. Set one's own compensation (and perquisites) and the compensation (and perquisites) of related-party employees.
15. Select joint ventures and enter into joint venture and partnership agreements.
16. Decide what products and/or services to offer and how to price those products/services.
17. Decide what markets and locations to serve, to enter into, and to discontinue serving.
18. Decide which customer categories to market to and which not to market to.
19. Enter into inbound and outbound license or sharing agreements regarding intellectual properties.
20. Block any or all of the above actions.

[SOURCE: Shannon P. Pratt with Alicia V. Nicolita, *Valuing a Business*: *The Analysis and Appraisal of Closely Held Companies*, 5th Edition (The McGraw-Hill Companies, 2008), pp. 384–385.]

* * *

Factors Affecting the Degree of Control That Can Be Exercised. In reviewing Exhibit 1-8, it is apparent that the owner of a controlling interest in a company enjoys some valuable rights that the owner of a minority interest does not have. However, many factors may limit the ability of a majority owner to exercise those rights. Therefore, even if a shareholder or a group of shareholders acting as one block owns more than 50% of a company's stock, they may not be able to exercise all of the benefits of control. In addition, minority owners may enjoy some significant rights through their ability to cast important swing votes. It is therefore not enough to say that a control value is appropriate for any ownership interest of more than 50%, nor can the consultant always assume that an interest of less than 50% should be valued strictly as a minority interest. The extent of control premium or minority discount in a given situation is often a matter of degree. Factors that affect the degree of control that can be exercised include the following:

a. Cumulative versus noncumulative voting.

b. Contractual restrictions.

c. Effects of regulations, including state statutes.

d. Financial condition of the business.

e. Effects of distribution of ownership.

Cumulative versus Noncumulative Voting. A company's board of directors exercises a great deal of influence over a company's actions. Many companies have noncumulative voting provisions, which means that a majority owner has the ability to elect the entire board of directors, and that ability cannot be blocked by minority interests. Some companies, however, have a cumulative voting system in which all voters (shareholders) are given votes in proportion to their ownership percentages. The shareholders may cast all of those votes for one candidate or distribute them in any way among the candidates. This system often allows minority shareholders to gain some representation on the company's board of directors.

To illustrate this process, assume that a company has 10 director slots to fill during a given year. Further assume that one group of people owns 80% of the common stock (80 shares) and that another group owns 20% of the stock (20 shares). The controlling shareholders therefore have 80 votes, and the minority shareholders have 20 votes. The controlling shareholders have proposed a slate of 10 candidates, and can easily elect all 10 of those candidates if the company has a noncumulative voting system. If the company has a cumulative voting system, however, the minority shareholders can gain two of the 10 seats by submitting two candidates of their own and voting 10 shares for each of the two candidates. The majority owners will usually split their 80 votes evenly among their 10 candidates, with each candidate gaining eight votes. Alternatively, the majority shareholders may concentrate their votes among eight candidates, with each candidate getting 10 votes. Regardless of how the majority shareholders split their votes, however, both of the minority shareholders' candidates will have 10 votes each, and they will gain board seats. Only eight of the majority owners' candidates will join the company's board. The resulting board will consist of 8 directors elected by the majority owners and two directors elected by the minority owners.

Contractual Restrictions. Companies may give up some of the control rights listed in Exhibit 1-8 through contractual provisions. For example, a bank may require that certain activities of a company be restricted or prevented in order to fund a new loan or continue an existing debt relationship. Some of the more common restrictions involve the payment of dividends, liquidation of assets, acquisition of other companies, or changes in the direction of the business, not to mention compensation to controlling stockholders.

Effects of Regulation, Including State Statutes. Regulations at both the federal and state level can often impact the ability of owners to enjoy all of the control rights listed in Exhibit 1-8. For example, companies in many regulated industries, such as banking, insurance, and public utilities, cannot usually be sold as freely as nonregulated companies. Many of these regulated companies also have restrictions preventing certain acquisitions and limiting other areas of operations.

Statutes concerning the rights of minority and majority owners vary from state to state. In about half of the states, major actions, such as mergers, sales, liquidation, and recapitalization can be approved by a simple majority. Other states require a *super majority* (two-thirds or greater majority) to approve such actions. In those states, a minority who owns just over one-third of a company's stock (or even less in a few states) has the power to limit a majority's shareholder's ability to unilaterally exercise all of the prerogatives of control by blocking major actions. Thus, minority interest discounts may be lower in states that require major actions to be approved by a super majority when compared to states that allow such actions to be approved by a simple majority. Because statutes vary from state to state, the valuation consultant should always research the laws of the state of incorporation whenever an engagement is started.

Effects of Distribution of Ownership. The amount of stock a person (or group of people) owns *in relation to other shareholders* is often important in determining control issues. For example, if each of three stockholders or partners owns a one-third interest in a company, no one has complete control. However, no one is in a relatively inferior position unless two of the three have close ties with each other that the third does not share. Equal individual interests are usually worth less than a prorata portion of what the entire company is worth. The sum of the values of the individual owners is therefore less than what the total company could be sold for to a single buyer. However, the percentage discount from pro rata value for each interest normally will be lower than that for a minority interest that has no control whatsoever.

A shareholder who owns as little as 2% of a company's stock can sometimes exert a great deal of control over the company's major actions. If one person owns 49% of a company's stock and another owns 51%, the 49% holder has little or no positive control and, in many states, may not even have the "negative control" of being able to block certain actions. However, if two stockholders own 49% each and a third owns 2%, the 2% stockholder has a great deal of "swing vote" power. The 2% owner may be able to command a considerable premium for that particular block of stock over a prorata portion of the total company value. In addition, the IRS has used the swing vote theory to challenge valuation discounts.

Occasionally, the consultant will be engaged to value a 50% interest of a closely held business. Such an interest is not a minority interest, nor is it a controlling interest. Another similar situation occurs when a shareholder has an *operating* interest, but not an absolute controlling interest. Clearly in both of these examples, some discount for lack of control should be considered.

Summary of Factors Affecting Degree of Control. Obviously, many factors can impact the degree of control a partial owner has over the operations of a company. Whenever a valuation consultant is engaged to value a partial interest, the consultant must determine the extent of any control limitations or opportunities on the ownership interest. When any of the control elements are not available to the ownership interest, the value attributable to control must be reduced accordingly. On the other hand, if there are any significant elements of control present in a minority interest, that value also should be recognized. Exhibit 1-9 summarizes some of the factors previously discussed that tend to influence the values of minority shares relative to control shares.

Exhibit 1-9

Factors Affecting the Degree of Control

Factors That May Increase a Minority Interest Discount or a Control Premium

- The presence of nonvoting stock.
- An extreme lack of consideration for the interests of minority stockholders on the part of the company's management, board of directors, and/or majority owners.

Factors That May Decrease a Minority Interest Discount or a Control Premium

- The presence of enough minority interest votes to elect or have meaningful input on electing one or more directors in a company with cumulative voting.
- The presence of enough minority interest votes to block certain actions (subject to state statutes and/or articles of incorporation).
- The presence of state statutes granting certain minority stockholder rights.

Factors That May Increase OR Decrease a Minority Interest Discount or a Control Premium

- The distribution of other shares (e.g., two shares when two others own 49 shares each are more valuable than two shares when 49 others own two shares each).

* * *

Quantifying Minority Interest Discounts and Control Premiums. The thousands of daily transactions on stock exchanges are, of course, minority interest transactions. Each year, a controlling interest in a few hundred of these public companies is purchased. In approximately 85% of the cases, the prices paid for the stock of these companies represent a premium over the market price at which the stock previously traded as a minority interest. Several services follow these acquisitions and publish data on the control premiums. A widely followed service is *Mergerstat® Review*, which is published annually by FactSet Mergerstat, LLC. Exhibit 1-10 summarizes overall control premium/minority discount data from the 2009 edition of that source (which contains information for transactions through 2008). This source indicates that since 1980, the average control premium paid has been approximately 42%, the median control premium has averaged approximately 32%, and the implied minority interest discount has averaged approximately 24%. It should be noted, however, that these premiums are based on a company's stock price shortly before the announcement date of a merger transaction. Because stock prices have a tendency to rise shortly before such transactions, the premiums may be understated. It is important to remember that, although these premiums are commonly referred to as "control" premiums, they are, in reality, acquisition premiums paid for control, synergy, overpayment, and other factors. For example, an acquiring company may pay a premium to acquire an important supplier of its raw materials. For these reasons, *a typical control premium is usually less than the acquisition premium reflected in the Mergerstat data*.

Exhibit 1-10

Percent Premium Paid over Market Price

Year of Buyout	Number of Transactions	Average Premium Paid over Market (%)[a]	Median Premium Paid (%)	Implied Minority Interest Discount (%)[b]
1980	169	49.9	44.6	30.8
1981	166	48.0	41.9	29.5
1982	176	47.4	43.5	30.3
1983	168	37.7	34.0	25.4
1984	199	37.9	34.4	25.6
1985	331	37.1	27.7	21.7
1986	333	38.2	29.9	23.0
1987	237	38.3	30.8	23.5
1988	410	41.9	30.9	23.6
1989	303	41.0	29.0	22.5
1990	175	42.0	32.0	24.2
1991	137	35.1	29.4	22.7
1992	142	41.0	34.7	25.8
1993	173	38.7	33.0	24.8
1994	260	41.9	35.0	25.9
1995	324	44.7	29.2	22.6
1996	381	36.6	27.3	21.5
1997	487	35.7	27.5	21.6
1998	512	40.7	30.1	23.1
1999	723	43.3	34.6	25.7
2000	574	49.2	41.1	29.1
2001	439	57.2	40.5	28.8
2002	326	59.7	34.4	25.6
2003	371	62.3	31.6	24.0
2004	322	30.7	23.4	19.0
2005	392	34.5	24.1	19.4
2006	454	31.5	23.1	18.8
2007	491	31.5	24.7	19.8
2008	294	56.5	36.5	26.7

[SOURCE:*Mergerstat® Review 2009*. [Santa Monica: FactSet Mergerstat LLC, 2009.]

Notes:

[a] The premium paid over market is a percentage based on the buyout price over the market price of the seller's stock five business days prior to the announcement date. These calculations exclude negative premiums.

[b] Formula: 1 – [1 ÷ (1 + Median Premium Paid)].

*   *   *

Another widely followed service is the *Mergerstat®/BVR Control Premium Study ™*. Exhibit 1-11 summarizes the overall control premium/minority discount data from that source. The exhibit illustrates four ways to compute the implied minority discount from the control premium data. It is believed that the median is a better measure of central tendency than the mean, which usually is distorted by a few high outlying premiums. Moreover, most people are surprised to learn that *over 15%* of public company takeovers occur at *discounts* from their previous public trading prices. Most published materials omit these discounted transactions from both their mean and median computations. Moving from left to right on Exhibit 1-11, the implied minority discounts consistently become less as medians are substituted for means and transactions at discounted prices (negative premiums) are included. Since 1998, implied discounts due to lack of control fall to between 14%–25% when using median premiums paid and discounted prices, reflecting that generally over half the premium is paid for synergies.

Exhibit 1-11

Percent Mean and Median Premium Paid and Implied Minority Discount

Year of Buyout	Mean Premium Paid (%) (without negatives)[a]	Mean Implied Minority Discount (%)[b]	Median Premium Paid (%) (without negatives)[a]	Median Implied Minority Discount (%)[b]	Mean Premium Paid (%) (with negatives)[a]	Mean Implied Minority Discount (%)[b]	Median Premium Paid (%) (with negatives)[a]	Median Implied Minority Discount (%)[b]
2000	48.7	28.3	37.1	27.1	35.3	8.6	28.9	22.4
2001	52.1	28.7	35.9	26.4	34.0	(3.8)	25.9	20.6
2002	49.1	27.7	34.0	25.4	33.1	(5.2)	24.6	19.7
2003	84.1	29.5	39.0	28.1	47.4	22.8	35.1	26.0
2004	36.3	23.2	26.6	21.0	28.5	13.0	22.4	18.3
2005	32.7	21.1	22.7	18.5	22.4	10.8	17.0	14.5
2006	30.4	20.4	22.0	18.0	27.8	13.2	19.2	16.1
2007	27.5	19.2	20.7	17.2	21.9	10.2	18.4	15.6
2008	43.2	25.8	31.4	23.9	31.6	(3.5)	25.7	20.5
2009	82.1	35.5	46.0	31.5	67.2	18.7	38.1	27.6

Notes:

[a] *Without negatives* does not include public company sale transactions at *discounts* from their previous trading prices. *With negatives* does include such discount transactions.

[b] Formula: 1 − [1 ÷ (1 + Control Premium Paid)]. (Each transaction has an implied minority discount, so the mean and the median of these were taken.)

[SOURCE: Compiled from *Mergerstat®/BVR Control Premium Study ™* (Santa Monica: FactSet Mergerstat LLC, January 12, 2010.)] (The database is accessible at **www.bvmarketdata.com**.)

* * *

Studies concerning control premiums and minority discounts have highlighted the potential abuses of control premium data. One paper suggests that the value of a control premium relates to the extent that the owners were able to exercise the prerogatives of control listed in Exhibit 1-8, as well as the ownership structure of the firm. Another study discussed the impact of leverage on the control premium. These studies highlight the problems with using the mean or median control premium when valuing a closely held firm.

Synergistic value is an important factor that may distort control premium studies. Some of the transactions included in control premium studies involve economic benefits of synergies between the parties. The synergistic or strategic benefits reflected in these control transactions contain more than *only* prerogatives of control and are not applicable to the typical buyer. This relationship is illustrated in Exhibit 1-7.

For these reasons, it is recommended that consultants investigate the circumstances behind the paying of a control premium on a transaction-by-transaction basis. To the extent that the premium primarily relates to a synergy unavailable to a typical buyer or the buyer has some other special motivation for making the acquisition, the transaction may contain elements of "investment value."

It is suggested that a good starting point for analyzing the control portion of the acquisition premium from the other elements included in a particular premium is to first look at those acquisition premiums paid by financial buyers. These types of transactions typically do not reflect unique synergies available to a particular buyer. Moreover, in the situation where there are a number of strategic buyers, the acquisition premium may reflect elements closer to a control premium and very little, if any, to other elements.

Ultimately, the application of a control premium is predicated on the buyer's ability to extract more cash flow from the company. This concept was initially expressed in the 1990's and most recently by Aswath Damodaran in 2005. Damodaran has provided a framework for analyzing the applicability of a control premium which is based on the premise that the value of a business is determined by how existing management has performed. Specifically, management decisions concerning where to invest resources, how to fund those resources, and how much free cash flow will be available to the owners of the business determine the value of a business. Within that context, the value of control is based on the ability to operate the company better than it has been. Thus, the value of control would generally be higher for a poorly operated business and lower for a well-operated business.

The amount of the control premium, if any, is based on whether a change in the way the business is operated will result in either:

- An increase in cash flows
- An increase in the expected growth rate
- A reduction in the discount rate

Therefore, if a business is operated so well that a change in operations will not result in one of the factors listed above, no control premium would be warranted. Alternatively, if a change in operations causes a change to one of the factors listed above, a control premium may be applicable. Examples of operational changes include improving accounts receivable procedures to more effectively and efficiently collect amounts due from customers and reducing finance costs by modifying the mix of debt and equity to better match the company's asset mix. Both of these examples would increase cash flows by either reducing the amount of working capital or increasing the leverage of the business to a more appropriate capital structure, resulting in a control premium.

Under the framework suggested by Damodaran, a control premium is not guaranteed because if a change in operations will not result in one of the factors listed above, no control premium would be warranted. Alternatively, if the firm is not run well and operational changes would result in more cash flow at the same level of risk, a control premium may be applied. However, if operational changes would result in more cash flow at a higher level of risk, the increase in risk may partially or completely negate any potential control premium resulting from the increase in cash flow.

If a control premium is used, it is preferable to look at control premiums by industry and investigate the amounts actually paid. These can be adjusted to reflect the individual circumstances of the company being valued. Some potential adjustments that would affect the size of the control premium include:

a. Size of the block (absolute versus operating control).

b. Actual dividends paid.

c. Quality and attractiveness of the company being valued.

d. Prerogatives of control available to the equity holders.

e. The degree of leverage.

Sources of information of merger and acquisition transactions by industry include the *Merger and Acquisition Sourcebook* and *Mergerstat®/BVR Control Premium Study ™*.

Determining Whether a Control Premium or Minority Interest Discount Is Needed. Based on the factors discussed in the preceding paragraphs, the valuation consultant must make two important decisions regarding control premiums/minority discounts on each engagement:

a. Is a control premium or minority interest discount needed?

b. If so, how much of a premium or discount is appropriate?

The first decision is usually easier to make. If the final value estimate determined by the consultant represents a minority interest value, but the client needs to know the value of a controlling interest, a control premium may be added. Alternatively, if the consultant has determined a control value, but the client needs to know the value of a minority interest, a minority discount usually should be subtracted.

Exhibit 1-12

Ownership Interest Appropriate for Common Valuation Engagements

Type of Valuation Engagement	Ownership Interest Normally Being Valued
Sole proprietor wanting to sell his/her company.	Controlling interest.
Sole proprietorship being valued as part of a divorce proceeding.	Controlling interest.
The value of an individual partner's interest in a partnership that is made up of two partners, each owning 50%.	Depends on the degree of control that the partner can exercise.
The value of an individual partner's interest in a partnership that is made up of three partners, each owning $33^1/_3$%.	Depends on the degree of control that the partner can exercise, but probably a minority interest.
The value of a general partner's interest in a limited partnership.	Depends on the degree of control that the limited partners can exercise over the affairs of the partnership. On the surface, it would appear that a controlling interest is appropriate for a general partner with at least a 50% ownership interest. However, it depends on the extent of control benefits (if any) that the limited partners are given in the partnership agreement.
The value of a minority shareholder's interest in an oppression case. (Some state laws called share-holder oppression statutes, allow certain minority interests to petition the court for dissolution of the corporation, thereby causing the sale or distribution of company assets.)	Usually a prorata share of the company's total value.
The value of stock under a dissenting stockholder suit.	Varies from state to state depending on statutory and case law.
The value of stock for estate tax purposes.	Depends on the degree of control or minority position held in the estate.
The value of stock for gift taxes, charitable contribu-tion, stock repurchases, etc.	Depends on the amount of stock involved in each actual transaction.

* * *

Determining the Level of a Control Premium or a Minority Interest Discount. Determining the amount of the premium or discount is difficult and involves a great deal of judgment. Some controlling interests may not be able to enjoy all of the benefits of control for a variety of reasons. In addition, some minority interests may be able to exercise at least some degree of "negative control" whereby they are able to block certain actions of the controlling owners. As a result, how much of a control premium or minority discount should be applied in a given situation will depend on a careful analysis of all of the factors previously discussed. The following guidelines should provide a starting point for estimating control premiums and minority discounts in various situations:

a. *Control Premiums.* A minority interest value may be determined using either the discounted or capitalized returns methods using a discount or cap rate derived in part from Ibbotson Associates data and other market information. A large control premium may be required to convert such a minority interest value to a controlling interest that enjoys all of the benefits of control if the returns discounted or capitalized do not already reflect how a control buyer would operate the company. Such a control premium is often between

25% and 75% of the company's estimated value, although it is not uncommon to be outside this range on either side. The required control premium should be reduced as the controlling interest being valued loses benefits of control or as the minority interest gains measures of negative control. Industry and market conditions also affect the level of control premiums that buyers are willing to pay at any given time.

b. *Minority Discounts.* A large minority interest discount may be required to convert a control value determined using guideline merger and acquisition transaction data and similar information to a minority value that has no negative control powers. Such a minority interest discount often ranges from 25% to 50% of a prorata share of the company's estimated value, although it is not uncommon to be outside this range on either side. The required minority interest discount should be reduced as the minority interest gains negative control powers or as the controlling interest loses benefits of control. Industry and market conditions may also have an impact on the level of minority interest discounts at any given time.

Discounts for Lack of Marketability

Distinction between Minority Interest Discount and Discount for Lack of Marketability. Many writers and business valuation consultants fail to distinguish between a minority interest discount and a discount for lack of marketability. Although they are somewhat related, these are two separate concepts. As previously discussed, a *minority interest discount* is measured in terms of the relative degree of control a minority owner has over the operations and important decisions of the company. The concept of *marketability*, however, deals with the liquidity of an ownership interest, that is, how quickly and easily it can be converted to cash if the owner chooses to sell. These two concepts are somewhat related in that, even after discounting a minority interest for its lack of control, it is still usually much harder to sell a minority interest than to sell a controlling interest in a closely held business.

Need for Such Discounts in Valuing Closely Held Companies. By definition, ownership interests in closely held companies are typically not readily marketable compared to similar interests in public companies. Therefore, a share of stock in a privately held company is usually worth less than an otherwise comparable share in a publicly held company. This may be true to some extent regardless of whether a controlling interest or a minority interest is being valued. A valuation consultant may therefore be required in some cases to apply both a minority interest discount and a discount for lack of marketability to the same company. It is not uncommon to find a minority interest valued at 35% or less of the stock's underlying net asset value because both types of discounts were appropriate. Consultants may also find it necessary to apply both control premiums and discounts for lack of marketability to the same company. It sometimes works out that the discount for lack of marketability and the control premium offset each other, although the premium usually exceeds the discount, or vice-versa.

Factors Affecting the Required Level of a Discount for Lack of Marketability. Discounts for lack of marketability should usually be applied to any minority ownership interest that cannot be easily sold in a timely manner such as by phoning your stock broker and receiving your cash within three business days. In certain instances, it may also apply to controlling interests. Such discounts are therefore applicable to most investments in stock that is not listed on an organized exchange or traded in an active over-the-counter market. The level of discount that should be applied to a specific investment, however, depends on a number of factors, including those listed in Exhibit 1-13.

Exhibit 1-13

Discount for Lack of Marketability Checklist

Factors That May Increase Discount for Lack of Marketability

- Restrictions on transfers.
- Little or no dividends or partnership payout.
- Little or no prospect of either public offering or sale of company (especially if so stated in corporate minutes or other documentation).

Factors That May Decrease Discount for Lack of Marketability

- "Put" option.
- Limited market available (such as ESOP) that may be interested in purchasing shares.
- Imminent public offering or sale of company.
- High dividend or partnership payouts.

Factors That May Increase OR Decrease Discount for Lack of Marketability

- Size of block (depending on size and circumstances, but usually a large block size relative to shares outstanding increases the discount for lack of marketability).
- Buy-sell agreement (depending on provisions).

* * *

Studies Designed to Determine the Required Level of a Discount for Lack of Marketability

Two Types of Empirical Studies. A number of studies during the past 35 years have attempted to determine average levels of discounts for lack of marketability. These studies all fall into one of two basic categories, depending on the type of market transaction data on which they are based:

- Restricted ("letter") stock studies.
- Studies of transactions in closely held stocks prior to initial public offerings (IPOs).

The following paragraphs discuss the most recent results of both of these lines of studies.

Restricted ("Letter") Stock Studies. Letter stocks are identical in all respects to the freely traded stocks of public companies except that they are restricted from trading on the open market for a certain time period. Marketability is the only difference between a letter stock and its freely traded counterpart. The studies have therefore attempted to find differences in the price at which letter stock transactions take place compared with open market transactions in the same stock on the same date.

Restricted stocks are governed by the Securities and Exchange Commission Rule 144 (Rule 144), which specifies how long the restricted stocks must be held, the way in which they are sold, and the amount that can be sold at any one time. Rule 144 has undergone changes that have progressively increased the liquidity of restricted stocks. Thus, the average lack of marketability discounts for restricted stocks has decreased over time. The following paragraphs give the history of changes to Rule 144.

<u>Pre-1990.</u> Prior to 1990, the minimum holding period for a restricted stock before it could be offered in the public market was two years, and institutional sales within that time period had to be registered with the SEC. Average discounts on sales of block relative to their public market trading price were about 33% to 35%.

<u>1990–1997.</u> In 1990, the SEC removed the requirement to register sales of institutional blocks of restricted stock. This action resulted in a substantial increase in the number of restricted stock sales, increasing the liquidity and lowering the discounts for lack of marketability for restricted stocks. Average discounts dropped to the mid-20s.

Post-1997. In 1997, the SEC lowered the minimum holding period for restricted stocks from two years to one year, further reducing the discounts on restricted stock transactions. The average percentage discount was in the low 20s and mid-teens for the only two post-1997 restricted stock studies published.

Since 1990, the public stock market's liquidity and trading volume has greatly increased, which has lowered the overall lack of marketability discounts for restricted stocks of public companies. Many factors have contributed to the market's heightened activity and liquidity, including the following:

a. A reduction of the maximum settlement period (the time between a transaction's execution and its cash settlement) from five days to three days.

b. An increase of puts, calls, and other derivative securities on many more stocks.

c. A reduction of commissions due to the introduction of discount brokers.

d. A reduction of the average spreads between the bid and asked prices due to the replacement of the fractional quotation system with the decimal quotation system.

However, none of these developments has had any impact on the lack of marketability of closely held stocks. Thus, the difference in lack of marketability discounts between restricted stocks of public companies and closely held stock has widened considerably in recent years.

Relationship between Size of Block and Discount for Lack of Marketability. Even after the Rule 144 restrictions expire, the holder is only allowed to sell the greater of 1% of the outstanding stock or 1% of the quarterly trading volume in any 90-day period. Consequently, a holder of a 1% block of stock could sell immediately when the restrictions expire, but the holder of a 32% block may require up to eight years (32 quarters) to sell the entire block in the public market.

Because of these restrictions on the sale of "large blocks" of stock and the fact that the number of potential buyers for larger blocks of stock is more limited, the larger the block of restricted stock, the greater the discount for lack of marketability.

Using Restricted Stock Studies to Estimate a Discount. Due to the "large block effect" and the difference in lack of marketability discounts between restricted stocks of public companies and closely held stock, using restricted stocks to estimate a discount for lack of marketability of a closely held stock is a two-step process: (a) estimate a restricted stock equivalent discount, and (b) add an increment for a closely held stock.

To estimate the restricted stock equivalent discount, the valuation consultant should select specific transactions from restricted stocks with characteristics, such as size, profitability, and level of (dividend) distributions, as close to the subject company as possible. (Note that the type of industry generally does not make much difference when selecting transactions.) When selecting such transactions. consultants should use a reputable source, such as the FMV Restricted Stock Database (available at **www.bvmarketdata.com**).

Studies of Transactions in Closely Held Stocks Prior to IPOs. It is recognized, of course, that restricted stocks are only restricted from public trading for a limited period of time. Following that, they will be eligible to trade in a public market that is already established. It is logical, then, to expect that the discount for lack of marketability for truly closely held stocks, for which no public market has been established (and may never be), would be greater than discounts for lack of marketability for restricted stocks that in the foreseeable future would be eligible for trading in an established public market.

The business appraisal community and users of its services obviously could benefit if someone were to gather evidence to determine how much greater the discount for lack of marketability should be for closely held stocks than for restricted stocks of companies already public. Three independent but somewhat similar series of studies (Emory, Willamette Management Associates, and Valuation Advisors) were designed to answer this question. These studies were based on transactions in closely held stocks compared to subsequent transactions in the same stocks in IPOs.

Emory Studies. John Emory, Sr. started the Emory Studies when he was with Baird & Co., an investment banking firm. Among other characteristics, transactions, including option transactions, used in the Emory Studies must have occurred within five months prior to the IPO. Also, there was no attempt to eliminate insider transactions, and if more than one private transaction occurred within five months prior to the IPO, only the initial transaction was selected for the study. The transaction price was compared to the IPO price with no adjustments for changes, in either earnings or industry price indexes, which may have occurred within the months prior to the IPO.

The Emory Studies are no longer being updated. The data on every qualifying transaction in the studies are available free of charge at **www.emoryco.com**. The results of the Emory Studies are summarized in Exhibit 1-14.

Exhibit 1-14

The Value of Marketability As Illustrated in Initial Public Offerings of Common Stock

Study	Number of IPO Prospectuses Reviewed	Number of Qualifying Transactions	Discount	
			Mean	Median
1997–2000 [a]	1,847	266	50%	52%
1995–1997	732	84	43%	41%
1994–1995	318	45	45%	47%
1992–1993	443	49	45%	43%
1990–1992	266	30	34%	33%
1989–1990	157	17	46%	40%
1987–1989	98	21	38%	43%
1985–1986	130	19	43%	43%
1980–1981	97	12	59%	68%
	4,088 (Total)	543 (Total)	46%	47%

[SOURCE: Presentation by John Emory at the Institute of Business Appraisers' Annual National Conference, Orlando, Florida, June 3, 2003.]

Note:

[a] This is an expanded study.

*   *   *

Willamette Management Associates Studies. Over the past several years, Willamette Management Associates has conducted a series of studies comparing private stock transactions to subsequent public offerings of stock in the same companies. The Willamette studies include transactions with different characteristics than the Emory studies. Specifically, the Willamette studies include transactions, excluding options transactions, which occurred at any time during the three-year period prior to the IPO. Also, the Willamette studies attempt to exclude any transactions with insiders, leaving only arm's-length transactions. Once the discounts are calculated, they are adjusted for changes in the company's earnings and in industry price/earnings multiples between the private stock transaction and the IPO.

Willamette does not publish the actual transactions underlying its data. The results of the Willamette Studies are summarized in Exhibit 1-15. The Willamette studies are no longer being updated.

Exhibit 1-15

Summary of Discounts for Private Transaction P/E Multiples Compared to Public Offering P/E Multiples Adjusted for Changes in Industry P/E Multiples

Time Period	Number of Companies Analyzed	Number of Transactions Analyzed[a]	Standard Mean Discount	Trimmed Mean Discount[b]	Median Discount	Standard Deviation
1975–78	17	31	34.0%	43.4%	52.5%	58.6%
1979	9	17	55.6%	56.8%	62.7%	30.2%
1980–82	58	113	48.0%	51.9%	56.5%	29.8%
1983	85	214	50.1%	55.2%	60.7%	34.7%
1984	20	33	43.2%	52.9%	73.1%	63.9%
1985	18	25	41.3%	47.3%	42.6%	43.5%
1986	47	74	38.5%	44.7%	47.4%	44.2%
1987	25	40	36.9%	44.9%	43.8%	49.9%
1988	13	19	41.5%	42.5%	51.8%	29.5%
1989	9	19	47.3%	46.9%	50.3%	18.6%
1990	17	23	30.5%	33.0%	48.5%	42.7%
1991	27	34	24.2%	28.9%	31.8%	37.7%
1992	36	75	41.9%	47.0%	51.7%	42.6%
1993	51	110	46.9%	49.9%	53.3%	33.9%
1994	31	48	31.9%	38.4%	42.0%	49.6%
1995	42	66	32.2%	47.4%	58.7%	76.4%
1996	17	22	31.5%	34.5%	44.3%	45.4%
1997	34	44	28.4%	30.5%	35.2%	46.7%
1998	14	21	35.0%	39.8%	49.4%	43.3%
1999	22	28	26.4%	27.1%	27.7%	45.2%
2000	13	15	18.0%	22.9%	31.9%	58.5%
2001	2	2	– 195.8%	n/a	– 195.8%	n/a
2002	5	7	55.8%	n/a	76.2%	42.8%

[SOURCE: Willamette Management Associates. Reprinted from Pamela J. Garland and Ashley L. Reilly, "Update on the Willamette Management Associates Pre-IPO Discount for Lack of Marketability Study for the Period 1998 through 2002," Willamette Management Associates Insights, Spring 2004. See **www.willamette.com**.]

Notes:

[a] Caution must be taken as to sample size when relying on this data.

[b] Excludes the highest and lowest of indicated discounts.

* * *

Valuation Advisors' Studies. Valuation Advisors has constructed the Valuation Advisors' Lack of Marketability Discount Study™ database that includes all transactions within two years of the IPO, including transactions in common stock, convertible preferred stock, and options. The database includes data on approximately 3,700 transactions, with 15 data points for each transaction, such as company sales and operating profit. The database does not include adjustments for changes in earnings or industry price indexes. However, the database includes both the SIC and NAICS codes, so, if desired, the analyst can access the SEC filings and make earnings and industry adjustments.

Studies published using the Valuation Advisors' database break down the number of transactions by length of time that the private transaction occurred prior to the IPO: 1–90 days prior, 91–180 days prior, 181–270 days prior, 271–365 days prior, and 1–2 years prior. Results for years 1999–2007 are shown in Exhibit 1-16.

Exhibit 1-16

Valuation Advisors' Lack of Marketability Discount Study™
Transaction Summary Results by Year from 2001–2009

Time of Transaction Before IPO	1–90 Days	91–180 Days	181–270 Days	271–365 Days	1–2 Years
2001 Results					
Number of Transactions	15	17	18	17	48
Median Discount	14.7%	33.2%	33.4%	52.1%	51.6%
2002 Results					
Number of Transactions	9	13	7	16	36
Median Discount	6.2%	17.3%	21.9%	39.5%	55.0%
2003 Results					
Number of Transactions	12	22	24	21	44
Median Discount	28.8%	22.3%	38.4%	39.7%	61.4%
2004 Results					
Number of Transactions	37	74	63	59	101
Median Discount	16.7%	22.7%	40.0%	56.3%	57.9%
2005 Results					
Number of Transactions	18	59	58	62	99
Median Discount	14.8%	26.1%	41.7%	46.1%	45.5%
2006 Results					
Number of Transactions	25	76	69	72	106
Median Discount	20.7%	20.8%	40.2%	46.9%	57.2%
2007 Results					
Number of Transactions	46	76	92	79	124
Median Discount	11.1%	29.4%	36.3%	47.5%	53.1%
2008 Results					
Number of Transactions	4	4	7	8	9
Median Discount	20.3%	19.2%	45.8%	40.4%	49.3%
2009 Results					
Number of Transactions	11	19	19	17	35
Median Discount	(7.7%)	31.9%	26.4%	29.3%	31.9%
2001–2009 Transaction Results					
Number of Transactions	177	362	357	352	604
Median Discount	14.7%	25.0%	38.8%	47.3%	53.5%

[SOURCE: The Valuation Advisors' *Discount for Lack of Marketability Database*; January 12, 2010. Database access is available at **www.bvmarketdata.com**.

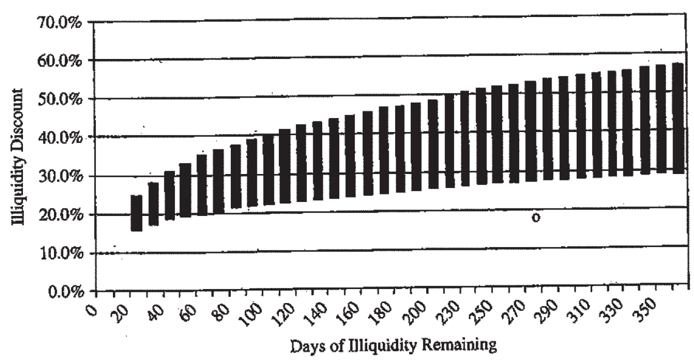
* * *

LiquiStat Database. Espen Robak, at Pluris Valuation Advisors, has conducted a study resulting in the LiquiStat Database-a continuously updated database of transactions in the secondary market for illiquid securities. The transactions in the LiquiStat database are made on the SecondMarket online trading platform managed by SecondMarket, Inc. of New York, NY (**www.secondmarket.com**). This distinguishes LiquiStat from other restricted stock studies. Other restricted stock studies measure the discounts taken in private placements which generally involve sales of a significant portion of a company's shares to a group of investors. LiquiStat, however, analyzes discounts taken when investors not affiliated with the issuing company sell restricted stock in private transactions to other investors.

The average holding period for the shares sold in the secondary market was 138 days, which is shorter than the assumed holding periods in other restricted stock private placement studies. Also, the LiquiStat data shows higher discounts than in other recent studies. Analysis of the LiquiStat data also shows that discounts are higher for shares: (a) sold in larger blocks (relative to market trading volume), (b) with a greater period (in days) of remaining illiquidity, (c) with a lower share price, or (d) considered to have greater risk. The results of the LiquiStat discounts for restricted stocks are summarized at Exhibit 1-17.

Exhibit 1-17

LiquiStat™ Discounts for Restricted Stocks



SOURCE: Espen Robak, Discounts for Illiquid Shares and Warrants": The LiquiStat™ Database of Transactions on the Restricted Securities Trading Network." *Pluris Valuation Advisors White Paper* (January 2007): 30. All rights reserved. Used with permission. Available at **www.plurisvaluation.com/pressroom/index.htm**.

* * *

The LiquiStat database also tracks transaction data for sales of warrants. The discounts for these restricted securities, which are directly comparable with the nonqualified stock options issued by thousands of companies, are significantly higher than for restricted stock. The discounts were generally higher for warrants associated with more volatile stocks or "out-of-the-money" options and those having longer times to expiration. Information concerning the LiquiStat database is available at **www.PlurisValuation.com**.

Mining Transaction Data. Courts favor data from companies with characteristics as close to the subject company as possible. It is possible to "mine" the numerous transactions from many of the major transaction databases (such as the Valuation Advisors database, the FMV Restricted Stock Study database, the Mergerstat/BVR Control Premium database and the LiquiStat data). By narrowing the range of industry code, sales revenue, EBITDA, transaction dates, and other parameters, the consultant may be able to extract lists of companies that more closely match the subject company. If the original parameters produce too few transactions, they can be broadened, and if they produce too many transactions, they can be narrowed.

Acceptance of the Studies by the Courts. Some analysts still use the average or median discounts from the restricted stock and pre-IPO studies. However, courts are increasingly demanding that data from databases represent companies with characteristics as similar as possible to the subject company in categories that matter. For example, size and profitability are factors proven to impact the magnitude of the discount for lack of marketability while industry does not have much effect. Thus, for example, in the *Okerlund* case [53 Fed. Cl. 341, 90 AFTR 2d 2002-6124 (Ct. Fed. Cl. 2002)], because the subject company was very large and profitable, the estate's expert selected only companies from the Valuation Advisors database that had over $100 million sales and were profitable. The court was very receptive to the detailed, pre-IPO analysis presented by the estate's expert.

Cost of Flotation. A private company's cost of flotation represents the cost of going public. This is a very expensive process, involving the payment of significant attorney, accountant, and investment banker fees. Many practitioners feel that the cost of flotation should be used as the discount for lack of marketability in valuing controlling interests. These costs, including commissions, attorney fees, accounting, printing, and other items, can range from a few percentage points of the offering for a very large company to 25% or more of the company's equity value for small company offerings.

Quantitative Marketability Discount Model (QMDM). The QMDM was developed to aid business valuation consultants in the development of discounts for lack of marketability, using conventional discounted cash flow (DCF) analysis. When employing the QMDM, valuators model the future benefits expected to flow to hypothetical investors of illiquid minority interests in closely-held or thinly-traded business entities. Therefore, the QMDM is a shareholder-level DCF model based upon assumptions about expected future benefits attributable to hypothetical investors in the subject property. The timing and amounts of future benefits are modeled by the appraiser based on the specific facts and circumstances pertaining to the subject interest. These assumptions are necessary components of all DCF models, whether at the enterprise or shareholder levels.

Conceptually, if the cash flow expected to be received by shareholders is less than all of the cash flows of the enterprise, and if minority shareholders experience risks in addition to the risks of the enterprise, then the value to the shareholder will be less than the freely traded value indicated by the Gordon Model. However, the primary issues are how much less and how to determine that difference. These are the issues addressed by the QMDM.

Overview. Consistent with DCF modeling disciplines, shareholder-level cash flows are modeled over discrete projection periods (or in the case of the QMDM, over a range of discrete forecast periods). Each discrete forecast culminates with a terminal cash flow, which is the appraiser's current marketable minority value compounded at the expected growth in value until the end of the forecast period.

The interim benefits and terminal value are discounted at a shareholder-level required rate of return, incorporating the enterprise-level equity discount rate plus incremental risk premiums determined by the valuator after examining the specific facts and circumstances of the subject investment, as well as the inherent uncertainties associated with the assumed benefit stream and terminal value. The percentage shortfall of the present value of the discounted shareholder-level benefit stream in relation to the undiscounted, marketable minority interest of the subject interest equals the discount for lack of marketability.

The QMDM is used to determine the value of nonmarketable, minority interests (V_{sh}) relative to their marketable, minority values (V_{mm}). These two values are then used to calculate the discount for lack of marketability (MD), as represented in the following formula.

$$MD = 1 - (V_{sh}/V_{mm})$$

V_{sh} is calculated using the QMDM (a shareholder-level DCF model), based on facts and circumstances unique to the valuation subject. Once V_{sh} is calculated, it is used in the above formula.

Assumptions of the QMDM. Often, the objective of a valuation is to provide a conclusion of the nonmarketable minority value (V_{sh}) of a closely held company, but only the value at the marketable minority level (Vmm) has been determined. The nonmarketable minority interest can be valued, in relationship to its marketable minority value, based on an analysis of certain assumptions. These assumptions, the QMDM's underlying assumptions, which specify its model in relationship to the enterprise-level DCF model, are shown in comparative form as follows:

DCF Assumptions	Corresponding QMDM Assumptions
Forecast Period	Expected Holding Period
Projected Interim Cash Flows (during forecast period)	Expected Distribution/Dividend Yield
	Expected Growth in Distributions/Dividends
	Timing (Mid-year or End of Year)

DCF Assumptions	Corresponding QMDM Assumptions
Projected Terminal Value (*at end of forecast period*)	Growth in Value (*Defines the estimated terminal value relative to the marketable minority value at the valuation date*)
	Premium or Discount to Marketable Value
Discount Rate	Range of Required Holding Period Returns

The QMDM is very sensitive to slight changes in its underlying assumptions, so it is necessary for the valuation consultant to develop specific assumptions when using the QMDM. The following is a discussion of the five primary QMDM assumptions:

a. *The Expected Holding Period for the Investment.* Rational investors making investments in illiquid securities estimate their expected holding periods before the realization of liquidity. Currently, investors in restricted stock transactions generally have expected holding periods of one year, which is the period of restriction under Rule 144 of the Securities Exchange Act of 1934. (For restricted stock transactions before April 1997, Rule 144's period of restriction was two years.) Investors in closely held securities must estimate the expected holding period for their investments based on the facts and circumstances of each investment. The QMDM has been criticized by some who are concerned that the expected holding period cannot be estimated with certainty. However, uncertainty is characteristic of the investment world, and when employing the QMDM, the consultant must make decisions in the face of uncertainty similar to investors.

b. *The Expected Level of Dividends/Distributions.* Generally, an illiquid investment that is expected to pay regular dividends or distributions is worth more than an otherwise identical investment with no expected distributions. The QMDM quantifies the value of the expected distributions over the expected holding period of each particular investment, considering each dividend/distribution after corporate taxes. It is necessary to consider expected dividends/distributions in the valuation of nonmarketable minority interests, just as it is important to consider interim cash flows in DCF models used to value business enterprises. Thus, the ability to *quantify* the impact of expected distributions over the expected holding period is an important distinction between the QMDM and benchmark analysis.

c. *The Expected Growth in Dividends/Distributions.* Unless holding periods are somewhat lengthy and distributions are significant, the growth rate of dividends may not have much impact on the value of an illiquid security. However, it is appropriate to make an assumption in each case.

d. *The Expected Growth Rate in Value.* The expected growth rate in value at the marketable minority level (Gv) provides the foundation for the value of an illiquid security. The QMDM assumes that value will be realized at the marketable minority level at some point in the future, which is considered the terminal value of the QMDM's shareholder investment analysis.

e. *The Required Return (Discount Rate) for the Expected Holding Period.* Cash flows to the shareholder are usually *derivative* cash flows; that is, a subset of the enterprise's cash flows. Cash flows to shareholders are subject to the same risks as the cash flows of the enterprise. However, from the shareholders' perspective, there are additional risks such as the enterprise not distributing its cash flows to the shareholders or that the shareholders' interests cannot be transferred. Consultants using the QMDM begin with the enterprise discount rate, usually developed using the build-up method, and add *holding period premiums* for the relevant risks to the shareholder. (The process is similar to adding estimated increments for specific company risks to the average market discount rate in the build-up method.) To test for reasonableness, the consultant can compare the estimated holding period premium to the implied required returns estimated from restricted stock studies.

Using the QMDM as a means of estimating a discount for lack of marketability has merit, but application of the model is only as good as the assumptions made by the consultant, and the QMDM requires numerous assumptions to be made. The consultant should be aware of the model and, if appropriate, apply it when warranted as a method to estimate a discount for lack of marketability.

Selecting a Discount for Lack of Marketability. The studies mentioned in the preceding paragraphs clearly indicate that substantial discounts for lack of marketability are often required when valuing a closely held company. The range of discounts, however, is quite wide, and even the average (or median) discounts are only somewhat consistent from one study to the next. All of this indicates that the selection of a discount for lack of marketability involves a great deal of judgment and should be based on all of the factors listed in Exhibit 1-13. There is considerable evidence, however, suggesting that the marketability discount for a closely held stock compared with a publicly traded counterpart should average between 35% and 50%, in the absence of special circumstances such as those noted in Exhibit 1-13 that would tend to reduce the discount for lack of marketability.

Marketability Discounts and Derivative Instruments

Financial theory and practice has begun to provide both insight and practical advice into the measurement of marketability discounts. The marketability discount captures the reduction in asset price due to the inability to convert an asset into cash in a short time period without any loss of value. Hedging instruments perform this function in many markets. For example, put options provide investors the ability to hedge against the falling price of a financial asset.

Specifically, a put option is a contract giving the owner the right, but not the obligation, to sell a specified amount of an underlying security at a specified price within a specified time. Thus, the right to sell at a set price effectively eliminates the downside risk. However, the investor's upside potential is not limited because if the underlying stock goes up in price, the investor only loses the option premium (the cost of the put option) by allowing the option to expire while fully participating in the stock's increase in value.

In effect, the cost of a put option is the price someone is willing to pay to guarantee marketability; however, the put option only protects from downward price pressure. In a real sense put options are a type of insurance. Put options insure against receiving less than the market price of a security. The following paragraphs provide an overview of how hedging instruments can theoretically remove the lack of marketability in financial markets and a brief discussion of how this logic can be applied to determine marketability discounts for business interests.

Using Option Pricing Models to Quantify a Discount for Lack of Marketability. In recent years, a number of hedging strategies using option pricing models have been proposed as providing a basis for a discount for lack of marketability (DLOM). In 1993, David B.H. Chaffe, III, proposed using such hedging vehicles as a proxy for DLOMs in private company valuations. Chaffe indicated that a holder of restricted stock can create liquidity by buying options to sell the shares (Option at Market price). Using the Black-Scholes model with an estimated range of volatility of between 60% and 90%, Chaffe determined that a DLOM of 28% to 41% was applicable when there was a two-year holding period, while a DLOM of 32% to 49% was applicable when there was a four-year holding period. He indicates that "these put prices, expressed as percentages of the market price (strike price), offer us an estimate of the discount for lack of marketability. The discount ranges of 28% to 49% are quite similar to those developed using data for market evidence studies for marketability such as the SEC Institutional Investor Study, the Robert E. Moroney studies, and the John D. Emory data."

In 1995, Francis Longstaff published an article using option pricing theory to set the upper bound on the value of marketability. Longstaff's hedge strategy made use of a *lookback put*. A lookback put allows the purchaser the right to sell the underlying asset at the best price available over the contract period. Using this strategy, Longstaff calculated that the maximum DLOM with restriction periods between one day and five years and volatility between 10% and 30%, produced discounts ranging ranging from approximately 8% to 66%, depending on which combination of restriction period and volatility was used.

Finnerty attempted to extend the Longstaff Study without using a lookback put option. He sampled 101 private placements of letter stock to conclude that the discount depends on, in part, the stock's volatility, restriction period duration, riskless rate, and dividend yield. Results from the Finnerty model indicate stocks that have dividends and shorter restriction periods command lower discounts for lack of marketability. Also, when stock price volatility is under 30%, the appropriate discount is smaller than the customary discount range of about 25% to 35%. For example, when volatility is between 20% and 30% and there is a two-year restriction period, the proper discount is in the range from approximately 16% to 20% for non-dividend paying stock and 11% to 16% for stocks with a dividend yield of 3%.

Weaknesses in Using Option Pricing Models for Quantifying a DLOM. Many consider the use of option models as an advancement in developing a DLOM for privately owned securities. However, using option models to quantify a DLOM does have some weaknesses, including the following:

a. The theoretical basis of these financial instruments is not meant to address long-term securities.

b. Put options only address *downside risk* which may overstate the discount as it does not account for any upside in the form of a call option or collar that would offset the cost of the put option.

c. The method is a theoretical concept as put and call options are not available for most holdings, and therefore, the approach is based on some form of comparative and/or includes many elements of judgment.

In addition, there have been a number of practitioners who have tested these models and expressed concerns about the usefulness of these methods. For example, one test generated discounts that were generally too high (and in some instances greater than 100%). While it is important to understand the limitations associated with these models, it is also important to note that the basis of comparison used to test the option models were restricted stocks studies, which themselves have limitations. Exhibit 1-18 presents an example of a put option to estimate the DLOM.

Exhibit 1-18

Illustrative Example of Using a Hedge Strategy to Estimate DLOM

In April 20X3, an investor owns 100 shares of Acorda Therapeutics, Inc. (ACOR) stock which is trading at $20.00. Believing the price of the stock will increase in the near-term, the investor wants to hold onto the shares for another six months. However, due to concerns about the possibility of the stock price falling over the next six months, the investor considers purchasing put options.

A review of the option market indicates that there are Acorda put options available that expire in April, May, July, and October of 20X3; January 20X4; and January 20X5. With a six-month window, the investor narrows the choice to the October 20X3 put options. From the pool of October 20X3 put options, the investor looks for in-the-money put options with a *strike* price close to the current share price. The investor finds put options trading at $3.60 with a strike price of $20 (same as exercise price) and an expiration date of October 16, 2009. Thus, for $3.60, the investor receives the right to sell a share of ACOR stock at $20 anytime between today and October 16, 20X3. The investor buys 100 of the put options to adequately hedge the 100 shares of ACOR stock.

After a brief increase in the price of ACOR stock, the share price slowly fell during the summer with an accelerated decline heading into October. Realizing the stock was not going to rebound in 20X3, the investor exercised the put options. Without the put options, the investor would have lost $500 over the six month period [($20 initial price/share − $15 sale price/share) × 100 shares]. However, using the put options, the investor only lost $360 during the six month period [(($20 initial price/share − $20 sale price/share) × 100 shares) − ($3.60 premium/option × 100 options)]. Thus, on a cash flow basis, instead of realizing $15/share of ACOR stock, the investor realized $16.40/share as follows:

Price paid for put options ($3.60 option × 100 options)	$ (360)
Proceeds received for sale of stock through exercise of put options ($20 sale price/share) × 100 shares)	2,000
Net cash flow	$ 1,640
Price received per share	$ 16.40

As of the date the options were purchased, the cost to the investor to insure that he would receive $20 per share of ACOR stock (or the marketability discount,) is the price of the individual put option divided by the stock price when the option is purchased. Thus, as of the April 20X3 date the investor purchased the options, the marketability discount for the ACOR stock is 18% ($3.60/option ÷ $20/share).

Recognition by IRS and the Courts of Discount for Lack of Marketability

As far back as 1977, through Revenue Ruling 77-287, the IRS recognized the effectiveness of restricted stock study data in providing useful information for the quantification of discounts for lack of marketability. The Emory and Willamette studies of transactions in closely held stocks did not exist at that time, but the authors have found both the IRS and the courts receptive to this data to assist in quantifying discounts for lack of marketability. In *Bernard Mandelbaum et al. v. Commissioner* [TC Memo 1995-255 (1995)], the U.S. Tax Court recognized both the restricted stock studies and the pre-IPO studies as average starting bases from which to adjust upward or downward for company specific factors in determining an appropriate discount for lack of marketability. In *Estate of Artemus D. Davis v. Commissioner* [110 TC 530 (1998)], the U.S. Tax Court stated that the reliance on restricted stock studies alone by the IRS's expert was insufficient, and that the taxpayer's experts' consideration of both restricted stock studies and the Willamette Management and Emory pre-IPO transaction studies was necessary to determine an appropriate discount. The court in *Mandelbaum* also cited the following factors that might cause a marketability discount to be higher or lower than benchmark averages:

a. Financial statement analysis.

b. Dividend policy.

c. Nature of the company, its history, its position in the industry, and its economic outlook.

d. The company's management.

e. Amount of control in the transferred shares.

f. Restrictions on transferability of the stock.

g. Holding period for the stock.

h. Company's redemption policy.

i. Costs associated with a public offering.

Discount for Lack of Voting Rights

A valuation consultant may be asked to value an interest that has impaired voting rights or no voting rights. Closely-held entities often create these types of interests when forming family limited partnerships. These interests do not convey the ability to control and, unlike typical minority interests, do not have the ability to gain control by accumulating additional shares.

Discounts associated with the lack of voting rights depend on the size of the block of stock, the dividends paid, and the distribution of ownership. A number of empirical studies have been conducted that compared nonvoting, publicly traded minority shares with their voting publicly traded counterparts. These studies have indicated that for small minority interests, the difference in voting rights has a negligible impact on value. For example, in a business where a shareholder already has control and there is not cumulative voting, there is usually little difference between the position of a minority owner with voting rights and a minority owner with no voting rights.

According to the empirical studies, in those instances where there were differences between voting and nonvoting minority shares, the effect on value was less than 5%, normally between 1.5% and 5%.

If a consultant determines that a discount for lack of voting rights is applicable to the interest being valued, the discount is normally reflected in the valuation before any discount for lack of marketability.

Other Discounts

As previously mentioned, the most common premiums and discounts encountered in performing valuation services are control premiums, minority interest discounts, and discounts for lack of marketability. Other types of discounts, however, are often required. Some of the more common additional discounts include the following:

a. *Blockage Discount.* Blockage is a term that applies to large blocks of publicly traded stock. If the size is large relative to a normal level of trading volume, the seller may have to accept a discount from the current market quote to induce a block trader to take the entire position. The size of a blockage discount will depend on a number of factors, including the relative size of the block in relation to the normal trading level. An investment banker or an analyst knowledgeable in the operations of public markets may be able to estimate the size of a blockage discount for a specific company.

b. *Key Person Discount.* Often the value of a company is diminished by the loss of a key person who has been intimately involved in the operations of the business. This is especially true in estate situations where the involvement of the key person has contributed significantly to the success of the business for a number of years. The level of this type of discount depends on how important the key person has been to the business and how easily the person's skills, contacts, and other attributes can be replaced. These key person factors may also be considered in determining the appropriate discount or capitalization rate for a company being valued. An example of how the key person discount can affect a company's value was seen in the case of the *Estate of Paul Mitchell v. Commissioner* [TC Memo 1997-461 (1997)]. The court considered Mitchell a very key person and at the "moment of death," the company was without his services. The court determined a 10% key person discount, which decreased the value of Paul Mitchell Systems' stock by $15,000,000.

c. *Portfolio Discount.* A portfolio discount is sometimes appropriate for companies with two or more dissimilar operations. The concept is that buyers who want to buy a company in a certain industry might be less inclined to pay "full price" for a company that also has other operations in which the buyer is less interested.

d. *Environmental Liability Discount.* Because of the increasing claims against companies for environmental damages, an environmental liability discount is being more frequently recognized to reflect the potential for such claims, especially in certain industries.

e. *Litigation Discount.* A discount for pending litigation may be applied to account for a potentially adverse judgment that would significantly impact the business. However, some courts may take the view that the discount for litigation is already accounted for by the discount for lack of marketability.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. One factor that affects the degree of control that can be exercised by majority and minority interests is cumulative versus noncumulative voting. Of the following statements concerning voting for a company's board of directors by minority interests, which one is applicable for companies with a cumulative voting system?

    a. Minority interests cannot exercise any control over who is elected to the board of directors.

    b. Minority interests can cast votes for candidates to the board of directors if majority interests give their approval.

    c. Minority interests are automatically given 10% of the vote in electing the board of directors.

    d. Minority interests are allowed the same percentage of votes as their percentage of stock ownership.

22. Federal and state regulations can have an impact on the degree of control that a company's owners would normally be able to exercise. As such, a company in which of the following industries would be the easiest to sell?

    a. Trinity Bank.

    b. Red River Insurance Company.

    c. Baxter's Books and Periodicals.

    d. Southwestern Electric Service Company.

23. Which of the following statements is correct regarding the effects of distribution of ownership?

    a. If each of three stockholders owns a one-third interest in a company, in some circumstances it is possible for one stockholder to exert complete control.

    b. If each of three stockholders, A, B, and C, each own a one-third interest in a company, no one stockholder can be put in a relatively inferior position to the other two stockholders.

    c. The sum of the values of the individual owners is usually less than what the entire company could be sold for to a single buyer.

    d. The percentage discount from pro rata value for each interest will generally be higher than that for a minority interest that has absolutely no control.

24. A control premium should be added in which of the following circumstances?

    a. A shareholder with a 50% interest in a closely held business.

    b. A shareholder with an operating interest (but not an absolute controlling interest).

    c. A shareholder with a controlling interest.

25. Which of the following factors may *increase* a minority interest discount or a control premium?

    a. The presence of sufficient minority interest votes to elect or have significant input on electing one or more directors in a company with cumulative voting.

    b. The distribution of two shares to a minority interest when 49 others own two shares each.

    c. The presence of adequate minority interest votes to block certain actions within the bounds of state statutes and/or articles of incorporation.

    d. The presence of various state statutes grants certain rights to minority stockholders.

26. In 2006, the average percent of control premium paid over the market price for a buyout of seller's stock five business days prior to the announcement date was:

    a. 30.7%.

    b. 31.5%.

    c. 34.5%.

    d. 35.7%.

27. No control premium is necessary for a firm that is well-run if a change in operations results in which of the following?

    a. An increase in cash flows.

    b. An increase in the expected growth rate.

    c. An increase in the discount rate.

28. The valuation consultant must make two important decisions on each engagement regarding control premiums/minority discounts. Which of the following is **not** one of those two decisions?

    a. Is a control premium or minority discount needed?

    b. Are prerogatives of control available to equity holders?

    c. How much of a premium or discount is appropriate?

29. If the type of valuation engagement is the value of a minority shareholder's interest in an oppression case, the ownership interest normally being valued:

    a. Depends on the degree of control that the partner can exercise.

    b. Depends on the degree of control that the partner can exercise, but probably a minority interest.

    c. Is usually a prorata share of the company's total value.

    d. Varies from state to state depending on statutory and case law.

30. Which of the following factors may *decrease* discount for lack of marketability?

    a. Limited market available that may be interested in purchasing shares.

    b. Restrictions on transfers.

    c. Little or no dividends or partnership payout.

    d. Little or no prospect of either public offering or sale of company.

31. Bill's Investment Company acquired a block of restricted stock on January 1, 1995. Based on when the restricted stock was acquired, when can this company enter into a stock transaction to sell this stock?

    a. January 1, 1996.

    b. January 1, 1997.

    c. January 1, 1998.

32. Which of the following factors has contributed to the increase in the public stock market's liquidity and trading volume that has occurred since 1990?

    a. An increase to the maximum settlement period.

    b. A decrease of derivative securities on many more stocks.

    c. An increase of commissions.

    d. A reduction of the average spreads between the bid and asked prices.

33. In performing valuation services, the most common premiums and discounts encountered are control premiums, minority interest discounts, and discounts for lack of marketability. There are other types of discounts that are often required. Which of the following businesses would likely require the blockage discount?

    a. A company with a large percentage of publicly traded stock.

    b. A company who's Chief Operating Officer (COO) has resigned.

    c. A company that operates businesses in three distinctively different industries.

    d. A company that manufactures petroleum-based products.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

21. One factor that affects the degree of control that can be exercised by majority and minority interests is cumulative versus noncumulative voting. Of the following statements concerning voting for a company's board of directors by minority interests, which one is applicable for companies with a cumulative voting system? **(Page 274)**

    a. Minority interests cannot exercise any control over who is elected to the board of directors. [This answer is incorrect. Minority interests cannot exercise any control over who is elected to the board of directors in a company with *noncumulative* voting provisions.]

    b. Minority interests can cast votes for candidates to the board of directors if majority interests give their approval. [This answer is incorrect. Minority interests do *not* cast votes for candidates to the board of directors as a result of approval by majority interests under either cumulative or noncumulative voting provisions.]

    c. Minority interests are automatically given 10% of the vote in electing the board of directors. [This answer is incorrect. Minority interests are not granted an automatic 10% of the vote in electing the board of directors under any circumstances since all shareholders are given votes in direct proportion to their ownership percentages.]

    d. Minority interests are allowed the same percentage of votes as their percentage of stock ownership. [This answer is correct. For companies with cumulative voting provisions, minority interests are afforded the same percentage of votes for a company's board of directors as their percentage of stock ownership in the company. This allows minority shareholders to gain some representation on the company's board of directors.]

22. Federal and state regulations can have an impact on the degree of control that a company's owners would normally be able to exercise. As such, a company in which of the following industries would be the easiest to sell? **(Page 274)**

    a. Trinity Bank. [This answer is incorrect. A company in the banking industry operates under federal banking regulations and affects the degree of control that the bank's owners have. As a result, selling a bank falling under federal regulations when being sold would inhibit the bank's owners control over the sale, thereby making the sale more difficult.]

    b. Red River Insurance Company. [This answer is incorrect. Insurance companies fall under state insurance board regulations that affects sales as well as other areas of operations making them more difficult to sell and limiting the owners control rights.]

    c. Baxter's Books and Periodicals. [This answer is correct. A book company does not fall under federal or state regulations and, therefore, would be the easiest to sell. Regulated industries cannot usually be sold as freely as nonregulated companies.]

    d. Southwestern Electric Service Company. [This answer is incorrect. Public utilities are controlled by state regulations that cover operations and sales and acquisitions making the sale of a public utility more difficult.]

23. Which of the following statements is correct regarding the effects of distribution of ownership? **(Page 275)**

    a. If each of three stockholders owns a one-third interest in a company, in some circumstances it is possible for one stockholder to exert complete control. [This answer is incorrect. It is not possible for one stockholder to exert complete control in this scenario because each stockholder owns the same percentage interest in the company.]

    b. If each of three stockholders, A, B and C each own a one-third interest in a company, no one stockholder can be put in a relatively inferior position to the other two stockholders. [This answer is incorrect. If stockholders A, B and C each own a one-third interest in a company, stockholder C can be put in a relatively inferior position if stockholders A and B have close ties with each other, excluding stockholder C.]

    c. The sum of the values of the individual owners is usually less than what the entire company could be sold for to a single buyer. [This answer is correct. The sum of the values of the individual owners is usually less than what the entire company could be sold for to a single buyer since equal individual interests are normally worth less than a prorate portion of what the entire company is worth.]

    d. The percentage discount from pro rata value for each interest will generally be higher than that for a minority interest that has absolutely no control. [This answer is incorrect. The percentage discount from pro rata value for each interest will generally be *lower* than that for a minority interest with absolutely no control because the amount of stock owned compared to other shareholders is important in determining control issues.]

24. A control premium should be added in which of the following circumstances? **(Page 275)**

    a. A shareholder with a 50% interest in a closely held business. [This answer is incorrect. A 50% interest is neither a minority interest nor a controlling interest and would therefore not call for a control premium to be added.]

    b. A shareholder with an operating interest (but not an absolute controlling interest). [This answer is incorrect. A shareholder with an operating interest but not a controlling interest would not qualify to have a control premium added to the valuation calculation.]

    c. A shareholder with a controlling interest. [This answer is correct. A shareholder with a controlling interest, by definition, would necessitate that a control premium be added to the valuation.]

25. Which of the following factors may *increase or decrease* a minority interest discount or a control premium? **(Page 275)**

    a. The presence of sufficient minority interest votes to elect or have significant input on electing one or more directors in a company with cumulative voting. [This answer is incorrect. If there are enough minority interest votes to elect or significantly impact the election of one or more directors in a company with cumulative voting, value is added and results in a decrease in a minority interest discount.]

    b. The distribution of two shares to a minority interest when 49 others own two shares each. [This answer is correct. The distribution of two shares to a minority interest when 49 other minority interests own two shares each prevents the minority interest that received two shares from exerting any control thereby reducing that minority interest's value and thus increasing the minority interest discount that should be applied.]

    c. The presence of adequate minority interest votes to block certain actions within the bounds of state statutes and/or articles of incorporation. [This answer is incorrect. Value is increased when sufficient minority interest votes are present to block certain actions and results in a decrease to the minority interest discount.]

    d. The presence of various state statutes granting certain rights to minority stockholders. [This answer is incorrect. If certain rights are granted to minority stockholders due to various state statutes, value is increased and the minority interest discount is decreased.]

26. In 2008, the average percent of control premium paid over the market price for a buyout of seller's stock five business days prior to the announcement date was: **(Page 276)**

   a. 30.7%. [This answer is incorrect. The average percent of control premium paid over the market price for a buyout of seller's stock five business days prior to the announcement date in *2004* was 30.7%.]

   b. 56.5%. [This answer is correct. In 2008, the average percent of control premium paid over the market price for a buyout of seller' stock five business days prior to the announcement date was *56.5*%.]

   c. 34.5%. [This answer is incorrect. 34.5% was the average percent of control premium paid over the market price for a buyout of seller's stock five business days prior to the announcement date in *2005*.]

   d. 35.7%. [This answer is incorrect. In *1997*, 35.7% was the average percent of control premium paid over the market price for a buyout of seller's stock five business days prior to the announcement date.]

27. No control premium is necessary for a firm that is well-run if a change in operations results in which of the following? **(Page 278)**

   a. An increase in cash flows. [This answer is incorrect. If a change in the way a business that is well-run is operated results in a increase in cash flows, a control premium may be applicable and would be based on that increase.]

   b. An increase in the expected growth rate. [This answer is incorrect. An increase in the expected growth rate could result in a control premium being applied to a well-run business.]

   c. An increase in the discount rate. [This answer is correct. A *reduction* in the discount rate, not an increase, would have an effect on the amount of the control premium, if any, that is applied to a well-run business.]

28. The valuation consultant must make two important decisions on each engagement regarding control premiums/minority discounts. Which of the following is **not** one of those two decisions? **(Page 279)**

   a. Is a control premium or minority discount needed? [This answer is incorrect. The first decision the valuation consultant must make on each engagement regarding control premiums/minority discounts is whether either or both are needed because, if a change in operations causes an increase in cashflows, an increase in expected growth rate, or a reduction in the discount rate, a control premium may apply. Also, if the client needs to determine the value of a minority interest, a minority discount usually should be subtracted.]

   b. Are prerogatives of control available to equity holders? [This answer is correct. The consultant's decision regarding prerogatives of control that are available to equity holders is a potential adjustment that would affect the *size* of a control premium but not whether a control premium is actually needed.]

   c. How much of a premium or discount is appropriate? [This answer is incorrect. The second decision that must be made by the valuation consultant is how much control premium or minority discount is appropriate for the engagement to determine whether a control premium should be added, or a minority discount subtracted.]

29. If the type of valuation engagement is the value of a minority shareholder's interest in an oppression case, the ownership interest normally being valued: **(Page 280)**

    a. Depends on the degree of control that the partner can exercise. [This answer is incorrect. The ownership interest normally being valued depends on the degree of control that the partner can exercise if the type of valuation engagement is the value of an individual partner's interest in a partnership that is made up of two partners, each owning 50%.]

    b. Depends on the degree of control that the partner can exercise, but probably a minority interest. This answer is incorrect. If the type of valuation engagement is the value of an individual partner's interest in a partnership that is made up of three partners, each owning 33 1/3%, the ownership interest normally being valued depends on the degree of control that the partner can exercise, but probably a minority interest.]

    c. Is usually a prorata share of the company's total value. [This answer is correct. The ownership interest normally being valued, if the type of valuation engagement is the value of a minority shareholder's interest in an oppression case, is usually a prorata share of the company's total value since, in many cases, dissolution of the corporation may occur, resulting in the sale or distribution of company assets.]

    d. Varies from state to state depending on statutory and case law. [This answer is incorrect. The ownership interest normally being valued varies from state to state depending on statutory and case law if the type of valuation engagement is the value of stock under a dissenting stockholder suit.]

30. Which of the following factors may *decrease* discount for lack of marketability? **(Page 282)**

    a. Limited market available that may be interested in purchasing shares. [This answer is correct. This is one factor that may decrease discount for lack of marketability. Other factors include the "put" option, imminent public offering or sale of company, and high dividend or partnership payouts.]

    b. Restrictions on transfers. [This answer is incorrect. Restrictions on transfers are factors that may *increase* discount for lack of marketability since this a factor that investors value in a company.]

    c. Little or no dividends or partnership payout. [This answer is incorrect. Little or no dividends or partnership payout is a factor that may *increase* discount for lack of marketability since investors value payouts and dividends from companies.]

    d. Little or no prospect of either public offering or sale of company. [This answer is incorrect. This is a factor that may *increase* discount for lack of marketability due to little or no prospect of either public offering or sale of the company since this probably means a limit on growth of the company.]

31. Bill's Investment Company acquired a block of restricted stock on January 1, 1995. Based on when the restricted stock was acquired, when can this company enter into a stock transaction to sell this stock? **(Page 283)**

    a. January 1, 1996. [This answer is incorrect. The minimum holding period for restricted stock acquired in 1995 is greater than one year as governed by the SEC Rule 144, which specifies how long restricted stock must be held.]

    b. January 1, 1997. [This answer is correct. Since the holding period for restricted stock acquired in 1995 is two years, Bill's Investment Company can enter into a stock transaction to sell the restricted stock on January 1, 1997.]

    c. January 1, 1998. [This answer is incorrect. The minimum holding period for restricted stock acquired in 1995 is less than three years as governed by the SEC Rule 144, which specifies how long restricted stock must be held.]

32. Which of the following factors has contributed to the increase in the public stock market's liquidity and trading volume that has occurred since 1990? **(Page 283)**

   a. An increase to the maximum settlement period. [This answer is incorrect. One of the factors that have contributed to increased activity and liquidity in the public stock market since 1990 is a *reduction* of the time between a transaction's execution and its cash settlement since the process can move much faster, more transactions take place.]

   b. A decrease of derivative securities on many more stocks. [This answer is incorrect. An *increase* of derivative securities including puts and calls on a greater number of stocks has contributed to the increase in liquidity and trading volume in the stock market since 1990.]

   c. An increase of commissions. [This answer is incorrect. The stock market's trading volume and liquidity have increased because of commissions being *reduced* as a result of the advent of discount brokers.]

   d. A reduction of the average spreads between the bid and asked prices. [This answer is correct. The stock market has experienced increased activity and liquidity due to a reduction of the average spreads between the bid and asked prices. This has occurred due to the implementation of the decimal quotation system that has replaced the fractional quotation system.]

33. In performing valuation services, the most common premiums and discounts encountered are control premiums, minority interest discounts, and discounts for lack of marketability. There are other types of discounts that are often required. Which of the following businesses would likely require the blockage discount? **(Page 293)**

   a. A company with a large percentage of publicly traded stock. [This answer is correct. A blockage discount is often applied to a company with large blocks of publicly traded stock. If the trading volume is large compared to normal trading volume levels, the seller may be required to accept a discount from the current market quote to encourage a block trader to take the entire position.]

   b. A company who's Chief Operating Officer (COO) has resigned. [This answer is incorrect. A key person discount is applied if the value of a company is reduced as a result of the loss of a key person such as the COO who has been intimately involved in the operation of the business.]

   c. A company that operates businesses in three distinctively different industries. [This answer is incorrect. When a company has two or more widely different operations, it may be appropriate to apply a portfolio discount since a buyer who may want to purchase a company in one industry, may be likely to pay less for a company that also has other operations the buyer is not as interested in purchasing.]

   d. A company that manufactures petroleum-based products. [This answer is incorrect. A company that manufactures petroleum-based products may be subject to liability claims for environmental damages and, thus, would be subject to having an environmental liability discount applied.]

OBTAINING A REPRESENTATION LETTER

In a valuation engagement, a great deal of reliance is placed on documents furnished and oral representations made by the company being valued. The valuation practitioner does not attempt to substantiate the information provided by the company; however, any information that appears questionable or inconsistent should usually be investigated. A valuation is not intended to provide the assurance of an audit or review of financial statements. Although not a requirement, it is believed that it is desirable to obtain a representation letter on many valuation engagements.

Reasons for Obtaining a Representation Letter

When obtained, a representation letter serves two important functions in a valuation engagement:

a. It makes the management of the company being valued aware of its responsibility for providing accurate and reliable information. Even if the consultant prepares historical financial statements, forecasts of future operations, or other documents used in the valuation process, the company is still primarily responsible for the accuracy and completeness of the information. Representation letters may also serve to obtain management disclosure of facts relevant to the valuation, such as conflicts of interest (or the absence thereof) between management and a potential buyer (or between the owner and employees) that could potentially affect the business valuation.

b. It documents management's acknowledgement of the responsibilities and disclosures discussed above.

The client should be informed of the need for a representation letter in the engagement letter. This should also be communicated to the management of the company being valued (either orally or in writing) if this company is not the same as the client. A signed representation letter should be obtained before the final valuation report is issued, or before the oral report is delivered in the event a written report is not required. An effective approach is to have the letter signed at the conference with the client when the preliminary draft of the valuation report is discussed.

What If a Representation Letter Cannot Be Obtained?

In some circumstances, a representation letter cannot be obtained from the company being valued. For example, in many litigation engagements, the valuation consultant is in an adversarial relationship with the owner of the company being valued. In these circumstances, the valuation report should contain a caveat on the reliability of the financial and other information obtained from the company being valued.

WORKPAPER DOCUMENTATION, PERFORMING THE APPROPRIATE WORKPAPER REVIEWS, AND RESOLVING PROFESSIONAL DISPUTES

Workpaper Documentation

An engagement's workpapers serve as the principal documentation of the engagement, including information obtained, analysis and procedures performed, assumptions used, methods and approaches considered and used, and other decisions made in establishing the conclusion of value. SSVS No. 1 states that the quantity and type of documentation are matters of professional judgment. However, the Statement provides the following list of potential documentation items:

a. Assumptions and limiting conditions.

b. Any restriction or limitation on the scope of the valuation analyst's work or the data available for analysis.

c. Information gathered and analyzed to obtain an understanding of matters that may affect the value of the subject interest.

d. Basis for using any valuation assumption during the valuation engagement.

e. Valuation approaches and methods considered.

f. Valuation approaches and methods used, including the rationale and support for their use.

g. Sources of data and the process used to apply any rule of thumb.

h. Information relating to subsequent events considered by the valuation analyst, if applicable.

i. Other documentation considered relevant to the engagement by the valuation analyst.

SSVS No. 1 (VS 100.45) does not specify a mandatory retention period for valuation engagement workpapers, stating that the "valuation analyst should retain the documentation for a period of time sufficient to meet the needs of applicable legal, regulatory, or other professional requirements for records retention."

Engagement Review

Before the draft valuation report is discussed with the client, all workpapers should be reviewed by engagement personnel. This review should be performed to determine the following:

a. The engagement was adequately planned and properly staffed.

b. The proper valuation methods were selected given the unique aspects of the company being valued and the purpose of the engagement.

c. The engagement program and workpapers show that the program steps were performed and the work is complete. In some cases, mere initialing of a program step may be sufficient indication that a step was performed; in other cases, a notation, explanation, document, analysis, etc. in the workpapers may be necessary.

d. The workpapers provide evidence that sufficient relevant data were obtained to fulfill the engagement objectives.

e. All applicable professional standards have been adhered to.

In addition to these matters, firm policy might call for the reviewer to consider compliance with administrative policies such as budgeting and billing, staff evaluations, etc.

Performing the Engagement Review. The engagement review should cover both the workpapers and the valuation report. The engagement review may be performed on a detailed basis by the consultant in charge of the fieldwork. When this occurs, a less-detailed, higher-level review is usually performed by the engagement partner, president of the consulting company, or whoever else is charged with the ultimate responsibility for the successful completion of the engagement. In some cases, the engagement partner, company president, or other responsible party may be the consultant in charge of the fieldwork. In such cases, this person would perform the detailed review, and there may or may not be an independent review by another partner or officer, depending on firm policy.

If the consulting firm is large enough, and has a policy requiring independent reviews of all business valuation engagements, the responsibility for conducting such independent reviews may be assigned, on a rotating basis, to any qualified partner, officer, manager, etc. who did not participate in the engagement. Many firms are not large enough to warrant an independent engagement review for every valuation engagement. Such firms may choose to have independent reviews performed only on selected engagements.

Resolving Professional Disputes

Professional disputes sometimes arise between members of a valuation team or between the valuation team and the designated reviewer. Such disputes may involve the selection of valuation methods, the application of those methods, the interpretation of valuation results, reporting issues, or a wide range of other issues. Such disputes can sometimes be resolved through adequate library research or by obtaining the opinion of either in-house or outside specialists.

PERFORMING ADDITIONAL ADMINISTRATIVE MATTERS DURING THE WRAP-UP PHASE

By this point in the engagement process, most of the hard work has been done. The consultant has selected and completed the appropriate valuation methods. The results of the various methods have been used to select a single value estimate or a range of estimated values. The resulting value or range of values has been modified as necessary for the unique aspects of the particular engagement. This adjusted value estimate has been tested and found to be reasonable (or appropriately modified). The workpapers have been reviewed, and all issues have been resolved to the satisfaction of the engagement partner or appropriate officer of the firm. The report has even been written and reviewed by the appropriate parties (although this process is not covered in this course). No job is ever complete, however, until all of the paperwork has been finished. Although the specific procedures to be performed during the wrap-up phase will vary from one firm to the next, the final administrative procedures that are normally performed include the following:

a. Determine that all review points and open items have been cleared. Most firms destroy such points after they have been cleared.

b. Sign the report or transmittal letter (usually performed by the engagement partner or the president of the firm).

c. File the completed workpapers.

d. Evaluate the staff's performance.

PROCEDURES FOR INDUSTRY ACCOUNTANTS AND ANALYSTS

The wrap-up procedures discussed up to this point are those that are usually performed by independent valuation consultants. As shown in Exhibit 1-1, however, most of these same procedures should also be performed by industry accountants and analysts. Many of the procedures discussed thus far should be performed and documented in exactly the same way regardless of whether the valuation is performed by an independent consultant or by an industry accountant or analyst. The process of determining a final value estimate, normally involves the following three steps:

a. Weighting of values determined using two or more methods.

b. Applying "sanity checks" to the final value estimate.

c. Applying premiums and/or discounts.

These procedures should be considered in all valuation situations and should usually be performed by both independent valuation consultants and industry analysts.

Some Wrap-up Procedures Are Different from Those Previously Discussed

Some of the procedures listed in Exhibit 1-1, however, have been adapted for the unique nature of the valuation engagements typically performed by the in-house accountant/analyst. The procedures that are somewhat different from those previously discussed relate to the following:

a. Representation letters.

b. Reviews of workpapers and report drafts.

c. Discussing engagement findings with the appropriate level of management.

Representation Letters. Representation letters can be just as important to industry accountants/analysts whenever they perform valuations of other companies. Many times, however, industry analysts perform valuations of their own companies. Accountants/analysts do not normally obtain representation letters from their own employers. They should, however, ensure that all financial and other information used during the valuation process is accurate and that all assumptions that were made regarding future operations are reasonable and achievable.

Reviews of Workpapers and Report Drafts. The various levels of engagement review that should be performed during the wrap-up phase of a valuation engagement should normally be performed on all engagements whether conducted by independent consultants or industry personnel. Industry analysts should have their work reviewed by a member of the company's management who has been trained in business valuation principles and has some experience in this field. Unfortunately, this is not always possible. If the company has no experienced valuators to perform the review, the accountant/analyst should consider engaging an outside consultant to perform the required review.

Discussing the Valuation Results with the Appropriate Level of Management. The results of a valuation engagement should normally be communicated to the client at the end of the project. This procedure should be conducted whether or not a formal written report is to be issued. For an industry analyst, the "client" is usually the analyst's own employer. It is therefore easy for the industry analyst to keep the appropriate members of management up-to-date throughout the valuation process. Independent valuation consultants usually schedule a formal meeting with the client after the final value estimate has been determined to discuss the results of the engagement. Many industry analysts prefer to have periodic status meetings with the company's management (often informal) throughout the engagement. These meetings sometimes take the place of a formal written report.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

34. If a representation letter cannot be obtained from the company being valued, the valuation consultant should:

    a. Postpone the valuation until a representation letter can be obtained from the company being valued.

    b. Compare the financial information obtained to other similar valuation exercises.

    c. Include a statement in the valuation report concerning the reliability of information obtained.

35. An engagement review can be performed without covering which of the following elements?

    a. Workpapers.

    b. Independent review.

    c. Valuation report.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

34. If a representation letter cannot be obtained from the company being valued, the valuation consultant should: **(Page 303)**

    a. Postpone the valuation until a representation letter can be obtained from the company being valued. [This answer is incorrect. Postponing the valuation is a possible option but it is not necessary due to the inability to obtain a representation letter. Acquiring the representation letter may not be possible in all situations.]

    b. Compare the financial information obtained to other similar valuation exercises. [This answer is incorrect. The financial information obtained from other similar valuations has no bearing on the valuation exercise currently being conducted and should not be considered by the consultant.]

    c. Include a statement in the valuation report concerning the reliability of information obtained. [This answer is correct. If the valuation consultant cannot obtain a representation letter from the company being valued, the valuation report should indicate that the reliability of the information obtained from the company may be impacted so that it has been disclosed to the reader of the valuation report.]

35. An engagement review can be performed without covering which of the following elements? **(Page 304)**

    a. Workpapers. [This answer is incorrect. An engagement review should always include the workpapers generated during the valuation engagement.]

    b. Independent review. [This answer is correct. An independent review may or may not be performed as part of an engagement review. In some cases, however, large consulting firms may require that independent reviews be conducted of all valuation engagements.]

    c. Valuation report. [This answer is incorrect. The valuation report is a vital element of the valuation engagement and should always be included in the engagement review.]

EXAMINATION FOR CPE CREDIT

Lesson 2 (VALTG103)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

13. A valuation consultant is using the mathematical weighting technique to weight the values on a valuation engagement for ABC Drywall Corporation and has determined that the excess earnings method is the most appropriate valuation method to use. The consultant has computed a value of $2,225,000 and a percentage weight of 65% under the excess earnings method, a value of $2,515,000 and a percentage weight of 20% under the discounted future cash flow method, and a value of $2,675,000 and a percentage weight of 15% under the capitalized earnings method. What is the weighted average value estimate of ABC Drywall Corporation based on the above computations?

    a. $2,275,250.

    b. $2,325,000.

    c. $2,350,500.

    d. $2,375,750.

14. Revenue Ruling 59-60 takes which of the following positions regarding the use of the mathematical weighting technique and the subjective weighting technique to weight various values to determine an overall final value estimate?

    a. The mathematical weighting technique is always preferred over the subjective weighting technique.

    b. The mathematical weighting technique is generally preferred over the subjective weighting technique.

    c. The mathematical weighting and subjective weighting techniques are viewed as equal methods by the IRS.

    d. The subjective weighting technique is preferred by the IRS to weight values used to determine an overall final value estimate.

15. Jack wants to test the reasonableness of the value estimate he has created. Which of the following is **not** one of the typical "sanity checks" that he can use for this purpose?

    a. Test the reasonableness of the value using the perspective of an adversary.

    b. Compare ratios of the company being valued to ratios of the same company from a prior valuation.

    c. Test the reasonableness of the value from a buyer's perspective.

    d. Reassess each valuation method's math and logic.

16. Tim has been notified that he must appear in court to support his value estimate. Which of the following actions would be of greatest benefit to Tim in defending his estimate?

    a. Illustrating the payback period computation.

    b. Comparing the company being valued to other companies.

    c. Testing the reasonableness of the value estimate from a buyer's perspective.

    d. Testing the reasonableness of the value estimate from the perspective of an adversary.

17. Joan has determined a weighted average value estimate and needs to apply any required premiums or discounts to the estimated value. Joan will be able to determine what premiums or discounts to apply based on a number of factors. Which of the following is **not** one of those factors?

    a. Unique ownership characteristics of the subject interest.

    b. The standard of value the consultant is attempting to identify.

    c. Required premiums or discounts applied in prior valuations.

    d. Characteristics of the previously determined weighted average value estimate.

18. Compared to a proportionate share of the value of the total entity, how much are minority interests usually worth?

    a. Significantly more than.

    b. Slightly more than.

    c. The same as.

    d. Less than.

19. Joseph Smith is a controlling shareholder of Electronic Widgets Corporation. As a result, he is able to control many actions. In spite of being a controlling shareholder, which action listed below would Mr. Smith be unable to control?

    a. Appoint or change operational management.

    b. Determine how all shareholders will vote for board of directors.

    c. Set operational and strategic policy.

    d. Select which suppliers will be awarded contracts.

20. Which of the following actions is a significant right afforded to a minority shareholder?

    a. Cast critical swing votes.

    b. Negotiate mergers and acquisitions.

    c. Sell or acquire treasury shares.

    d. Select and enter into joint ventures.

21. Alan is a majority owner of Sand and Gravel Co. and resides in a state that requires a super majority of minority and majority owners to approve a recapitalization. Alan is voting for recapitalization. A minimum of what percent of majority approval must be obtained in order for recapitalization to occur?

    a. 60%.

    b. Two-thirds.

    c. Three-fourths.

    d. 80%.

22. Susan is minority shareholder in City Glass Works. In order to be able to have the power of a "swing vote" in her company's major decisions, Susan must own a minimum of what percent of City Glass Works stock?

    a. 20%.

    b. 10%.

    c. 3%.

    d. 2%.

23. Each year, a controlling interest is purchased in a few hundred public companies through thousands of daily minority interest transactions. In approximately what percent of the transactions were the prices paid for the stock of these companies the same as the market price the stock previously traded at as a minority interest?

    a. 10%.

    b. 12%.

    c. 15%.

    d. 20%.

24. What percent of public company takeovers occur at discounts from their previous public trading prices?

    a. 5% to 7%.

    b. 7% to 10%.

    c. More than 10%.

    d. More than 15%.

25. There are various potential adjustments that would affect the size of the control premium. Which of the following listed items is **not** a potential adjustment that would affect the size of the control premium?

    a. The block size.

    b. Estimated dividends.

    c. The amount of leverage.

    d. Equity holders preferences of control.

26. If the ownership interest normally being valued is a controlling interest, the type of valuation engagement is:

    a. The value of a general partner's interest in a limited partnership.

    b. The value of stock for estate tax purposes.

    c. Sole proprietorship being valued as part of a divorce proceeding.

    d. The value of stock for gift taxes, charitable contributions, stock repurchases, etc.

27. In some cases, a large minority interest discount is required to convert a control value determined using guideline merger and acquisition transaction data to a minority value that has no negative control powers. A discount percent of which of the following falls outside the usual percent range of a prorate share of the company's estimated value?

    a. 40%.

    b. 30%.

    c. 25%.

    d. 15%.

28. Regarding public stock market transactions, the maximum settlement period between a transaction's execution and its cash settlement is a maximum of:

    a. Five days.

    b. Four days.

    c. Three days.

    d. Two days.

29. Subsequent to the expiration of Rule 144 restrictions, Jeremy, a holder of 16% of stock, may require up to how many years to sell his entire block of stock in the public market?

    a. Up to 12 quarters (3 years).

    b. Up to 16 quarters (4 years).

    c. Up to 20 quarters (5 years).

    d. Up to 32 quarters (8 years).

30. If there are no special circumstances that would tend to reduce the discount for lack of marketability, the marketability discount for a closely held stock compared with a publicly traded counterpart should be a minimum of:

    a. 25%.

    b. 30%.

    c. 35%.

    d. 40%.

31. Discounts associated with the lack of voting rights associated with an interest being valued depend on all of the following **except**:

    a. The block of stock.

    b. The stock trading volume.

    c. The dividends paid.

    d. The distribution of ownership.

32. Studies have found that, in cases where there are differences between voting and nonvoting publicly traded minority shares, the effect on value was normally no greater than:

    a. 3%.

    b. 5%.

    c. 7%.

    d. 9%.

33. When a consulting firm performs an independent review of a valuation engagement, which of the following individuals would be unqualified to perform the review?

    a. A partner who did not participate in the engagement.

    b. An officer who did not participate in the engagement.

    c. A manager who did not participate in the engagement.

    d. A consultant who played only a minor role in the engagement.

34. Of the following individuals, which member of the consulting firm performing the valuation engagement usually signs the report or transmittal letter during the wrap-up phase of the engagement?

    a. Any member of the valuation team performing the engagement.

    b. The principal valuation consultant performing the engagement.

    c. The manager of the principal valuation consultant performing the engagement.

    d. The engagement partner or the president of the firm performing the engagement.

35. The process of determining a final value estimate normally involves three steps. These steps are (a) the weighting of values using at least two valuation methods, (b) applying "sanity checks" to the final value estimate, and (3) applying applicable premiums and/or discounts. These steps should be taken into account in all valuations and normally should be performed by which of the following:

    a. Independent valuation consultants.

    b. Industry analysts.

    c. Both independent valuation consultants and industry analysts.

    d. Performing these steps is purely discretionary, and not required.

GLOSSARY

Acquisition: When one company (A) acquires a majority share in the voting stock of another enterprise (B) but both entities continue their legal existence: A + B = A + B. It is an affiliation. Each company retains its legal existence in a parent-subsidiary relationship. An acquisition is accounted for as a purchase and is usually reported by consolidated financial statements. Prior to June 30, 2001, acquisitions could also be accounted for as a pooling of interests.

Attest services: Services that have been performed and are affirmed as true. One may attest by signing one's name as a witness to the execution of a document; or bear witness to.

Control premium: An amount paid to gain enough ownership to set policies, direct operations, and make decisions for a business.

Minority interest discount: A discount for lack of control applicable to a minority interest, or an ownership interest less than 50% of the voting interest in a business enterprise.

Minority shareholder: A shareholder who, in the aggregate, owns less than half the shares in a corporation.

Payback period: In capital budgeting, the length of time needed to recoup the cost of a capital investment. The payback period is the ratio of the initial investment (cash outlay) to the annual cash inflows for the recovery period.

Perquisites: Special benefits for executives that are usually non-cash items.

Price/earnings ratio: The price of a stock divided by its earnings per share, also known as the multiple. The price/earnings ratio may either use the reported earnings from the latest year or employ an analyst's forecast of next year's earnings.

Price/net cash flow ratio: A measure of the market's expectations of a firm's future financial health. Because this measure deals with cash flow, the effects of depreciation and other non-cash factors are removed. Similar to the price/earnings ratio, this measures provides an indication of relative value.

Retainer: A percentage of the quoted fee that is paid to the consultant at the outset of the engagement.

Sanity check: A basic test to quickly evaluate the validity of a claim or calculation.

Sole proprietorship: A business or financial venture that is carried on by a single person and is not a trust or corporation.

Transaction: Any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer.

Valuation: Estimated worth or price.

Valuation Engagement: A valuation engagement involves arriving at an opinion regarding the estimated value of an ownership interest in a business entity (company) as of a given point in time. The ownership interest valued may be the company's common equity or its total capital, which includes both interest-bearing debt and equity.

Value: The worth of all the rights arising from ownership.

Value Estimates: The process of re-determining the value of a company for tax purposes.

Value Multiples: Market-derived factors used to determine the value of a business or ownership interest (or fractional interest therein).

INDEX

V

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Business Valuations—Course 1—Overview of a Business Valuation Engagement Including Valuation Terms and Methodology (VALTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
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   Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of $79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $336 (a 15% discount on all five courses or more).

4. To receive CPE credit, completed answer sheets must be postmarked by **March 31, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional $24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.

5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy for your records.

6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to Business Valuations—Course 3—Pre-engagement Procedures and Wrapping Up the Engagement (VALTG103)

Price $79

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this not like this .

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	10.	○	○	○	○	19.	○	○	○	○	28.	○	○	○	○
2.	○	○	○	○	11.	○	○	○	○	20.	○	○	○	○	29.	○	○	○	○
3.	○	○	○	○	12.	○	○	○	○	21.	○	○	○	○	30.	○	○	○	○
4.	○	○	○	○	13.	○	○	○	○	22.	○	○	○	○	31.	○	○	○	○
5.	○	○	○	○	14.	○	○	○	○	23.	○	○	○	○	32.	○	○	○	○
6.	○	○	○	○	15.	○	○	○	○	24.	○	○	○	○	33.	○	○	○	○
7.	○	○	○	○	16.	○	○	○	○	25.	○	○	○	○	34.	○	○	○	○
8.	○	○	○	○	17.	○	○	○	○	26.	○	○	○	○	35.	○	○	○	○
9.	○	○	○	○	18.	○	○	○	○	27.	○	○	○	○					

You may complete the exam online by logging onto our online grading system at **OnlineGrading.Thomson.com**, or you may fax completed Examination for CPE Credit Answer Sheet and Course Evaluation to Thomson Reuters at (817) 252-4021, along with your credit card information.

Expiration Date: March 31, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Business Valuations—Course 3—Pre-engagement Procedures and Wrapping Up the Engagement

Course Acronym: VALTG103

Your Name (optional): ____________________ Date: ____________

Email: ____________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this ● not like this ⃠ ⊗ ✓.

Satisfaction Level:	Low (1) . . . to . . . High (10) 1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course material?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○
8. If applicable, was the technological equipment appropriate?	○	○	○	○	○	○	○	○	○	○
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	○	○	○	○	○	○	○	○	○	○
10. If applicable, how well did the audio/visuals contribute to the program?	○	○	○	○	○	○	○	○	○	○

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
(Please print legibly):

Additional Comments:

1. What did you find **most** helpful?
2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? ________
5. How many employees are in your company? ________
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No** ○ ○

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