

SIXTH  
EDITION

EXCERPT FROM

# UNDERSTANDING BUSINESS VALUATION

Gary R. Trugman, CPA/ABV, FASA, MVS

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What It's Worth



# **UNDERSTANDING BUSINESS VALUATION**

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Gary R. Trugman, CPA/ABV, FASA, MVS



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111 SW Columbia Street, Suite 750, Portland, OR 97201

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## **What It's Worth**

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*Dedication*

*To Linda, my partner in life and business*

*Even though you have retired from direct client work, you continue to make my stuff better. I would not want to keep going if it weren't for you. I am still the luckiest person alive because of you!*



# Preface

---

OK, so this is really the sixth edition. This journey started a long time ago, in 1998, when the AICPA published the first edition of this book. Although that organization got out of the publishing business, this has been so much fun that I was lucky enough to contact my good friends, Lucretia and David, at Business Valuation Resources, and they never even flinched about continuing with this book. I am so grateful to them for agreeing to do this and even more for being my friends.

I have been saying this with every new edition: This is just what we need: another book on business valuation. Years ago, there were only a few books on this topic—mostly finance texts. It has become nearly impossible to read everything that is being published in this field unless you have no life. Wow, I just looked in the mirror and realized that I read everything that I can and probably have no life. Now I am depressed. Anyway, for those of you with a limited life, there are definitely some books on this topic that you cannot avoid reading. The problem is that I can no longer list only two or three books that are my favorites because so many good books on this topic have been published over the last decade that the list has grown too much. I have included many references to these books throughout this edition, so you should have no problem figuring out which ones I like.

I wrote this sixth edition for several reasons: First, I have too much time on my hands (not really, but I need the royalties) and, second, I find that there is still a need for this stuff to be explained in plain, uncomplicated English in a manner that helps a valuation analyst apply valuation theory to real-world practice. Please don't get me wrong—I am not claiming to know everything! In fact, I keep finding out that the smarter I get, the less I realize I know. But I have come to accept that there are things in this world we may never understand.

The purpose of this book is to provide some guidance on the theory, as well as on how to apply the theory in a meaningful fashion. Whether I'm successful is up to you. First, some basic ground rules and general information:

1. To get the most out of this book, you must read it, not only in its entirety, but also in the sequence in which it is written. Don't go to the chapter on discount rates without reading the earlier sections of the book. Otherwise, you may feel like you walked into the middle of a movie. It is also important to make sure that you read the exhibits and the appendixes at the time they are referenced. The exhibits have been included as an integral part of this book. If you skip over them or go back to them later, you may miss a valuable point I am trying to make. Most of the exhibits come from actual assignments that I am including to demonstrate the point that I am trying to explain to you. In some cases, I took an author's liberty to update a date here or there, so please do not get excited if the dates seem weird. For example, I may have a report section for a valuation in 2020, and I do not discuss the pandemic anywhere in the exhibit. I promise you that, in the real world, I discuss this in almost every current valuation that it has impacted.
2. In general, I do not think in terms of complex mathematical formulas. My mind does not work that way. I do not like equations with lots of parentheses, nor do I like formulas that have Greek letters in them. I love the Greek people, I love Greek food, but I do not like Greek letters in formulas. Therefore, if you really enjoy mathematical equations, this book is not for you. However, if you are a student or a young staff person and your professor or your boss has chosen this book for you, you're stuck. I am sorry. Believe it or not, my intentions are honorable because I want readers to understand this stuff! In certain sections of this book, you will see some mathematical formulas. You will even see some Greek letters. It is not for a fraternity or sorority. The notation may be different from that found in other books. Concentrate on the concepts, not the letters and symbols used.
3. I am a firm believer in the keep it simple, stupid (KISS) theory. This does not mean, however, that business valuations are simple, nor are they stupid. Quite the contrary! If you are at all like me, after reading this book, you will never feel comfortable doing or relying on a business valuation again. This can be an extremely subjective process. For the accountants reading this book, this is not at all like accounting in which the debits have to equal the credits. What you will learn is that there is no black and white answer. There are 1 million shades of gray. To quote a good friend of mine, the answer to most questions that are asked about business valuation is, "It depends."

4. The concepts discussed in this book cannot be read and applied as if they were in a vacuum. Many of the items discussed will directly or indirectly affect other parts of the valuation process. You must be a big-picture type of person.
  5. In some of the exhibits, I cheated. They were so good in the last edition that I decided to merely update the dates to freshen them up. If I messed up because the interest rates are not from that exact period, please forgive me. I am much more concerned with the concepts than the dates. In some instances in which I felt the exhibit was date-sensitive, I did not change the dates. In some cases, I also changed the location of the business to protect the confidentiality of the client, so here, too, if it is a little inconsistent, please forgive me.
  6. This book is not intended to present every alternative to every situation. Just because I have included something in this book, please do not rely solely on my writings. There may be facts and circumstances that could negate my opinion. You will find that there is no substitute for common sense in this process. You may even find that the facts of a particular assignment would cause my opinion to differ from my writing. If you are an attorney that wants to use this book against me in court, understand that there will be times where a different position may make sense.
  7. In some instances, I will be illustrating points from the negative. Several of the exhibits contain sections of actual reports critiquing someone else's work. Learn from what they may have done wrong.
  8. Please don't shoot the messenger! Throughout this book, several topics will be discussed that may be controversial. Some may not even have a definitive answer, but you must think about these issues when you do or use a business valuation.
  9. While reading this book, you will be exposed to my own form of humor. This is not intended to insult anyone but, rather, to add a little levity to what can be a very dry and technical topic. The very last thing that I ever want to do is insult anyone. If any of my comments make you feel uncomfortable, please accept my apology in advance. I promise that it was not intended to do so. Although business valuation tends to be extremely complex, let's have some fun while we learn. You just can't take this stuff too seriously, unless, of course, you have a midterm, a final exam, or an accreditation exam that will impact your livelihood.
  10. And, finally, in much of what I am trying to teach, I have made many of the mistakes that I am trying to prevent you from making. Someone once told me I will learn from my mistakes. By now, I should be a genius!
- With that stuff out of the way, please enjoy my attempt to explain what little I know about business valuation.



# Acknowledgments

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I must acknowledge several people for their contributions to this book. These people are not listed in any special order, but they are all very important to me. The first person is admittedly the most important. First and foremost, I have to thank Mark Zyla, CPA/ABV, CFA, ASA, who was the primary author of the chapters on valuations for financial reporting and intangibles. This is one of Mark's areas of expertise, and I was delighted to have him participate in this book. I also want to thank William Harris, ASA, CFA, from my firm, and my newest partner, for his significant contribution to updating many of the chapters with new content. Another individual who deserves special thanks is Brian Jones, also from my firm, who helped update many of the resource references through the book.

Another group of folks who deserve a thank you, and I apologize for not listing everyone by name, is the group of individuals who sent me various emails about either corrections that needed to be made to the book or items they felt needed additional clarification. You are the folks who bought this book and actually took the time to go through it and provided comments to make it better. I hope we fixed all the typos and clarifications.

And one more special thanks to a group of folks I could not have done without—the group at Business Valuation Resources who made this book what it is: Monique Nijhout-Rowe, David Solomon, Andy Dzamba, and anyone else that worked behind the scenes that I do not know. These folks had to put up with my writing style and the many mistakes I made throughout the manuscript. This group of folks is my dream team. I could not have done this without you all!

And, finally, one more thank you goes to two different groups of individuals. The first group consists of the many practitioners I have taught with over the years who have taught me so much. This list goes on and on and just keeps getting longer as I get older. You know who you are. The second group of individuals consists of all the students who have attended my classes, participants at past conferences who attended sessions where I spoke, and all my colleagues who have had such flattering things to say to me over the years about my teaching, my writings, and, particularly, the first five editions of this book. I have said this before, and I will repeat it here: It is hard to make me humble, but you have succeeded.



# Table of Contents

<b>Preface</b> .....	v	DEVELOPMENT .....	24
<b>Acknowledgments</b> .....	vii	THE VALUATION REPORT .....	35
<b>Introduction</b> .....	xv	EFFECTIVE DATE .....	45
DOWNLOADABLE MATERIALS .....	xvii	<b>VS SECTION 9100, VALUATION OF A BUSINESS, BUSINESS</b>	
STEPS OF A BUSINESS VALUATION .....	xvii	<b>OWNERSHIP INTEREST, SECURITY, OR INTANGIBLE ASSET:</b>	
NOTATION SYSTEM USED IN THIS BOOK .....	xvii	<b>VALUATION SERVICES INTERPRETATIONS OF SECTION 100.</b> .....	45
<b>Chapter 1. Overview of Business Valuation</b> .....	1	SCOPE OF APPLICABLE SERVICES .....	45
LEARNING OBJECTIVES .....	1	<b>AICPA STATEMENT ON STANDARDS FOR CONSULTING SERVICES</b> ..	57
INTRODUCTION .....	1	AICPA CODE OF PROFESSIONAL CONDUCT .....	58
A BRIEF WALK DOWN MEMORY LANE .....	1	PROFESSIONAL COMPETENCE .....	58
WHY ARE BUSINESSES VALUED? .....	2	<b>ASA STANDARDS</b> .....	63
MERGERS, ACQUISITIONS, REORGANIZATIONS, SPIN-OFFS,		<b>UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE</b> ..	63
LIQUIDATIONS, AND BANKRUPTCY .....	2	<b>NACVA</b> .....	63
ALLOCATION OF PURCHASE PRICE .....	3	<b>GLOSSARY OF BUSINESS VALUATION TERMS</b> .....	71
ESTATE, GIFT, AND INCOME TAXES .....	4	<b>CONCLUSION</b> .....	71
MARITAL DISSOLUTION .....	4	<b>Chapter 3. Getting Started</b> .....	73
EMPLOYEE STOCK OWNERSHIP PLANS .....	5	LEARNING OBJECTIVES .....	73
BUY-SELL AGREEMENTS .....	5	INTRODUCTION .....	73
OWNERSHIP DISPUTES .....	5	LEARNING ABOUT THE ENGAGEMENT .....	73
FINANCING .....	6	DECIDING WHETHER TO ACCEPT THE ENGAGEMENT .....	74
AD VALOREM TAXES .....	6	CONFLICTS OF INTEREST .....	74
INCENTIVE STOCK OPTION (EQUITY) CONSIDERATIONS .....	6	PURPOSE AND FUNCTION OF THE ENGAGEMENT .....	81
INITIAL PUBLIC OFFERINGS .....	6	AMOUNT OF TIME REQUIRED TO DO THE JOB .....	81
DAMAGES LITIGATION .....	6	THE SCOPE OF THE ASSIGNMENT .....	81
INSURANCE CLAIMS .....	7	THE TYPE OF REPORT TO BE ISSUED .....	84
CHARITABLE CONTRIBUTIONS .....	7	<b>ENGAGEMENT LETTERS</b> .....	84
EMINENT DOMAIN ACTIONS .....	7	DESCRIPTION OF THE SCOPE OF THE ASSIGNMENT .....	94
FAIRNESS OPINIONS .....	7	DETAILED DESCRIPTION OF THE VALUATION SUBJECT .....	97
<b>WHO VALUES BUSINESSES?</b> .....	8	STANDARD OF VALUE THAT WILL BE USED, INCLUDING THE	
BUSINESS VALUATION ANALYSTS .....	8	DEFINITION OF THAT STANDARD .....	97
ACCOUNTANTS (CPAs) .....	9	EFFECTIVE DATE(S) OF THE VALUATION .....	97
BUSINESS BROKERS .....	9	TYPE OF REPORT THAT WILL BE ISSUED TO COMMUNICATE THE	
COLLEGE PROFESSORS .....	10	VALUE ESTIMATE .....	97
COMMERCIAL REAL ESTATE APPRAISERS .....	10	CLIENT RESPONSIBILITIES .....	98
INVESTMENT BANKERS .....	10	METHOD OF DETERMINING FEES AND THE TERMS OF PAYMENT .....	98
INDUSTRY EXPERTS .....	10	<b>THE FIVE STEPS OF A VALUATION ASSIGNMENT</b> .....	98
THE INTERNET .....	10	ENGAGEMENT LETTER CONSIDERATIONS FOR LITIGATION REPORTS ..	98
<b>PROFESSIONAL VALUATION ORGANIZATIONS</b> .....	11	<b>THE INITIAL DOCUMENT REQUEST</b> .....	99
THE AICPA .....	11	USING A STANDARD CHECKLIST .....	99
THE AMERICAN SOCIETY OF APPRAISERS .....	12	SETTING UP MULTIPLE CHECKLISTS .....	103
THE NATIONAL ASSOCIATION OF CERTIFIED VALUATORS AND ANALYSTS ..	13	<b>CONCLUSION</b> .....	103
THE CFA INSTITUTE .....	15	<b>Chapter 4. Valuation Principles and Theory</b> .....	105
THE APPRAISAL FOUNDATION .....	15	LEARNING OBJECTIVES .....	105
<b>CONCLUSION</b> .....	15	INTRODUCTION .....	105
<b>Chapter 2. Business Valuation Standards</b> .....	17	<b>PRINCIPLES OF VALUATION</b> .....	105
LEARNING OBJECTIVES .....	17	PRINCIPLE OF ALTERNATIVES .....	105
INTRODUCTION .....	17	PRINCIPLE OF SUBSTITUTION .....	105
<b>AICPA STATEMENT ON STANDARDS FOR VALUATION</b>		PRINCIPLE OF FUTURE BENEFITS .....	106
<b>SERVICES NO. 1</b> .....	17	<b>STANDARDS OF VALUE</b> .....	107
WHY ISSUED .....	18	FAIR MARKET VALUE .....	107
VALUATION OF A BUSINESS, BUSINESS OWNERSHIP INTEREST,		FAIR VALUE .....	111
SECURITY, OR INTANGIBLE ASSET .....	18	INVESTMENT VALUE .....	112
INTRODUCTION AND SCOPE .....	18	INTRINSIC VALUE .....	113
OVERALL ENGAGEMENT CONSIDERATIONS .....	21	<b>HOW THE PURPOSE OF THE VALUATION INFLUENCES THE</b>	
		<b>STANDARD OF VALUE</b> .....	114

SUBSEQUENT EVENTS (KNOWN OR KNOWABLE) . . . . . 115

IRS INFLUENCE ON BUSINESS VALUATIONS . . . . . 117

    REVENUE RULING 59-60 . . . . . 117

    REVENUE RULING 65-192 . . . . . 118

    REVENUE RULING 65-193 . . . . . 118

    REVENUE PROCEDURE 66-49 . . . . . 118

    REVENUE RULING 68-609 . . . . . 119

    REVENUE PROCEDURE 77-12 . . . . . 119

    REVENUE RULING 77-287 . . . . . 119

    REVENUE RULING 83-120 . . . . . 119

    REVENUE RULING 85-75 . . . . . 119

    REVENUE RULING 93-12 . . . . . 120

    TECHNICAL ADVICE MEMORANDUM 94-36005 . . . . . 120

    CHAPTER 14 OF THE IRC . . . . . 120

CONCLUSION . . . . . 120

**Chapter 5. Data Gathering . . . . . 121**

LEARNING OBJECTIVES . . . . . 121

INTRODUCTION . . . . . 121

WHAT ITEMS AFFECT VALUE? . . . . . 121

INTERNAL INFORMATION . . . . . 121

    NONFINANCIAL INFORMATION . . . . . 121

    FINANCIAL INFORMATION . . . . . 127

EXTERNAL INFORMATION . . . . . 128

    ECONOMIC DATA . . . . . 128

    INDUSTRY DATA . . . . . 135

    PUBLICLY TRADED GUIDELINE COMPANY DATA . . . . . 141

    OTHER SOURCES OF DATA . . . . . 145

THE ON-SITE INTERVIEW . . . . . 147

CONCLUSION . . . . . 151

**Chapter 6. Data Analysis . . . . . 153**

LEARNING OBJECTIVES . . . . . 153

INTRODUCTION . . . . . 153

ECONOMIC ANALYSIS . . . . . 153

INDUSTRY ANALYSIS . . . . . 157

    PORTER'S FIVE FORCES . . . . . 157

    OTHER CONSIDERATIONS . . . . . 161

SUBJECT COMPANY ANALYSIS . . . . . 168

SWOT ANALYSIS . . . . . 168

FINANCIAL ANALYSIS . . . . . 170

    COMPARATIVE COMPANY ANALYSIS . . . . . 171

    COMMON SIZE FINANCIAL STATEMENTS . . . . . 171

    FINANCIAL RATIOS . . . . . 174

    COMPARATIVE INDUSTRY ANALYSIS . . . . . 178

    TREND ANALYSIS . . . . . 188

    OPERATIONAL ANALYSIS . . . . . 189

FINANCIAL STATEMENT ADJUSTMENTS . . . . . 191

    CONVERSION OF CASH OR INCOME TAX BASIS TO GAAP . . . . . 192

    TAX RETURN ADJUSTMENTS . . . . . 192

    UNDERSTANDING FINANCIAL STATEMENTS FOR VALUATION PURPOSES . . . . . 192

    ANALYSIS OF HISTORICAL BALANCE SHEETS . . . . . 195

    ANALYSIS OF HISTORICAL INCOME STATEMENTS . . . . . 195

    BARDAHL ANALYSIS . . . . . 195

    NORMALIZATION ADJUSTMENTS . . . . . 198

    COMPARABILITY ADJUSTMENTS . . . . . 201

    NONOPERATING AND NONRECURRING ADJUSTMENTS . . . . . 201

    DISCRETIONARY ADJUSTMENTS . . . . . 202

NONCONTROLLING INTEREST VALUATIONS . . . . . 206

CONCLUSION . . . . . 214

**Chapter 7. Statistics for Valuation and Economic Damages . . . . . 215**

LEARNING OBJECTIVES . . . . . 215

INTRODUCTION . . . . . 215

POPULATION AND SAMPLE: DESCRIPTIVE AND INFERENTIAL STATISTICS . . . . . 215

DISCRETE AND CONTINUOUS VARIABLES . . . . . 216

FREQUENCY DISTRIBUTIONS AND MEASURES OF VARIATION . . . . . 216

CENTRAL TENDENCY (MEAN, MEDIAN, MODE, AND SO FORTH) . . . . . 216

    RELATION BETWEEN MEAN, MEDIAN, AND MODE . . . . . 217

    RELATION BETWEEN ARITHMETIC, GEOMETRIC, AND HARMONIC MEANS . . . . . 218

    QUANTILES, DECILES, AND PERCENTILES . . . . . 218

VARIATION . . . . . 219

PROBABILITY . . . . . 220

CORRELATION . . . . . 228

LET'S DO SOME NUMBER CRUNCHING . . . . . 231

    CALCULATION OF THE MEAN . . . . . 231

    CALCULATION OF THE HARMONIC MEAN . . . . . 231

    CALCULATION OF THE STANDARD DEVIATION . . . . . 232

    CALCULATION OF THE COEFFICIENT OF VARIATION . . . . . 232

    CALCULATION OF MEDIAN AND PERCENTILE . . . . . 232

BE CAREFUL NOT TO DRINK THE STATISTICS KOOL-AID: THIS STUFF CAN BE MISLEADING . . . . . 232

CONCLUSION . . . . . 237

**Chapter 8. Developing Forecasts for Business Valuations and Economic Damages . . . . . 239**

LEARNING OBJECTIVES . . . . . 239

INTRODUCTION . . . . . 239

FORECAST VERSUS PROJECTION . . . . . 239

MANAGEMENT'S FORECAST . . . . . 240

FACTORS TO CONSIDER WHEN EVALUATING MANAGEMENT'S FORECAST . . . . . 241

    COMPANY-SPECIFIC FACTORS . . . . . 241

    ECONOMIC CONDITIONS . . . . . 244

    INDUSTRY TRENDS . . . . . 247

PREPARING THE FORECAST . . . . . 248

THE SALES FORECAST . . . . . 250

    REVENUE FACTORS FOR CERTAIN INDUSTRIES . . . . . 250

    SALES FORECASTING TECHNIQUES . . . . . 251

    AVERAGE HISTORICAL GROWTH RATE . . . . . 251

    LINEAR REGRESSION MODELS . . . . . 261

    MONTE CARLO SIMULATION . . . . . 277

PROJECTING SALES FOR A NEW BUSINESS . . . . . 277

COST OF GOODS SOLD . . . . . 284

OPERATING EXPENSES . . . . . 286

DEPRECIATION AND CAPITAL EXPENDITURES . . . . . 287

INTEREST EXPENSE AND BORROWING NEEDS . . . . . 287

BALANCE SHEET FORECAST . . . . . 290

APPLICABLE STANDARDS FOR FORECASTS IN BUSINESS VALUATION AND ECONOMIC DAMAGE ASSIGNMENTS . . . . . 294

COURT ACCEPTANCE . . . . . 295

CONCLUSION . . . . . 296

<b>Chapter 9. The Market Approach—Part I</b> .....	297	<b>VALUATION METHODS</b> .....	407
<b>LEARNING OBJECTIVES</b> .....	297	ADJUSTED BOOK VALUE METHOD .....	407
<b>INTRODUCTION</b> .....	297	ECONOMIC OBSOLESCENCE .....	425
<b>GUIDELINE PUBLIC COMPANY METHOD</b> .....	299	LIQUIDATION VALUE METHOD .....	429
CREATING A LIST OF POTENTIAL GUIDELINE COMPANIES .....	305	COST-TO-CREATE METHOD .....	438
GET THE BUSINESS DESCRIPTION .....	314	<b>WORKING WITH OTHER APPRAISERS</b> .....	439
SIZE CRITERIA .....	314	<b>HOW TO LOCATE AND RECOGNIZE SPECIALISTS</b> .....	439
FOR THOSE THAT PASS MUSTER .....	317	<b>CONCLUSION</b> .....	440
<b>USING VALUATION MULTIPLES</b> .....	330	<b>Chapter 12. The Income Approach</b> .....	441
PRICE-TO-NET EARNINGS .....	330	<b>LEARNING OBJECTIVES</b> .....	441
PRICE-TO-PRETAX EARNINGS .....	331	<b>INTRODUCTION</b> .....	441
PRICE-TO-CASH FLOW .....	331	<b>VALUE IS FROM AN INVESTOR'S VIEWPOINT</b> .....	442
MVIC-TO-SALES .....	331	<b>ADVANTAGES AND DISADVANTAGES OF THE INCOME APPROACH</b> .....	443
PRICE-TO-DIVIDEND OR DIVIDEND-PAYING CAPACITY .....	332	ADVANTAGES .....	443
PRICE-TO-BOOK VALUE .....	332	DISADVANTAGES .....	443
<b>VALUING INVESTED CAPITAL INSTEAD OF EQUITY</b> .....	333	<b>SELECTING BENEFIT STREAMS</b> .....	443
ADJUSTING PUBLIC COMPANY MULTIPLES FOR RISK .....	334	THE NATURE OF THE BUSINESS AND ITS CAPITAL STRUCTURE .....	444
VALUATION CONSIDERATIONS .....	336	THE PURPOSE AND FUNCTION OF THE VALUATION .....	444
WHAT PRICE DO WE USE IN THE MULTIPLES? .....	338	THE PARTICULAR SUBJECT OF THE VALUATION .....	444
REGRESSION ANALYSIS .....	338	<b>USING PRETAX OR AFTER-TAX INFORMATION</b> .....	444
ADJUSTING MULTIPLES BASED ON SGLPTL .....	338	<b>VALUING INVESTED CAPITAL INSTEAD OF EQUITY</b> .....	445
MAKING QUANTITATIVE ADJUSTMENTS TO MULTIPLES .....	344	<b>USING CASH FLOW INSTEAD OF EARNINGS</b> .....	445
ADJUSTING THE MARKET MULTIPLE FOR SIZE .....	346	<b>DEFINING CASH FLOW</b> .....	446
ADJUSTING THE MARKET MULTIPLE FOR GROWTH .....	347	<b>FORECASTING FUTURE BENEFIT STREAMS</b> .....	448
HOW TO CALCULATE THE PRESENT VALUE WEIGHTED PERPETUAL GROWTH RATE .....	348	<b>INCOME APPROACH METHODS</b> .....	459
<b>ADVANTAGES OF USING THE GUIDELINE PUBLIC COMPANY METHOD</b> .....	350	CAPITALIZATION OF BENEFITS METHOD .....	459
<b>DISADVANTAGES OF USING THE GUIDELINE PUBLIC     COMPANY METHOD</b> .....	350	DISCOUNTED FUTURE BENEFITS METHOD .....	465
SO LET'S BE HONEST .....	351	THE EXCESS EARNINGS (FORMULA) METHOD .....	469
LET'S DEMO TIGNIFI .....	351	<b>CONCLUSION</b> .....	477
<b>CONCLUSION</b> .....	362	<b>Chapter 13. Discount and Capitalization Rates</b> .....	479
<b>Chapter 10. The Market Approach—Part II</b> .....	363	<b>LEARNING OBJECTIVES</b> .....	479
<b>LEARNING OBJECTIVES</b> .....	363	<b>INTRODUCTION</b> .....	479
<b>INTRODUCTION</b> .....	363	<b>DISCOUNT RATES</b> .....	481
<b>MERGER AND ACQUISITION (TRANSACTION) METHOD</b> .....	363	FACTORS THAT AFFECT THE SELECTION OF A DISCOUNT RATE .....	482
VALUSOURCE MARKET COMPS (IBA) .....	365	COMPONENTS OF A DISCOUNT RATE .....	482
BIZCOMPS .....	370	COMPARING THE SUBJECT COMPANY .....	492
DEALSTATS .....	378	COST OF CAPITAL PROFESSIONAL .....	500
VALUSOURCE M&A COMPS DATABASE .....	384	APPLICATION OF THE DISCOUNT RATE .....	500
FACTSET MERGERSTAT/BVR CONTROL PREMIUM STUDY .....	386	WHEN ALL ELSE FAILS, GO BACK TO THE THEORY .....	501
RETIVIA MERGERS & ACQUISITIONS .....	387	THE BUILDUP METHOD .....	501
BUSINESS BROKERS .....	387	CAPITAL ASSET PRICING MODEL .....	503
<b>TRANSACTION ANALYSIS</b> .....	389	OTHER METHODS FOR ESTIMATING A DISCOUNT RATE .....	509
QUALITATIVE ANALYSIS .....	390	<b>CAPITALIZATION RATES</b> .....	514
QUANTITATIVE ANALYSIS .....	394	FACTORS AFFECTING THE SELECTION OF THE CAPITALIZATION RATE .....	516
<b>LET'S GET BACK TO VALUATION THEORY</b> .....	396	SOURCES OF DATA ON CAPITALIZATION RATES .....	516
ADVANTAGES OF USING THE MERGER AND ACQUISITION METHOD .....	396	<b>DERIVING DISCOUNT AND CAPITALIZATION RATES</b> <b>APPLICABLE TO NET INCOME DIRECTLY FROM THE MARKET</b> .....	518
DISADVANTAGES OF USING THE MERGER AND ACQUISITION METHOD .....	396	<b>BACK TO THE REAL WORLD</b> .....	518
<b>INTERNAL TRANSACTIONS</b> .....	400	USING PRETAX OR AFTER-TAX RATES .....	520
<b>INDUSTRY METHOD</b> .....	401	DISCOUNT RATES FOR ECONOMIC DAMAGES .....	520
<b>CONCLUSION</b> .....	401	<b>CONCLUSION</b> .....	522
<b>Chapter 11. The Asset-Based Approach</b> .....	403	<b>Chapter 14. Premiums and Discounts (Valuation Adjustments)—Part I</b> .....	523
<b>LEARNING OBJECTIVES</b> .....	403	<b>LEARNING OBJECTIVES</b> .....	523
<b>INTRODUCTION</b> .....	403	<b>INTRODUCTION</b> .....	523
<b>COMMON APPLICATIONS OF THE ASSET-BASED APPROACH</b> .....	403	<b>TYPES OF DISCOUNTS</b> .....	525
<b>ADVANTAGES AND DISADVANTAGES OF THE ASSET-BASED     APPROACH</b> .....	406		

LEVELS OF VALUE ..... 526

VALUATION ADJUSTMENT—CONTROL PREMIUM ..... 527

    PROTECTING THE NONCONTROLLING OWNER WITH RIGHTS AND  
    RESTRICTIONS THROUGH AGREEMENTS ..... 527

    LEGAL REMEDIES ..... 529

    MORE CONTROL PREMIUM ISSUES ..... 529

LACK OF CONTROL (NONCONTROLLING) DISCOUNTS ..... 536

DISCOUNT FROM NET ASSET VALUE ..... 542

DISCOUNT FOR EMBEDDED CAPITAL GAINS ..... 542

    THE EMBEDDED CAPITAL GAIN PROBLEM ..... 543

    COURT CASE PRECEDENTS ON EMBEDDED CAPITAL GAINS TAX  
    WITH C CORPORATIONS ..... 544

    EMBEDDED CAPITAL GAINS IN PASS-THROUGH ENTITIES ..... 545

    COURT DECISIONS ON EMBEDDED CAPITAL GAINS IN PASS-  
    THROUGH ENTITIES ..... 545

NONVOTING STOCK DISCOUNT ..... 545

CONCLUSION ..... 547

**Chapter 15. Premiums and Discounts (Valuation Adjustments)—Part II ..... 549**

LEARNING OBJECTIVES ..... 549

INTRODUCTION ..... 549

DISCOUNT FOR LACK OF MARKETABILITY (ILLIQUIDITY) ..... 549

    DLOM FOR CONTROL ..... 550

    DLOM—THE QUALITATIVE STUFF ..... 551

    DLOM—The Quantitative Stuff ..... 598

    Where the Qualitative and Quantitative Factors Meet (or Not?) ..... 608

PRIVATE-COMPANY DISCOUNT ..... 612

    SOME MORE EMPIRICAL DATA ..... 613

KEY-PERSON DISCOUNT ..... 614

    QUANTIFYING THE MAGNITUDE OF THE KEY-PERSON DISCOUNT ..... 615

    COURT CASES INVOLVING KEY PERSON DISCOUNT ..... 615

BLOCKAGE DISCOUNT ..... 616

    HOW ABOUT SOME COURT CASES? ..... 621

OTHER PREMIUMS AND DISCOUNTS ..... 621

APPLICATION OF VALUATION ADJUSTMENTS ..... 623

CONCLUSION ..... 623

**Chapter 16. Revenue Ruling 59-60 ..... 625**

LEARNING OBJECTIVES ..... 625

INTRODUCTION ..... 625

REVENUE RULING 59-60 ..... 625

CONCLUSION ..... 635

**Chapter 17. The Valuation Report ..... 637**

LEARNING OBJECTIVES ..... 637

INTRODUCTION ..... 637

COMPONENTS OF A VALUATION REPORT ..... 637

    LETTER OF TRANSMITTAL ..... 638

    TABLE OF CONTENTS ..... 638

    INTRODUCTION ..... 638

    DESCRIPTION OF THE ASSIGNMENT ..... 639

    SCOPE OF WORK ..... 640

    ASSUMPTIONS AND LIMITING CONDITIONS ..... 640

    SOURCES OF INFORMATION ..... 641

    ANALYSIS OF THE SUBJECT ENTITY AND RELATED NONFINANCIAL  
    INFORMATION ..... 641

    FINANCIAL STATEMENT OR INFORMATION ANALYSIS ..... 643

    VALUATION APPROACHES AND METHODS CONSIDERED ..... 643

    VALUATION APPROACHES AND METHODS USED ..... 643

VALUATION ADJUSTMENTS ..... 643

NON-OPERATING ASSETS, NON-OPERATING LIABILITIES, AND  
EXCESS OR DEFICIENT OPERATING ASSETS ..... 643

REPRESENTATION OF THE VALUATION ANALYST ..... 644

RECONCILIATION OF ESTIMATES AND CONCLUSION OF VALUE ..... 644

QUALIFICATIONS OF THE VALUATION ANALYST ..... 644

APPENDIXES AND EXHIBITS ..... 644

TYPES OF VALUATION REPORTS ..... 644

    DETAILED REPORTS ..... 647

    SUMMARY REPORTS ..... 647

    CALCULATION REPORTS ..... 648

    ORAL REPORTS ..... 649

PREPARING THE BUSINESS VALUATION REPORT ..... 649

    FEDERAL RULES OF CIVIL PROCEDURE ..... 649

    USING THE REPORT AS A SELLING TOOL ..... 649

    USING THE OTHER SIDE'S REPORT TO HELP SELL THE CONCLUSION ..... 652

    UNDERSTANDING THE WEAKNESSES IN THE VALUATION PROCESS ..... 671

    VALUATION ANALYST, PROTECT YOURSELF! ..... 672

DEFENDING THE BUSINESS VALUATION REPORT ..... 672

THE REBUTTAL REPORT ..... 673

COMMON ERRORS IN BUSINESS VALUATION REPORTS ..... 673

THE RECONCILIATION PROCESS ..... 675

CONCLUSION ..... 677

**Chapter 18. Valuation of Pass-Through Entities ..... 679**

LEARNING OBJECTIVES ..... 679

INTRODUCTION ..... 679

WHAT IS AN S CORPORATION? ..... 679

KEY COURT CASES ..... 680

SO, WHERE DO WE GO FROM HERE? ..... 684

VALUATION ISSUES ..... 684

    STANDARD OF VALUE ..... 685

    CONTROL VERSUS NONCONTROLLING ..... 686

    DISTRIBUTING VERSUS NONDISTRIBUTING ..... 686

    CORPORATE OR PERSONAL INCOME TAX RATES ..... 690

    HOLDING PERIOD OF THE INVESTMENT ..... 691

    TIMING OF THE VALUATION ..... 692

    SO, WHAT DO WE DO? ..... 692

    BACK TO THE FUTURE ..... 693

    S CORPORATION MODELS ..... 694

    HOW OUR FIRM HANDLED THE S CORPORATION ISSUE ..... 707

    HOW DO THE MODELS COMPARE? ..... 709

    SOME POINTS TO CONSIDER ..... 709

SOME NEWER THOUGHTS ON THE ISSUE ..... 711

OTHER PASS-THROUGH ENTITIES ..... 711

CONCLUSION ..... 722

**Chapter 19. Valuation in Financial Reporting ..... 723**

LEARNING OBJECTIVES ..... 723

INTRODUCTION ..... 723

BACKGROUND OF VALUATION IN FINANCIAL REPORTING ..... 723

FASB ASC 820, *FAIR VALUE MEASUREMENT* ..... 724

    DEFINITION OF FAIR VALUE ..... 724

    EXAMPLE OF PRINCIPAL AND MOST ADVANTAGEOUS MARKETS ..... 726

    MARKET PARTICIPANTS' ASSUMPTIONS ..... 726

    HIGHEST AND BEST USE APPLICATION CRITERIA APPLIED IN FAIR  
    VALUE MEASUREMENTS ..... 727

FASB ASC 805, *BUSINESS COMBINATIONS* ..... 727

    RECOGNIZING IDENTIFIED ASSETS IN BUSINESS COMBINATIONS ..... 728

FAIR VALUE MEASUREMENTS IN IMPAIRMENT TESTING ..... 737

WHEN TO TEST FOR ONGOING IMPAIRMENT . . . . .	738	AS VALUATION ANALYSTS, DO WE GO FOR THE BIG DISCOUNTS? . . . . .	802
DEVELOPING BEST PRACTICES IN VALUATION FOR FINANCIAL REPORTING . . . . .	739	CONCLUSION . . . . .	803
THE APPRAISAL FOUNDATION . . . . .	739	<b>Chapter 22. Divorce Valuations . . . . .</b>	<b>805</b>
AICPA . . . . .	739	LEARNING OBJECTIVES . . . . .	805
WORKING WITH THE CLIENT'S OUTSIDE AUDITING FIRM . . . . .	739	INTRODUCTION . . . . .	805
THE MANDATORY PERFORMANCE FRAMEWORK . . . . .	740	THE ROLE OF THE VALUATION ANALYST . . . . .	806
IDENTIFICATION OF INTANGIBLE ASSETS FOR FINANCIAL REPORTING	741	DEFINITION OF VALUE . . . . .	806
CONCLUSION . . . . .	742	FAIR MARKET VALUE . . . . .	807
<b>Chapter 20. Valuing Intangible Assets: An Overview . . . . .</b>	<b>743</b>	INTRINSIC VALUE . . . . .	808
LEARNING OBJECTIVES . . . . .	743	FAIR VALUE . . . . .	808
INTRODUCTION . . . . .	744	WHAT DO THE DEFINITIONS REALLY MEAN IN A DIVORCE CONTEXT? . . . . .	808
WHAT IS INTELLECTUAL PROPERTY? . . . . .	746	VALUATION DATES . . . . .	809
CONDUCTING A VALUATION OF INTANGIBLE ASSETS . . . . .	748	DATE OF THE MARRIAGE . . . . .	810
MARKET APPROACH . . . . .	749	DATE OF A GIFT OR INHERITANCE . . . . .	810
INCOME APPROACH . . . . .	749	DATE OF THE SEPARATION . . . . .	810
COST APPROACH . . . . .	750	DATE OF THE DIVORCE COMPLAINT (OR PETITION) . . . . .	810
WHAT IS A RUL ANALYSIS? . . . . .	751	DATE THE PARTIES AGREED TO . . . . .	810
WHAT IS A REASONABLE ROYALTY RATE AND WHERE DO I GET THIS STUFF? . . . . .	752	DATE OF THE TRIAL . . . . .	810
WHAT IS AN AMORTIZATION BENEFIT? . . . . .	757	VALUATION METHODS . . . . .	811
HOW ABOUT SOME MORE EXAMPLES . . . . .	758	VALUATION AS OF A SPECIFIC DATE . . . . .	811
CREATE A LEAD SCHEDULE FOR YOUR ANALYSIS . . . . .	758	DATA GATHERING AND ANALYSIS . . . . .	812
FAIR VALUE OF THE CUSTOMER LIST . . . . .	760	GATHERING FINANCIAL DATA . . . . .	812
FAIR VALUE OF ACQUIRED SOFTWARE . . . . .	761	THE VALUATION PROCESS . . . . .	813
FAIR VALUE OF CUSTOMER-RELATED INTANGIBLES WITH AN EXCESS EARNINGS MODEL . . . . .	761	NORMALIZING THE FINANCIAL STATEMENTS . . . . .	813
FAIR VALUE OF NONCOMPETE AGREEMENTS USING A 'WITH AND WITHOUT' MODEL . . . . .	762	UNREPORTED REVENUES . . . . .	813
FAIR VALUE OF THE ASSEMBLED WORKFORCE . . . . .	762	STOCKHOLDER LOANS . . . . .	814
PERSONAL GOODWILL . . . . .	765	INCOME TAXES . . . . .	814
CONCLUSION . . . . .	777	EXPLAINING THE VALUATION . . . . .	815
<b>Chapter 21. Estate and Gift Valuations . . . . .</b>	<b>779</b>	REACHING A CONCLUSION OF VALUE . . . . .	815
LEARNING OBJECTIVES . . . . .	779	DIVORCE VALUATIONS OF PROFESSIONAL PRACTICES . . . . .	815
INTRODUCTION . . . . .	779	PROFESSIONAL PRACTICES DIFFER FROM REGULAR BUSINESS ENTERPRISES . . . . .	815
PENALTIES FOR UNDERVALUATION ON ESTATE AND GIFT TAX RETURNS . . . . .	780	DIVORCE VALUATIONS AND THE MARKET CAN BE VERY DIFFERENT . . . . .	816
2006 PENSION PROTECTION ACT . . . . .	781	FINANCIAL INFORMATION . . . . .	816
REVENUE RULING 59-60 . . . . .	782	PROFESSIONAL VERSUS PRACTICE GOODWILL . . . . .	817
CHAPTER 14 GUIDELINES . . . . .	782	PERSONAL GOODWILL IN GENERAL . . . . .	819
CASE LAW . . . . .	782	NONCOMPETE AGREEMENTS . . . . .	844
THE VALUATION REPORT . . . . .	782	VALUATION OF OTHER MARITAL ASSETS . . . . .	873
THE FLP VALUATION . . . . .	783	PROFESSIONAL LICENSES . . . . .	873
WHAT IS AN FLP? . . . . .	783	CELEBRITY GOODWILL . . . . .	873
WHY ARE FLPs ATTRACTIVE? . . . . .	783	PASSIVE VERSUS ACTIVE MARITAL ASSETS . . . . .	874
WHAT EXACTLY IS THE ASSIGNMENT? . . . . .	784	CONCLUSION . . . . .	914
WHAT DOCUMENTS ARE NECESSARY FOR PREPARING THE VALUATION REPORT? . . . . .	784	<b>Chapter 23. Professional Practice Valuations . . . . .</b>	<b>915</b>
HOW DOES REVENUE RULING 59-60 HELP? . . . . .	785	LEARNING OBJECTIVES . . . . .	915
WHAT IS CHAPTER 14? . . . . .	785	INTRODUCTION . . . . .	915
HOW DOES ALL THIS AFFECT THE VALUATION ASSIGNMENT? . . . . .	787	WHY ARE PROFESSIONAL PRACTICES VALUED? . . . . .	915
SECTION 2036 . . . . .	787	CHARACTERISTICS OF THE PROFESSIONAL PRACTICE . . . . .	916
MORE COURT CASES . . . . .	789	PROFESSIONAL PRACTICE VERSUS OTHER BUSINESS VALUATIONS . . . . .	916
THINGS TO CONSIDER IN THE VALUATION PROCESS . . . . .	790	BUY-SELL AGREEMENTS . . . . .	916
WHAT ABOUT METHODOLOGY? . . . . .	791	INTERNAL TRANSACTIONS . . . . .	918
VALUATION ADJUSTMENTS . . . . .	793	EXTERNAL TRANSACTIONS . . . . .	918
THE FLP WRITTEN REPORT . . . . .	798	SUBSEQUENT EVENTS . . . . .	919
		MORE ABOUT PROFESSIONAL PRACTICE VERSUS OTHER BUSINESS VALUATIONS . . . . .	920
		THE VALUATION PROCESS . . . . .	920
		HISTORY OF THE PRACTICE . . . . .	938
		CASH VERSUS ACCRUAL ACCOUNTING . . . . .	945

**VALUATION CALCULATIONS—UNIQUE ASPECTS OF THE CALCULATIONS** . . . . . 968  
 ISSUE: DIFFERENT CLASSES OF WILLING BUYERS RESULT IN DIFFERENT VALUES . . . . . 968  
**RULES OF THUMB** . . . . . 970  
 ASSET-BASED APPROACH . . . . . 971  
**CONCLUSION** . . . . . 971

**Chapter 24. Ownership Disputes** . . . . . 973  
**LEARNING OBJECTIVES** . . . . . 973  
**INTRODUCTION** . . . . . 973  
**DISSENTING SHAREHOLDER MATTERS** . . . . . 976  
**OPPRESSED SHAREHOLDER MATTERS** . . . . . 978  
**FAIR VALUE** . . . . . 979  
**THE VALUATION DATE** . . . . . 983  
**FAIR VALUE METHODOLOGY** . . . . . 986  
**CONCLUSION** . . . . . 995

**Chapter 25. Other Valuation Assignments** . . . . . 997  
**LEARNING OBJECTIVES** . . . . . 997  
**INTRODUCTION** . . . . . 997  
**STOCK OPTIONS** . . . . . 997  
**VALUATION OF OPTIONS** . . . . . 999  
**BLACK-SCHOLES-MERTON OPTION PRICING MODEL** . . . . . 999  
**THE BINOMIAL OPTION PRICING MODEL** . . . . . 1004  
**WARRANTS** . . . . . 1012  
**PREFERRED STOCK** . . . . . 1015  
 DIVIDEND RIGHTS . . . . . 1016  
 OPTIONS . . . . . 1016  
 VOTING RIGHTS . . . . . 1016  
 PARTICIPATION RIGHTS . . . . . 1016  
 CONVERSION RIGHTS . . . . . 1017  
**DEBT SECURITIES** . . . . . 1021  
**EARLY-STAGE COMPANIES** . . . . . 1029  
 STAGES OF DEVELOPMENT . . . . . 1029  
 VALUATION APPROACHES . . . . . 1031  
 ASSET-BASED APPROACH . . . . . 1031  
 MARKET APPROACH . . . . . 1031  
 INCOME APPROACH . . . . . 1039  
**CONCLUSION** . . . . . 1040

**Chapter 26. Economic Damages** . . . . . 1041  
**LEARNING OBJECTIVES** . . . . . 1041  
**INTRODUCTION** . . . . . 1041  
**LOST PROFITS** . . . . . 1041  
 ELEMENTS OF A LOST PROFITS CLAIM . . . . . 1042  
 TYPES OF DAMAGES . . . . . 1043  
**THE LOST PROFITS ANALYSIS** . . . . . 1043  
 MEET WITH THE CLIENT AND CLIENT’S ATTORNEY TO DETERMINE THE OBJECTIVES OF THE ASSIGNMENT . . . . . 1043  
 PLASTER YOUR FILES WITH SUPPORT . . . . . 1045  
 OBTAINING DOCUMENTS AND RECORDS FROM THE OPPOSING SIDE . . . . . 1045  
 SHOULD THE DAMAGES EXPERT WORK WITH ORIGINAL DOCUMENTS OR COPIES? . . . . . 1046  
 GET INFORMATION FROM THE CLIENT AND THE OTHER SIDE . . . . . 1046  
 PERFORMING THE LOST PROFITS COMPUTATION . . . . . 1047  
 MITIGATION OF DAMAGES . . . . . 1054  
 PERIOD OF RECOVERY . . . . . 1054  
 VARIABLE COST OF LOST REVENUES . . . . . 1055

INCREMENTAL REVENUES AND EXPENSES—NOT FIXED OR VARIABLE . . . . . 1055  
 SHOULD LOST NET EARNINGS BE REDUCED FOR INCOME TAXES? . . . . . 1068  
 PREJUDGMENT INTEREST . . . . . 1068  
 PROJECTED LOST REVENUES AFTER TRIAL . . . . . 1068  
 DISCOUNTING PROJECTED LOST PROFITS AFTER TRIAL TO PRESENT VALUE . . . . . 1068  
 EX ANTE VERSUS EX POST . . . . . 1068  
 DON’T FORGET TO CHECK THE LOST PROFITS COMPUTATION FOR REASONABLENESS . . . . . 1070  
 OTHER SITUATIONS . . . . . 1070  
 LOST PROFITS OR LOST BUSINESS VALUE? . . . . . 1076  
 OTHER TYPES OF DAMAGES MEASUREMENTS . . . . . 1077  
 PLAINTIFF OR DEFENSE? . . . . . 1082  
 COMMON MISTAKES MADE BY DAMAGES EXPERTS . . . . . 1082  
**CONCLUSION** . . . . . 1099

**Chapter 27. My Favorite Court Cases** . . . . . 1101  
**LEARNING OBJECTIVES** . . . . . 1101  
**INTRODUCTION** . . . . . 1101  
**ESTATE OF JOYCE C. HALL V. COMMISSIONER** . . . . . 1102  
 ISSUE: WHAT MAKES A GUIDELINE COMPANY? . . . . . 1102  
**ESTATE OF SAMUEL I. NEWHOUSE V. COMMISSIONER** . . . . . 1103  
 ISSUE: DIFFERENT CLASSES OF WILLING BUYERS RESULT IN DIFFERENT VALUES . . . . . 1103  
**CHARLES S. FOLTZ V. U.S. NEWS & WORLD REPORT, INC.** . . . . . 1106  
 ISSUE: EXCESS ASSET AND THE MINORITY INTEREST . . . . . 1106  
**BERNARD MANDELBAUM, ET AL. V. IRS COMMISSIONER** . . . . . 1109  
 ISSUE: DISCOUNT FOR LACK OF MARKETABILITY . . . . . 1109  
**MAD AUTO WRECKING INC. V. COMMISSIONER** . . . . . 1112  
 ISSUE: REASONABLE COMPENSATION . . . . . 1112  
**DELAWARE OPEN MRI RADIOLOGY ASSOCIATES P.A. v. HOWARD B. KESSLER, ET AL.** . . . . . 1127  
 ISSUE: TREATMENT OF S CORPORATION TAXES IN FAIR VALUE . . . . . 1127  
**CONCLUSION** . . . . . 1130

**Index** . . . . . 1131

**Appendices**

(Available at [bvresources.com/products/UBV6](http://bvresources.com/products/UBV6))

APPENDIX 1. INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (ORIGINAL VERSION)  
 APPENDIX 2. INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (NEW VERSION)  
 APPENDIX 3. SSVS 1 APPENDIX C  
 APPENDIX 4. REVENUE RULING 59-60  
 APPENDIX 5. REVENUE RULING 65-192  
 APPENDIX 6. REVENUE RULING 65-193  
 APPENDIX 7. REVENUE PROCEDURE 66-49  
 APPENDIX 8. REVENUE RULING 68-609  
 APPENDIX 9. REVENUE PROCEDURE 77-12  
 APPENDIX 10. REVENUE RULING 77-287  
 APPENDIX 11. REVENUE RULING 83-120  
 APPENDIX 12. REVENUE RULING 85-75  
 APPENDIX 13. REVENUE RULING 93-12  
 APPENDIX 14. TECHNICAL ADVICE MEMORANDUM 94-36005  
 APPENDIX 15. BUSINESS VALUATION RESOURCES



# Introduction

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This book has been methodically organized to help you get the most you possibly can out of it. Each chapter contains new stuff since the last edition. The chapters are set up as follows:

- Chapter 1 provides background stuff regarding why businesses are valued, who values them, and the various valuation organizations. The intention of this chapter is to provide you with some background about the valuation profession. You want to be aware of the different types of valuation analysts and their standards because you will most likely run across them in your endeavors.
- Chapter 2 consists of an annotation of the AICPA business valuation standard. I have used this standard as the centerpiece because I find that it is really good at providing guidance and, fortunately, it does not differ too much from the other standards. Other standards from other organizations are also covered in this chapter. This chapter is so important (and also so long) that I made it into its own chapter.
- Chapter 3 gets you started in the valuation process. In this chapter, I discuss the things that a valuation analyst must know to start an assignment. Chapter 3 includes information about engagement letters, conflicts of interest, internal work programs, and the initial document request.
- Chapter 4 takes you through the basic valuation principles and theory behind the stuff that we are trying to figure out how to do. We will learn that the term *value* has many different meanings in business valuation, and we will discuss some of the more important definitions. Because so much of the valuation work we do involves taxes, this chapter will also point out the influence of the IRS on what we do.
- Chapter 5 includes a discussion of internal and external sources of information that the valuation analyst will gather. Numerous references are provided about where the valuation analyst can locate information. This chapter lists all types of neat websites for doing the required research. However, by the time that you read this chapter, many of the references may have already changed.
- Chapter 6 walks you through the process of what the valuation analyst should do with the data that were gathered during the valuation process. This chapter includes a discussion of economic, industry, company, and financial analysis. This is one of the most important chapters in the valuation process. It will help the valuation analyst arrive at the numbers needed to apply to valuation methodologies, as well as help the valuation analyst assess the riskiness of the income stream of the valuation subject.
- Chapter 7 covers statistics for business valuation and economic damages. Don't worry; I kept it relatively basic because I could not make it complex. Keeping it simple is a good thing! If you will do this work, don't skip this chapter.
- Chapter 8 addresses forecasts. So much of what we do involves working with forecasts that I decided to dedicate a separate chapter to this topic. The intention is to keep the valuation analyst out of trouble. Various forecasting techniques are discussed. I also discuss what to do if your client gives you a really poor forecast.
- Chapter 9 presents the first part of the market approach to valuation. The underlying theory for the market approach is presented in this chapter. The balance of the chapter concentrates on the guideline public company method, including detail on how to perform the analysis involving publicly traded companies. You will have to read this chapter to find out about size, growth, leverage, performance, turnover, and liquidity. You will also learn how to size-adjust multiples.
- Chapter 10 presents the second half of the market approach. This chapter includes a detailed discussion of the guideline transaction method, including a description of the various databases available to find merger and acquisition information involving closely held businesses. Some of the databases have been changed, and this chapter includes updated information about them. This chapter takes you step by step through the process of using this method, including making you aware of the potential pitfalls. Using internal transactions and rules of thumb are also discussed in this chapter.

- Chapter 11 presents the asset-based approach to valuation. Several methods are also explored here, and there is a discussion of how to find and communicate with other types of appraisers. A detailed discussion about economic obsolescence is included in this chapter.
- Chapter 12 presents the income approach to valuation. For small- and medium-sized businesses, this chapter may be one of the most important. For larger businesses, this chapter is needed to assist the valuation analyst in supporting a market approach valuation. Single-period and multiperiod models are presented. Forecasting financial information is also included in this chapter because it is the very essence of this approach to valuation.
- Chapter 13 is the chapter everyone will want to turn to! Discount rates and capitalization rates are discussed. Lots of theory and, hopefully, practical guidance have been included in this chapter. This chapter always changes from edition to edition because so much changes in our industry. An in-depth discussion about the equity risk premium and the small stock premium are included in this chapter. This chapter may cause even the experienced valuation analyst to look at things differently.
- Chapter 14 includes the first part of my discussion on valuation adjustments, also known as *premiums and discounts*. In this chapter, the valuation analyst will learn when to use different premiums and discounts, as well as how to support his or her opinion. This chapter includes a discussion on valuation premiums and discounts, in general, control premiums, lack of control (noncontrolling or minority) discounts, and discounts from net asset value.
- Chapter 15 is the second part of my discussion on valuation adjustments. This chapter includes everything that you want to know about discounts for lack of marketability (maybe not). I have a lot of stuff in this chapter, including a separate discussion on quantification techniques of this discount. I have an expanded discussion about the Stout DLOM Calculator. Other discounts and premiums discussed in this chapter include private-company discounts, key-person discounts, nonhomogeneous (portfolio) discounts, blockage discounts, and more. I even explain how to apply these discounts.
- Chapter 16 contains an annotated version of Revenue Ruling 59-60. This revenue ruling is so important that it deserves a separate chapter. You can never get enough of a Revenue Ruling that is more than 60 years old but has the makings of being the best writing in business valuation of all time (maybe with the exception of my book).
- Chapter 17 addresses the valuation report. The valuation analyst can learn how to prepare and defend the report and learn some tips regarding presentation techniques. This chapter includes the reporting requirements of the various business valuation standards. I have also added a section about writing a rebuttal report.
- Chapter 18 is dedicated to pass-through entities. Besides having a discussion about the tax issues of these types of entities, I have included a discussion about all of the leading models being used to calculate the impact on value. This chapter is expected to be a help to all valuation analysts.
- Chapter 19 covers valuations for financial reporting. While it is intended to be basic, if the valuation analyst does valuations for financial reporting purposes, he or she knows that this work is anything but basic. This chapter discusses the basic rules and pronouncements in this area of practice.
- Chapter 20 is a basic chapter on intangible assets. There are several examples to help the valuation analyst learn how to value different types of intangibles. Some really good reference materials are cited in this chapter, as well.
- Chapter 21 addresses valuation assignments that are performed for estate and gift tax purposes. Learn about the Chapter 14 (of the IRC) requirements, the adequate disclosure requirements, and family limited partnership valuations. Also, learn about valuation analyst penalties if you mess up.
- Chapter 22 covers issues involved in divorce valuations. Valuations performed as part of a divorce assignment entail very unique considerations for the valuation analyst. Included in this chapter is a new section on valuing personal goodwill.
- Chapter 23 contains a discussion on unique aspects of valuing professional practices. Learn what factors should be considered in valuing different types of professional practices, making these assignments different from valuing an operating company. Also included in this chapter is a detailed analysis on the valuation of work in process for a contingent fee law firm.

- Chapter 24 addresses valuation assignments for ownership disputes, including issues involving the fair value standard (from a legal point of view). Some new exhibits in this chapter address very significant issues regarding fair value.
- Chapter 25 includes a discussion on the valuation of stock options, warrants, preferred stock, debt, and early-stage companies. It also includes a discussion of the backsolve method. These very complicated topics are broken down into simple concepts with the intention of making them understandable.
- Chapter 26 contains a discussion about economic damages. Several new exhibits addressing different types of damages issues are in this chapter.
- Chapter 27 contains a discussion of some of my favorite court cases. In fact, the name of this chapter is “My Favorite Court Cases.” Pretty catchy, isn’t it? This chapter has a few really good court cases that will help you understand some important issues regarding valuation. In many instances, I refer to these cases in other chapters.

## DOWNLOADABLE MATERIALS

Because technology changes regularly, the publisher of this book has decided to take advantage of the times. All the appendixes, as well as some reports for you to plagiarize, are included as downloadable materials from the Business Valuation Resources website. I only hope that you will give our firm proper attribution. Several new sample reports are included so that you can see the differences among the types of reports. The website will also provide some of the court cases that are discussed throughout this book. Other stuff will also be added to this special website as time passes. Special thanks go out to the folks at BVR who have made this possible.

Although the material in this book is not necessarily unique, it has been organized in a manner that is intended to provide you with a logical analysis of the valuation process. Many of the exhibits contain actual sections of valuation reports to help emphasize the subject matter. Make sure you read them!

## STEPS OF A BUSINESS VALUATION

This book proceeds in a sequence that resembles the steps of performing a business valuation. The chapters will address these steps in detail. Because you are probably dying to know what these steps are, I listed them here:

1. Define the valuation engagement;
2. Gather the necessary data to perform the engagement;
3. Analyze the data that you gathered;
4. Estimate the value of the interest being valued; and
5. Write the report to communicate the value.

## NOTATION SYSTEM USED IN THIS BOOK

A source of confusion for those trying to understand financial theory and methods is the fact that financial writers have not adopted a standard system of notation. Although I have attempted to follow the most common notation system, I may have deviated along the way. This should not concern you.

Following are the symbols used in this book:

- Value at a point in time:
  - $PV$  = Present value; and
  - $FV$  = Future value.

- Cost of capital and rate of return variables:

$k$	=	Discount rate (generalized);
$k_e$	=	Discount rate for common equity capital (cost of common equity capital); unless otherwise stated, it generally is assumed that this discount rate is applicable to the net cash flow available to common equity;
$k_d$	=	Discount rate for debt ( <i>Note: For complex capital structures, there could be more than one class of capital in any of the preceding categories, in which case, expanded subscripts would be required.</i> );
$c$	=	Capitalization rate;
$C_{pt}$	=	Capitalization rate for a pretax benefit stream;
$C_{at}$	=	Capitalization rate for an after-tax benefit stream;
CP	=	Control premium;
$t$	=	Tax rate (expressed as a percentage of pretax income);
$R_f$	=	Rate of return on a risk-free security;
$\beta$	=	Beta (a coefficient, usually used to modify a rate of return variable);
$(R_m - R_f)$	=	Risk premium for the “market” (usually used in the context of a market for equity securities such as NYSE or S&P 500);
SCA	=	Specific company adjustment;
SCP	=	Small company premium; and
WACC	=	Weighted average cost of capital.

- Income variables:

$E$	=	Expected economic income (in generalized sense [that is, could be dividends], any of several possible definitions of cash flow, net income, and so on; also called a <i>benefit stream</i> );
EBIT	=	Earnings before interest and taxes; and
EBITDA	=	Earnings before depreciation, interest, and taxes (“depreciation” in this context usually includes amortization).

- Periods or variables in a series:

$i$	=	The $i$ th period, or the $i$ th variable in a series (may be extended to the $j$ th variable, the $k$ th variable, and so on);
$n$	=	The number of periods or variables in the series, or the last number in the series;
$\infty$	=	Infinity; and
0	=	Period, the base period, usually the latest year immediately preceding the valuation date.

- Weightings:

$W$	=	Weight;
$W_e$	=	Weight (percentage) of common equity in capital structure;
$W_p$	=	Weight (percentage) of preferred equity in capital structure; and
$W_d$	=	Weight (percentage) of debt in capital structure.

*Note: For purposes of computing a weighted average cost of capital (WACC), it is assumed that the above weightings are at market value.*

- Growth:

$g$	=	Rate of growth.
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- Mathematical functions:

$\Sigma$	=	Sum of (add up all the variables that follow).
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