SIXTH EDITION

EXCERPT FROM

UNDERSTANDING BUSINESS VALUATION

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

BVR
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

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.

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Introduction

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 (*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.*);
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;
β	=	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 *benefit stream*);
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 ith 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;
∞	=	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.

- Mathematical functions:

Σ	=	Sum of (add up all the variables that follow).

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