## Contents

### Preface

- Highlights of This Book: xix
- Who Should Read This Book?: xix
- About the Book: xix

### Acknowledgments

- xxiii

### PART I

#### FOUNDATIONS: VALUING A BUSINESS

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Pages</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Fundamental Concepts for Defining Value</td>
<td>1-12</td>
</tr>
<tr>
<td>2</td>
<td>Defining the Engagement</td>
<td>13-28</td>
</tr>
</tbody>
</table>

### Copyrighted Material
<table>
<thead>
<tr>
<th>CHAPTER 3</th>
<th>Information Collection and Due Diligence</th>
<th>29</th>
</tr>
</thead>
<tbody>
<tr>
<td>Importance of the Information Collection and Due Diligence Phase</td>
<td>29</td>
<td></td>
</tr>
<tr>
<td>Industry and Economic Considerations</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Financial Information and Analysis</td>
<td>31</td>
<td></td>
</tr>
<tr>
<td>The Management Interview</td>
<td>35</td>
<td></td>
</tr>
<tr>
<td>Preparation</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>Agenda of a Typical Management Interview</td>
<td>38</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td>CHAPTER 4</td>
<td>An Overview of Valuation Approaches</td>
<td>41</td>
</tr>
<tr>
<td>Recognized Valuation Approaches</td>
<td>41</td>
<td></td>
</tr>
<tr>
<td>Methodology and Level of Value, Direct and Indirect Methodology</td>
<td>42</td>
<td></td>
</tr>
<tr>
<td>CHAPTER 5</td>
<td>Valuation Approaches: The Cost Approach</td>
<td>47</td>
</tr>
<tr>
<td>The Cost Approach</td>
<td>47</td>
<td></td>
</tr>
<tr>
<td>Typical Adjustments in the Cost Approach (Using Tangible Net Asset Value Methods)</td>
<td>53</td>
<td></td>
</tr>
<tr>
<td>To Tax Affect or Not</td>
<td>54</td>
<td></td>
</tr>
<tr>
<td>CHAPTER 6</td>
<td>The Income Approach to Value</td>
<td>59</td>
</tr>
<tr>
<td>Direct Capitalization and Discrete Projection Methods</td>
<td>60</td>
<td></td>
</tr>
<tr>
<td>Reconciliation of Income Methods to Market Methods</td>
<td>61</td>
<td></td>
</tr>
<tr>
<td>Typical Adjustments to the Income Statement</td>
<td>62</td>
<td></td>
</tr>
<tr>
<td>Adjustments That Correspond to Balance Sheet Treatments</td>
<td>63</td>
<td></td>
</tr>
<tr>
<td>Reconciling or Reclassifying Interim-Period Measures to Fiscal-Period Measures</td>
<td>63</td>
<td></td>
</tr>
<tr>
<td>Income Statement Adjustments and Considerations</td>
<td>65</td>
<td></td>
</tr>
<tr>
<td>Matching the Cost of Capital to the Benefit Stream</td>
<td>69</td>
<td></td>
</tr>
<tr>
<td>Developing the Cost of Capital</td>
<td>70</td>
<td></td>
</tr>
<tr>
<td>Summary Examples of Developing the Cost of Equity Capital</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Growth Rate of Earnings/Net Cash Flow</td>
<td>77</td>
<td></td>
</tr>
<tr>
<td>Finishing the Direct Capitalization Equation</td>
<td>83</td>
<td></td>
</tr>
<tr>
<td>Developing the Single-Period Benefit (Ongoing Earnings and Ongoing Net Cash Flow) and Preparation for the Discounted Future Benefits Method</td>
<td>84</td>
<td></td>
</tr>
<tr>
<td>Example of a Single-Period Capitalization to Derive the Market Value of Total Invested Capital</td>
<td>86</td>
<td></td>
</tr>
<tr>
<td>The Discounted Future Benefits Method (DFB)</td>
<td>88</td>
<td></td>
</tr>
<tr>
<td>Conclusion</td>
<td>93</td>
<td></td>
</tr>
</tbody>
</table>
Contents

CHAPTER 7 The Market Approach 95
  Valuation Methods under the Market Approach 96
  Rules of Thumb 97
  Transactions Method 98
  Guideline Public Company Method 99
  The Fundamental Adjustment 105
  Guideline Transactions Method 110

CHAPTER 8 Correlation of Value 113
  Global Considerations in the Correlation Process 113
  Examples of Correlating a Value Indication 118
  Conclusion 124

CHAPTER 9 Valuation Discounts and Premiums 125
  The Levels of Value Revisited 125
  Perspective on the Control Premium 127
  Control Premiums—Substance Over Form 129
  Perspective on the Minority Interest Discount 130
  Marketability Discounts 132
  Conclusion 133

PART II BUSINESS VALUATION STANDARDS 135

CHAPTER 10 Uniform Standards of Professional Appraisal Practice (USPAP) 137
  Overview of USPAP Valuation Standards 138
  USPAP Ethics Rule 139
  2010–11 USPAP Competency Rule 140
  2010–11 USPAP Scope of Work Rule 141
  2010–11 USPAP Jurisdictional Exception Rule 142
  USPAP Business Appraisal Review (USPAP Standard 3) 142
  Business Appraisal Development: USPAP Standard 9 146
  Business Appraisal Report Standards USPAP Standard 10 148
  USPAP Certification Requirement 149
  USPAP Statements on Appraisal Standards and Advisory Opinions 150

CHAPTER 11 American Society of Appraisers (ASA) 153
  Business Valuation Standards 153
  ASA BVS General Preamble 153
  ASA BVS-I (General Requirements for Developing a Business Valuation) 154
  ASA BVS-II (Financial Statement Adjustments) 156
  ASA BVS-III (Asset-Based Approach to Business Valuation) 156
  ASA BVS-IV (Income Approach to Business Valuation) 157
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td>The American Institute of Certified Public Accountants (AICPA) Statement on Standards for Valuation Services</td>
<td>165</td>
</tr>
<tr>
<td></td>
<td>Introduction and Scope</td>
<td>165</td>
</tr>
<tr>
<td></td>
<td>Overall Engagement Considerations</td>
<td>165</td>
</tr>
<tr>
<td></td>
<td>Development</td>
<td>168</td>
</tr>
<tr>
<td></td>
<td>Valuation Approaches and Methods</td>
<td>170</td>
</tr>
<tr>
<td></td>
<td>Detailed Report</td>
<td>176</td>
</tr>
<tr>
<td></td>
<td>Summary Report</td>
<td>180</td>
</tr>
<tr>
<td></td>
<td>Calculation Report</td>
<td>181</td>
</tr>
<tr>
<td></td>
<td>Oral Report</td>
<td>181</td>
</tr>
<tr>
<td>13</td>
<td>National Association of Certified Valuation Analysts (NACVA) Professional Standards</td>
<td>183</td>
</tr>
<tr>
<td></td>
<td>Preamble—General and Ethical Standards</td>
<td>183</td>
</tr>
<tr>
<td></td>
<td>Valuation Services</td>
<td>184</td>
</tr>
<tr>
<td></td>
<td>Development Standards</td>
<td>184</td>
</tr>
<tr>
<td></td>
<td>Reporting Standards</td>
<td>185</td>
</tr>
<tr>
<td></td>
<td>Miscellany</td>
<td>186</td>
</tr>
<tr>
<td>14</td>
<td>The Institute of Business Appraisers (IBA) Business Appraisal Standards</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Standard One: Professional Conduct and Ethics</td>
<td>187</td>
</tr>
<tr>
<td></td>
<td>Standard Two: Oral Appraisal Reports</td>
<td>190</td>
</tr>
<tr>
<td></td>
<td>Standard Three: Expert Testimony</td>
<td>190</td>
</tr>
<tr>
<td></td>
<td>Standard Four: Letter Form Written Appraisal Reports</td>
<td>191</td>
</tr>
<tr>
<td></td>
<td>Standard Five: Formal Written Appraisal Reports</td>
<td>192</td>
</tr>
<tr>
<td></td>
<td>Preliminary Reports</td>
<td>193</td>
</tr>
<tr>
<td>15</td>
<td>Canadian Institute of Chartered Business Valuators Practice Standards</td>
<td>195</td>
</tr>
<tr>
<td></td>
<td>Practice Standard 110—Valuation Reports</td>
<td>195</td>
</tr>
<tr>
<td></td>
<td>Practice Standard 120—Scope of Work</td>
<td>198</td>
</tr>
<tr>
<td></td>
<td>Practice Standard 130—File Documentation</td>
<td>200</td>
</tr>
</tbody>
</table>
Practice Standard 210—Advisory Reports 201
Practice Standard 220—Scope of Work for Advisory Reports 202
Practice Standard 230—File Documentation for Advisory Reports 202
Practice Standard 310—Expert Reports 202
Practice Standard 320—Scope of Work for Expert Reports 204
Practice Standard 330—File Documentation Standards in Expert Reports 205
Practice Standard 410—Limited Critique Reports 207
Practice Standard 420—Scope of Work for Limited Critique Reports 209
Practice Standard 430—File Documentation Standards for Limited Critique Reports 210
Practice Bulletins 210

CHAPTER 16 Internal Revenue Service (IRS) Business Valuation Standards
IRM 4.48.4.1—Introduction 215
IRM 4.48.2—Development Guidelines 215
IRM 4.48.4.3—Resolution Guidelines 218
IRM 4.48.4.4—Reporting Guidelines 218
Addendum A USPAP 3 Comparison Chart 219
Addendum B USPAP 9 Comparison Chart 220

PART III LESSONS FROM THE TRENCHES 221

CHAPTER 17 Alleged Errors of Omission by Appraisers
Failure to Comply with USPAP 224
Valuation Credentials 225
Too Much Involvement by Counsel in the Appraisal Report Preparation 225
Standard of Value 225
Valuation Date 226
The Subject Property Interest 227
Bias 228
Sources of Data 229
Independence 230
Pure Reliance on Case Law 230
Site Visits and Management Interviews 231
Failure to Provide Sufficient Explanation 232
Disregard of Material Facts 232
Failure to Find Available Information 233
Failure to Adequately Support Selection of Beta 234
Improper Sampling Techniques 235
Off Financial Statement Items 236
Failure to Sufficiently Explain Assumptions 236
Insufficient Due Diligence 237
Failure to Make Inquiries with Significant Third Parties 237
Failure to List All Appraisers’ Qualifications 238
Failure to Consider the Small-Stock Premium 238
Failure to Factor in Income Tax 239
Failure to Set Forth the Adjustments to Financial Statements in the Appraisal Report 239
Failure to Produce a Replicatable Report 240
Failure to Identify the Multiples Selected 240
Failure to Discuss Weightings in the Appraisal Report 240
Failure to Distinguish between Tax and Book Depreciation 240
Failure to List Guideline Companies 241
Failing to Separate Operating and Nonoperating Aspects of a Company 241
Failing to Lay Foundation for Small Stock Premium 241
Failing to Justify Capitalization or Discount Rates 242
Failing to Think Like an Investor 242
Failing to Define Capital Structure 243
Failing to Adequately Consider the “Willing Buyer” 243
Failing to Adequately Consider the Willing Seller 243
Failing to Accurately Describe the Subject Property 244
Failing to Properly Classify the Subject Company 244
Failing to Explain the Basis for a Valuation Discount 245
Failing to Properly Consider the Subject Company’s Growth Rate 245
Failing to Explain Market Multiples Selected for Guideline Companies 245
Failing to Explain Equal Weighting of Conclusions of Value 246
Failing to Consider Differences between the Subject Company and the Guideline Companies 246
Failing to Utilize Data from a Guideline Company That the Appraiser’s Own Summary Chart Reflects Is Closest to the Subject Company 246
Failing to Explain the Selection of the Range of Performance Ratios Selected 246
Failing to Adequately Explain Why Companies Selected as Guideline Companies Are in Fact Comparable to the Subject Company 247
Failing to Explain Why So Few Comparable Properties or Guideline Companies Were Selected 247

CHAPTER 18 Alleged Errors of Commission 249
Retrospective Appraisals 249
Use of Past Publications of an Appraiser against the Appraiser 250
Using Untested Methodology 250
Improper Reliance on a Draft Appraisal 251
Conclusion of Value Offends Common Sense 251
Mathematical Errors 252
Inconsistency 253
Double Counting 253
Conflicting Conclusions of Value 254
Sole Reliance on a Valuation Model 254
Incorrect Usage of Discounted Cash Flow Method 256
Skewed Assumptions 256
Overemphasis on Buy-Sell Restrictions among Related Parties 256
Using Historic Book Value of Assets in Net Asset
   Value Approach, Even Though Asset Appraisals
   Had Been Obtained 257
Misapplication of Pre- and Post-Tax Figures 257
Ignoring the Hypothetical Nature of the Willing
   Buyer or Willing Seller 257
Inconsistent Use of Commercially Available Data 258
Use of Commercially Available Data That Warns of
   Statistical Inaccuracy 258
Misstatement of Methodology Employed by Appraisers
   on Whose Work the Appraiser Has Relied 259
Undue Reliance on the Work of Another Appraiser 259
Using a Valuation Method without Laying a Foundation
   That It Is a Legitimate Method (for Example, the Business
   Broker Method Using Data from the IBA Market Database) 259
Improper Reliance on a Study That Does Not Completely
   Provide All Relevant Data 260
Failure to Apply Discussion of Economic Factors to the
   Subject Company 260
Using Commercially Available Data in a Manner Contrary
   to How the Data Source Says the Data Should Be Used 261
Failure to Proofread Report Prior to Issuance 261
Apparently Conflicting Assumptions Used for the Same
   General Purposes without Sufficient Explanation 261
Use of Different Valuation Methods in Valuing the
   Same Interest in Valuation Reports Offered at
   Different Times without Adequate Explanation 262
Making Improper Adjustments to Financial Statements 262
Reliance on the Pre-IPO Studies and the Restricted
   Stock Studies to Determine the Discount for Lack of
   Marketability for a Controlling Interest 263
Misreading or Failing to Properly Consider Revenue
   Ruling 59–60 263
Failure to Accurately State the Number of Shares
   Outstanding in the Subject Company 264
Inconsistency in Valuation Methodology Expressed in
   Testimony versus the Appraiser’s Methodology as
   Expressed in another Writing 264
Unreasonably Low Projections 264
Failure to Add Back Depreciation Included in the Costs-of-Goods-Sold Computation in the Computation of EBIT 264
Combining the Discount for Lack of Control with the Discount for Lack of Marketability 264
Utilizing an Assumed Income Tax Rate That Differed from the Actual Past Tax Rates of the Subject Company 265
Disconnect between Assumption about When Revenues or Expenses Would Be Received or Incurred and When Those Items Were Actually Received or Incurred 265
Error in Computing Terminal Value When Using the Income Approach 265
Discounting an Income Stream Only at or Close to the Risk-Free Rate 266
Modifying or Abandoning Positions Taken in the Written Appraisal Report during the Appraiser’s Testimony 266
Referring to a Standard Industrial Code in the Appraisal Report without Identifying That Number in the Report 267
Relying upon Guideline Companies That Were Not Comparable to the Subject Company 267
Preparing and Utilizing Earnings Projections That Vary Significantly from the Earnings Projections Prepared by the Subject Company 268
Use of Only One Year’s Worth of Guideline Company Data 269
Inappropriate Employment of a Discount to Make a Conclusion of One Valuation Approach Appear More in Line with Another 269
Failing to Properly Calculate a Valuation Discount 269
Inappropriate Use of a Price-to-Asset Multiple Where the Difference between Book Value and Asset Fair Market Value Is Not Close 270
Selection of Too Few Guideline Companies or Comparable Properties 270
Selection of Too Few Performance Measures in the Guideline Company Method 270
Cherry Picking Valuation Multiples 271
Using an Inexcusably Old Comparable Sale 271
Inappropriate Reliance on Governance Document Restrictions in Establishment of Valuation Multiples 272
Stating the Wrong Date from a Comparable Sale 272
Mismatching the Valuation Dates of the Guideline Companies and the Subject Company in Computing Price Multiples 272
Defining “Guideline Company” Too Narrowly 273
CHAPTER 19  Ten Burning Issues within the Appraisal Profession 275

Issue 1: Methods of Determining the Discount for Lack of Marketability 276
Issue 2: Applicability of Discount for Lack of Marketability to a Controlling Interest 286
Issue 3: Validity of Discount for Imbedded Capital Gains 288
Issue 4: Shift of “Comparability” from the Publicly Traded Arena to the Private Arena 289
Issue 5: Efficient Market Hypothesis and Exceptions (For Example, Small-Firm Effect) 290
Issue 6: Value of Control versus Value of Synergy 291
Issue 7: Do Public Company Stock Prices Indicate a Marketable, Minority or a Marketable, Control Position? 298
Issue 8: S Corporation Tax-Affecting 299
Issue 9: Factoring Financial Statement Adjustments When Estimating the Value of a Noncontrolling Interest 301
Issue 10: Validity of the Capital Asset Pricing Model for Valuing Interests in Closely Held Businesses 301
Conclusion 303

CHAPTER 20  Random Practical Valuation Tips and Thoughts 305

Discovery and Privileges 305
Attorney-Client Privilege 307
Attorney Work Product Privilege 308
Tax Practitioner Privilege 309
A Free Standing, Complete Report, or a Mere Letter or Restricted Use Appraisal Report? 309
Those Business Appraisers Must Be Identified in Time 311
Should a Business Appraiser Always Follow USPAP? 311
How Much Input Can a Client’s Advisor Have in the Preparation of a Business Appraisal Report? 312
Types of Appraisers; Appraisal Associations 312
Random Strategy Tips 315

APPENDIX A  Appraisal Standards Chart 321

APPENDIX B  Information Request List 325

APPENDIX C  Management Interview Checklist 327

APPENDIX D  Sample Engagement Letter 329
<table>
<thead>
<tr>
<th>Contents</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Glossary</strong></td>
</tr>
<tr>
<td><strong>Bibliography</strong></td>
</tr>
<tr>
<td>Business Valuation Texts</td>
</tr>
<tr>
<td>Business Valuation Journals and Newsletters</td>
</tr>
<tr>
<td>Cost of Capital</td>
</tr>
<tr>
<td>Equity Risk Premiums</td>
</tr>
<tr>
<td>Articles</td>
</tr>
<tr>
<td><strong>About the Authors</strong></td>
</tr>
<tr>
<td><strong>About the Web Site</strong></td>
</tr>
<tr>
<td><strong>Index</strong></td>
</tr>
</tbody>
</table>