CHAPTER ONE

INTRODUCTION TO BUSINESS VALUATION

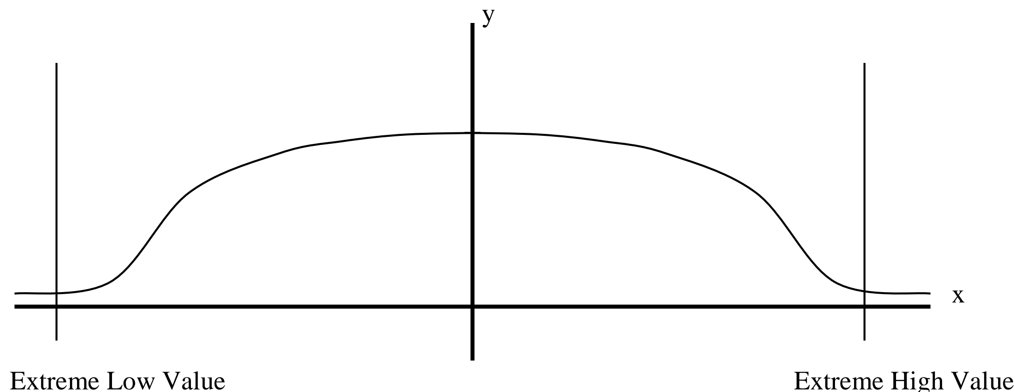
"Everybody is ignorant, only on different subjects."
Will Rogers (1879–1935)
American Philosopher, Author

I. EVOLUTION OF BUSINESS VALUATION

"How much is this business interest worth?" This question is not one that is easily answered. The answer depends on 1) economic factors (these can be local, regional, national, and international); 2) the premise and standard of value selected; 3) appropriate valuation method applied; and, 4) interest being valued, to name just a few factors. In this course, all of the above factors are discussed in detail.

Historically, the valuation of a closely held company was more of an art than a science; there was some guidance provided by the IRS and minimal reporting standards. Accordingly, many in the business valuation profession served as advocates for the client, rather than as an expert (or advocate for the conclusion of value). The growth and diversity within the valuation profession, improvement in software, growing sophistication of the judiciary[1] and availability of data through the Internet has transformed the profession and practice. There is now less guesswork and more scrutiny.

If the value of a company were determined by a sample of inexperienced or unqualified valuation professionals, the distribution of Conclusions of Value (terms defined in NACVA's Professional Standards) can be illustrated by the following bell curve. This bell curve depicts a wide range of values demonstrating valuation as more of an art than science:



[1] See *Daubert et. ux. v. Merrell Dow Pharmaceuticals, Inc*., 509 U.S. 579 (1992) (Court held that the Federal Rules of Evidence, not Frye, provide the standard for admitting expert scientific testimony in a federal trial; nothing in the rules gives any indication that "general acceptance" is a necessary precondition to the admissibility of scientific evidence. The trial judge has the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand) and *Kumho Tire C. v. Carmichael*, 526 U.S. 137 (1999) (Daubert standard applies to scientific, technical or other specialized knowledge; Rule 702 imposes a special obligation upon the trial judge to ensure testimony is relevant and reliable; reliability assessed by considering if methodology has been tested, subject to peer review, has error rates, and/or is "acceptable" in the relevant scientific or technical community). A summary of both cases is included in Appendix One.

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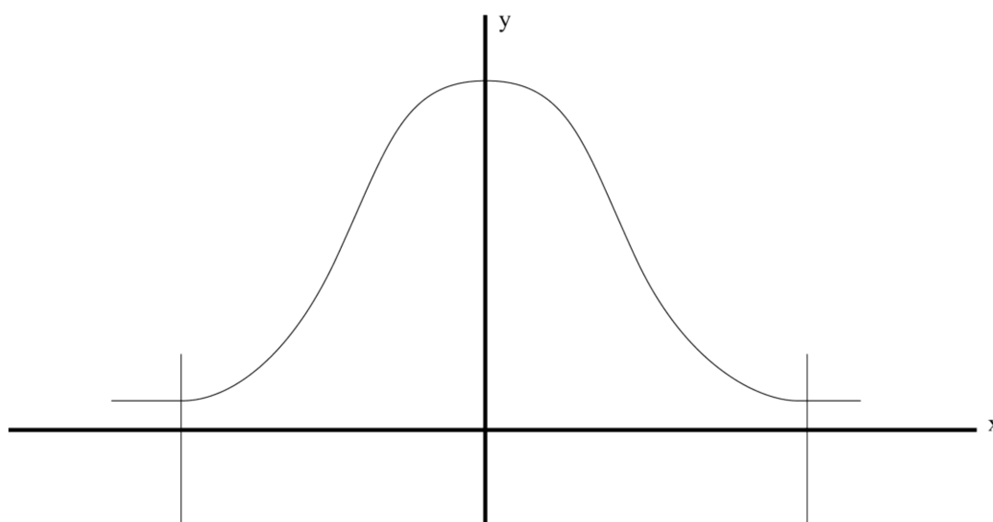
The distribution of values, obtained from a sample of experienced valuation professionals, illustrates two important things:

- The curve is relatively flat, indicating a broad range of opinions of values
- The range or spread between the highest and lowest conclusion of value would be relatively large

A vast difference in values is considered detrimental to the credibility of professionals involved in business valuation activities. Consequently, valuation analysts must attempt to explain the difference between their different conclusions of value (the term conclusion of value is an important term defined in NACVA's Professional Standard 2.1). One of the primary purposes in this course is to place more emphasis on the science of performing valuations of closely held companies. That said this does not mean the course is intended to teach a prescribed format or preferred methodology.

As valuation theory and practice evolve, one expects the bell curve to evolve and appear as follows:



This illustration reflects a situation where the various "conclusions of value" are more similar and the range between the highest and lowest value is smaller.

NOTE: During the first two or three days of this program you may find studying this topic more than a little frustrating compared to other financial disciplines with which you've been involved. We urge you to remain patient. As the program is fully laid out you'll begin to see the "big picture" of the topic.

> **Observation**
>
> **Business valuation is not for the faint at heart!**

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II. REGULATORY BODIES

Business valuation practice and theory have evolved significantly in the last decade, but many believe this field is still in its relative infancy. Valuation theory in the areas of intellectual property, venture capital, and limited partnerships is still emerging. A strong theoretical foundation is essential in any field, and the valuation professional can look to the following professional and regulatory bodies for guidance.

A. INTERNAL REVENUE SERVICE (IRS)

1. Catalyst in the Development of Standards

The Internal Revenue Service has substantially contributed to valuation theory and is regarded by many as a primary theoretician in the field of valuation of closely held businesses. The IRS has issued numerous rulings and pronouncements on this subject, and in 2002 the IRS issued new Business Valuation Guidelines, which were updated in 2006 (see Appendix III).

Revenue Rulings do not have the force of law, but they do present the position of the IRS on specific tax matters, such as the valuation of businesses or equity interests. Beginning in the 1920's, the IRS published Appeals and Revenue Memorandum 34 (ARM 34, see Appendix III) in response to the Eighteenth Amendment, which enacted Prohibition laws. The purpose of ARM 34 was to establish guidelines and methodologies for determining the amount of loss sustained by a taxpayer as the result of the new laws on Prohibition. Since then, many positions taken by the IRS in Revenue Rulings were rooted in legal disputes. The resolution of these disputes by the courts has established case law precedent.

Some of the most important Revenue Rulings (RR) related to business valuations are:

a) RR 59–60 Valuing Closely held Stock
b) RR 68–609 Formula Method
c) RR 83–120 Valuation of Preferred Stock
d) RR 93–12 Allowance of Minority Interest Discount in Family Owned Business

Any discussion of valuation theory must include an analysis of IRS pronouncements to understand some basic regulatory premises. IRS pronouncements began with the issuance of ARM 34 in 1920 and continue to the present day.

Observation

The Internal Revenue Service (IRS) was and remains an important body in the development and transformation of valuation theory.

Rev. Ruling 59- 60 is among the most important and often cited revenue rulings; participants are urged to read and understand this revenue ruling.

In this section the evolution of business valuation theory, as developed in various Revenue Rulings, is introduced.

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IRS pronouncements are discussed in the following text as they relate to business valuation theory. It is extremely important for the valuation analyst to become knowledgeable of the relevant issues in these pronouncements. It is highly recommended that you take the time to study these pronouncements carefully (copies of the following IRS pronouncements are provided in Appendix III of this manual).

a) 1920—ARM 34 (See Appendix III)

(1) Issued in 1920
(2) Resulted from the enactment of Prohibition
(3) Issued as the result of the enactment of Prohibition, to assist taxpayers in determining the amount of "intangible value" lost by businesses previously involved in the alcoholic beverage industry

Methods prior to ARM 34

Very few owners of businesses understood that their businesses might have had intangible value; therefore, many businesses were sold and transferred at tangible asset values only.

ARM 34 introduced two key concepts:

(1) Goodwill exists if a business has excess earnings
(2) Goodwill value is determined by capitalizing the excess earnings

ARM 34 also introduced two key problems:

(1) What are excess earnings?

ARM 34 says that "excess earnings" are the earnings of the company in excess of earnings above the norm of companies with similar activities and size.

(2) What is an appropriate capitalization rate?

ARM 34 failed to define an appropriate capitalization rate. However, it gave approximate ranges for tangible and intangible assets. A discussion of these rates will be presented in Chapter 5.

b) 1959—Revenue Ruling 59–60 (See Appendix III)

(1) Issued in 1959
(2) Regarded as the single most important piece of valuation literature
(3) Outlined methods and factors to be used in valuing closely held businesses
(4) Involved itself with Estate and Gift Taxes
(5) Is widely accepted for tax and non–tax purposes

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(6) Provided for a series of valuation formulas or methods

(a) The various formulas are not alternatives to one another; all of its methods should at least be considered
(b) Many formulas are tied to "earnings" rather than "excess earnings"
(c) Earnings are multiplied or capitalized by certain industry factors or "public" company comparable factors

(7) Realized that due to certain circumstances other methods could be used
(8) Recognized that if "comparable" factors are not available, other methods could be used
(9) The key 59–60 methods are:

(a) Comparable price methods (just a few of the many)

i) Price/earnings ratio
ii) Dividend paying capacity
iii) Price/book value

(b) Asset method
(c) Income method
(d) Combined method

(10) Refer to Revenue Ruling 59–60, Section 7, Average of Factors, which states:

> *"Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (e.g., book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance."*

c) 1965—Revenue Ruling 65–193 (See Appendix III)

(1) Modified Revenue Ruling 59–60
(2) Deleted a portion of Section 4.02(f) of Revenue Ruling 59–60
(3) Concerned with separately valuing tangible and intangible property. Section 4.02(f) of Revenue Ruling 59–60 states that:

> *"In some instances it may not be possible to make a separate appraisal of the tangible and intangible assets of the business. The enterprise has a value as an entity. Whatever intangible value there is, which is supported by the facts, may be measured by the amount by which the appraised value of the tangible assets exceeds the net book value of such assets."*

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d) 1966—Revenue Procedure 66–49 (See Appendix III)

(1) Issued January 1, 1966
(2) Provided information and guidelines relative to appraisals of contributed property for federal income tax purposes
(3) Required properly prepared appraisals by qualified individuals
(4) Provided guidelines regarding proper appraisal reports

e) 1968—Revenue Ruling 68–609 (See Appendix III)

Sometimes referred to as the "excess earnings method" or "treasury method", this Ruling introduced a "formula" method to determine values for intangibles, specifically goodwill. Revenue Ruling 68-609 required that adjusted net assets be considered in deriving the total value of a business and discussed the possible use of the following ranges of capitalization rates (generally assumed to be after-tax):

(1) Tangible Assets 8% to 10%
(2) Intangible Assets 15% to 20%

f) 1977—Revenue Ruling 77–287 (See Appendix III)

(1) Issued in 1977
(2) Amplified Revenue Ruling 59–60 relative to discounts for lack of marketability
(3) Specifically recognized criteria for determining discounts for lack of marketability
(4) Provided direction on discounts for publicly traded securities restricted under federal securities laws

g) 1981—Revenue Ruling 81–253 (See Appendix III)

(1) Issued in 1981
(2) Added to Revenue Ruling 59–60
(3) Stated that:

> *"Absent family discord, no minority interest discount will be available for blocks of stock transferred to family members when the family as a group owns a controlling interest in the company."*

(4) Superseded by Revenue Ruling 93–12

h) 1983—Revenue Ruling 83–120 (See Appendix III)

(1) Issued in 1983
(2) Amplified Revenue Ruling 59–60
(3) Contained guidelines for valuing preferred stock
(4) Specified factors to be considered on valuing common and preferred stock for gift and other tax purposes in a recapitalization of a closely held business

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i) 1993—Revenue Ruling 93–12 (See Appendix III)

(1) Issued in 1993
(2) Superseded Revenue Ruling 81–253
(3) Stated that:

> *"A minority discount will not be disallowed solely because a transferred interest, when aggregated with interests held by family members, would be a part of a controlling interest."*

j) 1998—Revenue Procedure 98–34 (See Appendix III)

(1) Issued in 1998
(2) Sets forth a methodology to value certain compensatory stock options
(3) Followed similar approach, as does FASB 123

k) Internal Revenue Code §2703

IRC Code §2703 states for estate, gift and other tax purposes, the value of any property is determined without regard to any right or restriction relating to the property. Key issues for a valuation analyst to be aware of:

(1) An exception exists for any option, agreement right or restriction which, (a) is a bona fide business arrangement, (b) is not a device to transfer property for less than its fair market value, (c) is comparable to similar arm's length arrangements, and (d) these safe harbors must be independently satisfied.
(2) The mere showing that a right or restriction is a bona fide business arrangement is not sufficient to establish the absence of a device.
(3) Each right or restriction must be tested separately.
(4) A right or restriction is considered to meet the three 'safe harbor' requirements if more than 50 percent of the applicable property is owned by individuals who are not members of the transferor's family.
(5) Property owned by non–family members must be subject to the same rights or restrictions.

For more information of these and other Rulings, see Appendix III.

B. UNITED STATES DEPARTMENT OF LABOR (DOL)

The Department of Labor issues regulations specifically pertaining to business valuations for Employee Stock Ownership Plans (ESOPs). Similar to IRS Revenue Rulings, DOL regulations do not have the force of law. Instead, the regulations represent the DOL's stance as it relates to certain issues.

The United States Department of Labor (DOL) issues regulations that are unique to Employee Stock Ownership Plan (ESOP) valuations. These regulations are not included or tested in this course, since the topic is considered advanced.

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Observation

The Financial Accounting Standards Board (FASB) is another body that impacts the valuation profession, along with the International Accounting Standards Board (IASB).

C. U.S. SECURITIES AND EXCHANGE COMMISSION (SEC)

The U.S. Securities and Exchange Commission (SEC) has statutory authority to establish financial accounting and reporting standards for publicly held companies under the Securities Exchange Act of 1934. Throughout its history, however, the Commission's policy has been to rely on the private sector for this function to the extent that the private sector demonstrates ability to fulfill the responsibility in the public interest. In addition to the authority to establish standards, the SEC is responsible for enforcing requirements for key participants in capital markets within its jurisdiction. The SEC provides an overview of its history and current role in a brief publication available on its website:[2]

> When the stock market crashed in October 1929, public confidence in the markets plummeted...Congress held hearings to identify the problems and search for solutions. Based on the findings in these hearings, Congress—during the peak year of the Depression—passed the Securities Act of 1933. This law, together with the Securities Exchange Act of 1934, which created the SEC, was designed to restore investor confidence in our capital markets by providing investors and the markets with more reliable information and clear rules of honest dealing. The main purposes of these laws can be reduced to two common-sense notions:
>
> - Companies publicly offering securities for investment dollars must tell the public the truth about their businesses, the securities they are selling, and the risks involved in investing.
> - People who sell and trade securities—brokers, dealers, and exchanges—must treat investors fairly and honestly, putting investors' interests first…
>
> Though it is the primary overseer and regulator of the U.S. securities markets, the SEC works closely with many other institutions, including Congress, other federal departments and agencies, the self-regulatory organizations (e.g. the stock exchanges), state securities regulators, and various private sector organizations. In particular, the Chairman of the SEC, together with the Chairman of the Federal Reserve, the Secretary of the Treasury, and the Chairman of the Commodity Futures Trading Commission, serves as a member of the President's Working Group on Financial Markets.

[2] "The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation." http://www.sec.gov/about/whatwedo.shtml

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D. FINANCIAL ACCOUNTING STANDARDS BOARD (FASB)

The Financial Accounting Standards Board (FASB) is the designated organization for establishing standards of financial accounting and the preparation of financial reports for non-governmental entities. The FASB is a private sector, self-regulated organization, but the standards set forth by FASB are officially recognized as authoritative by the Securities Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA). FASB replaced the AICPA's former authoritative body, the Accounting Principles Board (APB), in 1973. Prior to the change, the APB had issued APB Opinion No. 16, Business Combinations, and APB Opinion No. 17, Intangible Assets (August 1970). FASB officially weighed into the valuation field in June 2001, with the issuance of Statement of Financial Accounting Standards (SFAS) No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets—which replaced the APB Opinions. SFAS 157, Fair Value Measurements, became effective for financial statements issued for fiscal years beginning after November 15, 2007.

In 2008, FASB reorganized its pronouncements into the Accounting Standards Codification ("ASC" or "Codification").[3] The ASC is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. It is effective for interim and annual periods ending after September 15, 2009. Rules and interpretative releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants.

ASC 350, Intangibles—Goodwill and Other, superseded SFAS 142 and "provides guidance on financial accounting and reporting related to goodwill and other intangibles, other than the accounting at acquisition for goodwill and other intangibles acquired in a business combination or an acquisition by a not-for-profit entity."

ASC 805, Business Combinations, superseded SFAS 141R and "provides guidance on the accounting and reporting for transactions that represent business combinations to be accounted for under the acquisition method." The required use of the acquisition method was a shift from SFAS 141R's prescribed "purchase method."

ASC 820, Fair Value Measurement, superseded SFAS 157, and "defines fair value," "sets out in a single Topic a framework for measuring fair value," and "requires disclosures about fair value measurements."

These topics will be discussed further in the Fair Value Study Guide.

E. INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

Like FASB, the International Accounting Standards Board (IASB) is a private sector, self-regulated standard-setting body. IASB is the independent standard-setting body of the IFRS Foundation. The IFRS Foundation is an independent, not-for-profit organization, whose "primary mission is to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted International Financial Reporting Standards (IFRS) based upon clearly articulated principles." The Trustees of the IFRS Foundation undertake governance and oversight over the IASB and are monitored by a board (The

[3] January 2008 was the initial release of the Codification, which was available during an extended verification period.

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Monitoring Board) composed of public authorities, including representatives from the SEC, the Japan Financial Services Agency, the European Commission, and the International Organization of Securities Commissions (IOSCO).[4] The IFRS Advisory Council is the formal advisory board to the IASB and the Trustees of the IFRS Foundation.

In 2002, Paul Volcker, the first chairman of the Foundation's trustees, addressed the World Congress of Accountants: "I do not think it reasonable today, if it ever was, to take the position that U.S. GAAP should, de facto, be the standards for the entire world. Rather, the International Accounting Standards Board, whose oversight trustees I chair, is now working closely with national standard setters throughout the world to develop common solutions to the accounting challenges of the day. The aim is to find a consensus on clearly defined principles."

The objective of initial memorandum of understanding between FASB & IASB (the "Norwalk Agreement") was to make the existing financial reporting standards of the two entities "fully compatible," which was understood to mean that compliance with U.S. GAAP would result in compliance with IFRS & vice versa, though it was not intended that the standards would be identical. The Norwalk Agreement has been praised by global financial leaders as an important step on the path toward a single set of global accounting standards; nevertheless, some convergence projects remain incomplete or have been discontinued due to an inability of the boards to agree.

Convergence projects that relate to valuation issues have had mixed success. Business Combinations (ASC 805 and IFRS 3) have been largely converged, though Combinations of Entities Under Common Control have not been converged (Pooling of Interests for U.S. GAAP remains). IASB issued IFRS 13, which was basically a verbatim equivalent to FASB's Fair Value Measurement (SFAS 157, now ASC 820). In 2007, the IASB and FASB decided not to address convergence of reporting standards for Intangible Assets (including goodwill). Joint work on Impairment has been discontinued.

III. PROFESSIONAL ORGANIZATIONS

Observation

NACVA, ASA, IBA, and AICPA are other accredited bodies impacting professional and ethical standards for business valuation.

One other accrediting organization in North America is the Canadian Institute of Chartered Business Valuators (CICBV). While it, too, has impacted the valuation profession, it is not discussed here.

A. THE NATIONAL ASSOCIATION OF CERTIFIED VALUATORS AND ANALYSTS (NACVA)

In 1990, the idea to establish an association to support the needs of CPAs and other business professionals in their pursuit to provide business and intangible asset valuation and litigation consulting services was conceived. The idea and dream to have such an association came at the suggestion of numerous professionals throughout the country, who, while attending business valuation seminars offered by the subsequent founders of the National Association of Certified

[4] The chairman of the Basel Committee on Banking Supervision serves as an observer on the Monitoring Board.

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Valuators and Analysts (NACVA®), took the time to express their thoughts and pledge their support to an effort such as NACVA. Since then, NACVA has garnered the loyal support of thousands of valuators in building the Association and expanding its reach.

NACVA's membership of approximately 6,000 professionals is comprised of CPAs and other valuation and consulting professionals, all of whom are pursuing business valuation, litigation forensics consulting, and various other types of related services serving the legal and business communities. Of the total membership, about 80% have obtained the Certified Valuation Analyst® (CVA®), Master Analyst in Financial Forensics™ (MAFF™), or Accredited in Business Appraisal Review™ (ABAR™) designations. You will find our membership comprises some of the most intelligent, dynamic, and innovative people in the professional financial/accounting community. NACVA's members are an elite group of people. As you learn about NACVA, you will discover we have taken many steps to bring together our wealth of resources in order to facilitate the networking of knowledge and theory in the fields of valuation, litigation, fraud deterrence, and related disciplines.

Thousands of organizations and individuals throughout the USA and other parts of the world have an interest in our professional expertise. We are a substantial group of professionals all with unique expertise, who, by and large, are the most qualified group in the country to serve the needs of the users of business and intangible asset valuation services and financial forensic services, including damages determinations of all kinds and fraud detection and prevention services. NACVA's members are all very well educated; most are experienced in accounting, tax, and financial analysis; and all certified members are required to obtain at least 36 hours of Continuing Professional Education (CPE) every three years. The integrity of the Association is furthered by NACVA's rigorous certification programs which require a complete understanding of the process. We believe our valuation, litigation, and fraud certification programs are the country's most objective for specialists in these areas because they emphasize a solid and broad base of knowledge which a professional can build.

NACVA is a progressive organization. The Association consciously pursues goals to attain and disseminate knowledge, develop better theory, increase public awareness of the profession, encourages strategic alliances within the accounting, legal, and business communities, and expands benefits and services to members. NACVA is the premier organization of professionals representing the dominant force in the valuation, litigation forensics and fraud consulting communities.

NACVA's mission is to provide resources to members and enhance their status, credentials, and esteem in the field of performing valuations and other related advisory services. To further this purpose, NACVA will advance those services as an art and science, establish standards for admission to the Association, provide professional education and research, foster practice development, advance standards of ethical and professional practice, enhance public awareness of the Association and its members, and promote working relationships with other professional organizations.

To achieve these purposes, NACVA carries out numerous activities, including but not limited to the following:

1. Advancement, communication, and enforcement of standards of ethical and professional practice
2. Development and presentation of quality educational and training programs

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3. Certification of practitioners on the basis of professional competence, ethics, independence, and objectivity. This includes the establishment of criteria for certification as a Certified Valuation Analyst (CVA), Master Analyst in Financial Forensics (MAFF), and Accredited in Business Appraisal Review (ABAR).
4. Fostering public awareness that a credentialed member has met and continues to abide by standards of ethical conduct, objectivity, and independence and performs his or her services at the highest level of professional competence
5. Promoting and enhancing collegial and professional relationships among members of the Association and among the Association and other professional organizations

B. THE INSTITUTE BUSINESS OF APPRAISERS (IBA)

The Institute of Business Appraisers (IBA) is the oldest and most prestigious professional association devoted solely to the appraisal of closely-held businesses. Established in 1978, IBA is the pioneer in business appraisal education, professional accreditation, and development of the market data necessary for making sound appraisal decisions. The IBA Market Database, with more than 33,000 comparables, is free to IBA members. Since 1978, IBA has been instrumental in promoting the advancement of the careers and practices of business appraisers throughout the world.

IBA's mission is to provide the highest quality of service to our members by assisting them in a journey to professional excellence. Our goal is to provide a supportive and nurturing environment for each member through our resources, including technical support, market data, professional certification, and practical education in all aspects of appraisal of small and mid-size businesses. In fulfilling this mission, IBA Headquarters staff is assisted by the generosity of the many volunteers who provide professional mentoring, report review, instruction, and technical publications for the enhancement of the profession.

To help us meet the professional needs of our members, IBA has established the following goals:

- To increase awareness of business appraisal as a specialized profession
- To ensure that the services of qualified, ethical appraisers are available
- To expand the knowledge regarding the theory and practice of business appraisal
- To develop and provide information, programs, and services for members
- To impact national policy and law affecting the business appraisal community

IBA's professional accreditation program is one of the most important components of our professional development curriculum. Members who meet established criteria may attain the following designation:

1. Certified Business Appraiser (CBA)

This designation denotes a level of competence attained only by the most accomplished business appraisers, and grants its recipients special recognition and prestige among fellow appraisers, the courts, and throughout the business appraisal community.

In order to maintain the high standards of this credential, accredited members are required to obtain at least 36 hours of Continuing Professional Education (CPE) every three years.

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IV. OVERVIEW OF THE BUSINESS VALUATION INDUSTRY

In the first decade of the 21st century, certain key factors will continue to fuel the need for valuations of closely held companies.

A. HISTORY

The valuation of closely held businesses first became a formal issue during the 1920s when the Eighteenth Amendment instituting Prohibition was enacted. Businesses involved in the alcoholic beverage industry were forced to close and found it necessary to value their businesses in order to determine the extent of their losses. ARM 34 discussed earlier was issued to assist in valuing these businesses. Since the 1920s, closely held businesses have been valued for a variety of reasons, resulting in the creation of the consulting service niche in which today's professionals play a pivotal role.

B. ECONOMIC INSTABILITY

During a recessing economy, companies of all sizes react by laying off personnel. Historically, these layoffs have involved only blue–collar workers. Past recessions have affected both blue–collar and white–collar employees. In prior years, companies such as IBM Microsoft and Boeing, once thought of as companies that could provide unquestioned employment security, have had to lay off employees. Many employees near retirement are often encouraged to leave early with golden parachutes or similar incentives. However, other employees became victims of downsizing, which was especially true at the turn of the 21st century.

Many of these individuals consider the possibility of starting their own businesses or purchasing an entire or partial interest in an existing business. Those considering a purchase of an existing business generally require a valuation of that business. Unstable economic conditions have also caused many companies to reassess their long-term objectives and strategic direction.

During the 1980s there were mergers and acquisitions of many larger companies. In the 1990s, and now currently, small- to medium-sized companies entered the M&A arena. Companies consider merging with or acquiring another company in order to:

1. Help ensure economic stability in a recessing economy through overhead sharing
2. Maintain or increase market share
3. Establish strategic alliances for growth and diversification

Presently, acquiring companies often require valuations of each company associated with the proposed combination or purchase. In addition, economic instability has resulted in increased numbers of bankruptcies. Tax and other regulations related to these bankruptcies frequently necessitate a business valuation.

C. AGE DEMOGRAPHICS

During the next 10 to 20 years, the so–called baby boomers will be retiring. In America, the 55 to 64 age group is expected to rise from 29 million in 2004 to 40 million in 2014. That is because of the explosion of births during the prosperous postwar period between 1946 and 1964. These retiring parents, who represent the wealthiest generation in history and whose

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major assets frequently consist of interests in closely held businesses, will need assistance with their succession planning. Succession planning entails transferring their businesses in the following ways:

1. Gift the business to their heirs
2. Sell the business to their heirs
3. Sell the business to third parties
4. Establish a charitable trust
5. Establish an ESOP
6. Issue options to key employees

Regardless of the alternative selected, a valuation is usually necessary.

D. LITIGATION ENGAGEMENTS

It has been said that ours is a litigious society; it is. When finances become strained, there is more pressure on relationships, which often leads to dissolution or a break-up amongst key employees, resulting in the need for a valuation.

1. Valuations are often required in situations involving:

   a) Partner disputes
   b) Dissenting shareholder actions
   c) Fairness opinions
   d) Divorces[5]

2. Valuations are also often necessary in situations that may involve litigation[6] related to the establishment of an economic loss involved in the following types of cases:

   a) Wrongful death
   b) Wrongful injury
   c) Wrongful loss of property
   d) Patent infringement

E. TAX PLANNING

Tax planning is associated with rights/restrictions of ownership interests in non–traditional legal entities.

1. Family Limited Partnerships and Family Limited Liability Companies
2. Limited Liability Companies

[5] The Consultant's Training Institute (CTI) offers an in-depth matrimonial workshop; the workshop is ideally suited to valuation analysts that are either new to the profession or have less than five years of work experience in the matrimonial "niche".
[6] The CTI also offers courses to practitioners interested in the areas mentioned hereunder. The training provided through the MAFF is suited to practitioners that provide "litigation support" (or forensic economic) services with a focus on commercial damages, and to a lesser extent personal damages, which arise in employment litigation, wrongful death and/or personal injury matters.

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F. FINANCIAL REPORTING

Relatively new but important changes in financial reporting are also increasing the demand for business valuations. For example, Financial Accounting Standard No. 142 requires that goodwill be tested for impairment at least annually. In order to test goodwill for impairment, it is necessary to estimate the Fair Value of the acquired company or business unit.

V. PURPOSES OF VALUATIONS

A. PURPOSES FOR VALUING BUSINESS

Before valuing a company, one must know the purpose of the valuation. There are four basic purposes for valuing a business; tax, litigation, transaction and regulatory. The purpose of the valuation will affect the assumptions and methodologies used to determine value. There are many reasons to have a closely held business valued, including:

1. Mergers and acquisitions
2. Sales and divestitures
3. Buy/sell agreements
4. Fairness opinions
5. Shareholder transactions
6. Capital infusions
7. Employee Stock Ownership Plans (ESOPs)
8. Employee benefit plans
9. Expert testimony/litigation support
10. Estate planning and taxation
11. Gift taxes
12. Solvency opinions
13. Insolvency opinions
14. Collateral valuations
15. Purchase price allocations
16. GAAP valuations under FAS 141 and/or FAS 142
17. Charitable contributions
18. Determination of net operating loss in bankruptcy
19. Determination of liquidation value in bankruptcy
20. S Corporation Elections—calculation of built-in gain per asset
21. Banks—loan applications
22. Eminent domain proceedings
23. Marital dissolution

Some of the common reasons for valuations are expanded in the following paragraphs.

1. Mergers, Acquisitions and Sales

Whenever a company merges with another company, is acquired by another company, or sold, a valuation is necessary. In a merger situation, a professional may be asked to establish an "exchange value" of the companies involved. The valuator may be engaged to establish the value for either or both of the companies. In a sale or divestiture of a company or of an interest in a company, the seller may engage a professional's services to establish a range of values of the business that will assist the seller in negotiating a sales price.

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Conversely, a person or company may engage a professional to perform a valuation of a company they want to acquire. When businesses are acquired, they are often acquired for a flat or lump-sum amount. For accounting and tax reasons, the lump-sum purchase price must be allocated among the various classes of tangible and intangible assets of the business.

a) IRC Code §338

Under Code §338 (see Appendix III), a corporation, which acquires a controlling interest in another corporation may elect to treat the stock purchase as an asset purchase. It, therefore, is not a valuation method per se, but a procedure for allocating the lump-sum purchase price among various classes of assets. The seven classes of assets and their descriptions are indicated in Table 1–2.

Table 1–2 IRC Section 338 Classes of Assets

Class No.	Description
I	Cash and cash equivalents
II	Certificates of deposits and marketable securities
III	Accounts receivable
IV	Inventory
V	All assets not in any other class
VI	All amortizable Section 197 intangibles
VII	Goodwill and going concern value

Prior to IRC Code §197, the distinction between Class VI and Class VII was very important, as it differentiated between amortizable and non–amortizable assets. However, since purchased goodwill is currently amortizable for tax purposes, the classification is somewhat less important.

There are certain advantages of electing to treat a stock purchase as an asset purchase:

(1) Income tax benefits of being able to depreciate or amortize assets
(2) Ability to pick and choose which liabilities are being assumed
(3) Ability to exclude all contingent liabilities
(4) Ability to change form of business entity

b) IRC §1060

While Code §338 pertains to the corporate purchase of a controlling interest in stock, Code §1060 pertains to the transfer of assets which constitute a trade or business, whether it is a corporation or otherwise. The purchaser's basis in the assets purchased is allocated among all tangible and intangible assets using the classification criteria provided in Code §338.

It should be noted that both the seller and the buyer of a group of assets which constitute a trade or business must report to the IRS the effects of the allocations of the purchase price to the various assets (a copy of the necessary Form 8594 is provided at the end of this Chapter).

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As previously indicated, Code §1060 applies to all taxable entities while Code §338 applies only to corporations.

2. Buy-Sell Agreements

All closely held businesses should adopt a buy-sell agreement among the partners or shareholders. Much protracted litigation could be avoided if, in the beginning, the business owners would address the issue of a buy-sell agreement in their partnership or shareholders agreements. A buy-sell agreement is an agreement that establishes the methodology to be followed by the parties regarding the ultimate disposition of a departing or a deceased owner's interest in a closely held business. The process of determining the value of the business is directed by the buy-sell agreement and there are many alternative procedures for doing so. Some buy-sell agreements provide for the determination of value merely by agreeing to a value at the beginning of each year. Some agreements are based on a predetermined or prescribed formula, whereas other agreements require that an independent valuation be performed periodically. Regardless of the alternative selected by the owners, a professional may be asked to assist in the valuation process.

There are two basic types of buy-sell agreements: the stock-repurchase and cross-purchase agreements. Under a stock-repurchase agreement, the company agrees to purchase the interest of a departing owner. A cross-purchase agreement allows the remaining owners to purchase the departing owner's stock.

An appropriately constructed buy-sell agreement will address several important items including:

a) What events (e.g., death, disability, etc.) trigger the buyout?
b) How will the buyout be funded: insurance, financing or something else?
c) How soon will the buyout occur, in 30 days, 60 days or longer?
d) How is the interest to be valued, i.e., based on a fixed value, a formula, or a valuation?

Note: when preparing a business valuation one should always review the existing buy-sell agreements for restrictions, valuation methodology, puts/calls, terms of purchase, etc.

3. Employee Stock Ownership Plans (ESOPS)

An ESOP is a type of employee benefit plan. It is considered a defined contribution plan and is intended to invest primarily in the employer's stock. The ESOP is a mechanism by which employees become beneficial owners of stock in their company.

To establish an ESOP, a firm creates a trust which the employer funds by either contributing shares of the company and/or contributing cash to buy company shares. The company can also have the ESOP borrow funds to buy new or existing shares of company stock. The trustee responsible for managing the ESOP trust may be a bank, trust company, disinterested individual, company officer, or employee. The contributions a company makes to its ESOP can be tax-deductible up to an amount equal to 25 percent of the payroll of the participants in the plan.

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Many small- to mid-sized employers have instituted ESOPs. Generally, any non-publicly traded company with an ESOP must obtain a valuation of its stock on an annual basis. One significant advantage of an ESOP is that shareholders of a closely held corporation can defer taxation on the gain resulting from their sale of company stock to an ESOP, provided the ESOP owns 30 percent or more of a company's shares after the sale. In order to defer the gain, the seller must reinvest sale proceeds in qualified replacement property (QRP) consisting of stocks or bonds in operating companies in the U.S.

IRC Section 401(a)(28)(C) specifically requires the use of an "independent appraiser" for ESOP valuations. At a panel discussion sponsored by the ESOP Association, the employee stock ownership plan (ESOP) requirements for independent appraisers were discussed. Practitioners wanted to know the conditions for meeting these requirements by outside CPA firms providing audit and tax services to an employer. According to a projects leader for the IRS Employee Plans Technical and Actuarial Division, a firm will be treated as an independent appraiser under Sec. 401(a)(28)(C) if all of the following conditions are met:

a) The firm represents itself to the public as an appraiser or performs appraisals on a regular basis
b) The appraiser is qualified to value the type of property
c) The appraiser is not a related party. See IRC. Reg. Sec. 1.170A–13(c)(5)

4. Estate, Gift and Income Taxes

In many cases, the value of an interest in a closely held business is an individual's primary asset. The value of the closely held business must be ascertained to adequately perform a thorough and comprehensive estate or financial plan. It may also be necessary to establish the value of an interest in a closely held business to properly prepare estate or gift tax returns and to establish the basis of inherited stock in the hands of an heir to an estate.

Age demographics, as previously stated, will involve parents wanting to retire who will have to properly deal with the value that has accumulated in their closely held businesses. There are various ways a business owner can transfer the value that has accumulated in a closely held business. These include giving the business to the heirs, selling the business to the heirs or to third parties, or giving the business to a charity. Regardless of how the business is transferred, an independent valuation of the business interest is imperative.

If parents die before making transfer arrangements for the business, a value will have to be established for reporting on an estate tax return.

The universal standard of value for gift, estate, and inheritance taxes is "fair market value." Fair Market Value is defined in Revenue Ruling 59–60 as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

Revenue Ruling 59-60 also outlines a number of valuation methods and techniques which have become generally accepted and which must be considered in each case. However, as previously mentioned, valuation is as much an art as a science. The final determination of value under the regulatory standard will depend upon the facts and circumstances of the particular valuation.

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Practice Pointer

The Taxpayer Relief Act of 1997 added IRC Section 2001 (f); Section 2001 (f) requires full disclosure of the method used for valuing a business interest; for the IRS to revalue a gift made after August 5, 1997, that has been adequately disclosed, a final notice of re-determination must be issued within the applicable statute of limitations period.

If a charitable gift is made of property valued at more than $5,000, a "qualified appraisal" must be attached to IRS Form 8283; the charity, in turn, must provide contemporaneous written acknowledgement (the substantiation requirement).

See *Estate of Roark v. Commissioner*, T.C. Memo 2004-27 (failure to properly substantiate a donation results in a denial of charitable tax deduction). U.S. Tax Court opinions are available at www.ustaxcourt.gov.

See IRS Regulation §1.170A- 13(c)(3)(ii).

5. Litigation Support

For a variety of reasons, an attorney involved in a pending lawsuit might need to determine the value of a closely held business. The professional, as the expert, will be asked to give expert testimony regarding the conclusions. The need for litigation support[7] relative to business valuations can arise in divorces, partner disputes, dissenting shareholder actions, insurance claims or wrongful death and injury cases.

6. Regulatory—FAS 141 and 142

The FASB now requires that independent valuations be made to establish the purchase value of all intangibles included in a business combination. Similarly, FAS 142 requires an annual review of the values of intangible assets in order to measure whether or not any impairment of the original or carrying value has occurred. Under Sarbanes-Oxley, an independent auditor is explicitly forbidden to provide "appraisal or valuation services, fairness opinions, or contribution-in-kind reports" for any of its audit clients.

7. Attestation Under FAS 141 and 142

The independent valuations discussed above will be subject to the audit process and under current AICPA guidelines; the independent auditor must possess the skills necessary to evaluate the valuer's methods, critical assumptions, and data. The AICPA recommends that auditors engage their own expert if the auditor does not possess sufficient expertise.

[4] NACVA, through the Consultants' Training Institute (CTI) offers one additional certification program, the Master Analyst in Financial Forensics (MAFF), to meet the need of its membership in competing in these new business opportunities.

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VI. VALUATION CONCEPTS

In this chapter, we will "search for truth" as it relates to valuation theory and make an attempt to reconcile it with practice. In order to develop our understanding of valuation theory, we must understand and agree upon certain valuation concepts.

A. VALUATION

A valuation is a process taken to establish a value for an entire or partial interest in a closely held business or professional practice, taking into account both quantitative and qualitative tangible and intangible factors associated with the specific business being valued.

Definition: The act or process of determining the value of a business, business ownership interest, security, or intangible asset (as defined in the International Glossary of Business Valuation Terms (IGBVT) found in Chapter Eight).

B. APPRAISAL

In the process of performing a valuation of a closely held business, the valuation analyst may require property appraisals of various specific assets owned by the company, such as:

1. Art (from a reputable art dealer)
2. Coins (from a reputable coin dealer)
3. Real estate
4. Machinery and equipment (from a reputable appraiser)
5. Jewelry (from a reputable gemologist or dealer)
6. Antiques (from a reputable dealer)
7. Other collectibles (from other reputable dealers)

C. VALUE OF A PARTICULAR BUSINESS (DEFINED)

> *"One of the frequent sources of legal confusion between cost and value is the tendency of courts, in common with other persons, to think of value as something inherent in the thing being valued, rather than an attitude of persons toward that thing in view of its estimated capacity to perform a service. Whether or not, as a matter of abstract philosophy, a thing has value except to people to whom it has value, is a question that need not be answered for the sake of appraisal theory. Certainly for the purpose of a monetary valuation, property has no value unless there is a prospect that it can be exploited by human beings."*

James C. Bonbright (1891–1985)
Professor of Finance, Columbia University

Similar to the value of many items or possessions, the value of an interest in a closely held business is typically considered to be equal to the future benefits that will be received from the business, discounted to the present, at an appropriate discount rate.

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This seemingly simple definition of value raises several problems, some of which are:

1. Whose definition of "benefits" applies?
2. Future projections are extremely difficult to make (absent a crystal ball) and also very difficult to get two opposing parties to agree to.
3. What is an appropriate discount rate?
4. How long of a stream of benefits should be included in this determination of value?

The following chapters will address each of the problems posed above, and provide a variety of practical methods/solutions for resolving them.

D. THEORETICAL BASIS OF VALUE

Almost everyone has an opinion of value, be it of a business, a tangible asset, or an intangible asset. Unfortunately, the term "value" means different things to different people. This presents problems for the valuation analyst who has the extremely important task of working with clients and other parties to come up with an appropriate definition of value for a specific valuation.

As defined by Webster's dictionary, value is:

> *"A fair return or equivalent in goods, services, or money for something exchanged; the monetary worth of something; marketable price; relative worth, utility, or importance; something intrinsically valuable or desirable."*

> **Observation**
>
> **Three "Standards of Value" are introduced in this section; Fair Market Value, Fair Value, and Strategic/Investment Value. Readers should understand when to apply these and also be able to distinguish between them.**
>
> **"Premises of Value" are also subsequently discussed. All valuations will require the use of one of these six premises of value along with a Standard of Value.**

Three Standards of Value:

1. Fair Market Value

In the 1990s, Arthur Andersen & Co. provided a tongue-in-cheek definition of FMV:

"Fair Market Value is the amount, price, highest price, most probable price, cash or cash–equivalent price at which property would change hands or the ownership might be justified by a prudent investor or at which a willing buyer and seller would exchange, would agree to exchange, have agreed to exchange, should agree to exchange or may reasonably be expected to exchange, possibly with equity to both and both fully aware or having knowledge or at least acting knowledgeably of the relevant facts, possibly even acting prudently and for self–interest and with neither being under compulsion, abnormal pressure, undue duress or any particular compulsion."

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In the U.S., the most widely recognized and accepted standard of value is termed fair market value (FMV). It is the standard used in all Federal tax matters, whether it is gift taxes, estate taxes, income taxes or inheritance taxes. The IRS has defined FMV in Revenue Ruling 59–60 as follows:

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

It is important to remember the "willing buyer and willing seller" mentioned above are considered hypothetical as opposed to specific. Thus a representative price would not be considered a FMV if it were affected by a buyer's or seller's unique motivations. This would be an example of investment value, defined by real estate terminology as "value to a particular investor based on individual investment requirements."

In the *International Glossary of Business Valuation Terms* (IGBVT) (see Chapter Eight for the full glossary), Fair Market Value has this common definition:

Fair Market Value—the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. (NOTE: In Canada, the term "price" should be replaced with the term "highest price.")

2. Fair Value

Fair Value can have several meanings, depending on the purpose of the valuation.

a) In most states, fair value is the statutory standard of value applicable in cases of dissenting stockholders' valuation rights. In these states, if a corporation merges, sells out, or takes certain other major actions, and the owner of a minority interest believes that he is being forced to receive less than adequate consideration for his stock, he has the right to have his shares appraised and to receive fair value in cash. In states that have adopted the Uniform Business Corporation Act, the definition of fair value is as follows:

   "Fair value," with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.

   Even in states that have adopted this definition, there is no clearly recognized consensus about the interpretation of fair value in this context, but published precedents established in various state courts certainly have not equated it to fair market value. The state of Utah has also adopted this definition of fair value with the exception that Utah Code Ann. Section 16–10a–1201(4) 1995 eliminates the words "unless exclusion would be inequitable" from the end of the definition. Within the

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valuation profession the strictest definition of fair value of a minority interest is a pro rata share of a controlling interest valuation on a non-marketable basis.

While each jurisdiction has its own interpretations and definitions, according to the Model Business Corporation Act, Fair Value means "…the value of the corporation's shares determined (i) immediately before the effectuation of the corporate action to which the shareholder objects, (ii) using customary and current valuation concepts and techniques…, and (iii) without discounting for lack of marketability or minority status…"[8]

b) Fair Value is also the standard of value used by the *Financial Accounting Standards Board (FASB)* in its pronouncements pertaining to business valuation. In June of 2004 the FASB released its Exposure Draft *Fair Value Measurements* which attempts, for the first time, to "define fair value and establish a framework for applying the fair value measurement objective in GAAP." Although FASB uses the term "fair value" just as it is used in various state statutes, it should be clearly understood that this is a completely different definition of value. Although FASB's definition of fair value should be considered a work in progress, as of June 2006 FASB's revised definition of Fair Value was as follows:[9]

> *"Fair value is the price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date."*

c) Fair value may also relate to value in divorce. Many states have specific definitions of fair value with regard to marital dissolution.

Note: The differences in the various definitions used for Fair Value are, at present, irreconcilable. That is why you will not find this term in the International Glossary of Business Valuation Terms (IGBVT).

3. Strategic/Investment Value

Investment value is the value to a particular investor based on individual investment requirements and expectations. (NOTE: In Canada, the term used is "Value to the Owner.") (IGBVT)

E. PREMISE OF VALUE

In the valuation context, once the standard of value is determined, the appropriate premise of value must then be selected. Premise of value can be further broken down into various subsets, including:

1. Book Value

Definition: With respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear

[8] "Model Business Corporation Act," Comments copyright © American Bar Foundation and Law and Business, Inc. Section 13.01, pg. 237.
[9] FASB maintains a Fair Value Project website at http://www.fasb.org/project/fv_measurement.shtml.

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on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise. (IGBVT)

Book Value is synonymous with shareholders' equity, net worth, and net book value. It is essentially the difference between the total book value of a company's assets and the total book value of its liabilities. Assets are generally recorded at historical cost, net of any accumulated depreciation and/or value allowances, and liabilities are generally recorded at face value. Because of the potential for unrecorded intangible assets, understated values for the tangible assets, as well as unrecorded assets and liabilities, book value of the company is not an appropriate measure of business value. The longer a particular asset or liability is carried on the books, the greater the potential for differences between book value and fair market value.

2. Going Concern Value

Definition: The value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems and procedures in place. (IGBVT)

A trained and assembled work force is a valuable intangible asset for many businesses because of the substantial costs involved with developing a new work force.

Going concern value can be particularly relevant to service firms, such as medical practices. The American Medical Association refers to going concern value as "in–place value" and states the following relative to practice valuation:
Some advisers give an in–place value to assets because they are assembled into a working system and they help to produce income. For example, a physician may have purchased a piece of equipment for $10,000 and depreciated it over a period of five years at $2,000 per year. At the end of those five years, when the physician decides to sell the practice, the balance sheet shows the value of the equipment as zero because it has been written off in the intervening years. But to a buyer the equipment has value, because it is in place and functioning.

3. Liquidation Value

Definition: The net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced." (IGBVT)

4. Replacement Value

Replacement value refers to the current cost of a similar new property having the nearest equivalent utility to the property being valued.

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VII. HOW VALUATION PURPOSE AFFECTS THE CONCLUSION OF VALUE

Before a valuation analyst proceeds in valuing a business, he/she must recognize the purpose for which the valuation is needed. Different purposes require the use of different valuation methods and approaches and will frequently generate different values.

NACVA Professional Standards require the valuation analyst specifically and carefully define the purpose of each valuation. (NACVA Standard 3.3(d))

> *"No single valuation method is universally applicable to all appraisal purposes. The context in which the appraisal is to be used is a critical factor. Many business appraisals fail to reach a number representing the appropriate definition of value because the appraiser failed to match the valuation methods to the purpose for which it was being performed. The result of a particular appraisal can also be inappropriate if the client attempts to use the valuation conclusion for some purpose other than the intended one."*

Pratt, Reilly, Schweihs, *Valuing A Business* – 4th edition, McGraw–Hill

All valuations can be classified as either:

A. TAX VALUATIONS

1. Estate tax
2. Gift tax
3. ESOPs
4. Allocation of lump-sum purchase price (Code §§338 and 1060 allocations)
5. Charitable contributions
6. Calculation of the Built-in Gain (BIG) for S Corporation Elections

Or

B. NON-TAX VALUATIONS

1. Purchase
2. Sale
3. Merger
4. Buy-sell agreements
5. Regulatory valuations: asset allocation/valuation under FAS 141 and 142
6. Litigation support

    a) Partner/shareholder disputes: There is a growing need for valuation services in this area
    b) Divorce actions: State law governs disputed property settlements. Most states have failed to establish standards of value

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c) Damage/economic loss cases

(1) Breach of contract
(2) Lost business opportunity
(3) Antitrust
(4) Other

Over 30 years ago, former chairman of the Business Management Institute, Victor I. Eber, CPA, pointed out the crucial relevance of appropriately defining the purpose of a valuation:

> *"Appraisal techniques for income, estate, and gift tax purposes can substantially differ from methods used to appraise a business for purposes of acquisition, merger, liquidation, divestiture, split–up and spin–offs.... [T]he typical appraisal for commercial purposes will frequently deal with factors of concern to prospective purchasers, liquidators or merger partners, as distinguished from a determination of an IRS–acceptable value of the business as a free-standing going concern.*
>
> *Many principals and their advisers in buy-sell situations consciously consider a limited number of variables in establishing a value. For example, a small loan holding company negotiating for the purchase of an additional office would concentrate almost entirely on the origin and condition of receivables, with minimum regard for the organization structure, the condition of the office, book value, or the past earnings of the business under existing management .Such truncated appraisal is based on the assumption that the acquiring company can supply those things. Thus, it appears that many essential factors are being ignored, on the recognized assumption that the principals expect to overcome the business deficiencies.*
>
> *For estate and gift tax appraisals, such shortcuts are not taken because the appraiser is typically valuing a business in a noncommercial, non–acquisition setting. Further it is a situation in which the appraiser must follow requirements."*[10]

VIII. VALUATOR VERSUS ADVOCATE

This is a vital concept that must be understood! A valuator relies more heavily on quantifiable, objective data in performing a valuation and attempts to remove as much subjectivity as possible. An advocate introduces subjective factors and attempts to rely more heavily on qualitative factors in providing valuation services.

Definition:

> *To "advocate" is to attempt to make an argument on behalf of an idea or a person. The purpose of advocacy is persuasion. The advocate wants to instill an idea in order to bring about a change in thinking or behavior. The primary tools of an advocate are words and tact.*

[10] Victor I. Eber, "How to Establish Value for Close Corporation Stock That Will Withstand an IRS Audit", Estate Planning (Autumn 1976), pp. 28-29.

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It is critical that the valuation analyst understand his/her role in the valuation engagement such that advocacy in particular engagements (expert engagements) is minimized. The primary focus in this course will be in the context of a "valuator" or an objective "valuation analyst." However, regardless of how much we attempt to be completely objective, we oftentimes find ourselves taking some advocacy position as each valuation engagement will require some subjective choices at various steps in the valuation process. Therefore, we are talking about reducing the level or degree of advocacy when we are in a "valuator" position.

IX. IRC SECTION 6662 ACCURACY RELATED PENALTIES (TAX VALUATIONS)

The Omnibus Budget Reconciliation Act (OBRA) consolidated into one Internal Revenue Code section (Code §6662) several different accuracy-related taxation penalties.

- The negligence penalty (previously assessed under Code §6653(a))
- The substantial understatement of income tax penalty (previously assessed under Code §6661, substantial understatement of liability)
- The substantial valuation overstatement penalty (previously assessed under Code §6659, addition to tax in the case of valuation overstatement for purposes of the income tax)
- The substantial estate or gift tax valuation understatement penalty (previously assessed under Code §6660, addition to tax in the case of valuation understatement for purposes of estate and gift taxes)
- The substantial overstatement of pension liabilities penalty (previously assessed under Code §6659A, addition to tax in case of overstatements of pension liabilities)

The accuracy-related penalty is applied to the portion of any underpayment of tax that is attributable to one or more of the above five issues. All accuracy-related penalties apply to tax returns due, without regard to extensions after December 31, 1989.

In controversies with the IRS[11] which concern valuation issues, it is not uncommon for the IRS to assess accuracy related penalties. However, the Tax Court has consistently refused to allow these assessments when the taxpayer has acted "reasonably" by engaging a valuation professional who has obtained proper training in valuation theory.

Practice Pointer

The North American valuation organizations enforce ethical standards. These ethical standards are separate and distinct from IRC accuracy-related penalties… penalties which valuation analysts involved in tax matters are potentially subject.

X. THE EQUITY INTEREST AS AN INVESTMENT

The purchase of an equity interest in a closely held business should be treated no differently than the purchase of any other investment. The investor should not only expect to receive the investment (the amount invested or principal) back, but should also expect to receive a fair return on the investment. The return should be commensurate with the amount of risk involved.

[11] See Sharp, Jr. vs. Commissioner, February 27, 1997, 97-1 USTC 60,268, http://usataxcourt.gov.

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Observation

The purchase of an equity interest (regardless of whether it is a majority or minority interest) is deemed or considered by the valuation profession an *investment*; as such, the investment requires a fair or reasonable return. Fair or reasonable return depends on the level of business and financial risk.

When thinking of the purchase of an equity interest as an investment, there are certain principles to be kept in mind.

A. THE ALTERNATIVES PRINCIPLE

1. This principle applies to valuing businesses in the context of buying or selling a business
2. In any valuation involving a business that is being offered for sale, it must be realized that both the buyer and the seller have alternatives (choices), and do not necessarily need to enter or proceed with a proposed purchase/sale transaction

B. THE PRINCIPLE OF SUBSTITUTION

The value of an asset tends to be determined by the cost of acquiring an equally desirable substitute.

C. THE INVESTMENT VALUE PRINCIPLE

1. Valuation of security interests in closely held businesses is often a very difficult process. This is due to the lack of an active free trading market for securities in closely held businesses. Because of this lack of a market, many small closely held businesses are valued based on the investment value principle or approach.
2. Simplified formula:

$$\text{Value} = \frac{\text{Benefit Stream}}{\text{Required Rate of Return}}$$

Note: If any two of the three variables are known, the value of the third can be calculated:

a) The investment value of the business (present value)
b) The amount of return (profit) that a business provides to its owner
c) The rate of return expected on the investment (sometimes referred to as yield)

D. RATE OF RETURN/LEVEL OF RISK PRINCIPLE

1. A fundamental relationship exists between rate of return from an investment and the amount of risk associated in the investment
2. There is a direct relationship between risk and return. The greater the risk—the greater the required rate of return
3. There are various types of investments that carry different levels of risk and, therefore, different potential returns. The following are sample rates of return on various types of investments

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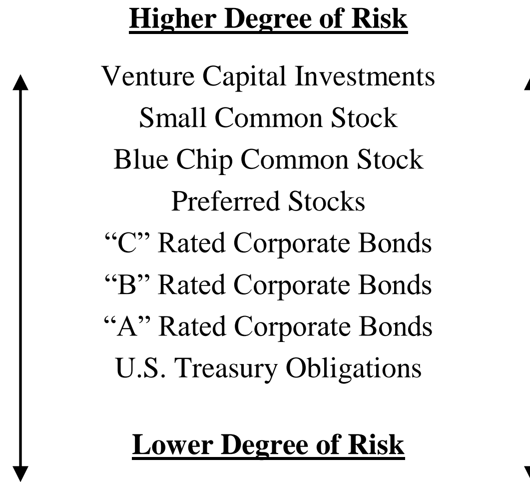
Description of Investment	Rates of Return* (2000)	Rates of Return (2005)
Bank mortgages (30–year fixed conventional)	8.08%[1]	5.81%[4]
Long–term (20 yr) treasury bonds	6.23%[1]	4.85%[5]
Intermediate (5 yr) term treasury bonds	6.16%[1]	3.63%[5]
Six month CDs	5.09%[1]	2.72%[5]
Common stocks (publicly traded):		
Large Company Stock Total Returns for Year	–9.11%[2]	10.87%[6]
Long Horizon NYSE Equity Risk Premium	7.10%[3]	6.10%[7]

[1]Statistical Abstract of the United States – 2001 pages 736–740
[2]SBBI Valuation Edition Annual Year Book – 2000 page 31
[3]SBBI Valuation Edition Annual Year Book – 2000 page 266
[4]www.stlouisfed.org January 12, 2005
[5]tmpages.com Board of Governors Federal Reserve Jan. 11, 2005
[6]SBBI Valuation Edition Annual Yearbook- 2005 page 31
[7]SBBI Valuation Edition Annual Yearbook- 2005 Appendix C

*This information illustrates that the required rate of return changes over time and that riskier investments require higher rates of return. The valuation analyst will use different rates to fit the year of the valuation. Current year rates of return are not applicable to all engagements, and the analyst should not be lulled by current year numbers.

ORDER OF INVESTMENT RISK



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XI. KEY FINANCIAL VARIABLES

Whether one focuses on historical data or future projections, there are three key variables that are extremely important in determining the value of a closely held business. Each of these variables are equally important in estimating "value" and the valuation analyst, utilizing personal knowledge and judgment combined with sufficient facts about the business being valued, must make informed decisions regarding each variable in order to reach a proper Conclusion of Value. Chapters Two, Four, and Five will discuss these factors in more detail. These three key financial variables are:

- Identification and definition of appropriate benefit stream
- Measurement of appropriate benefit stream (which forms the basis for determining the value of the expected benefit stream)
- Determination of an appropriate capitalization/discount rate

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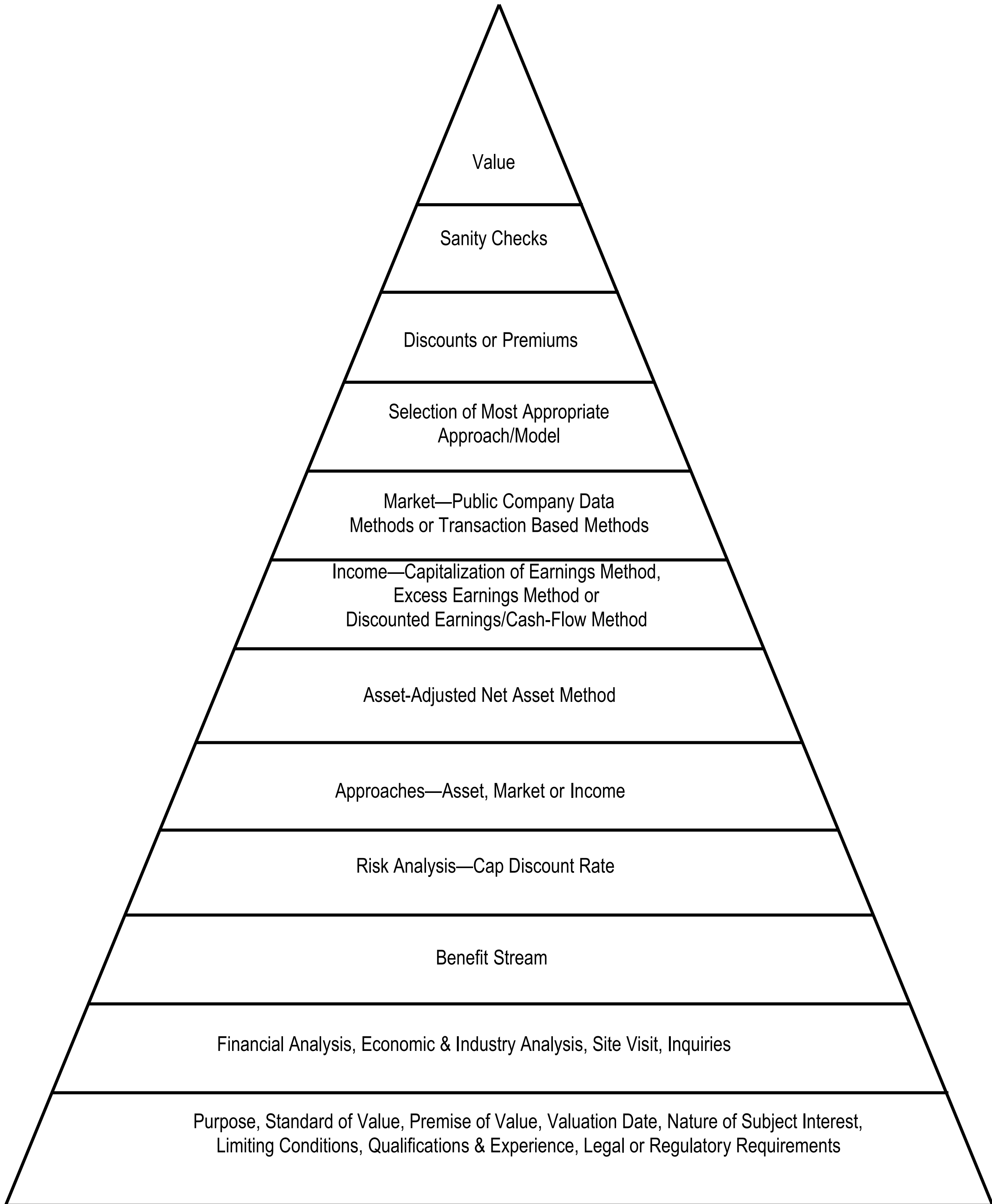
The Valuation Process



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Form **8594** (Rev. February 2006) Department of the Treasury Internal Revenue Service

Asset Acquisition Statement Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021 Attachment Sequence No. **61**

Name as shown on return | Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I General Information

1 Name of other party to the transaction | Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale | 3 Total sales price (consideration)

Part II Original Statement of Assets Transferred

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 2-2006)

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Form 8594 (Rev. 10-2002) Page **2**

Part III **Supplemental Statement—**Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

Form **8594** (Rev. 10-2002)

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Instructions for Form 8594

Department of the Treasury
Internal Revenue Service

(Rev. February 2006)

Asset Acquisition Statement Under Section 1060

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Both the seller and purchaser of a group of assets that makes up a trade or business must use Form 8594 to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Form 8594 must also be filed if the purchaser or seller is amending an original or a previously filed supplemental Form 8594 because of an increase or decrease in the purchaser's cost of the assets or the amount realized by the seller.

Who Must File

Generally, both the purchaser and seller must file Form 8594 and attach it to their income tax returns (Forms 1040, 1041, 1065, 1120, 1120S, etc.) when there is a transfer of a group of assets that make up a trade or business (defined below) and the purchaser's basis in such assets is determined wholly by the amount paid for the assets. This applies whether the group of assets constitutes a trade or business in the hands of the seller, the purchaser, or both.

If the purchaser or seller is a controlled foreign corporation (CFC), each U.S. shareholder should attach Form 8594 to its Form 5471.

Exceptions. You are not required to file Form 8594 if any of the following apply.

- A group of assets that makes up a trade or business is exchanged for like-kind property in a transaction to which section 1031 applies. If section 1031 does not apply to all the assets transferred, however, Form 8594 is required for the part of the group of assets to which section 1031 does not apply. For information about such a transaction, see Regulations sections 1.1031(j)-1(b) and 1.1060-1(b)(8).
- A partnership interest is transferred. See Regulations section 1.755-1(d) for special reporting requirements. However, the purchase of a partnership interest that is treated for federal income tax purposes as a purchase of partnership assets, which constitute a trade or business, is subject to section 1060. In this case, the purchaser must file Form 8594. See Rev. Rul. 99-6, which is on page 6 of Internal Revenue Bulletin 1999-6 at *http://www.irs.gov/pub/irs-irbs/irb99-06.pdf,* and Regulations section 1.1060-1(b)(4).

When To File

Generally, attach Form 8594 to your income tax return for the year in which the sale date occurred.

If the amount allocated to any asset is increased or decreased after the year in which the sale occurs, the seller and/or purchaser (whoever is affected) must complete Parts I and III of Form 8594 and attach the form to the income tax return for the year in which the increase or decrease is taken into account.

Penalties

If you do not file a correct Form 8594 by the due date of your return and you cannot show reasonable cause, you may be subject to penalties. See sections 6721 through 6724.

Definitions

Trade or business. A group of assets makes up a trade or business if goodwill or going concern value could under any circumstances attach to such assets. A group of assets can also qualify as a trade or business if it qualifies as an active trade or business under section 355 (relating to distributions of stock in controlled corporations).

Factors to consider in determining whether goodwill or going concern value could attach include:

- The presence of any section 197 or other intangible assets (but the transfer of such an asset in the absence of other assets will not be a trade or business);
- Any excess of the total paid for the assets over the aggregate book value of the assets (other than goodwill or going concern value) as shown in the purchaser's financial accounting books and records; or
- A license, a lease agreement, a covenant not to compete, a management contract, an employment contract, or other similar agreements between purchaser and seller (or managers, directors, owners, or employees of the seller).

Consideration. The purchaser's consideration is the cost of the assets. The purchaser's consideration is the amount realized.

Fair market value. Fair market value is the gross fair market value unreduced by mortgages, liens, pledges, or other liabilities. However, for determining the seller's gain or loss, generally, the fair market value of any property is not less than any nonrecourse debt to which the property is subject.

Classes of assets. The following definitions are the classifications for deemed or actual asset acquisitions.

Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations, and other depository institutions.

Class II assets are actively traded personal property within the meaning of section 1092(d)(1) and Regulations section 1.1092(d)-1 (determined without regard to section 1092(d)(3)). In addition, Class II assets include certificates of deposit and foreign currency even if they are not actively traded personal property. Class II assets do not include stock of target affiliates, whether or not actively traded, other than actively traded stock described in section 1504(a)(4). Examples of Class II assets include U.S. government securities and publicly traded stock.

Class III assets are assets that the taxpayer marks-to-market at least annually for federal income tax purposes and debt instruments (including accounts receivable). However, Class III assets do not include:

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- Debt instruments issued by persons related at the beginning of the day following the acquisition date to the target under section 267(b) or 707;
- Contingent debt instruments subject to Regulations sections 1.1275-4 and 1.483-4, or section 988, unless the instrument is subject to the noncontingent bond method of Regulations section 1.1275-4(b) or is described in Regulations section 1.988-2(b)(2)(i)(B)(2); and
- Debt instruments convertible into the stock of the issuer or other property.

Class IV assets are stock in trade of the taxpayer or other property of a kind that would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.

Class V assets are all assets other than Class I, II, III, IV, VI, and VII assets.

Note. Furniture and fixtures, buildings, land, vehicles, and equipment, which constitute all or part of a trade or business (defined earlier) are generally Class V assets.

Class VI assets are all section 197 intangibles (as defined in section 197) except goodwill and going concern value. Section 197 intangibles include:

- Workforce in place;
- Business books and records, operating systems, or any other information base, process, design, pattern, know-how, formula, or similar item;
- Any customer-based intangible;
- Any supplier-based intangible;
- Any license, permit, or other right granted by a government unit;
- Any covenant not to compete entered into in connection with the acquisition of an interest in a trade or a business; and
- Any franchise (including a sports franchise acquired after October 22, 2004), trademark, or trade name.

However, the term "section 197 intangible" does not include any of the following:

- An interest in a corporation, partnership, trust, or estate;
- Interests under certain financial contracts;
- Interests in land;
- Certain computer software;
- Certain separately acquired interests in films, sound recordings, video tapes, books, or other similar property;
- Interests under leases of tangible property;
- Certain separately acquired rights to receive tangible property or services;
- Certain separately acquired interests in patents or copyrights;
- Interests under indebtedness;
- Professional sports franchises acquired before October 23, 2004; and
- Certain transactions costs.

See section 197(e) for more information.

Class VII assets are goodwill and going concern value (whether or not the goodwill or going concern value qualifies as a section 197 intangible).

Allocation of consideration. An allocation of the purchase price must be made to determine the purchaser's basis in each acquired asset and the seller's gain or loss on the transfer of each asset. Use the residual method for the allocation of the sales price among the amortizable section 197 intangibles and other assets transferred. See Regulations section 1.1060-1(c). The amount allocated to an asset, other than a Class VII asset, cannot exceed its fair market value on the purchase date. The amount you can allocate to an asset also is subject to any applicable limits under the Internal Revenue Code or general principles of tax law.

Consideration should be allocated as follows.

1. Reduce the consideration by the amount of Class I assets transferred.
2. Allocate the remaining consideration to Class II assets, then to Class III, IV, V, and VI assets in that order. Within each class, allocate the remaining consideration to the class assets in proportion to their fair market values on the purchase date.
3. Allocate consideration to Class VII assets.

If an asset in one of the classifications described above can be included in more than one class, choose the lower numbered class (e.g., if an asset could be included in Class III or IV, choose Class III).

Reallocation after an increase or decrease in consideration. If an increase or decrease in consideration that must be taken into account to redetermine the seller's amount realized on the sale, or the purchaser's cost basis in the assets, occurs after the purchase date, the seller and/or purchaser must allocate the increase or decrease among the assets. If the increase or decrease occurs in the same tax year as the purchase date, consider the increase or decrease to have occurred on the purchase date. If the increase or decrease occurs after the tax year of the purchase date, consider it in the tax year in which it occurs.

For an increase or decrease related to a patent, copyright, etc., see *Specific Allocation,* later.

Allocation of increase. Allocate an increase in consideration as described under *Allocation of consideration.* If an asset has been disposed of, depreciated, amortized, or depleted by the purchaser before the increase occurs, any amount allocated to that asset by the purchaser must be properly taken into account under principles of tax law applicable when part of the cost of an asset (not previously reflected in its basis) is paid after the asset has been disposed of, depreciated, amortized, or depleted.

Allocation of decrease. Allocate a decrease in consideration as follows.

1. Reduce the amount previously allocated to Class VII assets.
2. Reduce the amount previously allocated to Class VI assets, then to Class V, IV, III, and II assets in that order. Within each class, allocate the decrease among the class assets in proportion to their fair market values on the purchase date.

You cannot decrease the amount allocated to an asset below zero. If an asset has a basis of zero at the time the decrease is taken into account because it has been disposed of, depreciated, amortized, or depleted by the purchaser under section 1060, the decrease in consideration allocable to such asset must be properly taken into account under the principles of tax law applicable when the cost of an asset (previously reflected in basis) is reduced after the asset has been disposed of, depreciated, amortized, or depleted. An asset is considered to have been disposed of to the extent the decrease allocated to it would reduce its basis below zero.

Patents, copyrights, and similar property. You must make a specific allocation (defined below) if an increase or decrease in consideration is the result of a contingency that

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directly relates to income produced by a particular intangible asset, such as a patent, a secret process, or a copyright, and the increase or decrease is related only to such asset and not to other assets. If the specific allocation rule does not apply, make an allocation of any increase or decrease as you would for any other assets as described under *Allocation of increase* and *Allocation of decrease.*

Specific allocation. Limited to the fair market value of the asset, any increase or decrease in consideration is allocated first specifically to the patent, copyright, or similar property to which the increase or decrease relates, and then to the other assets in the order described under *Allocation of increase* and *Allocation of decrease.* For purposes of applying the fair market value limit to the patent, copyright, or similar property, the fair market value of such asset is redetermined when the increase or decrease is taken into account by considering only the reasons for the increase or decrease. The fair market values of the other assets are not redetermined.

Specific Instructions

For an original statement, complete Parts I and II. For a Supplemental Statement, complete Parts I and III.

Enter your name and taxpayer identification number (TIN) at the top of the form. Then check the box for purchaser or seller.

Part I—General Information

Line 1. Enter the name, address, and TIN of the other party to the transaction (purchaser or seller). You are required to enter the TIN of the other party. If the other party is an individual or sole proprietor, enter the social security number. If the other party is a corporation, partnership, or other entity, enter the employer identification number.

Line 2. Enter the date on which the sale of the assets occurred.

Line 3. Enter the total consideration transferred for the assets.

Part II—Original Statement of Assets Transferred

Line 4. For a particular class of assets, enter the total fair market value of all the assets in the class and the total allocation of the sales price. For Classes VI and VII, enter the total fair market value of Class VI and Class VII combined, and the total portion of the sales price allocated to Class VI and Class VII combined.

Line 6. This line must be completed by the purchaser and the seller. To determine the maximum consideration to be paid, assume that any contingencies specified in the agreement are met and that the consideration paid is the highest amount possible. If you cannot determine the maximum consideration, state how the consideration will be computed and the payment period.

Part III—Supplemental Statement

Complete Part III and file a new Form 8594 for each year that an increase or decrease in consideration occurs. See *Reallocation after an increase or decrease in consideration,* on page 2, and *When To File,* on page 1. Give the reason(s) for the increase or decrease in allocation. Also, enter the tax year(s) and form number with which the original and any supplemental statements were filed. For example, enter "2004 Form 1040."

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this tax form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Recordkeeping	11 hr.
Learning about the law or the form	2 hr., 34 min.
Preparing and sending the form to the IRS	2 hr., 52 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the IRS at the address listed in the instructions for the tax return with which this form is filed.

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In addition to the foregoing chapter of Fundamentals, Techniques and Theory, there are other sources of information which many professionals in the valuation business have read and/or added to their library. The valuation analyst, progressing through the steps in a valuation, should be generally familiar with the body of knowledge represented by this text and other publications. These can include books, papers, articles, seminars, classes and the experience of a valuation mentor or other business mentor the valuation analyst may know. Those at the top of the field continue to grow.

Recommended reading includes, but is not limited to:

- Blackman, Irving L., *Valuing Your Privately Held Business, The Art & Science of Establishing Your Company's Worth*, Section A, Chapter 1 (Valuation, Future Expectation and Uncertainty) and Chapter 2 (Why Valuation is a Must).
- Campbell, Ian R., and Howard E. Johnson, *The Valuation of Business Interests*, Chapter 1 (Business Valuation and Pricing).
- Damodaran, Aswath, *Damodaran on Valuation, Security Analysis for Investment and Corporate Finance*, Chapter 1 (Introduction to Valuation).
- Hitchner, James R., *Financial Valuation Applications and Models*, Chapter 1 (Introduction to Financial Valuations).
- Pratt, Shannon P., R. F. Reilly and R. P. Schweihs, *Valuing a Business, The Analysis and Appraisal of Closely Held Companies*, Part I, Chapter 1 (Business Valuation Standards and Credentials).
- http://www.fasb.org/ is the website maintained by the Financial Accounting Standards Board. It contains current exposure drafts, FASB rulings, and other relevant information. FASB Statements—Full Text, Summaries, and Status (Including Concepts Statements—Full Text and Status are available).
- Fishman, Jay, Shannon Pratt, and William Morrison, *Standards of Value, Theory and Applications.*

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