Business Valuation 101
Compound Value Advisers, LLC
By Jerry Matecun

Business appraisal and valuation can be a highly technical endeavor for those of you who are newly in the market for an appraisal, or for those of you who are engaged in another profession where you need to have a working knowledge of the terminology and key concepts. This primer is intended to give you a high-level overview of some of the purposes for valuation and their respective standards of value, as well as key concepts, terminology, and theory that are utilized in the appraisal process.

Listed below are four broad categories whose purpose will determine a standard of valuation. Once the standard of value is established, this will inform the appraiser of the most appropriate assumptions and methodologies to use in the valuation. Within each of these four categories are multiple reasons that require valuations. For brevity, we will list only a few of the more common.

Common Purposes for Appraisals

1. Tax: estate, gift, income taxes, ESOPs, charitable contributions, lump-sum price allocations.
2. Litigation: divorce, shareholder disputes.
3. Transaction: merger & acquisitions, sales (partial or full), buy-sell agreements.
4. Regulatory: FASB requires independent valuations to establish the purchase price of all intangible (FAS 141 and 142); under Sarbanes-Oxley auditors are explicitly forbidden to provide appraisal services to their audit clients.

In the words of Shannon Pratt, understanding the purpose of the valuation is important because "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. Different statutory, regulatory, and case precedent standards govern valuations of businesses and business interests under various jurisdictions for diverse purposes."[1]

Tax vs. Non-Tax – What is the Difference?

All appraisals fall under these two broad categories and each has different valuation implications. Victor Eber, CPA noted 30 years ago that "appraisal techniques for income, estate, and gift tax purposes can substantially differ from methods used to appraise a business for purposes of acquisition, liquidation, or divestiture……a typical appraisal for commercial purposes will frequently deal with factors of concern to the prospective buyer, liquidator, or merger partners, as distinguished from an IRS acceptable value of the business as a free standing going concern."[2] Shortcuts are common in commercial settings, whereas in tax situations an appraiser must follow standards and requirements.

[1] Shannon Pratt, Alina Niculita, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 5th Edition (McGraw-Hill, 2008), Kindle Edition, LOC 3359

[2] Victor I. Eber, How to Establish Value for Close Corporation Stock That Will Withstand an IRS Audit, Estate Planning, (Autumn 1976), p28-29

Three Standards of Value

1. Fair Market Value: used in most tax settings and its definition is closely aligned with IRS Revenue Ruling 59-60. It assumes that value is a hypothetical price that a knowledgeable buyer and seller would be willing to pay, absent any unique motivation (investment or otherwise of either party).
2. Fair Value: (has several meanings depending on the purpose)
   a) In most states this is the statutory standard that applies to dissenting shareholder valuation rights. The strict definition in the appraisal community is a "pro rata share of a controlling interest on a non-marketable basis."
   b) Ibbotson's definition: "the amount that will compensate an owner involuntarily deprived of property." Others consider fair value to be fair market value without discounts.
   c) FASB Statement 157 provides a single definition for fair value which is similar to fair market value. However, the board observed that the fair market value definition is closely tied to case law developed in the context of tax regulation and may not be relevant for financial reporting purposes.[3]
   d) States often have specific definitions of fair value in divorce situations.
3. Investment or Strategic Value: every investor has different motivations that can impact the price they are willing to pay for an investment.

Once a standard is chosen a premise of value is then selected. Premise of value is defined as an assumption regarding the most likely set of transactional circumstances that may apply to the subject business being valued.

Premise of Value

1. Book Value: assets – liabilities = equity (or book value). Assets are usually recorded at historical cost. The longer an asset is on the books, the greater the potential discrepancy between book value and fair market value.
2. Going Concern Value: the value of a business enterprise that is expected to continue operations into the future. The intangible elements of going concern value result from factors such as having a trained workforce, an operational plant, and the necessary licenses, systems, and procedures in place.
3. Liquidation Value: the net amount that would be realized if the business were terminated and the assets were sold piecemeal. A forced liquidation usually results in less value than an orderly liquidation.
4. Replacement Value: the current cost of a similar new property having the nearest equivalent utility to the property being valued.

Appraiser's Role

The role of an appraiser (or valuation analyst – the terms are used interchangeably) will depend upon the purpose of the engagement. The analyst may act as an appraiser or as consultant, but NEVER both on the same engagement. Appraisers are hired to develop an independent, objective, and unbiased opinion of value. In this role, the appraiser may not serve to advocate the client cause. Conversely, if engaged as a consultant the objective is then to pursue the client cause, either to increase value or to help attorneys or other client advisers. We work with clients in both capacities depending upon the nature of the engagement.

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[3] Shannon Pratt, Alina Niculita, Valuing A Business: The Analysis and Appraisal of Closely Held Companies, 5th Edition (McGraw-Hill, 2008), Kindle Edition, LOC 3547

Objectivity is critical in tax settings. The IRS levies accuracy related penalties per IRC Code 6662 for negligence, underpayment of tax, and overstatement of pension liabilities[4]. The reason that you will want to have an appraisal performed by an accredited professional is that the Tax Court has consistently refused to allow these penalties if the taxpayer has acted "reasonably" by engaging a valuation professional.

Valuation Approaches and Methods

A valuation approach is a general way of determining the value of a business, a percent ownership interest in the business, or the intangible assets in the business. After we collect the information received from the Subject business and obtain information from our own sources, we analyze this information in order to select those approaches and methods of valuation most applicable to the assignment. The three primary approaches in determining the market value of closely held companies are listed below, followed by specific methods within that approach:

1. Income Approaches: Capitalization of Earnings; Discounted Future Earnings
2. Market Approaches: Guideline Public Co.; Merger; Direct Market Data; Prior Sales; Buy-Sells
3. Asset Approaches: Book Value; Liquidation; Adjusted Book Value; Excess Earnings

1. The income approach has its theoretical basis in the Principle of Future Benefits, which states that economic value reflects anticipated future benefits. This approach estimates value by considering the economic income (future benefits) accruing to the Subject's owner over a period of time. This method is advocated in revenue ruling 59-60; appraisers generally accord this primary weighting when valuing operating companies with positive cash flow.

2. The market approach compares multiples of sales, cash flow, or some other metric that may be specific to an industry. It has its theoretical basis in the Principle of Substitution, which states economic value tends to be determined by the cost of acquiring an equally desirable substitute. Equally desirable does not mean identical. It means equally desirable from an ownership or investment standpoint. This method is also advocated in revenue ruling 59-60, and is generally used if 4-6 comparable companies can be found. Appraisers often use this as a "sanity check" on discounted cash flow methods.

3. The asset approach has its theoretical basis in the Principle of Substitution, which is based on the proposition the informed purchaser will pay no more than the cost of producing a substitute business with the same utility as the Subject. This approach uses various methods that consider the value of individual assets, including intangible assets, and liabilities. Appraiser's often use this approach as a "floor" against the other approaches.

It is important to make clear that these three approaches are interrelated. Cash flow drives value and generally determines what a buyer is willing to pay. Determining the growth and sustainability of the cash flow requires analysis and assumption. However, it is the assets that drive the cash flow, so it makes sense to evaluate the assets and try to assign them current market values. Market multiples are direct evidence of what a buyer was willing to pay, yet it is clear that most buyers make an assessment of the assets and the cash return they can achieve with their investment. Each approach has a measure of subjectivity owing to different facts, circumstances, and available information of the subject business.

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

Discount Rate

A discount rate is a key determinant of value which seeks to capture the time value of money, inflation, and the various risks associated with the ownership interest of the Subject Company. It also referred to as the "required return" because it is the return that an investor requires to invest in a company for its perception of the risk involved. Cost of equity is the discount rate used when valuing the equity of the business; the weighted average cost of capital (WACC) is used when valuing the entire enterprise (equity and debt). The build-up and the CAPM methods are two primary ways to determine the discount rate. Both methods require numerous market, company specific, and industry factors. Various assumptions are used to develop a discount rate in order to accurately reflect the risk-reward of the business.

Capitalization Rate and Long-Term Sustainable Growth Rate

The capitalization rate is similar in concept to the discount rate because it discounts future cash flows to the present. The capitalization rate, however, is used only when valuing a stable, predictable benefit stream. It is expressed as the **Discount Rate - Long-Term Sustainable Growth Rate = Capitalization Rate**. A long-term sustainable growth rate implies "perpetual" (i.e. stable, predictable cash flow). Long-term growth rates are generally at or below the growth rate of the economy, depending on the industry and the subject company's economic prospects.

Discounts/Premiums: Discounts for Lack of Marketability (DLOM) and Lack of Control (DLOC)

Determining and applying the various discounts or premiums is one of the most difficult aspects to valuing a business. We will briefly touch on the basic concepts and provide an overview of the common methods used to calculate discounts or premiums. No one way or one method is appropriate for all companies. Before arriving at a final opinion of value, the appraiser must consider adjustments appropriate to the valuation assignment.

There are two discounts most commonly addressed in the valuation of a closely held business: the "minority-interest discount" or "discount for lack of control" (DLOC), and the "discount for lack-of marketability" (DLOM). There are many variations of these discounts including "key-man discount," "liquidity discount," "restricted-stock discounts," and many more. The extent to which a discount reduces valuation, either from a marketable or a control perspective, is influenced by many factors. There is no one formula the analyst can uniformly apply, and often there is a high degree of subjectivity in the process. Adjustments are broadly categorized at the Entity level and at the Shareholder level below in **Exhibit 1:**

Exhibit 1 **Entity Level**	**Shareholder Level**
Voting vs. nonvoting stock	Control Premium
Key person discount	Discount for lack of control
Discount for trapped-in-capital gains	Discount for lack of marketability
Portfolio discount	S-Corp Premium
Contingent liabilities (environmental etc.)	

Entity level: discounts should be applied prior to shareholder level adjustments. All of these issues need to be considered prior to applying discounts at the shareholder level.

Shareholder level: The most common adjustments to indicated values initially determine the differences between the level of control and/or marketability in the interest being appraised versus the level reflected in the value initially determined by each method employed. Although adjustments may be required for differing levels of lack of control and marketability, each are considered separately.

The issues related to level of control must first be considered and once correctly reflected, any adjustments necessary to properly reflect any lack of marketability will be determined. S-Corp's warrant a premium relative to a C-Corp for its tax advantages, but caution is required in its application. Lastly, adjustments may also be required for excess cash and non-operating assets that were previously excluded from this analysis, but must be considered in determining the final opinion of value.

The control interest and marketability basis for each method are detailed below in **Exhibit 2**. In tax cases, the size of the discount is less important than understanding the court's interpretation of the relevance of the analysis in determining the discount. In Mandelbaum v. Commissioner, (69 T.C.M. (CCH) 2852, 1995 where the court determined a 30% discount) the tax court delineated nine factors to consider in determining a DLOM in a gift tax case. Mandelbaum laid out a process and an analytical framework for adjusting the discount as opposed to simple acceptance of an aggregate statistic or a single study. A comprehensive appraisal must thoroughly discuss the analysis and adjustments required in each method used in valuing the Subject, along with rationale used to quantify the discount or premium associated with these control and marketability factors.

Exhibit 2 **Method**	**Control Interest**	**Marketability Basis**	
Income Approach			
Capitalization	Control or Minority	Freely traded or	Closely held
DCF	Control or Minority	Freely traded or	Closely held
Market Approach			
Guideline Public Co.	Control or Minority	Freely traded	
M&A public	Control	Freely traded	
M&A private (DMDM)	Control		Closely held
Discretionary Earnings	Control		Closely held
Asset Approach			
Net Asset Value	Control	Freely traded or	Closely held
Excess Earnings	Control	Freely traded or	Closely held
Liquidation Value	Control		Closely held

Summary

Private companies by their nature have less information available than their public company counterparts. For example, a lack of financial reporting transparency, lack of management depth, and lack of liquidity all create additional uncertainty and the need for subjective judgment. It is not a pure science that can be simply formulated and copied into Excel; often there can be wide variations in the opinions of value from one appraiser to another. The lack of information makes the analysis both objective and subjective to varying degrees depending upon the availability and the quality of information. In this brief primer you can see that there is a lot of technical detail to analyze, theory to apply, and subjective judgment to incorporate into the appraisal process.