THE ART OF BUSINESS VALUATION

ACCURATELY VALUING A SMALL BUSINESS

GREGORY R. CARUSO

WILEY

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Contents

Foreword

This book, *The Art of Business Valuation: Accurately Valuing a Small Business* is an important guide and desk reference for valuing small businesses under $10 million in revenues. The vast majority of businesses are this size, yet most business valuation books, even the ones claiming to be for small businesses, do not address the unique factors impacting these small and very small businesses (also sometimes called micro-businesses). The author's business broker and valuation background provides a practical view of technical valuation issues from someone who has had to then "find the number" in the market. Yet this is not a book about price. It is about business valuation, namely, finding a business value for a specified interest as of a specified date to a specified standard of value.

My contribution to this work has been to provide insight and modification as an experienced practitioner, instructor, and mentor, from a more technical accounting business valuation view. The book's focus on small businesses does not mean that methods or techniques have been simplified or ignored. What has been provided is a thorough examination of how valuation methods really work, with the data that is really available for these businesses. Things like, how to work with less than perfect financial information, how to find a highly supportable multiplier using available data, when to use the market or the income method, how to meet valuation standards, and more. Included in the book are detailed figures, tables, explanations, and on the related website working Excel files and even sample reports that provide a framework that can be adapted to most business valuation needs.

Lastly, while an exact "opinion" may only be supportable and *not* be accurate, our methods, work product, and reports can and should be accurate. That is the standard we all must strive for every day in every engagement. That is why accurate is in the sub-title.

Clearly, the best a valuator can do is issue an "opinion." Therefore, there will be varying viewpoints on the topics and methods presented here. In fact, there will be situations where the facts and assumptions would dictate that we use different techniques than the ones recommended here. That illustrates the importance of professional judgment. That is the Art of Business Valuation.

We find this variety of viewpoints and challenges to our thoughts to be exciting and invigorating. It makes business valuation better. With this view in mind, please contact us at ron@theartofbv.com with your thoughts on the book and the valuation of small businesses. We also would be pleased to receive additional reports, studies, techniques and other viewpoints that can be posted on our related website www.theartofbusinessvaluation.com. This way, we can all continue to learn, grow, and improve together.

Ronald D. Rudich, CPA/ABV/CFF, MS, MCBA, CVA/ABAR/MAFF, CM&AA, CMEA, BCA

Preface

My father was the CEO of a $750,000,000 revenue general contracting firm when he retired 25 years ago. With 20 jobsites under construction, he was king of just knowing where the problem was—and getting someone to solve it—before it became a threat to the company. After all, large general contractors work on 5% or less gross profit. One "bad" job can wipe out a year's profits. Excelling in this environment, one of his favorite maxims was: "I would rather be approximately right than perfectly wrong."[1]

His maxim came out of jobsites full of technical engineers who each solved their system problems perfectly but with no regard for how the building as a whole would work. All too typical were pipes that were shown running through the structural steel that held the building up. What made this more difficult was the fact that often there was nowhere else for the pipes to go. This was offset by the more practical guys in the field who had to make it all work.

This tension between technical perfection and seeing the big picture still exists today in construction and it also exists in business valuation. It is all too easy to get lost in technical details. After all, business valuators tend to be technical people with extensive technical training. Being able to work between these two worlds—the technical and the practical—is the art of contracting for my father and the *Art of Business Valuation* for us.

In most approaches to business valuation, an equation or model is created where a company being valued is compared to other similarly known data. In the asset approach, it is other asset sales. In the market approach, it is sales of other businesses. In the income approach, it is investment options of investors.

The problem with small and very small businesses is that there is an information gap on both sides of the equation. Small businesses tend to have poor data collection. Compilations of the collected data are based on the suspected data. Yet, that is all there will ever be. Small businesses will not be expected to provide GAAP-based audited statements. Therefore, much of this book is about how to work with suspicious company data and other relevant information to close the gap.

Yet most businesses are small and very small businesses. Using 2012 data with $10 million of revenues as an upper limit, 96% of the businesses with payroll are very small. In fact, revenues of $5 million and below cover 93% of the total businesses and revenues under $1 million cover 75% of the firms in the United States.[2]

Even with imperfect data, these owners are still engaged in planning for the future. They are taking out loans. They are adding and eliminating partners who often are lifelong friends or family members, adding volatility to the mix. They are getting divorced. Some are even eventually selling. All of these common activities require an accurate business valuation.

That is the genesis of this book.

HOW DOES ONE ACCURATELY VALUE SMALL BUSINESSES?

How do we as business valuators, business brokers, accountants, lawyers, owners, and other interested parties prepare, review, evaluate, or use an accurate business valuation for small and very small businesses in a clearly difficult environment?

The answer in just a few words may be: “I’d rather be approximately right rather than perfectly wrong.”

After all, we are never going to accurately predict the future. But we can accurately value a business. Accurately valuing a business is using credible cash flows and methods properly based on professional judgment as to material matters.

Accurate does not mean with the advantages of hindsight that we predicted the future precisely. It means we performed our work to high ethical and professional standards based on what is known and knowable, as of the valuation date.

The book is not about how to value mid-sized or large businesses. Much has already been written on that. Even though the methods are the same, valuing larger businesses involves focusing on different specific analyses, different parts of the data, and different risks than valuing small and very small businesses.

A few key elements that both continue through the entire book and should always remain part of the focus when preparing or using a business valuation are:

- Does this make sense?
- What are we valuing?
- What method provides the best comparisons?
- How can we improve one or both sides of the valuation equation?
- How can we tie our value found into a price as a sanity check?
- Does this make sense?

Note the circular effect of these key areas of focus. "Does this make sense?" is listed twice. That question should be listed after every other area of focus and after every question asked, document reviewed, assumption made, and so forth "Does this make sense?" is the essence of the art of business valuation. "Does this make sense?" is the most interesting and most infuriating thing about business valuation.

At its heart, a business valuation is a mix of facts and assumptions to estimate a value based on future results, as of a given day. Integral to the process is the addition of assumptions—after all, we *are* looking to the *FUTURE*. It is said the stock market is valued on the future 18 months. So are private businesses. This brings in assumptions. Layers of assumptions.

The future will rarely be the same as an accurate business valuation. But, by following a systematic process filled with plenty of "Does that make sense?" questions, we can build and document and report accurate business valuations even when any one piece of the puzzle does not quite fit. We can master our art.

Improving the Art of Business Valuation should be the goal of every valuator. Hopefully this book will assist valuators and other users in that endeavor.

HOW TO USE THIS BOOK

Depending on who you are and what you want to accomplish, there are different ways to use this book. This book is more than a book. It also includes a related website with links to a business broker-level estimate of value, a sample annotated calculation report, a sample annotated summary conclusion/opinion report, various checklists and Excel files for many of the calculations and methods shown in the book.

Some suggestions on how different readers could use this book are:

- **New valuation analyst.** The book, along with the sample reports, and using Statements for Standards for Valuation Services (SSVS) No. 1 as a checklist, is a great way to prepare your first few business valuations, assuming they are for typical companies under $10 million in revenues. Keep in mind every valuation is different, so assume you are 85% complete if following these suggestions. Hitchner, Pratt, Mercer, Trugman, and others have written or contributed to more encyclopedic and technical area books. Use them for reference liberally. Do find someone to review your work if you are on your own.
- **Experienced business valuator.** You will find most of this book VERY basic. But many valuators are not familiar with more up-to-date small business market methods. For most

businesses and situations under $1.5 million to $3 million in value, this is the most reliable methodology. In addition, an attempt has been made to present current positions on current income method matters, such as multiple sources of capitalization rate buildup method data, tax affecting, and a review of projections.

- **Certified public accountant (CPA), analyst, or other advisor to a business owner or business buyer.** There are chapters on working with business brokers, transactions, due diligence, increasing business value, the sales process, listening, negotiation, and, of course, business valuation. These are all to the point yet comprehensive enough for many small and very small business situations.
- **Business owner.** Read the chapters on increasing business value, how to sell or buy a business, negotiation, and listening, which are all likely to be helpful and well worth your time. Do hire competent experts. Use this to have a working knowledge and be able to manage your experts.
- **Business broker.** Depending on your level of interest in business valuation, you might want to read how to apply the market method and how to best work with small business financial statements. This was my initial level of interest and work in business valuation. You will also find helpful chapters on asking questions and listening, the business brokerage process, negotiation, Small Business Administration (SBA) loans, and due diligence. Great summaries and checklists are provided. Finally, as you progress and want to have better tools and estimates, you may find the whole book helpful.
- **Attorney.** If you primarily work with small business owners in litigation, growth, or exit planning, this book will provide helpful background. Chapter 14, How to Review a Business Valuation, provides insight into how valuations might be tilted to favor one side or another, either inadvertently or intentionally.

DISCLAIMER

This is a book about business valuation. Business valuation is a curious mix of facts, assumptions, comparisons, methodologies, and theories, used to estimate a value to set standards, as of a specific date. If any part of the mix varies even a small amount, the suggested solution and the calculated result are likely to change substantially.

In addition, in many areas of business valuation, there are multiple methods and theories which may be correct and equally suitable. Finally, the theory and accepted practices are always changing. An effort has been made to reflect current thinking as of the publication date but change is constant.

The need for professional judgment cannot be understated in business valuation. Therefore, use this book as the resource it is. But, liberally use other resources and always follow Standards. Finally, no tax, legal, financial, valuation, or other specific advice is being given. Always use your best judgment and, if you are unsure, check with experts.

NOTES

1. Regarding the source of this quote by Richard Caruso, a variation is often claimed to be by Warren Buffett but my dad was saying it long before that. Officially traced to John Maynard Keynes, "It is better to be roughly right than precisely wrong." Before that, John Banham, a British industrialist, was quoted as saying, "We are in danger of valuing most highly those things we can measure most accurately, which means we are often precisely wrong rather than approximately right." This seems to have particular meaning for valuators. Finally, the original quote is attributed to Carveth Read (1848–1931), a British philosopher and logician, "It is better to be vaguely right than exactly wrong."
2. 2012 Census Data Employer Firms. *See* https://www.sba.gov/advocacy/firm-size-data

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The Art of Business Valuation

CHAPTER 1

What Is My Business Worth?

> In theory, the value of a business or an interest in a business depends on the future benefits that will accrue to it . . .
>
> —Shannon Pratt, *Valuing a Business*, 4th Edition (New York: McGraw-Hill, 2000)

What is my business worth? This is the essential starting point for business valuation.

VALUE IS NOT PRICE

Price is what someone is willing to pay for the business. Price includes the quality of the sales process, negotiation, emotion, economic demand, timing, luck, and financing. Price for private businesses often includes terms with post-closing price adjustments based on continued business performance or adjustments due to failures of representations and warranties. These terms are hard to translate into useful data. There are no mechanisms to determine downstream what actually gets paid for earn-outs and seller notes.[1] There is no verifiable data on how often representations and warranties result in post-closing price adjustments. The importance of emotion in the sales process cannot be overstated. It takes tremendous energy to buy or sell a business. This is diametrically opposed to the valuation process.

VALUE IS ...

Valuation consists of applying established analytical methods and preset assumptions to what is known or knowable about a company in order to estimate its value as of a specific date. These assumptions rarely resemble real-world sales situations. Value and valuations are useful for sale and exit planning discussions but they do not represent prices. In the same way, value is useful when there will not be an arm's length sale. Value is the best that can be done for situations such as adding or removing owners, divorce, litigation, and required compliance situations, for example bank loans, estate and gift taxes, Employee Stock Ownership Plans (ESOPS), fairness opinions, and the like.

Value and price are related but not the same. The only way to determine its price is to buy or sell a business.

Most of this book is about how to value a business. Chapter 13 addresses working with business owners to prepare them and the business with an exit strategy. The chapter concludes by explaining ways to sell small businesses in the market for a price profitably.

NOTE

1. Earn-outs are adjustments to the price based on results that occur after a sale closing. Seller notes are sometimes adjusted or not paid after closing. Each of these can be viewed as an adjustment to the price paid. There is no mechanism for these post-closing price adjustments to be reported to the transaction databases.

CHAPTER 2

Valuation Basics

This chapter covers the basic business valuation assumptions and methodologies that are the necessary building blocks of every estimate of value.

VALUATION IS MODELING

Business valuation is the process of taking a subject company and, through the application of different models, estimating a value. Different models work best in different situations. Each model is generally referred to as a method in business valuation. Selecting the correct model is done using professional judgment, reviewing all available information along with the standards of value and purpose of the valuation.

A key concept is that business valuation models tend to be comparisons. In each case, there are two sides to the comparison: the subject company and the comparables. It is important to try to align the two sides as closely as possible. When that is not possible, it may make sense to use another model. Sometimes there is no model that is close and more professional judgment than is typical will be required.

There is no perfect method, only useful methods. However, even a useful method can be applied in a misleading way. At every level, selection of the model and then proceeding to choose and screen the inputs for comparison, are key to a supportable valuation.

All comparisons have shortfalls. There is no perfect data on either side of the modeling equation. Our job as valuators is to impartially align the two sides and then account for variances where possible, using the method to project into the future.

What is important is considering what will improve our model. Ask the right questions, use the right model, select inputs for apples to apples comparables and then adjust as reasonable. Finally, ask, "Does this make sense?" Work with the case until the answer is YES. That is the truest application of "I would rather be approximately right than perfectly wrong" and that is the Art of Business Valuation.

THREE PRIMARY APPROACHES TO BUSINESS VALUATION

There are many models or methods for valuing a business. These fall into three main approaches.[1] It is important to select the best model or method in order to obtain the most accurate business valuation.

There are three primary approaches, each with different methods for valuing a business. The approaches are the market approach, the income approach, and the asset approach:

1. **Market Approach.** The market approach uses the theory of substitution. Market comparable sales are substituted for the company being valued. In practice, this means that market comparable cash flows and financial information are compared and substituted for the subject company to estimate a value. This is the primary means used for valuations of small and very small businesses.
2. **Income Approach.** The income approach examines what an investor would pay for a business, based primarily on its cash flows. Investors have many choices of how to deploy

their money. Using financial data collected since 1926, the risk and reward actions of investors are used to estimate the value of the subject company.

3. **Asset Approach.** The asset approach estimates the current value of the individual assets of the business. These approaches tend to ignore or underestimate the value of intangible assets, such as goodwill. For this reason, the asset method is often referred to as a floor value. If the business is not generating value based on its cash flows in the market approaches and income approaches, then the assets may be sold, establishing a floor value or high liquidation value. The asset method tends to be used when the subject company may be considering whether to stop operating, owns valuable assets such as real estate, definable and protectable intellectual property, valuable equipment, e.g., excavation companies, or the company is a holding company.

Types of Business Valuation Engagements

Business valuation engagements fall into two different categories: the calculation of value and the conclusion of value. These are revisited in more detail in Chapter 12, Details for Business Valuators.

Calculations of Value. *Calculations of value cover a large range of work product agreed to by the valuator and the client.* Calculations may vary from the simple flat spreadsheet estimate of value (see Tom's Residential Air, provided on the associated website), to something just short of a conclusion or opinion of value in breadth and scope. In all cases, the client needs to be notified that calculations require less valuation procedures and the resulting estimate may vary from what a full valuation engagement would have found.

Conclusion of Value. These are commonly thought of as Opinions of Value but the American Institute of Certified Public Accountants (AICPA) reserves the word "opinion" for audits exclusively. *Conclusions are complete valuation engagements* where the valuation analyst had access to all the necessary data in order to determine the estimate of value. The underlying work and analysis are thorough and complete. Report levels may vary depending on agreement and use.

VALUATION THEORY BACKGROUND

Business valuations for all sizes of business are built on a framework of assumptions. The highest level building blocks of these assumptions are identified and defined in the business valuation report. This section defines some very significant assumptions on which business valuations are built.

STANDARDS OF VALUE

Standards of value is a subtle concept that permeates every assumption made throughout the business valuation. *Who is the buyer and who is the seller?* Every buyer and every seller will have biases and limitations, along with advantages, that will be reflected in the final value found.

A simple way to look at this is to think what would happen if you are selling a high speed but somewhat dangerous race car. A race car driver is going to have a very different view of the value than a family looking for a safe way to transport three kids. At some point the family may buy the race car because it is considered a bargain, but only to resell it because it dos not suit their purposes. Clearly who the buyer is matters. Who the seller is can work very much the same way.

Professional judgment is understanding what is important. That begins with understanding who are the parties to the transaction you are valuing.

Different businesses have different risks and rewards which will be acceptable or unacceptable to different buyers and sellers. Different businesses will also require different levels of sophistication to manage. Different buyers will have different expectations of advantages or disadvantages in running the business that should result in different expected levels of profitability. Therefore, the individual characteristics of the buyer and seller drive many elements and assumptions in valuation. Real-world examples are:

- Gas stations and convenience stores are often sold to people for whom English is a second language. These businesses do not require as much conversation as a consulting business.
- Tax practices are usually sold to CPAs or enrolled agents or other types of accountants and tax preparers.
- Industrial distribution companies can be sold to a variety of people depending on the size and level of complexity of the products distributed.

There is one other piece to this puzzle of standard of value. Namely, is the value being estimated the value to the seller, the value to the buyer, or both? The two parties to the theoretical transaction may have very different views of the value of the business. In the real world of buyers and sellers, most businesses are not for sale, which is just another way of saying the business is worth more to the owner than to buyers who are just other potential owners.

Let's look at some common standards of value:

Fair Market Value

What is the definition of fair market value?

> *Fair market value is 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. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.*[2]

An alternative definition is:

> *Fair market value is 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 arm's 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.*[3]

Critical to the understanding of fair market value is its inherent subjectivity, which even the Appraisal Foundation acknowledges. According to the Uniform Standards of Professional Appraisal Practice (USPAP):

> *Value expresses an economic concept.* As such, it is never a fact, but always an opinion *of the worth of a property at a given time in accordance with a specific definition of value.*

Fair market value is about a fictitious buyer AND a fictitious seller. It is important to remember that we are dealing with the actual business and other surrounding actual facts but even the "seller" is not our actual owner. Our owner for personal reasons might never sell, but the assumption is our fair market value seller will make a deal at some price.

With small businesses it often is helpful to try to visualize the buyer and seller under this standard. Some businesses can be purchased by almost anyone, such as a convenience store or liquor store. These require few special skills and anyone with the drive and money could buy them. Many businesses take some level of expertise or licensure. Law firms tend to be purchased by other lawyers or law firms. As businesses get larger, more expertise and skill are required by buyers. Looking at a possible real-world buyer often makes it easier to apply professional judgment about how the buyer would treat various facts and unknowns or unknowables about the business.

Note that market value in real estate valuation and fair market value in business valuation do not have the same definition. In real estate appraisal, market value includes the assumption of "highest and best use." Real estate appraisals assume a reasonable marketing period as part of the definition of market value instead of a marketability discount that is often used in business valuation under a fair market value standard of value.

Many people assume fair market value includes highest and best use. When working with clients or other users, make sure they understand the value you are calculating is based on the assumptions about the buyer and seller. Talk to them about what fair market value really means in business valuation.

Market Value

IFRS, the International Financial Reporting Standards, contain a reference to market value. Market value has a definition similar to fair market value in real estate:

> *30.1. Market Value is the estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing and where the parties had each acted knowledgeably, prudently and without compulsion.*
>
> *30.2. The definition of Market Value shall be applied in accordance with the following conceptual framework: (a) "the estimated amount" refers to a price expressed in terms of money payable for the asset in an arm's length market transaction. Market Value is the most probable price reasonably obtainable in the market on the valuation date in keeping with the market value definition. It is the best price reasonably obtainable by the seller and the most advantageous price reasonably obtainable by the buyer. This estimate specifically excludes an estimated price inflated or deflated by special terms or circumstances such as atypical financing,*

sale and leaseback arrangements, special considerations or concessions granted by anyone associated with the sale, or any element of value available only to a specific owner or purchaser.[4]

This appears to be much closer to price and to the real estate appraisal definition of fair market value than standards of value currently used in America.

Investment Value

Investment value is the value of a known company to a known specific buyer. In effect, it is the opposite of fair market value where both parties are fictional. In this case both parties are known. The buyer may be a financial buyer or may have recognizable synergies. An investment value definition is: "The value to a particular investor based on individual investment requirements and expectations."[5]

Actual pricing situations with known parties are investment value.

Synergistic Value

The definition of synergistic value is:

70.1 Synergistic Value is the result of a combination of two or more assets or interests where the combined value is more than the sum of the separate values. If the synergies are only available to one specific buyer, then Synergistic Value will differ from Market Value, as the Synergistic Value will reflect particular attributes of an asset that are only of value to a specific purchaser

70.2 If the synergies are available to multiple market participants, then the Synergistic Value may be consistent with the Market Value, as the price the asset should exchange on the valuation date between a willing buyer and a willing seller would likely reflect the value of any synergies available to multiple market participants.[6]

Can a Synergistic Value Also Be a Fair Market Value? To go back to the race car analogy, who is a fair market buyer? Is it anyone wanting a car? Is it only those people wanting race cars? Exactly how broad or narrow is the definition of people wanting race cars? While this question seems silly, contrast this with Synergistic Buyers. At what point is a race car driver synergistic? This leads to the question that has been raised: "Are all market sales synergistic since they were purchased by the most motivated buyer not the typical motivated buyer?"

In *BTR Dunlop Holdings, Inc. v. Commissioner* (*Dunlop*),[7] the U.S. Tax Court ruled, among other things, that a valuation analyst must look at the pool of potential buyers when determining the fair market value of a target entity.

With respect to *Dunlop*, there were six potential buyers, all of whom had a synergistic incentive to acquire the target entity. Therefore, based on the synergistic pool of potential buyers, the Tax Court ruled that a hypothetical willing and able buyer would enjoy the benefits of synergistic value upon acquisition. This indicates that, when it comes to valuing a target entity, a valuation analyst must first examine and understand the market of potential buyers.

A pool of potential buyers comprised exclusively of financial entities (e.g., a private equity fund) would likely find no synergistic value in the target entity. If this were the case, the fair market value standard of value would be more appropriate.[8]

Fair Value

There are at least two different definitions of Fair Value. The first, according to FAS157, for General Accounting and Auditing Standards (GAAS) purposes, namely, for financial reporting:

> *5. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.*

It is an exit price for a particular asset or liability. It could be a stand-alone asset or liability or a collection of assets and liabilities, such as a reporting unit or whole business. Part of the fair value definition is that the asset or liability price will have a reasonable time on the market. Therefore, there would not be independent discounts for marketability.

The second definition of fair value is specified by many state codes and court decisions for the purposes of corporate and divorce litigation. In most of these cases, fair value of the interest is calculated to be fair market value of the entire business divided on a pro rata ownership interest basis. However, there is no universal definition.

Example

One example is from Maine. According to the Supreme Judicial Court of Maine:

> *The valuation focus under the appraisal statute is not the stock as a commodity, but rather the stock only as it represents a proportionate part of the enterprise as a whole. The question for the court becomes simple and direct:*
>
> *What is the best price a single buyer could reasonably be expected to pay for the firm as an entirety? The court then prorates that value for the whole firm equally among all shares of its common stock.*[9]

Fair value in court cases provides indemnification to the minority owner who is unable to stop a majority owner from taking an action, but no longer wants to be an owner after the actions are taken.[10]

Intrinsic Value

Intrinsic value is occasionally used in litigation. It is used in Virginia divorce cases. Here is a quote from the lead case, *Howell v. Howell*:

> *Intrinsic value is a very subjective concept that looks to the worth of the property to the parties. The*

> *methods of valuation must take into consideration the parties themselves and the different situations in which they exist ... Commonly, one party will continue to enjoy the benefits of the property, while the other will relinquish all future benefits. Still, its intrinsic value must be translated into a monetary amount. The parties must rely on accepted methods of valuation, but the particular method of valuing, and the precise application of that method to the singular facts of the case must vary with the myriad situations that exist between married couples.*[11]

It is difficult to apply that standard of value. It has been summarized by Virginia practitioners as "Fair Value along with whatever the judge wants to consider and find." Others have said it is a "crap shoot" or "beauty contest". Be prepared.

It is important to note that there are two types of courts in the United States (except Louisiana), courts of "equity" and courts of "law." Courts of equity are supposed to make things right and produce fair and equitable results. Courts of law are presumed to apply the law even if the result does not seem fair or equitable.

Divorce courts are courts of equity. This means the court (often a judge or jury) is doing its best to be fair. Sometimes fair in the larger context of the case may mean ignoring or reading things into the best business valuation that are not there.

Liquidation Value

What is the definition of liquidation value?

> *Liquidation value: the net amount that can be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced.*[12]

The adjusted equity value found by the asset approach may be deemed to be a high liquidation value. There are tiers of liquidation value, each assumed to be lower than the last. Orderly liquidation will decrease this value based on "reasonable" costs with a somewhat restricted time to liquidate assets. Forced liquidation will further decrease value based on the additional costs and sellers "must sell now" situation.[13]

Standards of Value in Litigation and Divorce

Many small business valuations are performed for litigation and divorce situations. In those situations, state statutes and the relevant courts have often defined the standard of value. Usually these standards are fair market value or fair value. But, beware, sometimes the court will use one standard of value in name and apply a different standard of value in practice.

Therefore, whenever doing a business valuation for litigation, confirm the name and the definition of the standard of value being used in the state or local jurisdiction. Ask your client's attorney for the standard of value to be applied. If they do not know the standard of value to be applied, check on your own. Just Google the case law under a search such as, "Business Valuation, Standard of Value, Divorce, New Jersey." You may also look it up in a resource such as "Standards of Value: Theory and Applications."[14] Just make sure standards have not changed since the publication's date. Read the definition and even the leading case so you understand what the standard of value really is—not just what the term is.

Conclusion: Standard of Value

Standard of value is a subtle concept that permeates every assumption made throughout the business valuation. Who is the buyer and who is the seller? Every buyer and every seller will have biases and limitations along with advantages that will be reflected in the final value determined. Professional judgment begins with a clear understanding of the relevant parties in the transaction.

Make sure you understand the standard of value to be applied in the business valuation process. If the work is for litigation, make sure you understand the definition used for the standard in the jurisdiction. Fair value is NOT always your definition of fair value. The standard of value is a basic building block level of assumption that affects every other assumption and calculation made.

PURPOSE OF THE VALUATION

The purpose of the valuation and the standard of value are often linked together. Namely, the purpose will often define the user and often the user has specified a standard of value. For example, Gift Tax purpose will be prepared for the Internal Revenue Service (IRS) and maybe the tax court. IRS regulations and related court rulings specify that fair market value is the standard of value. Another example is corporate, or partnership, or limited liability company dissolutions will often specify a fair value standard of value under state law.

But, the purpose of the valuation does not always specify the standard of value. For instance, a business valuation for mergers and acquisitions (M&A) purposes can have a fair market value, investment value or synergistic value.

While not as all-defining as the standard of value, the purpose may influence the methods used and assumptions made. For instance, a valuation for internal M&A purposes is likely to be based on the market method. The same valuation for litigation may be based on the income method.

PREMISE OF VALUE

The premise of value answers the question, does the valuator expect the company to continue as a going concern or does the valuator expect the company to cease operations? Going concerns are expected to continue operating into the future. Companies that are not going concerns are expected to be liquidated usually for asset or liquidation value as discussed above.

The Three-Legged Stool

Ron Rudich, CPA, ABV, CFF, CVA, and an instructor for the NACVA/CTI, always teaches that there is a three-legged stool concept that valuators must know and follow.

1. Standard of value.
2. Premise of value.
3. Purpose of the valuation.

If any of these are incorrect, then the valuation will go "off the rails" and the conclusion will be suspect.

ANALYTICAL FRAMEWORK OF BUSINESS VALUATION

Below is a general framework for how to proceed with a business valuation, with cross-references to the relevant chapters in this book. What is not shown is the iterative nature of the process. Changes in one part of the valuation may cause changes throughout other parts. For instance, changes raising the cash flow might result in a lower multiplier if "soft data" does not support the overall found value. This iterative process is integral to business valuation.

- Define the Work (Chapters 3, 12)
- Examine the Company
  - Historical Financial Data (Chapters 4, 11)
  - Normalization of Financials (Chapters 5, 11)
  - Financial Ratios (Chapter 4)
  - Soft Data (Chapter 4)
    - Internal (e.g., People, Processes)
    - External (e.g., Economy, Industry)
    - Forecasts (Chapter 8)
- Select Approach
  - Market (Chapter 6)
  - Asset (Chapter 7)
  - Income (Chapter 8)

- Estimate Value (Chapter 12)
- Examine Interest/Discounts (Chapter 9)
- Goodwill (Chapter 10)
- Final Review (Chapters 14, 15)

This outline will be expanded in the book.

Chapter 13 covers preparing an owner and the small business for a sale and touches on the business purchase and sale process.

MECHANICS OF PREPARING A VALUATION

This section will cover an efficient method for preparing business valuations. Different practices will have different levels of delegation of these tasks. In larger practices, the signor may be providing oversight, guidance, and editing. In many practices, ministerial portions of the work are done by assistants and true valuation portions requiring professional judgment are done by valuators.

Obtaining the Engagement

Depending on the type of engagement, this usually involves a call with the client or the client's advisor. The level of technical discussion will depend on who is on the other end of the call and the purpose. The following questions need to be determined to prepare an engagement letter and provide a quote.

- What is the subject entity?
- What is the interest being valued?
- Who is the client?
- What is the purpose of the engagement?
- Who are the other parties authorized to use the report? (This is often clear from the purpose.)

The following points are always considered in price estimation:

- The size of the business in terms of people and revenues?
- A detailed review of available statements and quality level (e.g., tax returns prepared by owner or accountant, compilation, reviewed, or audited. Cash basis, GAAP, or some other basis). This is often more difficult than it sounds.
- An investigation of contractors, or as businesses get larger, ask for one year's tax returns and internal statements to see what we are working with. Some firms ask for most of the valuation data prior to quoting.

Other items that need to be determined to provide a quote are shown below.

- Standard of value
- Compilation or opinion
- If a compilation, what work needs be performed to meet user requirements and meet the client's needs and valuation standards? While standards provide flexibility for calculations, standards provide that work may not produce a misleading result. The Statements on Standards for Valuation Services (SSVS) also require objectivity in dealing in all professional services (SSVS No. 1, 14).

Can the engagement be performed for a fixed fee or are there so many unknowns that an hourly rate is required? This often bends into clients' desires and purpose. As businesses get larger, there tend to be multiple entities, investments in other businesses, and other loose ends that make fixed fees quite difficult. With small and very small businesses, outside of supporting discretionary add-backs, usually there is only so much documentation and information to be obtained, reviewed, and worked with.

Engagement Agreements. These are essential when doing a business valuation. Engagement agreements specify the work to be performed along with all the other crucial information. They are important to define the limits of your engagement and your ultimate liability for errors or problems. Many firms have several engagement agreements for different purposes, standards, and reporting levels.

When doing fixed fee work, it is important to specify exactly the work that is being performed for the fee. Clear specifications are important for both the work being developed in a calculation, the calculation report deliverable, and the cost. For an opinion or conclusion, the work must meet standards and is already defined. But the report level must be specified and the payment terms stated. When preparing an opinion or conclusion, the valuator has agreed to do the work necessary to render the opinion. That is a work specification.

However, if the valuation is being done for a fixed fee, the work included in the fee may not be everything that is required or desired. For instance, forensic work in litigation to verify underlying numbers is likely to be outside the scope of the fixed fee valuation and report work. Clear specifications of the work included in the fixed fee can provide the best of both worlds by allowing the analyst to quote a fixed fee for known work and the ability to bill for unknown work. Just be very clear in the specification of what is included in the price and be clear with the client so they understand the specific terms.

Documentation. Often the most difficult part of the process to manage is obtaining documentation. Sometimes clients have little or no motivation to provide the documentation. This can be particularly egregious in divorce and litigation situations. Another variation is "compliance," i.e., providing documents under court order where the other party sends the documentation but cut-offs, cash or accrual basis, and the like are mysteriously different. Even when clients are motivated, they tend to be busy and in small companies the book-keeper and owner are each likely to have three other responsibilities.

It is good practice to tell clients at the time of the engagement that there are generally two major document requests. The original one at the beginning and a supplemental one to further support matters that arise from initial review. Clearly, there may be more document requests but in most cases this creates the expectation on the client's behalf to expect a second round of documentation. Often creating a reasonable expectation is half the battle.

The owner/management interview is often done in two steps for small and very small businesses. Many valuators use a questionnaire for the basic interview. The questionnaire covers business organizational matters, potential add-backs, accounting matters, and so on. Sample questionnaires are on the website for this book. Most valuators develop their own questionnaires to fit what they think is important. An important consideration is to develop one that actually gets completed. With small and very small businesses, long questionnaires tend never to be completed. For larger businesses with true financial staff, more detailed questionnaires will be useful. Later, after initial review, a true interview may be set up or additional questions and document requests sent to answer remaining questions.

Documents, when saved into the computer, should be saved with file names that are meaningful. As firms get larger, standardization of folder layout and file names becomes a must. Anyone who may need to access files to prepare, review, or figure out what was done three years later must be able to understand the folder and file structures.

Around this time, initial research should be performed. Economic reports, industry information, comparable data, build-up data, and any other necessary research should be performed, reviewed, and placed in the file.

Once the initial documents have been received, the financial data should be entered into the worksheets. Initial draft adjustments and rough-cut valuation estimates may be calculated. This provides a better understanding of the case and provides time to think about assumptions and other professional judgment matters.

Initial Review. The folder should be reviewed based on data received to date, and should specify what other documents are going to be needed. Often these will revolve around verifying add-backs. Sometimes additional detail is needed with payables or receivables. Sometimes notes and items in the financial statements or tax returns will also indicate loose ends that need to be followed up. Remember, in an opinion of value, standards require doing all the work necessary to issue the opinion.

Questions to ask yourself at preliminary review:

- Does this make sense?
- What is unclear or inconsistent?
- What seems unusual for the business, industry, and so on?
- Is data clear and organized? If not, how can we supplement and test reasonableness?
- What additional data from the company or third parties will help?
- What is missing? What advantage or risk is not being seen at all? Remember your biggest risk is what you do not see at all.
- How will the report be sanity tested? How will the value found be tied on some level to the world of price?

While work must be done in a linear fashion, there is an iterative nature to business valuation. Major assumptions provided by standards and purpose are mixed with company and financial information to then hone new assumptions and questions. This cycle may go on two or three or more times. It can be much like solving a complex math equation. This is truly the Art of Business Valuation.

Once all the initial documentation, research, and financial data and the questionnaire replies have been entered, the analyst will follow this up with email questions and/or a phone or in person conference. Make sure that the notes include who the parties are, the date and start time, and the matters covered. Contemporaneous notes are very helpful. Some younger valuators record the calls with permission. (Always get permission and make the request for permission the first part of the call.) Zoom or other computer/video conferencing is becoming common and is quite effective.

The draft calculations should be updated with revised figures derived from original financials, support documents, and answers to questions. Critical assumptions and judgment issues should be worked through. A second draft of the computations should be completed.

Report Writing. The report can be started. Most small and very small business valuations are based on some level of standardized template report. Specialized software for business valuations often contain templates.[15] Sometimes the calculations are included in the report and sometimes they are attached as exhibits. The report detail and level will vary with what was agreed in the engagement agreement.

In most cases (again unless clearly otherwise specified in an engagement agreement letter or if it falls in a category reporting exception), it is important to write up all assumptions used in preparing the report. All professional judgment matters should be discussed. Methodologies used to verify add-backs, if any, should be reviewed. The valuator should create a road map that can be followed by others as to how the value was determined. This gives users and reviewers the ability to see what was done, replicate results when desired, and modify if they believe that is in order.

Usually writing the report will generate a few more questions and perhaps the need for more documentation. Get these resolved as soon as possible at this stage.

Complete the report. Put all the exhibits and other information into the report. Review the report to make sure all critical matters are addressed and that the value found is fully supported. The aim is to make a case for your value found that is fully supportable and credible and can be reproduced by other qualified valuators. The AICPA Professional Standards are very rule-based. For that reason, SSVS can serve as a checklist for your work. The NACVA has developed checklists which are useful for this purpose also. Finally, Chapter 14, How to Review a Business Valuation also can be used to check your work.

Proofing and Publishing the Work. Have the report proofed. Point out any matters that may be questionable or where you are still considering alternatives to the reviewer so they may focus on them.

Make final modifications and publish and send to the client. In some instances it may make sense to provide the work to the client or attorney as a draft. This may be even more the case with small and very small businesses. Often, upon reading the report, no matter how many times you asked, new helpful information comes out at the time of the review. Sometimes these legitimately change the value found.

Make further changes and issue the final report and opinion or calculation of value. Most business valuators are paid in full prior to issuance of the final report. For small assignments often the retainer obtained at the start covers the entire fee. This simplifies collection and removes any concern about "contingent payments."

PROFESSIONAL JUDGMENT

> USPAP STANDARDS Rule 9-5 Comment, The value conclusion is the result of the appraiser's judgment and not necessarily the result of a mathematical process.
>
> (2018–2019 USPAP)

As clearly stated in the above USPAP Standard, judgment is key. Yet how does one apply judgment to develop an accurate business valuation? The topic of professional judgment is further developed in Chapter 12, Details for Business Valuators.

You're Never Going to Be Exactly Right

There are many reasons why finding the "exact" answer is not going to happen. The biggest reason is the premise that valuation is about future cash flows from a going concern. One thing most small businesses owners will agree on is that they really cannot predict future cash flows. If an owner with 20 years' experience cannot *correctly* predict his next year's cash flow, how can we?

We cannot. But we can make a *reasonable* prediction of cash flows and we can apply *reasonable* (again they are unlikely to be what happens with hindsight) multipliers and capitalization rates to produce very meaningful and accurate opinions of value or conclusions of value as the AICPA and other bodies specify. After all, the best we are expected to do is give an "opinion."[16] This is never going to be demonstrably correct like a simple tax return or audit. It is rarely going to be consistent with what actually happens over the next few years.

Focus on What Matters

Business valuation requires a high level of professional judgment; this is the "art" in what valuators do. There are many elements and applications of professional judgment. This element is very different from book-keeping, basic taxes, or much of auditing. There is often no clear right or wrong. For a more detailed discussion of professional judgment and what matters, see Chapter 12, Details for Business Valuators.

Much of professional judgment boils down to focusing on what matters. If we ask the right questions and use reasonable assumptions and valid logic, we are going to meet our professional obligations and standards while providing a valuable service to our clients and third parties. This is "accurate" in business valuation. Accurate is not exactly predicting the future. That is never going to be achievable.