Business Valuation Reference Guide

Methods, Standards & Terminology

Common Reasons For Valuations

- Mediation & Arbitration
- Buy/Sell Agreements
- Mergers & Acquisitions
- Succession Planning
- Shareholder Disputes
- Employee Stock Ownership Plans
- Obtaining/Providing Financing
- Charitable Contributions
- Purchase Price Allocations
- Divorce
- Estate/Gift Taxes
- Bankruptcy
- Stock Options
- Business Damages
- Intellectual Property
- Fair Value Analyses
- Financial Reporting

Valuation Methods

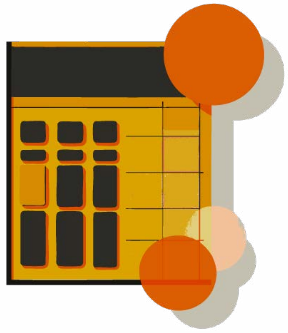
- **Capitalized Returns:** Derives a value of the company by capitalizing some measure of the company's earning capacity at a rate reflective of the return on investment required by the hypothetical investor.
- **Discounted Future Returns:** Derives a value of the company by discounting the projected future earnings of the company to determine the fair market value at the valuation date.
- **Net Asset Value:** Derives a value by adjusting the company's assets and liabilities to market value, and subsequently subtracting those liabilities from the assets.
- **Liquidation Value:** Derives a value by adjusting the company's assets to liquidation value, reducing that number by respective liabilities and income tax implications, and determining the resulting cash flow which will benefit the owner.
- **Excess Earnings:** Return on Assets/Sales—determines the company's fair market value by establishing a value for the adjusted net assets and the intangible assets by capitalizing the earnings of the business that exceed a reasonable rate of industry return on assets or sales.
- **Transactions Method:** Produces a value by comparing the company with comparable privately held companies that have been sold.
- **Guideline Public Company:** Produces a value by comparing the company with various valuation multiples of publicly traded companies.

Common Problems

- Failure to adhere to professional standards, including proper standards of value and valuation methodologies.
- Insufficient understanding and documentation of the subject company.
- Overemphasis on results rather than sound analysis and objective review.

Glossary

- **Asset-Based Approach:** A general way of determining a value indication of a business, business ownership interest, or security by using one or more methods based on the value of the assets of the business net of liabilities.
- **Capital Asset Pricing Model (CAPM):** A model in which the cost of capital for any security or portfolio of securities equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the security or portfolio.
- **Capitalization:** A conversion of a single period stream of benefits into value.
- **Capitalization Rate:** Any divisor (usually expressed as a percentage) used to convert anticipated benefits into value.
- **Control Premium:** An amount (expressed in either dollar or percentage form) by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise that reflects the power of control.
- **Cost of Capital:** The expected rate of return (discount rate) that the market requires in order to attract funds to a particular investment.
- **Discount for Lack of Control:** An amount or percentage deducted from the pro rata share of value of one hundred percent (100%) of an equity interest in a business to reflect the absence of some or all of the powers of control.
- **Discount for Lack of Marketability:** An amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.
- **Discount Rate:** A rate of return (yield rate or cost of capital) used to convert a monetary sum, payable or receivable in the future, into present value.
- **Excess Earnings:** That amount of anticipated benefits that exceeds a fair rate of return on the value of a selected asset base (often net tangible assets) used to generate those anticipated benefits.
- **Excess Earnings Method:** A specific way of determining a value indication of a business, business ownership interest, or security determined as the sum of a) the value of the assets obtained by capitalizing excess earnings and b) the value of the selected asset base. Also frequently used to value intangible assets.



- **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 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.
- **Going Concern Value:** The value of a business enterprise that is expected to continue to operate into the future.
- **Goodwill:** That intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified and/or valued, but which generate economic benefits.
- **Income-Based Approach:** A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated benefits into a present single amount.
- **Intangible Assets:** Non-physical assets (such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities and contracts as distinguished from physical assets) that grant rights, privileges, and have economic benefits for the owner.
- **Invested Capital:** The sum of equity and debt in a business enterprise.
- **Investment Value:** The value to a particular investor based on individual investment requirements and expectations.
- **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."
- **Market-Based Approach:** A general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interest, securities, or intangible assets that have been sold.
- **Marketability:** The ability to convert an asset to cash very quickly, at a minimum cost, and with a high degree of certainty of realizing the expected amounts.
- **Minority Discount:** A discount for lack of control applicable to a minority interest.
- **Net Book Value:** With respect to a business enterprise, the difference between total assets and total liabilities of a business enterprise as they appear on the balance sheet.
- **Non-Operating Assets:** Assets not necessary to ongoing operations of the business enterprise.
- **Premise of Value:** An assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation.
- **Rate of Return:** An amount of income (loss) and/or change in value realized or anticipated on an investment, expressed as a percentage of that investment.
- **Rule of Thumb:** A mathematical relationship between or among variables based on experience, observation, hearsay, or a combination of these, usually applicable to a specific industry.
- **Standard of Value:** The identification of the type of value being utilized in a specific engagement; e.g., fair market value, fair value, investment value.
- **Valuation Approach:** A general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more valuation methods-generally, based on net assets, income or market.
- **Valuation Date:** The specific point in time as of which the valuator's opinion of value applies (also referred to as "Effective Date" or "Appraisal Date").
- **Valuation Method:** Within a valuation approach, a specific way to determine value.
- **Weighted Average Cost of Capital (WACC):** The cost of capital (discount rate) determined by the weighted average, at market value, of the cost of all financing sources in the business enterprise's capital structure.

Resources

- Revenue Ruling 59-60: Valuing closely held businesses.
- Revenue Ruling 65-192: Extends 59-60 to all types of business interests and to income taxes as well as gift and estate taxes.
- Revenue Ruling 68-609: "Formula Method" (excess earnings).
- Revenue Ruling 77-287: Valuing restricted stock.
- Revenue Ruling 93-12: Allows minority discounts when valuing minority interests of family members in family-controlled businesses.

Visit the American Society of Appraisers (appraisers.org) or the National CVA Association (nacva.com) for more resources.

Maximize Your Business Value

Call our team at (800) 477-7458 to learn how an accurate business valuation can support informed strategic decisions.

Jarot Scarbrough, CVA, JD, LLM
Senior Manager
jarot.scarbrough@saltmarshadvisors.com

Lee Bell, CPA
Chief Executive Officer
lee.bell@saltmarshadvisors.com