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# VALUING A BUSINESS

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THE ANALYSIS AND  
APPRAISAL OF  
CLOSELY HELD  
COMPANIES

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SHANNON P. PRATT     *Second Edition*

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# VALUING A BUSINESS

## The Analysis and Appraisal of Closely Held Companies

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Second Edition

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Shannon P. Pratt, DBA, CFA, FASA

President

*Willamette Management Associates, Inc.*

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The Analysis and Appraisal of  
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*To the staff of Willamette Management Associates, Inc.,  
who have demonstrated dedicated professionalism  
and who have contributed immeasurably to this book*

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## About the Author

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Shannon P. Pratt is president of Willamette Management Associates, Inc., a national business valuation firm headquartered in Portland, Oregon, with a branch office in Washington, D.C. Over the past 20 years, Dr. Pratt and his staff of business valuation analysts have become widely recognized and respected as leading contributors to the conceptual development of the business appraisal profession. Having completed thousands of appraisal assignments, Dr. Pratt and his professional associates are frequently called upon to testify in state and federal courts as expert witnesses in business valuation disputes.

Sometimes characterized as the "quintessential researcher" for his endeavor to keep abreast of the issues in the business appraisal profession, Dr. Pratt has been instrumental in developing within his firm one of the most extensive business valuation research libraries in existence, with a constantly updated collection of hundreds of books, articles, transaction data sources, and court cases involving business valuation issues. This book draws heavily on that resource.

Dr. Pratt holds a Doctorate in Finance from Indiana University. He is a Fellow of the American Society of Appraisers in Business Valuation (the highest designation awarded by the Society for outstanding contribution to his field). He also holds the professional designations of Chartered Financial Analyst, Certified Review Appraiser, Certified Business Counselor, Certified Financial Planner, and Senior Certified Valuer.

Dr. Pratt has been a member of the American Society of Appraisers Business Valuation Committee since its inception in 1980; he currently serves as Chairman of The ESOP Association Valuation Advisory Committee and is a member of its Legislative and Regulatory Advisory Committee.

Author of numerous articles on business valuation topics, published in a variety of national professional and trade journals, Dr. Pratt is a frequent speaker at professional appraisal meetings, as well as bar and CPA meetings, industry associations, and financial and estate planning groups. He is also the author of the first edition of this book, *Valuing a Business* (1981), and *Valuing Small Businesses and Professional Practices* (1986), (see outside back cover), both published by Dow Jones-Irwin.

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# Preface

As my professional colleagues are well aware, I thoroughly enjoy the challenge of keeping abreast of developments in the rapidly evolving business valuation profession and sharing the knowledge and insights with others. This book is the core of that ongoing effort.

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## Intended Audience

I have developed this book primarily for the use of business and professional people who must deal with business valuation matters in one way or another. This audience includes business appraisers, attorneys, CPAs, bankers, fiduciaries, and, of course, owners of businesses and business interests. The book is also suitable as a text for a course in business valuation at the graduate or senior undergraduate level.

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## Objective and Scope

The book is a primer on the theory and practice of determining the value of a business or business interest. Its purpose is twofold:

- To provide a complete, self-contained educational tool for those seeking a comprehensive introduction to the basics of business valuation.
- To serve as reference manual for those needing information or direction on some specific aspect of business valuation.

Each aspect of business valuation is described in fundamental terms, with no prior knowledge on the reader's part assumed. Each possibly esoteric term or reference is defined or otherwise identified the first time it is used. Extensive use of examples is made where appropriate. For those who must go beyond the scope of a single-volume text, extensive bibliographical and court case citations are included.

I have attempted to identify, where appropriate, those valuation matters on which there is general consensus among practitioners and those subject to controversy at the time of this writing. Any personal opinions are clearly identified as such.

## Changes Since the First Edition

The preparation of this second edition was a humbling experience. The research involved in making it as comprehensive as possible revealed several hundred new laws, regulations, court cases, books, articles, and information sources in the eight years since the first edition. Also, during these eight years I have gained greater appreciation for the current relevance of some earlier classic works and have incorporated their highlights as additional background in this edition.

I have included more excerpts from the wisdom of long-established valuation theory, such as James Bonbright's *Valuation of Property*. The theory section also includes more material from modern financial theory, particularly the capital asset pricing model. This strengthened theoretical underpinning is followed up with greatly expanded attention to methods and sources for developing required rates of return and capitalization rates.

In keeping with the needs of business valuation and related professionals in this litigious age, the edition devotes far more attention to valuation law; Part VII dedicates three entire chapters to litigation. The chapters on estate planning and ESOPs have been greatly revised and expanded. Several chapters on important topics that the original edition did not address have been added, including a four-chapter section on valuing partial interests.

Chapters and appendixes that are new to this edition are:

Chapter 8	Data on Required Rates of Return
Chapter 15	Valuing Minority Interests
Chapter 16	Valuing Debt Securities
Chapter 17	Valuing Preferred Stocks
Chapter 18	Valuing Stock Options
Chapter 24	Court Cases Involving ESOP Valuation Issues
Chapter 25	Divorces, Dissolutions, Dissenting-Stockholder Suits, and Damages
Chapter 26	Going Public
Chapter 27	Litigation Support
Chapter 28	Expert Testimony
Chapter 29	Arbitration
Appendix B	Uniform Standards of Professional Appraisal Practice—Excerpts Applicable to Business Appraisals
Appendix C	Definitions of Terms Adopted by the Business Valuation Committee of the American Society of Appraisers.

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## Organization of the Book

Chapter 1 addresses the foundation of any appraisal exercise: defining the assignment. From there, the book moves from the general theory and practice of business valuation through a step-by-step application



of the theory and principles to the final product in the form of a complete written valuation report. The second half of the book is divided into three parts: Part V, "Valuing Partial Interests"; Part VI, "Valuations for Specific Purposes"; and Part VII, "Litigation."

Eight chapters contain bibliographies on their subject matter. In addition, an extensive general bibliography at the end of the book covers both general and specific topics. I have attempted to exclude from the bibliographies material that is proprietary, obscure, or very difficult to find and include only material that is available for purchase and/or can be found in major libraries.

Finally, the book is comprehensively indexed to assist readers in locating references to a specific topic, author, source, regulation, or court case. I have attempted to present the material in a form as comprehensive and easy to use as possible within the constraints of a single volume. As always, I welcome readers' comments and discussion on anything from errata to conceptual issues.

**Shannon Pratt**  
Portland, Oregon  
September 1988

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## Acknowledgments

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This work has benefited immensely from the unstinting efforts of many of the leading intellects in the business valuation profession, as well as of several eminent attorneys and other professionals who interface regularly with business valuation practitioners. Two valuation experts willingly donated their time to review and comment on all or most of the manuscript and provided invaluable input from their unique perspectives:

Mike Bolotsky  
*American Appraisal Associates, Inc.*  
Jay Fishman  
*Financial Research, Inc.*

In addition, the entire professional staff of Willamette Management Associates reviewed the full manuscript and provided critiques in a series of 15 two- to three-hour intensive give-and-take sessions. These included Ralph Arnold, Kathryn Aschwald, Jacie Daschel, Richard Dole, Todd Henne, John Hunter, Curt Kimball, Christy Kolbye, Steve Krug, Pam Mastroleo, Mary McCarter, Ed McReynolds, Lou Paone, Jeff Patterson, Phil Smith, and Donna Walker. Kathie Martin, our administrative vice president, and Charlene Cottingham, my secretary, also made valuable contributions to these sessions. Jan Bear, our valuation report editor, meticulously and thoughtfully edited the manuscript and also participated in the critique sessions.

Others reviewed anywhere from one to several chapters and provided very valuable comments:

John Bakken  
*Business Appraisal Associates*  
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*Hawley, Troxell, Ennis &  
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Several members of my professional staff prepared the initial drafts of various chapters or portions of chapters. Christy Kolbye, Ed McReynolds, and Todd Henne, all CPAs, contributed their accounting expertise to the revision of Chapter 5, "Company Data—Written Information." Jacie Daschel revised Chapter 6, "Company Data—Field Trips and Interviews"; Chapter 7, "Economic and Industry Data"; and Chapter 9, "Comparative Transaction Data." Jeff Patterson was responsible for updating Chapter 11, "Analyzing and Adjusting Financial Statements." Phil Smith revised the text in Chapter 12, "Comparative Ratio Analysis" and designed the formulas, tables, and exhibits presented there. A team effort by Mary McCarter, Kathryn Aschwald, and Jacie Daschel created the sample report in Chapter 14.

Part V is completely new to this book. Members of my professional staff responsible for drafting the initial chapters were Jeff Patterson (Chapter 16, "Valuing Debt Securities"), Kathryn Aschwald (Chapter 17, "Valuing Preferred Stocks"), and Phil Smith (Chapter 18, "Valuing Stock Options"). Chapter 19, "Estate Planning and Tax Valuations," and Chapter 22, "Other Federal Gift and Estate Tax Cases," were substantially updated by Curt Kimball, whose extensive knowledge in this area was particularly helpful in light of the sweeping tax reform in recent years. Mary McCarter was responsible for the initial draft of Chapter 23, "Employee Stock Ownership Plans," another area that has undergone considerable change. Another new chapter to this book is Chapter 25, "Divorces, Dissolutions, Dissenting-Stockholder Suits, and Damages." The initial draft for this chapter was the result of a joint effort by Ralph Arnold and Jacie Daschel.

In addition to either revising or writing the initial drafts, these individuals contributed their unique talents and expertise to the creation of the exhibits included in the respective chapters.

For permission to use material, I wish to thank AMACOM, American Institute of Certified Public Accountants, American Institute of Real Estate Appraisal, American Society of Appraisers, Appraisal Foundation, *Business Week*, Callaghan & Company, Commerce Clearing House, CPA Services, Inc., Disclosure, Inc., Dow Jones-Irwin, The Dryden Press, The ESOP Association, *The Financial Planner*, *Harvard Business Review*, Ibbotson & Associates, *Illinois Bar Journal*, *Journal of the American Society of CLU*, Leopold Bernstein, McGraw-Hill Book Company, *Mergers & Acquisitions*, Merrill Lynch, Pierce, Fenner & Smith, Inc., The Miche Company, *Oklahoma Law Review*, Panel Publications, Para Publishing, Prentice-Hall, Reston Publishing (a division of Simon & Schuster), Robert Morris Associates, Standard & Poor's Corporation, University of Southern California Institute on Federal Taxation, *Value Line Investment Survey*, W. T. Grimm & Company, Inc., and Warren, Gorham & Lamont.

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My deep gratitude goes to all of the above contributors of time, effort, and talent and to many others who extended their help somewhere along the way. Final responsibility for all judgments and content rests, of course, with the author.

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# Introduction: The State of the Art of the Business Appraisal Profession

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Default in Academia

Professionalization of the Practitioners

Canadians Lead the Way

The ESOP Association Valuation Advisory Committee

Business Valuation Committee of the American Society of Appraisers

"Beware of Amateur Hour"

Uniform Standards of Professional Appraisal Practice

Summary

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As this second edition is written, the profession of business appraisal is still in an embryonic state, but it is growing rapidly.

According to the U.S. Small Business Administration, there were over 17 million businesses in the United States in the 1980s:

Over 2.8 million corporations.

Almost 1.5 million partnerships.

More than 13 million sole proprietorships.

Every year, hundreds of thousands of businesses completely change ownership. Millions of partial changes of ownership also occur. Moreover, hundreds of millions of dollars in payments based on decisions about the values of businesses are made every year. Such payments arise from gift, estate, and inheritance taxes, ad valorem (property) taxes, matrimonial property settlements, amounts of relief in damage cases, and many other matters. Considering the economic importance to millions of people of the proper appraisal of businesses and business interests, it seems almost incredible that it is only in the last few years that business appraisal has begun to emerge as a unified discipline in the United States.

In the last few years, the emergence and growth of the business valuation discipline have been led by a core of dedicated professionals who have conducted and disseminated a large amount of research and education on the subject. The discipline's development benefited from the availability of many new data sources on relevant subjects such as merger and acquisition prices, rates of return on equity, and measurement of risk. Most of these data bases did not even exist in the 1970s. Their usefulness in a broad variety of business valuation applications has been vitally enhanced by the communication and computer capabilities for searching out, retrieving, and analyzing data that meet almost any set of criteria the analyst may choose to specify.

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## Default in Academia

The typical finance professor at most business schools still is not even aware of business appraisal as a career option for students. This is especially unfortunate because business appraisal offers one of the most challenging and intellectually rewarding career opportunities for the brightest students of finance, applying as it does the full gamut of financial theory and principles.

Economists and business school professors teach us in no uncertain terms that the most important objective of the owner, or head, of a business enterprise—one who is economically motivated by the “invisible hand” of Adam Smith—should be to maximize the value of the firm. However, in 1987 the closest most business schools got to teaching students how to determine a firm's value was through a theoretical



chapter or two in a general finance or investments text. Only about a dozen business schools offered even a single course in how to value a business. The number appears to be growing, albeit slowly.

Courses in the closely related subjects of security analysis and investment portfolio management abound. But such courses are narrowly focused, dealing almost entirely with minority interests in large corporations in the form of publicly traded stocks and bonds. Such courses do not, for the most part, deal directly with the question of the value of the total firm. Furthermore, they do not cover the values of either total or partial interests in closely held firms.

Business schools also offer courses in corporate finance, whose content tends to focus on obtaining and managing funds and making investment decisions in regard to capital budgeting. Capital budgeting decisions have much in common with decisions on a reasonable price to pay for an existing business. However, business schools generally fail to point out this important connection.

The analytical skills germane to the disciplines of security analysis and corporate finance are essential to the discipline of business appraisal. But business schools have left a major gap by failing to undertake the logical step of applying these skills to the valuation of closely held companies and interests in them. The result is that the conceptual leadership in the development of the business appraisal discipline has arisen from collaborative efforts on the part of professional practitioners rather than from the academic community.

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## Professionalization of the Practitioners

### Canadians Lead the Way

Canada led the United States in an organized effort toward conceptual development of the business appraisal discipline. Not surprisingly, a specific catalyst spurred the discipline's earlier organized development. That catalyst was called *Valuation Day*, December 31, 1971 (Valuation Day for publicly traded companies was December 22, 1971).

The significance of Valuation Day was that it set a base valuation date from which all capital appreciation was measured for capital gains taxes and estate taxes. Consequently, the valuation of all property, including all businesses and business interests, as of that date became a considerably significant matter. Since there were no market quotations for the values of closely held businesses and business interests, there suddenly was a need to develop values as of one specific date for a large number of entities.

The Canadian Institute of Chartered Business Valuators (CICBV), originally called the Canadian Association of Business Valuators, was born on January 6, 1971. Since then it has held biennial meetings, with the proceedings published as *The Journal of Business Valuation*.