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Financial Valuation Workbook

*Step-by-Step Exercises and Tests to Help You
Master Financial Valuation*

Third Edition

JAMES R. HITCHNER
MICHAEL J. MARD

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To my wife Karen, who makes everything so much better.

*To our combined family, Jason, Michael, Deborah,
Katie, Kenny, Jackie, and our two granddaughters,
Siena and Brooke.*

*To my mother and father, Earle and Virginia Hitchner,
and my sister, Deborah Hitchner, who left this world too
early for me to get to know her.*

To Pam, Seph, Joe and Shelley, with all my love, Mike.

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He has also been a faculty member teaching valuation courses for judges for the National Judicial College and the Flaschner Judicial Institute. He is an inductee in the AICPA Business Valuation Hall of Fame and a two-time recipient of the AICPA's Business Valuation Volunteer of the Year award. He was also one of only four members of the original AICPA Business Valuation Standards Writing Task Force and served for the entire six years up to the June 2007 official release of the standards.

Mr. Hitchner is past chairman of the Business Valuation Committee of the Georgia Society of CPAs, past member of the AICPA Business Valuation Subcommittee, past member of the AICPA ABV exam committee, past chairman of the ABV exam review course committee, and contributing editor of the AICPA *CPA Expert* newsletter. He has a bachelor of science degree in engineering from the University of Pittsburgh and master of business administration degree from Rider University.

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Mr. Mard has been a full-time business appraiser and expert witness for more than 21 years, specializing in intangible assets, specifically intellectual property. He has developed analyses that have been reviewed and accepted by the Securities and Exchange Commission (SEC), numerous accounting firms (including the Big Four), the Internal Revenue Service (IRS), and the courts. Mr. Mard has provided expert testimony in both federal and state courts related to intangible assets, intellectual property, business damages, marital dissolution, shareholder disputes, and IRS matters.

Mr. Mard is lead author of *Driving Your Company's Value: Strategic Benchmarking for Value* and lead co-author of *Valuation for Financial Reporting: Intangible Assets, Goodwill, and Impairment Analysis—SFAS 141 and 142* and co-author of *Financial Valuation: Applications and Models*, all published by John Wiley & Sons. He is co-author of the American Institute of Certified Public Accountants (AICPA) three-part self-study video course series on SFAS 141 and 142 on business combinations, intangible assets, and goodwill impairment. He also co-authored the AICPA *Consulting Services Practice Aid 99-2: Valuing Intellectual Property and Calculating Infringement Damages*. Mr. Mard has co-authored 20 courses and published more than 70 articles. He has been a presenter, speaker, and instructor more than 80 times.

Mr. Mard is very active at state and national levels with emphasis on business valuation standards and intellectual property valuations. He has served on numerous committees and task forces of the AICPA, Florida Institute of Certified Public Accountants, American Society of Appraisers, and the Financial Accounting Standards Board (FASB). Mr. Mard continues to serve on two FASB task forces: Disclosure About Intangible Assets and Business Combination/Purchase Method Procedures.

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Preface

The *Financial Valuation Workbook* (FVW) contains both educational exercises that guide the reader through a complete business valuation and valuation tools that professionals can use in preparing business valuations. It also contains detailed information on how to run a successful valuation practice. It is structured to be used on a stand-alone basis. It is also a companion text to *Financial Valuation: Applications and Models*, Third Edition (FVAM) (John Wiley & Sons), in which the subject matter contained in the workbook is expanded upon. This workbook contains basic, intermediate, and advanced topics on valuing businesses conveyed in a series of easily understandable exercises with comprehensive answers.

FVW is targeted to the following professionals and groups that are typically exposed to financial valuation issues:

- Appraisers
- Appraisal Associations and Societies
- Actuaries
- Attorneys
- Bankers
- Business Brokers
- Business Executives, including CEOs, CFOs, and Tax Directors
- Business Owners
- CPAs
- Estate and Gift Planners
- Financial Analysts
- Government Agencies including the IRS, SEC, and DOL
- Insurance Agents
- Investment Advisors
- Investment Bankers
- Judges
- Pension Administrators
- Stockbrokers

FVW contains eight chapters, each with a different purpose.

Chapter 1 contains more than 75 exercises that have been placed throughout excerpts of an actual business valuation report presenting numerous valuation topics, including rates of return, the capitalized cash flow method of the income approach, and the guideline company transaction and guideline public company methods of the market approach.

Chapter 2 contains comprehensive answers to the exercises in Chapter 1.

Chapter 3 includes more than 300 exercises that are a companion piece and correlate to the relevant chapters of *Financial Valuation: Applications and Models*, Third Edition. These exercises/tests can be used to prepare for business valuation certification exams or for university professors in the academic field or as reinforcement to learn the material.

Chapter 4 includes more than 400 ValTips that are extracted from the companion book FVAM. This summary of ValTips can serve professionals as a quick reference source of important concepts, application issues, and pitfalls to avoid.

Chapter 5 presents a Valuation Process Flowchart to allow professionals to follow a more structured process in applying and documenting the income approach.

Chapter 6 highlights strategies for marketing, managing, and making money in a valuation services practice. It discusses risk management in regard to reports and engagement letters, and gives examples of each. This chapter also includes information on how to keep up technically; find, train, and retain staff; and delegate authority.

Chapter 7 includes guidelines for practice management workflow procedures, which starts with the initial prospective client call, highlights checking points through the valuation analysis, then moves on to draft and final record, then to file retention and engagement closure.

Chapter 8 includes more than 35 checklists that can be used by professionals in documenting their valuations. It can also be used by less-experienced professionals as a guide in applying valuation concepts.

This book also includes a companion website, which can be found at www.wiley.com/go/fvamwb3e. The website includes the exhibits and forms found in Chapter 7, and the checklists found in Chapter 8.

* * * * *

Financial valuations are very much affected by specific facts and circumstances. As such, the views expressed in these written materials do not necessarily reflect the professional opinions or positions that the authors would take in every business valuation assignment, or in providing business valuation services in connection with an actual litigation matter. Every situation is unique and differing facts and circumstances may result in variations of the applied methodologies. Furthermore, valuation theory, applications, and methods are continually evolving and, at a later date, may be different from what is presented here.

Nothing contained in these written materials shall be construed to constitute the rendering of valuation advice; the rendering of a valuation opinion; the rendering of an opinion as to the propriety of taking a particular valuation position; or the rendering of any other professional opinion or service.

Business valuation services are necessarily fact-sensitive, particularly in a litigation context. Therefore, the authors urge readers to apply their expertise to particular valuation fact patterns that they encounter, or to seek competent professional assistance as warranted in the circumstances.

* * * * *

Disclaimer Excluding Any Warranties: This book is designed to provide guidance to analysts, auditors, management, and other professionals, but is not to be used as a substitute for professional judgment. Procedures must be altered to fit each assignment. The reader takes sole responsibility for implementation of material from this book. The implied warranties of merchantability and fitness of purpose and all other warranties, whether expressed or implied, are excluded from this transaction, and shall not apply to this book. None of the authors, editors, reviewers, or publisher shall be liable for any indirect, special, or consequential damages.

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Valuation Case Study Exercises

INTRODUCTION

The purpose of this chapter is to highlight and discuss important concepts in valuation through a series of exercises. These exercises have been intermittently placed in excerpts of a valuation report. You should attempt to complete these exercises as you read the report with reasoning and emphasis on an explanation of your conclusion. The authors' solutions to these exercises can be found in Chapter 2.

The following case presents selected excerpts from a business valuation report that, in its entirety, was in full compliance with the AICPA's Statement on Standards for Valuation Services No. 1 and the Uniform Standards of Professional Appraisal Practice. For more information on reports and standards compliance, see Chapters 10 and 11 of *Financial Valuation: Applications and Models*, Third Edition. This report format is one of many that analysts can use in presenting business valuations. All schedules have been omitted as they are not necessary for the exercises. Some of the terms, numbers, sources, and other data have been changed for ease of presentation.

THE VALUATION REPORT

August 20, 20X8

Mr. Tom Profit
LEGGO Construction, Inc.
123 Builders Drive
Anycity, Anystate 54321

Re: Fair Market Value of 5,000 Common Shares of LEGGO Construction, Inc. as of August 20, 20X6

Dear Mr. Profit:

At your request, Valking LLP (Valking) was retained to prepare a valuation analysis and appraisal (valuation engagement and conclusion of value) and detailed/comprehensive appraisal report (report) to assist you in the determination of the fair market value of 5,000 common shares of LEGGO Construction, Inc. (LEGGO, or the Company), which represents a 100 percent common stock interest in LEGGO. This 100 percent control interest is marketable. [Note: A more informative term could be *marketable illiquid* (See Chapter 9 of *Financial Valuation: Applications and Models*, Third Edition)]. Assume for this case that marketable for a 100 percent control

interest means marketable in a reasonable amount of time but illiquid (cannot be sold instantly with cash within three days like most freely traded public companies). The value conclusion is considered as a cash or cash equivalent value. The valuation date is December 31, 20X5. This valuation and report are to be used only as of this date and are not valid as of any other date.

EXERCISE 1: Which of the following is the *as of* date for valuation?

- a. Anytime within one year
- b. *As of* a single point in time
- c. *As of* a single point in time or six months later
- d. Date that the report is signed

We have performed a valuation engagement and present our detailed report in conformity with the “Statement of Standards for Valuation Services No. 1” (SSVS) of the American Institute of Certified Public Accountants. SSVS defines a valuation engagement as “an engagement to estimate value in which a valuation analyst determines an estimate of the value of a subject interest by performing appropriate procedures, as outlined in the AICPA Statement on Standards for Valuation Services, and is free to apply the valuation approaches and methods the analyst deems appropriate in the circumstances. The valuation analyst expresses the results of the valuation engagement as a conclusion of value, which may be either a single amount or a range.”¹

SSVS addresses a detailed report as follows: “The *detailed report* is structured to provide sufficient information to permit intended users to understand the data, reasoning, and analyses underlying the valuation analyst’s conclusion of value.”

EXERCISE 2: This is a detailed report per SSVS No. 1. What other types of reports are allowed under SSVS No. 1?

This valuation was performed solely to assist you in your determination of the value solely for management and internal planning purposes and the resulting estimate of value should not be used for any other purpose, or by any other party for any purpose, without our express written consent.

¹Note: The American Society of Appraisers uses the term *estimate* as part of a limited appraisal. The AICPA usage of the term is equivalent to the result of the highest scope of work specified by the ASA, which is for an appraisal.

EXERCISE 3: The purpose of the valuation of LEGGO is to assist management in internal planning. What other purposes are there?

Our analysis and report are in conformance with [if appropriate] the 2008 [other date] Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Foundation,² the ethics and standards [if appropriate] of (ASA, IBA or NACVA)³ and with IRS [if appropriate] business valuation guidelines, which include development and reporting guidelines.⁴

EXERCISE 4: If the analyst belongs to more than one valuation organization with standards, that analyst must comply with the standards of each organization he or she belongs to.

- a. True
- b. False

Our analysis is also in conformance with various revenue rulings, including Revenue Ruling 59–60, which outlines the approaches, methods, and factors to be considered in valuing shares of capital stock in closely held corporations for federal tax purposes. Revenue Ruling 65–192 extended the concepts in Revenue Ruling 59–60 to income and other tax purposes as well as to business interests of any type.

The standard of value is fair market value defined in Revenue Ruling 59–60 as “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

² The Appraisal Standards Board (ASB) of the Appraisal Foundation develops, interprets, and amends the Uniform Standards of Professional Appraisal Practice (USPAP) on behalf of appraisers and users of appraisal services. The Appraisal Foundation is authorized by Congress as the source of Appraisal Standards and Appraiser Qualifications. USPAP uses the terms *appraisal* and *appraisal report*, which are defined in pages U-1 and U-72, respectively. SSVS uses the terms *valuation engagement* and *detailed report*, which are defined in pages 54 and 22–23, respectively. USPAP also uses the term *appraiser* while SSVS uses the term *valuation analyst*. We use these terms interchangeably in this report.

³ ASA, American Society of Appraisers; IBA, Institute of Business Appraisers; NACVA, National Association of Certified Valuation Analysts.

⁴ Department of the Treasury, Internal Revenue Service, IRM 4.48.4, Engineering Program, Business Valuation Guidelines. “This material is the product of the Valuation Policy Council (VPC), a cross-functional committee with executive representation from LMSB, SBSE, and Appeals. The VPC was established in 2001 to assist IRS leadership in setting direction for valuation policy that cuts across functional lines, and in identifying process improvements to improve compliance and better utilize resources.” Issued July 1, 2006.

latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.” Revenue Ruling 59–60 also defines the willing buyer and seller as hypothetical as follows: “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.” Furthermore, fair market value assumes that the price is transacted in cash or cash equivalents. Revenue Ruling 59–60, while used in tax valuations, is also used in many nontax valuations.

Fair market value is also defined in a similar way in the *International Glossary of Business Valuation Terms*⁵ as “the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms’ length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.”

EXERCISE 5: Which of these are standards of value?

- a. Fair market value, fair value financial reporting, investment value
- b. Fair value investment reporting, fair value state actions, intrinsic value
- c. Investment value, intrinsic value, equal value
- d. Fair market value, equal value, investment value

The premise of value is going concern.⁶ The liquidation premise of value was considered and rejected as not applicable, as the going-concern value results in a higher value for the interest than the liquidation value, whether orderly or fixed.

In our conclusion of value, we considered the following relevant factors, which are specified in Revenue Ruling 59–60:

- The history and nature of the business
- The economic outlook of the United States and that of the specific industry in particular
- The book value of the subject company’s stock and the financial condition of the business
- The earning capacity of the company
- The dividend-paying capacity of the company
- Whether or not the firm has goodwill or other intangible value
- Sales of the stock and size of the block of stock to be valued
- The market price of publicly traded stocks or corporations engaged in similar industries or lines of business

Our analysis included, but was not limited to, the above-mentioned factors.

⁵ The *International Glossary of Business Valuation Terms* has been jointly adopted by the AICPA, ASA, Canadian Institute of Chartered Business Valuators, NACVA, and the IBA.

⁶ The *International Glossary of Business Valuation Terms* defines *going concern* as “an ongoing operating business enterprise,” and *going concern value* as “the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of going concern value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place.”

Understanding with the Client and Scope of Work

Per SSVS No. 1, the valuation analyst should establish an understanding with the client. “The understanding with the client reduces the possibility that either the valuation analyst or the client may misinterpret the needs or expectations of the other party. The understanding should include, at a minimum, the nature, purpose, and objective of the valuation engagement, the client’s responsibilities, the valuation analyst’s responsibilities, the applicable assumptions and limiting conditions, the type of report to be issued, and the standard of value to be used.”⁷

Furthermore, “A restriction or limitation on the scope of the valuation analyst’s work, or the data available for analysis, may be present and known to the valuation analyst at the outset of the valuation engagement or may arise during the course of a valuation engagement. Such a restriction or limitation should be disclosed in the valuation report (paragraphs 52(m), 68(e), and 71(n)).”⁸

We have established an understanding with the client to perform a valuation engagement and have complied with the requirements of SSVS as stated earlier. There were no scope restrictions or limitations on the work or the data available for analysis.

In accordance with the business valuation standards promulgated by the American Society of Appraisers and the Appraisal Foundation (USPAP), we have prepared an appraisal. “The objective of an appraisal is to express an unambiguous opinion as to the value of a business, business ownership interest, or security, which opinion is supported by all procedures that the appraiser deems to be relevant to the valuation.”⁹ It is based on all relevant information available to the appraiser as of the valuation date; the appraiser conducts appropriate procedures to collect and analyze all information expected to be relevant to the valuation, and the appraiser considers all conceptual approaches deemed to be relevant.¹⁰

In accordance with the Scope of Work rule in USPAP, we must:

- Identify the problem to be solved
- Determine and perform the scope of work necessary to develop credible assignment results
- Disclose the scope of work in the report¹¹

To gain an understanding of the operations of LEGGO, we reviewed Company financial information and operational data as detailed in the appendix and exhibits, interviewed Company management, and visited the Company’s facility. To understand the environment in which LEGGO operates, we researched the status of and trends in the various industries that have an impact on it. We also studied economic conditions as of the valuation date and their impact on LEGGO and the industry. To understand

⁷AICPA SSVS No. 1, paragraph 17.

⁸Ibid., paragraph 19.

⁹ASA Business Valuation Standards BVS-1, General Requirements for Developing a Business Valuation.

¹⁰Ibid.

¹¹USPAP 2008–2009, p. U-12.

the Company's financial condition, we analyzed its financial statements as available.

As discussed in this report, we considered all valuation approaches and methods and applied the most appropriate methods from the income, asset, and market approaches to value to derive an opinion of value of the subject equity interest (100 percent control marketable interest). Our conclusion of value reflects these findings, our judgment and knowledge of the marketplace, and our expertise in valuation.

In performing our work, we were provided with and/or relied upon various sources of information, including (but not limited to):

- Audited financial statements for LEGGO for the fiscal years ended March 31, 20X1 through December 31, 20X5
- Tax returns for the Company for the years 20X1 through 20X5
- Information regarding the management and shareholders of LEGGO
- Information regarding the Company's history and current operations
- LEGGO's articles of incorporation and bylaws
- Data from Morningstar *Ibbotson S&P Valuation Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation*
- Duff & Phelps, LLC, *Risk Premium Report*
- 20X1/20X5 editions of *Benchmark Statistics and Ratios* (fictitious)
- Federal Reserve Bank statistical releases and other information
- Current and future economic conditions as forecast by various sources
- Public company data sources, including EDGAR
- Various transaction databases
- Miscellaneous other information

The procedures employed in valuing the subject interest in LEGGO included such steps as we considered necessary, including (but not limited to):

- An analysis of LEGGO's financial statements
- An analysis of LEGGO management's 20X6 expectations and other information supplied by management
- Discussions with management
- A visit by one of the analysts to the Company's headquarters in Anycity, Anystate
- An analysis of the retail grocery industry, as well as the retail health and organic food industry
- An analysis of the general economic environment as of the valuation date, including investors' equity and debt-return expectations
- An analysis of applicable discounts, including the discount for lack of marketability
- An analysis of other pertinent facts and data resulting in our conclusion of value

Valking staff, under the direct supervision of the lead appraiser on this engagement, assisted in performing research, populating models with data, and providing other general assistance.

Based on our analysis as described in this valuation report, and the facts and circumstances as of the valuation date, the estimate of value of 5,000 shares