

SIXTH EDITION

SHANNON PRATT'S VALUING A BUSINESS

The Analysis and Appraisal
of Closely Held Companies

SHANNON P. PRATT AND
ASA EDUCATIONAL FOUNDATION



PRAISE FOR

Shannon Pratt's *Valuing a Business*

Business lawyers—and judges—don't just have to know the law, they must be able to apply the language of other disciplines, and none more so than corporate finance. Whether preparing required disclosures, settling an estate, selling a business, or writing an appraisal decision, understanding basic principles of valuation is essential, especially of businesses that don't have publicly traded shares. *Valuing a Business* is an invaluable resource that has on point chapters on recurring questions and contexts, enabling you to brush up quickly, dig more deeply when necessary, and forge a practical approach to sensibly answering difficult valuation questions.

—Leo E. Strine Jr, Of Counsel, WLRK; former Chief Justice and
Chancellor, Delaware

Dealing with valuation issues can be a daunting task. *Valuing a Business* is one of my go-to resources for addressing the principles and practical applications of valuation theory. In my experience, valuation experts often rely on it in their reports, and courts and attorneys addressing valuation issues regularly cite it as authority. It is written in an understandable style that has been the hallmark of Shannon Pratt books. This sixth edition should be included in every law firm library.

—John W. Porter, Esq., Baker Botts, LLP, Houston, TX

It is not hyperbole to say that Shannon Pratt's *Valuing a Business*, the first edition of which was published 40 years ago, has played a central role in creating the architecture around which the modern appraisal business has been built. The sixth edition of this book continues that tradition by laying out the first principles as well as suggested practices on every aspect of valuation.

—Aswath Damodaran, PhD, professor, Kerschner Family Chair
in Finance Education, Leonard N. Stern School of Business,
New York University

Shannon Pratt's *Valuing a Business*, sixth ed., is the masterpiece of business valuation texts. This edition brings much new material to the body of knowledge. I especially commend the readable language used throughout, thus making this edition accessible not only as an updated reference for experienced practitioners, but as a thoroughly comprehensible text for newer valuers.

—Howard A. Lewis, MA, MS, CVA (emeritus), ABAR (emeritus),
former National Program Manager, IRS Engineering &
Valuation Program

I have just finished reading the sixth edition of *Valuing a Business* by the iconic Shannon Pratt. I served as a Family Court judge in New Jersey for 22 years and another 10 years as a mediator and arbitrator. I have been entrusted with the care of many high-end and complicated business evaluations over the years. Both Jay E. Fishman and Roger Grabowski have testified in my courtroom. Dr. Pratt's mantle could not have been passed to a more formidable duo than the team that includes Jay and Roger. The clarity of their chapters will provide valuable insight to judges and lawyers in understanding the "forensic" language. I heartily endorse this edition.

—Hon. Thomas P. Zampino, P.J.F.P. (ret.), Superior Court,
State of New Jersey

A comprehensive and authoritative survey of professional business valuation practice. A new standard reference for the field.

—Jerald E. Pinto, PhD, CFA senior director (ret.), CFA Institute

Valuing a Business, sixth ed., provides a comprehensive survey of valuation methodologies of closely held companies and related issues that constitute a significant contribution to the state of the art on the subject. It will immensely benefit practitioners, professionals dealing with the issues, and students.

—Harvey A. Poniachek, PhD, CVA, professor, Rutgers University

Preparing a valuation of a business is a very important undertaking. Shannon Pratt's *Valuing a Business* has been one of the most important sources I have used over the last 40 years of preparing business valuations. I cite *Valuing a Business* regularly. The sixth edition of this book touches on every aspect of business valuation. It is an invaluable resource.

—Kenneth M. Haffey, CPA, CVA, CEPA, partner, Marcum LLC,
adjunct professor, Weatherhead School of Management,
Case Western Reserve University; instructor,
Exit Planning Institute

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To

The late Millie Pratt

The late Steven Pratt

*Members past and present of the
ASA Business Valuation Committee*

*A very bright and dedicated
group of professionals*

*Thank you very much for all your
contributions and friendship*

Shannon P. Pratt
(April 2021)

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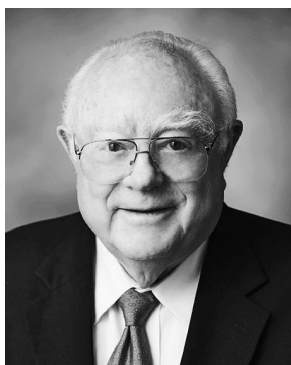
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About Shannon P. Pratt



Shannon P. Pratt, DBA, CFA, FASA, ARM–BV, MCBA, MCBC, CM&AA, perhaps the most well-known authority in the field of business valuation, has written numerous books that articulate many of the concepts used in modern business valuation around the world.

Over the last 50 years, he performed valuation engagements for many purposes. He testified in a wide variety of federal and state courts across the country and participates in arbitration and mediation proceedings.

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Anthony J. Pumphrey, ASA, CFA, co-updated the chapter “Valuations for Financial Reporting.” He is a Managing Director with Valuation Research Corporation and has published and presented on numerous tax and financial reporting topics. He is also a member of the Appraisal Foundation’s Working Group preparing a Valuation Advisory on Company-Specific Risk Premiums.

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Sujan Rajbhandary, CFA, co-updated the chapters “Analyzing Financial Statements” and “Financial Statement Ratio Analysis.” Mr. Rajbhandary is a vice president at Mercer Capital, where he is a senior member of that firm’s Financial Reporting Valuation Group and leads that firm’s Medical Device industry team.

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Keith Sellers, D.B.A., M.T., CPA/ABV, co-updated chapter “Valuing Interests in S Corporations and Other Pass-Through Entities.” He has thirty years of business valuation experience, serves on the editorial boards of several valuation journals and served on the AICPA’s ABV Credential Committee. Dr. Sellers has authored articles and coauthored *Taxes and Value: The Ongoing Research and Analysis Relating to the S Corporation Valuation Puzzle* (Business Valuation Resources).

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Adam Smith, ASA, IA, coauthored the appendix “Minimum Performance Requirements for Financial Reporting.” He is a Managing Director with Price-waterhouseCoopers, LLP, with 20 years of valuation experience. Mr. Smith served as a practice fellow at the Financial Accounting Standards Board, specializing in fair value issues and as Technical Director of Business Valuation Standards for the International Valuation Standards Council.

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Chris Swiecicki, MBA, coauthored the chapter “Solvency Opinions.” He is a Director with the Fairness and Solvency Opinions practice of Kroll, with over 15 years of experience providing fairness opinions, solvency opinions and other corporate finance advisory services.

Jeffrey S. Tarbell, ASA, CFA, co-updated the chapters “Valuation Provisions in Buy-Sell Agreements,” and “Litigation Support Services,” and coauthored the chapter “Fairness Opinions.” He has more than 30 years of valuation experience. He is a member of Houlihan Lokey’s Financial and Valuation Advisory business, where he leads that firm’s Estate and Gift Tax Valuation practice, co-leads the ESOP Valuation practice, and is a member of the Technical Standards Committee. He is member of the ASA Board of Governors, a former chair of the ASA Business Valuation Committee, and a former chair of the Valuation Advisory Committee of The ESOP Association. He has testified in various state and federal courts and before hearings of the U.S. Congress and U.S. Department of Labor.

Joseph W. Thompson, ASA, CFA, co-updated the chapters “Valuations in Shareholder and Partner Disputes” and “Shareholder and Partner Dispute Court Cases.” He is a principal at The Griffing Group, LLC, with 20 years of experience in the finance industry. Mr. Thompson has provided expert witness testimony in various courts including the Delaware Court of Chancery. He has authored numerous articles on business valuation and is an adjunct professor of finance at DePaul University.

Marissa Pepe Turrell, MBA, M.S., ASA, CVA, co-updated the chapter “Valuing Interests in S Corporations and Other Pass-Through Entities.” She is a Director at Marcum LLP, where she is a member of the Valuation, Forensic & Litigation Services group. Ms. Turrell has served on the ASA Business Valuation Education subcommittee.

Donna J. Walker, FASA, ARM-BV, CFA, co-updated the chapters “Valuations for Employee Stock Ownership Plans” and “ESOP Court Cases.” She is a principal and founding shareholder of Columbia Financial Advisors, Inc. She has been qualified as an expert witness. Ms. Walker was course developer and instructor for the ASA business valuation course on valuing ESOP shares. Ms. Walker was former president of the ASA.

Laurie-Leigh White, ASA, CEIV™, IA, CPA/ABV, coauthored the chapter “Valuing Intangible Assets.” She is a partner with BVA Group and leads the firm’s Houston office. Ms. White co-chairs the firm’s transaction advisory committees and also leads the firm’s ESOP practice. She was selected as a recipient of the 2020 ASA Rising Stars award and the 2016 AICPA Forensic and Valuation Services Standing Ovation Recognition award and was an honoree in the Houston Business Journal’s Women Who Mean Business 2019 class.

L. Deane Wilson, MA, ASA, coauthored the chapter “Valuing Real Property with a Business Component.” He is the Managing Partner for The Blackwell Group, a real estate appraisal firm. Mr. Wilson is the author of *Going Concern Valuation for Real Estate Appraisers, Lenders, Assessors, and Eminent Domain Professionals*. Mr. Wilson has developed courses for the ASA and is an AQB Certified USPAP instructor.

Arik Van Zandt, ASA, CDBV, co-updated the chapters “Expert Testimony” and “Expert Testimony.” He is a Managing Director with Alvarez & Marsal Valuation Services, LLC, with a primary focus of supporting clients in business disputes.

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Foreword

Over these many years I have found *Valuing a Business* to be a valuable tool in teaching new appraisers the basics of valuation and in teaching attorneys and other stakeholders what business appraisers do.

The primary goal of the sixth edition is to explain business valuation in an easy-to-understand style, focused on the nuances of valuing closely held businesses and interests in those businesses. I think readers will agree that the sixth edition has succeeded in meeting this goal.

I want to thank each of the contributing authors for sharing their knowledge in bringing their most current thinking to the sixth edition. It has been 12 years since I sat down to update the fifth edition. While some things changed and needed to be updated, the basic valuation methodologies we all learned are still valid.

Readers will benefit from their contributions to the sixth edition. Each of the contributing authors should be proud of the results of the sixth edition as this book is a significant contribution to passing on your expertise in valuation to the next generation of business appraisers. Job well done!

Thank you also to the many reviewers. No book of this magnitude is completed without the efforts of the reviewers to ensure completeness and clarity.

Finally, I want to thank the ASA Educational Foundation for taking the lead in bringing *Valuing a Business* to the ASA. I am pleased that *Valuing a Business* has a long-term “home” with the ASA and that I can pass on my legacy to the ASA. The ASA has been a great home for me and I have made many life-long friends through my involvement with the ASA. Hopefully *Valuing a Business* will enhance the reputation of the ASA for years to come.

Shannon P. Pratt, CFA, FASA, ARM-BV, MCBA, MCBC, CM&AA
(April 2021)

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Preface

The book is designed to serve three purposes:

1. A comprehensive and updated reference for business appraisers
2. An introductory text on business valuation for both academic and accreditation courses and beginning practitioners
3. A reference for nonappraisers who use and/or evaluate business appraisals

Evolution of *Valuing a Business*

The first edition was published in 1981. It was *the* primary source for educating business appraisers in valuing closely held businesses. Shannon Pratt updated the book four times, the last being the fifth edition in 2008. When Shannon retired, the ASA Educational Foundation stepped up and has taken over maintaining Shannon's legacy for the valuation profession. This sixth edition is the first edition updated with the help of many of the foremost practitioners in business valuation. This group of contributing authors has worked to maintain the style of the book as established by Shannon while updating the content to 2021.

Evolution and State of the Profession

Since the first edition was published, the profession of business appraisal has matured. There are now widely accepted business valuation standards, where there were none in 1981. Since the fifth edition of this book, the ASA, the CBV Institute, RICS, and TAQEEM have published an international valuation glossary for business valuation, which is reproduced in the online appendix. While each organization's standards or guidelines are slightly different from the others, there is unanimous agreement on the central concepts of business valuation.

The contributing authors have endeavored to present the current state of the art, thinking, and practice of the business valuation profession, which has progressed significantly in many areas since the fifth edition. Where clear consensus on positions exists, such consensus is presented. Where there are differing opinions, they tried to present the issues clearly and fairly, reflecting extensive peer review (see Acknowledgments for a list of reviewers). We also present considerable documentation of various courts' positions on controversial issues.

Emphasis on Valuations That Withstand Challenge

Virtually every business valuation is potentially subject to challenge from one party or another—one or more buying or selling parties, taxing authorities, ESOP beneficiaries, a spouse in a divorce, or any of a variety of interested parties. The section on valuations for specific purposes has been greatly expanded and enhanced with new sections and hundreds of court cases detailing which aspects of valuation in various contexts the courts have provided guidance on. These valuation contexts, with extensive discussion of legal challenges and the courts' positions include, especially:

- Gift and estate taxes and charitable contribution issues
- Income tax issues
- Employee stock ownership plans
- Shareholder and partner disputes
- Marital dissolutions.

It is very enlightening to see just what methods, procedures, and data have held up under challenge and what methods, procedures, and data (or omissions in any of these categories) have caused appraisers to be admonished or rebuked by the courts. These insights should help analysts to avoid pitfalls, and should help attorneys, clients, and other users of valuations to critically evaluate valuation work products in light of the legal contexts that may govern the acceptability of these valuations.

Highlights of What's New in This Edition

This edition reflects the substantial advances in the tools and sophistication in business valuation as well as new appraisal standards and regulations that have evolved since 2008. These advances fall broadly into three categories:

- Increasing consensus among the valuation professional organizations on standards, methodology, and terminology
- Updated appraisal rules, regulations, standards, and guidance issued by governmental, or quasigovernmental, and professional bodies
- Major advances in the quantity, quality, and accessibility of empirical data available to support business valuation conclusions

While there has been a growing consensus regarding business valuation issues, there also has been a growing volume of litigation over business valuations. This edition summarizes the important opinions in gift, estate, charitable contribution, and income tax; shareholder and partner disputes (dissenting stockholder and minority oppression actions); marital dissolutions; and ESOP cases.

Along with the growing body of litigation, there has been a proliferation of business valuation tools in the nature of empirical databases of actual transactions. Regarding the cost of capital, the Kroll (formerly Duff & Phelps) *Risk Premium Report – Size and Risk Studies* continue to gain wider usage and the new chapter on developing discount rates includes new examples. The latest on these and other databases are thoroughly described in this edition. The methodologies of measuring discounts for lack of control and discounts for lack of marketability continue to be refined.

There have also been several Tax Court decisions on the valuation of noncontrolling interests in Subchapter S corporations and other pass-through entities that continue to cause business appraisers to re-evaluate the methodology traditionally

used. We discuss the criticisms of the court decisions and the ensuing research into alternative models.

Key additions reflecting these developments include:

- Extensive court case analysis and citations, as noted in the previous section
- Updated chapter on business valuation standards
- Updated and expanded checklist, Reviewing a Business Valuation Report
- Up-to-date credentialing standards of all major professional associations, including ASA, AICPA, CBV, NACVA, and RICS
- Expanded chapter on developing discount rates with added examples
- New chapter on forecasting economic income including new data on long-term industry growth rates when using the income approach
- Updated descriptions of online databases that can be used for identifying guideline public companies
- Updated descriptions of transactional databases
- Updated chapter exploring the degrees of control in assessing discounts for lack of control (DLOC) for noncontrolling interests
- Description of new restricted stock studies and databases of restricted stock transactions with new tools for analyzing transactions
- Greatly expanded discussion on new data sources and new tools for quantifying discounts for lack of marketability (DLOM)
- New chapter on valuing intangible assets
- New section on valuing goodwill and going concern value including court citations.
- Updated sample report (see Chapter 23)
- Expanded chapter on reviewing business valuation reports, including the minimum performance requirements for financial reporting
- Expanded chapter on fair value for financial reporting
- New section on valuing private promissory notes
- New chapter on valuing interests in REITs and other real property holding entities
- New chapter on valuing real property with a business component
- The latest court guidance on discounts for trapped-in capital gains and tax-affecting of pass-through entities
- Updated sections on avoiding common errors made in applying the income approach.
- Expanded chapter introducing option pricing theory
- New chapter on valuing complex capital structures, focused on early-stage, venture capital-backed businesses
- Updated list of subsequent event court decisions
- Updated sections on “active versus passive” and “double-dipping” in marital dissolution appraisals
- Updated discussion on enterprise versus personal goodwill in marital dissolution matters
- Expanded and updated discussions of Family Limited Partnerships and their treatment by the IRS and the courts
- Updated discussion on federal income tax issues, including intercompany transfer pricing
- Updated chapter on valuation provisions in buy-sell agreements
- New chapter on fairness opinions
- New chapter on solvency opinions
- Updated *International Valuation Glossary—Business Valuation*
- New online appendix with additional chapter materials

- Hundreds of updated data sources and bibliographical references in the new online appendix
- Significantly expanded index

Audiences for Whom the Book Is Designed

The book is designed to be useful not only to business appraisers but also to others dealing with business appraisal issues such as:

- Attorneys dealing with business valuation litigation and/or sales or mergers of business enterprises
- CPAs
- Financial planners
- Bank trust officers dealing with closely held businesses
- Investment bankers
- Business owners, CFOs, and corporate directors

Business Valuation Continues to Be Dynamic

The momentum of business valuation developments of the past 13 years is sure to continue. Very importantly, the positions of various courts on many business valuation issues continue to evolve. We will reflect these developments in future editions. Please address your comments, observations, and suggestions to us.

ASA Valuing a Business Coordinating Committee

Ken Pia, Past Chairman of the Business Valuation Committee

Matt Crow, Member at-Large of the Business Valuation Committee

Jay E. Fishman, Past Chairman of the Business Valuation Committee

Roger J. Grabowski, Past Editor of *Business Valuation Review*®

Jeff Tarbell, Past Chairman of the Business Valuation Committee

Finally, it has been a great pleasure to be the Chair of ASA's Business Valuation Committee as ASA becomes the new home for Shannon's highly regarded valuation treatise. This will ensure the legacy Shannon deserves for many years to come.

Ken Pia
(June 2021)

Acknowledgments

As with previous editions, this sixth edition has benefited immeasurably from peer review by a dedicated group of professionals who provided valuable input and assistance.

We wish to thank the following individuals who have reviewed significant portions or all of the manuscript and provided commentary and suggestions for this edition. We believe this volume truly represents a consensus of a broad cross section of the practitioners from all facets of the business valuation community.

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Grant Zindel served as project manager for this edition. This included acting as a liaison and coordinating with the contributing authors, the publisher, and the outside reviewers, assisting with obtaining permission to use material reprinted in this book from other sources, and editing the manuscript. Grant Zindel also assisted in creating the index for this edition. Thanks to his dedication and professionalism, the index is

comprehensive and user friendly. This book would simply not have been completed without Grant's dedication.

Robert Schweihs and Robert Reilly were coauthors with Shannon Pratt on the third and fourth editions of this book. Much of the material from those editions is carried forward to the fifth edition and this sixth edition. Because they were coauthors and shared both writing and editing functions and much was carried forward from the first and second editions, it is not possible to single out which particular chapters or sections for which they were primarily responsible. Therefore, we make a general acknowledgment of their contributions to the third and fourth editions.

We express our gratitude to all of the people singled out above. As always, final responsibility for all content and judgment rests with the Coordinating Committee.

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Notation System Used in This Book

A source of confusion for those trying to understand financial theory and methods is the fact that financial writers have not adopted a standard system of notation. For this edition, we have studied dozens of financial texts and have developed a system of notation that reflects the most commonly used conventions or ones that seem intuitively easy to understand. If other financial writers adopt this standardized system of notation, we believe it will go a long way toward removing ambiguity, clarifying communication, and making it easier for readers to absorb financial articles and texts.

Value at a Point in Time

EV = Enterprise Value

PV = Present value

FV = Future value

MVIC = Market value of invested capital

Cost of Capital and Rate of Return Variables

k = Discount rate (generalized)

k_e = Discount rate for common equity capital (cost of common equity capital). Unless otherwise stated, it generally is assumed that this discount rate is applicable to common equity

k_p = Discount rate for preferred equity capital

k_d = Discount rate for debt (Note: For complex capital structures, there could be more than one class of capital in any of the above categories, requiring expanded subscripts)

$k_{d(pt)}$ = Cost of debt prior to tax effect

k_{ni} = Discount rate for equity capital when net income rather than net cash flow is the measure of economic income being discounted

c = Capitalization rate

c_e = Capitalization rate for common equity capital (cost of common equity capital). Unless otherwise stated, it generally is assumed that this capitalization rate is applicable to net cash flow available to common equity

- c_{ni} = Capitalization rate for net income
 c_p = Capitalization rate for preferred equity capital
 c_d = *Capitalization* rate for debt (Note: For Complex capital structures, there could be more than one class of capital in any of the previous categories, requiring expanded subscripts)
 t = Tax *rate* (expressed as a percentage of pretax income)
 R = Rate of return
 R_f = Rate of return on a risk-free security
 R_i = Historical return for publicly traded stock i
 R_m = Historical return on market portfolio m
 $E_{(R)}$ = Expected rate of return
 $E_{(Rm)} = E(R_{market})$ = Expected rate of return on the “market” (usually used in the context of a market for equity securities, such as the NYSE or S&P 500)
 $E_{(Ri)}$ = Expected rate of return on security i
 B = Beta (a coefficient, usually used to modify a rate of return variable)
 B_L = Levered beta
 B_U = Unlevered beta
 RP = Risk premium
 $RP_m = RP_{market}$ = Equity risk premium for the “market” (usually used in the context of a market for equity securities, such as the NYSE or S&P 500)
 $RP_s = RP_{size}$ = Risk premium for “small” company stocks (e.g., average size of lowest quartile of NYSE as measured by market value of common equity) over and above RP_m , typically drawn from Risk Premium Report – Size Study or CRSP Decile Size Study
 $RP_u = RP_{CSR}$ = Risk premium for unsystematic risk attributable to the specific company (i.e., company-specific risk premium)
 $RP_i = RP_{ind}$ = Risk premium for the industry
 $RP_{m+s(levered)}$ = Risk premium for the market plus size using data from Risk Premium Report – Size Study portfolios in build-up method
WACC = Weighted average cost of capital

Income Variables

- E = Expected economic income (in a generalized sense; i.e., could be dividends, any of several possible definitions of cash flows, net income, and so on)
 NI = Net income (after entity-level taxes)
 NCF_e = Net cash flow to equity
 NCF_f = Net cash flow to the firm (to overall invested capital, or entire capital structure, including all equity and long-term debt)
 PMT = Payment (interest and principal payment on debt security)
 D = Dividends

GCF = Gross cash flow (usually net income plus noncash charges)

EBIT = Earnings before interest and taxes

EBITDA = Earnings before interest, and taxes, depreciation, and amortization

Periods or Variables in a Series

i = The i th period or the i th variable in a series (may be extended to the j th variable, the k th variable, and so on)

n = The number of periods or variables in the series, or the last number in the series

∞ = Infinity

$_o$ = Period _{o} , the base period, usually the latest year immediately preceding the valuation date

Weightings

W = Weight

W_e = Weight of common equity in capital structure

W_p = Weight of preferred equity in capital structure

W_d = Weight of debt in capital structure

Note: For purposes of computing a weighted average cost of capital (WACC), it is assumed that above weightings are at market value.

Growth

g = Rate of growth

Mathematical Functions

Σ = Sum of (add up all the variables that follow)

π = Product of (multiply together all the variables that follow)

\bar{x} = Mean average (the sum of the values of the variables divided by the number of variables)

G = Geometric mean (the product of the values of the variables taken to the root of the number of variables)

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PART I

**STATE OF THE PROFESSION,
THE ENGAGEMENT,
AND THE BASIC THEORY**

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CHAPTER 1

Business Valuation Standards and Credentials

Introduction

The Appraisal Foundation

- Background and Organization

Uniform Standards of Professional Appraisal Practice (USPAP)

- Business Valuation Guidance from TAF
- Standards Published by Business Valuation Professional Organizations

Other Organizations That Have Offered Guidance on Business Valuation Issues

- Internal Revenue Service
- Certified in Entity and Intangible Valuation
- CFA Institute
- Association of Insolvency & Restructuring Advisors
- Recognition of Professional Standards by Courts
- International Valuation Standards and Practices
- Royal Institution of Chartered Surveyors
- International Institute of Business Valuers
- International Association of Certified Valuation Specialists

Professional Organizations Offering Accreditation in Business Valuation

- ASA
- National Association of Certified Valuation Analysts
- American Institute of Certified Public Accountants
- CBV Institute
- Royal Institution of Chartered Surveyors

Summary

Appendix to Chapter 1 online at www.appraisers.org/VAB6

- Information about ASA, NACVA, AICPA/ABV, CBV Institute, and RICS
- International Valuation Glossary—Business Valuation
- ASA Business Valuation Standards
- Bibliography

Introduction

Consensus regarding business appraisal¹ professional standards, as noted in the fifth edition, has continued to grow, accompanied by a proliferation of business valuation professional education.

It is important that all those either providing or using business valuation services be aware of these standards. The days when there was virtually no generally accepted guidance and almost anything could pass as a credible business valuation are gone forever. Owners, investors, attorneys, government agencies, and the courts all demand that business valuation work live up to these higher standards.

This chapter provides the reader a road map to business valuation professional standards, as they exist as of this writing. It also gives the reader the sources to get complete copies of current standards and to keep up to date as they evolve. The chapter also catalogs the current state of business valuation professional credentials.

Business valuation standards are often updated on a periodic basis. Readers can keep up to date on the changes through various monthly or quarterly periodicals including *Business Valuation Review*, *CPA Experts*, *The Value Examiner*, *Business Valuation Update*, *Hardball with Hitchner*, and other professional journals. Information on each of these journals is provided in the bibliography, which is contained in the online appendix.

The Appraisal Foundation

Background and Organization

The Appraisal Foundation (TAF) was established in 1987 by nine appraisal organizations constituting the North American Council of Appraisal Organizations (NACAO) and six nonappraiser members, including the American Bankers Association and the U.S. League of Savings Institutions. Eight of the nine appraisal organizations were composed entirely of real estate appraisers. One, the ASA (American Society of Appraisers), is multidisciplinary. The ASA awards certifications in real estate appraisal, machinery and equipment appraisal, personal property appraisal, business valuation, and technical valuation.

The board of trustees of TAF consists of representatives of the sponsor organizations plus trustees-at-large. The board of trustees appoints individuals who comprise two independent boards:

1. The **Appraisal Standards Board** (ASB) promulgates the *Uniform Standards of Professional Appraisal Practice* (USPAP) (see next section).
2. The **Appraisal Qualifications Board** (AQB) promulgates appraiser qualifications. So far, it has done so only for real estate appraisers and personal property appraisers. As of this writing, the AQB has left the issue of business appraiser qualifications to the various professional credentialing organizations, discussed in a subsequent section.

¹ Throughout this text the words appraisal and valuation will be used interchangeably.

Uniform Standards of Professional Appraisal Practice (USPAP)

In order to maintain public trust in appraisal practice, the ASB issues USPAP, which establishes requirement for appraisers. USPAP is designed to ensure that appraisers will develop and communicate their analyses, opinions, and conclusions to intended users of their services in a manner that is meaningful and not misleading.² The Financial Institution Reform, Recovery, and Enforcement Act (FIRREA) of 1989 makes compliance with USPAP mandatory for all federally related commercial real property transactions having a transaction value of more than \$500,000. Although not mandatory for federally related transactions involving personal property and business appraisals, USPAP has been adopted by several appraisal organizations in North America and has been recognized as emblematic as a generally accepted multidiscipline standard of appraisal practice. Although TAF's ASB writes, amends, and interprets USPAP, the board does not enforce USPAP. Through FIRREA, the federal government has mandated that the states enforce USPAP compliance for real estate appraisers. Standards are included for real property, personal property, business, and mass appraisals.

The content of USPAP is summarized in Exhibit 1–1. The 2020–2021 edition of USPAP was adopted with an effective date of January 1, 2020. USPAP is typically on a two-year publication cycle. However, considering the dislocation due to the pandemic, on February 19, 2021, the ASB announced that the 2020–2021 USPAP will be extended to December 31, 2022 (www.Appraisalfoundation.org).

Business Valuation Guidance from TAF

Beginning in 2010, TAF has also published several Valuation Advisories relating to Valuation for Financial Reporting (VFR). These VFRs provide guidance as to best practices for financial reporting. To date, TAF has issued four such VFRs:

- VFR–1 *Identification of Contributory Asset and Calculation of Economic Rents*
- VFR–2 *Valuation of Customer-Related Assets*
- VFR–3 *The Measurement and Application of Market Participant Acquisition Premiums*
- VFR–4 *Valuation of Contingent Consideration*

These VFRs can be found on TAF's website.

In addition, in 2014 TAF started a Business Valuation Resource Panel (BVRP). The purpose of the BVRP is to provide TAF's board of trustees with ongoing communication with representatives of the business valuation profession and to provide insight and recommendations on relevant business valuation issues.

² USPAP Preamble.

Exhibit 1–1

Uniform Standards of Professional Appraisal Practice

Forward	Standards and Standards Rules
Table of Contents	Standard 1: Real Property Appraisal, Development
Preamble	Standard 2: Real Property Appraisal, Reporting
Definitions	Standard 3: Appraisal Review, Development
Ethics Rule	Standard 4: Appraisal Review, Reporting
Record Keeping Rule	Standard 5: Mass Appraisal, Development
Competency Rule	Standard 6: Mass Appraisal, Reporting
Scope of Work Rule	Standard 7: Personal Property Appraisal, Development
Jurisdictional Exception Rule	Standard 8: Personal Property Appraisal, Reporting
	Standard 9: Business Appraisal, Development
	Standard 10: Business Appraisal, Reporting

Advisory Opinions

AO-1 Sales History (RP)	AO-24 Normal Course of Business (RP, PP)
AO-2 Inspection of Subject Property (RP, PP)	AO-25 Clarification of the Client in a Federally Related Transaction (RP)
AO-3 Update of a Prior Appraisal (ALL)	AO-26 Readdressing (Transferring) a Report to Another Party (ALL)
AO-7 Marketing Time Opinions (RP, PP)	AO-27 Appraising the Same Property for a New Client (ALL)
AO-9 The Appraisal of Real Property That May Be Impacted by Environmental Contamination (RP)	AO-28 Scope of Work Decision, Performance, and Disclosure (ALL)
AO-13 Performing Evaluations of Real Property Collateral to Conform with USPAP (RP)	AO-29 An Acceptable Scope of Work (ALL)
AO-14 Appraisals for Subsidized Housing (RP)	AO-30 Appraisals for Use by a Federally Regulated Financial Institution (RP)
AO-16 Fair Housing Laws and Appraisal Report Content (RP)	AO-31 Assignments Involving More Than One Appraiser (ALL)
AO-17 Appraisals of Real Property with Proposed Improvements (RP)	AO-32 Ad Valorem Property Tax Appraisal and Mass Appraisal Assignments (RP, PP)
AO-18 Use of an Automated Valuation Model (AVM) (ALL)	AO-33 Discounted Cash Flow Analysis (RP)
AO-19 Unacceptable Assignment Conditions in Real Property Appraisal Assignments (RP)	AO-34 Retrospective and Prospective Value Opinions (RP, PP)
AO-20 An Appraisal Review Assignment That Includes the Reviewer's Own Opinion of Value (ALL)	AO-35 Reasonable Exposure Time in Real and Personal Property Opinions of Value (RP, PP)
AO-21 USPAP Compliance (ALL)	AO-36 Identification and Disclosure of Client, Intended Use, and Intended Users (ALL)
AO-22 Scope of Work in Market Value Appraisal Assignments, Real Property (RP)	AO-37 Computer Assisted Valuation Tools (RP)
AO-23 Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment (RP)	AO-38 Content of an Appraisal Report and Restricted Appraisal Report (RP, PP, IP)

Note: AOs do not hold the same weight as standards. Statements 1–10 on Appraisal Standards have been retired. ALL = All disciplines, PP = personal property, RP = real property, IP = intangible property.

Source: *Uniform Standards of Professional Appraisal Practice* 2020–2021 ed. (Washington, DC: The Appraisal Foundation, 2020). Reprinted with permission.