

Financial Valuation and Litigation Expert

IEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES



Editor's Outlook

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Holiday greetings! Here's wishing you a slower schedule and time to relax with friends and family. Thank you for your continued support of Valuation Products and Services!

This issue brings you the AICPA's recently released Valuation Services, VS Section, "Statements on Standards for Valuation Services," and VS Section 100, "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, Calculation Engagements, Frequently Asked Questions (FAQs), Non-Authoritative." This initial version was released at the November FVS conference, and we hope it will help answer many of your questions regarding calculation engagements.

Next up, Chris Hamilton points out that although the adjusted net asset method is a viable option for valuing a closely held business, it does not take into consideration what in many cases is the largest asset—intangible assets. Here, Chris shares a fresh perspective on the asset approach.

Robert Reilly brings us Part Two of his three-part series on the fair value of intangible assets for acquisition accounting controversy purposes. This component highlights examples of typ-

Continued on next page

AICPA Releases Guidance on Use of Calculation Engagements

Calculation engagements have been a hot-button issue since the AICPA Statements on Standards for Valuation Services were released in 2007. Yes, the standards have now been out for over 10 years. During this time, valuation analysts have been asking many questions including the following:

- What is the difference between a calculated value and a conclusion of value?
- Can a specific standard of value be used and referred to in a calculation engagement and report?
- Can a calculation engagement and report be performed in conformity with Revenue Ruling 59-60?
- Can a valuation analyst provide an opinion of value in a calculation engagement?
- Is a calculation report acceptable in court?

- Can a valuation analyst have an opinion of a calculated value in a litigation setting where the valuation analyst is an expert witness?
- Can a valuation analyst be the one to suggest the approaches and methods to be used and the extent of the procedures to be used?
- Can the valuation analyst present an oral report for a calculation report?

These questions are all answered in the new AICPA, Valuation Services, VS Section, "Statements on Standards for Valuation Services," VS Section 100, "Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, Calculation Engagements, Frequently Asked Questions (FAQs), Non-Authoritative." There are 48 questions addressed in this new guidance. *Continued on page three*

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Balance Sheets and the Asset Approach

It is generally accepted that applying an asset approach to valuing the equity of a small, closely held business is not appropriate. The historical cost basis or generally accepted accounting principles (GAAP) basis equity of a business is rarely a measure of the value of the business regardless of the standard of value. The adjusted net asset method is, theoretically, the only viable option to using the approach as a primary means of valuing a closely held business, although it does not resolve the issue of valuing what in many cases is the largest asset—intangible assets. At best, it produces a value of the net tangible assets.

The concepts articulated in the first paragraph represent the sum and substance of the extent many valuation professionals go to comply with the standards by “considering” the asset approach. The asset approach is limited to valuing holding companies, and the value conclusion in those cases will be the sum of asset appraisals. But, is that the appropriate extent of our consideration of the asset approach? Perhaps not!

Twenty plus years of valuation experience—and almost that many years teaching it—have given me a little different perspective on the approach that, early in my career, only warranted scant attention and maybe the shortest paragraph in my reports. The following is a patchwork of asset approach and balance sheet considerations that could apply to almost any valuation and raise the specter of considering the asset approach more deliberately as a tool than as a method that is rarely applicable.

GUT CHECK

You are valuing 100 percent of the equity in a small, closely held business using an income and/or market approach. How do you know you got the right answer? One use of the asset approach is to “ballpark” a floor, or minimum, value to test the conclusion of value. If, for example, an income approach yields an equity value of \$500,000 but net assets (equity) on the GAAP basis balance sheet total \$2,000,000, there is a strong probability that either the income approach was applied improperly or there are significant non-operating assets. Considering the asset approach in this manner is advisable and helpful.

Where the valuation report will be critically reviewed and analyzed by another valuation expert (litigation, tax, etc.), you can be sure the balance sheet analysis will be one point of consideration. A persuasive report will address the balance sheet in the context of the conclusion of value by making it clear how much of the value is attributable to net tangible assets versus intangible assets. There may be good reason that the general rule described above (value exceeds historic cost basis net assets) does not apply to the subject valuation. If so, it should be addressed directly.

TRANSACTIONAL WORK

Participants in the sale/purchase of a business rarely focus on the value of equity. The buyer is interested in assets because they are usually either unwilling or unable to assume existing company debt. It is customary in such engagements to use invested capital as the benefit stream in a discounted cash flow method. Invested capital cash flow is that which is available to debt and equity investors—the right side of



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the balance sheet. If you know the value of invested capital (the right side of the balance sheet), then you know the value of total tangible and intangible assets (the left side of the balance sheet). And, by valuing the left side of the balance sheet, intangible assets can be quantified by subtracting tangible assets.

Understanding the progression from valuing invested capital to the elements of the value of tangible and intangible assets is the basis for understanding and explaining the difference between price and value (FMV, fair value, etc.).

MARKET APPROACH

I used to think that the market approach was easy—grab the multiple, apply it to the subject company, and be done! I came to understand that the market approach is really a modification. *Continued on next page*

expert TIP

The adjusted net asset method is, theoretically, the only viable option to using the approach as a primary means of valuing a closely held business, although it does not resolve the issue of valuing what in many cases is the largest asset—intangible assets.

tion of the income approach. But, I also came to understand that to properly use the market approach I had to become familiar with, and comfortable with, the asset approach and balance sheet. Depending on the database used to find “comparable companies,” the multiples may be based on asset sales—not the sale of equity. The ability to convert values from equity and market value of invested capital (MVIC) to assets and vice-versa is critical in the development of a valuation expert and the accurate utilization of the market approach. The easy answer that “debt is the difference” is not always enough. Other issues such as working capital, excluded assets, shareholder debt, and real estate are some of the other considerations that must be factored into applying a multiple to the subject company.

It is highly advisable to read the user guides and FAQs associated with transaction databases from the perspective of what the balance sheets of the “comparable” companies looked

like. A failure to understand the importance and mechanics of that process can lead to incorrect value conclusions as well as embarrassing exposure in a dispute context.

PRESENTATION

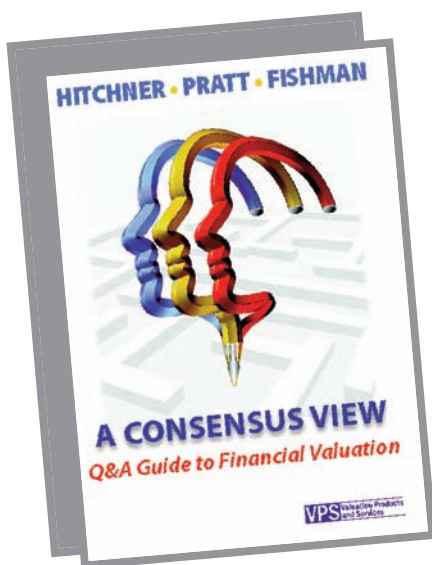
Early in my career an attorney called with a question: “You used the capitalization of earnings approach but you didn’t add book value to that value. Why not?” I learned a couple things in the ensuing conversation. I did not have a clear enough understanding myself, and that resulted in a jumbled explanation. I also learned that a picture is worth its weight in gold. Intent on fixing the weakness in my ability to effectively articulate the answer to his question, I prepared a valuation balance sheet to visually show what it meant when I had replied that “the value indicated by the income approach included the assets and debt of the business.” By simply adding the value of the intangible assets to arrive at the value of equity on a balance

sheet presentation, the attorney instantly “got it.”

Depending on the context of the engagement, presenting a valuation balance sheet may range from advisable to mandatory. For example, in some courts (e.g., family), the court may require the valuation presentation include a balance sheet that shows the intangible value. When presenting value conclusions to a small business owner or others, showing a valuation balance sheet helps to explain the concepts of operating assets versus non-operating assets and the difference between tangible and intangible assets.

Obviously, simply presenting a value conclusion on a balance sheet does not mean that the asset approach was used to value the business. However, a balance sheet presentation and analysis can be very helpful in a profession where persuasive communication is critical and the asset approach must be considered. ☞

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