Appraising a business

ETHICS AND STANDARDS ARE IN THE MIX

By Terri A. Lastovka

Your client wants to buy a small business. How much is it worth? Where do you even start?

Business valuation is a relatively new field that has evolved quickly, driven especially by the corporate accounting scandals. As with any young discipline, there are growing pains. There are a wide range of people performing business valuations — some are accredited, some aren't. Even among the groups that accredit these, there is a huge range of experience required for the accreditation.

In the practice of law, accounting and medicine, there are certifications required by law to enable one to practice. That is not true with respect to business valuation. There is no business-valuation-specific college major, and there are no requirements that must be met for one to claim to be a business appraiser. As a result, there are many who promote and perform business valuations without the knowledge and experience requisite of an expert — in many instances without being even minimally qualified.

To ensure that you receive the best valuation for your client, it is helpful to know a few things about the valuation field itself and about how to find a competent appraiser.

Business appraisals, or valuations as they are now often called, grew out of the appraisal discipline and the real property appraisal field. The discipline expanded during subsequent decades, going by names including intangible property, equities and future potentials. In the late 1970s and early 1980s, the American Society of Appraisers and the Institute of Business Appraisers formed business valuation organizations to formalize the discipline, provide educational materials for members and develop standards for accreditation. Later, an increase in mergers and acquisitions, corporate governance legislation, and corporate accounting scandals led accounting organizations to develop business valuation accreditations as well.

The field has grown rapidly with increased awareness of the discipline and with tax laws, litigation and SEC regulations requiring valuations.

Choosing the right valuator — The safest bet in beginning the search for a business valuator is to find someone who is currently accredited by one of the organizations offering business valuation certification. The following professional societies offer this.

The requirements for accreditation or certification vary among these organizations. Review the requirements for yourself and

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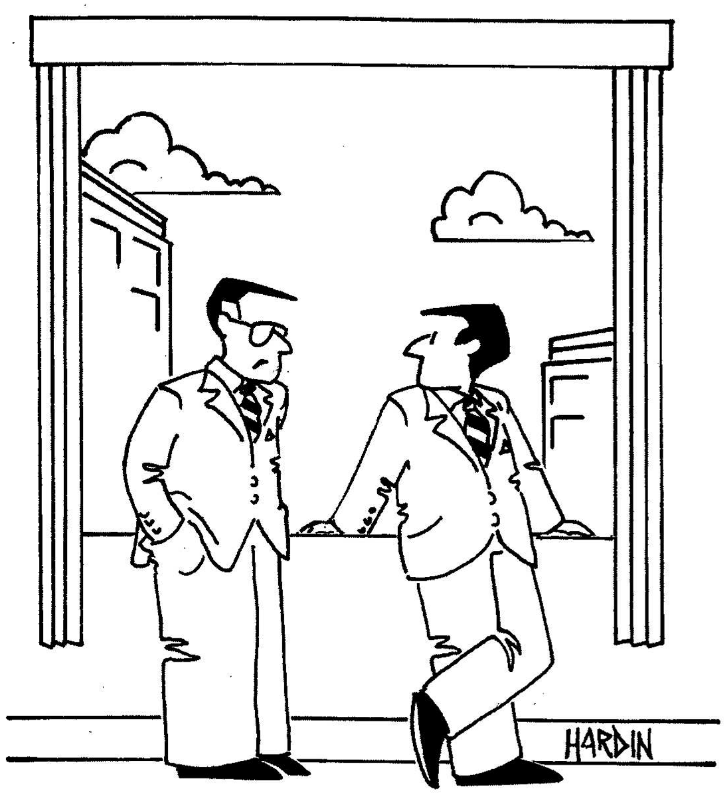
decide which type of background you find most adequate.

The American Society of Appraisers requires business valuators to take numerous courses, demonstrate proficiency in and agree to practice by the Uniform Standards of Professional Appraisal Practice (USPAP) as well as abide by a code of ethics. In addition to education and testing, candidates are required to have a minimum of two years of full-time experience in business valuation to become an accredited member. An additional three years of full-time experience (for a total of five years) is required to attain the accredited senior member status. Once this has been achieved, candidates are required to submit for approval two business valuation reports. These reports must have been prepared for actual clients within two years and be acceptable to the International Board of Examiners.

The Institute of Business Appraisers requires business valuators to have a four-year college degree, pass a $3\frac{1}{2}$ hour examination, and provide documentation of experience with two business valuation engagements. Also, candidates are required to submit for approval two business valuation reports that have been prepared for actual clients to show professional competence.

Business valuation credentials offered in the United States

Organization	Credential	Year established
[illegible]	[illegible]	[illegible]
Institute of Business Appraisers (IBA)	Certified Business Appraiser (CBA)	1978
[illegible]	[illegible]	[illegible]
American Institute of Certified Public Accountants (AICPA)	Accredited in Business Valuation (ABV)	1997



'Love gets the credit, but business *makes the world go 'round.'*

The National Association of Certified Valuation Analysis requires candidates for accreditation to maintain a CPA license. The candidates must also take a five-day course and pass a one-day examination. Rather than submit actual reports for approval, the candidates for accreditation participate in a case study.

The American Institute of Certified Public Accountants also requires candidates for accreditation to maintain a CPA license, pass a one-day examination, and have been involved in 10 business valuation engagements within 24 months of passing the exam. Valuation standards have been proposed and are currently in draft form. The standards are expected to be finalized and become effective sometime in 2006.

Before selecting a business valuation expert, obtain the prospect's business valuation specific qualifications and professional activities, as contrasted to qualifications and activities related to accounting, consulting, brokerage or other professions incidental to business valuation. Also, you should consider in which practice areas the business appraiser concentrates. The appraiser should be familiar with the laws that have an effect on valuation matters for your current case. For example, a business appraiser may have extensive experience in valuations for M&A and financing transactions subject to federal regulations, but little if any experience in divorce or litigation matters subject to state laws.

U.S. Tax Court Judge David Laro has strongly suggested (in remarks presented at the 2003 AICPA national business valuation conference) that an individual seeking to practice in the business valuation area should acquire the appropriate credentials, education and experience. This is particularly important for those who provide expert testimony in court. Using an "expert" who does not have the requisite training and experience could produce disastrous results. If you do your homework up front and hire a qualified expert, it will pay off in the end.

Ethical standards are important — If step one in hiring a good valuation expert is understanding his or her credentials, then step two is making sure that they adhere to the highest ethical standards.

Your appraisal will stand up to scrutiny better if it was completed by a professional who follows the ethical codes that are now the industry standard. In 1987, the Appraisal Foundation was founded as a national nonprofit organization, created to establish uniform criteria for professional appraisers. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 recognizes Uniform Standards of Professional Appraisal Practice (USPAP) as the generally accepted standards, and requires USPAP compliance for appraisers in federally related transactions (www.appraisalfoundation.org).

Business Valuation Accreditation Criteria

Certification		Organization	Prerequisites	Course/Exam	Reports	Experience/Other
ABV	Accredited in Business Valuation	American Institute of Certified Public Accountants (AICPA)	CPA license	One-day exam	None	10 business valuation engagements within 24 months of passing exam
AM	Accredited Member	American Society of Appraisers (ASA)	Bachelors degree or equivalent	4 courses of 3 days each, with a half day exam following each course, plus ethics exam and USPAP exam	2 actual reports to the satisfaction of the International Board of Examiners	2 years full-time or equivalent (e.g. 5 years of 400 hours per year = one year full time equivalent)
ASA	Accredited Senior Appraiser	American Society of Appraisers (ASA)	AM requirements, plus 3 years full-time experience			5 years full time or equivalent for a total 10,000 hours
CBA	Certified Business Appraiser	Institute of Business Appraisers (IBA)	4 years college or equivalent	4 1/2 hour exam	2 actual reports showing professional competence	2 business valuation engagements
CVA	Certified Valuation Analyst	National Association of Certified Valuation Analysts (NACVA)	CPA license	5 day course, plus a half day exam	Case study	None

The primary goal of USPAP is to promote and maintain a high level of public trust in appraisal practice. It is updated annually to stay current with business practices. Since 1989, the Appraisal Foundation has been recognized by Congress as the source for the development and promulgation of appraisal standards and qualifications.

Lawyers should be aware that the ethical guidelines for appraisers are very different from the advocacy position that lawyers take during a case. The Ethics Rules found in USPAP prohibit appraisers from advocating a party's position or showing bias. Also, unlike lawyers, it is unethical for an appraiser to have a compensation arrangement that is contingent on the reporting of a predetermined result, assignment results that favor the cause of the client, the amount of a value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the appraiser's opinions. An appraiser may be an advocate only in support of his or her assignment results. Advocacy in any other form in appraisal practice is a violation of the ethics rules.

What makes a good appraisal — The last part of the road to ensuring that you receive a good valuation is to know enough about the field to make sure that the valuation report will be in line with the needs of your case and your client.

The most important component when developing a valuation is choosing the correct definition of value, as well as the effective date of the appraisal. The definition of value is often referred to as the "standard of value." Unnecessary litigation may arise if an improper definition (standard) of value is used. The definition of value is dependent on the purpose of the assignment.

Federal tax controversies require "fair market value." State law requires either fair market value or fair value for shareholder disputes or domestic relations matters. Banking or finance issues may require orderly liquidation value, forced liquidation value, or some other definition of value, depending on the specific circumstances. It is imperative that the appraiser understand the purpose, relevant law and appropriate definition of value required for the specific purpose of the assignment. Therefore, it is important for you to communicate this information to the appraiser.

For example, family law courts have routinely held that the family-owned business should be valued as a going concern, meaning that it will continue to operate in the future as it has in the past. With that in mind, it would be inappropriate to value the business "as if" all the tangible assets were sold and the debts were paid off (that is, liquidation value) because the goodwill that has been built over the years would be completely ignored.

Similarly, commercial lending policies generally use the fair market value of real estate and equipment for collateral purposes rather than the book value that is reported on a business' financial statements. The true value is typically more or less than the original purchase price reduced for related depreciation.

The following are standards of value as defined in something known as the international glossary of business valuation terms, adopted by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts and the Institute of Business Appraisers. The complete glossary can be found at http://www.bvappraisers.org/glossary/glossary.pdf.

Fair market value: the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at 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.

Forced liquidation value: the value at which the asset or assets are sold as quickly as possible, such as at an auction.

Going concern value: 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.

Investment value: the value to a particular investor based on individual investment requirements and expectations.

Liquidation value: the net amount that can be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced."

Net book value: with respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion and amortization) and total liabilities of a business enterprise as they appear on the balance sheet (synonymous with shareholder's equity); with respect to an intangible asset, the capitalized cost of an intangible asset less accumulated amortization as it appears on the books of account of the business enterprise.

Net tangible asset value: the value of the business enterprise's tangible assets (excluding excess assets and nonoperating assets) minus the value of its liabilities.

Orderly liquidation value: the value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.

Standard of value: the identification of the type of value being used in a specific engagement; such as, fair market value, fair value, investment value.

Also, the business enterprise, assets or equity to be valued must be identified. That includes identification of any buy-sell agreements, stock-restriction agreements, or any similar factors that may have an influence on value. This is so because equity interests subject to such factors in a business enterprise are not necessarily worth the pro rata share of their business enterprise value as a whole.

Conversely, the value of the business enterprise is not necessarily a direct mathematical extension of the value of the fractional interests. It is essential to pay special attention to the attributes of the interest being appraised, including the rights and benefits of ownership. The elements of control in a given situation may be affected

IT'S IMPORTANT TO CHOOSE THE CORRECT DEFINITION OF VALUE.

by law, distribution of ownership interests, contractual relationships, and many other factors. As a consequence, the degree of control or lack of control depends on a broad variety of facts and circumstances that must be evaluated in the specific situation.

The scope of work that is necessary to complete the assignment must permit the appraiser to meet applicable professional standards. An appraiser must have sound reasons to support his or her determination of how much work is to be done and must be prepared to support the decision to exclude any information or procedure that would appear to be relevant to the client, an intended user, or the appraiser's peers in the same or a similar assignment. Furthermore, the appraiser must have a reasonable basis for including extraordinary assumptions or hypothetical conditions. Exclusion or inclusion must be reasonable in the specific circumstances for the results to be credible.

The guidelines set forth by the Internal Revenue Service lay out the data that are required to be considered (Revenue Ruling 59-60). The IRS guidelines are similar to the data suggested by USPAP to be included in the analysis when relevant. They include:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The earnings capacity of the business.
- The dividend paying capacity of the business.
- Whether or not the enterprise has goodwill or other intangible value.
- Prior sales of ownership interests of the business.
- The market price of stocks of corporations engaged in the same or a similar line of business, which have their stocks actively traded in a free and open market, either on an exchange or over the counter.

Not only must all the pertinent data and facts be considered, but the appraiser is required to use all relevant approaches for which sufficient reliable data are available. That is not to say that all methods or approaches are required to be used. Those not applicable may be ruled out after appropriate consideration. The report should state why any particular method or approach is not applicable.

Once the appraiser has arrived at indications of value resulting from the various approaches, he or she must then reconcile those various results to arrive at a final value conclusion. The relative reliability of the various indications of value must be evaluated, taking into consideration the quality and quantity of data leading to each of the indications of value. The value conclusion is the result of the appraiser's judgment and not necessarily the result of a mathematical process.