Forensic Forum
published by The BARSON GROUP

Volume 7 - Issue 2 Fall 2008

What Did He Mean By That?

As a reference tool, this article will provide the reader with an overview of various of the terms commonly used in the business valuation process.

Approaches to Value – a phrase covering the concept of the three broad ways in which to value a business. The three approaches are the cost, market and income approaches. These are distinguished from Methods of Value, which are subsets of Approaches.

Asset Approach – also referred to as the cost approach, this is one that is generally not applied to a profitable operating business, but is more commonly applied to a holding company or an entity whose main function is investment; or where the underlying operating business in a sense doesn't have enough income to justify its existence. It means the value, stated at current market values, of all of its assets less all of its liabilities.

Balance Sheet – a basic accounting term, meaning the assets, liabilities and equity of the subject business as of a particular date (often December 31st).

Book Value – an accounting phrase, having little to do with valuation. It is the net of assets minus liabilities, and represents the result, typically after a few or many years of operations, of the net of a business' assets (such as cash, inventory, equipment, receivables, etc.) less its liabilities (such as payables and notes). This phrase is typically interchangeable with net worth, equity, capital and stockholders' equity.

Capitalization of Income Method – the process of taking an income stream and capitalizing it (essentially meaning multiplying it) by a factor in order to arrive at a value. This is one of the methods within the income approach.

Capital (see Book Value)

Capitalization Rate — often abbreviated as cap rate, this is the discount rate less an assumed growth rate. That is, the discount rate reflects the total return necessary, with some part of that return assumed to be realized in the form of growth. Factoring in the growth (subtracting that anticipated return from the discount rate) yields the cap rate. The cap rate is most easily thought of as the inverse of a multiple – so that a 20% cap rate can be thought of as a 5 multiple.

Cash Flow Approach (see Income Approach)

Comparables (see Market Approach)

Cost Approach (see Asset Approach)

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Calendar
Recent & Upcoming Events

Speeches:

May 2008

5 - Business Valuation Standards, Practice Management, Cost Cutting – CPA-USA Network (Las Vegas, NV)

16 - Business Valuation Standards, Practice Management, Cost Cutting – CPA-USA Network (Baltimore, MD)

21 - Unreported Income & Business Valuation – Institute of Management Accountants (East Hanover NJ)

September 2008

9 - Divorce & Valuation – Shenkman Seminar Series (Teaneck NJ)

26 - Divorce Taxation – NJ Society of CPAs (Iselin NJ)

December 2008

13 - Divorce Taxation – ICLE (New Brunswick, NJ)

January 2009

6 - Hot Issues in Business Valuation – CPA Club (Saddle Brook, NJ)

CLE Ongoing

* * *

Articles:

Spring 2008 issue of the American Journal of Family Law – Civil Unions – Uncivil Taxes

June 9, 2008 issue of NJ Biz – interview of Kal Barson on Valuing a Business

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(Editorial, Design & Layout)

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Discount Rate – the total return that an investor is assumed to require in order to invest in a business.

Earnings Approach (see Income Approach)

EBIT/EBITDA – these very common acronyms are often used in finance, including in business valuations. In general, the reference to income or earnings (the "E" in these phrases) refers to the final, bottom line net income. When we want to refer to a different type of income, you will sometimes see these "words". They mean "Earnings Before Interest and Taxes" or "Earnings Before Interest, Taxes, Depreciation and Amortization".

Equity (see Book Value)

Excess Earnings (or Formula) Method – originating out of IRS Revenue Ruling 68-609, a very common and popular method of valuation. It is a hybrid, mixing elements of both the income and the asset approaches.

Fair Market Value – the so-called classic sense of value, meaning in theory what a hypothetical buyer would pay and what a hypothetical seller would accept for a business or an interest in a business.

Fair Value – generally considered the same as fair market value, but without the consideration of marketability or minority interest discounts (also referred to as discount for lack of marketability and discount for lack of control).

Going Concern – while this phrase is used as a negative in an accountant's opinion report letter, in valuation it does not carry that type of negative connotation. Rather, it means that the business entity being valued is anticipated to continue in operation as a business, as a going concern. This is as contrasted with where it is expected that it will need to be liquidated in order to realize value.

Guideline Companies (see Market Approach)

Income Approach – also sometimes referred to as the earnings approach or cash flow approach. The value of a business entity is determined in relationship to the income (or earnings or cash flow) that it generates. This is the most common approach for valuation, particularly for smaller closely-held businesses.

Income Statement – other terms meaning essentially the same thing are statement of operations, statement of revenue and expenses, P & L, profit and loss, etc. Represents, typically for a full year, the revenues or sales, expenses and resulting net income of a business operation.

Market Approach – the subject entity is valued based on comparisons to other companies (through the use of comparable or guideline companies) for which market transaction data is available, whether those be privately transacted situations, or from the public markets.

Marketability Discount – also referred to as a DLOM (discount for lack of marketability). It is the application against the otherwise determined value of the entity or part of the entity to take into account that a closely-held (non-public) business is not readily marketable. That is, it of course can be sold, but it will likely take time, and possibly expense.

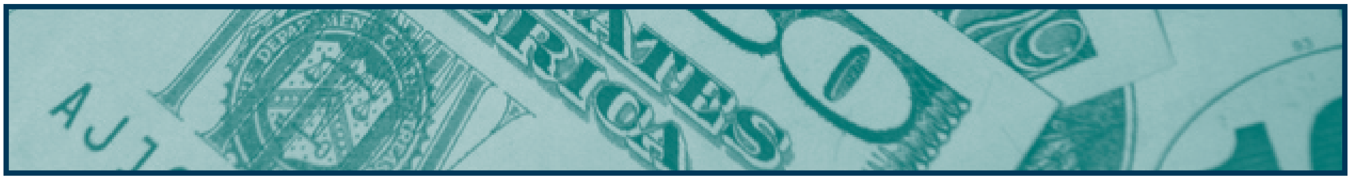
Methods of Value – methods are subsets within the Approaches to Value. While there are three approaches to value, within each approach, there can be a few or even several methods of using that approach. In lay terms, the use of the word "method" as contrasted with "approach" is almost interchangeable.

Minority Interest Discount – also referred to as a DLOC (discount for lack of control), this is often relevant when the valuation is of a less than controlling (generally meaning 50% or less) interest in the business being valued. The concept is that all other things being equal, an interest in a business that does not control the business, is worth less than (subject to a discount) a proportionate amount of a controlling interest, or the value of the business in its entirety.

Net Asset Value – one of the methods within the cost approach, this is an indication of the net of the assets of a business stated at their current values less the liabilities of that business.

Net Worth (see Book Value)

Non-operating Assets – assets (this can also pertain to liabilities) not used in, not needed for, the operations of the business entity. Sometimes this includes personal assets carried by a business, other times excess assets. These are added back (subtracted if they are liabilities) from the otherwise determined value in the income approach as well as in some market approaches.



Normalization Adjustments – changes, or adjustments to the reported figures, whether they be on the balance sheet, or more commonly to the income and expense statement. This is often a euphemism for the adding-back of personal expenses paid through the business.

Officer Loan (also referred to as shareholder loan) – sometimes a business owner/shareholder/officer will "borrow" money from his/her company, or conversely lend money to the company, and as a result it will be reflected on the balance sheet as a loan (whether as a receivable/asset or as a payable/liability). Generally, in the valuation process, unless these loans are treated as genuine arm's length arrangements, they tend to be subtracted from equity (if a loan receivable), or added to equity (if a loan payable). The receivable/payable references are as to the company/business. The theory/logic is that they are not real loans, they may never be paid back; and if a receivable by the company it is merely money that has been taken by the owner as compensation that has not yet been called compensation; or if a payable by the company it is the equivalent of additional capital. While that tends to be the valuation expert's treatment for valuation purposes, it needs to be carefully considered depending on the nature of the matter – for instance, in a divorce action that might be considered a marital asset/liability; if it is a shareholder suit, that may or may not be considered a legitimate receivable or payable as to one or more of the shareholders.

P & L (see Income Statement)

Profit and Loss (see Income Statement)

Reasonable Compensation – a phrase used almost exclusively in business valuation, meaning the salary/compensation necessary to hire, at an arm's length, a person or people to run the business being valued. Reasonable compensation is used in valuation as a substitute for, to replace, the actual compensation taken by owners.

Standard of Value – the basis or foundation of the type of value being developed. An interest in a business, or the business in its entirety, can have different values, depending on the purpose for which the valuation is being performed. The most common standards of value we expect will be of interest to our readers are Fair Market Value and Fair Value.

Statement of Operations (see Income Statement)

Statement of Revenue and Expenses (see Income Statement)

Stockholder's Equity (see Book Value)

Strategic or Synergistic Value – another standard of value, generally one that concludes with a value higher than most, if not all, other types of valuation. This may be used where there is some greater value that can be ascribed to the entity because of its potential when in combination with another similar type entity. This synergistic value kind of fits the cliché that the whole can be greater than the sum of its parts. It also assumes that the entity being valued will not be considered as a stand-alone operation, but rather will realize some increased value through the combination with another entity.

Value – while we can pretty much accept that the word value means what something is worth (though there is the question as worth to whom and for what purpose), the reason for including it herein is to indicate that when we are dealing with business valuation, value means a determination of what a future income stream is worth. The key is the word "future". While we will often use the past as a guide, value is not in what happened in the past, but what is expected to happen going forward. The exception would be in the asset approach where the business is not being valued for its ongoing operations, but rather for its pieces.

Value to the Holder – who really knows what this means. It has become popular in the past few years, to mean what the real value is to the one now owning it, in his/her hands, with no sale contemplated. Sounds nice – but there is no concurrence in the profession as to what it means, let alone how to calculate it.

FOCUS ON FUN

Accountants & Humor
– A Sociological Fable

1. The Tax Court ruled that a taxpayer was only able to deduct expenses incurred in his bass fishing tournament activities to the extent that he earned income in that activity. Mr. Hill began bass fishing when he was just a child, and as an adult participated in competitive bass fishing. As if that fast paced lifestyle were not enough, he started a website as a means of generating income by offering guidance to fishermen. Notably, he abandoned this project when his website failed to receive ANY hits. I guess this is one that got away.

2. Wanda, who had a trusted position at the Stanford Medical Center near San Francisco, needed to decorate her new home. So, she accessed financial data belonging to some of the more prominent doctors at the facility and used their credit card information to pay for the furnishings. She was home free, so to speak, until she invited the same doctors to a housewarming party. They quickly figured out what was going on and reported her to the police.

3. Alice went on a shopping spree at a Georgia Wal-Mart, filling several carts to the brim. When the cashier totaled up $1,672 in merchandise, Alice handed the worker a $1 million dollar bill and asked for the remaining change in cash. Wal-Mart called the police. "This is the first time in my law enforcement career that I've seen someone try to use a $1 million dollar bill" said the local police chief, who promptly arrested Alice.

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