

BUSINESS VALUATION: WHAT AN ATTORNEY NEEDS TO KNOW

- A. Understanding the True Value of a Business**
- B. Models, Formulas and Techniques of Business Valuation**
- C. Asset-Based Approach – Real World Examples**
- D. Income-Based Approach – Real World Examples**
- E. Market-Based Approach – Real World Examples**

A. Understanding the *True Value* of a Business

a. Purpose: Sale by Client to a Third Party

i. Asset Sale versus Stock Sale

An asset sale is the purchase of individual assets and liabilities, whereas a stock sale is the purchase of the owner's shares of a corporation. Primary concerns are tax implications and potential liabilities for C-Corp or S-Corp. Sole proprietors, partnerships, or LLCs sell their partnership or membership interests as opposed to the entity selling its assets.

ii. Enterprise Value – A combination of assets including real property, such as equipment, fixtures, leases, goodwill, trade secrets and/or trade names, telephone numbers, inventory, customer list, and workforce, etc.

iii. Legal – Purchase Agreement or Asset Sale Agreement

iv. Financing – Conventional Financing, Alternative Financing, or By Seller

b. Other Purposes

i. Succession – Transfer to a Family Member or Key Person

ii. Estate-Planning – Minimization of Estate Taxes upon future sale

iii. ESOP – Transfer to an Employee-Owned Entity held in Trust

c. Standard of Value

- i. Fair Market Value – most common between small business holders defined 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 latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts (Revenue Ruling 59-60).
- ii. Fair Value – more common between mid-sized to large or public company defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (SFAS 157 and ASC 820).
- iii. Investment Value – value to a particular investor
 1. sale to a strategic buyer
 2. investor has the capacity to put the property to good use—its highest and best use—usually highest range in valuation
 3. financing usually a combination of debt (opm) & cash (equity)
- iv. Intrinsic Value (to Owner)
 1. annuity value to the owner (high cash flow / lowered risk)
 2. may or not be highest value
 3. may be an intangible asset (goodwill or intellectual property)

d. Types of Businesses

- i. Crops & Natural Resources
- ii. Manufacturing
- iii. Construction
- iv. Retail/Wholesale – bricks & mortars
- v. Services, Financial or Professional Practice – location-based
- vi. Virtual – non location-based

B. Models, Formulas and Techniques of Business Valuation

Overview

Business valuation methodology is based on two principles: "the principal of substitution" and "the principal of future benefits". The principle of substitution states that the value of property tends to be determined by the cost of acquiring an equally desirable substitute. In other words, a person will not purchase a particular asset if an equally desirable substitute can be purchased at a lower price.

The principal of future benefits states that the economic value of an asset reflects anticipated future benefits, i.e., an individual purchases an asset in order to receive the benefits it will provide in the future, not necessary for what it has done in the past. Although the past may serve as a proxy for the future, a business that has had poor earnings in the past but bright future prospects will be worth more than a business that has been successful in the past but is not expected to be profitable in the future.

The value of a business, then, will be determined with a view towards the investment value of the assets, the value of the income flow, the value of the equity in the marketplace, and other facts and circumstances which a potential buyer and seller would consider. Thus, the above principles form the basis for the three approaches used in valuing a business:

1. Asset-Based Approach
2. Income-Based Approach
3. Market-Based Approach

Within each of these approaches there are different methods for determining a business value. The applicability of each approach and the subset of methods contained there under must be assessed, given the facts and circumstances of the particular valuation assignment. Because the fair value standard is based heavily in the principles and approaches of Revenue Ruling 59-60, the scope of our work considered all the elements of a business valuation listed in that Ruling, including an investigation of the following eight factors:

1. The nature of the business and the history of the enterprise from its inception;
2. The economic outlook in general and the condition and outlook of the specific industry in particular;
3. The book value of the stock and the financial condition of the business;
4. The earning capacity of the company;
5. The dividend-paying capacity of the company;
6. Whether or not the enterprise has goodwill or other intangible value;

7. Sales of the stock and the size of the block of stock to be valued;
8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market.

Rules of Thumb

Reducing the complexity of business valuation to rules of thumb is an appealing proposition. Avoiding complex cash flow calculations and side stepping necessary adjustments makes the process of valuation more appealing and more accessible to the lay user. However, one must still deal with the dilemma: “Should it be done simply because it can be done?” Is there value in the simplicity of rules of thumb?

The answer is “maybe.” It all begins with the intended purpose of the valuation. An early retiree seeking a second career might use the methodology to narrow down the number of potential investment selections. The business owner in the initial stage of succession planning may need a number to allow him to work through the steps in the process. The aging parents concerned with equitable distribution when leaving a family business to their children. There are many other examples where a “quick-fix” calculation is a necessary first step to addressing a specific situation. Later, as the process progresses, additional detailed analysis and more sophisticated methodologies can be used to replace the rule of thumb value. The value determined by the rule is simply a bookmark to be replaced at the appropriate time.

Rules of thumb based on actual completed transactions are perhaps the most useful. These types of rules theoretically approximate the Market Comparison Approach. The word “approximate” should be used loosely, as there will no doubt be differences between the subject company and the rule of thumb “average.” These differences include, but are not limited to: expense structure, age of equipment, building lease term, cash flow trends, and specific competition. Equally important are the terms of sale. A rule of thumb based on seller financing likely produces a different result from a rule based upon a cash purchase premise.

How does the rule address inventory, real estate, and debt? Unless the rule specifically states how these issues are addressed, one cannot know if they are accounted for in the rule. Is inventory and real estate added to value? Is debt subtracted from value? The answer to either question can impact value dramatically.

Yes, rules of thumb are quick and simple. If properly understood and applied correctly, they can be useful in some valuation situations. Unfortunately, the only thing certain about their use is the uncertainty as to the comparability to the target situation. A single formula cannot address all of the company-specific differences. Furthermore, users should be aware that rules of thumb from different sources are not necessarily comparable. The source of the rule is important. Independent, professional sources utilizing data based on completed transactions would more likely provide market-driven rules.

Rules of thumb are useful. The source of the rule must be identified and the underlying assumptions understood. Professional business valuers can assist in determining the appropriate application of a specific rule in a given situation.

Industry Formula and Rules of Thumb

This method calculates the value of a business based on a standard industry formulas commonly referred to as a rule of thumb. These formulas are theoretical market-driven measures of comparison and are derived from multiple transactions in a particular industry occurring over an extended period of time.

A difficulty in applying rules of thumb is the lack of information that usually surrounds the transactions, which make up the formulas. This leaves the valuation analyst unable to adequately evaluate the appropriateness of the rule of thumb and to make adjustments for its proper utilization. Thus, value estimates using formulas are not accorded substantial weight unless it can be established that knowledgeable buyers and sellers place substantial reliance on them. Otherwise, rules of thumb are normally used to support values determined by other methodologies.

A rule of thumb valuation basically consists of using a simple formula that estimates the value of a business through a set of established and very general business pricing guidelines.

Keep in mind like all quick valuation methods “rules of thumb” are subject to the various unique characteristics of each target business being valued. Reference books like the aforementioned “Business Reference Guide” offer a comprehensive and excellent database of “rules of thumb” by individual business category

Business brokers use rules of thumb every day to help sellers put price tags on their businesses. Such "rules" are very useful tools for appraising nearly every small business. They can be used to cut through the confusion.

But, rules of thumb are only rough descriptions of reality. They are gross simplifications. In that sense, they are 'dumb'. When misunderstood and misapplied, they are even dumber!

Earnings Multiplier is Best

The most widely used method to value and determine an asking price for a small business is based on the adjustment or recasting of a business's most recent annual profit and loss statement. The goal in this process is to determine the true earning power of the business by adding back to the net profit all the non-essential or discretionary expenses not necessary to run the business to demonstrate a more realistic net cash flow for the owner.

Once this number is determined, the next step is to multiply it by a business category related multiple (service, retail, manufacturing, etc) that are widely used as rules of thumb by the business valuation and business brokerage community. For instance, in general terms small

service related businesses are generally valued at a multiple of somewhere 2 to 2.5 times the Sellers annual adjusted net cash flow. Small manufacturing businesses generally receive higher multiples that can be in the 3 to 3.5 times range.

It is also recommended if you are considering selling your business to contact a local professional business broker in your area. He or she may be able to provide you with valuable information about recent sales in your market of similar businesses like yours, and the net cash flow multiple that they eventually sold at.

If we are going to use a rule of thumb to value a business, some type of earnings multiplier makes the most sense to prospective buyers. It directly addresses the buyer's motive to make money - to achieve a return on investment. Sales multiples mean nothing unless they can be translated into earnings.

Two areas of confusion are inappropriate comparisons to investment real estate and/or to stock market earnings multiples. Real estate is often priced at 8 to 10 times its net operating income. Stock market prices are often as much as, or even more than, 20 times earnings

These two comparisons do not work for small businesses primarily because the risk of owning a small closely-held, privately owned business is thought to be much higher than owning either real estate or publicly held stock. Running a small business is also a lot tougher than managing an office building or a stock portfolio.

But, even if we settle on an earnings multiplier, we are not even able to start the valuation process until we decide which earnings figure we are going to multiply. Is it last year's earnings? This year's? Next year's? Is it the last five year's earnings averaged? Is it the next five year's projected?

The next issue is our precise calculation of 'earnings.' Should it include or exclude the owner's pay and perks, interest expenses, depreciation and taxes? What about those one-time expenses that may be on the books?

But, What's the Right Earnings Multiplier?

After we define which 'earnings' we should use, we still have to choose the right multiplier. How many times are we going to multiply earnings to get to a value of the business? Is it 1, 3, 5, 8, 10 or 20? Based upon what? Figured how? Most people can agree that this multiplier will vary based upon the risk of the business, but how can that be measured?

What about the various tangible and intangible asset values? Do we include the real estate, equipment, vehicles, inventory? Is there a separate value for a seller's agreement to consult with the new owner after the sale? What about non-compete agreements? What about patents, franchises and other extraordinary intangibles?

Finally, how do we define 'value' itself? Do we want 'fair market value?' Or, do we want a specific value for a specific circumstance?

Estimating the market value of a business is difficult when we can't observe a marketplace of buyers and sellers. Sometimes, there aren't many buyer prospects for a given small business.

When no active market seems to exist, buyers pay prices that are unique to their circumstances, sometimes considerably above or below any so-called 'fair market value.'

Let Common Sense Prevail!

We must allow our common sense to prevail if we are to make our way through these issues. Let's not forget that potential buyers create the market. We have to place ourselves in the positions of would-be buyers for the business we're trying to value.

Let's start with the issue of which earnings to use. It would be easiest to use the most recent year's earnings directly from the latest tax return. But, does that make any sense? Not in my opinion.

A buyer is buying the future, not the past. Projected earnings, therefore, is my answer to which earnings figure to use.

The obvious problem with this is that it is difficult to estimate. But, it's still the right figure to use. It makes sense to most buyers as long as the projection looks realistic.

For most small businesses, I believe a one year 'normalized' earnings projection is in order. But, if one could realistically project five years ahead, I could be persuaded to use such a projection.

Use Earnings Before Interest & Taxes (EBIT)

The second issue is the specific calculation of what constitutes 'earnings.' I vote for a simple definition here - one used by accountants for businesses large and small. I'm referring to 'Earnings Before Interest and Taxes' (EBIT) as it is known and defined by accountants. Again, I defer to buyer preferences here. Their advisors are often CPAs and EBIT is an understood norm.

What's the right multiple? Well, it depends! For most businesses, it's somewhere between 3 to 5 times 'normalized' EBIT. But, it can be less than that when there are few tangible assets and it can be more than that when the business is uniquely attractive.

The right multiple is, in the eyes of buyers, a matter of assumed risk. Buyers feel better about buying tangible assets that they can appreciate with their five senses - things like real estate and equipment. On the other hand, one can entice them by offering a clearly attractive opportunity to make money, regardless of the tangible assets included, as long as it's believable.

Why is it 3 to 5 times earnings? Well, to buyers, such a multiple represents getting your investment back in 3 to 5 years from profits. That's equivalent to a projected annual return on investment between 20% and 33%. That's the type of return rate that encourages buyers to take the leap of faith to buy an existing business.

What About Other Assets?

Tangible and intangible assets often seem to have a value separate from the business. The test of whether or not the value of an asset should be included in the multiple-derived price is based upon whether or not it is needed to generate the projected earnings. If it's needed, it's included.

Exceptions to this are most often real estate and inventory for re-sale, because owning real estate and inventory items is theoretically less risky than owning the other assets of a business.

This is especially true for the valuation of businesses which occupy and own buildings which could easily be sold on the open market if the business failed, or businesses which have large amounts of inventory for re-sale which would be easy to liquidate.

The way to treat such assets in this type of pricing analysis is to separate them from the business; value them separately, then add-back these separate values to the multiple-derived value of the business.

Care must be taken, however, not to double-count assets. In the case of real estate, for example, we separate it by making appropriate expense adjustments in the business expenses. If the real estate value is to be added back to the business value, then we must subtract a real estate rent expense when we calculate business earnings. This will lower business earnings and the business entity value. But, we can then add-back the real estate value as a separate figure.

The handling of inventory values can be equally tricky. Inventory is almost always valued at cost, but we have to carefully consider the effect that adding-back inventory value will have on the buy-sell transaction. How inventory is purchased and financed by a buyer has a dramatic effect on the economics of the transaction.

Generally, intangible assets like an owner's agreement not to compete, or to consult during a transition period, are included in the value of the business derived by using a multiple of earnings, even though such assets may well be treated separately at a business closing for tax purposes.

How Can You Be Certain?

After reading and re-reading all the material on business valuation that you can find, you may still wonder how you can be certain that the price you've chosen is correct. Unfortunately, you can't.

Using and applying the various multiples is uncertain and imprecise because buyers are uncertain and imprecise. Most buyers use some type of valuation approach based upon the multiplication of earnings, but they don't all use the same procedures.

There are proprietary databases (i.e., BizComps, Institute of Business Appraisers Transaction Database) that contain nationwide sales data on small business sales. One of the most interesting

results of this new data, so far, is that it confirms the above rules of thumb, if used and applied properly, are fairly accurate.

Some industries have Rules of Thumb about how to value companies in their industry; however, Rules of Thumb are usually quite simplistic. They fail to differentiate either operating characteristics or assets from one company to another. On the one hand, if such Rules of Thumb are widely disseminated and referenced in the industry, they probably should not be ignored. On the other hand, there usually is no credible evidence of how such rules were developed nor how well they actually comport to actual transaction data. Consequently, Rules of Thumb rarely, if ever, should be used without other, more reliable valuation methods.

Sources of Rules of Thumb:

Desmond, Glenn M. *Handbook of Small Business Valuation Formulas and Rules of Thumb*, 3rd ed. Camden, ME: Valuation Press, 1993.

West, Thomas L., ed. *Business Reference Guide*, 9th ed. Concord, MA: Business Brokerage Press (published annually).

Work Product

A comprehensive (written) business appraisal report should contain the following:

- An introduction, including the purpose and use, the standard of value, description of what is being appraised, and limiting conditions.
- An economic analysis and industry section (i.e., RR 59-60, Factor #2)
 - Current Economic Reports
 - National
 - Regional
 - State
 - Local (County)
 - Industry Research
 - National
 - Regional
 - Recent Market Transactions (i.e., RR 59-60, Factor #8)
 - Financial Trends and Ratios
- An analysis and description of the subject business including its history and future prospects.
- A financial analysis of the subject company.
- A financial forecast including assumptions used.
- A discussion of the valuation process and methods used including a detailed explanation of how each method utilized was applied.
- A description of any applicable discounts or premiums applied including justification for amounts selected.
- A reconciliation of indicated values developed from the various business appraisal methods utilized.
- The professional qualifications of the appraiser showing that the appraiser has the qualifications and experience necessary to perform business appraisals.
- Exhibits showing historical financial information, projections, and other information used in preparing the business appraisal.

OBVIOUS DOCUMENTATION:

- I. Financial Statements
 - A. Audited
 - B. Reviewed
 - C. Compiled
 - D. Supplemental Financial Information
 - E. General Ledgers
 - F. Bank Statements & Reconciliations
- II. Income Tax Returns
 - A. 1120
 - B. 1120S
 - C. 1065
 - D. State Filings
 - E. Sales Tax Filings and/or Audits
 - F. Franchise Tax Filings
 - G. Gift Tax Returns
 - H. Estate Tax Returns
- III. Bank Loans and/or Financing
 - A. Note Documentation
 - B. Lines of Credit
 - C. Borrowing Base Documents
 - D. Personal Guarantees
 - E. Personal Financial Statements
- IV. Significant Contracts
 - A. Customers
 - 1. Purchase Orders
 - 2. Formal Contracts
 - 3. Sole-Supply
 - 4. Servicing (Periodic)
 - 5. Vendor Commitments
 - B. Leases
 - 1. Premises (Lessee)
 - 2. Equipment & Equipment
 - 3. Capital Leases
 - C. Employees
 - 1. Non-Compete
 - 2. Management
 - 3. Consulting
- V. Legal Documents
 - A. Certificate of Incorporation
 - B. Stock Ledger
 - C. By-Laws
 - D. Shareholders' or Operating Agreements
 - E. Buy-Sell Agreements & Certificates of Value
 - F. Transfer and Assumption Documents (Minority Holders)

C. ASSET-BASED METHODS OF VALUATION

Book Value

In some situations, underlying asset values may represent the value of an enterprise. For example, book value represents the "accounting value" of assets minus liabilities at the balance sheet date. Because balance sheets are prepared in accordance with generally accepted accounting principles, the book value of a company may not consider the fair value of underlying net assets nor its economic earnings capacity. Thus, book value may not be indicative of the fair value of a business, but it can serve as a measure of its minimum value.

Adjusted Book Value or Adjusted Net Asset Value

The adjusted book value or adjusted net assets of a company is represented by total equity as shown on its historic balance sheet, with adjustments for the fair value of tangible assets and liabilities at the balance sheet date. Any off-balance sheet and/or contingent assets and liabilities would also be included at their fair values.

Liquidation Value and Replacement Cost

Liquidation value is not normally applicable in the valuation of a typical going concern. However, if the company is worth more in liquidation and the holder of the appraised interest can force such an action to occur, the liquidation value of assets less liabilities would be an appropriate measure of value. Replacement cost is used to report what it would cost to replace a company's assets since it has been held that the value of a business can be no more than the cost of duplicating it. Depending on the existence and value of goodwill, this may in fact be the case.

Types of Company Valued Using an Asset Approach

- Public Utilities
- Real Estate Holding Companies
- Mills
- Pharmaceuticals
- Conglomerates
- Banks
- Crops (Farms)
- Natural Resources (Mining)
- Start-Ups
- Jewelry Stores
- Cargo

ABC Real Estate Holdings, LLC

Adjusted Balance Sheet

As of January 15, 2015

	Unadjusted Dec-14	Adjustment	Note	Fair Market Value	% of Total
Assets					
Cash	\$ 232,333	\$ (45,695)	(1)	\$ 186,638	1.5%
Rents Receivable	155,438	(438)	(1)	155,000	1.2%
Fixed Assets, Net	3,017,701	9,482,299	(2)	12,500,000	97.3%
Land	1,500,000	(1,500,000)	(2)	-	
Other Assets (Investments)	585,959	(585,959)	(1)	-	0.0%
	<u>\$ 5,491,431</u>	<u>\$ 7,350,207</u>		<u>\$ 12,841,638</u>	<u>100.0%</u>
Liabilities					
Accounts Payable	\$ 5,662	\$ -		\$ 5,662	0.0%
Mortgage Payable	\$1,259,861	-		1,259,861	
Rent Security Deposits	125,000	-		125,000	1.0%
	<u>1,390,523</u>	<u>-</u>		<u>1,390,523</u>	<u>1.0%</u>
Adjusted Net Asset Value	<u>\$ 4,100,908</u>	<u>\$ 7,350,207</u>	(3)	\$ 11,451,115	<u>89.2%</u>
			Rounded:	\$ 11,451,000	

(1) The bank and brokerage account balances were adjusted to fair market value as of the valuation date. The Company has represented there are no material differences between September 30, 2014 to December 31, 2014.

(2) Per the real estate appraisal performed by Expert Appraisers of Flushing, New York (dated September 19, 2014), the investment in the commercial building equals the Company's equity value in XXX-XX Roosevelt Ave., Flushing, New York.

(3) The net changes in value is accumulated in equity.

The financial information presented above is included solely to assist in the development of the value conclusions presented within this report. Due to the limited purpose of this presentation, it may be incomplete and contain departures from generally accepted accounting principles. Management has represented that the current Balance Sheet is not materially different from the Balance Sheet as of September 30, 2014. We used this prior information to base our valuation.

ABC Pharma, Inc. and Affiliates

Adjusted Balance Sheet

June 30, 2014

	Unadjusted 12/31/2012	Adjustments	Note	Fair Value	% of Total
Assets					
Cash	\$ 2,254,082	\$ -		\$ 2,254,082	0.11%
Accounts receivable	227,184	-		227,184	0.01%
Total Current Assets	<u>2,481,266</u>	<u>-</u>		<u>2,481,266</u>	<u>0.12%</u>
Property and equipment (net)	6,662,106	-		6,662,106	0.31%
Receivable due from related party, net	4,654,180	-		4,654,180	0.22%
Other assets	235,643	-		235,643	0.01%
Due from employees	6,237,728	-		6,237,728	0.29%
Research & development intangible assets	-	2,112,639,000	(1)	2,112,639,000	99.05%
Total Assets	<u>\$ 20,270,923</u>	<u>\$ 2,112,639,000</u>		<u>\$ 2,132,909,923</u>	<u>100.00%</u>
Liabilities					
Accounts payable and accrued expenses	\$ 10,690,827	\$ -		\$ 10,690,827	0.50%
Accounts payable and accrued expenses - clinical	2,220,777	-		2,220,777	0.10%
Short-term debt	64,360,861	64,360,861	(2)	128,721,722	6.04%
Long-term debt and capital lease	<u>2,597,331</u>	<u>2,597,331</u>	(2)	<u>5,194,662</u>	<u>0.24%</u>
Total Liabilities	79,869,796	66,958,192		146,827,988	6.88%
Equity					
Redeemable convertible preferred stock	107,815,630	-		107,815,630	5.05%
Common Stock, warrants and paid in capital	5,343,042	-		5,343,042	0.25%
Accumulated (deficit)/surplus	<u>(172,757,545)</u>	<u>2,045,680,808</u>	(3)	<u>1,872,923,263</u>	<u>87.81%</u>
Total Equity	<u>(59,598,873)</u>	<u>2,045,680,808</u>		<u>1,986,081,935</u>	<u>93.12%</u>
Total Liabilities and Equity	<u>\$ 20,270,923</u>	<u>\$ 2,112,639,000</u>		<u>\$ 2,132,909,923</u>	<u>100.00%</u>
			Subject Interest (Rounded):	<u>\$ 19,861,000</u>	<u>1.00%</u>

The financial information presented above is included solely to assist in the development of the value conclusions presented within this report. Due to the limited purpose of this presentation, it may be incomplete and contain departures from generally accepted accounting principles. We have not audited, reviewed or compiled this presentation and express no assurance on it.

Note 1: We have recognized the real option value ascribed to ABC's enterprise value as a going concern. This intangible assets are more fully described in the text to this report (equals real option value of \$2.123 billion).

Note 2: The Lender of the current Debt Facility is entitled to twice the face amount of borrowings by the Company in any liquidity event.

Note 3: Aggregate of adjustments recognized as accumulated surplus to equity.

D. INCOME STATEMENT METHODS OF VALUATION

This approach generally considers the company being valued as though it were an investment mechanism whose purpose is to produce a monetary return for its owner(s). Application of income-based methods generally involves establishing an income figure for the company being valued, determining the appropriate relationship between income and risk, and then converting the estimated income into an estimate of value.

Discount and Capitalization Rates

An important consideration of the income-based approach and the various methodologies there under is the discounting or capitalization of some measure of earning power. The discount rate is a rate of return that converts all of the expected future returns on an investment to a present value. The capitalization rate is a rate of return that converts a static level projection of earnings on an investment to a present indicated value.

It has been stated that the difference between the two rates is the annually compounded percentage growth rate built into the projected earnings stream that is not reflected in the single measure of projected earnings. This is not always true. In many instances, a discount or capitalization rate is developed based on what an external investor would expect the rate of return to be. However, the discount rate and capitalization rate are interchangeable in a specific set of circumstances, as follows:

- The future estimated earnings being discounted are static, i.e., no growth.
- The terminal value calculation is included in the discounting process.
- The terminal value is computed using a capitalization rate, which equals the discount rate used in the discounting process.

Both rates assess the risk associated with the subject company achieving the estimates of projected future earnings. If the projected earnings of the Company assumes a perpetual rate of growth the discount rate and the rate for capitalization purposes will be different by the amount of the presumed rate of growth in the earnings projection.

Capitalization of Earnings Method

This is a method for determining the value of a business or other contemplated investment by establishing a relationship between (1) normalized historic earnings (a proxy for expected future earnings), (2) the expected or required yield or rate of return (capitalization rate) on a comparable investment of similar risk, and (3) the estimated value of the subject business. This relationship is modeled below:

Economic Income / Capitalization Rate = Estimated Value

The method assumes that all of the assets tangible and intangible, are indistinguishable parts of the business and does not attempt to separate the values of the two.

Capitalization of Excess Earnings Method

This method values the net tangible and intangible assets of a business separately and adds them together to determine the fair value of the entity. Net tangible assets are comprised of the fair value of total assets minus total liabilities. The value of intangible assets are estimated by capitalizing earnings, which exceed a reasonable rate of return on the adjusted net tangible equity (or total assets), by an excess earnings capitalization rate.

Discounted Earnings Method or Discounted Cash Flows

The Discounted Earnings Method is an income oriented valuation approach. This approach assumes that the company's assets, both tangible and intangible, are indistinguishable parts of the business. The discounted earnings method suggests that the company's value resides primarily in its future income generating ability. The total value of the business under this method is calculated by adding the present value of its projected future earnings (cash flows) to the present value of the terminal (residual) value of the business.

Types of Company Valued Using an Income Approach

- Service Companies
- Finance Companies
- Manufacturers
- Wholesalers
- Retailers
- Aerospace
- Shipping
- Food Stores
- Liquor Stores
- Restaurants

ABC CORPORATION
Calculation of Earnings Discount Rate for Next Year's Earnings
Buildup Method

Risk free rate of return	
20-year Treasury Constant Maturity Rate as of April 1, 2014 (Taken from Federal Reserve Board of Governors)	3.35%
Equity Risk Premium	
Long-horizon expected equity risk premium - Supply Side Taken from 2014-Duff & Phelps ("D&P") Valuation Handbook (Note 1)	6.18%
Industry Risk Premium - Plastics Moldings - SIC 3089 (2014-D&P Valuation Handbook)	4.25%
Average Market Return	13.78%
Small Stock Premium	
Expected 10b Decile Equity Size Premium (Taken from 2014-D&P Valuation Handbook)	8.99%
Company Specific Risk Premium/Adjustment (Note 2)	2.50%
Increment by Which Earnings Exceed Net Cash Flow (Note 3)	0%
Discount Rate - Net Earnings - Next Year	25.27%
Less: Long Term Sustainable Growth Rate (Note 4)	5.00%
Capitalization Rate - Net Earnings - Next Year	20.27%
Rounded	20.0%

Note 1: The equity risk premium, industry risk premium, and small stock premium were obtained from the Duff & Phelps Valuation Handbook - Guide to Cost of Capital, 2014 Edition. The historical equity risk premium reported in prior Ibbotson's SBBI Yearbooks is based on the Supply Side Model which is originally based on a study completed by Roger Ibbotson and Peng Chen, published in the February 2003 issue of the Financial Analysts Journal.

Note 2: Since market approach more suitable and more widely used to value this type of business, we look to the implied capitalization multiples of EBITDA and EBIT (i.e., pre-tax basis). With a range of 5x to 7x, capitalization rates of between 10.0% and 15% are implied even after considering long-term growth; therefore we did not adjust the Company's cost of capital given strategic considerations including its longevity, customer relationships, location, and the shareholders' stated desire to continue the business indefinitely.

Note 3: The Company's net earnings and net cash flow are expected to be roughly equal as we have assumed that depreciation expense and capital expenditures will remain value neutral, and working capital requirements will be funded from operating cash flows.

Note 4: Long-term median rate of growth of GDP of 2.6%; from 10-year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, December 2013. First Research forecasts growth of 5% for 2013 through 2018.

ABC Corporation

Earnings Analysis

Fiscal Year Ended December 31st	Adjusted After Tax Net Income	Weighting	Weighted Net Income
TTM 3/31/14	\$493,033	5	\$2,465,166
2013	311,416	4	1,245,664
2012	817,359	3	2,452,078
2011	711,792	2	1,423,584
2010	495,832	1	495,832
		15	<u>\$8,082,324</u>
Average	\$ 565,886		
Weighted Average			\$538,822

ABC Corporation

Capitalization of Earnings Method⁽¹⁾

Weighted Average Adjusted Net Income (Projected)	\$ 538,822
Divide by the Capitalization Rate	<u>20.0%</u>
Value of ABC - Controlling, Marketable Interest Basis	<u>\$2,694,110</u>
<i>Rounded</i>	<u>\$2,700,000</u>

⁽¹⁾ The Company's weighted average net income (Fiscal 2009 - 2013) serves as a reasonable proxy for net cash flow, as net working capital is value neutral, and nominal capital expenditures and depreciation are assumed to be offsetting.

ABC EMERGENCY MANAGEMENT SYSTEMS, LLC
Discounted Cash Flows Model (\$000s)

	Base Year 2013	Prospective				
		2014	2015	2016	2017	TV
Time Period Adjustment to Year-End:		<u>0.5</u>	<u>1.5</u>	<u>2.5</u>	<u>3.5</u>	<u>4.0</u>
Total Revenues	\$ 71,966	\$ 77,700	\$ 81,600	\$ 85,700	\$ 90,000	\$ 94,500
<i>Projected Growth (Implied):</i>		8.0%	5.0%	5.0%	5.0%	5.0%
Less: Cost of Services	80.76% (60,512)	(62,750)	(65,900)	(69,211)	(72,683)	(76,318)
Gross Margin	11,454	14,950	15,700	16,489	17,317	18,182
<i>Indicated GM Percentage:</i>	15.9%	19.2%	19.2%	19.2%	19.2%	19.2%
Less: Selling, General & Administrative	6.30% (6,465)	(6,993)	(7,344)	(7,713)	(8,100)	(5,954)
<i>Indicated SG&A Percentage:</i>	9.0%	9.0%	9.0%	9.0%	9.0%	6.3%
EBITDA	4,989	7,957	8,356	8,776	9,217	12,229
Less: Depreciation & Amortization	(32)	(30)	(30)	(30)	(30)	(30)
EBIT	\$ 4,957	\$ 7,927	\$ 8,326	\$ 8,746	\$ 9,187	\$ 12,199
<i>Indicated EBIT Percentage:</i>	6.9%	10.2%	10.2%	10.2%	10.2%	12.9%
Tax Expense	40.0% (1,983)	(3,171)	(3,331)	(3,499)	(3,675)	
Debt-Free Net Earnings	\$ 2,974	4,756	4,996	5,248	5,512	
Add: Depreciation & Amortization		30	30	30	30	
Add/(Less): Changes in Debt-Free W/C	5.00%	(287)	(195)	(205)	(215)	
Less: Capital Expenditures		-	-	-	-	
Debt-free Cash Flow Available for Distribution		4,500	4,831	5,073	5,327	
Terminal Value (see TV Exhibit)						0
Long-term Growth	5.0%					
Discount Factor	15.0%	0.932504808	0.810873746	0.705107605	0.613137048	0.571753246
Present Values		\$ 4,196	\$ 3,917	\$ 3,577	\$ 3,266	27,030
Present Value of Interim Cash Flows						14,956
Net Present Value	→					\$ 41,986
Less: Debt Used						(21,450)
						\$ 20,536

ABC EMS, LLC

Discounted Cash Flow Method - Terminal Value

		(\$000s)
<u>Normalized Debt-Free Cash Flow</u>		
EBITDA		\$ 12,229
Less: Normalized Depreciation & Amortization		<u>(35)</u>
EBIT, Adjusted		12,194
Other Expense / (Income)		<u>-</u>
Earnings Before Taxes (EBT)		12,194
Tax Expense	40.0%	<u>(4,878)</u>
Subtotal, Debt-free Net Earnings		7,316
Add: Depreciation & Amortization		35
Add/(Subtract): Changes in Debt-free Working Capital	25.0%	<u>(225)</u>
Less: Capital Expenditures		<u>(35)</u>
Debt-Free Cash Flow Available for Distribution		<u>\$ 7,091</u>
 <u>Terminal Value Calculation</u>		
Debt-free cash flow, normalized		\$ 7,091
Terminal year growth rate		<u>0.0%</u>
Debt-free cash flow, prospective		\$ 7,091
Divided by: Capitalization Rate		<u>15.0%</u>
Capitalized value at end of estimation period	4.0	\$ 47,276
Present Value Factor	10.0%	<u>0.5718</u>
Present Value of Terminal Year		<u>\$ 27,030</u>
 <u>Business Enterprise Value "BEV" Calculation</u>		
Sum of Present Values (2014 to 2017)		\$ 14,956
Terminal Value		<u>27,030</u>
DCF Value		41,986
Less: Debt		<u>(21,450)</u>
Fair Value of Equity (Rounded)		<u>\$ 20,536</u>

E. MARKET-BASED METHODS OF VALUATION

These methods represent a market-oriented approach to estimating value of a subject company. In application of the principle of substitution, these methods compare the company being valued to ownership interests in similar companies, public and/or private, that have actually been sold or are publicly traded to determine a value estimate. The Guideline Company Method is contingent upon the availability of exchanges involving reasonably similar businesses in a free and active marketplace. There are four methods that can be used in applying this approach:

1. Industry Formula or Rule of Thumb Method
2. Industry Average Multiple Method
3. Guideline Merger and Acquisition Method
4. Guideline Company Method

Industry Formula and Rules of Thumb

This method calculates the value of a business based on a standard industry formulas commonly referred to as a rule of thumb. These formulas are theoretical market-driven measures of comparison and are derived from multiple transactions in a particular industry occurring over an extended period of time.

A difficulty in applying rules of thumb is the lack of information that usually surrounds the transactions, which make up the formulas. This leaves the valuation analyst unable to adequately evaluate the appropriateness of the rule of thumb and to make adjustments for its proper utilization. Thus, value estimates using formulas are not accorded substantial weight unless it can be established that knowledgeable buyers and sellers place substantial reliance on them. Otherwise, rules of thumb are normally used to support values determined by other methodologies.

Industry Average Multiple Method

Similar in many respect to the Industry Formula or Rule of Thumb Methods, the Market Data Method follows the analytical process of determining the sales price as a ratio to sales, sales price as a ratio to earnings, and/or sales price as a ratio to book value. However, the multipliers are derived from an average of multiple publicly traded companies operating in the same industry as the subject company and applying these ratios to the sales, earnings, and/or book value of the subject company.

Guideline Merger and Acquisition Method

The Guideline Merger and Acquisition Method is similar in concept to the Guideline Company Method. The comparative data are from transactions involving transfers of ownership of entire companies or major interests in companies (usually controlling interests). Prior to transfer, the companies may have been either public or private. The guideline merger and acquisition method

usually results in a control marketable value, since the comparative data are typically control transactions. From that indicated value, adjustments may be appropriate for lack of marketability.

Guideline Company Method

The guideline company method determines the value of the subject company by comparing it with several specific comparable enterprises traded in active, public markets. This is accomplished by applying comparative market-derived multiples of value, such as a price to earnings ratio, price to revenue ratio, and price to book ratio to the respective earnings, revenue, and book value of the subject company. In recognition that no publicly traded companies will ever be truly comparable to most closely-held businesses, the term "comparable" companies is synonymous to "near comparable" companies.

Valuation multiples derived from publicly traded companies can be important determinants of value because they reflect the expectations of market participants. These multiples provide a reading of the market's psychology and its consensus as to the relative worth of a security. This is significant for three reasons. First, the market is competitive, with investors desiring to enhance their wealth. Second, the market is informed, with investors seeking to deepen their understanding of the companies and industries in which they have positions. Finally, the market is rational, with investors acting upon information acquired to further their objectives.

If comparable publicly-traded companies can be found, meaningful valuation multiples for a subject company can be determined by comparing the firm with others in the same industry and, from its relative standing in the industry, inferring subject company market valuation ratios based on market based valuation ratios.

Types of Company Valued Using a Market Approach

- Technology Companies
- Internet Companies
- Financial Services
- Professional Services
- Franchises
- Transportation
- Retailers
- Wholesalers
- Real Estate
- Gas Stations
- Convenience Stores

Table 1

ABC Lumber & Supply Co., Inc.

Company Normalized Metrics as of October 1, 2014

	Gross Profit	OCF	EBIT
Selected Metric (Projected Revenue)	\$ 10,377,000	\$ 10,377,000	\$ 10,377,000
Selected Company Metric	27.5%	5.0%	2.0%
Indicated Value	\$2,853,675	\$518,850	\$207,540
Less: Adjustments	-	-	-
Indicated Normalized Metric	\$2,853,675	\$518,850	\$207,540

Table 2

ABC Lumber & Supply Co., Inc.

Company Benchmark Information

Industry Category (Small - Under \$5M)	Weights	Gross Profit	EBIT + O/C	EBIT
Lumber Wholesalers	20%	20.2%	2.9%	1.6%
Building Materials Dealers	60%	28.7%	3.1%	1.2%
Home Centers & Hardware Stores	15%	33.5%	4.2%	2.0%
Electrical & Plumbing Supply Wholesalers	5%	22.9%	4.8%	3.0%
	100%			
Average Multiples		26.3%	3.8%	2.0%
Weighted Multiples		27.4%	3.3%	1.5%

Capitalized Value of OCF:

Normalized EBIT/OCF (After-Tax @ 30%)	\$ 363,195
Capitalization Rate = 22.5% - 7.50%	15.0%
Capitalized Value	<u>\$ 2,421,300</u>
Rounded:	\$ 2,421,000

Table 3

ABC Lumber & Supply Co., Inc.

Market Approach - Market Value of Invested Capital (MVIC)

	Revenue	Gross Profit	Adjusted EBIT	Adj. EBITDA
Selected Metric (Normalized)	\$ 10,377,000	\$ 2,853,675	\$ 518,850	\$ 543,850
Selected Market Multiple	0.25	0.85	5.00	4.50
Indicated Value (MVIC)	\$2,594,250	\$2,425,624	\$2,594,250	\$2,447,325
Less: Interest-Bearing Debt	-	-	-	-
Indicated Equity Value	\$2,594,250	\$2,425,624	\$2,594,250	\$2,447,325

Table 4

ABC Lumber & Supply Co., Inc.

Industry Market Multiples to Invested Capital

Industry Category	Weights	Revenue	Gross Profit	EBIT	EBITDA
Lumber Wholesalers	20%	0.20	0.50	4.30	4.10
Building Materials Dealers	60%	0.40	0.90	4.80	4.20
Home Centers & Hardware Stores	15%	0.50	0.90	5.40	5.00
Electrical & Plumbing Supply Wholesalers	5%	0.40	1.20	6.80	6.80
	100%				
Average Multiples		0.38	0.88	5.33	5.03
Weighted Multiples		0.38	0.84	4.89	4.43

Table 5

ABC Lumber & Supply Co., Inc.

Selected Multiples:	0.25	0.85	5.00	4.50
Rationale:	Private/Size	Composite	Composite	Composite

Table 1

ABC Nursing Staff Inc.

Company Normalized Metrics as of January 2014

	Gross Profit	OCF	EBIT
Selected Metric (Projected Revenue)	\$ 33,000,000	\$ 33,000,000	\$ 33,000,000
Selected Company Metric	84.0%	7.0%	3.5%
Indicated Value	\$27,720,000	\$2,310,000	\$1,155,000
Less: Adjustments	-	-	-
Indicated Normalized Metric	\$27,720,000	\$2,310,000	\$1,155,000

Table 2

ABC Nursing Staff Inc.

Company Benchmark Information

Industry Category (Small - Under \$5M)	Weights	Gross Profit	EBIT + O/C	EBIT
Home Healthcare Services	25%	81.6%	2.7%	1.8%
Nursing Homes & LTC Facilities	45%	100.0%	9.3%	4.4%
Mental Health & Substance Abuse	5%	94.7%	10.0%	4.3%
Podiatrists	5%	85.4%	7.3%	5.0%
Rehabilitation Services	5%	100.0%	15.0%	5.3%
Staffing Services	5%	86.8%	5.5%	3.1%
Hospitals	5%	93.3%	5.2%	4.3%
Healthcare Sector	5%	<u>93.3%</u>	<u>8.1%</u>	<u>3.2%</u>
	<u>100%</u>			
Average Multiples		91.9%	7.9%	3.9%
Weighted Multiples		84.1%	6.6%	3.2%

Capitalized Value of OCF:

Normalized EBIT/OCF	\$ 2,310,000
Capitalization Rate = 25% - 5.0%	<u>20.0%</u>
Capitalized Value	<u>\$ 11,550,000</u>
Rounded:	\$ 11,550,000

Table 3

ABC Nursing Staff Inc.

Market Approach - Market Value of Invested Capital (MVIC)

	Revenue	Gross Profit	Adjusted EBIT	Adj. EBITDA
Selected Metric (Normalized)	\$ 33,000,000	\$ 27,720,000	\$ 2,310,000	\$ 2,460,000
Selected Market Multiple	0.50	0.70	3.70	3.70
Indicated Value (MVIC)	\$16,500,000	\$19,404,000	\$8,547,000	\$9,102,000
Less: Interest-Bearing Debt	2,350,000	2,350,000	-	-
Indicated Equity Value	\$14,150,000	\$17,054,000	\$8,547,000	\$9,102,000

Table 4

ABC Nursing Staff Inc.

Industry Market Multiples to Invested Capital

Industry Category	Weights	Revenue	Gross Profit	EBIT	EBITDA
Home Healthcare Services	25%	0.50	0.50	3.50	3.50
Nursing Homes & LTC Facilities	50%	0.60	0.70	3.80	3.80
Mental Health & Substance Abuse					
Podiatrists					
Rehabilitation Services	10%	0.50	0.50	3.20	3.10
Staffing Services	15%	0.30	1.10	4.00	3.90
Hospitals					
Healthcare Sector					
	<u>100%</u>				
Average Multiples		0.48	0.70	3.63	3.58
Weighted Multiples		0.52	0.69	3.70	3.67

Table 5

ABC Nursing Staff Inc.

Selected Multiples:	0.50	0.70	3.70	3.70
Rationale:	Private/Size	Lower G/M	Composite	Composite

ABC Lumber & Supply Co., Inc.

Summary of Control, Marketable Value Indication - Value of Operations

	Control Marketable Value		Weight		Weighted Value
Capitalization of Earnings Method	\$ 2,421,300		40%	\$	968,520
Merged and Acquired Method - MVIC/Sales Revenue	2,594,250		15%	\$	389,138
Merged and Acquired Method - MVIC/Gross Profit	2,425,624		15%	\$	363,844
Merged and Acquired Method - MVIC/EBIT	2,594,250		15%	\$	389,138
Merged and Acquired Method - MVIC/EBITDA	2,447,325		15%	\$	367,099
Indicated Control, Marketable Value - Operations			100.00%	\$	2,477,737
			<i>Rounded:</i>	\$	2,500,000

ABC Nursing Staff Inc.

Summary of Control, Marketable Value Indication - Value of Operations

	Control Marketable Value		Weight		Weighted Value
Capitalization of Earnings Method	\$ 11,550,000		40%	\$	4,620,000
Merged and Acquired Method - MVIC/Sales Revenue	\$14,150,000		15%	\$	2,122,500
Merged and Acquired Method - MVIC/Gross Profit	\$17,054,000		15%	\$	2,558,100
Merged and Acquired Method - MVIC/EBIT	\$8,547,000		15%	\$	1,282,050
Merged and Acquired Method - MVIC/EBITDA	\$9,102,000		15%	\$	1,365,300
Indicated Control, Marketable Value - Operations			100.00%	\$	11,947,950
			<i>Rounded:</i>	\$	11,950,000

SELECTING A BUSINESS APPRAISER

Most professionals, such as doctors, attorneys, engineers, dentists, etc. have clearly defined career paths that must be followed to enter their profession. Typically, a specific college program must be completed followed by some examination for licensing or other certification.

Unfortunately, the business valuation profession does not have a clearly defined path. No specific college major exists for business valuation, nor are there any governmental licensing requirements to prove minimum competency. Because of this lack of a specific career path and licensing requirements, many individuals with different backgrounds claim expertise and perform business appraisals often with poor results.

Business appraisers typically come from one of the following groups: certified public accountants (CPAs), business brokers, college professors, and stockbrokers. Without special training and business valuation credentials, none of the individuals from these groups are competent to do business appraisals. Very few individuals actually performing business appraisals have earned a professional designation from a recognized professional organization certifying business appraisers.

For years many assumed CPAs were competent in valuing businesses. In 1997 the American Institute of Certified Public Accountants (AICPA) established a special credential for business valuation called Accredited in Business Valuation (ABV) to demonstrate competence in business appraisal. This seems to indicate that the vast majority of CPAs nationwide have little or no training or expertise in business valuation. Another problem for CPA's is potential conflicts of interest. In 1991, another organization called the National Association of Certified Valuation Analysts (NACVA), exclusively for CPAs, was also formed to give CPAs some training and a credential in business valuation called Certified Valuation Analyst (CVA). However, only approximately "one percent" of the CPA's across the nation currently hold either of these two credentials in business valuation.

Business brokers sell businesses, but most have no training in business valuation. Often business brokers use generic rules of thumb to list and sell businesses. Also, many business brokers lack the financial expertise necessary to properly analyze a company's financial statements.

College professors typically have expertise in financial theory and may be able to analyze financial statements, but they often try to apply sophisticated financial techniques designed for very large companies to small privately held companies. They also often lack the "real world" experience necessary to properly value most privately held companies.

Stockbrokers and stock analysts usually have the ability to analyze financial statements and understand public markets. However, they typically have no experience dealing with privately held companies.

In order to meet the need of demonstrating competence in business valuation, several professional organizations have evolved that certify business appraisers. Additionally, often a business appraisal is done because of some type of litigation. Historically, it was fairly easy to

qualify an individual with a business background as an "expert witness." In 1993, this began to change. Now, trial judges are deemed to be "gatekeepers." Meaning that the trial judge has the ability to exclude experts if they do not meet appropriate standards. It is now more important than ever to ensure that an expert witness has the credentials and experience to survive a challenge. Otherwise, their testimony might be excluded in court, or perhaps, admitted but given little or no weight.

The four organizations in the United States that certify business appraisers are: 1) The Institute of Business Appraisers, Inc.; 2) the American Society of Appraisers; 3) the National Association of Certified Valuation Analysts; and 4) the American Institute of Certified Public Accountants. The table shown below compares and contrasts the requirements to obtain credentials from each of these professional organizations. Before you select a business appraiser, carefully review his or her credentials and experience. Generally, those who have obtained the more difficult credentials, such as the Certified Business Appraiser (CBA) from the Institute of Business Appraisers or the Accredited Senior Appraiser (ASA) in business valuation from the American Society of Appraisers, will do high quality work and be well regarded in court.

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Business Valuation Credentials

A Comparison of the Primary Requirements to Obtain & Maintain a Credential

Requirement	CBA ¹	ASA/AM ²	CVA ³	ABV ⁴
Education	College/Equivalent	College/Equivalent	College/Equivalent	College/Equivalent
Experience	Minimum of two assignments--two reports must be submitted and approved	5 Years for ASA; 2 years for AM	No Minimum	Involved in 10 Business Valuations
Qualifying Exam	Proctored, Closed Book	Proctored, Closed Book. Also must pass an Ethics Exam. A USPAP exam must be passed every five years	Take-Home, Open Book until 1999; Proctored, Closed Book starting in 1999. Exam includes a report writing portion.	Proctored, Closed Book
Report Review Requirement	Yes, 2 Reports rigorously reviewed by leading Business Appraisers	Yes, 2 Reports rigorously reviewed by leading Business Appraisers	None other than portion of qualifying exam.	None
Continuing Professional Education	Yes, 24 Credits every two years or equivalent	Yes, 100 Credits every five years	Must maintain CPA credential. Other classes in business valuation are required to maintain designation.	60 Credits and involvement in 5 reports every 3 years
Organization has Professional Standards	Yes, for over ten years	Yes, for over ten years	Yes, since 1995	Under Consideration

Organizations Awarding the Above Referenced Business Valuation Professional Designations

(1) CBA	Certified Business Appraiser from The Institute of Business Appraisers, Inc.
(2) ASA/AM	Accredited Senior Appraiser/Accredited Member from the American Society of Appraisers
(3) CVA	Certified Valuation Analyst from the National Association of Certified Valuation Analysts
(4) ABV	Accredited in Business Valuation awarded to CPAs by the American Institute of Certified Public Accountants