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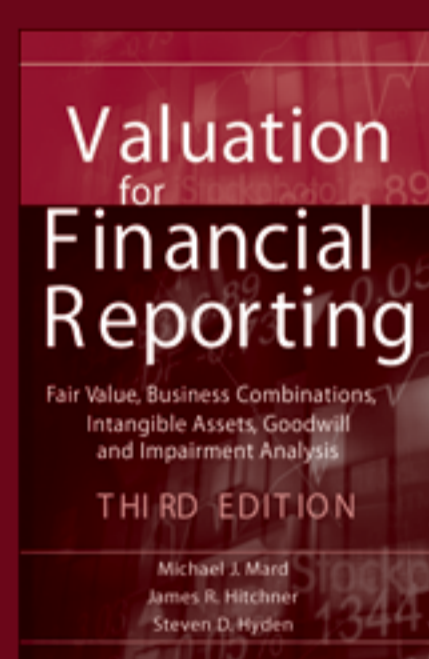
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Michael Mard, among many others, was involved in the creation and development of SSVS. If you would like an electronic version of SSVS, email info@fvqfl.com and a copy will be provided to you. Please put "SSVS Copy" in the subject line.

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Transparency in Collaboration

Principles of Transparency Specific to the Market Approach

Part 5 of 7 in a Series

By

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This is the fifth of a series of articles discussing and setting forth principles of transparency related to business valuations and financial analyses performed in a collaborative process setting. This article discusses methods specific to the Market Approach.

Summary

In the first article of this series, I proposed specific principles of transparency applicable to a financial analyst, including a business valuator, working in a collaborative process. The specific principles proposed are designed to allow the verification, reproduction, and evaluation of findings and conclusions and include:

- Clarity of scope of roles, responsibilities and objectives,
- Open process for formulating reporting,
- Public availability of information,
- Accountability and assurance of integrity,
- Shared vocabulary,
- Benchmarking or verification of work performed, and
- Fees based on time and materials.

I proposed general and specific principles to assure transparency of the work performed by a financial expert in a collaborative process. This article focuses specifically on the application of these principles to a financial expert performing a business valuation.

Market Approach Methodology

The valuation process must include consideration of Market Approach (sometimes called sales comparison approach) methodologies. This is because the market - that is, the economic environment where arm's length transactions occur between unrelated parties - is often the best indicator of the value of tangible and intangible assets. A valuation professional will analyze the market most applicable to the asset (often the stock owned in a company) for both sales and license transactions ("transactions").

The process used to apply the Market Approach to the appraisal process may be summarized as follows:

- Research the appropriate market for information on sales transactions, listings, and offers to purchase or license comparable properties ("properties" is used in the broadest sense to include all assets, including stock owned). Comparability is judged in relation to factors such as property type, property use, industry in which the property functions, and the date of the sale or license.
- Verify the information by confirming that the market data obtained is accurate and that the transactions reflect arm's length market considerations. This verification procedure may also elicit additional information about the current market conditions for the sale or license of the subject property.
- Select relevant units of comparison (e.g., income multipliers or dollars per unit) and develop a comparative valuation pricing analysis for each unit of comparison.
- Compare guideline property transactions with the subject property, using the elements of comparison (see "Elements of Comparison" below), and adjust the prices of each guideline transaction appropriately to the subject property. If such an adjustment is not possible, eliminate the transaction as a guideline.
- Reconcile the various value indications into a single value indication or range of values (see "Reconciliation" below)

Elements of Comparison

There are ten basic elements of comparison generally considered in selecting and analyzing guideline property transactions:

1. The specific legal rights of property ownership conveyed in the guideline transaction;
2. The existence of any special financing terms or other arrangements;
3. Whether the elements of arm's length conditions existed;
4. The economic conditions that existed in the appropriate secondary market at the time of the transaction;
5. The industry in which the guideline property was (or will be) used;
6. The physical characteristics of the guideline properties, compared with the subject property;
7. The functional characteristics of the guideline properties, compared with the subject property;
8. The technological characteristics of the guideline properties, compared with the subject property;
9. The economic characteristics of the guideline properties, compared with the subject property; and
10. The inclusion of other properties in the guideline; this may include the sale of a bundle or a portfolio of assets, which could include tangible personal property or real estate, as well as intellectual properties.

Reconciliation

The last phase of the Market Approach valuation analysis is the reconciliation. In this step, two or more value indications that have been derived from the guideline sale and/or license market data must be synthesized into an overall value estimate. In the reconciliation, the valuation professional summarizes and reviews the empirical data, the valuation analysis, and the result of each of the value indications.

These value indications are then resolved into a range of value or a single value indication. The valuation professional considers the strengths and weaknesses of each guideline value indication derived and examines the reliability and appropriateness of the market data compiled and of the analytical techniques applied.

Application of the Market Approach

The Market Approach is critical to the concept of "fair market" value for property. As such, a valuation professional can look to either similar property or guideline companies in the marketplace. However, given that the Market Approach relies on the existence of similar or guideline market data, the valuation professional must remember that guideline transactions for intangible assets, especially intellectual property, typically have unique characteristics, and therefore the valuation professional must exercise judgment - especially when selecting intellectual property comparables.

There are a number of sources available to the valuation professional to assess the existence of market data. These sources can be broken down into three categories: periodicals and publications, professional organizations, and internet searches. Although a valuation professional can research the marketplace to find out whether there are transactions of comparable property, there are often challenges associated with this process. Either public information regarding transfers of property does not exist or, more often, the specific nature of the property being valued does not make it comparable to any other asset in the marketplace. Remember, comparability extends to both characteristics and specific application.

Many property assets are owned by privately held companies or individuals, and the availability of information regarding sales and exchanges is limited in certain respects. If another property is comparable and has been used as a guideline transaction, the valuation professional may need to determine that the substance of the underlying agreements is also similar to the pending transaction or use for which the property is being valued. These difficulties aside, the Market Approach, because it relies on value determined in the open market, is still a useful methodology to value a property, whether a tangible asset, an intangible asset, or stock of a closely held company.

Conclusion

This article focused on Market Approach methodologies utilized by a financial analyst working in a collaborative process. The remaining two articles in this series will address applicable discounts and premiums, and suggested checklists for use by non-appraisers.