

## BUSINESS VALUATION TERMINOLOGY IN THE ABV EXAMINATION

**Beta:** A measure of systematic risk of a security.

*Levered Beta* — Published betas for publicly traded stocks that reflect the actual capital structure (i.e., the degree of financial leverage) of each respective company.

*Unlevered Beta* — The beta that the company would have if it had no debt.

*Relevered Beta* — Adjusted beta based on a different capital structure.

**Capital Structure:** The composition of the invested capital of a business entity; the mix of debt and equity financing.

**Capitalization Rate:** Any divisor (usually expressed as a percentage) used to convert anticipated economic benefits of a single period into value.

**Cost of Capital:** The expected rate of return that is required to attract funds to a particular investment. It depends on the general level of interest rates and the amount of premium for risk (i.e., above the risk-free rate) that the market demands, as well as the risks attributable to the subject business.

**Debt-Free Net Income (DFNI):** After tax net income (revenue less expenses) plus interest expense (net of related tax) related to invested capital holders.

**Debt-Free Cash Flow (DFCF):** DFNI plus non-cash charges (depreciation, amortization, addition to deferred revenue, and deferred taxes) less **incremental** capital expenditures less **incremental** debt-free working capital.

**Debt-Free Working Capital:** Current assets less current liabilities, excluding short-term interest-bearing debt.

**Direct to equity:** Cash flows attributable directly to equity.

**Discount rate:** A yield rate used to convert anticipated future payments or receipts into present value. It is also referred to as *rate of return* or *cost of capital*. A *cash flow* discount rate unless stated otherwise.

**Discounted Cash Flow (DCF):** A method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.

**Earnings Cap Rate:** The capitalization rate attributable to earnings.

**Earnings Discount Rate:** The discount rate attributable to earnings.

**Economic income or benefit stream:** Any measure of inflows to the subject business that can be converted into value through either discounting or capitalization at appropriate rates. This could include net income, net cash flow, etc.

**ESOP:** Employee stock ownership plan.

**Excess Earnings:** That amount of anticipated economic benefits that exceeds an appropriate rate of return on a selected asset base (often net tangible assets) used to generate those anticipated economic benefits.

**Excess Earnings Method:** A specific procedure for estimating a value indication of a business, business ownership interest, or security determined as the sum of a) the value of the intangible assets obtained by *capitalizing* excess earnings and b) the value of the selected tangible asset base. See **Excess Earnings**.

**Invested Capital:** The sum of equity and debt in a business enterprise. Debt is typically a) long-term liabilities or b) the sum of short-term interest-bearing debt and long-term liabilities. When the term is used, it should be supplemented by a specific definition in the given valuation context.

**Net Assets:** Total assets less total liabilities.

**Net Cash Flow to Equity:** Cash available for distribution to equity investors without jeopardizing the ongoing operations. Also known as *free cash flow*.

**Net Cash Flow to Invested Capital:** Cash available to service interest-bearing debt and for distribution to equity investors.

**Net Income:** Revenue less expenses, including taxes. Also referred to as *net earnings* or *net profits* or *income after taxes*.

**Net Working Capital or Working Capital:** Current assets less current liabilities.

**Put Option:** An option that allows the holder of the option to require the writer of the option to buy a specific asset at some fixed or determinable price in the future.

**REITs:** Real estate investment trusts.

**Return/Rate of Return:** The total yield to an investor, reflecting all dividends, interest, or other cash and cash equivalents received, plus or minus any realized or unrealized appreciation or depreciation in the investment's value. An amount of income (loss) and/or change in value realized or anticipated on an investment, expressed as a percentage of that investment.

**Systematic Risk:** The uncertainty of future returns due to the sensitivity of the subject investment's return to the fluctuations in the return for the market as a whole. Systematic risk is common to all risky securities and cannot be eliminated through diversification. When using the capital asset pricing model, systematic risk is measured by beta.

**Terminal Value:** Sometimes also called *residual value*. It is the prospective value as of the end of the discrete projection period in a discounted benefit streams model.

**Unsystematic Risk:** The portion of total risk specific to an individual security or company or industry that can be avoided through diversification.

**Valuation Multiples or Ratios:** Valuation pricing multiples, e.g., P/E multiples. Based on guideline publicly traded companies or guideline transaction information. In a valuation multiple, a known value or price serves as the numerator and a financial or operating measure serves as the denominator.

## **INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS**

To enhance and sustain the quality of business valuations for the benefit of the business valuation profession and the users of the services of its practitioners, the below identified societies and organizations whose members provide business valuation services have adopted the definitions for the terms included in this glossary. The performance of business valuation services requires a high degree of skill, and imposes upon the valuation professional a duty to communicate the valuation process and conclusion, as appropriate to the scope of the engagement, in a manner that is clear and not misleading. This duty is advanced through the use of terms whose meanings are clearly established and consistently applied throughout the profession. If, in the opinion of the business valuation professional, one or more of these terms needs to be used in a manner which materially departs from the enclosed definitions, it is recommended that the term be defined as used within that valuation engagement. This glossary has been developed to provide guidance to the business valuation practitioners who are members of the listed societies, organizations, and others performing valuations of business interests or securities by further memorializing the body of knowledge which constitutes the competent and careful determination of value and, more particularly, the communication of how that value was determined. Departure from this glossary is not intended to provide a basis for civil liability and should not be presumed to create evidence that any duty has been breached.

**American Institute of Certified Public Accountants  
American Society of Appraisers**

**Canadian Institute of Chartered Business Valuators  
National Association of Certified Valuation Analysts  
The Institute of Business Appraisers**

**Adjusted Book Value** – the value that results after one or more asset or liability amounts are added, deleted, or changed from their respective financial statement amounts.

**Appraisal** – See **Valuation**.

**Appraisal Approach** – See **Valuation Approach**.

**Appraisal Date** – See **Valuation Date**.

**Appraisal Method**– See **Valuation Method**.

**Appraisal Procedure** – See **Valuation Procedure**.

**Asset (Asset-Based) Approach** – a general way of determining a value indication of a business, business ownership interest, or security by using one or more methods based on the value of the assets of that business net of liabilities.

**Benefit Stream** – any level of income, cash flow, or earnings generated by an asset, group of assets, or business enterprise. When the term is used, it should be supplemented by a definition of exactly what it means in the given valuation context.

**Beta** – a measure of systematic risk of a security; the tendency of a security's returns to correlate with swings in the broad market.

**Blockage Discount** - an amount or percentage deducted from the current market price of a publicly traded security to reflect the decrease in the per share value of a block of those securities that is of a size that could not be sold in a reasonable period of time given normal trading volume.

**Business** – See **Business Enterprise**.

**Business Enterprise** – a commercial, industrial, service, or investment entity, or a combination thereof, pursuing an economic activity.

**Business Valuation** – the act or process of determining the value of a business enterprise or ownership interest therein.

**Capital Asset Pricing Model (CAPM)** – a model in which the cost of capital for any security or portfolio of securities equals a risk-free rate plus a risk premium that is proportionate to the systematic risk of the security or portfolio.

**Capitalization** – a conversion of a single period stream of benefits into value.

**Capitalization Factor** – any multiple or divisor used to convert anticipated benefits into value.

**Capitalization Rate** – any divisor (usually expressed as a percentage) used to convert anticipated benefits into value.

**Capital Structure** – the composition of the invested capital of a business enterprise; the mix of debt and equity financing.

**Cash Flow** – cash that is generated over a period of time by an asset, group of assets, or business enterprise. It may be used in a general sense to encompass various levels of specifically defined cash flows. When the term is used, it should be supplemented by a qualifier (for example, “discretionary” or “operating”) and a definition of exactly what it means in the given valuation context.

**Control** – the power to direct the management and policies of a business enterprise.

**Control Premium** – an amount (expressed in either dollar or percentage form) by which the pro rata value of a controlling interest exceeds the pro rata value of a non-controlling interest in a business enterprise, that reflects the power of control.

**Cost Approach** – a general way of estimating a value indication of an individual asset by quantifying the amount of money that would be required to replace the future service capability of that asset.

**Cost of Capital** – the expected rate of return (discount rate) that the market requires in order to attract funds to a particular investment.

**Discount** – a reduction in value or the act of reducing value.

**Discount for Lack of Control** – an amount or percentage deducted from the pro rata share of value of one hundred percent (100%) of an equity interest in a business to reflect the absence of some or all of the powers of control.

**Discount for Lack of Marketability** – an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

**Discount Rate** – a rate of return (cost of capital) used to convert a monetary sum, payable or receivable in the future, into present value.

**Economic Life** – the period of time over which property may generate economic benefits.

**Effective Date** – See **Valuation Date**.

**Enterprise** – See **Business Enterprise**.

**Equity Net Cash Flows** – those cash flows available to pay out to equity holders (in the form of dividends) after funding operations of the business enterprise, making necessary capital investments, and reflecting increases or decreases in debt financing.

**Equity Risk Premium** – a rate of return in addition to a risk-free rate to compensate for investing in equity instruments because they have a higher degree of probable risk than risk-free instruments (a component of the cost of equity capital or equity discount rate).

**Excess Earnings** – that amount of anticipated benefits that exceeds a fair rate of return on the value of a selected asset base (often net tangible assets) used to generate those anticipated benefits.

**Excess Earnings Method** – a specific way of determining a value indication of a business, business ownership interest, or security determined as the sum of a) the value of the assets obtained by capitalizing excess earnings and b) the value of the selected asset base. Also frequently used to value intangible assets. See Excess Earnings.

**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. {NOTE: In Canada, the term "price" should be replaced with the term "highest price".}

**Forced Liquidation Value** – liquidation value at which the asset or assets are sold as quickly as possible, such as at an auction.

**Going Concern** – an ongoing operating business enterprise.

**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.

**Goodwill** – that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.

**Goodwill Value** – the value attributable to goodwill.

**Income (Income-Based) Approach** – a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated benefits into a present single amount.

**Intangible Assets** – non-physical assets (such as franchises, trademarks, patents, copyrights, goodwill, equities, mineral rights, securities and contracts as distinguished from physical assets) that grant rights, privileges, and have economic benefits for the owner.

**Invested Capital** – the sum of equity and debt in a business enterprise. Debt is typically a) long-term liabilities or b) the sum of short-term interest-bearing debt and long-term liabilities. When the term is used, it should be supplemented by a definition of exactly what it means in the given valuation context.

**Invested Capital Net Cash Flows** – those cash flows available to pay out to equity holders (in the form of dividends) and debt investors (in the form of principal and interest) after funding operations of the business enterprise and making necessary capital investments.

**Investment Risk** – the degree of uncertainty as to the realization of expected returns.

**Investment Value** – the value to a particular investor based on individual investment requirements and expectations. {NOTE: in Canada, the term used is “Value to the Owner”}

**Key Person Discount** - an amount or percentage deducted from the value of an ownership interest to reflect the reduction in value resulting from the actual or potential loss of a key person in a business enterprise.

**Levered Beta** – the beta reflecting a capital structure that includes debt.

**Liquidity** – the ability to quickly convert property to cash or pay a liability.

**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”.

**Majority Control** – the degree of control provided by a majority position.

**Majority Interest** - an ownership interest greater than fifty percent (50%) of the voting interest in a business enterprise.

**Market (Market-Based) Approach** - a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.

**Marketability** – the ability to quickly convert property to cash at minimal cost.

**Marketability Discount** – See **Discount for Lack of Marketability**.

**Minority Discount** – a discount for lack of control applicable to a minority interest.

**Minority Interest** – an ownership interest less than fifty percent (50%) of the voting interest in a business enterprise.

**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 Cash Flow** – a form of cash flow. When the term is used, it should be supplemented by a qualifier (for example, "Equity" or "Invested Capital") and a definition of exactly what it means in the given valuation context.

**Net Tangible Asset Value** – the value of the business enterprise's tangible assets (excluding excess assets and non-operating assets) minus the value of its liabilities. {NOTE: in Canada, tangible assets also include identifiable intangible assets}

**Non-Operating Assets** – assets not necessary to ongoing operations of the business enterprise. {NOTE: in Canada, the term used is "Redundant Assets"}

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

**Premise of Value** – an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation.

**Portfolio Discount** – an amount or percentage that may be deducted from the value of a business enterprise to reflect the fact that it owns dissimilar operations or assets that may not fit well together.

**Rate of Return** – an amount of income (loss) and/or change in value realized or anticipated on an investment, expressed as a percentage of that investment.

**Redundant Assets** – {NOTE: in Canada, see "Non-Operating Assets"}

**Report Date** – the date conclusions are transmitted to the client.

**Replacement Cost New** – the current cost of a similar new property having the nearest equivalent utility to the property being valued.

**Reproduction Cost New** – the current cost of an identical new property.

**Residual Value** – the prospective value as of the end of the discrete projection period in a discounted benefit streams model.

**Risk-Free Rate** – the rate of return available in the market on an investment free of default risk.

**Risk Premium** – a rate of return in addition to a risk-free rate to compensate the investor for accepting risk.

**Rule of Thumb** – a mathematical relationship between or among variables based on experience, observation, hearsay, or a combination of these, usually applicable to a specific industry.

**Special Interest Purchasers** – acquirers who believe they can enjoy post-acquisition economies of scale, synergies, or strategic advantages by combining the acquired business interest with their own.

**Standard of Value** – the identification of the type of value being utilized in a specific engagement; e.g. fair market value, fair value, investment value.

**Sustaining Capital Reinvestment** – the periodic capital outlay required to maintain operations at existing levels, net of the tax shield available from such outlays.

**Systematic Risk** – the risk that is common to all risky securities and cannot be eliminated through diversification. When using the capital asset pricing model, systematic risk is measured by beta.

**Terminal Value** – See **Residual Value**.