

BOOK REVIEW



Cost of Capital: Applications and Examples, Third Edition

By Shannon P. Pratt and Roger J. Grabowski
Wiley & Sons, New Jersey, 2008
Hardcover, 778 pages, \$150

Reviewed by Darrell D. Dorrell, MBA, CPA/ABV, CVA, ASA, CMA, DABFA

The first edition of *Cost of Capital* was published in 1998, and contained 226 pages. The second edition was published in 2002 with 322 pages.¹

I expected the third edition, published last year, likewise to be bigger and more valuable. My expectations were exceeded. *Cost of Capital 3rd* is 778 pages long. I call it “Cost of Capital on Steroids,” and I consider it a *must*-purchase book for business valuation professionals and forensic accountants.

The third edition contains valuable ancillary material, including a 28-page bibliography of articles and other publications, with additional resources; a 10-page “Data Resources” section supporting the book’s research contents; a 20-page “Sample Report Submitted to U.S. Tax Court” by Roger Grabowski; a short discussion of ValuSource valuation software; and a 37-page “Review of Statistical Analysis” written by Mark Shirley, perhaps the most talented statistician in the valuation profession.

This book is strong on both theory and application. An excerpt from the forward by Aswath Damodaran describes the book as follows:

In general, books on valuation-related topics take one of two paths. One is to follow the cookbook style and provide the reader with the “right answers” to questions, even though there may be debate about what is “right.” The other is to present the alternatives, explain the pros cons, and trust the reader to make the right choices at the end. This book adopts the latter approach and provides comprehensive discussions not only of the standard inputs—risk-free rates, risk premiums, and debt ratios—but also of issues that come up infrequently in valuations but often enough that practitioners look for guidance.

Following is a summary of the table of contents:

Part 1: Cost of Capital Basics (6 chapters, 66 pages). The basics include contemporary topics such as FASB Concepts Statement No. 7, cash flows and present value discount rates.

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¹A separate, soft-cover “workbook” accompanying the second edition contains 144 pages. I wrote a review of the second edition for *National Litigation Consultants’ Review*, Litigation Consultants, February 2003.

Part 2: Estimating the Cost of Equity Capital and the Overall Cost of Capital (13 chapters, 294 pages). This covers the build-up method, CAPM and criticisms, ERP, beta distinctions and criticisms, size effect and criticisms, company-specific risk, alternative models (e.g., APT, WACC), global models, and using Morningstar data. Also, many of these topics have supporting appendices.

Part 3: Corporate Finance Officers: Using Cost of Capital (5 chapters, 56 pages). The contents focus specifically on valuation concepts used in day-to-day business decision making. They cover budgeting and feasibility studies, cost of capital for divisions and reporting units, evaluating acquisitions and mergers, transfer pricing, and EVA (economic value added).

Part 4: Cost of Capital for Closely Held Entities (5 chapters, 62 pages). Topics include discounts for lack of marketability for operating businesses, private company discount, pass-through entity and private investment company discount rates, and venture capital investments.

Part 5: Other Topics (6 chapters, 80 pages). Varied topics include minority versus control implications, excess earnings method, adjusting the discount rate to alternative economic measures, estimating net cash flows (including distressed businesses), common errors, and cost of capital in the courts.

Part 6: Real Estate and Ad Valorem (3 chapters, 80 pages). Comprises real property, real estate entities, and ad valorem taxation.

Part 7: Advice to Practitioners (2 chapters, 30 pages). Focuses on dealing with cost of capital issues and “Questions to Ask Business Valuation Experts.”

New to the Third Edition

The Preface summarizes results and practical implications of the latest research, including unpublished academic work. Key additions to this edition also include:

- A *conclusion* that the equity risk premium is in the range of 4 to 6 percent rather than above 7 percent.
- Private company discounts exceed 25 percent compared to otherwise comparable public companies.
- New data and literature contained in the bibliography, extensive footnotes, working paper extracts, and discussion covering the global capital markets.
- Corporate finance and practitioner advice are contained in Parts 3 and 7, respectively.

Certain chapters go beyond their titles in scope, and merit mention. For example:

- Chapter 3, Net Cash Flow: Preferred Measure of Economic Income, is a concise summary of the economic benefit stream and the implications of a probability-weighted component.
- Chapter 12, Size Effect, details the derivation and present application of the Morningstar (formerly Ibbotson) deciles in comparison to Duff & Phelps’ 25 size categories.
- Chapter 33, Estimating Net Cash Flows, contains techniques for testing your results for veracity and reasonableness.

This book is a gem that belongs in every practitioner’s library. It will not gather dust. **VE**

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From the Editor

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“I tell you, the economy continues to spiral. Oh, man, I saw a bank robber today being held up by a teller.”

“Barack Obama said today, again, he wants to raise taxes on the rich. That’s provided...anyone is still rich.”

Most of us have not experienced anything like the economic climate we are in today. “We valuers need to intensely think through current events and how they impact the work we do,” says Michael Goldman. “After that, all we can do is sit back and try to find humor in the situation.” **VE**



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