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One Point Does NOT Define a Line — One Method Does NOT (Usually) Constitute an Appraisal

Paul R. Hyde, EA, CBA, BVAL, ASA

A few months ago, a case I was working on went before a judge to try and work out an agreement. In the meeting, I was startled to hear the judge say only one appraisal method—the Excess Earnings Method—should be used. Since then I have thought about this comment and how best to respond to the idea of using only one "favorite" method to value a privately held business. Using only one method is very similar to trying to define a specific line by using only one point—as we all learned in our math classes at school, an infinite number of lines can be drawn through only one point.

Valuing a closely held, privately owned small business is a complex assignment. Small, closely held businesses are generally operated with the primary aim being the minimization of income taxes. Often, "discretionary expenses" are paid by the business reducing the net income to an amount not representative of the business's real economic income. The appraiser usually needs to identify and adjust to account for these items.

When an income approach method is deemed appropriate for use, the appraiser should also identify and quantify risks and develop appropriate rates of return to be applied in order to value the business. In this process, a number of subjective, albeit informed and supported, decisions must be made. Due to the subjective nature of some appraisal methods, well-qualified and experienced appraisers typically try to use a variety of appraisal methods and then reconcile the results in order to develop a final estimate of value. Using more than one appraisal method, when possible, helps an appraiser develop a supportable value in the same way that the use of two or more points helps define a line. Occasionally, only one method is possible—for example, when appraising a family limited partnership, often only an asset-based method can be used.

In order to better explain my point, I have included an example of the Excess Earnings Method and have shown the differences in the result when components are modified. I understand that technically the Excess Earnings Method by itself provides only an indication of the intangible assets of a business. Actually as shown, the "Excess Earnings Method" is combined with the Adjusted Book Value Method in order to provide an estimate of value for the entire company.[1] Due to the common usage of the Excess Earnings in this manner, I consider the use of these combined methods as using only one appraisal method to determine the value of the entire business.

The following chart illustrates the use of this method to provide an indication of value for a business:

EXCESS EARNINGS METHOD

Forecasted Net Cash Flow			265,000
Return on Net Tangible Assets:			
Value of Net Tangible Assets (Net Worth From Adjusted Book Value Method)	250,000		
Rate of Return on Net Tangible Assets	x 0.08		
Actual Return on Net Tangible Assets			20,000
Excess Earnings (amount to be applied to the intangible assets)			245,000
Capitalization of Excess Earnings to Value Intangibles:			
Excess Earnings (from above)	245,000	=	980,000
Capitalization Rate for Intangibles	0.25		
Add: Value of Net Tangible Assets (from above)			250,000
Indicated Value of Company – Excess Earnings Method			1,230,000

In this example, the value of the company is shown to be $1,230,000 based on using an 8% rate of return on tangible assets and a 25% rate of return on intangible assets. The rates used should be supported and explained. These rates have simply been chosen as part of the example. Note that the Forecasted Net Cash Flow was used. In the Excess Earnings Method, net cash flow is generally used but other income streams could also be used.[2] For example, I have seen appraisers use pretax income, net income after tax, and seller's discretionary cash flow to name just a few—without adjusting the rates used in the Excess Earnings method. Using a different income stream is not a problem if the rates used are adjusted appropriately for the income stream selected. However, this is often not done by inexperienced appraisers resulting in some very different indicated values for the company as illustrated in the chart below:

Income Stream Used	Indicated Value
Pretax Income	1,670,000
Net Income After Tax	1,070,000
Net Cash Flow	1,230,000
Seller's Discretionary Cash Flow	2,150,000

This example shows the difficulties that can arise when only one method is used. The difficulties are compounded when a method that has as many subjective variables as the Excess Earnings Method is the only method used. Using more than one appraisal method often lets the appraiser see that an error has been made in the application of one of the methods thus allowing further examination of what was done prior to issuing a report.

There is no substitute for a carefully thought out and well documented business appraisal report prepared by a credentialed and experienced business appraiser. A business appraisal report should use a variety of methods, when possible, provide a well reasoned recon

ciliation of the values determined by the various methods employed, and support the final value with some checks for reasonableness, again where possible.

Paul R. Hyde, EA, CBA, BVAL, ASA is Enrolled to Practice Before the Internal Revenue Service (an Enrolled Agent), and holds the Certified Business Appraiser and Accredited Senior Appraiser designations. He is the owner of Hyde Business Properties and Valuations, Inc., a business brokerage and business appraisal firm operating primarily in Idaho and Eastern Oregon.

Endnotes:

1. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 285.

2. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 289.