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# Business Appraisal Practice

*In this issue*

# Discounts and Premiums: A Chart to Illustrate Them More Clearly

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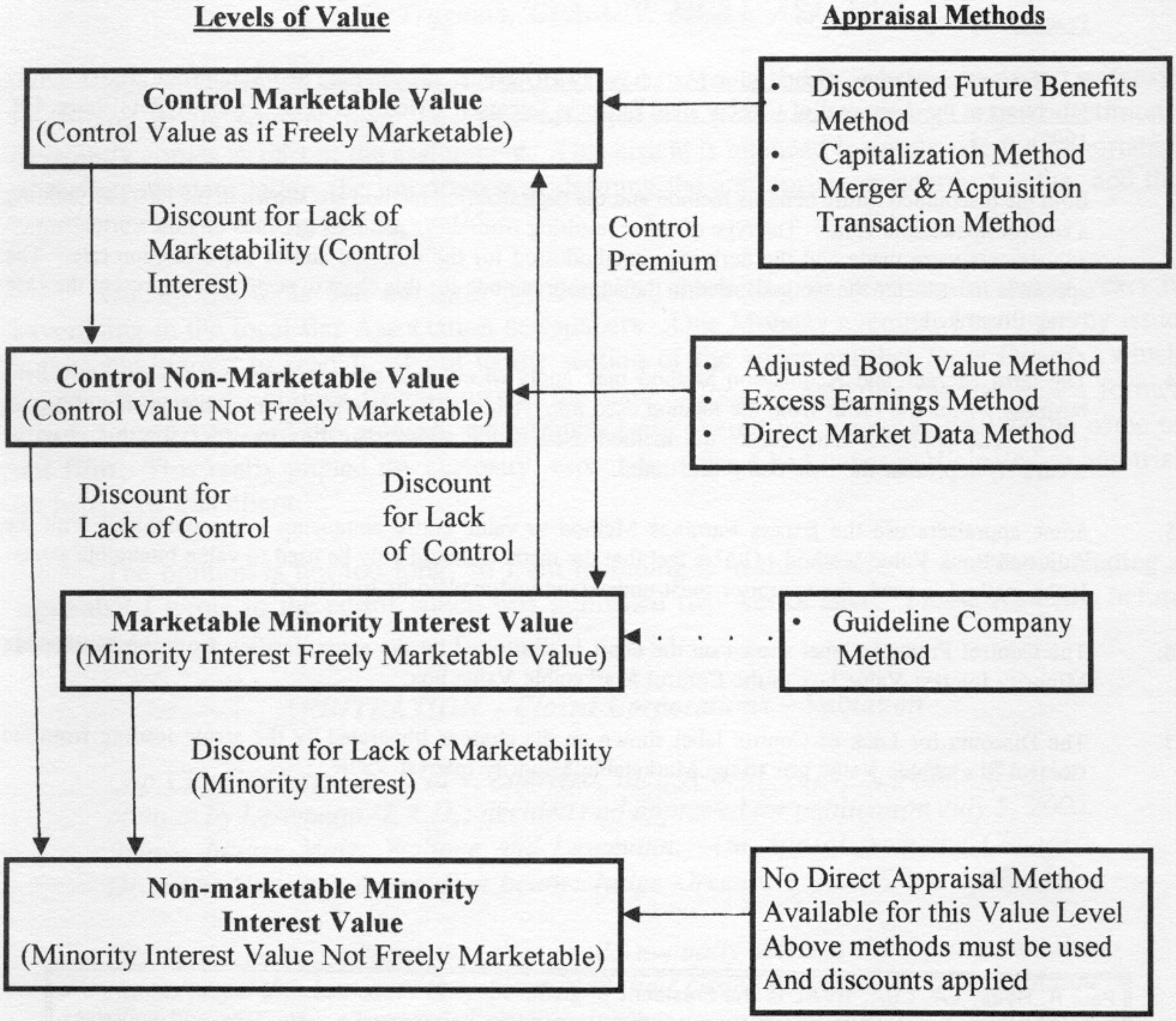
The application of discounts and premiums in an appraisal report for a minority interest has long been the focus of criticism of our industry. A long, well written business appraisal report supporting the value selected before discounts is often hit with a discount of 35% to 60% near the end of the report with only a paragraph or two in explanation. This can lead to confusion, skepticism, and misunderstanding on the part of the reader.

Discounts and premiums are an area of our business replete with differences of opinion and controversy. For instance, whether or not a discount for lack of marketability should be applied to a control marketable (sometimes referred to as control as if freely marketable) interest is controversial.[1] Other differences of opinion relate to what type of indicated value is derived from a specific appraisal method. The discounted future benefits method could generate a control or minority, marketable or non-marketable value depending on a variety of circumstances. Additionally, there is a variety of methods referred to by the name Merger and Acquisition Transaction Method; some result in control marketable values, others in control non-marketable values, or others still in non-marketable minority interest values. The appraiser must clearly define the term marketable or marketability as he or she is using it in a specific instance. The marketability of a subject business interest is relative, not absolute. In other words, marketability or the degree to which a specific business interest is "as if freely marketable" or "not freely marketable" needs to be clearly stated and supported in appraisal reports.

The selection of the discounts and premiums applied by the appraiser to various methods used, the size of each of them, and the stated type of value to which they are applied is often subjective. Also, depending on how the methods used are applied, the nature of the value obtained may be different in one appraisal than in another. The appraiser must support his or her position and explain it thoroughly and well.

The chart on the following page illustrates the various types of indicated values typically generated by a number of common appraisal methods and the types of discounts and/or premiums applied to the indicated value to calculate the level of value needed. If you feel that an appraisal method belongs at a different level of value than shown, simply move it and explain why it belongs at that level of value in your description of the method. This chart is an adaptation of the well known "Levels of Value" chart developed by Chris Mercer.[2] I find it helpful to show the levels of value, the directions and names of discounts and premiums together with the appraisal methods utilized on the same chart lined up with the appropriate level of value. Seeing each of these items together often helps the reader understand why the various discounts and premiums are needed.




Clearly identifying how the various level of value apply to the specifics of the business being appraised allows the reader to understand why discounts or a premium are applied to the indicated value derived from a specific appraisal method used in the report. The appraiser must still explain in detail the selection of the size of each discount or premium. However, by using a chart similar to the one shown above, the "big picture" as to why the discounts or premiums are necessary is more easily understood.

## Endnotes:

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1. Bishop, David M., "Lack of Marketability Discounts for Controlling Interests," Business Appraisal Practice, Spring 2000, p. 39.

2. Z. Christopher Mercer, Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests. (Memphis Tenn: Peabody Publishing, LP, 1997), p 15.

3. Both the discounted future benefits method and the capitalization method are shown in the chart as yielding a control marketable value. The type of value resulting from these methods depends on how normalization adjustments were made and the derivation method used for the discount and/or capitalization rate. The appraiser must locate the methods used in the appropriate box for this chart to accurately represent the case being illustrated.

4. The term Merger and Acquisition Method may apply to either a public company or a privately held business. Thus the result from the method used may yield a different type of value than is shown in this chart. The appraiser must locate the method used in the appropriate box in order for this chart to accurately represent the case being illustrated.

5. Some appraisers use the Excess Earnings Method to value entire companies when combined with the Adjusted Book Value Method. Others feel that the method should only be used to value intangible assets. If the method is used, the appraiser must understand and explain its limitations.

6. The Control Premium label shown on the chart is illustrated by the arrow leading from the Marketable Minority Interest Value box to the Control Marketable Value box.

7. The Discount for Lack of Control label shown on the chart is illustrated by the arrow leading from the Control Marketable Value box to the Marketable Minority Interest Value.

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