REVIEWING A BUSINESS APPRAISAL REPORT

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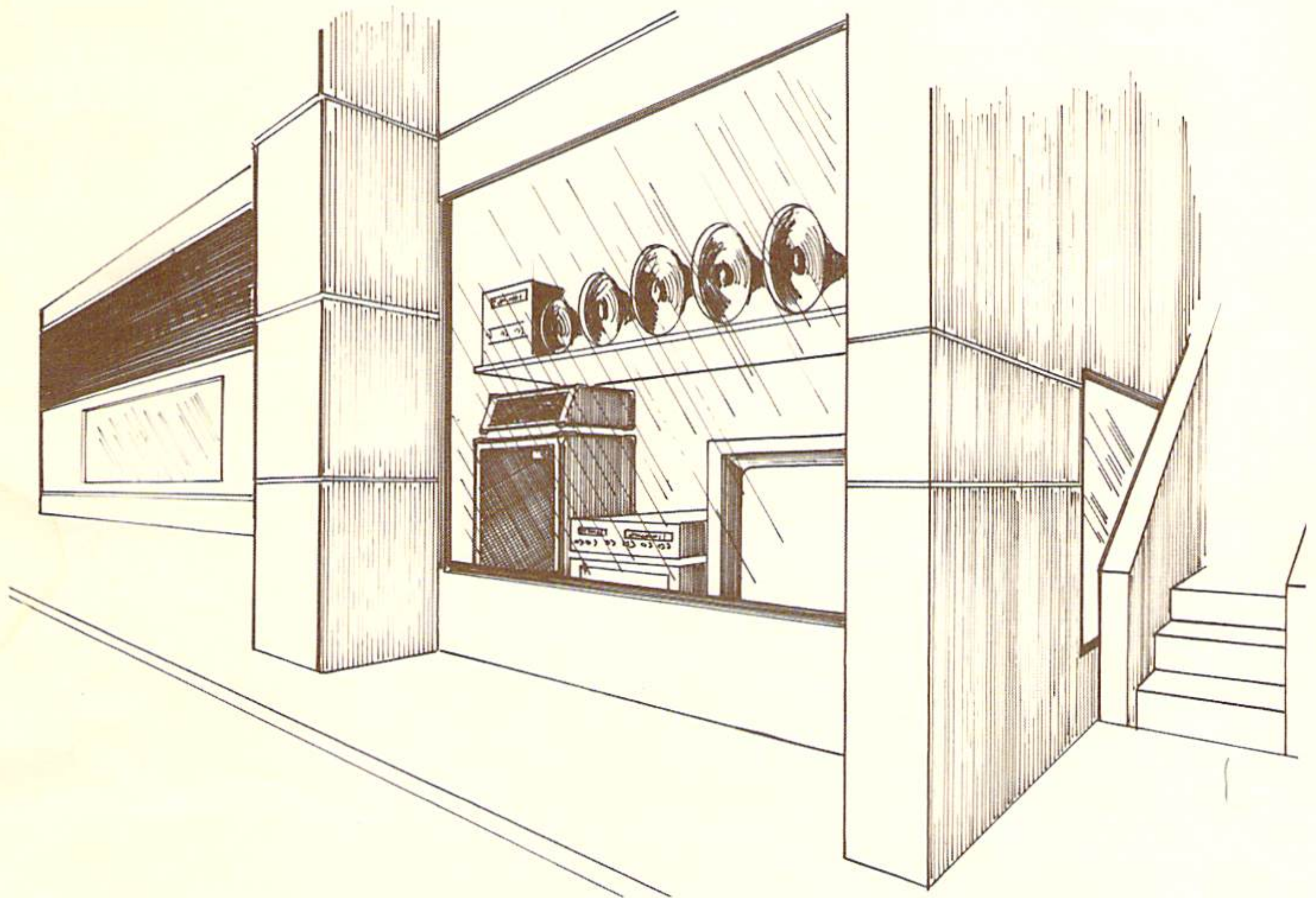

APPROACHES TO BUSINESS APPRAISAL

Beware of the appraiser who makes a blanket statement such as, "There are three approaches to valuing a business" or, "There are seven approaches to valuing a business." Trying to force the approaches to the appraisal of all businesses under all circumstances into a fixed number of labeled categories is vain.

Business appraisal approaches tend to fit less neatly than real estate appraisal approaches into three narrow categories, such as "the income capitalization approach." One way or another, the financial benefits from owning an interest in a business enterprise must come from the following sources:

1. Earnings or cash flow:
   a. from operations
   b. from investments (e.g., interest and or/dividends received)
2. Liquidation of assets
3. Sale of the interest

Therefore, any valuation approach (at least from a financial point of view) must focus on measuring the ability of the business interest to provide benefits to its owner from one or some combination of the above sources.

The most commonly used approaches to the valuation of a business are generally found under the following categories:

- Discounted future earnings or discounted cash flow
- Capitalization of current, normalized or historical earnings
- Capitalization of current, normalized or historical cash flow
- Capitalization of dividends or dividend-paying capacity
- Multiple of gross revenue or physical volume
- Excess earnings approach
- Adjusted net asset value
- Ratio of price to book value or to adjusted net asset value
- Prior transactions in, or offers for, the stock adjusted to current conditions

Most of the above categories of approaches can be focused on appraising either just the equity in the business (stock, partners' capital or sole proprietorship interest) or on appraising the total business as if it had no debt ("debt-free" approaches).

It is, of course, critical that the approach or approaches selected are appropriate for the nature of the business or business interest being valued, and that the choice of approach or approaches is well justified in the report. In some cases, certain approaches may be either mandated or precluded by legal requirements applicable to the use to which the appraisal is to be put, such as estate taxes or dissenting stockholder actions. Finally, it is essential that the appraiser justify the relative emphasis or weight placed on different approaches in reaching the final estimate of value.

INTRODUCTION

Appraisals of businesses or business interests need to be reviewed by a wide variety of people for a wide variety of reasons, such as:

- An owner considering a sale
- A prospective buyer considering a purchase
- A fiduciary for an ESOP, estate, charitable trust or other entity for adequate due diligence relative to a transaction
- An attorney involved in litigation or potential litigation relating to a business valuation
- An owner or taxing entity determining value for various tax purposes, such as estate and gift taxes, inheritance taxes and state and local ad valorem taxes
- A commercial loan officer evaluating a credit
- An appraiser asked to review someone else's appraisal report
- A spouse for a marital property settlement
- A judge deciding a business valuation issue on the basis of appraisals submitted

In most cases, such persons will not have theoretical or technical training in the complex discipline of business valuation. Nevertheless, significant decisions, often involving substantial sums of money, must be made based on the acceptability of business appraisal reports. This booklet has been prepared to assist attorneys, fiduciaries, investors, and others who must rely on business appraisal reports in their efforts to critically assess the validity of such reports and the reliability of their conclusions.

APPRAISAL REVIEW CHECKLIST

STATEMENT OF INDEPENDENCE

- ❑ Is there a statement that the appraiser has no present or contemplated interest in the subject property, or, if so, an explanation of the interest?

STATEMENT OF THE APPRAISAL ASSIGNMENT

- ❑ Is the name of the party who retained the appraiser clearly disclosed?
- ❑ Is the name of the entity being appraised spelled out completely and accurately?
- ❑ Is the form of organization indicated? (regular corporation, subchapter S corporation, general partnership, limited partnership, etc.)
- ❑ Is the state in which the entity is incorporated or registered indicated?

Reviewer's note: *There may be companies with identical names in each of several states. More importantly, however, the statutory and case law of the state in which the company is registered or incorporated may have a bearing on acceptable appraisal practices in some situations.*

- ☐ Is the interest in the entity being appraised clearly indicated? (100% of the common stock; 5,000 shares of common stock out of 100,000 shares outstanding; a 40% general partnership interest; the value of certain assets for an asset sale; etc.)
- ☐ Is the applicable standard of value specified? (fair market value, fair value, investment value, etc. See "Statement and Definition of Standard Value" below for further elaboration.)
- ☐ Is the effective date of the appraisal specified?
- ☐ Is the purpose (function) of the appraisal specified? (for sale of interest, federal estate taxes, employee stock ownership plan, marital dissolution, etc.)

Reviewer's note: *There can be wide variations in the appraised value of a business or business interest from one date to another, sometimes even within a fairly short time span. Also, acceptable appraisal procedures may vary for different purposes because of variations in applicable law and other factors. For this reason, business appraisal reports typically contain some statement in the "Assumptions and Limiting Conditions" such as, "This appraisal is valid only for the appraisal date or dates specified herein and only for the appraisal purpose or purposes specified herein."*

STATEMENT AND DEFINITION OF THE STANDARD OF VALUE

- ☐ Is the standard of value not only stated (as checked above) but also clearly defined? For example, in an appraisal for estate or gift taxes:

Fair market value is considered to represent a value at which a willing seller and willing buyer, both informed of the relevant facts about the business, could reasonably conduct a transaction, neither person acting under compulsion to do so. Among other factors, this appraisal considers all elements of appraisal listed in Internal Revenue Service Ruling 59-60, which generally outlines the valuation of closely held stocks and includes the following:

1. The nature of the business and history of the enterprise
2. The economic outlook in general and condition and outlook of the specific industry in particular
3. The book value of the stock and the financial condition of the business
4. The company's earning capacity
5. The company's dividend-paying capacity
6. Whether or not the enterprise has goodwill or other intangible value
7. Sales of stock and size of the block to be valued
8. The market prices of stocks of corporations engaged in the same or similar lines of business whose stocks are actively traded in a free and open market, either on an exchange or over the counter

- ❑ If the appraisal is being done pursuant to a statute, regulation or documentary authority such as a buy/sell agreement, is the relevant language defining the standard of value quoted? For example, in an appraisal of dissenting stockholders' stock:

  The standard of value was fair value, as set forth by Section 30-1-81 of the Idaho Code. According to the statute, 'fair value' of shares means their value immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of such corporate action unless such exclusion would be inequitable."

  If it is necessary to refer to case law to interpret the standard of value, some reference to that fact should be included.

Reviewer's note: *Definitions of standards of value such as "fair market value" and "fair value" vary somewhat from one legal context to another. Thus it is extremely important that the standard of value that the appraisal represents be clearly specified.*

CAPITALIZATION AND OWNERSHIP

- ❑ Is the amount outstanding and description of each class of stock or partnership interest clearly described?

Reviewer's note: *In a multi-class capitalization structure, the rights of one class of ownership may have an important bearing not only on the value of ownership interest in that class but on the value of other classes of ownership interests as well.*

- ❑ Is the distribution of ownership clearly described (list of major owners, usually those over 10%, number of other owners, broken down by class of ownership interest if more than one class of stock or other interest)?

Reviewer's note: *If less than a 100% ownership position is being appraised, the distribution of the remaining ownership may have a bearing on the value of the interest. For example, a 49% owner normally would have much more control over a company if there were many other small owners than if there were one 51% controlling owner.*

COMPANY BACKGROUND AND OPERATIONS

- ❑ Brief history of company leading to where it stands today
- ❑ Location(s) of operations
- ❑ Product/services lines
- ❑ Markets served
- ❑ Customer base (type, degree of concentration/dispersion)
- ❑ Competition
- ❑ Position of subject company relative to its industry
- ❑ Competitive strengths and weaknesses (uniqueness of product, quality, service, price, location, etc.)
- ❑ Description of facilities (sites, plants, equipment, etc.)

- ❑ Management and work force (size of work force, description and degree of dependence on key personnel, the latter especially if highly dependent on one or a few key people)
- ❑ If the company has subsidiaries, affiliates or significant interests in other entities, are the relationships (percentage ownerships, methods of accounting basis for transfer pricing, etc.) clearly spelled out?
- ❑ Overall, have the positive and negative aspects of the company's operations and resources been pointed out and/or summarized?

FINANCIAL STATEMENT ADJUSTMENTS

- ❑ Have proper financial statement adjustments been made, or is there a statement that the financial statements have been analyzed and no adjustments are appropriate? Possible adjustments might include, for example:

1. Adjustments to recognize adequate reserves, such as allowance for doubtful accounts receivable or reserve for pension liabilities
2. An adjustment to inventory
   a. To write down or write off obsolete inventory or inventory in poor condition
   b. To adjust the basis of inventory accounting for comparison with other companies, such as an adjustment from the LIFO (last-in, first-out) method of inventory reporting to the FIFO (first-in, first-out) method of inventory reporting
3. An adjustment to remove nonrecurring items from the income statements for the purpose of estimating a "normalized" level of earnings. Such items could include, for example:
   a. Gains or losses from payment or settlement of lawsuits
   b. Losses from a strike
   c. Losses from a catastrophe
   d. Insurance recovery proceeds
   e. Gains or losses from discontinued operations
   f. Gains or losses from sale of major assets

Reviewer's note: *In order to be proper subjects of adjustment, nonrecurring items do not necessarily have to meet the strict definition of "extraordinary" in an accounting sense. The point is whether or not the gains or losses would be expected to recur in the normal course of business.*

4. Adjustments to depreciation, amortization, or depletion:
   a. To reflect a more realistic amount of depreciation in an economic sense
   b. To adjust the basis for depreciation accounting to make it comparable to other companies being used for comparative purposes

- ❑ Have statements of companies used for comparative analyses been similarly analyzed and similar adjustments made if needed, so that financial comparisons are on an "apples to apples" basis?
- ❑ Are there no improper adjustments to statements?

- ☐ If a balance sheet has been adjusted to reflect unrealized appreciation on assets that might be liquidated, has the related tax on the gain also been reflected?

FINANCIAL STATEMENT ANALYSIS

- ☐ Have relevant ratios been computed and strengths/weaknesses of subject company on its own and relative to peer companies and industry averages been adequately pointed out?
- ☐ Are ratios computed clearly defined so that the reader could go to source documents and make the same computations?

If comparisons of financial information or ratios are made between the subject company and peer companies or industry averages:

- ☐ Are the computations of the ratios defined in exactly the same way for the subject company as for the peer companies or industry averages with which the subject company is being compared?
- ☐ Are the time periods for which the data are measured or estimated for the subject company the same as the time periods covered by the data for the peer companies or industry averages with which the subject company is being compared?
- ☐ Are the results of the financial statement analysis summarized and conclusions drawn?
- ☐ Does the financial statement analysis ultimately result in some statement or evaluation of implications for the degree of risk associated with the subject company, either on an absolute basis or relative to peer companies or industry averages?

EXHIBIT 1[1]

JMK, INC.
AND COMPARATIVE PUBLICLY TRADED COMPANIES
FINANCIAL AND OPERATING RATIOS

	Audio/ Video 1/87	Best Buy 3/87	Circuit City 2/87	Federated 2/87	Fretter 1/87	Good Guys 9/86	Highland 1/87	Luskins 1/87	Newmark & Lewis 1/87	Sound Advice 6/86	Tipton Centers 3/87	Average	Median	JMK 4/87
LIQUIDITY														
Current Ratio	2.7	2.9	2.0	2.7	1.8	1.9	2.7	2.0	1.5	2.0	2.6	2.3	2.0	2.2
Quick Ratio	0.4	0.4	0.5	0.3	0.3	0.5	0.8	0.6	0.3	1.0	0.4	0.5	0.4	0.6
Working Capital ($000)	48,156	48,750	97,320	77,596	30,758	13,310	105,172	18,603	13,857	5,297	14,505	43,029	30,758	22,584
ACTIVITY	7	8	4	10	1	7	6	4	3	6	9	6	6	9
Days in Receivables (Avg.)	3.2	4.2	5.5	3.7	4.7	7.5	3.8	4.1	5.7	4.2	3.6	4.6	4.2	3.3
COGS/Inventory (Avg.)	4.4	7.8	13.4	6.3	12.3	11.0	7.7	8.8	17.3	6.1	7.7	9.3	7.8	5.7
Sales/Working Cap. (Avg.)	7.7	29.6	8.8	8.0	13.7	24.9	10.9	21.6	30.1	27.1	36.8	19.9	21.6	5.8
Sales/Net Fixed Assets (Avg.) / Sales/Total Assets (Avg.)	2.1	4.0	3.3	2.3	3.2	3.8	3.0	3.2	4.1	3.1	3.8	3.3	3.2	2.0
COVERAGE/LEVERAGE														
Int. Expense Coverage	23.9	NA	14.8	Df	5.0	NM	11.1	3.8	17.6[c]	23.8	27.0	15.9	16.2	10.4[d]
Cash Flow/Curr. Mat. LTD	31.6	29.3	28.6	0.3[a]	18.2	NM	34.8	44.5	NM	0.9	5.3	21.5	28.6	11.6[d]
Fixed Assets/Equity	0.5	0.2	1.0	0.9	0.4	0.3	0.7	0.2	0.3	0.2	0.2	0.4	0.3	0.6
LTD/LTD + Equity	0.06	0.10	0.40	0.56	0.16	--	0.36	0.18	0.08	0.02	--	0.17	0.10	0.17
Total Debt/Equity	0.44	0.57	1.42	2.22	0.80	0.91	1.15	0.62	1.32	0.65	0.52	1.0	0.85	0.75
PROFITABILITY														
% Net Income/Sales	3.3	3.2	3.5	(1.4)[a]	1.5	1.6	3.1	0.7	2.5[c]	4.0	2.7	2.2	2.7	2.9[d]
% Net Income/Equity (Avg.)	10.0	22.1	27.1	(9.5)[a]	9.7	12.1	19.4	2.1	24.5[c]	25.6	18.9	14.7	18.9	9.9[d]
% Net Income/Assets (Avg.)	6.9	13.0	11.7	(3.2)[a]	4.7	5.9	9.3	2.1	10.3[c]	12.2	10.1	7.5	9.3	7.8[d]
ANNUAL AVERAGE COMPOUND GROWTH														
% Growth in Sales	32.3	103.3	42.4	48.2	32.6	30.2	39.0	27.4	35.1	31.7	36.8	41.7	35.1	30.0
% Growth in Earnings	27.5	201.0	59.1	--[b]	13.9	24.4	45.3	1.1	93.2[c]	45.3	87.9	59.9	45.3	28.8[d]
OTHER														
Sales per Store ($000)	2,159	9,979	11,617	6,717	5,799	7,456	12,386	2,642	5,344	2,129	3,484	6,337	5,799	4,165
Sales per Sq. Ft. Sell. Space ($)	965	1,053	1,489	NA	NA	1,427	909	NA	800	NA	456	1,014	965	403

COGS = Cost of goods sold
LTD = Long-term debt
NA = Not available
Df = Deficit
NM = Not meaningful

[a] Before nonrecurring income from cumulative effect of change in accounting principle.
[b] Company had a deficit; therefore, growth calculation was not meaningful.
[c] Before nonrecurring gain on sale of securities.
[d] Before nonrecurring litigation settlement income.

1 This exhibit is taken from Chapter 14, "A Sample Report," of Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 2nd edition, by Shannon P. Pratt (Homewood, Ill: Dow Jones-Irwin), 1989.

EXHIBIT 1 (Continued)

Ratios. Exhibit 1 shows various operating and financial ratios for JMK and the comparative publicly traded companies. All ratios utilizing pretax and after-tax income have been adjusted to exclude nonrecurring items.

JMK's liquidity, as measured by the current and quick ratios, was close to the median of the comparative companies. As Exhibit 1 shows, all of JMK's activity ratios are below the comparative company medians, indicating that the company uses its assets less efficiently than the comparatives. However, as noted in the "Trend Analysis" section, JMK's activity ratios have improved steadily since 1984. Working capital turnover is on the low side but is similar to that of three of the comparative companies.

JMK's coverage ratios, as measured by interest expense coverage and cash flow coverage of currently maturing long-term debt, are significantly below the median of the comparative companies. However, at 10.4 and 11.6, respectively, JMK's interest expense coverage and cash flow coverage of currently maturing long-term debt are more than adequate.

JMK has slightly more of its total capital in the form of long-term debt than the comparative companies, as is evidenced by JMK's long-term-debt-to-total-capital ratio of 0.17 versus 0.10 for the comparative company median. However, JMK's total debt-to-equity ratio of 0.75 is less than the comparative company median of 0.85.

The profitability ratios indicate that JMK's less efficient use of assets and slightly lower use of leverage have resulted in return-on-equity and return-on-asset ratios that are below the comparative company medians. JMK's return on equity was 9.9% versus a median of 18.9% for the comparative companies, and its return on assets was 7.8% versus a median of 9.3%. JMK's net profit margin of 2.9% was slightly above the comparative company median of 2.7%.

JMK's sales and earnings growth at 30.0% and 28.8%, respectively, were also below the comparative company medians of 35.1% and 45.3%, respectively.

In the consumer electronics industry, the sales per store and sales per square foot of selling space are analyzed to determine potential profitability on a per-store basis. JMK's sales per store, at $4.165 million, was below the median of $5.799 million but higher than Audio/Video's, Luskins', Sound Advice's and Tipton Centers'. Also, many of these stores sell appliances, which greatly increases sales per store. JMK's sales per square foot of selling space was $403,000, well below the median of $965,000 but this information was unavailable for four companies, three of which had below-average sales per store. Tipton Centers, with $456,000 of sales per square foot of selling space, was the most comparable to JMK.

The preceding ratio analysis indicates that JMK's liquidity is about average when compared to the comparative companies, its coverage is below average but adequate, and its overall capitalization is about average. However, JMK's less efficient use of assets has resulted in below-average return on equity, return on assets and growth.

ECONOMIC AND INDUSTRY DATA AND ANALYSIS

- ❑ Are the economic data and analysis adequate and relevant to the appraisal?
- ❑ Are the industry data and analysis adequate and relevant to the appraisal?

PAST TRANSACTIONS

- ❑ Is there a listing of past transactions in the stock or partnership interests and/or offers to buy (with dates, amounts, price, whether or not arm's length) or a statement that there have not been any?

COMPARATIVE COMPANY SELECTION

- ❑ Are the criteria for comparative company selection (percent of sales in subject company's industry, size, capital, structure, location, etc.) clearly set forth?
- ❑ Is the population of possible companies from which the comparative set is drawn clearly defined?
- ❑ Is the population from which the comparative companies are drawn of adequate size and relevance to the subject company that it is likely that all or most of the best comparative companies are included? (For example, if appraising a closely held company with $15 million sales, it generally would be inadequate to draw comparatives from sources that contained only very large public companies, such as Value Line or the Standard & Poor's 500, rather than from broader sources that include many smaller companies, some of which might trade over the counter or on the American Stock Exchange.)
- ❑ Are the sources and procedures for selecting the comparative companies clearly spelled out so that the reader could go to the sources, follow the procedures, and generate a similar list?
- ❑ Is enough description of the comparative companies included in the report so that the reader can get a sense of their degree of comparability?
- ❑ Does it appear that the comparative companies used constitute the best available list?

SELECTION AND JUSTIFICATION OF VALUATION APPROACHES

- ❑ Is the selection of valuation approaches used adequately justified?
- ❑ If seemingly obvious alternative approaches were not used, is there a satisfactorily convincing explanation of why not?
- ❑ Are the valuation approaches used consistent with the statement of the appraisal assignment and the statement and definition of the applicable standard of value, including any applicable legal requirements or interpretations?

VALUATION METHODOLOGY AND PRESENTATION

- ❑ Are the data and steps used in each valuation approach clearly presented, so that the reviewer could replicate the work done and reach the same conclusion?

Valuation measures or parameters may include such variables as capitalization or discount rates, or multiples of some fundamental data such as revenues, earnings, cash flow, book value and so forth. It is essential that these measures be clearly defined and used consistently between the subject and comparative companies if comparative analysis is used in the valuation procedures.

- ☐ Is each valuation measure or parameter clearly defined so the reviewer can have an exact understanding of its meaning? For example, if price/earnings ratios are used:

    1. The date of the price should be specified. This normally is the date of or a date very near the effective date of the appraisal, as indicated in the statement of the appraisal assignment
    2. The exact definition and time period for the earnings should be specified. For example, the report may state that the earnings base used is net income after taxes for the fiscal year ended September 30, 1988, as adjusted in the financial statement adjustments of the report

Reviewer's Note: *There are many acceptable ways to define commonly used financial variables, such as earnings, cash flow, operating income, net asset value and so forth. The definition of each financial variable used should be adequate so that the reviewer can consult the financial statements and/or other data provided and determine exactly how the financial variable relied on in the appraisal was derived.*

- ☐ If valuation measures such as price/earnings ratios are derived from analysis of comparative companies, are the definitions of the variables derived from the comparative companies identical to the definitions of the variables for the subject company. (For example, if price/earnings ratios are used, is the definition of earnings for the comparative companies the same as the definition of earnings for the subject company, such as "net income after taxes, adjusted for extraordinary or nonrecurring items.")
- ☐ If valuation measures such as price/earnings ratios are derived from analysis of comparative companies, are the time periods over which the variables were derived for the comparative companies the same as the time periods for which the subject company variables are measured or estimated?

Reviewer's Caution: *A common error is to derive valuation parameters such as a price/earnings ratio based on comparative companies' earnings for a certain time period and then apply that ratio to the subject company's earnings for a different time period, resulting in an invalid indication of value for the subject company.*

- ☐ Has appropriate recognition been accorded to the size of the block and its voting rights with respect to the degree of control or lack of it?
- ☐ Has appropriate recognition been given to the degree of ready marketability (liquidity), or lack of it?
- ☐ Were all data used known or susceptible of being known as of the effective date of the valuation (except to the limited extent of permissible ex post data)?
- ☐ Are all discount rates, capitalization rates and multipliers used adequately justified? (Normally, discount rates, capitalization rates and multipliers will be based on empirical market data, which should be clearly explained as to definition and source, so that the reader can go to the source and verify its accuracy. The analyst may use the mean or median of such data, or may make adjustments above or below such market averages. The report should explain why the average of data from whatever market source is used is appropriate for the subject company or why some upward or downward adjustment from the comparative data is appropriate for the subject company.)

- ❑ Where weightings of various factors and/or approaches are used, are the weightings used adequately justified?
- ❑ Have all capital requirements needed to support continued or expected future operations been take into consideration?
- ❑ If there are significant differences in financial leverage (e.g., significantly different debt/equity ratios) between the subject company and the comparative companies, have these differences been adequately reflected in the valuation methodology?

Reviewer's Note: *There are many ways to reflect differences in financial leverage. One is to require higher rates of expected return on equity for more leveraged companies to reflect the higher risk. Another is to analyze the subject and comparative companies on a "debt-free" basis, deriving a value for total invested capital, and then deduct the amount of debt to determine the value of the equity.*

- ❑ If there are potential obligations to issue additional equity, such as through exercise of warrants or conversion of convertible securities, has the potential dilution been reflected in the value of the common stock?
- ❑ Is the degree of risk of the investment adequately addressed and reflected in the valuation?

Reviewer's Note: *The higher the risk, the higher the expected rate of return the market requires. One of the most essential aspects of any business appraisal is the assessment of the risk of the subject company, usually relative to comparative companies, and reflection of the degree of risk in valuation parameters selected (discount rates, multiples, and so forth).*

IF THE "EXCESS EARNINGS METHOD" (OR SOME VARIATION) IS USED:

- ❑ In general, is the procedure used consistent with the steps and example shown in Exhibit 2?
- ❑ Does the amount used for the asset base represent the value of net tangible assets (exclusive of intangibles)?
- ❑ Is the earnings base used representative of ongoing earning power of the entity?
- ❑ Is the earnings base net of reasonable compensation to any owner(s) involved in managing the business?
- ❑ If a corporation, is the earnings base used net income after taxes?
- ❑ Is the required rate of return applicable to net tangible assets adequately justified?

Reviewer's Note: *This normally should be at least the company's cost of borrowing. A common error is to use some "safe" rate, such as the current rate on risk-free U.S. Treasury bills, or a rate of 8%-10% as used in an illustrative example in Revenue Ruling 68-609, reflecting economic and market conditions prevalent in 1968.*

- [ ] Is the rate at which the "excess earnings" (earnings over and above the amount required to support the tangible asset base) adequately justified?

Reviewer's Note: *This normally should be a considerably higher rate than the rate of return applicable to tangible assets because of the considerably higher risk. As with the rate applicable to tangible assets, a common error is to use a rate of 15%-20% because that was the range of rates used in the illustrative example in Revenue Ruling 68-609, reflecting economic and market conditions in 1968.*

Reviewer's Note: *In many businesses, there are no "excess earnings," because the total earnings are not even enough to justify the investment in the net tangible assets. In some such cases, the business may even be worth less than the net tangible asset value (unless the asset values could actually be realized by net proceeds from liquidation).*

EXHIBIT 2

THE EXCESS EARNINGS METHOD [2]

BACKGROUND

Variations of an appraisal procedure referred to by different names, most commonly the "excess earnings method," often are encountered. The method was originated by the U.S. Treasury Department in 1920 for the purpose of computing the value of goodwill that breweries and distilleries lost because of prohibition. Referring to the method, Revenue Ruling 68-609 states "The 'formula' approach may be used in determining the fair market value of intangible assets only if there is no better basis available for making the determination" (emphasis supplied).[3] Nevertheless, perhaps partly because of its wide publicity and partly because its apparently simplistic nature is appealing, it is encountered frequently in appraisals of small businesses and professional practices. It is important that the appraisal reviewer be able to recognize this procedure (by whatever name it is presented), and evaluate whether or not it is applied correctly.

2 This exhibit is adapted from Chapter 12, "The Excess Earnings Method," in Shannon P. Pratt, Valuing Small Business and Professional Practices (Homewood, Ill.: Dow Jones-Irwin), 1986.

3 Revenue Ruling 68-609, 1968-2, C.B. 327.

A STEP-BY-STEP EXPLANATION

The steps in the excess earnings method can be summarized as follows:

1. Determine a net tangible asset value. (Note that this value is for net tangible assets only and would not include intangible items such as leaseholds, patents, copyrights, and so on.)
2. Determine a normalized level of earnings. This must be after all expenses, including reasonable compensation to any owner(s) involved in management and after taxes if the entity is a corporation.
3. Determine an appropriate percentage rate of return, or, in the parlance of finance, a capitalization rate on the net tangible asset value. Multiply the net tangible asset value from Step 1 by that rate to determine the amount of earnings attributable to the tangible assets. Subtract that amount from the normalized earnings developed in Step 2. The result of this step is called the excess earnings, that is, the amount of earnings above a fair return on the net tangible asset value.
4. Determine an appropriate capitalization rate to apply to the excess earnings, which are presumably the earnings attributable to goodwill or other intangible assets, as opposed to tangible assets. Capitalize the excess earnings at that rate.
5. Add the values from Steps 1 and 4.[4]

AN EXAMPLE

Let's suppose that Flora's Flower Shop has a net tangible asset value of $20,000. Let's also suppose that, after allowance for a reasonable salary for Flora, the shop earns about $8,000 per year. For the purpose of this example, we will use a rate of return of 15% on the tangible assets, and will capitalize the excess earnings at 33 1/3%. (The matter of determining applicable rates must be discussed and supported in the appraisal report in light of economic and capital market conditions as of the appraisal date.) In this scenario, the value of Flora's Flower Shop would be computed as follows:

Net Tangible Asset Value		$20,000
Normalized Earnings	$8,000	
Earnings Attributable to Tangible Assets ($20,000 x 0.15) =	3,000	
"Excess" Earnings	$5,000	
Value of Excess Earnings ($5,000 divided by 0.333) =		15,000
Total Value		$35,000

4 As an alternative to using the present net tangible asset value and normalized earnings, some appraisers base the computations of the value of excess earnings on average net tangible assets and average earnings for some period of time, usually five years. This procedure is satisfactory if the period used is representative of reasonable future expectations. If this procedure is used, the value of excess earnings still is added to the present net tangible asset value to arrive at the value for the total entity.

SOURCES OF INFORMATION

In general, the sources of information should be complete, and should be identified well enough that the reader of the report can locate the source and verify the information if so desired.

Company Financial Statements

- ❑ Is there a complete list of the statements (and tax returns, if any) consulted by year, including the designation of the fiscal year-end?
- ❑ Does the report indicate for each year whether the statements are internally compiled, compiled by a CPA firm, reviewed by a CPA firm, or audited by a CPA firm?
- ❑ Did the appraiser use an adequate set of financial statements and schedules for an adequate number of years for the purpose of the appraisal?

Site Inspection and Interviews

- ❑ Did the appraiser visit the operation(s)?
- ❑ Did the appraiser interview appropriate management personnel?

Publications

- ❑ Are publications used cited adequately, including issue date for periodicals, so that the reader can locate the publication and verify the information?

COHERENCE

- ❑ Does the report have a logical organization that is followed consistently?
- ❑ Does all content under a heading pertain to the topic of that heading?
- ❑ Does each paragraph contain a sentence or group of sentences that pertain to a single topic?
- ❑ Does each sentence convey a single or closely related set of information or ideas?
- ❑ If a question logically is raised in the mind of the reader, is it addressed?
- ❑ If esoteric or potentially ambiguous terms are used, are they defined?
- ❑ Do the data and analysis presented clearly support the conclusion reached?
- ❑ Are the steps taken clearly spelled out so that the reviewer could independently replicate the steps and reach the same conclusion?
- ❑ If there are data or facts that would appear to contradict the conclusion, are they reconciled with the conclusion?
- ❑ Is all the material presented relevant to the valuation report?

- ❑ Is the degree of attention accorded to various factors in the report adequate relative to the degree of impact each of such factors has on the ultimate conclusion of the report?

INTERNAL CONSISTENCY

- ❑ Are all statements made in any part of the report consistent with statements made in any other part of the report?
- ❑ If statements are made concerning approaches to be used, factors to be considered, etc., were all such approaches and factors used or considered as stated?
- ❑ Is the conclusion consistent with all statements made and procedures used to lead up to that conclusion?
- ❑ Do the approaches and procedures used conform to the definition of the standard of value, including relevant case law, if applicable?
- ❑ Are all numbers, spellings, etc., referred to more than once in the report the same in all places?
- ❑ Do all headings in the Table of Contents and Lists of Tables, Exhibits, Appendixes, etc. conform exactly to headings in the body of the report?
- ❑ Are the calculations accurate (multiplications, divisions, additions, etc.)?

QUALIFICATIONS OF APPRAISERS

An important aspect of evaluating an appraisal is evaluating its source -- i.e., how well qualified are the people that prepared it to do this type of appraisal? Although the following factors are presented in list form with boxes to check (consistent with the format of other portions of this checklist), each category is really a matter of degree, which could be rated from strong to very weak.

- ❑ Academic and professional credentials
- ❑ Experience (related appraisal work, etc.)
- ❑ Professional involvement (membership and activities in professional organizations, committee service, offices held, speeches, courses taught, publications, etc.)
- ❑ Expert testimony on business valuation matters

CONTINGENT AND LIMITING CONDITIONS

- ❑ Does the report contain a statement of contingent and limiting conditions?

Reviewer's Note: *Since appraisal procedures and relevant factors can vary considerably from one appraisal purpose to another, one of the important limiting conditions is that the appraisal is only applicable to the purpose or function stated in the description of the assignment.*

SPECIAL CHECKLIST FOR EMPLOYEE STOCK OWNERSHIP PLAN STOCK APPRAISALS

MARKETABILITY

Has each of the following factors been adequately addressed and reflected?

- ❑ Repurchase liability arising from employee departures
- ❑ Repurchase liability arising from the diversification requirement imposed in the 1986 Tax Act
- ❑ Terms of the put option
- ❑ Past record of stock redemptions
- ❑ Financial condition of the company

OTHER ESOP VALUATION ISSUES

- ❑ Is the date when the appraisal is done close enough to the date of the transaction?
- ❑ If stock will be issued to the ESOP, has the resulting dilution been adequately accounted for in the valuation?
- ❑ If a capitalization of earnings and/or cash flow approach is used, are the adjustments (or lack of them) to the earnings or cash flow base to be capitalized appropriate?
- ❑ If the ESOP is leveraged, is the risk arising from the leverage properly reflected in the discount or capitalization rates or multiples used?

COMMON ERRORS AND SHORTCOMINGS IN BUSINESS APPRAISAL REPORTS

- **Inadequate Documentation of Sources (leaving reviewer unable to locate and verify the source material)**
- **Lack of Replicability (leaving the reviewer unable to follow through the steps purportedly taken and verify the conclusion)**
- **Failure to Clearly Define and/or Conform to Applicable Standard of Value**

Amazingly, one of the most common errors is failure to identify and conform to the applicable standard of value. In some cases, this is merely an omission from the written report. In other cases, it may become apparent, from either reading the report or questioning the appraiser, that the appraiser has gone off heedlessly to do an "appraisal" without ever determining the applicable standard of value.

In some cases, the applicable standard of value is identified but apparently not understood, because the analysis and conclusion do not conform to the standard of value identified. The standard of value may be misconstrued, or the report may simply fail to address some of the factors implied in the standard of value or mandated for consideration as a matter of law or regulation.

- **Internal Inconsistencies**
- **Extensive and Irrelevant Information**
- **Undefined Jargon**

Many terms used in finance are ambiguous. That is, there may be two or more acceptable definitions, but no way to know exactly which is intended unless the writer makes it clear. A good example is <u>cash flow</u>, which has many definitions but can be very precise once the author has specified which definition applies. Some authors also use terms which simply lack any clear-cut definition.

- **Inadequate Comparative Data (inadequate search for comparative data and/or lack of clear exposition of criteria for selection and exact method of using data)**
- **Comparisons of Non-Comparable Data (e.g., data developed for comparative companies for some certain time period and applied to the subject company for a different time period, or data defined or measured one way for comparative companies and a different way for the subject company)**
- **Leaps of Faith (the presentation of a fact or conclusion with no accompanying documentation of source or supporting analysis or data)**

This is especially critical, of course, if the unsupported fact or conclusion is part of an integral link in the valuation process, such as a capitalization rate, so that the valuation conclusion depends on it.

The variety of leaps of faith to which readers of business valuation reports may be subjected is almost boundless. The reader should evaluate whether all critical assertions are supported and consider that evaluation in determining the extent to which he or she is willing or able to rely on the report.

- **Emphasis of Items Not in Proportion to their Relative Importance**

The most common example of this error is probably the emphasis often accorded to developing the earnings base and the capitalization rates in a capitalization of earnings approach. The two variables are more or less equally critical to a value conclusion using that approach. Yet many reports devote 20 pages to painstakingly developing the earnings base to be capitalized and then cavalierly capitalize that earnings base at a capitalization rate supported only by one or two flimsy sentences. The reader should evaluate the report in light of whether the factors that really matter in reaching the final conclusion are indeed given their due consideration.

- **Overemphasis on Past Data**

As widely noted in regulations and in the literature of finance, a business valuation represents a prophesy of the future. The purpose of gathering and analyzing past data is only to provide guidance of reasonable expectations for the subject business. An

appraisal is deficient to the extent that it relies on data without convincing support that the historical data is indeed relevant as a guide to reasonable future expectations.

- **Reliance on Rules of Thumb**

While rules of thumb bandied around for businesses in certain industries should not be ignored, they rarely can be relied on in and of themselves to produce an accurate valuation.

ABOUT THE AUTHOR

Shannon P. Pratt is president of Willamette Management Associates, Inc., a national business valuation firm headquartered in Portland, Oregon, with branch offices in Washington, D.C., and Honolulu, Hawaii.

Besides being an author of numerous articles and a frequent seminar leader and speaker on business valuation topics, he is the author of two important reference books, both published by Dow Jones-Irwin: Valuing a Business: The Analysis and Appraisal of Closely Held Companies, 2nd edition (1989), and Valuing Small Businesses and Professional Practices (1986).

Dr. Pratt holds a doctorate in finance from Indiana University. He is a Senior Member of the National Association of Review Appraisers & Mortgage Underwriters, holding the CRA (Certified Review Appraiser) designation. He also holds the designations of Fellow of the American Society of Appraisers, Chartered Financial Analyst, Certified Business Counselor, Certified Financial Planner and Senior Certified Valuer.

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