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# BUSINESS VALUATIONS

Charles C. McCarter* and Beverly J. Greenley**

A good business lawyer needs to know more than just business law. In addition, a knowledge of business facts is essential. For example, he should know the value of the business enterprise he represents. Experience has shown that a client is far more impressed with a lawyer's ability to advise and consult concerning the value of his business than with the lawyer's knowledge of the law.

This article describes how to evaluate a closely-held business or its assets, be it an entrepreneurship, a partnership, or a corporation. The topic will be presented in four parts. Explored first will be the occasions for evaluating a business or an asset. Second, the initial steps for appraising a business or its assets will be delineated. Third, the article will discuss the problems and methods used to adjust historic data for valuation purposes. Finally, this article will explore and assess the numerous methods that exist for evaluating a business entity or its assets. The theme will be presented through a review of the recently published book, *Business Valuation Handbook*, authored by Glenn M. Desmond and Richard E. Kelley.[1]

## I. Occasions for Evaluating a Business or an Asset

The practicing lawyer will encounter many occasions where a basic understanding of the principles of valuation will prove beneficial. One occasion arises when the lawyer is advising his client on the sale or purchase of a closely-held business or its assets.

Another occasion arises at the demise of a client who owns part or all of a closely-held business or its stock. On such occasion, the lawyer

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1. G. Desmond & R. Kelley, Business Valuation Handbook (2d ed. 1979) [hereinafter cited as The Handbook or Desmond & Kelley's Handbook].

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may be called upon to prepare federal estate and state inheritance tax returns which require written appraisals of value of the closely-held business or its stock. While the lawyer may request an experienced appraiser to prepare such written appraisals, he nevertheless needs to understand the basic principles of appraising to be able to discuss values intelligently with his client and the appraiser. The attorney who knows the type of information an appraiser needs can provide information which will help guide the appraiser to values the attorney knows will be fair and yet, at the same time, beneficial to his client. This is important because the client will pay taxes based on the appraiser's conclusions. Such actions by the attorney constitute a meaningful service to the client since it saves him money he might have needlessly paid to the government. Of course, for similar reasons, it is useful for the attorney to be knowledgeable of valuation concepts when advising a client on the gift tax consequences of gifts of business interests.

The divorce lawyer particularly needs a knowledge of valuation principles. In any property settlement agreement, both the husband and wife need to know the value of the assets of their marriage, and often such assets include a closely-held business. Similarly, the lawyer representing the dissident owner of an interest in a closely-held business should be acquainted with methods of determining the value of his client's interest in the business, in order to better assist in a sale of his interest, or in representing him in any lawsuit concerning the value of such interest.

When the dissolution of a business is required, the appraisal value of the business or its assets is a prerequisite to a fair liquidation of such assets. Also, the fair market value of the goodwill of a business may need to be appraised in the event of a condemnation of land upon which a business entity operates where the loss of such property results in the loss of goodwill. In these situations, the lawyer's knowledge of valuation methods and principles will provide tremendous assistance to his client.

The lawyer's ability to work with appraisal concepts will prove invaluable when his client wishes to compensate his employees with stock of a closely-held business. For example, in Employee Stock Ownership Trusts, the stock must be valued to meet requirements of both the United States Department of Labor and the Internal Revenue Service.

Historically, the utility lawyer has been required to be knowledgeable in matters of evaluation since utility rates are set by governmental

regulatory bodies on the value of the "rate base". History has also borne out the wisdom of the business lawyer being familiar with valuation methodology. For instance, he may be called upon to draft a buy/sell agreement concerning business interests and to include therein formulas and techniques to be used for evaluating the business interests in the event of the demise of one of the parties to the agreement, his retirement, incompetency, or withdrawal from the business. Of course, knowledge of appraisal principles can be of immeasurable assistance to the business lawyer who is negotiating, and later drafting, legal documents relating to business reorganizations, consolidations, and conversions of one class of stock into another.

Not to be overlooked is the benefit to the client, who, because of his lawyer's knowledge of the varied uses of appraisements, can secure a loan which the client himself has been unable to negotiate. Often accounting records may not support and reveal the prerequisite security for a business loan, particularly when the books of the business reflect significant depreciation of business assets. However, an appraisal of the market value of the business assets, duly inspired by the alert attorney, may provide sufficient security to support the needed loan.

Several times Desmond and Kelley relate how the efforts of a qualified appraiser to educate them on the basic principles of appraising proved worthwhile. One author tells the story as follows:

> I was involved in a land condemnation case. One of my expert witnesses, an MAI, like Glenn Desmond, had taken time to enlighten me about the criteria an appraiser could and could not properly consider in evaluating property (under the law and under acceptable techniques of appraisal). The knowledge imparted paid off to my client who was a condemning authority and who wanted the jury verdict for the price of the property to be low. An opposing expert had just testified to a very high value of the property, evidence extremely detrimental to the cause of my client. Using the knowledge recently learned from the appraiser, I cross-examined the opposing witness about the methods he had utilized in making the appraisal, hoping the witness would respond with: "What do you mean criteria?" However, the witness was extremely knowledgeable. He responded curtly that he had used six specific criteria. A little depressed, but still hoping, I asked the opposing witness to name his six criteria. Then, I'm sure, hope arose in my eyes, for five of the six were "no-no's". Needless to say, the potentially dangerous

testimony of that expert became rather harmless and my client obtained an extremely favorable verdict, $150, instead of the $15,000 value to which the opposing expert had first testified.

Another time I was negotiating the purchase of a business enterprise. The seller announced his selling price of $150,000. Again remembering some of the knowledge my appraiser friend had imparted to me, I inquired how the seller had arrived at his selling figure. The seller said he had priced the business by multiplying the average net profits of the business over the last five years ($30,000) times the multiple of five, a rule of thumb sometimes used by businessmen in evaluating a business. The multiplier, at that point of time in economic history, did not seem out of line, and I was concerned I would never bring the seller down to a price my client thought was reasonable. The seller and buyer were miles apart in price.

However, still remembering the appraising techniques, I asked for verification of the net profits and was shown a five year comparable income statement indicating indeed an average net profit to the business of $30,000 a year. But the business was an entrepreneurship and there was no entry on the profit and loss statement for a salary for the owner—a customary practice for bookkeeping records of entrepreneurships since all the company makes is reportable as income to the IRS whether reported in the form of salary or profits from the business. I knew (and felt reasonably sure the seller did not know) that comparable businesses operated by corporations were selling for five times net profits after salaries to all managerial employees, including owner-managers, and that managers of such other companies were being paid in the neighborhood of $15,000 a year in salary. Accordingly, I inquired of the owner whether he felt his services were worth $15,000 each year. He was quick to respond in the affirmative, suggesting he might be worth even more, a point I readily admitted. With such matter clarified, I demonstrated (somewhat to the owner's discomfiture) that the proper way to evaluate the business was to first subtract the $15,000 as salary from the $30,000 profit and multiply the difference of $15,000 by five. Of course, such appraising techniques showed the business to be worth only $75,000, not $150,000.

While I cannot report that I succeeded in buying the business for my client at only $75,000, I, at least, can report

that I greatly undercut the argument of the seller and eventually a selling price much below the original asking price of $150,000 was agreed upon.

Reflecting on the many occasions when the business lawyer needs knowledge of the art of appraising and yearning for a clear, concise, and concrete explanation of appraising techniques, one leaps for joy upon discovering Desmond and Kelley's Handbook. Tomes like *The Valuation of Property; a Treatise on the Appraisal of Property for Different Legal Purposes*[2] and *The Financial Policy of Corporations*[3] certainly have their place in appraisal literature.[4] Their in-depth analysis help one understand the rationale behind various theories of appraising. However, if one is concerned with evaluating businesses and not theories of appraising, the Handbook is invaluable and worth the time of every practicing professional.[5]

The Handbook is written by practicing appraisers, experienced expert witnesses, and business consultants knowledgeable about the many legal problems related to the matter of evaluating a business. It is obvious that the experiences of Desmond and Kelley have taught them the importance of orderliness, comprehensiveness, and thoroughness in approaching the task of evaluating a business. They are entitled to the accolade "genius", for they have shown an "infinite capacity for taking pains."[6] Desmond and Kelley follow, and recommend to others, a ten step process when making an appraisal in order to prevent overlooking important considerations. These are:

1. Define what is to be valued.
2. Determine the date of valuation.
3. Obtain and analyze financial statements.
4. Interview the owners, managers, and others.
5. Prepare adjusted and projected financial statements.
6. Develop comparative data.
7. Value individual tangible assets.
8. Value goodwill and other intangibles.
9. Apply established valuation methods to the business.

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2. J. BONBRIGHT, THE VALUATION OF PROPERTY; A TREATISE ON THE APPRAISAL OF PROPERTY FOR DIFFERENT LEGAL PURPOSES (1937).

3. A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 275-506 (5th ed. 1953).

4. For a bibliography of appraisal books and articles, *see* THE BIBLIOGRAPHY OF APPRAISAL LITERATURE (D. MacBride ed. 1974).

5. For a more law-oriented presentation in the field of valuation for estate, gift and income tax purposes *see* VALUATION OF SHARES OF CLOSELY HELD CORPORATIONS [1978] TAX MNGM'T. (BNA).

6. J. HOPKINS, WORK AMONGST WORKING MEN (1870).

10. Correlate data and develop value opinion.[7]

We discuss the first four of these steps in Part II, the next two in Part III and the last four in Part IV.

## II. THE INITIAL STEPS FOR APPRAISING A BUSINESS

One of the first things a lawyer should know about appraising is that although he is often called upon to think and act like a professional appraiser, he is not one. When a professional appraiser is needed, the lawyer should see to it that one is employed.

In his role as an attorney, there are principles of appraising he should know to be able to effectively utilize the services of professional appraisers, to be able to question them on direct and cross-examination, to evaluate their work product, to help formulate and later use their appraisements to good advantage for his client, and, in select circumstances, to perform the functions of an appraiser. These principles for attorneys can be found in Desmond and Kelley's Handbook.

The key to working successfully with an appraiser, to discussing appraisal problems with clients, and, on occasion, performing the services of an appraiser, is understanding the steps involved in making an appraisal. The very first step is identifying what is to be evaluated. Is it an entire business enterprise with all of its assets and liabilities, or just a few or even one of the assets? Is it all of the assets of the business without a correlative assumption of the liabilities of the company? Another preliminary step is ascertaining the date of the appraisal.

Next comes obtaining and analyzing historic financial statements. While appraising involves the determination of the present and possible future value of a business entity or a business asset, "his-story" is the beginning of predicting such values. Thus, an appraiser (herein anyone, including lawyers, who determines or assists in determining value) must commence his study with the historic information available to him concerning the company or assets he is to evaluate. Accordingly, in appraising the value of a business, it is important for the appraiser to procure such written documents as past balance sheets, profit and loss statements, income tax returns and other accounting records, as well as leases, contracts, court papers, and partnership or corporate papers.[8]

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7. DESMOND & KELLEY, *supra* note 1, at 16-18.

8. The law-oriented reader will be interested in the emphasis the Handbook places upon the importance of knowing the legal classification of the business entity being appraised, i.e., a propri-

Having procured such written documents, the appraiser will need to study these documents and develop questions to address to key persons to help him better understand the historic information and to position himself better to make an accurate and factually circumscribed appraisal. Thus, he will proceed to inspect with detail his newly found information. In doing so, he will remember that fundamental to the evaluation of a business enterprise is the assembly of historic facts in such a manner as to make them comparable with similar information concerning other companies of the same type and size. Accordingly, he will follow somewhat standard procedures in organizing the facts found in the written material furnished him.

He will unearth from the mass of financial information certain traditional financial ratios. Later, these ratios will enable him to make meaningful comparisons of similar information emanating from financial statements of comparable companies and make it easier to arrive at comparable statistics which are useful in making any final determination of value.

One such ratio would be the current ratio determined by dividing the current assets by the current liabilities. The current ratio tests the ability of a company to meet its current debts. It is evident that the higher the current ratio, the greater the ability of the company to pay its debts. Hence the greater likelihood the business will appeal to a purchaser as a valued business. Thus, within limits, a company having a higher current ratio than another might be deemed by an appraiser as being the more valuable of the two.

Other indicators of the value of a company are ratios measuring the profitability of a company, such as the net profit on net worth ratio and the net profit on sales ratio. The company with the better ratios may have a higher appeal to a buyer and thus have a higher appraised

etorship, a partnership, an ordinary corporation, a pseudo corporation, a trust, etc. For instance: "[I]f the business being appraised is a proprietorship, its financial statements usually will not reflect salary to the proprietor nor income taxes payable on the business profit. Furthermore, if most of its competitors are corporations, comparisons of operating results cannot be made unless the company's figures are adjusted to what would be reflected if it were a corporation. . . .

It is important for the business appraiser to obtain and read any partnership agreements. The agreements may restrict the marketability of a partnership interest, specify the share of profits payable to various classes of partnership owner interest, limit voting rights, and limit or extend liability. Any or all of these factors can have considerable bearing on the value of the partners' individual and collective equity." There are similar words of wisdom about the appraiser reading corporate charters, by-laws, minutes, stock record books, etc. followed with the caveat that stock with restricted dividends or voting rights has a different value than ordinary common stock. *Id.* at 7-8.

value than a company with less favorable profit ratios. There are other ratios which can be helpful in evaluating a business, including the collection period, the inventory turnover, the net worth turnover, the debt to worth ratio, the fixed assets to worth ratio, and the purchases to trade payables ratio.[9]

A clear understanding of business ratios is essential to the good appraiser. The student of appraising needs to comprehend in detail such ratios and their uses. Unfortunately, it is not always easy to find study materials that clearly trace the proper paths of thought for the student of appraising as he strives to understand business ratios, their significance and use. While textual material often sets out what the ratios are and how to compute them, such literature commonly omits sufficient discussion about the significance of the various ratios, i.e., what should the ratios numerically be for the successful company. Too often, after careful explanation of the method for computing a given ratio an example is given and a conclusion is announced that the exemplified ratio is good or bad. However, that does not leave the reader with any criteria concerning the merits of a different ratio which he might compute for a different company. In short, the question, "How does the student of appraising use his new found information about ratios?" is frequently left unanswered.

Unfortunately, though with some exceptions, *Business Valuation Handbook* joins other appraisal literature in containing this fault. For example, in discussing the current ratio of their case study, BLM Electronics, Inc., and after determining the company had a current ratio of 2 to 8, for a given year, Desmond and Kelley observed, "While this result is a generally good indicator, it cannot be accepted as final evidence that the firm can easily pay its bills."[10] The reader naturally asks: "But what is generally a good indicator? Would a ratio of 1 to 1 be good or bad? How about 2 to 1 or 3 to 1?"[11] In short, Desmond and Kelley fail to give the perimeters of the standards one should ultimately use in judging the strengths and weaknesses of a company and its value.[12]

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9. *Id.* at 29-36.

10. *Id.* at 30.

11. For a discussion of a widely used rule of thumb, *see* W. MEIGS & C. JOHNSON, ACCOUNTING, THE BASIS FOR BUSINESS DECISIONS 835 (2d ed. 1967) [hereinafter cited as MEIGS & JOHNSON].

12. *See generally* S. COSTALES, FINANCIAL STATEMENTS OF SMALL BUSINESSES 37-41 (1970); MEIGS & JOHNSON, *supra* note 11, at 815-47; H. SELLIN, ATTORNEYS HANDBOOK OF ACCOUNTING (1971); L. TROY, ALMANAC OF BUSINESS AND INDUSTRIAL FINANCIAL RATIOS (1979).

With the foregoing exception, Desmond and Kelley set forth the analytical ratios in as clear and simplified a fashion as we have seen and their discussion is highly recommended. Understanding financial ratios is an early step in arriving at the ultimate destination of an accurate, factually based, appraisal of a business entity.

However, while comparing ratios of comparable companies may give indications of value of a business entity, perhaps the most important aspect of ratio studies lies in the fact that such studies lead to intelligent questions for the appraiser to ask key personnel. Accordingly, after the appraiser has carefully reviewed the written documentation furnished him, he must orally supplement his knowledge of the company being appraised.

After defining what is to be evaluated, determining the date of the evaluation, and obtaining and analyzing the historic financial data, extensive and well-planned interviews with knowledgeable personnel are required. While discussions with the company's owners are a "must", so are similar conferences with sales, production and financial personnel, executives of banks where the firm does business, the company's accountant and lawyer, creditors, major customers, employees, suppliers, and trade association people. Knowledge gained from such conferences is fundamental to an accurate appraisal.

Further, knowledge of plant conditions, owners' profiles revealing their capabilities, explanations of odd entries on the accounting records, understanding of investment problems, understanding of cash flow problems, findings leading to information concerning comparable sales of similar businesses, revelation of past sales of stock for an interest in the company, information about how the sale prices of such stock were negotiated, revelations of contingent or expected liabilities not on the balance sheet, revelation of large government contracts about to be signed that will double the company's income for the year, and other pertinent data can be procured by such personal interviews. By a case analysis of BLM Electronics, Inc., Desmond and Kelley portray the aforegoing and explain the importance in appraising of adhering to the biblical direction of: "Ask, and it shall be given to you; seek, and ye shall find; knock, and it shall be opened to you."[13]

13. DESMOND & KELLEY, *supra* note 1, at 49.

## III. Adjusting Historic Data for Valuation Purposes

Having secured written financial information and submitted it to strong, oral cross examination of persons knowledgeable of a company's affairs, the appraiser must recognize the deficiencies of the information he has gathered. While much helpful historic information is found in an accurately prepared financial statement based on generally accepted accounting principles, such statements can be misleading when it comes to values. The appraiser "must realize that generally accepted accounting principles (GAAP) do not result in statements which reflect value."[14] Desmond and Kelley explain several deficiencies of financial statements based upon generally accepted accounting principles.[15] A few of the more important deficiencies discussed are:

1. Most assets are reported in current financial statements at cost. In inflationary periods this usually means values are understated.[16]

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14. *Id.* at 41.

15. The accounting profession is aware of the deficiencies of financial statements for valuation purposes. However, they point out that financial statements are not designed to be evaluation tools in and of themselves, but are designed to record historic economic facts for tax and business purposes and that they serve those functions rather well. They fully realize adjustments to these historic facts are needed for appraisal purposes. Interview with John D. Huelster, C.P.A., president-elect of the Missouri Society of Certified Public Accountants and partner, Laventhol and Horwath.

16. Such understatement of assets in financial statements, without some supplemental reference to matters potentially affecting value, may not continue in the future at least for assets of substantial companies. The Financial Accounting Standards Board has recently specified that while no changes ought to be made in primary financial statements, nevertheless for fiscal years ending on or after December 25, 1979, large public enterprises [those having either (1) inventories and property, plant and equipment (before deducting accumulated depreciation) amounting to more than $125,000,000 or (2) total assets amounting to more than $1,000,000,000 (after deducting accumulated depreciation)] are required to report supplementarily the following:

a. Income from continuing operations adjusted for the effects of general inflation.
b. The purchasing power gain or loss on net monetary items.
c. Income from continuing operations on a current cost basis.
d. The current cost amounts of inventory and property, plant and equipment at the end of the fiscal year.
e. Increases or decreases in the current cost amounts of inventory and property, plant, and equipment, net of inflation.

The Financial Accounting Standards Board, in adopting such standard, was of the view that compliance with such standard would meet an urgent need for information about the effects of changing prices. They opined that if such information were not provided, resources may be allocated inefficiently; investors' and creditors' understanding of the past performance of an enterprise and their ability to assess future cash flow may be severely limited; and people in government who participate in decisions on economic policy may lack important information about the implications of their decisions. The board went on to say: "The requirements of the Statement are expected to promote a better understanding by the general public of the problems caused by inflation: Statements by business managers about those problems are unlikely to have sufficient credibility until financial reports provide quantitative information about the effects of inflation." Thus, the 1980's mark the first time that the accounting profession in the United States has

2. Reserves for depreciation or amortization and the variety of methods for computing same do not in fact adjust book values to real market values. They merely provide a rationale for current legal prescriptions allowing deductions for income tax purposes.
3. Some valuable assets, such as patents, licenses, trademarks, copyrights, technical libraries, sales contracts, advertising material, and goodwill are omitted entirely from financial statements, thus diminishing their effectiveness as indicators of value.
4. Estimates of such matters as uncollectable accounts receivable, the life of depreciable and amortized assets and income taxes on financial statements temper their reliability as accurate reports of value.
5. Divergent accounting methods are permitted by generally acceptable accounting principles and different companies often prepare financial statements in accordance with such contrasting methods. For instance, while nearly all large businesses employ accrual accounting, many closely-held businesses use a cash basis form of accounting. Further, inventories may be determined on the basis of actual cost, standard cost, or by the retail method, to name three of the most common. In addition, the movement of inventories may be determined on the basis of first in, first out (FIFO); last in, first out (LIFO); and the average method—to name but a few. Also depreciation methods vary. Among the more common are the straight line method, the sum of the digits method, and the declining balance method.

Such different methods of accounting lead to varying book values of business assets and thus tend not to reflect established real values. Such heterogeneity makes valuations based on financial statements of an otherwise comparable business most difficult. "Since the business appraiser must be concerned with economically real values, it is apparent he can never afford to accept financial statements prepared according to generally accepted accounting principles as being true economic representations of a company's financial position or of its real profitability," state Desmond and Kelley, and they conclude that financial statements prepared by accountants must be substantially reconstructed

deemed it a generally accepted accounting principle to make note of the impact of inflation. FINANCIAL ACCOUNTING STANDARDS BOARD, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 33 (1978).

in order to reflect true values for appraisal purposes.[17]

Nevertheless, since the "past is prologue", the historic balance sheet and income statements for the past five years of a company are the foundation stones upon which to erect an evaluation of a business enterprise. The foundation must be formed by chipping and molding the stones from irregular shapes unfit for appraising purposes into uniform stones capable of use in underpining the valuation. Thus, the historic balance sheet and income statements must be adjusted for use in evaluating the business enterprise. The four primary adjustments are:

1. Correct bookkeeping entries originally entered for tax purposes or other purposes that prevent presentation of the real economic picture of the company.
2. Eliminate from the balance sheet all intangible assets for separate appraisal so the adjusted balance sheet will reflect only the adjusted historic tangible net worth.
3. Extract from the financial statements for separate appraisement, items that are not customarily in the industry a part of balance sheets and income statements.
4. Adjust historic figures in income statements to restore interest paid, depreciation, and amortization to arrive at the figures which represent the adjusted profit before tax and before capital changes.

Adjustments, such as the above, are important because they allow meaningful comparisons with financial statistics of comparable businesses prepared in accordance with the same procedures. Such comparisons enable the appraiser to evaluate the relative strength of managements of comparable companies. If the company being appraised produces financial results similar to that created by recognized good management of other companies, the appraiser can feel justified in concluding that the company being appraised is on a sound financial footing and that its management is of high quality. This would be a plus because "Good management often means a relatively safe investment. . . . Weak management increases the risks of having funds in the business."[18] The safety of the investment is an important factor in determining capitalization rates to be applied to future earnings under certain valuation methods.

Other steps involved in the reconstruction of historic financial data

17. DESMOND & KELLEY, *supra* note 1, at 27; for a discussion of deficiencies based on generally accepted accounting principles, *id.* at 24-28.
18. *Id.* at 79.

necessary to provide a solid foundation for appraisals include the preparation of an economic balance sheet and a pro forma (projected) income statement. The economic balance sheet is the adjusted historic balance sheet with substitution of economic values for book values. Fixed assets are valued at their fair market value. Accounts and notes receivable and payable are adjusted to reflect reality. The net result of such reconstruction is to restate in current economic values the owners' equity. Information contained on the economic balance sheet is obviously useful in evaluating a company.

The pro forma (projected) income statement is the appraiser's best judgment as to the future profits of the company. Because of the difficulty in projecting future income, it is best to limit such statements to only a year or two, unless the appraiser anticipates using a method of appraising that requires further estimation of income such as the discounted cash flow method. With all these reconstructions of the historic information and the formulation of economic balance sheets and income statements, a foundation is set for the making of accurate appraisals.

## IV. EVALUATION METHODS

As there are many plans for the construction of houses, so there are many methods for appraising a business. However, most methods have one thing in common. They utilize information found on both the historic and economic financial statements.

It is impossible in a Handbook of only 322 pages to set out all methods. Desmond and Kelley choose to discuss twenty-four such methods. Some of these involve evaluating the business entity as a whole. Others involve evaluating the tangible net worth of the business separately, then evaluating the good will and the other intangibles of the business, and, thereafter, adding the several valuations together. Further, and as will be seen, the process of decision-making as to the ultimate value of a business involves judgment. Experience is of much help to the proper correlation of gathered data and the wise application of the various valuation methods. All of these aspects of appraising a business will be discussed below. First though, what are some of the key methods for appraising a business?

The first eight of the twenty-four methods explained by Desmond and Kelley can be conveniently categorized into three classes: balance sheet methods, earnings and cash flow methods, and the comparable

sales method. Two balance sheet methods are the net worth per books method[19] and the tangible net worth at market method.[20] Earnings and cash flow methods include (1) the excess earnings method,[21] (2) the capitalization of income stream method,[22] (3) the discounted cash flow method,[23] (4) the price earnings ratio method,[24] and (5) the dividend capitalization method.[25] The eighth method suggested by Desmond and Kelley involves the use of information regarding the sales of comparable companies or their stock and is traditionally known as the comparable sales method.[26]

## A. *The Balance Sheet Methods*

The two balance sheet methods follow the proposition that the value of a business enterprise is equal to the net worth of the company, meaning its assets minus its liabilities. The principal difference between the net worth per books method and the tangible net worth at market method is that, with a few adjustments, the first method accepts the net worth of the company as shown on its most recent historic balance sheet as the value of the company,[27] while the second method reflects the appraised market value of the assets listed on the books of the company and shown on the economic balance sheet.[28] In both methods the intangible assets appearing on the company's books are

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19. *Id.* at 93-94.
20. *Id.* at 95-96.
21. *Id.* at 97-101.
22. *Id.* at 103-07.
23. *Id.* at 107-11.
24. *Id.* at 111-19.
25. *Id.* at 119-23.
26. *Id.* at 123-25.
27. An example of computations under the net worth per books method is:

| | | | |
|---|---|---|---|
| Net Worth Per Books | | | $915,184 |
| Less Intangible Assets: | | | |
| New Product Investment | | 134,210 | |
| Other Assets (Goodwill & Patent) | | 25,001 | 159,211 |
| Tangible Net Worth Per Books | | | 755,973 |
| Less Unrelated Business Items: | | | |
| Notes Receivable - Long Term | 297,648 | | |
| Net of Deferred Income | (153,225) | 144,423 | |
| Partnership Interest | | 53,850 | |
| Plus: Income Tax on Unrelated Income | | (2,383) | 195,620 |
| Tangible Net Worth for Industry Comparisons | | | $560,353 |

*Id.* at 94.

28. An example of computations under the tangible net worth at market method is:

usually excluded from evaluation. It should be noted that the net book worth of a company is perhaps not so much a valuation method as it is useful preliminary information for evaluating a business under various appraisal methods.

B. *Earnings and Cash Flow Methods*

Four of the five earnings and cash flow methods (all but the discounted cash flow method) are readily seen to be based upon some application of the basic formula, V = I/R where "V" stands for value, "I" stands for income and "R" stands for rate of return or capitalization rate.

The excess earnings method involves establishing a dollar value for so-called excess earnings and substituting such figure for the "I" in the aforesaid basic formula and dividing it by an appropriate rate of return, thereby arriving at a value for such excess earnings. To such value the appraiser adds the market or economic value of the tangible net worth of the company, plus any unusual values, to arrive at the total value of the business.[29]

In computing the value of a business by the capitalization of income stream method the appraiser projects the company's future annual income before taxes, subtracts the taxes and any costs of debt service for anticipated borrowing to supply the company with needed working capital, and adds to the computation a sum equal to the depreciation deducted for tax purposes to arrive at net income. Addition of depreciation is needed because its book deduction from the income stream does not represent in truth a reduction in cash as actual expenditures do, but only a reduction of income for tax-saving purposes. The

| | | |
|---|---|---|
| Tangible Net Worth Per Books for Industry Comparison | | $560,353 |
| Less Decreases in Book Values to Economic Values: | | |
| Greater Reserve for Bad Debts | 10,000 | |
| Note Due from Owner Eliminated | 20,000 | |
| Reduction in Inventories by Appraisal | 20,000 | 50,000 |
| Subtotal | | 510,353 |
| Plus Increases in Book Values to Economic Values: | | |
| Increase in Fixed Assets by Appraisal | 129,226 | |
| Accounts Payable Officer Eliminated | 8,320 | |
| Note Payable Owner Eliminated | 10,000 | 147,546 |
| Tangible Net Worth at Market | | $657,899 |

*Id.* at 96.

29. An example of the excess earnings method is:

resultant figure is said to represent the current income stream for the business or, in other words, the "I" in the above basic formula. The appraiser then determines a rate of return or capitalization rate by surveying yields (rates of return) an investor can obtain if he purchases other investments such as U.S. Treasury bonds, industrial bonds, preferred stock, common stock. While the Handbook does not expressly state, we are sure Glenn Desmond, in his capacity as an appraiser, would also survey and find the rates of return of companies comparable to the business entity being evaluated. With the results of all such surveys at hand, the appraiser would determine a rate of return commensurate with the degree of risk involved for an investor. Such rate of return would then become the capitalization rate in the basic formula of Value equals Income divided by said Rate of Return, and the quo-

| | | | | |
|---|---|---|---|---|
| Pro Forma Income Before Capital Charges . . . | | | | $190,000 |
| 1. Deduct Economic Depreciation on Tangible Assets | | | | |
| | Economic Value | Economic Deprec. Rates | | |
| Machinery & Equipment | 80,000 | .167 (6 yr. life) | 13,360 | |
| Furniture & Fixtures | 50,000 | .125 (8 yr. life) | 6,250 | |
| Leasehold Improvements | 70,000 | .167 (6 yr. life) | 11,690 | |
| Tools, Dies & Molds | 50,000 | .250 (4 yr. life) | 12,500 | (43,800) |
| 2. Deduct Economic Amortization of Intangibles | | | | |
| | Economic Value | Amortization Rates | | |
| Belmur Process | 75,000 | .125 (8 yrs.) | 9,375 | |
| Lamp Patent | 15,000 | .100 (10 yrs.) | 1,500 | (10,875) |
| 3. Deduct Economic Return on Investment | | | | |
| | Amount | Rate of Return | | |
| Working Capital | 407,899 | 10% | 40,790 | |
| Required Long Term Debt | 50,000 | 12% | 6,000 | |
| Equipment & Improvements | 250,000 | 14% | 35,000 | |
| Belmur Process | 75,000 | 20% | 15,000 | |
| Lamp Patent | 15,000 | 15% | 2,250 | (99,040) |
| 4. Excess Earnings | | | | 36,285 |
| 5. Value of Goodwill (Excess Earnings at 18% Capitalization Rate) | | | | 201,583 |
| 6. Summary of Value | | | | |
| Adjusted Tangible Net Worth . . . | | | | 657,899 |
| Economic Value of Belmur Process | | | | 75,000 |
| Economic Value of Lamp Patent | | | | 15,000 |
| Value of Goodwill | | | | 201,583 |
| VALUE . . . | | | | $949,482 |

*Id.* at 101.

tient of such division would be the value of the business entity.[30]

Dividend capitalization is somewhat the same as income stream capitalization except it is the dividends, instead of the earnings of a company which are capitalized and it is a dividend yield rate, instead of a rate of return (earnings divided by net worth), that is the capitalization rate. Often a company does not distribute all its earnings to shareholders. Rather, a dividend of 40 percent to 60 percent of the earnings is often declared and paid with the balance of the earnings being plowed back into needed assets for company operations or into needed working capital. Since some investors could be looking to what they will receive from the company, and not what the company earns, as their measure of value, it might be appropriate for them, or their counsel, to determine value based on dividends rather than earnings. Under the dividend capitalization method, dividends (duly projected) become the "I" in the basic formula. The dividend yield rate which becomes the "R" in the basic formula is usually arrived at by discovering the dividend yield rate paid by comparable companies. As would be expected, the dividend yield rate will be much lower than a rate of return rate would be. Mathematical principles dictate that the dividend yield rate, used in the dividend capitalization method, would be less than the rate of return, used in the capitalization of income stream

30. An example of the capitalization of income stream method is:

| | | |
|---|---|---|
| Pro Forma Income Before Tax . . . | | $158,000 |
| Less: State Corporate Income Tax | 14,200 | |
| Federal Corporate Income Tax | 62,500 | 76,700 |
| Pro Forma Income After Tax | | 81,300 |
| Add: Depreciation | | 28,000 |
| Pro Forma Cash Flow Before Debt Service | | 109,300 |
| Less: Loan Amortization Needs | 10,000 | |
| Additional Working Capital to be Retained from Cash Flow | 15,000 | 25,000 |
| Available Income Stream | | 84,300 |
| Capitalization Rate | | 9.5% |
| VALUE . . . | | $887,368 |

In the above example, the appraiser assumed that $50,000 more working capital was needed in the form of a loan to be amortized at $10,000 per year. He assumed further that still another $15,000 of working capital would be needed each year as the business grew. Thus, $25,000 has been deducted from pro forma cash flow for debt service, resulting in an available income stream of $84,300. This income stream was then divided by 9.5, the capitalization rate. The . . . value . . . of $887,368 . . . [results].

*Id.* at 106-07.

method, in the same proportion as the dividends would be less than the earnings, although in practice this is seldom exactly the case. Of course, once the appropriate dividend yield rate is determined, it is divided into the projected dividends to arrive at the value of the company as computed by the dividend capitalization method.[31]

The price-earnings ratio method, simply stated, is merely the product of the net profits after tax of the company being appraised (adjusted for appraisal purposes) and the applicable price-earnings ratio, the latter theoretically being the value of a comparable company (in toto or per share) divided by the earnings (in toto or per share) of such company. In practice, of course, the price-earnings ratio is a judgmental figure arrived at after an intensive industry study, including a study of the prices of corporate stock and earnings of a number of somewhat comparable companies.[32] Despite its apparent non-relationship to the preceding basic formula, mathematically the price-earnings ratio method is the basic formula with one of its factors expressed in reciprocal form. That is, while under the basic formula, Value or price is computed by dividing Income or earnings by the Rate of Return, under the price-earnings ratio formula, Value or price is determined by multiply-

---

31. Computation of value by the dividend capitalization method, is illustrated as follows:

| | | Fiscal Year Ending | | | | |
|---|---|---|---|---|---|---|
| | | 3-31-72 | 3-31-73 | 3-31-74 | 3-31-75 | 3-31-76 |
| 1. | Net Profit Before Tax . . . | 153,707 | 130,410 | 137,741 | 155,039 | 102,574 |
| 2. | Deduct Corporate Taxes: | | | | | |
| | State Corporate Income Tax | (11,682) | (9,911) | (12,397) | (13,954) | (9,200) |
| | Federal Corporate Income Tax | (61,672) | (51,340) | (53,665) | (61,221) | (38,300) |
| 3. | Net Profit After Tax | 80,353 | 69,159 | 71,679 | 79,864 | 55,074 |
| 4. | Add Depreciation . . . | 13,406 | 19,149 | 16,518 | 19,766 | 28,720 |
| 5. | Cash Flow | 93,759 | 88,308 | 88,197 | 99,630 | 83,794 |
| 6. | Average Net Profit After Tax | | | | | 71,226 |
| 7. | Average Cash Flow | | | | | 90,738 |
| 8. | Dividend Paying Capacity Based on Comparable Firms: | | | | | |
| | 50% of Average Net Profit After Tax ($71,226 × 50%) | | | | | 35,613 |
| | 40% of Average Cash Flow ($90,738 × 40%) | | | | | 36,295 |
| | Dividend Paying Capacity | | | | | 36,000 |
| 9. | Dividend Yield Rate Based on Comparable Firms | | | | | 4% |
| 10. | VALUE . . . | | | | | $900,000 |

*Id.* at 122.

32. The Price Earnings Ratio Method is exemplified as follows:

ing the Income or earnings by the price-earnings ratio, which is simply a Rate of Return divided into one.[33]

Thus, according to pure mathematics, the value of a business determined by the capitalization of income stream and the value of the business determined by the price-earnings ratio method should be the same. But, in practice, such equality is seldom found because the methods for finding the facts for use in each method differ and accordingly the facts found often differ. Thus, while in the capitalization of income stream method projected earnings or income are used in the basic formula when computing value, in the price-earnings ratio method the actual historic net profits after taxes, duly adjusted for appraisal purposes but not projected into the future, are used. In addition, the capitalization of income stream method divides earnings by a rate of return determined by exercising judgment as to the proper rate due an investor for a similar risk from other comparable investments. While the price-earnings ratio method multiplies the earnings or income by a price-earnings ratio discovered from finding the price-earnings ratio of comparable companies.[34] Due to these differences of approach the results obtained from the two methods can be quite dif-

---

| | | |
|---|---|---|
| Adjusted Historical Net Profit Before Tax . . . | | $102,574 |
| 1. Deduct Applicable Corporate Taxes | | |
| State Corporate Income Tax | 9,200 | |
| Federal Corporate Income Tax | 38,300 | 47,500 |
| 2. Adjusted Historical Net Profit After Tax . . . | | 55,074 |
| 3. Applicable Price Earnings Ratio | | 15 |
| 4. VALUE . . . ($55,074 × 15) = | | $826,110 |

*Id.* at 118-19.

33. The above concept can be expressed algebraically as follows:

$$V = I/R$$

or

$$P\ (\text{Price}) = \frac{E\ (\text{Earnings})}{R\ (\text{Rate of Return})}$$

is the same as saying

$$P = E(1/R)$$

or

$$P = E \times \text{Price Earnings Ratio}$$

*Id.* at 102.03 and 111.

34. Price-earnings ratio of many companies are available through The Wall Street Journal, Standard & Poor's Stock Reports and Standard & Poor's Corporation Records, and Moody Manuals. The publishers of these papers or your local broker can furnish necessary copies of documents providing such price-earnings ratios.

ferent. The one requiring the greater amount of judgment may be the one most suspect, but computing the value of a business by both methods is recommended and then a value judgment can be made as to the figure nearest right under the facts of a given appraisal.

The discounted cash flow method (herein the discount method) is not a mathematical variation of the above basic formula. The discount method involves determining the present worth of the company's cash flow over a period of years and adding thereto the present worth of the liquidation value of the company's net assets. Desmond and Kelley describe the concept as follows: "This method requires a forecast of cash flow for a given number of years into the future. The present value of this cash flow is then computed. Any value of the assets of the business which is expected to remain at the end of the cash flow period is next valued on a discounted basis. The value of the company is the present worth of the cash flow plus the present worth of the residual assets less any liabilities expected to remain."[35] While this concept is not unduly complex, its application in practice is a bit involved.[36] Although Desmond and Kelley characterize the method as having limited

35. DESMOND & KELLEY, *supra* note 1, at 107.

36. Computation of value by the discounted cash flow method is recapitulated as follows by Desmond and Kelley:

| | Fiscal Year Ending: | | | | |
|---|---|---|---|---|---|
| | 3-31-77 | 3-31-78 | 3-31-79 | 3-31-80 | 3-31-81 |
| Pro Forma Net Profit After Tax | 81,300 | 85,000 | 90,000 | 95,000 | 100,000 |
| Add: Depreciation | 28,000 | 28,000 | 26,000 | 25,000 | 24,000 |
| Cash Flow Before Debt Service | 109,300 | 113,000 | 116,000 | 120,000 | 124,000 |
| Less: | | | | | |
| Loan Amortization Needs | 10,000 | 10,000 | 10,000 | 20,000 | — |
| Additional Working Capital Needs | 15,000 | 15,000 | 20,000 | 20,000 | 20,000 |
| Pro Forma Cash Flow | 84,300 | 88,000 | 86,000 | 80,000 | 104,000 |
| Present Worth Factor (9½% Rate) | .913 | .834 | .762 | .696 | .635 |
| Present Worth of Pro Forma Cash Flow | 76,966 | 73,392 | 65,532 | 55,680 | 66,040 |
| Total Present Worth of Cash Flow | | | | | 337,610 |
| Pro Forma Liquidation Value of Assets at 3-31-81: | | | | | |
| Accounts Receivable | | | | 300,000 | |
| Inventories | | | | 325,000 | |
| Prepaid Expenses | | | | 5,000 | |
| Machinery & Equipment | | | | 14,000 | |
| Furniture & Fixtures | | | | 19,000 | |
| Leasehold Improvements | | | | 12,000 | |

application,[37] they recognize that it serves a useful purpose in evaluating a special business whose existence is dependent upon a single contract following which the company may go out of business.[38] In addition, a form of discount evaluation is practical when evaluating the worth of damages caused a company by an action which deprives that company of future profits it otherwise would have earned. Many lawsuits have arisen over disputes about the present day value of such lost future profits.[39]

## C. *Comparable Sales Methods*

If it is true that the aim of all the balance sheet and earnings and cash flow methods is to find the present market value of a business, and if it is agreed that market value means the price a willing, unpressured and knowledgeable buyer and seller can agree upon, then it is difficult to argue with the conclusion that the most accurate measure of a business is its market selling price or, absent a selling price for the business being appraised, the selling price of a similar business.[40] Thus, the comparable sales method is to be given much credence. And, in one sense, it has the advantage of simplicity in that all the appraiser must do is find sales of companies comparable to the business being appraised and conclude that the sales price of a comparable company is the proper sales price for the business being appraised. But, just try to find a truly comparable business (one similar in size, type, financial

| | | |
|---|---|---|
| Tools, Dies & Molds | 5,000 | |
| Belmur Process | 5,000 | |
| Lamp Patent | 8,000 | |
| Goodwill | -0- | |
| Liquidation Value of Non-Cash Assets at 3-31-81 | 693,000 | |
| Present Worth Factor (9½% Rate) | .635 | |
| Present Worth of Liquidation Value of Assets | | 440,055 |
| Subtotal | | 777,665 |
| Less: Liabilities Remaining at 3-31-81 | | 10,000 |
| VALUE . . . | | $767,665 |

*Id.* at 110.

37. *Id.* at 107-11, 135.

38. *Id.* at 108.

39. R. DUNN, RECOVERY OF DAMAGES FOR LOST PROFITS (1978).

40. ENCYCLOPEDIA OF REAL ESTATE APPRAISING 5-7, 32, 383, 915 (E. Friedman ed. 1968).

statistics, age, plant, management, prospects, etc.) to the business being appraised. Better yet, try to find such a comparable business which sold recently.

While public companies can be found for purposes of comparing sales, earnings, dividends, and the like to similar figures for closely held firms, it is not always easy to obtain comparable public and private firms for the purpose of comparing managements, plants, and general prospects. Accordingly, there is considerable question whether any publicly-owned company is truly comparable to a closely-held firm. Similarly, it is difficult to find reliable information on the sale of privately-held firms. Even when such information is found, often there is a real question as to its comparability with the company being appraised. "Closely-held firms tend to be very individualistic and are strongly influenced by the whims, talents, and backgrounds of their owner-managers."[41]

Accordingly, when an appraiser utilizes the comparable sales method he must: (1) find as many sales of companies that are somewhat similar to the company being appraised as possible, (2) study the similarities and differences among the companies at length, (3) then by an extrapolated or judgmental process arrive at a determination of the value of an ideally identical company to the one being appraised, and (4) conclude that such determination provides the value of the company being appraised.

Notwithstanding all the problems involved in gathering comparable information, the market approach or comparable sales method is still deemed one of the most functional and useful, and any values attained by such method must be compared to the value-conclusions reached by other methods before a final appraisal is rendered.[42]

### D. *Correlation of Methods*

Obviously each valuation method has advantages and limitations. None is perfect. One sure truth is that the final decision is not determined by tabulating the final results of all eight methods and averaging them. But it is not a mistake to utilize all eight methods and tabulate and correlate the resulting values. Correlating such resulting values "entails analysis of the logic behind each approach as applied to the

41. DESMOND & KELLEY, *supra* note 1, at 124.
42. *See generally* ENCYCLOPEDIA OF REAL ESTATE APPRAISING, *supra* note 40, at 21-35.

company being valued."[43] After such analysis, there has to be a weighing and balancing of the strengths, weaknesses, and results of all the methods. These comparisons are vital to the veracity and accuracy of any final appraisal.

Rarely do such comparisons render a unanimous verdict of a single value. Hopefully, the results of several methods will approximate a single value and thereby suggest to the appraiser that such single value is the proper appraisal price. Occasionally, the results of one method alone will stand out as indicative of the fair market price for the company being appraised. If so, it should be used. In any event there will come a time for the appraiser to decide.

### E. *Evaluating a Single Asset*

The previous eight appraisal techniques are designed to arrive at the value of an entire business enterprise taking into consideration all of its assets and liabilities. However, sometimes an appraiser must segregate a particular asset for separate evaluation and thereafter add its evaluation to the balance of the business enterprise to arrive at an evaluation of the entire business.

Method 9, in the Handbook, is an example of such a situation. Method 9 is designed to value promissory notes which, prior to the date of appraisal, have been accepted by the corporation as consideration for the corporation's selling a particular business asset, for example, land. The method takes into consideration the fact that often such corporate notes carry a lower interest rate than money borrowed from a bank because the buyer of the asset (the drawer of the note) assumes that the seller is making a profit on the sale of the corporate asset, and thus the buyer is unwilling, at the time of the purchase, to pay the going interest rate on the promissory note. Finding the correct discount rate to reflect this fact is the essential ingredient of such note valuation.[44]

### F. *Evaluation of Personally Managed Businesses*

Evaluating the personally managed business, where the emphasis may be on what the owner can make from the business in exchange for his managerial services, can differ from evaluating a professionally managed business, where attention shifts from the owner's salary to the

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43. DESMOND & KELLEY, *supra* note 1, at 136.
44. *Id.* at 131-33.

ability of the hired manager to turn a profit for its owners.[45] When evaluating a personally managed business often the time and cost of the appraisal can become a factor. The first eight methods outlined above and discussed in the Handbook can consume many hours of the appraiser's time, involve extensive research into facts and circumstances, and ordinarily demand extensive knowledge and experience on the part of the appraiser. Such appraisals cost substantial amounts. Purchasers, sellers, and others needing appraisals are often not willing to pay for such appraisements, nor do they want to wait the needed time to allow the appraiser to perform a thorough job. They want their appraisal "now". To meet such circumstances and by reason of many historical experiences known to the appraising industry, there are rules of thumb that can be useful in determining ballpark figures for the value of a personally-managed business.

Desmond and Kelley provide fourteen examples of such rules of thumb for evaluating the personally managed business.[46] It is well to recognize that these rules vary greatly with the type of business involved, and it is important to ascertain, through experience and careful research, which rules of thumb are appropriate for use in evaluating the company being appraised. For example, insurance agencies sell for 125 percent to 150 percent of their annual fees plus separate values for their list of clients, working capital and fixed assets; whereas accounting and legal practices sell for the value of their goodwill computed at 50 percent to 75 percent of their typical annual historic billings (but not more than 2 to 5—usually 3 or 4—times the firm's typical, historic profits) plus the value of the firm's assets, including fixed assets, accounts receivable, work-in-progress, and other essential assets.[47] These formulas or rules of thumb are obviously quite different.

Although the rules of thumb differ from personal business to per-

45. In evaluating a personal business, earnings should be deemphasized because the very person who has contributed so significantly to the amount earned, the seller, will often not be involved in the business after the sale. Thus, a buyer of a personal business should recognize that because the very cause of the company's earnings may be disappearing with the sale, he should put more emphasis upon the value of the net assets or upon gross income (as distinguished from net income) of the personal business.

46. Such formulas are for appraising auto repair garages, liquor stores, advertising agencies, convenience grocery stores, bars, newspaper and periodical publication businesses, insurance agencies, auto wrecking yards, funeral homes, hotels and motels, nursing homes and mobile home parks, as well as service oriented businesses such as accounting and legal practices. DESMOND & KELLEY, *supra* note 1, at 151-56. *See, e.g.*, J. HANSEN, GUIDE TO BUYING OR SELLING A BUSINESS 167-91 (1975) (discussing fifty-three such formulas).

47. DESMOND & KELLEY, *supra* note 1, at 152-53.

sonal business, there are certain logical limits. "Generally, the business will not sell for less than its tangible net worth at market value, nor will it sell for more than five times net profit before tax but after a salary allowance to the owners."[48] This helpful overview for the inexperienced appraiser or counsel is furthered in the Handbook with an explanation that there are basically two types of rules of thumb, the sales-based and asset-based rules of thumb.

A sales-based rule of thumb applies a "market-derived multiplier such as .25, .50, 1.5 etc." to the "average annual sales of a business (pro forma or typical historic) . . . ."[49] The asset-based rules of thumb value the tangible net worth, at market, of a business and add a goodwill bonus "based on a multiplier times a typical monthly [or annual] pre-tax profit after provision for a suitable owner's salary."[50] Often it is useful to compute values by both types of formulas and compare them before choosing a final value of a business organization. Sometimes the concepts behind the two types of formulas are used together to arrive at a final value of a business entity. These general principles concerning rules of thumb do not replace knowledge of the customary rule of thumb used in evaluating the particular type of personally managed business, provided one is willing to go so far as to dub one rule of thumb as uniformly applicable to a particular business. There are a variety of opinions on the subject, but familiarity with some of the rules is a "must" for the good appraiser or business counsel. Thus, sources for such information are invaluable. A good source is the trade association of the business being appraised. Other sources are chief executive officers of similar companies. Experienced appraisers, lawyers, accountants, business consultants are all helpful, along with pertinent and competent literature like Desmond and Kelley's Handbook.

### G. *Evaluation of Goodwill and Other Intangibles*

Desmond and Kelley devote considerable space in their Handbook to defining and evaluating goodwill and other intangible assets.[51] Glenn Desmond adds needed discussion concerning goodwill in two monographs published separately from the Handbook.[52] These monographs are designed "to be used independently, or as an adden-

48. *Id.* at 156-57.
49. *Id.* at 146.
50. *Id.* at 144.
51. *Id.* at 161-229.
52. G. DESMOND, GOING CONCERN VALUE (BUS. VALUATION NEWSLETTER, Monograph

dum to the *Business Valuation Handbook*."[53]

In Monograph Number One, Desmond offers a much needed discussion of the differences between "going concern value" and "goodwill". In general, "going concern value" relates to that element of value which exists "in an assembled and established plant, doing business and earning money over one not thus advanced. . ."[54] It consists of and its value is measured by, such non-capital items as start-up expenses, developed procedures, methods and systems, established financial relationships, existing marketing procedures, advertising copy and ideas, promotional concepts, and established sources of supply. Differing therefrom, goodwill is "the expectancy that old customers will resort to the old places and the expectancy of continued patronage."[55]

Monograph Two and the Handbook discuss ten methods of appraising goodwill and other intangible assets. One of these is the formula adopted by the Internal Revenue Service for evaluating goodwill.[56] Three others relate to evaluating goodwill in eminent domain cases.[57] Six are concerned with evaluating intangible assets other than goodwill. They are the profit advantage method,[58] the relief from royalty method,[59] the cost savings method,[60] the cost to create method,[61] the cost to purchase method,[62] and the accountant's method.[63] Examples of intangibles, other than goodwill, include copyrights, patents, franchises, licenses, government-granted authorities such as an Interstate Commerce Commission authority to transport property by motor carrier, secret processes, methods and formulas, specialized mailing lists, customer lists, subscription lists, covenants not to compete, water rights, leases, drawings, film rights, and tax credits for past losses.

With the exception of the IRS formula for evaluating goodwill, extensive discussion of each such appraisal method is beyond the scope of this writing.[64] Because of its source, the so-called ARM-34 formula

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No. 1, 1979); G. DESMOND, VALUING GOODWILL USING UPDATED IRS FORMULA (BUS. VALUATION NEWSLETTER, Monograph No. 2, 1979).

53. G. DESMOND, GOING CONCERN VALUE, *supra* note 52, Introductory Comment.

54. *Id.* at 5.

55. *Id.*

56. DESMOND & KELLEY, *supra* note 1, at 181-84.

57. *Id.* at 222-28.

58. *Id.* at 184-85.

59. *Id.* at 185-87.

60. *Id.* at 188-89.

61. *Id.* at 189-91.

62. *Id.* at 191.

63. *Id.* at 191-92.

64. *Id.* at 184-92, 222-28.

for evaluating goodwill first promulgated by the IRS in 1920 and now updated by Revenue Ruling 68-609 deserves further discussion.[65] To determine the value of the goodwill of a closely held business by utilizing the IRS formula:

(1) Estimate the after tax earnings for preferably five years into the future and compute an average thereof. (Assume your answer is $200,000.)
(2) For each of the same five future years determine the market value of the company's tangible assets less all applicable liabilities and average same. (Assume a value of $1,500,000.)
(3) Using the rate of return on average net tangible assets prevailing in the industry being appraised or absent such information using a ten percent rate, compute the product of said rate and said average net assets to arrive at an estimated return on tangible assets of the company being appraised. (For example: $1,500,000 x 10% = $150,000.)
(4) Subtract such return on the tangible assets ($150,000) from your company's estimated average earnings ($200,000) to arrive at what the appraisers call "excess earnings" or "earnings on intangibles." (In example, $50,000.)
(5) Capitalize the excess earnings ($50,000) at a suggested IRS rate of 15% to 20% depending upon the relative hazards of the business. That is, divide the $50,000 by the 20% rate (assuming a somewhat risky business). The quotient will be the value of the goodwill of the company. (In our example, $50,000 divided by 20% equals $250,000 of goodwill.)

Of course, to arrive at the total value of a business, the tangible net worth of the business, plus any unusual values, must be added to the value of the goodwill determined by the IRS formula.

### H. *Appraising Minority Interests*

Three methods for valuing minority fractional interests in closely-held businesses conclude the twenty-four appraisal methods analyzed in the Handbook. These three methods, the cost to market method, the

65. Rev. Rul. 68-609, 1968-2 C.B. 327. Even though Rev. Rul. 68-609 expressly superseded A.R.M. 34, 2 C.B. 31 (1920), the IRS formula is still often referred to as A.R.M. 34. For an extended discussion on these rulings *see* [1978] APPELLATE CONFEREE VALUATION TRAINING PROGRAM, Pamphlet No. 49 (CCH).

comparable letter stock method, and the dividend yield method, are discussed within the larger framework of evaluating the entire closely-held business and its sub-properties, whether they are a minority or majority fractional interest. It is extremely important to the law-oriented reader to recognize that determining the value of fractional shares in a business entity is not merely a matter of finding a value of the whole business enterprise and pro-rating that value downward to represent the fractional interest being evaluated. For instance, if a corporation has issued and outstanding shares numbering 1,000 and the business enterprise is worth $2,000,000, it does not follow that each individual share of the corporation is worth $2,000. It makes a substantial difference whether the shares of stock being evaluated are part of a block of shares representing a majority interest in the corporate stock or are merely shares representative of minority interests in the corporation. "The owner of a minority interest in a closely-held business is generally in a rather undesirable position. His investment is virtually locked in. There may be no market at all for his shares, or to the extent they can be sold, the only buyers are often his fellow owners or the corporation itself. At the same time, the business may pay out little or no dividends or partnership distributions. As a minority holder he is virtually powerless to change this situation."[66]

These facts tend to minimize the value of a minority interest in a business entity. That being the case, the legal or business advisor to a person owning or about to purchase a minority interest can serve his client well by advising of the pitfalls of such ownership and their usual resultant diminution of value. A lawyer can secure a reduced estate tax for his client with such knowledge. A business consultant can often save his client who plans to purchase a minority interest considerable dollars by giving him arguments for negotiating a lesser value for such shares than would be prescribed for the majority shares of a corporation.

It is useful for these advisors to know that more and more courts are recognizing the merits of discounting the value of minority interests. "In the 1930's, about 20 percent of such cases [cases involving the valuation of minority interests in closely-held firms] involved discounts. By the 1970's about two-thirds of the cases recognized minority

66. DESMOND & KELLEY, *supra* note 1, at 233. For further discussion on the problems of the minority shareholder *see generally* F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS (1975).

interests discounts. . . ."[67] Desmond and Kelley report that whereas in the 1930's the maximum discount was around 33 percent, now in the 1970's the maximum discount approaches 55 percent.[68] "One knowledgeable writer," they observed, "suggests that discounts of up to 90 percent may now be in order."[69] Because of the tremendous dollar savings that can be accomplished by utilizing appraisal techniques demonstrating the diminution of minority interests in a business, a careful review of the few pages discussing such methods in the Handbook is highly recommended.[70]

Of course, not all minority interests should be subject to discounting. For example, if two parties each own a 48 percent interest in a company and a third owns a 4 percent interest, the latter could control shareholder decisions if the first two were in disagreement. Such facts could make the 4 percent block of stock very valuable. Further, a 16 percent minority owner could find his stock very valuable in a state having laws authorizing shareholders owning two-thirds or more of the voting stock of a company to effect a merger or sale of substantially all of the company's assets, if a 51 percent owner desired to effect such a merger or sale without having the consent of other shareholders.[71] The appraiser, lawyer, accountant, and other professional, as well as businessman, must be aware of all such circumstances in considering the value of fractional shares or interests in a company.[72]

## V. CONCLUSION

If one insisted upon being critical of the efforts of Desmond and Kelley, one would point to their virtue as their weakness. The clarity

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67. DESMOND & KELLEY, *supra* note 1, at 233.
68. *Id.* at 234.
69. *Id.*
70. *Id.* at 233-37.
71. *See, e.g.*, ILL. REV. STAT. ch. 32, §§ 157.64, -.72 (1977); MO. REV. STAT. §§ 351.400, -.425 (1978). *But cf.* OKLA. STAT. tit. 18, §§ 1.164, -.166 (1971) (Oklahoma does not require such a high percentage of the voting stock to effect such a merger or sale of stock).
72. There are many other facts that have an influence on values of fractional shares in companies or interests in companies, and they need to be considered by anyone evaluating such fractional shares or interests. The effect on the price of stock or a business interest when the same is sold in large quantities (sometimes called blockage) needs to be considered. Similarly, stock held in trust may lack marketability due to special provisions of the trust. Likewise, stock restrictions in buy-sell agreements and similar restrictive agreements must be considered in evaluating either majority interests or minority interests. Thus, any person seeking to appraise fractional interests in the company has many special factors to consider. For an effort by the Internal Revenue Service to minimize the claims of taxpayers for discounting the value of fractional or restricted interests in business enterprises *see* APPELLATE CONFEREE VALUATION TRAINING PROGRAM, *supra* note 65, at 107-109.

and preciseness of their presentations often omit the sometimes desired reasons for a given step, or even more, the scientific rationale behind the various methods of evaluation described in the Handbook. The reasoning of the value of the valuation methods themselves is not part of Desmond and Kelley's Handbook.

Good, or bad? Depends upon why you want to read Desmond and Kelley. If it is to learn "how" to appraise a closely-held business or to be a legal, or other professional advisor, or judge, able to understand and participate in the appraisal process, then *Business Valuation Handbook* is for you. On the other hand, if you seek to analyze and understand the merits and demerits of the theories lying behind the various valuation methods, to evaluate intellectually the worth of the methods themselves, and perhaps add to the wisdom of the ages on the subject in your own right, then the Handbook may not be sufficiently omniscient for you. But a quick rebuttal to that possible failure of Desmond and Kelley could be that even for such in-depth thinkers the Handbook is still a first step for learning the principles of evaluation. There is merit in the proposition that one should learn to pound nails before attempting to understand blueprints.

In short, Desmond and Kelley's Handbook and the related Monographs are recommended reading to anyone concerned with the business of appraising closely-held businesses.[73] We have learned much from them. We also know that you can render your clients a great disservice by not knowing the principles of appraising a business enterprise. Equally true, it will be to your clients economic advantage if you are knowledgeable in the field of business valuations.[74]

73. As this article goes to press a 1980 revised edition of DESMOND & KELLEY'S HANDBOOK is coming off the press. It is substantially the same as the 1979 edition with, of course, some improvements and reorganization.

74. The authors wish to express their appreciation to Glenn M. Desmond and John D. Huelster (see note 15 *supra*) for carefully reviewing the manuscript of this article and offering valuable changes and additions to the article.