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SUMMARY KEYWORDS

appraisal, method, goodwill, business, firm, practice, tangible assets, expert, assume, reports, appraiser, customers, thumb, theory, buyer, barbers, called, income, transactions, intangible asset

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Hello, my name is Michael sack I Molly. I'm a certified public accountant, certified valuation analyst. And the name of this course is goodwill in small service businesses. And this is a guide for attorneys and judges. A little bit about me, I have over 35 years of accounting and consulting experience. I've taught accounting, economics, statistics and mathematics and colleges in Maryland and Wisconsin. I have graduate degrees in accounting and philosophy. I published many peer reviewed articles on valuation theory in professional and academic journals. I'm currently on the editorial board of the Journal of business valuation and an economic loss analysis. I've served as an expert witness in Wisconsin and Maryland. And I'm the author of over a little accounting text called financial accounting, and mercifully brief introduction. And more on point for today's topic, I am the author of goodwill in small service businesses negotiating a fair price which is now available at Barnes and Noble on Amazon. And most of the material that I'm going to be going over in this two part course, comes from this book. And so I strongly encourage you, if you like the material and are interested in the material and find this useful, order the book, there's more detail and you can go over at your leisure. Some of the tables and examples that I'm going to use in this course, you'll find in the book as well. So the course is in two parts. And the course goals are these. We understand if you're an attorney and judge that you often encounter the issue of goodwill and closely held businesses and a number of different contexts. There's divorce, there's estate and gift tax, there's buy sell agreements, and there's partnership and corporate dissolutions. Now traditionally, when you when you as a judge or an attorney encounter goodwill questions, particularly in trial situations, you will be relying on appraisal experts to determine the value of goodwill. appraisal theory recognizes multiple methods and procedures as acceptable methods. This leaves room for experts to arrive at widely varying values for goodwill and contested cases. I'm sure that if you have had this kind of experience as a Trier of fact or as an appellate judge, or as an attorney representing one client in a evaluation dispute, and you received a report from a credentialed appraiser, you see 50 to 75 pages of

tables, you see many different methods discussed and you have arrived at a number. Often in these cases, you'll have another expert, also armed with 50 to 75 pages or 100 pages of of a report filled with tables. And at the end the number is diametrically opposite or different than the number that the first expert had. So we have a situation now very commonly, in cases of goodwill, where you have equally credentialed experts all using equally acceptable methods of appraisal coming out with diametrically different results and you are forced as the attorney or Trier of fact to try to determine which number makes most sense. The first part of this course, will basically provide you with a explanation and critique of the methods that you are likely to see in these reports or have already seen in these reports, and it will allow you to better judge and evaluate the merits of expert opinion when you receive valuations and appraisal or appraisal reports from credential appraisers. That is the first part of the course. The second part of the course will introduce an appraisal methodology that leads to I believe, more economically fair and reasonable outcomes than the widely used methods of current appraisal practice that you see in in reports and testimony of experts currently.

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Okay, so we begin our discussion with the question of what is goodwill. One of the best ways to determine goodwill is to look at marketplace transactions. If you have in an equity exchange rational, competent and motivated buyers who are willing to pay a amount for the equity of the closely held firm in excess of the tangible assets, that market transaction is telling you that you have goodwill. Question is, why would a rational, motivated competent buyer pay more than the tangible assets? For a closely held firm? What What is this goodwill that they're willing to pay above the tangible asset value of the company for what is it? Now the question we have to look at is how should buyers and sellers negotiate a fair value for goodwill? Now, this question is a market transaction question. But as an attorney, as a Trier of fact, or as an appellate judge, you have to look at that question and say, when you have two wildly different appraisals for a closely held firm, you have to decide what is the fair value, what is the reasonable value, so you are in effect, putting yourself in what is often market transaction where you have a buyer and seller trying to negotiate a fair a fair price, you as a Trier of fact or as an as an advocate, have to put yourself in the position of saying, if I were buying or selling this company, what would be a reasonable price for the equity? To get a handle on this very large and often difficult question, I think it is best to start with looking at Goodwill and small personal service firms. These are firms that typically typically have buyers willing to pay significantly more than the tangible the value of the tangible assets of the company. And as you can see from this slide, we're looking at accounting and bookkeeping practices, we're looking at dental practices, we're looking at chiropractors, we're looking at vet veterinarians, we're looking at barbers and hairstylist, house cleaning services, landscaping, lawn maintenance, and pool maintenance. What all of these types of businesses and service firms have in common is they have markets that are active. And by that I mean is you have Business Brokers and specialists who specialize in the buying and selling of

these practices. So if you haven't own and counting practice or a dental practice, or you were a hairstylist and you wanted to sell your business, it would not be difficult for you to obtain a broker who specializes in exactly buying and selling these businesses. Now, these of course, specialists are selling the business again, at a price that is normally quite quite in excess of the value of the tangible assets. So they are selling something and that something is goodwill. And we need to drill down a little further though, in terms of what what is it that buyers of these businesses are trying to have access to that wouldn't make them willing to pay more than the tangible assets. So let's look at Goodwill. What are the elements of goodwill? If we go back to the list of services, one of the first things you notice is that they all involve critical personal services. The accounting and bookkeeping practices deal with people's finances, dental practices, chiropractors, veterinarians are particularly dental practices. chiropractors are dealing with your personal health, that Nigerians are dealing with the health of your beloved pets, barbers and hairstylist are dealing with you know how you look your grooming, very critical. House Cleaning Services, landscaping, lawn service, new pool maintenance, your home, all of these services are a vital impact. They're very salient to customers, clients and patients. That's that is a critical feature of these businesses. What else do they have? These are businesses that have repeat customers, repeat clients, repeat patients again, go back to the list, accountant accounting and bookkeeping services. You don't have to file just one tax return once in your life. You have to file a tax return every year. If you are a business. You have to provide financial statements to your bank or to your lender or to your stockholders. Not once but On a continuing basis, dental practices, you don't go from one teeth cleaning in your life, presumably you go once or twice a year, your fillings, your cavities. Unfortunately, you have those more than once again, repetition, chiropractors veterinarians, the same thing, your vet, you know, your pet gets sick. Unfortunately, more than once, barbers and hair stylists same thing, same basic concept. You don't go for one haircut in your life, you don't go for one styling in your life. These are businesses that by their very nature require repetition, lawn maintenance, poor maintenance, not once, but over and over again. What else do they have? These businesses have,

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a regular pattern and patronization. When we talk about repetition. In most of these businesses, we can particularly when we look at the average pattern over the customer over the the customer base, the collection of customers, clients or patients that these businesses have, you can come up with reliable averages as to how long you know how often they will patronize the business, we know that in a tax practice, they're going to come once a year for barbers, we know that most of the people are going to come on a regular pattern of four to six weeks. With dental

practices, it might be a little bit more irregular. But again, if you have a large enough practice, you can, you can develop patterns. And you can predict on a fairly accurate basis how repetitive The patronization is going to be. Similarly, with house cleaning services, landscapers, poor painters, all of these businesses require repeat patronization. And there's a pattern to these patronization, which allows a buyer to look at a customer base of these practices and say, Okay, I know that if I'm successful in making a transition from the seller, to me, the buyer that I will have a fairly built in regular pattern or patronization when I buy this business. Another key factor that drives this intangible value of goodwill, in these kinds of businesses is that the relationship between the business and the customer, client or patient is exclusive. Very rarely do you go to two accounts. Very rarely do you go to two barbers or use two different dentists. This you have a trusted dentist, a trusted chiropractor, trusted veterinarian, a trusted accountant, a trusted house cleaner. Once you have this trust, you believe that the people are honest, you believe that they're competent, they believe that you are charging a fair fee that they're charging you a fair fee, you're not likely to want to have a second or shopped around too much for somebody else once you've got that trusted service provider. So that exclusivity of relationship is very, very important in generating goodwill. Another critical feature of the service firms that we're looking at is that the providers of these firms do not have to be large corporations. Oftentimes, they're small, own small business owners, they might have, you know, four or five chairs, they might clean, you know, only 50 or 60 houses if they're a house cleaner, the chiropractor might have a patient load of no more than a couple of 100. Similarly with barbers. You know, the accountants, a small accountant operating out of their own home can have their own home office in service of a few 100 clients. So often these provider firms are small. Now, the most critical thing from a market perspective, from the standpoint of this intangible value value we call this intangible asset we call goodwill is that the customer, once you once the owner of the firm has established this trust is in a position to transfer their client base their customer base their their patient base to a new owner. And what does this mean? It means in effect, that if if a barber if I've ever encountered if a dentist if if a landscaper says, Look, I'm retiring, I have to move I'm ill. I'm selling this business to a new service provider. And this service provider in my opinion is going to provide you with the same quality of service at a reasonable price. you as a customer, you as a patient, you as a client are going to be willing to give the new owner a chance to provide the services that the that that your old service provider had given you. Now, this is a very, very, very valuable asset. And this is really the core of goodwill, if you can transfer an entire client base an entire customer base of clients, patients, customers, who will regularly repeat their business, this is the core economic substance of goodwill.

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This is what these broker transactions this in the broker transactions and again, widely active broker markets, this is what dentists buying dental practices. This is what accountants buying accounting practices. This is what landscapers buying landscape practice landscape service businesses, what they are buying access to, is that repeat, transferable customer base, if you can

just in one fell swoop give me access to 50 new dental patients or 100 new bed dental patients or 100 new landscape

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homes that

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need landscape services, guess what, as a as a buyer, I don't have to compete for them. And because of the nature of the trust, and the fact that these businesses, once people are satisfied with their service pride because of that trust, it's very hard to gain to gain new clients, patients customers in these areas, except by referral. And referrals don't necessarily come that often depending on how large the market is and how much turnover there is in the market. So when a successful dentist, a successful barber successful veterinarian is in a position of retiring, what they're able to do is to provide an opportunity for the right buyer for the right. motivated and competent buyer to have access to a whole bunch of customers, clients and patients that they otherwise would have to wait years to get. So this is the economic source of goodwill. It is not simply the repetition, but it is the ability to take those who do basically have access to them in one transaction and have the access in a way that if if, if as the buyer, you can prove that you can provide as good a service at a reasonable price or comparable price to what was being done. You can basically establish the relationship the trust relationship that the seller had. This is the essence of goodwill. It's important to distinguish between enterprise and personal goodwill. The types of goodwill I've just been talking about. With these practice sales involve enterprise goodwill, you'll often see in contested cases, situation with a professional will claim and often correctly, that they have personal goodwill. Personal goodwill means that the customers patients or clients are not likely to continue patronizing the firm after the seller retires. Typically, medical specialists with a wide reputation have personal and not enterprise goodwill. And there are many professionals, particularly in law and architecture and engineering that have a reputation and get referrals from other professionals or from past clients. But their reputation is not basically something that somebody would pay to have as in an asset acquisition and an equity acquisition. They wouldn't buy it because that reputation is not transferable in the enterprise goodwill that we're talking about here. Even though the seller is the chiropractor's, the veterinarians, the accountants, the barbers, the hairstylist, even though they've established a personal relationship that is based on skill, it is not so personal. It is not so unique that the clients and the patients and the and the customers wouldn't give the new owner a chance to at least show that they have comparable skill. It said in cases of heart specialists and people who have these kind of reputations whether it is not transferable. If there is no enterprise goodwill, there's personal goodwill and this is something that you as attorneys and judges will confront. Again look always look for the possible With the transferability of a client base, that is the essence of the value. Now

want to turn now to the traditional appraisal methods that you're likely to see in these big valuation expert testimony reports. But before I do that, I want to tell you a

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simple economic truth that the appraisal community does not necessarily want to advertise in any widespread way. And the truth is this, that these broker transactions and there are 1000s of them, involving the types of service businesses that we've been talking about, are not valued, are not valued on any of the rigorous approved appraisal methods that you are going to see in your litigations. Let me repeat that for emphasis, everything that you see in those 75 page reports are totally ignored by the real world marketplace. So, you would ask yourself, if they are not using the widely accepted expert methods? What are people using to appraise this goodwill, this intangible asset? And the answer is they're using rules of thumb or formulas. a rule of thumb is an easy to apply formula rule leading to a supposedly precise equity value. And I have on this slide examples. accounting and bookkeeping services, a rule of thumb that is widely accepted and widely used in in actual market transactions is one to 1.5 times annual Billings. dake. barbers hairstylist and their nail salons will have a rule of thumb that says 35 cents for every dollar of annual revenue plus the cost of fixtures. dental practices will range from point six 2.65 times annual revenue, cleaning and janitorial services will be point four or five times annual revenue. These are quick and dirty rules of thumb.

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Now, why does the marketplace use rules of thumb? Well, number one, they're simple to use. Number two, they're often based on gross revenue, not net income. Now this is a very important point. Because net income as found on a tax return or on on audited financial statements, is often very hard to figure out. And we'll talk a little bit more about that later. But the point is gross revenue, the amount of top line revenue, the sales revenue, the the gross fees is often easier to determine than the net income. So formulas based on gross revenue are easier to use, because gross revenue is easy to ascertain. The other really big advantage to rules of thumb is they're seemingly precise. They don't give you necessarily a range, they tell you this is the exact value of the practice or the business that you're buying. The problem with them is that they're totally arbitrary. You have to ask yourself when you go back to that list, why do accountants get one to 1.5? Why not two not why not point seven but why the chiropractor's settle for point six and point six, five and not point five? Guess what? No one can answer that. Because these are so you basically rules of thumb handed down by Business Brokers reinforced by sales. And there is really no apparent reason why these numbers settled where they did so they that there's no economic theory behind them. And this is one of the reasons why In fact, the major reason why different appraisal more formal appraisal theories have been developed. Now, the other problem, in addition to them being arbitrary and not having any clear, you know, reason why these numbers

work is that they often ignore important economic conditions that apply to specific transactions. Let's go back to our accounting and bookkeeping service. Suppose I have an accounting practice that generates $100,000 of fees a year. But suppose I'm an older accountant who is selling my practice because I'm getting old and I don't want to, I no longer can are no longer willing to continue to provide accounting services. Now, suppose as is very reasonable that my accounting practice consists of mainly people in my age group. And suppose I'm 70. Now, take another practice generates $100,000 of fees, but this is owned by a younger person, say somebody in their 40s. Now this younger person in their 40s, unfortunately comes down with a significant disease and has to retire early. Now that person's client base is made up of younger people. Now, again, you apply a rule of thumb of one to 1.5 to the same practice, and you get 100 $250,000 value for both practices. But which one is really more valuable? When you look at the older person's practice, you realize that those older people are only going to be clients for so you know, a certain number of years that they live, whereas the younger, the younger practitioners client base is younger, and they will in effect have more future patronization is more funeral fees. And but but guess what? The formula didn't catch that. The formula alone can't drill down can't give you enough information, enough guidance to really decide what a fair amount is. But despite the limitations, despite the arbitrariness of these rules of thumb, they are by far the most popular way in which actual businesses and equity exchanges have closely held firms take place. The other more formal methods, while they're not, not accepted by the brokerage community, are not accepted by the appraisal expert community, the valuation analysts, the people who are giving you the 75 to 100 page documents, what they're not accepted there, they are totally accepted by Business Brokers who are actually brokering the exchanges. Now, here's something that I want every attorney who is listening to this course to recognize.

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If you receive a large appraisal report by an expert appraiser, and you go through and they look at the different methods, and we're going to we're going to go through them shortly. If you ask that appraiser if they were selling their own practice, and many if not most of these experts are CPAs. And they are a new ask them, would you apply to you to the sale of your own practice? Have you sold your own practice? Would you apply any of the methods that you have put into this appraisal report for whatever the client businesses or the client businesses? And if they are honest, they will say no, what they would do if they sell their own biz, what these experts will do is they will not apply their own theory, they will use a rule of thumb. And that rule of thumb for accounting practices and CPA practices is around one to one and a half, sometimes two times gross Billings, and they would not use on their own practice, what they are advocating for in the 75 or 100 page report that they've put in front of you as an attorney or judge. If they're honest, they'll tell you that or at least they will weigh if you're in a deposition or an expert, they will pause and they will have to consider very carefully their answer because the truth is that the the practices themselves of expert appraisers are not sold, utilizing the methods that they use to

appraise businesses and that is a very telling flaw in the formal methods necessary so the question is the marketplace rules and the marketplace is basically saying work, you know, we're gonna keep using these rules of thumb even though they're arbitrary. Why is that? Well, cognitive cognitive behavioral economic theory has some answers for that question. And one of the answers is that a rule of thumb is what is called a cognitive anchor. A cognitive anchor applies when you give a human being a difficult to estimate problem. The exam Coming out of cognitive behavioral theory is, if you ask somebody to appraise the length of a line, you give subjects in an experimental length of the line. If that is a very difficult task to do, and then you suddenly provide a, a cue, some kind of cue, a number cue, people will anchor on that cue, even though that cue might have nothing to do with the correct measurement amount. This anchoring is universal, a universal feature of brokered sales, if you go to or if you go to a broker, and you're a dentist, and you're selling your practice, and you know nothing about the valuation of goodwill, you know, you have it, you know, you you're giving something of value, and the broker tells you that the standard amount is, you know, point six, five times your gross fee. Your inclination is, what are you going to say? No, that's not right, I want you to prove it, no, what you're going to do is you're going to accept it. And once you have that number in your head, you're likely to hold to it, it's an anchor, you're not likely to move off of it. And one of the other reasons that I think that you have to acknowledge that rules of thumb dominate the marketplace is that they while they may be arbitrary, they may not be clear as to how they are derived. They obviously are at least just good enough to not cheat either the buyer or seller. And most importantly, the reason why rules of thumb still dominate the marketplace is that the alternative theory that we're going to go over the more formal methods that you see in those 75 to 100. Page reports are not sensible, or rational or fair enough to give them an alternative that the marketplace really feels is better than rules of thumb. We've seen what what creates goodwill, repeat customers clients that are transferable to a buyer. We've seen that rules of thumb are how real world brokered transactions take place. Question is, can we do better, because rules of thumb were arbitrary, and no one knew where they came from. It was totally justified for appraisers, and appraisal theorists to look for more substantial

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methods methods that had were rooted in the fundamental economics of enterprise goodwill, and try to develop methods that made more sense than the seemingly arbitrary and simplistic rules of thumb.

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So

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now we turn to what you're likely to see. And the 50 to 100 page reports, which you're likely to see when you have a credential appraiser in front of you testifying to the value of a closely held firm. Now, I should just say briefly that you're going to see an alphabet soup of of expert credentials. And NAC VA National Association of evaluation analysts, NAC VA has the CVA that's the credential I hope I had which is called certified valuation analysts, the aasa the American Society of appraisers have their certifications and the AI CPA, the American Institute of Certified Public Accountants has their credential, va va. All of these credentialed experts trained by these three institutions, the icpa NAC VA, and the American Society of appraisers teach essentially the same theory. So you're likely if you if you have somebody who is an a VA or CVA, you're likely to see the same kinds of methods and techniques and theories that I'm going to go over here. So, essentially, when appraisers are taught the theory there, they're basically saying you've got asset, market, and income methodologies. Those are the three broad categories of theory and practice and methodologies that all these certified appraisers, appraisal experts are trained in the first group that we should be discuss is the market methods. And the idea of the market method is pretty simple and pretty compelling. And that idea is that if you can find a recent equity sale of a company similar to the subject company, and I'm going to use that term SC, you'll see it on the slide. Several companies just a fancy name for the company you're valuing. So we call it the subject company sec for short. So if you see, if you have indications of recent equity sales of companies that are seemingly similar, similar to the subject company, then those sale prices ought to be useful in appraising the equity of the subject company in front of a very simple idea. Now, the in terms of actual methods, there are two kinds of methods you'll see when the market method is applied. You'll see what they call the transactional data approach. And you'll see a more a little bit more rigorous method called the publicly traded company approach. The transactional database approach essentially is this. Based on equity transactions reported on various databases and these databases are usually done deals, pad stats biz comps, or iba market data. These are transactions that have been reported by Business Brokers. And the logic is simple if the buyers are willing to pay on average 8.4 or five times annual revenue for for the firm's sold in the database, then the subject company and the subject company operates at a similar scale with similar operating results, then it is reasonable to suppose another Bible will will pay that same point four or five times the annual revenue of the subject company. The problem with the transactional database approach from a practical standpoint is there's often not enough information to determine if the firm's reported in the database have sufficiently similar operating characteristics to the subject company that you're you're looking at in your appraisal report. The reports only include broker transaction, and that's an important point because these broker transactions also may not be representative because while there are 1000s of broker transactions, many there are also non broker transactions where firms are, are sold on buy sell agreements, or no broker is involved in the transaction. And in fact, the non brokered transactions are often situations where the seller has a partner, or has a trusted employee, that they've grown to be the successor and do not need to go out into the marketplace to find a suitable buyer.

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types of transactions are not reported in the databases, because by the very nature of the database method, we're looking at broker transactions. My point here is that if the owners of the of the broker transaction had not done the dude, you know, the the groundwork to find a suitable buyer ahead of time, they have to pay the brokerage fees, are they as well managed, as a firm that has had a succession plan has been able to do a buy sell agreement with a trusted employee or a partner? I would question the fact that, you know, these are necessarily the same types of business. Another very key important failing in these databases, they fail to disclose the appraisal methods used in determining the sale price of the equity. So you'll see you might see in the databases, what the initial asking price is, and then you might see the actual negotiated end price. But you don't see what method was actually used to to appraise the particular business that's being reported. And here, of course, is the bottom line problem. What I want to say to you and what I want to say to anybody who uses the transactional data base approach is that it is almost a certainty that the transaction, the original sale price, and the negotiated ultimate price were developed out of a rule of thumb. So what you have in the transactional database method is simply a reinforcement of the power of rules of thumb. You don't really have necessarily any economic substance beyond the little bit. It's given by a rule of thumb and we know that was the thumb are pretty much arbitrary. So if Those broker transactions that are being reported are based on an arbitrary rule of thumb, you really are not necessarily ahead using those market broker transaction. And that would be my big criticism for using transactional databases. In effect, you realize it's just a method of reinforcing the power of rules of thumb. Let's look at the the other market method and this does not suffer from this reinforcement problem that the transactional database method suffers from the second method. The alternative and market method to the transactional database approach is called the guideline public company method, sometimes accurate, shortened to GPC. The basic idea is that if you can find a publicly traded company offering the same line of products or services is the subject company, you ought to be able to utilize the pricing of these shares as a guideline to pricing the equity of the subject company. Now, the best way to understand it is just to see the mechanics of it, and I have on this slide an example.

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And SC has earnings, annual earnings of $100,000. And for the purposes of this example, assume that they just have one share of stock outstanding. Now, assume that the average selling price per share for a group of publicly traded companies assumed to be in the same line of business, as the subject company is 630 $6 per share. Assume that the average earnings per share for the

public group is $3. Now earnings per share is equal to the net after tax profit divided by the total number of common shares. This entails that the price earnings ratio is 12. The quartered per share market price of $36 divided by the earnings per share are $3. Now here is the algebra of how the GPC method works. You have the price of the public company, which is the average price per share the guideline pump for publicly traded companies. So when you see this method applied, you're usually the expert appraiser will pick out anywhere from three to five to 10 different companies that are supposedly similar to the subject company. In this example, we're assuming that that average sale price was $36. The earnings per share for the public company, again is the average earnings per share the guideline companies traded we're assuming here in this example is $3. Now in our subject company, our earnings per share is the $100,000 annual revenue divided by the number of shares, which I assumed for simplicity was just one. So now what is that using these ratios? What is the value of the shares of the subject company. As the next slide shows, the ratio is the price of the public company divided by the earnings per share the public company is equal to the price and this is the value of the subject company divided by the earnings per share the subject company, and the GPC method assumes that the ratio of the price to earnings per share the subject company ought to be the same ratio of the price to earnings per share of the public companies. And substituting the known values you can see by the slide, the ratio of the public company is 36 to three, the ratio on the of this of the subject company is the the price or the value divided by 100,000. The resulting value, the value using this method is $1,200,000. The key practical problem with this approach is comparability and the fact is that if you are looking at an appraisal of a small, closely held service company of the sort that we're looking at, and you're likely to encounter fairly frequently, in your legal practices in your trials, it is virtually impossible to find any publicly traded company with sufficiently similar operating characteristics to the smaller service company, service firms that we're looking at in the closely held firms it just not possible the scale of operation, the diversity of products and services make these companies basically not comparable and that is the key flaw in the in the method. For that reason, you know, you may not see it in the big reports, but occasionally you will. The next category of methods that is widely trained, widely taught and used by trained experts is called the asset methods. The asset method the basic idea is this, the value of an of a subject called equity is simply the sum of the values of the firm's assets less liabilities. basic logic is the whole is equal to the sum of its parts. Problem is appraising the value of tangible assets and liabilities is not difficult. But the intangible asset appraisal is harder. Again, it's that it's that increment above the tangible assets that everybody tries to struggle is what is that goodwill worth? How do we develop that price? You know, how do we develop, assign a value to that intangible?

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There have been and and to a certain degree, the method has fallen on hard times, justifiably, I might add, there is a method called the Treasury or excess earnings method. And it's called the Treasury methods because the original use of the method derives goes back to the, to the

implementation of prohibition in the 1920s and the early 1920s. The breweries and distilleries that were going to be put out of business by the volstead Act, suffered a tremendous loss, they could no longer sell their products. So they needed a method that the IRS needed a method to value that loss. So they had to come up with a loss not only the tangible assets, but the intangible assets that these these these breweries and distilleries were losing. So they came up with this method called the Treasury, or excess earning method. And the basic logic of this method is the presence of goodwill can be detected and measured by the existence of profits in excess of some average. And I put that in scare quotes, rate of return on return on a firm's tangible assets. Again, looking at the slide and looking at an example is the best way to understand the method, there's three steps to the computation. First, you compute a fair and I put that again, in scare quotes, rate of return on tangible assets, then again, in square quotes, the second step is take a fair return on tangible assets and subtract that from the total net income to arrive at what they call an excess earnings figure. You then convert that excess earnings figure into a lump sum by dividing by an appropriate rate, which is called a capitalization rate. And we're going to talk significantly more at length on about capitalization rates are shortly. So here again, that's to look at an example, to see how the method works. In this case, the subject company has $45,000 worth of tangible assets $10,000 of liability and $50,000 in net income. It is assumed for the purposes of this example, that a fair return on tangible assets is 10%. And an appropriate an appropriate capitalization rate is 20%. You can see following along with the slides, that you apply the 10% fair return on tangible assets against the $45,000 amount of tangible assets to to to arrive at a 40 $500 fair return on tangible assets, takes the total from net income, which we assumed to be 50,000. And then we subtract that fair return on tangible assets of 4500. And then we arrive at what's called the excess earnings. These excess earnings are assumed to be derived from the intangible assets, we apply a capitalization rate to the excess earnings, which again in this case is we assumed to be 20%. And we then have an imputed value of goodwill of 227,500. We then take the tangible assets 45,000, the imputed value of of goodwill of 227,500 we arrive at 272,500 of total assets, subtract the liabilities, and voila, equity value in the form 262,500. There are significant problems conceptually and practically, with this method. And this method, again, is you're not likely to see this too often in your reports anymore, but you still couldn't see it. So I felt it was important to

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you know, included in this in this course. Problem with the method is first there is no obvious way to separate the overall net income of a company into two components. There are no databases showing historical rates of return derived strictly from tangible assets and or historical rates of return derived strictly from goodwill. The numbers I put in to this example were picked out earlier. There's no justification for saying 10% is due to the tangible acid and the rest is due to excess you know to excess earnings. There's no place you can go to just define those kinds of percentages. Usually net income from any business derives from a synergistic use of all operating assets,

tangible as well as intangible. And there are no theoretical grounds for assuming that the tangible assets provide a base level of return. And the excess above that base level is a trivial will go well, why not assume the reverse order. And in fact, we're dealing with small service businesses where expertise is the main generating source of revenue. So assuming the opposite would make more sense. Certainly, in manufacturing, situations where you have distillery, a distillery, maybe the assumption makes more sense that the main source of, of the income is due to the tangible assets, but in in the kind of businesses that create an enterprise goodwill, the opposite assumption works. So you know, Treasury excess earnings method is really not an acceptable approach. And as I said, you probably won't even see it that much in current appraisal reports. Now, another cost method is that has been developed by and used by some practitioners is called the replacement cost method. Now, this derives from the analogous replacement cost methods used in the appraisal of real estate, the idea is that the value of an asset cannot be worth more than the cost it would take to replace it. This, this, this replacement cost concept is, as I said, applied in real estate when one of the standard methods that when you appraise a piece of real estate with a building on it is to calculate what it would take to replace that building. And certainly no rational buyer would pay for that, that building in a market transaction, what they could, in effect pay in reconstructing it. So there's a there's a logic there that makes some sense. And so, we apply this replacement cost concept to the appraiser goodwill. And here again, look at the example on the slide, which makes the method fairly clear. Suppose, subject company has 200 transferable customers whose value we seek to appraise. And again, just as a reminder, praise by transferable means that, you know, if I had 200 tax clients, the new accountant is going to get access at least once to the 200 clients who are going to at least give that account a chance. So we have 200 transferrable customers. Now, suppose the subject company has an annual marketing budget of $10,000. And that on average, the firm's marketing efforts lead to 10 new customers per year. That's the cost per new customer in marketing is $1,000. So a reasonable estimate of the cost to replace 200 customers, a 200 customer base would be $200,000 200 times the average cost, the average of marketing cost per new customer, and this would be an upper bound value for the goodwill on the front. There are two problems with this approach. One is that in the service sector marketed costs are vanishingly small, because direct marketing is less than an effective way, cost effective way for gaining any significant amount of new customers. Again, we're dealing with service businesses, and it's that service element and the repetition that creates the enterprise goodwill. Well, advertisement is not very effective. Go back to the economics of, of the of these businesses. Once people have a trusted Barber, once they have a trusted landscaper, they're not going to easily be persuaded by advertising to shift. More shifts are going to take place when their old barber retires, or they're all landscaper decides to retire. Ordinarily, advertising is not a very effective way to gain new clients and service businesses. So this is not really a good approach to effective way to analyze replacement costs. The other issue, again, somewhat technical is the cost of acquiring new customers does not necessarily reflect their value, the value of a customer base ought to reflect the future economic base, the future economic benefits that the customer base will generate to the buyer. And the cost approach

really ignores the future benefits. So if we're interested in value, not just simply cost and the course when you're buying a business, you're interested in value, what's it worth, not, not necessarily what it costs you to develop it. So for those two reasons, this replacement cost method is not a good alternative to rules of thumb.

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Now, another approach which attempts to get at value, which really as you'll see later, when in the sec, Part of this course gets us on the doorstep, I think of the right answer to a more sensible approach is called the customer attrition approach combined with excess earnings. Again, look at the slide because the example is going to tell the story. The customer attrition approach explicitly recognizes that the value of a customer base resides in the future profits that will generate to the buyer. This approach also recognizes that an acquired customer base has a finite life customers are going to be lost due to relocation, death or competition. Remember my little example of the accounting firm with the older clients. At a certain point, those other clients are going to die, move away, retire and no longer be clients for that firm. So attrition is an important part of valuing the future economic benefits of intangible goodwill. And that is an important point. So this is a plus for this method. So here's how it's been applied. In informal appraisal practice, we have a we have an sc. And we assume that the SE has a customer base of 100. Customers that for the sake of simplicity, we're going to assume generates precisely $500 per year net income per customer. Suppose we expect after the firm is acquired precisely 20 customers per year will be lost over the next five years. As with the excess earnings method, it is further assume that some of the net income represents a return on tangible assets. And the balance represents a return on the customer base. If we assume if we've assumed that three quarters of the net income is a return on tangible assets, only the remainder represents the return on the customer base itself, then, we have the following calculation. And we're going to add to that calculation of FY, what we call a present value factor of 10%. And again, I'm going to explain present values very shortly. Here's the computation of the customer base using this attrition method. You start out, you have five years, and the customers remaining each year, first year, you get 100 transferred in 20, leave 20 leave 20 leaves, so you've got 180 6040 20. Again, for simplicity, we're assuming that each customer is going to generate $500 of net income each year per customer. So the total customer net income derived from the transferred customer base, it starts out at 50,000. But because we lost 20, from the original, it goes down to 40, then 30, then 20, down to 10. Now we're allocating that income between tangible assets and intangible assets. And again, we just assumed somewhat arbitrarily, that three quarters of that net income is due to tangible assets, no justification for it, I pulled it from there just to illustrate the method. But when when these appraisal experts use this, they're likely they use an equally arbitrary pull from the or number to allocate between tangible and intangible. So whatever is left over is in effect, like the excess earnings of the previous example. So in this table, and in this example, you see in year one is 12,500. in year two is 10,000, in year three, and so forth. The present value factor, which again, I'm going to describe very shortly, is applied

to each of these figures. And then the five years are added together and the same, the total value of that customer base, the intangible value is 30,002 30. There is again, no theoretical way to justify that allocation of income. But there is some really good thinking going on here much better thinking than a lot of what passes for appraisal theory. The good part of it is, this method recognizes that whatever value you're going to have a good will stems from the amount of revenue that transferred customer basis otherwise, all I'm paying for is the tangible assets. This is what I'm looking at that book of business those, those those, those those patients, those dental patients, those are counting tax return clients, I'm looking for them to generate revenue in the future. So whatever value I assigned to it ought to be tied to that future revenue stream.

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This is an extremely positive gain over rules of thumb. The problem with the method is it uses that silly excess earnings concept which has no economic or theoretical justification. But we're going to see in the second part of this course, how I've utilized this part of this concepts. This is attrition concept to develop a more economically reasonable approach to valuing the intangible asset. We've gotten over the market methods we've gone over the asset methods and now we go to the most theoretically preferred method of appraisal. practice called the income methods. The income method starts with a few very, very, I think, sensible premises. And the first premise is that appraisals are not simply about predicting exchange prices, appraisal theory and practice is concerned with stipulating what exchange prices ought to be. We want to know and buyers and sellers of business and want to know what is the fair and reasonable price that ought to be given for a subject company that has enterprise goodwill as well as tangible assets. So we move from the standpoint, you know, market method says this is what everybody else does? Well, as I tried to stress over and over again, what everybody else does is pretty much rules of thumb, doesn't really give you much economic justification. went over the asset methods, we saw the weaknesses there, we saw one that was I think, leaning in the right direction, but kind of went off the rails. But the income method says we are going to drill down and say that whatever you pay for that intangible asset or that customer base, that client base, that patient base has to be a function of what cash flow, what income, what compensation, the the new owner is going to get. And that is a stipulation. That's we're saying that is a reasonable approach using arbitrary rules of thumb, not so smart. But drilling down to what future revenue compensation cash flow is. That's rational, and I agree with that completely. There's no disagreement. there that is a positive step forward. In appraisal theory. The income method is normative principles. This stipulated principle of fair and rational basically states that the present value of an equity interest ought to be determined by the future free cash flow of the firm that is expected that the firm is expected to generate and that that present value of an equity interest ought to be directly proportional to the expected future free cash flows and inversely proportional to the risk of realizing those cash flows stated in an equation, the present value of an equity is equal to its future free cash flows divided by the risk. What's the present value, because you can't really even begin to grasp the methodology of the

income methodologies that are widely used without understanding the concept of a present value. Present Value computation is simply a means of converting a stream of future cash flows to a lump sum. A future stream of cash flows from a subject company is converted to a present value using a special type of rate called a discount rate. A discount rate is built up from three components, inflation, opportunity costs, and risk. Inflation, the purchasing power of money generally declines over time. $1, today will buy more goods and services than it will buy in the future. This is the concept of inflation, discounting future cash flows allows us to factor in the impact of inflation, that loss of purchasing power. Now, on this slide, I'm going to introduce some terminology, and you're going to see some equations, we're going to let R equal the inflation rate stated as a decimal percentage, we're gonna let n equal the number of periods of future cash flow, we're gonna fv stands for the future value, which means the annual face value of the amount of expected future cash flows. And then PV is the present value, discount factor of PV. And that is equal to one plus one plus r parentheses to the nth power. You'll see that on your slide.

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Now, as an example, again, look at your slides, assume that an SC will generate a cash flow of $1,000 in each period, each of the next five years. Here's the conversion of these cash flows discounted and an assumed annual input inflation rate of 3%. So you see here, your one through five, you see future cash flows, and you'll see the annual inflation rate. The present value, you'll see computed in decimal terms, is based on the formula I just referenced. And again, you'll see in your slide, you add, you then apply that formula to each of the future value amounts, and then you sum them up. That's the present value. You have to understand this concept to understand the income method. And again, it makes sense if $1 today is not equal to what $1 is in the future. If you can't buy the same basket of goods and services, somehow you have to account for that you simply don't want to add dollars that you know basically dollars that are apples $2 that are oranges. I want to stress that I totally support using present value factors. The valuation of closely held businesses This is not something that I criticize this is an important component to all valuation work and ought to remain. So. Now, there are three components to the discount factor this present value factor that is used, I just showed you the example of using inflation rates. The example was 3%. In valuation theory in appraisal theory, there's a second component called opportunity costs. By investing a lump sum of cash today would be expected that the investor is forgoing the present use of that cash, presumably this cash could have been used to purchase some other investment opportunity. And a plausible assumption is that the alternative investment would have to be at least equal to the safest possible investment return. And usually that is a treasury bill US Treasury notes or bills. So in the conversion of future cash flows, the present values, you must take into account not merely the loss of purchasing power due to inflation, but also interest income that was forgone, also known as opportunity costs had the investment not been made this. So now we have two elements to the discount, the discount rate to choose the inflation rate and the foregone interest based on treasury bills. Standard methodology, the

methodology you're going to see by the experts is that we're going to add a third critical factor called discounting for risk. And the theory is that it would be reasonable that potential investors demand a higher rate of return on investments that are deemed more risky. All variants of income method add a risk premium to the risk free Treasury rate and inflation rate in developing an overall discount rate to apply to future expected cash flow. The risk premium is the additional rate of return required to accept the risk of investment. Here's an example. Five years, we have a five year expected cash flow of $1,000, we have a 3% annual inflation rate a 3% Treasury rate, we assume that a rational investor should demand a 10% return to reflect the risk associated with the investment. All three of these rates are added together or built up to develop a discount rate, which then yields a present value for the equity investment as follows. So you can see by this little chart, that you have the annual inflation rate, the risk free Treasury rate, the risk premium rate, and you can see that it all adds up to 16%. The future cash flow as in the previous example, is $1,000 per each of the five years. And now notice in the first column under present value factor that the exponent the percentage that is used in the present value is now one divided 1.16. That 1.16 is the 16%. Again, we calculate that formula and apply the present value factors, and we arrive at a present value total of about 30 $300. Now, the problem, what is the problem? Certainly there's no problem conceptually, with discounting for inflation, there doesn't seem to me that much problem with discounting for opportunity costs. Both of those, to me make a lot of sense. But what about this risk premium. We know In theory, it makes sense

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that an investor should demand a higher rate of return on riskier investments.

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That

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is not a bad idea. But we have a really practical and theoretical problem. And that is that what we're basically saying when we're stipulating a fair price by stipulating a discount rate a risk rate is that it is not rational for an investor to accept an investment that would yield less than the rate of return that includes that risk premium or that hurdle rate. It's in effect, a hurdle rate don't invest unless you get at least this level of return. That is the stipulated aspect to the income method. But there's a problem in small service sector, such as that we're dealing with the kind of businesses that were valuing expertise is required to own and successfully operate the firm. expertise and experience come together is what allows dentists and landscapers and chiropractors and and hairstylist to do their job well. It's not a liquid asset that expertise, that experience, it's something they have to have it's in effect a sunk cost. The Economist mean that you can't recover that in any

obviously, once you've sunk the money into the training and you have the experience, you can't just recovered except by applying your skill that acquired skill in the actual trader business. economic theory says you should not apply hurdle rates to sunk costs. And that's in effect, what the income method is telling the buyers and sellers of these service businesses where expertise is sunk cost. So if I am a dentist, and I'm looking at buying a practice, and my appraisal expert says, We've got to apply, you've got to get 10 or 12% interest on their investment, because to reflect the risk of operating this dental practice, this does not make sense to use that kind of higher rate thinking because as since my expertise is an effective sunk cost I what I'm concerned with is just the best possible use of it. So I always have to look at my skill as a buyer, as to my next possible best alternative use, whether it's 10, or 12%. And we're going to talk more about that when we talk about my alternative valuation method. But the idea of a hurdle rate that you have to have this to be rational does not apply in the very situations that we're most concerned with, because expertise is a sunk cost. Another problem with the method very practically speaking, is that the risk premiums that your prey your appraisal expert are likely to use are based on free cash flow. free cash flow is the cash flow available to an investor after taking into account all the costs of operating the business, including a fair compensation to the owner if the owner is active in the business. But many of these small service businesses are bought by individuals, competent individuals, well motivated rational individuals whose motive is not free cash flow, but just higher compensation. and higher compensation does not have any theoretical basis to be discounted by risk. This is not something that the the economic model can account for. And in fact, though, many small business Acquisition Service business acquisitions are motivated not by free cash flow as defined in the standard model that appraisers use. But rather, they're looking for greater owner compensation. So that's a big problem in the model. And finally, a big practical problem and this is going to be the source of much of the contention you see in your dueling expert reports is that the income method attempts to condense all risks of operating a business and owning a business into one rate. There is no intent in standard methodology to analyze the impact of specific risks on future cash flow. Most importantly, there's no broad agreement in the appraisal community as to where to look for benchmark risk premiums, where do I get the 10% or 15%? How do I Where do I look for this, many believe that risk premiums should derive from historic rates of returns on publicly traded companies. They use generally, a company called ibbetson, which analyzes the rates of return historically on publicly traded shares as a source of information as to the relationship between risk and return. Many others believe that publicly traded equity shares should not be used as benchmarks.

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pawsley, who is written a book criticizing the use of publicly traded shares as benchmark has come up with Pepperdine University is an annual survey of lenders and investors in privately held firms as an alternative source of risk premiums. But the whole idea of applying one risk premium to future revenues is wrong. Risk should be built into forecast directly. I'm going to stress that and

I'm going to show how that is done in my in the second part of this course. Now, buried in every use of the income method you will see in virtually every report you will see it there's a fudge factor, and it's called the capitalization rate. You'll recall I mentioned that earlier. There is virtually no appraisals and currently accepted practice that make a serious effort to project cash flow. To buyers beyond three to five years into the future, notice the examples I gave a present values were all three or five years under existing appraisal theory and in the marketplace, no one expects a business they buy, if I'm going to buy it, if I'm a dentist buying another dental practice, or if I'm a landscaper buying another landscaping firm. I'm not thinking that all these clients, they may be, you know, slowly being lost due to retirement or moving away or death. But I'm not expecting them to just go away completely in three to five years. I'm looking to hopefully generate revenue, you know, for 510 1520 years off of that customer base. But standard practice, and application of the income methodology makes no attempt to make serious projections being on three to five years. So what do they do? Do they just stop it three to five years? No, they do not. They apply a capitalization rate for all the projected revenue beyond the three to five year period. Now, I'll show you how this works. This capitalization rate. Suppose a subject company has an expected cash flow of $100,000, I'm sorry, $10,000 in year one, and then grows at different rates through five years as summarized in the following table. And appraiser, somebody who you're reading the report, we'll assume that after year five, the year five cash flow will increase at a constant growth rate. Say, for example, at 2%. Assume the appraiser applies a risk adjusted discount rate at 13%. The post five year income will be capitalized at 11%. The difference between 13% and 2%. The capitalized cash flow for year six forward is the year five cash flow divided by this capitalization rate 11,004 66 divided by point one, one or $104,000. This is the value shown in your six. Here's the slide. So your your appraiser is going to do some kind of projects, they might use regression analysis, they might use any number of techniques, they're going to look at the past years, they're going to do a little they might even do a sensitivity analysis, but they're only going to do it for a few years, usually three to five. So here we'll assume that your appraisal report shows Okay, here's what we expect in year one, here's what we expect in year two, year three, year four, year five. And now, we're not going to even make a serious effort to project shear. Beyond that, what we're going to do is we're going to take the year five rate and we're going to apply this capitalization formula, this you know this discount rate minus the growth rate and come up with a terminal value and then we're going to discount it and we're going to add that terminal value and come up with a total present value you can see the chart now notice again that the total discount factor is 13%. But the formula and this is the formula, this formula, this this capitalization rate formula is based on two wildly absurd assumptions. One is that the service is the subject company will generate cash flow forever and the growth rate will be the same forever. This is flies in the face of economic reality, most firms do not last beyond 20 years. Buyers generally should not have to share revenues with sellers for more than a few years. And there are economic constraints that said upper bound values of equity that are not factored into the forecast that use this capitalization or Gordon growth factor.

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This is the this is the culprit right here. The Gordon growth factor this shows up in every single valuation report you are going to look at. It's the fudge factor. And it's senseless. This is derived from and you'll see it in an appendix in my book this is derived from the sum of an infinite geometric progression. Here is the Gordon growth factor. The algebra of the Gordon growth heavier the value equals the cash flow in the base period plus one plus the growth rate divided by k which in this case is the risk adjusted discount rate minus the growth rate. In my book is an appendix showing how this algebra this formula was derived it is essentially the sum or the limit of a geometric progression infinite geometric progression and it shows how in order to use this rate, you have to assume again that you have an infinite series an infinite progression and you have to assume a constant or geometric growth factor both of which are economic absurd. And now, another factor. Another thing you're going to see in your report, as this slide indicates is discounts for lack of marketability. Because many appraisers use risk factors derived from returns on publicly traded securities in such securities are highly liquid, it was felt that theoretically we had to have some method of discounting the shares of privately held firms for a lack of marketability this discount for lack of marketability you often see abbreviate dl om is applied again almost universally in the in the appraisal ports you have to look for, but again much like the golden Gordon growth factor, the discount for lack of marketability is economically absurd. No investor who is rational, invest in a closely held firm and expects anywhere near the degree of liquidity that is available in publicly traded company, real estate and arbitrators, which also appraise non liquid assets, real estate and art, do not apply discounts or lack a lack of marketability. nor should they and nor should appraisers and closely held business. So this is a second absurdity. And again, a big source of contention in a lot of your reports, when we're an expert will say that this count for lack of marketability should be 25%. In other words, it's 20. And they'll come up with what seeming you know seems like authoritative tables and research. In theory, the whole concept of discount or lack of marketability makes no economic sense. When buyers and sellers have of privately held firms negotiate prices, they don't think in terms of mark of liquidity, it's not a factor. So again, this is another element of of current practice that just is economically absurd. So now I'm going to leave and then end with this, this this this part of the course with the current state of the art. And I say art in quotes. attorneys can select experts who choose different risk adjusted discounts and different discounts for lack of marketability to arrive at appraisers most advantageous to their clients. my contention is that common appraisal theory and practice must be significantly changed to lead to appraisals that are fair to all parties and make economic sense, and only you with two quotes from two authorities, who have every reason to understand exactly what current appraisal practice consists of. The first quote is from aswath damodaran, who is a NYU professor who has written many books on the valuation of publicly traded companies. And here is his quote, you tell me who's paying the expert. And I'll tell you what the bias is and where it is going in the analysis that from an NYU finance professor, commenting pretty much on what I'm talking about as you choose your ex's dueling experts bad theory. Now I'm going to quote a bankruptcy judge called Stan Bernstein, who famously said, I have yet to find

an appraiser of value of non real estate that ever and I want to stress ever says anything that's cogent and persuasive. These are two very damning

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commentary comments on the state of appraisal theory. And so if you, as an attorney, get confused, and going through that 75 page report, and don't understand the basic theory, you're in good company. But I'm hoping that my book, which you can order, plus this course, will basically say the emperor has no clothes, the theory should be discarded. The marketplace ignores it, and deservedly so and so should you as an attorney, and as a judge. Thank you. And I will be back with the second part of the course where I'm going to introduce a method that does make economic sense. Thank you.