

VALUING THE VERY SMALL BUSINESS
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Valuing the very small company is often much more difficult than valuing a large company such as Walmart. While there are many reasons for valuing a business, one of the more common reasons for valuing a small business is for a divorce. There are other reasons as well, so this paper will address many of them.

Valuing small businesses for a divorce can be even more challenging because other factors frequently play into the ability to perform the assignment, such as local case law, support issues, forensic investigations and limited funds to accomplish that which needs to be done. Some of these items can be worked around, but others cannot.

The purpose of this paper is to discuss the practical side of performing valuation assignments for very small businesses, whether for a divorce litigation or any other purpose. The author does not intend to teach the principles of valuation in this paper, but rather provide the reader with a discussion of the practical considerations that can make or break the assignment for the practitioner.

BUSINESS VALUATION STANDARDS

For many years when I practiced accounting, discussions took place regarding creating a "Big GAAP¹" and a "Little GAAP," depending on the size of the client. Well, that never happened. In business valuation, there is also no distinction in the standards when it comes to valuing large or small businesses. What the standards tell us, is to consider all applicable approaches and methods based on the facts and circumstances of the particular appraisal assignment. This does not mean, however, that budget, or lack thereof, enters into the selection process. I will address this point in more detail shortly.

¹GAAP = Generally Accepted Accounting Principles

So, at the end of the day, the true question that faces the practitioner is how do we comply with standards, do a proper job, and keep it within the client's budget? Unfortunately, the answer is that, in many cases, you cannot. There are many ways that you can get yourself in trouble if you attempt to shortcut the proper procedures because of budgetary constraints. As Chairman of the Ethics and Disciplinary Committee of The Institute of Business Appraisers, I cannot begin to tell you how often we have complaints filed against our members for not following the standards.

Using the excuse that "I cannot follow the standards because my client cannot afford me to do everything that the standards require" will have you looking at either a malpractice suit or a judicial opinion where your reputation may take a beating. In fact, a published opinion may be worse for your firm, financially, than a malpractice suit. Once you are nailed by a judicial opinion, it is out there forever and every cross-examining attorney will attempt to use it against you. In fact, many attorneys will not want to use you as an expert because you are considered to be "tainted."

You must follow business valuation standards regardless of the size of the business that you are valuing.

OBTAINING RECORDS TO PERFORM THE VALUATION

We all know that the records maintained by small businesses are sometimes questionable, at best. Many of these businesses have no financial statements. Actually, some do not even file tax returns. For those that do file tax returns, many of these small businesses report their results on a cash basis and do not keep adequate records to allow accrual based accounting to be applied.

What makes these valuations even more challenging is when we represent the spouse that does not own the business. In some litigation assignments, getting the information that you need to perform the valuation frequently requires the practitioner to get the client's attorney

involved. Besides being a waste of time and money, more often than not, the practitioner will not get all of the documents that are really needed to do a complete job.

Many practitioners have seen and use standard document requests that appear in most valuation textbooks to attempt to gather the information that is needed to perform a business valuation assignment. Many of these document requests have as many as 45 items listed on them. Do you ask for the same information regardless of the type and size of the business to be valued? Hopefully, not! While we would all like to obtain as much information as possible, the request for records should make sense in light of the type of business being valued. How much of the standard list would be required to appraise the local hardware store? Asking for too much information can be as bad as not asking for enough.

Imagine being on the receiving end of this document request. Now let's go one step further. Imagine if you receive all of the information that you have asked for. Do you have the financial budget to review all of this documentation? Be careful what you ask for as you may get it. And if you get it, you need to do something with it.

The business appraiser should try to figure out what information is truly needed to complete the assignment and not ask for more than is needed. As simple as this seems, the reason that documentation is frequently not received is because we overwhelm the other side of the litigation by asking for too much. However, remember that certain types of documents may be critical, such as Articles of Incorporation. The size of the business does not matter in this case. The rights of the shareholders are determined by statute. You need to understand these rights whether the corporation is large or small.

There will also be times that a forensic investigation will have to be conducted. The financial aspects of all litigations are resolved either through negotiation or by trial based on the financial information submitted by each party. Each party is obligated to provide

complete and accurate disclosure of all pertinent information. We all know that this rarely happens in reality.

This raises several issues that can become interrelated; first, how do you get the necessary documentation; second, will the procedures to be employed cost more than the benefits are worth; and third, if the procedures are redesigned to eliminate costly steps, will the practitioner be sued for malpractice if something is missed? These are serious problems facing the practitioner in a litigation assignment.

In the real world, financial disclosures in a divorce often become tools of negotiation. They tend to support the position of the party that makes the disclosure and may be inaccurate, incomplete, or designed to advocate a position favorable to that party. For example, leaving off a business asset may allow one party to keep the undisclosed asset if the party is not caught. There may also be a strong incentive to understate income, particularly when support will be an issue of the divorce.

In many instances, it becomes necessary to examine underlying data to determine the reasonableness, fairness, and accuracy of financial disclosures made by one or both parties. CPAs are uniquely qualified to perform such examinations and therefore are usually engaged to perform this function.

When a disclosure made by an opposing party appears questionable or lacks credibility, a CPA may be engaged to test the reasonableness of the financial disclosure by performing a forensic examination. For example, if an individual claims to earn \$15,000 annually, but the family travels to Disney World every year, traveling first class, the client-spouse may engage a CPA to find the source of the monies used to pay for the first class vacation.

One of the initial steps in valuing a closely held business is to obtain the company's historical financial statements for the past several years. These financial statements are then reviewed to determine if any GAAP or normalization adjustments are necessary.

Some of the required adjustments may be identified as a result of performing a forensic examination of the financial records of the business.

All of the procedures that may be performed require a considerable amount of documentation. The business appraiser must understand which procedures will be employed in a given assignment and make certain that only information that is required be asked for. For example, can the last two years worth of records be requested instead of the last five years? This can cut down the documentation fairly significantly and still get what is required to do the job. However, do not just decide to do this before you have had the opportunity to examine other records, such as tax returns or financial statements of the prior years, to allow you to make an informed determination that the earlier years are not important to the overall analysis.

Before you ask for all of the documentation, think about the cost of performing the services so that the client knows up front what a reasonable estimate of the fees might be. Once you determine what you need to do in order to provide a supportable business valuation, and you discuss this with the client, and the client states "I cannot afford that," run for the hills. Do not lower the level of the assignment below that which you had already determined to be the minimum amount that is needed to do your job. All that will happen is that you will get in trouble. The judge or jury will not let you off the hook when you testify that you did not do a complete job because the client could not afford the service. The only thing that will be remembered is that you did not do a good job. It will be your reputation that suffers.

If you are foolish enough to take on one of these assignments, make the client sign a very long, detailed engagement letter outlining what you are going to do, and what you are not going to do that you should do. Go as far as to put a statement in the engagement letter that says "I believe that the following steps that the client has requested not be performed is necessary for a proper valuation to take place. Omitting this procedure may impair our opinion and the client acknowledges that they will accept the outcome of our analysis,

which may be deficient.” At least then when the client wants to sue you, they have signed off that you have warned them. But truthfully, I would rather not take on the assignment. We have a professional obligation to know when we are rendering services that are deficient. A jury may find that you, and not the client, should have known better. Who needs the grief?

What should you do if the client does not have the available funds to pay for your services?

Before you accept an engagement, you need to carefully screen the assignment. There is nothing worse than getting started on an assignment to find out that you cannot be paid for your time. Several things can be done to prevent this from happening.

First, make certain that you have a clear understanding of the assignment. Know what you are getting into before you get into it. Estimate the amount of time that the assignment will take and discuss this with the client. Frequently, the client will tell you that he or she cannot afford the service. At that point, you may wish to discuss this with the attorney so that a *pendente lite* application can be filed with the court for expert fees. What this may also do is allow the attorney the opportunity to narrow the scope of what really needs to be done within the client’s budget.

Another solution to consider is the possibility of obtaining a mortgage against the client’s marital property. Although this does not put cash flow on the table, you may feel protected by knowing that you will most likely be paid at a point in the future. You should check with your own legal counsel to make certain that this is legal in your jurisdiction as well as enforceable. Some judges really get upset when they find out that you have encumbered part of a marital asset.

In a non-litigation assignment, consider discussing alternative services with your client. Maybe he or she does not need a valuation, but can live with a calculation of value instead.

Maybe the client does not need a detailed report and can live with a summary report. These are ways to cut down on the fees and still provide the client with a meaningful result.

What should you do if the cost to perform the services will potentially far outweigh the benefits that may be realized from the services?

This is always a tough one. The client wants you to do everything under the sun but you know that you will never be able to cost justify the services. The danger in not performing the services is when the client decides to sue you for malpractice because you did not do your job!

When we figure out that an assignment will most likely cost more than the benefit to be realized, we try to be up front with the client. We even suggest that the client obtain competitive fee quotes to perform that portion of the assignment. Unfortunately, there are many firms that will perform services without the client's best interest in mind. The classic example is the client that wants a big forensic investigation of the cash business because the spouse always has cash to spend.

What should you do if the client is unreasonable regarding his or her expectations?

Before you decide to accept a divorce engagement, there are several items that need to be considered. A divorce litigation can become a highly emotional battle for both parties going through the divorce. According to Sylvan J. Schaffer, J.D., Ph.D., "many professionals consider it to be the most prone to anger and acting out by the parties." Dr. Schaffer relates this behavior to the fact that this type of litigation is "intensely personal."

Recognize that the fighting and anger by the parties may be turned against the professionals involved. If the client, or even sometimes the non-client perceives (rightfully or wrongfully) that a professional has harmed them, professional complaints may be filed. The client may blame the business appraiser for not getting enough value out of the other

spouse's business, or not getting enough support or for not considering the income tax consequences of a situation that the appraiser was not hired to deal with as part of the assignment.

The non-client may file complaints with professional organizations, state boards of accountancy and any other body that will listen. The first time that you get notified that a complaint was filed against you is the worst. However, the second, third or fourth time is not much better. I had one spouse of my client (not even my client) file a complaint against me for having an affair with his wife. Besides being happily married to my business partner, I had only met this client once. While I was cleared of the accusation, the amount of time required to respond to the six organizations that I belong to was extremely time consuming. Fortunately, the time it took to explain to my wife was much less!

Responding to even frivolous complaints takes a considerable amount of time, which can cost you many hours of unbilled work and countless hours of aggravation. Screening the cases that come to you is a major part of risk management. You must carefully select which assignments to accept.

Other Ways To Protect Yourself

A common problem for an expert is communication. Communication is time consuming and therefore, expensive. However, if one action has great return, it is documenting every action and letting the attorney and client know what is you are doing. It protects against malpractice claims, it helps the lawyer enforce document demands and it helps the client understand what is happening.

You may understand the issues but not realize that the client does not. It is even possible that you believe you have explained yourself but find that you were not understood. Many times, you may be actively working on a client's matter but since there is no report, the

client thinks nothing is happening. Communication is key and written communication essential.

When it is difficult or too expensive to obtain the documentation that is desirable, it is important to work directly with the client and attorney to decide upon alternatives. Clients know more than you do about their spouse. They often can focus the search and, therefore, help you to most efficiently apply your time. However, the client must be helped to tell you what you need. Simply asking the client what he or she knows, may not be enough. Suggest possible avenues to explore so that the client can then tell you what is known. Once an approach is agreed upon with a client, this should be memorialized in writing.

Sometimes, you may not want to talk to the client who is difficult or demanding. In that case, communicate in writing. These clients are the most dangerous and often, the most abused by the process. Because they are difficult, they distract experts from more worthy tasks and tend to make the expert avoid contact. The lack of contact brings the unfortunate consequence of dissatisfaction and missed opportunities.

Most attorneys have been able to protect the non-monied spouse by obtaining a good written record of the efforts made by the practitioner. That record includes written requests for documents; timely follow-up requests for missing documents, prompt review of the materials provided and good records of the documents provided. Do not be afraid of serial requests for documents if they are made promptly and follow from the last production of documents. At the same time, copies of all communications should be sent to the client.

Finally, let the attorney know as soon as a problem develops. Delay punishes the non-propertyed spouse. The judges are under pressure to move cases. The monied spouse is in no rush to provide discovery. Too often a prompt discovery notice is sent but nothing is produced and the expert moves on to other cases. Set up a reminder system and send out regular notices and reminders. If you do not get the information, follow up immediately.

The judge will then punish the monied spouse, not your client. It will also increase your likelihood of obtaining an award of fees. The court can and will order the monied spouse to pay for expert's fees when it is felt that the work is necessary and being done properly. This is even more likely when the court believes that the monied spouse is being recalcitrant.

Finally, be creative. Offer suggestions and solutions. All of the direction cannot come from the attorney and the client. Passive acceptance of directions will not bring the next referral. The attorney is busy and the client is unfamiliar with the system. Make yourself familiar with the applicable case law. Read articles on forensic accounting. These will suggest solutions that may be cost effective or provide an approach that you did not know. Talk to other experts. See if they have done similar work. Use computer programs to organize data. Get access to statistics and other experts in the business that is in issue. Sometimes, the solution is in getting more familiar with the way business is done in the industry. The client may be able to set up a meeting with someone who will not testify but who can explain the business and where to look for money. This is a team process. Anyone on the team can initiate the solution.

THE VALUATION ASSIGNMENT

Large companies have an abundance of good information to help us analyze these companies and determine values. Small companies frequently lack good accounting records. The amount of empirical data on the sale of small companies is also far less than their larger counterparts. However, over the past two decades, new databases have entered the valuers' tool bag allowing us to use market data to value these companies. Transaction databases are written about in many of the valuation treatises. I still believe that this is some of the most helpful data around when it comes to valuing these very small businesses. I know that some individuals are very critical of the databases, and admittedly they are not perfect, but it still beats pulling a capitalization rate out of my back pocket.

Comparative data is available at www.integrainfo.com (also available at BV Resources for one-stop shopping).

The common methodologies that can be used to value the very small business include:

- Transaction method
- Capitalization of earnings
- Capitalization of excess earnings
- Rules of thumb.

Let's discuss each of these.

Transaction Method

Too often, appraisers state that since the appraisal subject is a small company, a market approach could not be used. More often than not, the appraiser did not even try to use this approach. No one can argue that it is considerably more difficult to obtain good market data for closely-held companies than it is for publicly traded companies. However, that is not an excuse to roll over and play dead.

The public market affords a vast amount of information to the appraiser. However, many of the businesses that we appraise truly have little, if any, correlation with the public world. This does not mean that a market approach is impossible. In fact, the market approach is available in more instances than you can imagine.

The same theory that applies to large appraisal subjects should be applied to small appraisal subjects. Where we assimilate data from, as well as how much confidence we have in the data, varies, but it nevertheless should be used since it is the best that we have. Let's not lose sight of the fact that fair market value comes from the market.

To illustrate this point, consider how many small businesses sell based on some multiple of owner's discretionary cash flow. Many of these buyers are doing nothing more than buying jobs. From an economic standpoint, this makes no sense. For example, if 20 buyers purchase a particular type of business for two times owner's discretionary cash flow, does this automatically mean that an appraisal subject with similar qualities would be worth the same multiple of its cash flow?

Using Closely-Held Company Data

There are three sources of information that our firm has found to be somewhat useful in our quest for market data for small businesses. Recognizing that each of the following sources of information also has certain deficiencies, the appraiser is once again faced with using common sense and sanity tests. The three sources that we have used in the past include:

- IBA Market Data Base²
- BizComps³
- Pratt's Stats⁴

IBA Market Data Base

Available only to IBA members, this database is the largest known source of market transactions of small closely held businesses. It has been compiled over the years from IBA

2 IBA can be contacted at (954) 584-1144

3 BizComps, P.O. Box 71177, San Diego, CA 92171, (619) 457-0366. BizComps is also available at BVMarketdata.com.

4 Pratt's Stats is available online at BVMarketdata.com.

members and other professionals associated with the sales of businesses. According to the IBA website⁵, the following database parameters exist:

Database Parameters:

1. Number of transactions in the database: 30,311
2. Number of transactions in the database in the following size ranges:

\$0 - \$500,000 in annual sales:	21,611 (71.30%)
\$500,001 - \$1,000,000 in annual sales:	4,240 (13.99%)
\$1,000,001 - \$5,000,000 in annual sales:	3,114 (10.27%)
\$5,000,001 - \$10,000,000 in annual sales:	353 (1.16%)
Greater than \$10,000,000 in annual sales:	258 (.85%)

3. SIC categories in which there are:

At least 1 transaction:	775
At least 2 transactions:	596
At least 5 transactions:	427
At least 10 transactions:	299
At least 20 transactions:	184
At least 50 transactions:	99
At least 100 transactions:	50

The significance of the number of transactions is that, the greater the number of transactions, the more accurately the market can be defined. Not surprisingly, the SIC categories with the largest number of transactions correspond to the most common types of small and mid-size businesses.

4. Some individual SIC categories with more than 100 transactions in the database:

⁵ Website was accessed on September 17, 2007.

SIC	Business Type	No. of Transactions
5812	Eating Places	5358
8021	Dental Practices	2583
5813	Drinking places	942
5411	Grocery Stores	895
7231	Beauty Shops	689
7389	Business Services	679
5541	Gasoline Stations	671
7215	Laundry & Dry-Clean	670
0782	Lawn & Garden	480
5992	Florists	445
7349	Building Clean/Maint.	421
5921	Liquor Stores	380
5999	Misc Retail	379
2752	Commercial printing	337
7538	Auto Repair	336
8721	Accounting	334
8351	Day Care	313
7299	Personal Services	306
5947	Gift, Novelty Retail	290
7841	Video Rental	261
5461	Bakery	234
7216	Dry-Cleaning Plants	225
4724	Travel Agencies	217
5451	Dairy Product Retail	212
7331	Direct Mail Advertisers	196
7532	Auto Body Repair	194
5531	Auto and Home Supply Retail	192
6531	Real Estate Agent/Management	176
7212	Garment Pressing	174
1711	Heating, Plumbing A/C	158
5962	Vending Machine Operators	157
5331	Variety Stores	156
5941	Sporting & Bicycle Shops	153

The IBA Market Data Base includes more than 30,000 transactions in 775 SIC codes. Many SIC categories have so many transactions that a highly supportable statistical inference

can be drawn from this data. Most of the transactions included in the database are for businesses that had a sales volume below \$1 million.

As you can see, the database is geared toward transactions of the very small business. Small businesses typically are sold as asset sales as opposed to stock sales. An asset sale is a transaction where only certain assets (and maybe liabilities) are transferred to a purchaser who will effectively become the new owner of the business. More often than not, only the operating assets of the business are transferred to the buyer. This type of transaction is common for smaller businesses. It is also very different from a stock sale, which is typical of larger business transactions. In a stock sale, the stock (all assets and liabilities) is transferred to a buyer. This transfer represents the entire equity of the company. The transaction type is a critical point to understand when considering multiples.

In an attempt to better understand the significance of the transaction data included in the database, an empirical study was undertaken by Raymond Miles, the founder and past Executive Director of IBA, and his results were presented at an IBA national conference many years ago. The data from this presentation is still currently on the IBA website as it is still believed to be true.

Mr. Miles concluded the following:

The price-to-earnings and price-to-gross revenues multiples are almost equally valid criteria for estimating the market value of businesses. This conflicts with the conventional wisdom that the price-to-earnings ratio is the most significant performance criterion of a business.

In practice, the price-to-gross revenue multiple is especially useful for appraising closely held businesses, because price-to-gross revenue multiples are available for all sales in the IBA Market Data Base, while price-to-earnings multiples are only available for some sales.

Empirical data for all business categories, in aggregate, does not show any significant change in business value as a function of time. This is contrary to the conventional wisdom that only recent sales should be considered when choosing guideline ("comparable") companies.

The data shows no significant correlation between the selling price and the percentage down payment. This differs from the conventional wisdom that a business sold for cash should bring a lower total price than one sold for "terms."

As expected, business values as measured by price to earnings and price to gross multiples differ from one kind of business to another. However, this difference is not as large as might have been expected. This suggests that the search for guideline companies does not need to be limited to businesses in the same SIC category as the business being appraised. Thus, the search for guideline companies can reasonably include SIC categories other than the category assigned to the business being appraised.

Empirical evidence indicates that the "most probable price" for a business is significantly different from the average price of businesses that have been sold. Thus, when the standard of value is "most probable price," use of the average selling price of guideline companies can lead to a value estimate that is in error by a significant amount.⁶

Being the accountant that I am, and being suspicious of people who publish information that could be deemed to be self-serving, I was provided with the opportunity to review Mr.

6 Raymond C. Miles, "Business Appraising in the Real World—Evidence From the IBA Market Database" (document presented at the IBA National Conference, Orlando, Fla., February 7, 1992).

the fact that transactions that were 10 and 15 years old, in most industries, were still valid.. Now, don't get me wrong, using dated transactions can often be a difficult task, especially when you have to explain it to a judge or jury, but certain industries have been fairly consistent over the years. With that said, certain industries are very different. What I am really saying is analyze the data to see what the impact is for the particular situation.

Even geographically, the multiples were not materially different. In another study⁷ published by Mr. Miles, he disclosed the following:

Region	<u>Price to Earnings Diff. From</u>		<u>Price to Gross Rev. Diff. From</u>	
	<u>Mean</u>	<u>Nat'l avg.</u>	<u>Mean</u>	<u>Nat'l avg.</u>
Southwest	2.10	-11.00%	0.54	-4.00%
Northwest	2.60	11.00%	0.57	6.00%
Southeast	2.23	-7.00%	0.56	1.66%
Northeast	2.99	25.00%	0.54	1.66%
All Regions	2.39		0.54	

As can be gleaned from the above data, Price/Earnings multiples, and especially Price/Gross Sales multiples, were not materially different from one geographic region to another. Following completion of the study, the author determined that a major reason for the higher Price/Earnings multiples for the Northeast geographic region was submission of many business sales by one business broker who dealt with "high end" businesses.⁸

Now of course, you want to test the data before you use it, but this database gives the valuation analyst a methodology that can be applied to small businesses. You must also use your head when using this or any other database to ensure that you have enough transactions to be statistically reasonable. As you can see, there are many things to consider when using this data. Answers to many of the issues discussed above, as well as

⁷ Raymond C. Miles, "Business Values in the Real World: Evidence from the IBA Transaction Database," presentation at the American Society of Appraisers Business Valuation Conference, Houston, October 23, 1993.

⁸ Ibid.

others that may not have been addressed, can be found in publications available from IBA on its website (www.go-iba.com). In fact, IBA also has a variety of tutorials on its website as to how to use this data. IBA even offers a free data analyzer (I like that word) on its website that allows the user to analyze market data (the IBA market analyzer is available for download at www.go-iba.com/benefits.asp).

BizComps

The BizComps database includes sales information by SIC category as accumulated by Jack Sanders. The most convenient manner in which to subscribe to this database is through Business Valuation Resources, LLC (www.bvmarketdata.com). Here also is a lot of useful data, but the valuation analyst should be careful to understand what is included in each item. Much like the IBA database, BizComps reports seller's discretionary cash flow as a measure of earnings, but this definition includes depreciation, amortization, and all other non-cash and non-operating expenses.

According to Business Valuation Resources,

BizComps contains transactional information on "Main Street" businesses (service station, restaurant, convenience store, print shop, travel agent, florist, coin laundry, beauty salon, auto repair shop, video rental, day care center, etc.) dating back to 1993. Jack Sanders, who is located in San Diego, California, publishes this study. Historically, transaction data on small business transfers has been virtually nonexistent, leaving the investor or advisor to speculate about the fair market value of the small business enterprise. This database removes the marketplace uncertainty and provides the user with detailed, meaningful financial information about these "real world" transactions.

Subscribers to BizComps are granted access to all of the details in the

database, including annual gross revenue, asset figures, operating ratios, and the price and terms of the sale. Additionally, Sale Price/Gross Revenues and Sale Price/Seller's Discretionary earnings multiples are calculated for each transaction reported. And once you have found the information you need, you can effortlessly export it to a Microsoft Excel spreadsheet, print the individual transaction reports, or recalculate the summary financial statistics.

As of July 2007, BizComps contained 10,157 total transactions. In addition to 1,592 transactions in the restaurant industry, the database also contains over 900 deals in business services (SIC 7300) and 740 deals in the area of personal service (SIC 7200). 61% of the deals in the database have less than \$500,000 in annual gross revenue, while 18% of the deals have annual gross revenues over \$1 million. The entire database is searchable by various parameters with transactions updated throughout the year.⁹

According to the *BizComps User Guide*, what was actually sold includes

Only two elements are contained in either the BizComps Asking Price or the Sale Price. The items are Fixtures & Equipment (FF&E) and Goodwill -- or the intangible value. Cash, accounts receivable, loans receivable, real estate, and other assets are not included, and all liabilities have been excluded. All licenses necessary to conduct business are generally included. This is nothing magical -- just simply the way these businesses are sold. They are all asset sales or have been converted to an asset sale.

The sellers of these businesses rarely are willing to part with the cash and accounts receivable and the buyers are rarely willing to pay for it. And the businesses are considered to be debt-free at close even if there are new loans coming on board from the seller or

⁹ Accessed at www.bvmarketdata.com on September 17, 2007.

others. Sellers usually are responsible for paying off all debt at the close of sale.¹⁰

There are many useful data points in the BizComps database that the IBA database does not have. BizComps has the asking price as well as the sales price, which can give a valuation analyst a better idea of what is really going on in the market. Two important pieces of information included in BizComps are the percent down payment and terms of financing. Although the Miles study claims that the down payment does not matter, the terms of financing certainly do. This will allow a valuation analyst to estimate the cash equivalent value of the transaction price.

Also stated separately in this database are inventory and fixed assets. As with the IBA Market Data Base, the BizComps transactions are asset sales, which means that only the operating assets are transferred to the purchaser. The sales price, by definition in the database, excludes inventory. However, it would include the fixed assets (these are the operating assets). Therefore, even though it is not given in the database, the intangible assets that were part of the transaction can be calculated by subtracting the fixed assets from the transaction price. By including the operating assets in the database, BizComps gives the user the ability to estimate the intangible value that was part of the deal.

BizComps lists rent and franchise royalties as a percent of sales so that a user of the database can get a better idea of the fixed costs of the business. It also provides the number of days that the business was on the market before the sale closed. This piece of information is very interesting. One of the issues that analysts encounter with every assignment is the level of marketability of the subject business and a corresponding discount for lack of marketability if it is applicable. Although using a sales price-to-earnings stream multiple yields a control, nonmarketable value, this information gives the user some basis to support a discount for lack of marketability for another method (let's say that you capitalized earnings).

¹⁰

www.bizcomps.com, User Guide.

Overall, BizComps gives more data fields than the IBA Market Data Base, but as discussed, it has much fewer transactions (10,000 as compared with 30,000). The desktop version of the database comes with software that enables quick and easy analysis of selected transactions and gives a user the ability to value subject companies based on sets of transaction multiples.

Pratt's Stats™

Pratt's Stats™ is a resource for small/medium to large closely held company sale information. Pratt's Stats™ contains details on approximately 10,000 private and closely held business sales from 1990 to the present ranging in deal price from under \$1,000,000 to \$14,435,000,000. The industries represented in Pratt's Stats™ are also pretty broad, as evidenced by the roughly 700 unique SIC Codes and 840 unique NAICS Codes. Additionally, Pratt's Stats™ has about 210 SIC and 230 NAICS Codes with 10 or more transactions reported. This database, started by Shannon Pratt, and now carried on by Business Valuation Resources, is an excellent source for transaction data, and it has taken small business transaction reporting to the next level. Pratt's Stats™ data is available online at www.bvmarketdata.com.

Pratt's Stats™ search criteria includes the industry SIC or NAICS code, company description, city and state location, revenue range, text searches, and many other key data fields for each transaction. The ability to further select specific deals from the initial search, recalculate the summary statistics, and print or export to Excel spreadsheet formats are some of the features found here. Currently, you can download up to over 80 fields of information for each transaction from the database (although, as you may have noticed with IBA and BizComps, not all information is available for each transaction).

Each transaction does not have information in every data field, but this database does a good job at increasing the amount of information that is available for small company transactions. The more information that is available, the better the decision-making process

will be. This will lead to better valuation opinions. Pratt's Stats™ provides up to eight different valuation multiples including equity and invested capital (deal price) multiples. These include:

1. Equity price/net sales
2. Equity price/net income
3. Equity price/gross cash flow
4. Equity price/EBT
5. Deal price/discretionary earnings
6. Deal price/EBITDA
7. Deal price/EBIT
8. Deal price/net sales

In addition, the database gives the user information to calculate other multiples (e.g., equity price to book value). With so much data available, the possibilities are endless, but be careful that you understand what is listed in each field before you go crazy making up multiples.

Another important item that you must consider is that Pratt's Stats™ reports two different transaction types. BizComps and IBA report only asset sales. In addition to asset sales, Pratt's Stats™ also reports stock sales. Stock sales are transactions in which a business transfers its equity to the acquirer, or in other words, transfers all of its assets and liabilities. Based on the transaction type, price will most likely reflect different assets and/or liabilities that were transferred as part of the deal. This becomes very important in comparing and applying multiples.

Pratt's Stats™' website automatically calculates statistics on selected transaction data, and these are displayed on the subscriber results page. Users can limit the data set to include certain transactions and may recalculate statistics such as count, range, mean, median,

and coefficient of variation for each data set. These statistics can be useful in performing transaction searches, as well as multiple selection.

Another very useful tool that comes out of Pratt's Stats™ is the ability to calculate multiples for S corporations versus C corporations. This can further support your analysis when it comes time to address the question of whether to tax effect the earnings of an S corporation.

Finally, one more useful tool that comes out of this database is the ability to calculate the relationship of the value of non-compete agreements to the total transaction price of the deal. This is really handy when you have to address the issue of personal goodwill allocations.

Capitalization of Earnings

An alternative to the market approach is the income approach. This approach consists of a single period capitalization model and a multi period discounting model. Clearly, no one in their right mind would attempt to use a discounting model for a very small business (this assumes that it is a mature stable business and not a start-up that would require a discounting model to be used or some other situation like that). This would be like throwing darts at a target from six miles away. There is no way that you can hit the target.

Instead, a single period capitalization model can be used if the income stream being capitalized is relatively stable. Many small businesses have stable earnings which would allow this method to be used. The problem with this method is to determine the normalized earnings, requiring the appraiser to add back all of the personal stuff that got buried in the expenses. The other problem is determining a good capitalization rate for the business. Most of the valuation treatises teach us to develop a discount rate from public company rates of return that often have little resemblance to the closely held company. Then we can subtract growth, which very often, is zero. Once the appraiser overcomes these problems, this method can work.

Capitalization of Excess Earnings

The excess earnings method was founded in ARM (Appellate Review Memorandum) 34 in 1920. It originally came about in order to compensate the owners of breweries and distilleries for the loss of goodwill that resulted because of Prohibition.

ARM 34 included rates of return on the investment in assets employed in these types of businesses affected by its use. The rates included in the memorandum may not have been appropriate in every situation, nor were they appropriate over time, or in the case of industries other than those producing alcoholic beverages.

Revenue Ruling 68-609 was issued to correct the misinterpretations regarding the use of the excess earnings method in the valuation of goodwill. This revenue ruling suggested higher rates of return but also led appraisers to the belief that this methodology is appropriate for all types of businesses.

As time went by, the Internal Revenue Service began to recognize that the excess earnings approach was being misapplied in practice. It has been used to value entire businesses when it was only supposed to value the intangible assets.

The Internal Revenue Service, in Revenue Ruling 68-909 has gone on record to state that:

The (excess earnings) approach may be used only if there is not better basis available for estimating the value of intangible assets.

There are frequently better methods to use in valuing businesses and therefore, the excess earnings method is not always appropriate. Still, it continues to be used by many appraisers.

The more common application of the excess earnings method is seen in the valuation of professional practices and very small owner-operated businesses. In essence, the valuation of these entities takes on an asset based approach, with the goodwill (unidentifiable intangibles) being valued this way.

In order to use the excess earnings method for intangibles, all of the operating assets and liabilities of the business must first be appraised. Frequently, this is accomplished using the Adjusted Book Value method.

The next step is to calculate the normalized sustainable (stable) earnings of the business. Be careful to remove any nonoperating income or expenses during the normalization process. Also remove any line items that may be attributable to nonoperating assets or liabilities.

The appraiser must determine the appropriate rates of return on the net tangible assets (other than goodwill) owned by the company. There are several ways to determine the required rate of return on the net tangible assets of the business. There are no hard and fast rules but there is no substitute for common sense in choosing appropriate rates.

One method is to review the assets that make up the balance sheet to assess the amount of risk attributable to these assets. Obviously, a balance sheet with all cash would be considerably less risky than a balance sheet that is heavy in special technology equipment. The difference in the rates in this instance would be the difference between what a certificate of deposit pays as opposed to the cost of leasing the equipment.

Another method to determine the rate of return on the net tangible assets is to calculate a weighted average based on the borrowing power of the company. This calculation is suggested in the Practitioners Publishing Company *Guide to Business Valuations*.

Regardless of what method is used to determine the reasonable return on the net tangible assets, it is generally accepted in the appraisal community that this rate should not be below the subject company's cost of borrowing money.

The return on the net assets is then subtracted from the normalized earnings resulting in "excess earnings" subject to capitalization.

The capitalization rate applied to the excess earnings must be sufficiently high, since the excess earnings represent the return from intangibles, which are considered to be risky. Logically, if the rate of return on tangible assets is 8 percent, and the required rate of return on the company's earnings (which includes a return on the net tangible and intangible assets) was determined to be 25 percent, then the rate of return for only the intangibles has to be higher than 25 percent, so that on a weighted basis the 8 percent and the intangibles return equals 25 percent.

Rules of Thumb

Rules of thumb are dangerous!!! They should only be used as a sanity test against other methods. They should not be considered as a valuation method unless you have market data to support them. If you have the data, you have a true market approach and not a rule of thumb.

Example

In order to demonstrate how these methods can assist you to value the very small business, I am including actual sections from real reports (names have been changed to protect the guilty!!)

THE MARKET APPROACH

TRANSACTION METHOD

The merger and acquisition method utilizes transactions of similar companies, both closely held and publicly traded to determine a multiple of sales or earnings to apply to the subject company. Several sources were utilized to determine the appropriate multiple to apply to this valuation.

The first database utilized was located in the market data file maintained by The Institute of Business Appraisers, Inc. The Institute of Business Appraisers (IBA) is a professional appraisal organization, which among other things, maintains a computer database of transactions of closely-held businesses. There are approximately 14,000 entries in the database. Most of the information contained in the database is submitted by members of the organization who have been involved in actual transactions. Some data is purchased from outside sources that are deemed reliable.

This database was searched for transactions involving companies in SIC code 5812 - Retail Trade, Eating Places. Our search located approximately 1,500 transactions in this SIC code containing all types of restaurants whose revenues ranged from \$13,000 to in excess of \$200,000,000. In order to more appropriately utilize this information, we stratified this data into several more applicable categories.

The first category consisted of small Italian restaurants and pizzerias. This data is presented in Table 12.

TABLE 12
IBA MARKET COMPARISON DATA
ITALIAN RESTAURANTS/PIZZERIAS

<i>Business Type</i>	<i>Annual Gross \$000's</i>	<i>Sales Price \$000's</i>	<i>Price/ Gross</i>	<i>Geographic</i>	<i>Yr/Mo of Sale</i>
<i>Deli with pizza</i>	89	28	0.31	CA	86/04
<i>Fast Food-Pizza</i>	227	55	0.24	GA	93/07
<i>Fast Food-Pizza</i>	230	49	0.21	CA	94/12
<i>Restr-Pizza</i>	306	120	0.39	CA	90/05
<i>Restr-Italian</i>	310	29	0.09	CA	95/08
<i>Pizza Delivery</i>	317	81	0.26	TX	91/04
<i>Restr-Italian</i>	324	75	0.23	FL	94/05
<i>Restr-Italian</i>	390	53	0.14	CA	95/07
<i>Restr-Pizza</i>	477	397	0.83	ID	95/04
<i>Restr-Italian</i>	516	212	0.41	CA	95/08
<i>Restr-Italian</i>	653	89	0.14	CA	95/02
Mean			0.30		
Median			0.24		

As indicated, there were 11 transactions in this category indicating an average price to revenue multiple of 0.30, and a median of 0.24.

The second category consisted of 55 restaurants categorized as fast food restaurants. This information is shown in Table 13.

TABLE 13
IBA MARKET COMPARISON DATA
FAST FOOD RESTAURANTS

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Fast Food/Coffee Shop	58	23	0.40	FL	96/02
Fast Food-Yogurt	65	24	0.37	LA	93/12
Fast Food/Coffee Shop	74	60	0.81	FL	96/06
Fast Food-Smoothies	80	40	0.50	LA	95/02
Fast Food-Yogurt	86	27	0.31	LA	93/04
Fast Food/Coffee Shop	90	20	0.22	FL	95/09
Sandwich shop, fast food	90	34	0.38	Mid-West	86/07
Fast Food/Coffee Shop	100	32	0.32	FL	94/10
Fast food/coffee shop	108	50	0.46	FL	93/12
Fast food rest	111	20	0.18	Mid-West	87/02
Fast Food-Chicken	120	68	0.57	FL	94/04
Fast Food-Yogurt	120	52	0.43	FL	94/08
Fast Food-Chicken	120	40	0.33	FL	95/01
Fast Food/Coffee Shop	120	40	0.33	FL	95/02
Fast Food-Yogurt	120	38	0.32	TX	92/02
Restr-Mall Fast Food	120	48	0.40	FL	91/03
Fast Food/Coffee Shop	120	56	0.47	FL	94/08
Fast Food/Coffee Shop	132	27	0.20	FL	95/08
Fast Food-Chicken	132	25	0.19	FL	95/07
Deli, fast food	132	55	0.42	NJ	91/
Fast Food-Yogurt	135	70	0.52	Midwest	93/03
Fast Food-Yogurt	136	100	0.74	ID	92/07
Fast Food/Coffee Shop	140	85	0.61	FL	94/07
Fast Food/Coffee Shop	147	85	0.58	FL	94/08
Fast Food/Coffee Shop	150	65	0.43	FL	96/01
Fast Food-Baked Potatoes	152	43	0.28	MN	94/11
Fast Food-Yogurt	160	80	0.50	CA	92/01
Deli Fast Food	175	76	0.43	MA	90/09
Fast Food/Coffee Shop	175	70	0.40	FL	96/10
Fast Food-Dairy Queen	185	25	0.14	NM	92/09
Fast Food Dairy Queen	186	20	0.11	NM	91/10
Fast Food/Bakery/Coffee	200	95	0.48	FL	95/03
Fast Food/Coffee Shop	200	65	0.33	FL	96/11
Deli Fast Food	200	70	0.35	MA	90/08
Fast Food-Dairy Queen	220	99	0.45	Midwest	93/09
Fast Food (Mall Store)	220	90	0.41	NC	96/10

TABLE 13
IBA MARKET COMPARISON DATA
FAST FOOD RESTAURANTS

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Fast Food-Mexican	222	88	0.40	OR	95/03
Fast Food-Pizza	227	55	0.24	GA	93/07
Fast Food-Pizza	230	49	0.21	CA	94/12
Fast Food-Hamburgers	237	140	0.59	CA	91/08
Fast Food/Coffee Shop	250	128	0.51	FL	95/05
Fast Food-Dairy Queen	275	57	0.21	NM	91/07
Deli-Fast Food	285	83	0.29	FL	91/11
Fast Food/Coffee Shop	300	70	0.23	FL	97/05
Fast Food-Take Out	300	161	0.54	ID	95/09
Fast Food-Dairy Queen	312	117	0.38	NM	91/07
Fast Food-Dairy Queen	324	40	0.12	Midwest	94/01
Fast Food/Coffee Shop	346	150	0.43	FL	95/03
Fast Food/Coffee Shop	346	100	0.29	FL	95/06
Sub shop/fast food sand.	354	205	0.58	IL	89/
Fast Food-Ice Cream	354	185	0.52	CA	95/07
Fast Food-Roast Beef	398	93	0.23	CA	94/11
Fast Food-Fried Chicken	540	248	0.46	TX	94/08
Fast Food/Coffee Shop	832	200	0.24	FL	94/11
Fast Food-Hamburgers	832	200	0.24	FL	94/10
Fast Food-Hamburger	936	665	0.71	NV	90/07
Mean			0.39		
Median			0.40		

This category indicated an average multiple of 0.39, and a median of 0.40.

The final category consisted of restaurants with sales in the range of \$400,000 to \$700,000, regardless of type, as this range more appropriately reflects the revenues of the subject company. There were 168 transactions in this category shown in Table 14.

TABLE 14
IBA MARKET COMPARISON DATA
REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Bagel shop	400	190	0.48	L I New York	90/03
Restaurant	400	125	0.31		84/02
Bagel restaurant	400	160	0.40	FL	95/01
Bagel restaurant	400	150	0.38	FL	95/04
Restr-Dinner House	400	178	0.45	NV	92/10
Deli, grocery	400	205	0.51		91/
Catering, off premise	400	215	0.54	NY	91/12
Restaurant	400	350	0.88	Northeast	98/01
Restaurant	400	95	0.24	NY	89/
Deli	400	120	0.30	CT	90/12
Restaurant with liquor	400	50	0.13	IL	93/
Coffee shop	400	60	0.15	Calif/Ariz/Nev	83/07
Own, op restaurants	400	500	1.25	GA	93/03
Own and operate restaurant	400	300	0.75	KY	93/07
Sandwich shop	405	180	0.44	FL	94/12
Restaurant	407	120	0.29	FL	95/03
Restaurant-Family	408	69	0.17	MN	91/12
Restr Family	408	69	0.17	TX	91/12
Restaurant	408	50	0.12	Cal/Ariz/Nev	86/03
Restaurant-Gourmet	410	35	0.09	MA	91/05
Restr Family	410	92	0.22	TN	91/04
Food Caterers	410	70	0.17	TX	91/09
Restaurant	411	385	0.94		93/
Restaurant	416	30	0.07	HI	91/02
Restaurant	417	211	0.51	Midwest	87/06
Coffee Shop-Restaurant	420	145	0.35	CA	92/01
Restr Gourmet	420	103	0.25	MA	91/08
Restaurant	420	112	0.27	Mid-Atlantic	82/05
Restaur/breakfst, lunch	420	100	0.24	MA	95/04
Coffee shop	420	150	0.36	CA	92/
Restaurant	420	178	0.42	Mid-West	85/
Restr-Lunch Only	421	155	0.37	VT	95/05
Deli-office bldg.	422	450	1.07	So. Calif.	87/04
Restaurant	425	125	0.29	ME	93/
Deli Bakery-Retail	425	125	0.29	NJ	93/08
Restaurant	426	20	0.05	Texas	86/03
Restaurant in office bldg	430	175	0.41	CT	90/
Café	430	175	0.41	Texas	92/
Restaurant	433	145	0.33	HI	92/03
Restaurant/lounge	435	142	0.33		93/
Café, gourmet	435	105	0.24	FL	95/09
Delicatessen & stationery	438	275	0.63		84/10

TABLE 14
IBA MARKET COMPARISON DATA
REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Deli-Retail	439	220	0.50	WA	92/07
Restr Dinner	442	300	0.68	SC	91/09
Coffee shop	444	150	0.34	Cal/Ariz/Nev	85/05
Yogurt Store	444	275	0.62	CA	88/04
Sandwich shop	450	52	0.12	Midwest	90/09
Coffee shop	450	170	0.38	Calif/Ariz/Nev	83/07
Restr-Dinner House	453	196	0.43	AZ	85/05
Coffee shop	456	220	0.48	Calif/Ariz/Nev	83/07
Deli	459	175	0.38	GA	92/05
Deli Franchise	459	175	0.38	GA	92/05
Croissant	459	125	0.27	Texas	93/
Restaurant	470	240	0.51	NY	89/
Breakfast/lunch	470	158	0.34	FL	95/01
Restaurant	472	200	0.42	RI	89/
Restaurant	474	170	0.36	IL	91/
Restaurant at marina	474	170	0.36	ID	91/
Sub shop franchise	475	239	0.50	IL	92/
Deli-Sandwich Shop	475	175	0.37	FL	91/10
Catering	475	45	0.09	FL	94/08
Restr-Pizza	477	397	0.83	ID	95/04
Restaurant/lounge	480	150	0.31	New England	87/03
Restaurant	480	200	0.42	Cal/Ariz/Nev	85/04
Restaurant, family	480	163	0.34	So. Calif.	90/09
Restaurant	480	125	0.26	CA	93/
Restaurant	480	97	0.20	TN	89/
Restaurant	480	97	0.20	CA	89/
Lunch	480	125	0.26	Texas	94/
Restaurant Lounge	480	170	0.35	Oregon	84/04
Restaurant w lounge	480	50	0.10	CA	90/
Restaurant	480	110	0.23	Calif/Ariz/Nev	83/07
Restr-Dinnerhouse	482	85	0.18	CA	94/02
Restr Family	483	80	0.17	TN	88/04
Restaurant	483	90	0.19	FL	95/11
Restaurant	483	80	0.17	Midwest	87/10
Deli	485	180	0.37	Calif.	87/07
Restaurant	490	190	0.39	Mid-West	85/
Restaurant/banquet	491	150	0.31		93/
Deli-Sandwiches & Coffee	491	118	0.24	CO	95/09
Restaurant	495	195	0.39	MD	96/04
Restr Gourmet	497	82	0.16	MA	90/07
Restr-Family	500	115	0.23	LA	93/04
Deli	500	50	0.10	FL	94/06

TABLE 14
IBA MARKET COMPARISON DATA
REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
C21 Restaurant	500	130	0.26	TX	89/
Continental	500	130	0.26	Texas	92/
Restaur/office bldg	500	215	0.43	FL	95/05
Restaurant, family	500	138	0.28	IL	90/08
Restaurant	500	30	0.06	Midwest	89/08
Deli	501	270	0.54	CT	93/
Deli	501	270	0.54	CT	93/
Restr-Coffee Shop	504	162	0.32	CA	92/10
Restaurant/bar	504	410	0.81	ID	91/
Coffee shop	504	165	0.33	Calif/Ariz/Nev	83/07
Sandwich/deli	504	205	0.41	Calif/Ariz/Nev	83/07
Restaurant	504	208	0.41	Calif/Ariz/Nev	83/07
Deli	505	130	0.26	IL	91/
Deli, Franchise	510	230	0.45	TN	97/07
Restaurant, gourmet	510	186	0.36	CA	93/07
Restr-Italian	516	212	0.41	CA	95/08
Restaurant	516	190	0.37	Mid-West	85/
Restaurant-Family	522	63	0.12	TN	90/01
Restaurant	522	62	0.12	Midwest	90/01
Restaurant, Family Style	534	200	0.37	Midwest	87/07
Deli	535	215	0.40	MA	93/06
Deli	536	340	0.63	CA	90/
Retail-Ice Cream	540	190	0.35	CA	94/06
Restaurant/bar	540	175	0.32	TX	90/
Fast Food-Fried Chicken	540	248	0.46	TX	94/08
Restaurant	541	83	0.15	Texas	92/
Restaurant, family	541	83	0.15	TX	91/07
Restaurant b & w	548	150	0.27	Cal/Ariz/Nev	86/04
Restr-Seafood	550	80	0.15	NC	94/01
Deli-retail	550	391	0.71	So. Calif.	86/12
Deli-Retail	550	400	0.73	CA	88/03
Restaurant/Bar	550	309	0.56	D.C.	85/04
Coffeehouse	553	296	0.54	CA	95/10
Restaurant/mini golf	554	258	0.47	IA	93/09
Restaurant	564	200	0.35	ME	90/
Restr-Fine Dining	566	181	0.32	CA	94/08
Restaurant	568	240	0.42		90/11
Restaurant-Family Style	569	145	0.25	MA	93/06
Food Catering-Mobil	570	295	0.52	NC	94/05
Restaurant	572	130	0.23	MA	95/07
Restaurant, steak house	572	375	0.66	TX	85/04
Catering-Truck Route	575	79	0.14	TX	92/01

TABLE 14
IBA MARKET COMPARISON DATA
REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Catering-Truck Route	575	116	0.20	TX	92/01
Restaurant	575	25	0.04	FL	94/09
Restr Family	580	163	0.28	So CA	90/09
Restaurant-Full Service	582	179	0.31	CA	93/09
Food catering	584	200	0.34	So. Calif.	90/10
Restr-Seafood	596	250	0.42	CA	86/02
Restaurant	599	180	0.30	NH	89/
Restaurant	600	90	0.15	NC	91/
Restaurant/lounge	600	210	0.35	NC	93/
Restaurant-Dinnerhouse	600	225	0.38	NY	93/07
Restaurant, family	600	105	0.18	IA	92/03
Restaurant, bar	600	250	0.42	NC	89/
Restaurant	600	110	0.18	FL	94/06
Restaurant	600	130	0.22	FL	95/07
Restaurant, family	600	450	0.75	AL	93/
Restaurant, full service	600	325	0.54	D.C.	85/01
Restr., continental	600	200	0.33	VA	85/12
Restaurant	600	100	0.17	HI	90/01
Coffee shop in bowl alley	600	235	0.39	Cal/Ariz/Nev	82/06
Restaurant/Bonanza	602	200	0.33		87/11
Restaurant-Beer & Burgers	604	275	0.46	FL	93/06
Coffee shop	624	230	0.37	Cal/Ariz/Nev	86/06
Restaurant	625	645	1.03	New England	86/11
Coffee shop	628	225	0.36	Calif/Ariz/Nev	83/07
Deli-Bakery	635	125	0.20	FL	93/01
Restaurant - Ital. Café	638	275	0.43	CA	96/08
Restaurant/w ice cream	639	215	0.34	IL	91/
Restaurant/ice cream	639	215	0.34	IL	91/
Yogurt, franchise store	640	400	0.63	PA	90/
Restaurant, full service	643	175	0.27	WA	90/
Restaur./dinner only	644	190	0.30	FL	96/01
Restr Family	650	250	0.38	TN	89/01
Restr-Italian	653	89	0.14	CA	95/02
Restaurant Function Ctr.	654	125	0.19	NH	96/03
Restaurant	669	90	0.13	AL	93/
Restaurant-Dinnerhouse	672	158	0.24	FL	92/08
Restaurant, family style	678	152	0.22		89/12
Restaurant	679	275	0.41		88/09
Restaurant, full line	680	325	0.48	NC	93/
Restaurant	693	205	0.30	WA	90/
Restr-Dinnerhouse	700	140	0.20	MA	92/10
Dunkin Donuts	700	400	0.57	East	90/01

TABLE 14
IBA MARKET COMPARISON DATA
REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Diner	700	235	0.34	FL	93/12
Mean			0.36		
Median			0.34		

This category indicates an average price to revenue multiple of 0.36, and a median multiple of 0.34.

The price to revenue multiple was analyzed, as this is typically the way that small businesses sell. This is because owners of very small companies tend to adjust expenses in order to minimize taxes, and therefore, a willing buyer looks at the revenues he or she will be able to generate, believing that there will be certain costs that will be eliminated when he or she takes over the running of the business.

For each category, a mean and median price to revenue multiple was calculated. Statistically, the median is more appropriate than the mean because an average can be skewed by data that are outliers in the sample. The median is the point of central tendency when all of the values are arranged by size. Therefore, the median multiple was utilized.

The three median multiples derived result in an average price to revenues multiple of 0.33. This is the multiple that will be applied to the appropriate revenue stream.

An analysis of historic and adjusted revenues was performed in the financial analysis section of the report. This analysis indicated that revenues increased from 1993 through 1995, and then declined again. Since there appears to be no consistent growth pattern over the last five years, it appears that average adjusted revenues over the period should be used to reflect the future. This amounts to \$703,067.

The values derived using the IBA database includes any assets that the buyer will receive such as equipment, but does not include the assets that the seller will keep such as cash, accounts receivable and accounts payable. Therefore, the value of these assets and liabilities must be added or subtracted from the sales value to determine the value of the operating entity.

Therefore, the calculation of value on a control, non-marketable basis utilizing the data from The Institute of Business Appraisers is as follows:

<i>Average Revenues</i>	<i>\$ 703,067</i>
<i>Price to Revenue Multiple</i>	<i>x 0.33</i>
	<hr/>
<i>Value</i>	<i>\$ 232,012</i>
<i>Plus: Inventory</i>	<i>6,250</i>
<i>Less: Current Liabilities</i>	<i>63,460</i>
	<hr/>
<i>Value of Operating Entity</i>	<i>\$ 174,802</i>
	<hr/>
<i>Rounded</i>	<i>\$ 175,000</i>
	<hr/>

A second database utilized was Pratt's Stats maintained by Business Valuation Resources. A search of SIC code 5812 revealed 32 transactions. Many of the transactions included in this database were of chains of restaurants with revenues greater than several million dollars, which are not considered to be comparable to the subject company. After removing the inapplicable transactions, the transactions shown in Table 15 remained.

TABLE 15
PRATT'S STATS TRANSACTIONS

Company Type	Sales Price	Revenues	Price to Revenues	Date of Sale
<i>Restaurant</i>	\$ 100,000	\$ 474,900	0.21	8/1/97
<i>Restaurant</i>	125,000	429,500	0.29	3/15/97
<i>Restaurant</i>	160,000	533,500	0.30	3/16/97
<i>Restaurant</i>	220,000	618,769	0.36	7/1/97
<i>Italian Restaurant</i>	158,000	382,067	0.41	8/1/97
<i>Italian Restaurant</i>	350,000	1,170,948	0.30	7/10/98
<i>Pizza</i>	265,000	470,147	0.56	8/1/96
Mean			0.35	
Median			0.30	

The median multiple for these transactions was determined to be 0.30. This falls within the range of the multiples determined using the IBA database, which indicates that the multiple and value derived utilizing the IBA data is reasonable.

A final check of the multiple derived using the IBA database was The Business Reference Guide, edited by Thomas L. West, and published by Business Brokerage Press. This book is a compilation of methodologies utilized by different industries to determine a purchase price when a business is going to be bought or sold. According to the chapter entitled "Rules of Thumb," the sales price to revenue multiple for restaurants in the category fast food - pizza was 0.35. Again, this figure reinforces the validity of the multiple determined with the IBA data.

Justification For Purchase Test

Valuation is not the process of developing capitalization rates or multiples. It is, however, the process of providing the user of the appraisal with an estimate of value within a reasonable range. Recognizing that valuation is not an exact science, a test was performed to substantiate the amount of indebtedness that could be undertaken, using a five year payback period, based on the normalized economic income that would be available to a "willing buyer".

Assuming typical terms for a business transaction for the kind of business being appraised, the appraiser can test the reasonableness of the conclusion by testing to see if the transaction will cash flow out for the buyer and the seller. In the example below, we assumed that a purchaser would use approximately a 40 percent down payment to acquire a business of this type. This means that the pretax income would have to carry debt service and taxes. The appraiser decided to use the 1999 income as indicative of future pretax income that would be available to service the debt incurred by the prospective buyer when purchasing The Company. The tax rate has been assumed at 40 percent. Using a 9.25 percent interest rate (prime rate plus 1 percent), and a \$4,371,810 (value of the entire operating company –not really a very small business but it was a good example) purchase price, results in the following:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Annual Payments	\$ 657,237	\$ 657,237	\$ 657,237	\$ 657,237	\$ 657,237
Interest	<u>224,598</u>	<u>182,839</u>	<u>137,048</u>	<u>86,836</u>	<u>31,778</u>
Principal	<u>\$ 432,639</u>	<u>\$ 474,398</u>	<u>\$ 520,189</u>	<u>\$ 570,401</u>	<u>\$ 625,459</u>
Cash Flow					
Pretax Income	\$ 935,233	\$ 963,290	\$ 992,189	\$ 1,021,954	\$ 1,052,613
Interest Expense	<u>224,598</u>	<u>182,839</u>	<u>137,048</u>	<u>86,836</u>	<u>31,778</u>
Taxable Income	\$ 710,635	\$ 780,451	\$ 855,141	\$ 935,118	\$ 1,020,835
Tax	<u>284,254</u>	<u>312,180</u>	<u>342,056</u>	<u>374,047</u>	<u>408,334</u>
Net Income	\$ 426,381	\$ 468,271	\$ 513,085	\$ 561,071	\$ 612,501
Principal Payments	<u>432,639</u>	<u>474,398</u>	<u>520,189</u>	<u>570,401</u>	<u>625,459</u>
Cash Flow	<u>\$ (6,258)</u>	<u>\$ (6,127)</u>	<u>\$ (7,104)</u>	<u>\$ (9,330)</u>	<u>\$ (12,958)</u>
Return on Down Payment	<u>-0.36%</u>	<u>-0.35%</u>	<u>-0.41%</u>	<u>-0.53%</u>	<u>-0.74%</u>

The calculations above indicate that a purchaser of this business could pay approximately \$4,371,810, and satisfy the normal debt obligations that would result from the purchase. The design of this reasonableness test is to make certain that the cash flow would be close to a break-even, so that a buyer does not get additional returns above the profits of The

Company, and a seller does not leave too much cash behind for the buyer. This test demonstrates the reasonableness of the concluded value.

CONCLUSION

Kenny Rogers sang a song named "The Gambler." My favorite line from that song is "You gotta know when to hold em, or when to fold em." The same is true in accepting business valuation engagements for the very small business, particularly in a litigation. There really are no shortcuts, particularly if the case goes to trial. If the case does not go to trial, you may be able to perform some calculations to help settle the case, but be careful that your engagement letter is clear that you will not testify to something that is less than a complete appraisal. The client will not want you to get on the witness stand and testify that you really do not have an opinion because your work was restricted. Chances are, the judge will not allow you to offer an opinion in that case.

First, protect yourself. After that, worry about the client. The key to valuing a very small business in a litigation is to get both sides to hire you with the understanding that you are going to perform calculations to help them settle the case. If hired by only one party, take the engagement in pieces. Just do not let yourself get boxed into testifying to less than a complete job.

GARY R. TRUGMAN CPA/ABV, MCBA, ASA, MVS

Gary R. Trugman is a Certified Public Accountant licensed in the states of New Jersey, New York, Connecticut and Florida. He is Accredited in Business Valuation by the American Institute of CPAs and is a Master Certified Business Appraiser as designated by The Institute of Business Appraisers Inc. He is also an Accredited Senior Appraiser in Business Valuation by the American Society of Appraisers. Gary is regularly court appointed and has served as an expert witness in Federal court and state courts in several jurisdictions, testifying on business valuation, matrimonial matters, business and economic damages and other types of litigation matters.

Gary is currently on the American Institute of CPAs' ABV Examinations Committee and he is a former member of the AICPA's Subcommittee Working with the Judiciary, ABV Credentials Committee, Executive Committee of the Management Consulting Services Division, and the Business Valuation and Appraisal Subcommittee. He is currently Chairman of the Florida Institute of CPAs' Litigation, Forensic Accounting and Valuation Services Section and was formerly on the New Jersey Society of CPAs' Litigation Services Committee, Business Valuation Subcommittee (past-chairman) and Matrimonial Committee.

Gary is Chairman of the Ethics and Discipline Committee, and formerly served on the Qualifications Review Committee and is the former Regional Governor of the Mid-Atlantic Region of The Institute of Business Appraisers Inc. He has received a "Fellow" Award from The Institute of Business Appraisers Inc. for his many years of volunteer work in the profession. Gary has also received an AICPA "Hall of Fame" Award for his service to the accounting profession in assisting in the accreditation in business valuation process. Gary formerly served on the Business Valuation Education Subcommittee and the International Board of Examiners of the American Society of Appraisers. He is currently a faculty member of the National Judicial College, educating judges around the country.

Gary lectures nationally on business valuation topics. He is the author of a textbook entitled Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses, published by the American Institute of CPAs. He has also developed numerous educational courses, including but not limited to, a six day business valuation educational series and a seminar entitled "Understanding Business Valuation for the Practice of Law" for the Institute of Continuing Legal Education. Gary also serves as an editorial advisor for The Journal of Accountancy, The CPA Expert, and formerly for National Litigation Consultants' Review and the CPA Litigation Service Counselor. He has lectured in front of numerous groups and has been published in The Journal of Accountancy, FairShare and The CPA Litigation Service Counselor.

Gary was born in New York and received his undergraduate degree from The Bernard M. Baruch College of the City University of New York. He was the first business appraiser in the United States to earn a Masters in Valuation Sciences from Lindenwood College. His Masters Thesis topic was "Equitable Distribution Value of Closely Held Businesses and Professional Practices". Gary's appraisal education also includes various courses offered by The Institute of Business Appraisers, the American Society of Appraisers, the American Institute of CPAs and others. He has taught federal income taxation at Centenary College, financial statement analysis in the masters degree program at Lindenwood College, and several topics at the AICPA. National Tax School in Champaign, Illinois. He is a member of The Institute of Business Appraisers Inc., the American Society of Appraisers, the American Institute of Certified Public Accountants, the Florida Institute of Certified Public Accountants, the New Jersey Society of Certified Public Accountants and the New York State Society of Certified Public Accountants.