

PRESIDENT'S MESSAGE
December 2009

President's Message:

To My Fellow ICBC Members:

It is with great honor that I assume the position of ICBC President for the upcoming year. I would like to take this opportunity to thank our past President Brian Wendler and all the ICBC board members and Executive Administrator, Mary Ann Gray, for their efforts. The ICBC board is made up of volunteers that take time from their individual practices to serve to make the ICBC organization better for all members. Under Brian's direction we accomplished quite a bit last year and put in place many ideas and goals which I hope to see implemented during my term.

One of the questions we are often asked as a board member is what is ICBC doing during the year and what is the benefit to me as a member. In an effort to better communicate what we are doing we have set up a site on LinkedIn® (http://www.linkedin.com/groups?gid=2407721&trk=hb_side_g) which I would encourage all members to join. If you are not familiar with LinkedIn®, it is a business-oriented social networking site mainly used for professional networking. Through LinkedIn® and Constant Contact email it is my hope to keep all members better informed as to the progress we are making. We plan to use these media to poll members and encourage you to actively participate in the development of the organization going forward.

I would like to wish all members Happy Holidays and a glorious New Year and please feel free to contact me or any other member of the board with your ideas, thoughts and suggestions. We have many items on the agenda and I believe as you see them implemented you will see many benefits of continuing to be a member of this fine organization.

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Editors Column

Fellow ICBC members:

I am pleased to take over the role of Editor of *"The Certified Business Counselor"* newsletter. In addition to my role as Editor I am responsible for heading up the Marketing Committee. Our Goals and objectives for the next year were set during a strategic planning meeting which was held In March 2009. I would like to outline below some of these activities that we have planned and ask for your input and comments on these topics:

1. BROCHURES

- *Membership Brochure* to be distributed to potential prospects. This piece will focus on the benefits of being a member of ICBC, the types of membership, services offered by our members, and our Code of Ethics.
- *Business Owner/Client Leave-behind Brochure*. This piece is designed to provide prospective clients information about what it means to be a select member of ICBC, our Standards of Excellence, and our Code of Ethics. We will also promote the fact that our association has members from many disciplines who all work together for the good of the client and their transaction. Each of our members has a team of experts who they can call on.

2. CLIENT NEWSLETTER

- A four page glossy newsletter available in print or electronic version to be used for clients and prospective clients. We will combine general business articles written by ICBC members along with a customizable section which can be written by the individual user to promote their own practice. These can be purchased in small quantities and will be fully personalized for each ICBC member.

3. PRESS RELEASE TEMPLAT

- Create a press release template for new members to use.

It would be a great help if anyone can help us with suggestions for naming our client newsletter. I would like to suggest that in conjunction with a name for the newsletter we use a tag line of "Skilled, experienced practitioners focused on the needs of businesses in ownership transition", which is taken directly from ICBC's new vision statement. Please feel free to send me your ideas at rmurphy@murphybusiness.com

Regards,

Roger Murphy
Newsletter Editor



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MEMBERSHIP SURVEY

1. Why did you join ICBC?

2. What is the greatest value you have received from ICBC membership?

3. What areas of our membership would you like to see expanded?

CPAs

Financial planners

Tax experts

Intermediaries

Other:

4. Additional comments

**Please return your responses via email to inquiry@i-cbc.org or
via fax to 503-292-8237.**

The Income Approach

By: George D. Abraham
CEO Business Evaluation Systems

The income approach is a general way of determining the value of a business or an intangible using methods that convert anticipated economic benefits into a present single value.

Under the Income Approach, appraisers will use three valuation methods; the Capitalization of Earnings (or benefits), Discounted Future Earnings (or the Discounted Cash Flow Method) and the Excess Earnings Method. The two main points to remember under this approach are:

- 1) We are using earnings that represent “future benefits (earnings)” and not historical earnings, unless the earnings from prior years help us to formulate our opinion as to the future earnings of the company we are appraising. Revenue Ruling 59-60 directs the appraiser to use a “prophecy as to the future” and to consider the earning capacity of the company to arrive at the value.
- 2) We must use the right terminology. Business appraisers have not been able to agree on terminology but we are currently making some progress. We need to differentiate which income we are using, future benefits, future earnings, net income, cash flow or net cash flow, or free net cash flow. For purposes of this article we will use earnings.

Capitalization of Earnings Method

Simply explained, the economic benefits for a representative single period are converted or valued through division by a capitalization rate. The discount rate minus the long term growth rate is the capitalization rate. An example would be the Build up Method:

| | |
|-------------------------------|---------------------------|
| Safe rate | 5.25% ¹ |
| Equity risk premium | 7.00% ² |
| Small company risk premium | 3.25% ³ |
| Specific company risk premium | <u>4.00% ⁴</u> |
| Discount rate | 19.50% |
| Less: Long term-growth | -3.00% |
| Capitalization rate | 16.50% |

Multiple of Earnings (100/19.5) = 5.13
Rounded: 5

1 Information from the Federal Reserve Board

2 Ibbotson Associates

3 Ibbotson Associates

4 Appraiser’s judgment from analysis of the company

To determine the specific company risk premium we look at key risk factors of the company and from our research of the company, industry forecasts and financial analysis. The following risk factors can form your premium:

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| Company Specific Risk Component | Risk Factor |
|--|--------------------------|
| Labor | 0.5% |
| Financial position of the company | 1.0% |
| Facilities and location | 0.0% |
| Management | 0.5% |
| Competition | 1.0% |
| Diversity of accounts | 0.0% |
| Future outlook | 0.5% |
| Owner Importance | <u>0.5%</u> |
| Total Company Specific Risk: | 4.0% ⁴ |

The Capitalization of Earnings method assumes that growth in the future will be constant or stable and is mathematically simple, but the difficult part is the selection of the capitalization rate. Some appraisers will add another component called “Industry Risk Premium” in forming the discount rate. James H. Schilt, a noted authority on capitalization rates, suggests that a risk premium of 6 to 30 percent will cover the broad categories of small businesses. Other professionals suggest a slightly narrower range of values: “A range of specific risk premiums from 12 to 24 percent will cover the wide range of profitable small businesses”.

Section 6 of Revenue Ruling 59-60 states “In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation.”

The process may seem highly subjective and, it is. What is important to remember that the simple definition of an appraisal is nothing more than a supportable opinion of value by an expert. When you perform an appraisal the client is paying for your expert opinion. The main part of that definition is the word “supportable”. A good starting point in helping to choose capitalization rate is to research comparable sales to get a good range of multiples and narrow the range of companies that have sold that are the closest to the subject company. The appraiser should research the company’s financials, capital requirements, its performance compared to industry standards as well as other internal research such as potential for growth, labor and management (age and the degree of difficulty to replace them), competitive position, customers, suppliers, the economic forecasts for the country and the company’s trade area, and the facility’s suitability. Each one of these factors, the appraiser must forecast its risk and impact it will have on the company in the future. It is all about the future! Once we begin to feel that it is not very subjective we are ready to start applying the methods and mathematics. Once we feel we are absolutely positive it is no longer subjective we can place the final value. Unfortunately only business appraisers can arrive at this enlightened state of egotism. Usually a good attorney can cure this phenomenon very quickly on the witness stand.

In all seriousness the point I am trying to make is twofold; everything is about predicting the future and whatever value you arrive at, be convinced from your research that you can definitely support it. Again it’s only your opinion and there is no such thing as the correct value, only the most believable and supportable value. Even Revenue Ruling 59-60 gives credence to this in Section 3, Approach to Valuation. It states:

Valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.

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Revenue Ruling 59-60 has been around for 40 years and has stood the test of time when it comes to the fundamental principles of valuing a business. When you think back 40 years ago and what businesses looked like then as to what they look like today, that's an impressive piece of work.

Discounted Future Earnings Method

A method within the Income Approach whereby the present value of future expected economic benefits is calculated using a discount rate. In simple language, value is estimated as the sum of the present values of the benefit stream for the projection period plus the present value of the terminal value. The terminal value is the present value of the stabilized benefit stream capitalized into the future. The terminal value can also be the present value of the sale or liquidation proceeds of the company. You can use one or the other, but not both. The method assumes, by the residual from the terminal value, that at some point in the future the income stream will stabilize and the stabilized income stream can then be capitalized into perpetuity and discounted back to the valuation date. It is an excellent method if the company is expected to have a limited life.

Unlike the Capitalization of Earnings Method that assumes the earnings will be constant or stable in the future, the Discounted Future Earnings Method assumes that earnings will not be stable in the future and that an analysis of multi-period projections are appropriate. Unstable earnings may exist in startup businesses or any business whereby a change in operations is expected in the future. However theoretically, using this method with stable earnings over multiple periods, the values should be the same as derived from the Capitalization of Earnings method.

Its foundation is in the principle of future benefits which states that the value of a business is the present value of all the "benefits" it can reasonably be expected to generate in the future. These "benefits" are generally considered to be the future cash flows available to the owners from the business.

The calculations are generally mathematically simple and present value calculations and tables are easily available. The hard part is the projections and what the expected changes will do to profits, working capital, capital expenditures and requirements in each of the projected years and when the company's income stream will finally stabilize. As stated before, it's all about the future and is highly subjective. The best we can do is support the value opinion so that the reader of the report can follow our logic and calculations and arrive at the same conclusion.

Although when used correctly, it is a theoretically one of the best valuation methods, but there are some problems with its believability to the public and the courts, as it relies solely on projections or prophecy that may not resemble any past performance of the company. Since potential future earnings are not to be considered as a marital asset, although theoretically sound, this method cannot be considered in valuing a closely held business in many divorces. The courts have found that the projections of "potential future earnings" associated with small businesses is not an asset subject to equitable distribution and that the projections associated with small businesses are frequently so speculative that it can carry no weight in the valuation process.

Excess Earnings Method

This method is a specific way of determining a value indication of a business as the sum of (a) the value of the assets and (b) the value of the intangible assets derived by capitalizing excess earnings. Excess earnings are the amount of the anticipated economic benefits that exceeds an appropriate rate of return on the value of a selected asset base used to generate those anticipated benefits.

Many appraisers feel the excess earnings method is more of an asset-based approach than it is an income approach. The excess earnings method is really a hybrid of both approaches as the return on tangible assets is derived from the market (market approach) and the excess earnings is capitalized (income approach), but since the majority of appraisers refer to it as an income approach I will follow the crowd on this one.

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However, not to get off on the subject of the excess earnings method, but maybe all the methods are hybrids that use an array of components of one or the other two approaches. Maybe this is why it is not a major controversy among appraisers. This is certainly an anomaly in our industry as anything controversial will be debated and written about extensively. The debates get so mathematically complex that when we finally come to the conclusion that it cannot be proven by mathematics, we all lose interest.

In any case, think of this, since we use the market approach to research companies that have sold in order to derive a Price to Earnings (P/E) ratio. Isn't this an income approach? The selected ratio is a multiple of earnings and a multiple of earnings is the same as a capitalization rate except instead of dividing you are multiplying, but the results are the same. Is the cost approach really just cost? Not really because when you adjust the balance sheet you are using comparable sales (Market approach) to value the hard assets. The same would be true for stocks and securities on the balance sheet. Also on the balance sheet you will find intellectual assets such as patents, copyrights, etc. These would most likely be valued using the market approach and the income approach. In the end it really makes no difference and the three approaches make good folders to store your methods in. One fact is definitely true, there are only three approaches to value; the cost approach (what it costs to create), the market approach (what other similar items are selling for) and the income approach (value based on a return on investment from the anticipated earnings from an income stream).

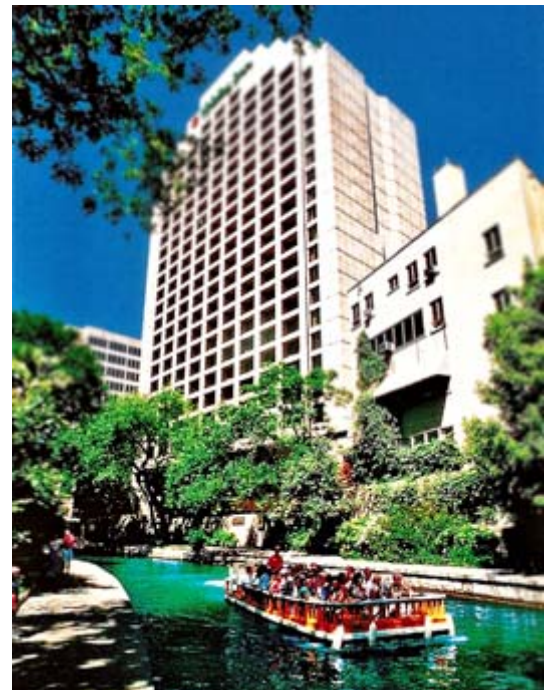
There are three extremely important principles that constitute the foundation of valuation theory:

- A. Principle of Alternatives
Simply put, there are generally alternatives to the investment. I have alternatives for whether I sell my business, how much I ask for it, and who I sell it to.
- B. Principle of Substitution
Individuals will not pay more for something than they would pay for an equally desirable substitute.
- C. Principle of Future Benefits
Economic value reflects anticipated future benefits. In other words, a purchaser would feel that historic earnings were not as important as prospective earnings.

SAVE THE DATE!!!

ICBC CONFERENCE 2010
SAN ANTONIO TEXAS
SEPTEMBER 22ND-25TH

TAKE FULL ADVANTAGE OF YOUR
MEMBERSHIP AND JOIN US FOR THE
LATEST IN CURRENT INDUSTRY
PRACTICES, NETWORKING AND IDEA
EXCHANGE.



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