

and sold with a substantial loss of the capital invested. With a second tier of management, the business would survive. There would be some loss of management skill, but it would survive, preserving most if not all of the capital invested.

**Invalid Zones of Appraising.** One can begin to picture two invalid zones of appraising by plotting appraisal-datum points on a graph. Starting with the Acme Widget Corporation as an example, one would plot the \$42,000 earnings assumed by the buyer along the horizontal axis (the X axis), and, using the 25% capitalization rate, the \$168,000 appraised value along the vertical axis (the Y axis). The first datum point would fall where the \$42,000 and \$168,000 values would intersect when projected into the field of the graph. If several more datum points were plotted using different earnings but with the same 25% capitalization rate, these points would fall in a straight line sloping towards the intersection point of the horizontal and vertical axes. The line thus formed could be used to determine graphically other appraised values for other amounts of earnings. One simply would locate the earnings along the horizontal axis and project upward to the plotted line to get the appraised value. The question arises how far up the line or down the line one might validly use the graph.

Looking first at the upward side of the line, assume that the sales, number of employees, number of customers, and other elements of the business are in a state of growth. It follows that the management duties also would grow and, presumably, so would the earnings. A point eventually would be reached where the owner would be forced by the increased management duties to hire an assistant to manage the company and where the company would produce enough earnings to pay the assistant's salary. Assuming the assistant capable of handling most if not all of the owner's functions, the owner's prolonged absence due to death, disability, or other cause would no longer inevitably result in shutting down the operation. The risk to the capital invested would largely diminish. At that point, however, the business in question would no longer be a small business. It would be a medium-size business or at least a business in the zone between small and medium. If the

business now would be placed on the market, then, as a normal consequence of market forces, the buyer's expected rate of return on the capital invested in such a multi-tiered business would have to be reduced to compensate for the reduced risk of invested capital. The new rate would be less than 25%. Thus, the graph described above for appraising various amounts of earnings would become invalid above the point where the second tier of management is added. (How the business with a second tier of management would be appraised is beyond the scope of this book but it surely would appraise with a lower rate of return on investment.)

The downward side of the appraisal graph is more complicated and much more interesting than the upward side. When the Acme Widget Corporation was introduced at the beginning of Chapter 6, the equipment was described as having a fair market value of \$75,000, in place, as determined by a competent appraiser, the replacement value was described as \$100,000, and the liquidation value as \$20,000. If the earnings of Acme Widget were to start declining to a range approaching zero, especially if the decline were steady enough to form a trend, the value appraised by using the capitalization method would become largely invalid *and so would the value of the equipment as appraised by the equipment dealer*. For example, if the earnings were to decline, say, to \$9,000, the appraised value using the 25% capitalization rate would be \$36,000. But this appraisal contradicts the equipment appraisal at \$75,000. Which appraisal is valid?

The answer to this conundrum lies in what is meant by appraised value. Appraised value is fair market value which is the price a buyer and seller would agree to if both were well informed, economically motivated, and not in distress. What is happening is that the conditions underlying the definition of appraised value, particularly motivation and absence of distress, are being eroded. This erosion can best be understood by looking at a case which is fairly common, if not typical:

The seller, nearing retirement, has let the sales decline for several reasons. The seller's home is paid for, the children are raised and started on careers of their own, the seller's energy is not what it was 20 years or even ten years earlier, the seller does not need a lot of money and therefore is not

trying to bring new customers to restore sales to former levels, and attrition not only has been, but still is causing the sales to decline. Despite the sales decline, the seller feels no pressure to restore sales because, in addition to the above reasons, the seller still takes a regular salary, the business is still profitable even if barely so, and the sales do not appear to have declined by a worrisome amount. However, what is happening, somewhat inconspicuously, is that as sales decline, even by a seemingly small amount, earnings decline at a faster rate due to the tyranny of fixed expenses such as rent, payroll, advertising, and medical insurance, and due to the semi-tyranny of semi-fixed expenses such as business insurance, legal and accounting, and maintenance and repair. The seller, in other words, does not quite realize the extent to which his business has slipped and does not quite realize that the trend is ongoing.

The seller's situation now is that, though motivated to sell, he no longer enjoys the vitality and economic motivation which once made the business thrive. Now, in the state of decline with earnings approaching zero, he is approaching a state of distress even though the distress may not yet be felt. In short, the conditions underlying what is known as fair market value have deteriorated and are continuing to deteriorate. Therefore, the appraised value no longer qualifies as fair market value. The value of this business is now headed towards liquidation value of the equipment. To confirm this hard-to-accept reality, recall that the equipment was appraised at \$75,000 in place. But equipment remains in place only when it is making a profit. When the profit-making ceases, the only way the equipment can remain in place is for the business to be sold to someone capable of making a turnaround, in which case a distress sale or at least a semi-distress sale will have occurred. If a turnaround does not occur, the equipment will not remain in place, and probably will be sold to someone at another location at prices approaching those at an auction.

What commonly happens in such cases is that if the buyer offers the capitalization value of \$36,000 for the business, the seller will reject the offer while citing the \$75,000 equipment appraisal, and he may do so with a tone of righteous indignation: "The equipment is worth \$75,000," the seller

will contend, “and it’s up to you to make the proper use of it.” The buyer will reply that the business with its present earnings of only \$9,000 cannot pay for itself at the seller’s price and the bank, therefore, will not lend the money necessary to purchase. The buyer will add that if he has to build the sales to a level capable of justifying the \$75,000 price, then he would be paying for the fruits of his own labors, something that he is not willing to do.

In an attempt to solve the impasse, the seller will consult with his accountant who, being neither trained nor experienced in these matters, probably will tell him that the equipment appraisal is valid because it was professionally done and that he should stick to his demand for \$75,000. Likewise, the buyer will hire a consultant, either a lawyer or an accountant, who, also being neither trained nor experienced in these matters, probably will tell him that a business earning only \$9,000 is barely worth \$36,000, much less \$75,000, and that “the equipment appraisal is probably trumped up, as everyone knows most of them are.” With contradictory appraisals fortified by contradictory professional advice and further fortified by the suspicions that the principals now harbor towards each other, the impasse they have reached is probably permanent and the deal is probably dead. One more case of shattered hopes and broken dreams.

This case, as the reader may already have surmised, describes more than an invalid zone of appraising. It also describes the anatomy of a broken deal. It is a woefully common happening in the business marketplace, and one where both sides lose.

The solution is for both parties to recognize that when the earnings of a business approach zero, conventional appraisals lose their validity. The principals should therefore ask themselves how badly they wish to make a deal and whether they are willing to negotiate a compromise. The intelligent, motivated buyer will recognize that if he can turn the business around—and he should not be bidding on it if he does not have that capability—he can do very well while paying more than \$36,000. The intelligent, motivated seller will recognize that the buyer is not necessarily a thief in businessman’s clothing and that the low earnings in a downward trend cast a cloud over the value of the equipment. They also cast a cloud over the viability of the business. A

compromise therefore is very much in order. A compromise that most buyers and sellers could live with might consist of splitting the difference between the two appraised values, settling in the range, say, of \$50,000 to \$60,000. Another type of compromise might set a firm price, say, \$36,000, plus a contingent price, say, a 15 or 20 percent royalty on sales in excess of present levels, such that an additional \$39,000 to bring the total price up to \$75,000 might be forthcoming. Such an agreement would place a cap on the royalties (as shown at \$39,000) and a date, say, five years after closing, past which no further royalties would be paid whether the cap had been reached or not. Such an agreement also would minimize the buyer's risk while assuring the seller of a better price if the business does turn around.

One may speculate on what would have happened if, by chance, the accountant advising the seller had never met the seller and, in normal course, had been hired by the buyer while, likewise, the buyer's accountant, by chance, had been hired by the seller. Would the accountant now paid by the buyer still emphasize the \$75,000 equipment appraisal and would the accountant now paid by the seller still laud the \$36,000 capitalization appraisal? The author thinks not although he has no documented evidence to hold that opinion. What he does have is a modicum of experience suggesting that advisors who lack training and experience usually don't understand appraising and, what's worse, they usually don't realize that closing the deal is probably more important to their clients than getting the best price.

The clients themselves often don't realize the full importance of closing the deal but could be swayed if their advisors would place things in perspective. Instead, thinking only of price, the advisors suggest their clients take the safest course of action. What is safest, however, may apply more to the professional advisor than to the client. If the buyer's accountant should advise paying \$55,000 for a business appraising at \$36,000, and if the business should fail causing financial and emotional ruination for the client, could the client sue the accountant for damages, both actual and punitive? Or, if not sued, could the accountant lose the trust and confidence of the client and, possibly, the client's business?

Such questions may be speculative but they take on fearful possibility

in a society so litigious as America. In a way, one can hardly not sympathize with the accountant being pressed to offer advice in a field so arcane as the small business marketplace and in a society where malpractice suits are so common. The author even questions himself as to how he would behave were he in the accountant's shoes and asked for advice on something which he is not sure about in an arcane field where exist no licensed or certified advisors to whom one could refer the client. It is not the kind of situation most normal people would ever wish to find themselves in.

In any case, it is clear that two zones of invalid appraisals exist: the upward part of the capitalization graph beginning where a second tier of management is added, and the downward part of the capitalization graph where the earnings approach zero, this lower zone to include the equipment appraisal. Actually, a third zone of invalid appraisals exists in the offices of lawyers and accountants who lack training and experience in these matters, their good intentions notwithstanding. There also may be other invalid zones not yet discovered.

**Doing Cash-Flow Projections and Appraisals On a Computer.** In general, using a computer for cash-flow projections is inadvisable and even harmful for several reasons. Most small business buyers and sellers probably would not understand the software and thus would lose the biggest value of the projections which is to understand what is going on. Learning the software would take more time than doing the projections by hand. The projection procedures, as described in this chapter, probably would have to be modified to fit the software, or vice versa, thus impeding the computer's primary value which is speed. Besides, the work and the challenge of cash-flow projections is in finding the facts and then organizing them. Doing the arithmetic on a paper spreadsheet with the aid of a pocket calculator is relatively quick and easy. Using a computer is therefore not warranted. The exception may be in the case of a person specializing in acquisitions who does his or her own fact-finding and who has developed the proper software for his own use and who will use it repeatedly, in which case all of the above objections would disappear.

The use of a computer for capitalization or for other appraisal methods