Capitalized Earnings Method of Value
Will Your Expert's Opinion Withstand Scrutiny?

By J. Richard Claywell, CPA, ABV, ASA, CBA, CVA, CBA, CM, AA, CFFA

There are two primary methods of determining the value of a business using the income approach: "the Capitalization of Earnings/Cash Flows" and "the Discounted Future Earnings/ Cash Flows.

The Capitalization of Earnings/Cash Flows can be used to determine value if the earnings/cash flows are stable. If they are not, then the Discounted Earnings/Cash Flows would be projected year by year until the earnings/cash flows stabilize.

It is often easy to go directly to a Capitalization of Earnings/Cash Flows instead of using a Discounted Earnings/Cash Flows method when doing a business valuation. The Discounted Earnings/Cash Flows method takes more thought and time to complete. The Discounted Earnings/Cash Flows involves analysis of anticipated revenues and earnings until they are stabilized. The Capitalized Earnings/Cash Flows method means that the appraiser applies one divisor (or multiple) to one economic income measure. The result is an indication of value derived from that single division or multiplication (with a few adjustments sprinkled in afterwards).

When using the Capitalized Earnings/Cash Flows, the assumption (imbedded in the model itself) is that the benefit stream is constant over time. This means that the earnings/cash flows are expected to be stabilized or constant over the foreseeable future. When this method is applied in real valuations, the practitioner often use a weighted average earnings level to estimate the earnings/cash flows to capitalize. Assuming that five years of historical data is available, appraisers normally apply a weighting of 1, 2, 3, 4 and 5 for the actual (historic) earnings/cash flows (1 applied to the oldest year, 5 applied to the most current year). Appraisers often proclaim the weights without any emperical support.

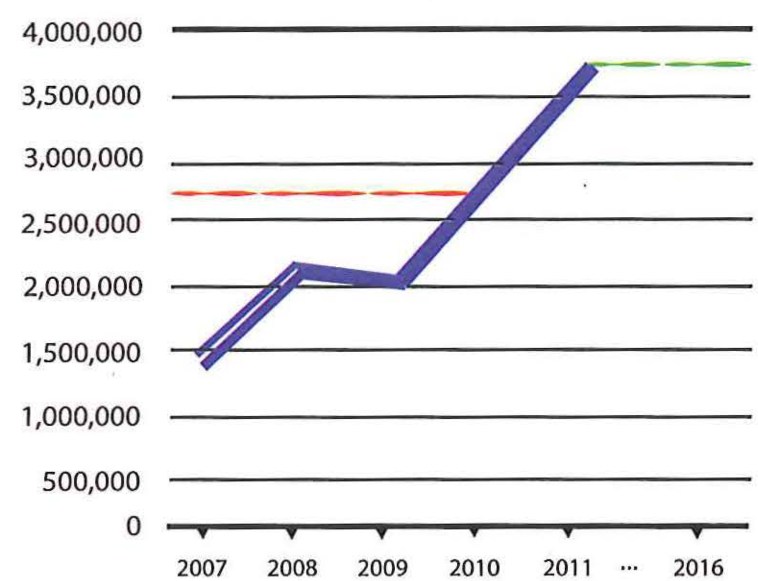
Let's examine the historical benefit stream of the company. The earnings are on an upward trend. The Capitalization of Earnings/Cash Flows method assumes that the earnings/cash flows, when stabilized will be at the specified level of earnings/cash flows into perpetuity.

It can be seen in Chart 1 (see full article on www.famiylawyermagazine.com for charts and graphs used in the example) that the upward trend in earnings has not leveled off and is not stable. In fact the final years earnings are $3,656,107. If the earnings/cash flows are assumed to be stable, the appraiser should use last year's earnings of $3,656,107. However, in this example the appraiser used $2,772,005 as the earnings to capitalize.

This analysis is flawed in that the weighting, as it is typically done, produces a lower value when the weighting is from the lowest to the highest and the earnings/ cash flows are increasing.

The full article feature more examples and information graphs. Claywell also provides a list of questions for family lawyers to consider so that they may question or challenge their expert appraisers when needed: www.familylawyer magazine.com/articles/richard-claywell-cap-earnings.

Chart 1. Sample Company Project Earnings



J. Richard Claywell is the co-author of Capitalization and Discount Rates: The Value of Risk, He has made presentations of business valuation topics in Germany and China and is the chief architect for the Business Valuation Manager Pro business valuation software program. www.biz-valuation.com.

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