

Cirr Produce Company – An Introduction to Business Valuation

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Monday, February 4, 2002

Jess Parker, a partner in charge of the business valuation area for Worth & Worth PSC, was going through the morning mail. On answering the phone Jess was greeted by an old college friend, Dan Cirr. Since college, Dan had been fairly successful in the wholesale grocery business with his brother Darryl and sister Ann. After the usual swapping of semi-true war stories from their college days, Dan got down to business. He needed Jess' help since a recent family quarrel was forcing Ann and Dan to buy out Darryl's interest in their family's grocery business. Dan agreed to come by the office after lunch on Tuesday.

Jess Jones, CPA/ABV had done tax consulting at Worth & Worth for twelve years before deciding to specialize in the area of business valuation. He had received his ABV (Accredited in Business Valuation) designation from the AICPA two years before and had done twenty or so valuation engagements since then. His experience and ABV designation had resulted in Jess becoming a very well respected valuation consultant. He was looking forward to the meeting with Dan since he knew that every valuation engagement had its own special "character" and presented unique challenges.

Tuesday, February 5

At 1pm, Dan arrived in Jess' office and the two began discussing the valuation situation. Dan briefly summarized Cirr's operations and ownership arrangements (Appendix I).

Dan, Ann and Darryl had each inherited one-third of the shares in the business from their father, Vincent, in 1990. Since then, all three had been active in running the business and had received equal compensation. Since early 1998, however, Darryl's in-laws had been the source of some friction in the business and Darryl had asked to be bought out effective the end of last year. Dan and Ann were happy to do so.

Having faced similar family business arrangements before, Jess immediately asked: "What sort of buy-sell provisions are spelled out in the shareholder agreement?"

Dan briefly summarized it, "In short, the shareholder agreement says that the Company must pay a price equal to the fair market value of Darryl's ownership interest as of the end of the most recent business year. I guess that would be December 31, 2001."

Dan jokingly continued: "So Jess, this seems rather simple. All you have to do is find out what the Company was worth five weeks ago and divide that by three! You can handle that, can't you?"

While laughing at Dan's attempt at humor, Jess thought to himself that a few years ago he had shared a similar view of small business valuation - how hard can it be? He had learned differently over the past three years.

Jess replied: "This certainly sounds like an interesting valuation job and I'd like to work with you. But, before I can formally say 'Yes', I'll need to do some background research and then run it by the partners group for approval. Initially, I'll need copies of your business plan, board minutes, company expectations on growth, future goals and objectives and the financial statements and tax returns for the past four years. If you can get them to me in a day or so, I can get started on the background work"

As Dan got up to leave, he said: "I'll fax the financials this afternoon (see Appendix II). You'll get the other information tomorrow."

Dan continued: "We really need these numbers ASAP! We want to get this buy-out over and done with quickly. Also, depending on the numbers you come up with, we may need to line up some additional financing. Sooner is better than later."

After Dan left, Jess' first concerns about the engagement were potential conflicts of interest with himself or his CPA firm. Since Cirr Grocery was not a publicly traded company, Jess knew that he personally had no financial interest in the company, either direct or indirect. After checking the firm's client list, Jess was also pleased to learn that Cirr Grocery had never been one of Worth & Worth's audit clients. Recent national publicity about "cozy" relationships between auditors and their clients had made the principals at Worth & Worth particularly attentive to conflict of interest concerns for audit clients. Also, Jess personally prided himself on remaining objective and independent in his valuation work.

Jess called Carlos, a two-year staff member that recently had been assigned to the business valuation area. Jess asked him to get a copy of the firm's standard valuation report checklist and list of documents to be collected as part of the background research. Jess would begin with the standard lists and modify them as needed for this job. Carlos was also able to locate some work papers on two other grocery valuation projects done by other firm partners several years ago. While no two valuations were ever the same, these work papers would help Jess in getting some general background information on the industry. As Jess had already learned, no business could be properly valued without a thorough understanding of the industry and its operating environment.

While delivering the materials, Jess asked: "Carlos, do you have some unassigned hours coming up over the next several weeks to help me on this job?"

Carlos, anxious to start on his first business valuation job, eagerly said: "Yes, I'm between jobs right now so I'm your man. What do you need?"

Jess replied: "Well, for the basic background work, see if you can find anything at the U. S. Census Bureau Web site related to the wholesale grocery industry. We're usually able to find some industry statistics on sales and inventory trends there. After we get the Cirr Grocery financials, see if you can find some basic industry comparison ratios from RMA. You'll need Cirr's total assets and sales figures to find those. Don't forget, you'll also need to first find the NAICS or SIC code for the industry in order to find the ratios."

Carlos replied: "Consider it done!"

REQUIREMENT 1: Put yourself in the role of Carlos as he begins to research basic background information for the Cirr Grocery valuation engagement.

- 1) First, using the business resources in your school library, find the SIC and NAICS code for the wholesale grocery industry.
- 2) Find the most recent RMA statement studies (or comparable resource) and find or compute the following financial statistics for the industry:
 - Current ratio
 - Sales / receivables
 - Cost of sales / inventories
 - EBIT / interest
 - Debt / Equity
 - Sales / Total assets
 - Officers, Directors, Owners' Compensation / Sales
- 3) On the Web site for the Census Bureau, locate the most recent annual percentage increase or decrease in the wholesale grocery industry's sales and inventories. [Hint: Look under Economic Indicators.]

Wednesday, February 6

As Jess had learned, much of the time on the typical valuation job was spent doing research. Using the background material collected by Carlos, Jess spent several hours searching for additional data relevant to the grocery job. Through experience, Jess was good at locating relevant sources on the Internet and in the firm's library. Jess also spent some time in the public library reviewing industry and trade publications related to the wholesale grocery industry. The information that he had requested from Dan arrived in Wednesday afternoon's mail. The financial information had arrived the day before, as promised (Appendix II).

Jess found that Cirr Grocery's mission was to be the premiere wholesaler of fresh fruits and vegetables in their service area (approximately 100 mile radius from their warehouse). They had built a reputation of delivering high quality produce at moderate prices.

Jess accessed a variety of sources as part of his external search. He found that the near-term sales growth prospects for most food commodities were relatively flat. He reviewed the Web resources of an industry trade organization, International Foodservice Distributors Association (IFDA) and looked for some comparable companies to use for comparisons and contrasts. However, despite his best efforts, Jess was unable to find another grocery wholesaler comparable to Cirr.

Overall, Jess concluded that the wholesale grocery business was an easy one to enter due to the relatively small amounts of start-up capital required. Thus, competition was likely to be strong. In addition, prices in the industry were very volatile since they depended on uncontrollable factors like weather and consumer demand.

Thursday, February 7

In the afternoon, Jess visited Dan at the Cirr Grocery site. In the Cirr offices, Jess reviewed and made copies where necessary of the shareholder agreement, supplier and customer contracts, aged receivables and payables, inventory records, lease agreements, loan documents, wage agreements, employee manuals, insurance policies and other relevant documents.

Later, Dan took Jess on a tour of the company's operations where Jess could examine the condition of the facilities and the efficiency of the inventory handling procedures.

While touring the facility with Dan, Jess asked: "I noticed that sales took a big jump two years ago and have kept growing nicely since then. What happened two years ago?"

Dan replied: "That was about the time that we landed the Tri-States Groceries chain. We had been after that chain for several years and finally landed them. They buy a lot and they keep opening new stores every year. It's been great for business".

"So," Jess inquired: "Tri-States must be about 25 percent of your business. Are there any other customers that you rely on so heavily?"

Dan responded: "Well, let's see. I guess the three chains - Tri-State, Food Magnate and Produce City - have accounted for about 60 percent of our sales in the past few years."

Jess asked: "Well, any reason to think that your relationship with them will change in the near future?"

"To tell you the truth", Dan answered, "both Food Magnate and Produce City are in merger talks with a big chain on the west coast. That chain has wanted to expand into this area and either one of our customers would be a good entry for them. We don't think anything will happen for several years, but there's always that chance. Unfortunately, in this business, after acquisitions, most parent companies require their subsidiaries to use the same vendors."

"What about your produce suppliers?" asked Jess, "Are those relationships good?"

"You really know how to focus on the key issues for our business!" exclaimed Dan. "Our suppliers have been very good at getting us quality produce at reasonable prices. In fact, that is our market niche - affordable quality. We have worked very hard on strengthening those relationships because we realize it is one of the keys to our profitability."

"Alright, I have a better picture of the business now" said Jess. "That's all for today; I need to get back to the office. I'll be in touch."

Friday, February 8

By Friday afternoon, Jess felt that he was familiar enough with Cirr Grocery and their business environment that he could realistically put together a time and fee budget for the job. Since the firm's partners committee had to approve all new engagements, Jess wanted to finish the proposal in time for next Monday's meeting. By late afternoon, Jess sent a copy of his proposal to the other partners for discussion on Monday.

Monday, February 11

The partners only had a few questions for Jess about the Cirr Grocery job. Jess had been with the firm long enough to earn their respect and they knew that Jess always did his homework before recommending any type of job.

Jess presented the details of what he would include in the engagement letter. Most of these were the standard items for valuation engagement letters including the purpose of the valuation, the valuation date, the specific business entity involved, notice that the financial statements included in the valuation report would not be audited, reviewed or compiled, the fee structure and variables, the estimated time frame for the engagement and the understanding that Jess was acting as an independent, objective valuator. The letter also included a notice that the cost and time amounts were only estimates and subject to change.

With the partners' agreement, Jess sent Dan the engagement letter on late Monday afternoon. The signed response was returned on Wednesday. Jess and Carlos could now officially work on putting a value on the Cirr Grocery Company.

The Next Two Weeks (February 12 - 26)

As they were finalizing the preparatory work for the Cirr engagement, Carlos asked: "This is my first valuation job, so may I ask what may sound like a stupid question? How do we find a value for a nonpublic company? Since we can't use stock market valuation it seems like it's going to be very subjective."

Jess smiled: "Carlos, you're very perceptive. However, we prefer to say that business valuation is primarily a function of professional judgment. The choice of valuation method is probably the most important decision that we'll make. There must be several dozen different ways to do it depending on the purpose of the valuation and the particular circumstances. Even the IRS has some guidelines on putting a value on businesses. Ideally, we'd like to use the value of another, similar company if one can be found. Unfortunately, I couldn't find one."

"Personally," Jess continued, "I prefer to value companies with one or two of these approaches: capitalized earnings, discounted cash flows, excess earnings, fair value of net assets or asset liquidation values. Each of these is appropriate in particular circumstances and they are not really substitutes for one another. Many valuers use a combination of methods and average or weight the results to find a composite value. This allows them to compute a value from several different perspectives and under different assumptions."

Carlos asked: "Well, what are the key variables that you need to consider when selecting a method? What criteria help you decide which one is right?"

Jess answered: "Business valuations are usually needed for liquidation purposes, sales purposes or buy-out purposes. As you get familiar with the company and the industry, you'll get some feel for expected changes in management, potential loss of major customers or suppliers, evidence of goodwill, past versus expected earnings and cash flows and possibilities for liquidation. With all of this as background, you should then be able to choose the most appropriate valuation method or methods."

REQUIREMENT 2: Again, put yourself in the role of Carlos. You have been assigned to research some of the basic valuation methods. Use resources in your school library, the public library or the Internet (some sample resources are listed in Appendix III).

Prepare a formal business report, addressed to Jess, summarizing the following valuation methods:

- Capitalized earnings method
- Discounted cash flows method
- Combination of Assets and Earnings (Excess Earnings) method
- Fair value of net assets method
- Liquidation value method

Include in your report a brief summary of each method and when it would be most appropriate. In the final part of your report, make your recommendation on which of these method(s) you think would be most appropriate for the Cirr Grocery valuation. Be sure to cite all references.

A Few Days Later

After studying Carlos' report, Jess commented that several of the methods identified by Carlos required "normalized" earnings rather than the reported amounts.

Jess said: "Normalization means adjusting discretionary expenses to industry averages and applying GAAP where appropriate. For example, looking at the RMA numbers for wholesale groceries, owner compensation as a percent of sales varies from about 1 to 3 percent. Here, I think maybe 2 percent would be a realistic industry average for Cirr."

Carlos, also looking at the RMA numbers, responded: "RMA shows a mean for their category of 1.7 percent, but there is also a high of about 3 and a low below 1.0. It's hard to know which average to use. Yeah, I suppose that 2 percent seems like a nice compromise here."

Jess said: "The industry averages are the broad guidelines to which we apply our professional judgment and experience. The important thing is to make sure that the earnings and cash flow components are not substantially out of line with the rest of the industry. That's why it's called a "normalization" process."

Carlos suggested: "As far as GAAP goes, the only areas that I suspect might need reviewing seem to be their depreciation expense and bad debt provisions. Although sales have grown, the bad debt provision has not grown proportionately."

Jess replied: "Good observation, Carlos. I had the same concerns but Dan assured me that most of the increased sales came from the new chain store customer who pays on time and in full. And, after my review, their depreciation methods seem proper, also."

Carlos asked, "So, we just take the client's word for that? We don't have to verify it in some way?"

Jess answered, "From an auditor perspective, your skepticism is fully justified. But remember, we're not doing an audit. If you recall, the engagement letter explicitly stated that the statements would not be audited, reviewed or assembled. We're valuing a business based on data that's presented to us by the client. We ask whatever questions that we think are necessary and document the client's responses. In fact, one part of our final report will be a list of client representations on which we relied. A key limitation to business valuation is that it's only as reliable as the data and support furnished by the client."

Jess, handing Carlos a report, said: "On a related topic, with Dan's permission I hired an appraiser who's come up with these fair value estimates for their assets (Appendix IV). Actually, all of their current assets were about right; only the fixed assets needed adjusting."

Jess continued: "While I was waiting for those numbers, I worked on the rate of return on assets that would be appropriate for a company like Cirr. My best estimate is somewhere around 18 percent."

Jess, anticipating Carlos' next question, added: "To get this, I used a combination of factors, including the client's existing debt arrangements, their remaining borrowing capacity and their estimated required rate of return on equity capital. This is the most sophisticated and subjective parts of business valuation and is usually the last thing that a valuator learns. We could just have well used the Capital Asset Pricing Model that you studied in your finance classes; either one works very well if applied correctly."

Carlos, looking puzzled, asked: "I'm confused. Are the discount and capitalization rates the same thing?"

Jess responded: "No. Although they are based on similar criteria, they are used for two different types of calculations. The discount rate is multiplied by the amount of assets to approximate those earnings that would be expected on the assets employed in the business. For example, someone investing \$10 million in an industry that averages an 11% annual return should expect average yearly earnings of \$110,000."

Jess continued: "The cap rate is used to approximate the capital investment required to generate a given amount of forecasted or excess earnings. The cap rate includes a risk premium but it's more dependent on the uncertainty of continued, uninterrupted operations and other factors such as expected customer loyalty. For example, if no major interruptions in supplier or customer relations were likely in the next five years, a 20 percent (100% / 5 years) cap rate would be appropriate. In this valuation, Cirr's biggest risk in the near term is the possibility of losing one or two of those big chain store customers. I'm conservatively estimating that this won't happen for at least another 2 ½ to 3 years since there are no actual deals in process right now."

Carlos asked: "How long do we have to finish this job? We've been on it about three weeks now."

"Glad you asked" replied Jess. "I just had a call from Dan and he'd like some final numbers next Monday. Today's Wednesday, so we need to wrap this up in the next two days."

REQUIREMENT 3: In your continuing role as Carlos, prepare a preliminary valuation report for Jess to read. Prepare it in a form that can be sent directly to the client, Cirr Grocery. In the report, include a summary paragraph that describes the methodology used, assumptions made and the estimated valuation amount. In the body of the report, fully describe the valuation process. All calculations should be presented in separate tables to be included as appendices. The last appendix will be your list of references.

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APPENDICES & REFERENCES

APPENDIX I
Background of Cirr Wholesale Grocery Company

Business Operations and Employees

- Carr is a wholesale distributor of fresh fruit and produce to groceries in a four-state area. Purchases are from produce brokers located throughout the United States with deliveries made directly to the Carr Warehouse.
- Customer deliveries are made daily on company-owned trucks. The Company owns the land and warehouse buildings.
- There are 20 unskilled, nonunion workers who load and unload trucks, sort merchandise, pack outgoing orders and drive the trucks. All full-time employees are paid hourly, and participate in the Company sponsored group health insurance and profit-sharing retirement plans.

Shareholder Compensation

- Each shareholder gets one-third of the annual expense item - Compensation of Officers
 - Since early 1997, each shareholder has had a company car that is used 50% for company business. Each owner repays the Company for the personal-use portion of the car expenses (gas, maintenance, insurance, etc). Depreciation on all three cars is \$20,000 per year.
 - Since 1997, each shareholder's spouse (none of whom work for the Company) also has had a company car. The owners repay the company for the gas, maintenance, insurance, etc. Depreciation of these three cars is \$10,000 per year.
 - The Company pays personal travel expenses of \$2,000 annually for each of the three shareholders.
 - Each shareholder gets a \$20,000 annual contribution to his or her profit sharing account.
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APPENDIX II
Carr Grocery Company
Financial Statements 1997 - 2001

CIRR GROCERY COMPANY
COMPARATIVE INCOME STATEMENTS
FOR THE YEARS ENDED DECEMBER 31

	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Net sales	\$17,037,000	\$15,921,000	\$11,508,000	\$11,932,000	\$10,502,000
Cost of Sales	<u>15,314,000</u>	<u>14,129,000</u>	<u>10,239,000</u>	<u>10,721,000</u>	<u>9,241,000</u>
Gross Profit	<u>1,723,000</u>	<u>1,792,000</u>	<u>1,269,000</u>	<u>1,211,000</u>	<u>1,261,000</u>
Operating Expenses					
Compensation of Officers	939,000	1,160,000	653,000	620,000	763,000
Salaries and Wages	217,000	234,000	183,000	178,000	164,000
Bad Debts	21,000	25,000	16,000	31,000	34,000
Telephone and Utilities	73,000	75,000	71,000	78,000	71,000
Insurance	18,000	16,000	16,000	12,000	2,000
Advertising	7,000	10,000	7,000	5,000	5,000
Maintenance and Repairs	43,000	38,000	25,000	41,000	24,000
Profit Sharing Plan					
Contributions	91,000	96,000	82,000	69,000	63,000
Employee Benefit Programs	23,000	19,000	14,000	13,000	12,000
Depreciation	42,000	46,000	41,000	26,000	3,000
Meals, Travel, and					
Entertainment	12,000	12,000	11,000	13,000	9,000
Taxes	40,000	37,000	34,000	27,000	25,000
Dues and Subscriptions	3,000	3,000	3,000	3,000	2,000
Gas and Oil	5,000	5,000	5,000	7,000	6,000
Legal and Accounting Fees	18,000	28,000	17,000	23,000	15,000
Licenses and Permits	2,000	2,000	2,000	2,000	1,000
Supplies	18,000	11,000	11,000	11,000	10,000
Office Expense	9,000	9,000	9,000	8,000	7,000
Miscellaneous	2,000	0	0	0	1,000
Interest	<u>45,000</u>	<u>40,000</u>	<u>24,000</u>	<u>33,000</u>	<u>31,000</u>
Total Operating Expense	<u>1,628,000</u>	<u>1,866,000</u>	<u>1,224,000</u>	<u>1,200,000</u>	<u>1,248,000</u>
Income (Loss) before Tax	95,000	(74,000)	45,000	11,000	13,000
Income Taxes	(38,000)	0	(18,000)	(4,000)	(5,000)
Net Income (Loss)	<u>\$57,000</u>	<u>(\$74,000)</u>	<u>\$27,000</u>	<u>\$7,000</u>	<u>\$8,000</u>

CIRR GROCERY COMPANY
COMPARATIVE BALANCE SHEETS
31-Dec

ASSETS	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Current Assets					
Cash	\$841,000	\$170,000	\$116,000	\$292,000	\$389,000
Accounts Receivable	424,000	205,000	204,000	103,000	65,000
Inventory	230,000	105,000	122,000	104,000	51,000
Loans Receivable	0	10,000	130,000	22,000	62,000
Prepaid Federal Tax	0	2,000	1,000	0	0
Advances	<u>0</u>	<u>15,000</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Current Assets	<u>1,495,000</u>	<u>507,000</u>	<u>573,000</u>	<u>521,000</u>	<u>567,000</u>
Fixed Assets					
Land	20,000	20,000	20,000	20,000	20,000
Buildings	530,000	530,000	530,000	530,000	530,000
Machinery and Equipment	299,000	335,000	325,000	299,000	180,000
Furniture and Fixtures	14,000	14,000	14,000	14,000	14,000
Automobiles and Trucks	<u>226,000</u>	<u>221,000</u>	<u>180,000</u>	<u>80,000</u>	<u>80,000</u>
Total Cost	1,089,000	1,120,000	1,069,000	943,000	824,000
Less: Accumulated Depreciation	<u>(670,000)</u>	<u>(525,000)</u>	<u>(587,000)</u>	<u>(466,000)</u>	<u>(442,000)</u>
Total Net Fixed Assets	<u>419,000</u>	<u>595,000</u>	<u>482,000</u>	<u>477,000</u>	<u>382,000</u>
Other Assets					
Produce Credit Association Bond	<u>37,000</u>	<u>32,000</u>	<u>21,000</u>	<u>26,000</u>	<u>31,000</u>
Total Other Assets	<u>37,000</u>	<u>32,000</u>	<u>21,000</u>	<u>26,000</u>	<u>31,000</u>
Total Assets	<u>\$1,951,000</u>	<u>\$1,134,000</u>	<u>\$1,076,000</u>	<u>\$1,024,000</u>	<u>\$980,000</u>

LIABILITIES AND
STOCKHOLDERS' EQUITY

	<u>2001</u>	<u>2001</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
Current Liabilities					
Accounts Payable	\$609,000	\$262,000	\$239,000	\$162,000	\$74,000
Note Payable--Produce Credit Assoc.	115,000	319,000	209,000	262,000	314,000
Accrued Payroll Taxes	1,000	1,000	2,000	0	0
Accrued Federal Income Tax	<u>0</u>	<u>0</u>	<u>0</u>	<u>1,000</u>	<u>0</u>
Total Current Liabilities	<u>725,000</u>	<u>582,000</u>	<u>450,000</u>	<u>425,000</u>	<u>388,000</u>
Other Liabilities					
Note Payable--Produce Credit Assoc.	<u>617,000</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Other Liabilities	<u>617,000</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Liabilities	<u>1,342,000</u>	<u>582,000</u>	<u>450,000</u>	<u>425,000</u>	<u>388,000</u>
Stockholders' Equity					
Capital Stock	40,000	40,000	40,000	40,000	40,000
Retained Earnings	<u>569,000</u>	<u>512,000</u>	<u>586,000</u>	<u>559,000</u>	<u>552,000</u>
Total Stockholders' Equity	<u>609,000</u>	<u>552,000</u>	<u>626,000</u>	<u>599,000</u>	<u>592,000</u>
Total Liabilities and Stockholders' Equity	<u>\$1,951,000</u>	<u>1,134,000</u>	<u>\$1,076,000</u>	<u>\$1,024,000</u>	<u>\$980,000</u>

APPENDIX III
Sample References on Valuation Methods

- VentureLine.com. [Www.ventureline.com/techniques.htm](http://www.ventureline.com/techniques.htm)
 - American Capital Strategies Valuation Services. www.corporate-valuation.com
 - American Express Small Business Services.
<http://home3.americanexpress.com/smallbusiness/resources/starting/valbiz.shtml>
 - Commerce Clearing House Business Owner's Toolkit: Valuation of Small
Businesses www.toolkit.cch.com/text/p11_2200.asp
 - Business Town.com, Valuing a Business.
www.businesstown.com/valuing/index.asp
 - Internal Revenue Service. Revenue Ruling 59-60 - Section 2031. Definition of
Gross Estate.
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APPENDIX IV
Fair Value Appraisals for Cirr Grocery Assets
As of December 31, 2001

Asset	Recorded Value	Estimated Market Value
Accounts Receivable	\$424,000	\$424,000
Inventory	230,000	230,000
Land	44,000	64,000
Machinery & Equipment	530,000	380,000
Furniture & Fixtures	14,000	7,000
Autos & Trucks	226,000	106,000
Other Assets	37,000	37,000

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- Annual Statement Studies - 2000. The Risk Management Association,
- Business Valuation Committee of the American Society of Appraisers - General Performance Requirements for Valuation (<http://www.appraisers.org/>)
- Fishman ASA, Jay E., Stanton L. Meltzer, CPA, J. Clifford Griffith, MPA, CPA and D. Keith Wilson, CPS. Developing Your Business Valuation Skills: An Engagement Approach. American Institute of Certified Public Accountants (1992).
- Internal Revenue Service. Revenue Ruling 59-60.
- Ibbotson Associates. <http://valuation.ibbotson.com/>.
- International Foodservice Distributors Association (IFDA). <http://www.fdi.org>.
- Institute of Business Appraisers - entirely devoted to business valuation, code of ethics and standards for performing valuations (<http://www.instbusapp.org/>)
- The Appraisal Foundation - Uniform Standards for Professional Appraisal Practice (<https://www.appraisalfoundation.org/default.asp>)
- ValuationResources.Com. www.valuationresources.com.
- Zipp, Alan S. "Business Valuation for Divorce" The Journal of Accountancy (April 1992). Pages 43 – 46, 48.

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TEACHING NOTES

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REQUIREMENT 1: The objective of this activity is for students to do some basic types of library and Internet research similar to that needed at the start of a valuation engagement. Students must locate industry codes, RMA ratios and specified data on the Census Bureau Web site. To keep the requirement manageable, only a limited amount of information is requested and some suggestions on finding them are also given. Instructors should point out that this is only a very limited amount of actual research data that would be required to get familiar with a firm or its industry. This requirement should only take about one hour for most students.

Students must make a decision about the appropriate SIC or NAICS code. In the RMA documents, students must decide into which size category of firms (based on assets or sales) Cirr Grocery should be placed for comparison with its peers. [Core competencies: research, technology, decision-making, industry/sector perspective and professional demeanor.]

[Instructor Note: To reduce the time requirement for the case, this information could be given to the students. While this would reduce the competency development scope of the case, it would allow more time for the other case requirements.]

Recommended solutions:

- 1) The wholesale grocery industry is SIC Code 5141 (Groceries, General Line) and NAICS Code 4224 (Grocery and Related Products Wholesale).
- 2) [The following answer is based on data in Risk Management Association's (RMA) Annual Statement Studies, 2000. Wholesale Groceries, General Line.] Students are asked to locate the ratios primarily to illustrate the types of financial data that is readily available to them. Only several of the ratios, such as owner compensation / sales, are directly discussed later in the case.

Students must choose which size category of firms is appropriate. Cirr's total assets in 2001 are \$1.951 million, which is at the upper limit of one of the total asset categories (\$.5 million - \$2.0 million). Some students may want to use the next highest asset category (\$2.0 million - \$10 million) since Cirr will likely grow into that category very soon. If students classify by total sales (\$17 million in 2001) they will also be in a relatively higher category of firms. Through class discussion, the instructor should get all students to agree on one classification category to simplify later decisions.

This is a good chance to discuss the many choices and the ethics involved in the valuation process. A quick look shows that only the very smallest categories of companies have owner compensation greater than 2% of sales. Therefore, Cirr would seem to have more in common with the larger firms.

In year 2000, Cirr's owners' compensation as a percentage of sales is 5.5% which is higher than any of the RMA categories. Thus, Cirr's owner compensation seems out of line. At this point the students may argue that to best benefit Dan, Jess should choose the category with the higher percentage. Perhaps later, students will realize that if Jess wants to slant the data in favor of Dan, he should actually use a lower percentage. The instructor should also point out that benefits to Dan should not be the choice criteria in any of the valuation decisions.

This is a good time to bring up the issue of the role of business valuers. Are they independent, objective appraisers (like external auditors) or advocates for their clients (like defense attorneys)? In most cases, valuers try to remain neutral and unbiased and this should be clearly understood by the client. On the Cirr engagement, Jess is actually working for all three owners, not just Dan, and will get paid by the company. Since these owners have competing agendas, Jess needs to remain objective. In other situations, however, valuers may take the advocate role. This often happens when the valuator is helping an individual client negotiate a purchase or sales price for a company.

Based on total sales (\$10 - \$25 million), the RMA ratios for 2000 are: Current ratio - 1.4; Sales/ receivables - 14.9; Cost of sales/ inventories - 12.8; EBIT/interest - 3.1; Debt/Equity - 2.2; Sales/Total assets - 4.9; Officers, Directors, Owners' Compensation/ Sales - 1.7.

- 3) Go to: www.census.gov. Link to: Economic Indicators; Monthly Wholesale Trade: Sales & Inventory; Adjusted percent Changes. Scroll down to NAICS code number 4224. Sales + 4.2% for Jan. 2001 - Jan. 2002. Inventories - 2.6% for Jan. 2001 - Jan. 2002. (These amounts may be different if data for a year other than 2002 is available when the case is presented.)

REQUIREMENT 2: The objective of this activity is for students to continue doing basic research, to critically evaluate several valuation approaches and to select one as the most appropriate for the Cirr Grocery valuation. Students should also begin to understand the degree of professional judgment that will be needed in this important decision. They will also discover that there are other valuation approaches besides these five.

Students will give a wide variety of responses depending on which particular sources are used. The following summaries are based on information from the sources in Appendix III that are typical of most discussions of these valuation methods. It's important that students describe not only the calculation procedures but also that they have at least some appreciation of when each method is most appropriate. Later in the case, they must

choose and apply one method. [Core competencies: research, communication, decision-making]

- Capitalized earnings approach: This is one of the most commonly used methods. It is appropriate when current earnings are presumed to be a good estimate of future earnings and will continue indefinitely. Historical earnings are first adjusted for unusual items and deviations from GAAP. Typical adjustments include removing excess owner and manager compensation and benefits and correcting for overly conservative or liberal accounting assumptions (e.g. depreciation, bad debts, and inventories). The normalized earnings are then projected into the indefinite future by dividing them by a capitalization rate. The capitalization rate is a risk-free rate of return that is adjusted for the risk inherent in the specific business situation.
- Discounted earnings or cash flows: This approach is used most often when historical returns are not a good long-term predictor of the future. The expected earnings or cash flows are projected into the future until they are expected to stabilize. These flows are discounted to the present using a discount rate that approximates the rate of return commensurate with the risk assumed. Beyond the forecasted period, the firm's "terminal" value is estimated, discounted to the present, and combined with the discounted return amounts to arrive at the business' total value.
- Fair value of net assets: This method is appropriate when the company's assets and liabilities depend primarily on estimated amounts of recorded items. The appraised or estimated fair value of identifiable assets less liabilities gives the firm's equity value. This method is not appropriate when the firm's financial performance suggests that there may be a large amount of unrecorded intangible assets such as going-concern value or goodwill.
- Excess earnings method: This is one of the few methods that uses both an asset and an income approach. The business is presumed to be worth the fair value of the existing net assets plus an amount for goodwill (going-concern value) based on the company's earnings in excess of a normal profit. Annual excess earnings are capitalized at an appropriate "cap" rate. The excess earnings method is appropriate when substantial going-concern value is suggested in the investigation phase of the valuation.

The excess earnings method, as presented in IRS Rev. Rul. 68-609, is a common technique but it is sometimes hard to implement in practice. It is, however, appropriate in the set of circumstances surrounding the Cirr Grocery job. In this method, a business' value is estimated as the sum of the fair value of net tangible assets plus an approximated amount of goodwill based on excess earnings ability. It requires three calculations: 1) a reasonable rate of earnings on the tangible assets, 2) the company's normalized earnings in excess of the reasonable return (excess earnings) and 3) capitalization of the excess earnings at a rate appropriate for intangible assets.

- Liquidation value: This method approximates the minimum value that a business is worth and might be used if the owners were forced to sell the business quickly. Liquidation value is the estimated amount that would be left if the owner were forced to quickly liquidate all of the assets and pay off the liabilities. The quick sale would preclude getting full, market value for the assets.

[Instructor Note: After students have had some experience with the subjectivity of business valuation, instructors might want to share with students the following valuation axioms (Zipp, page 48):

- Each valuation is unique with its own peculiar circumstances, functions and purposes.
- There are only general guidelines to valuation. Individual judgment must be applied as part of and beyond the general methods.
- There is no single correct value. The appraiser only hopes to get a rational and supportable value in light of the circumstances.
- Experts usually disagree in their judgments of value.
- There are generally accepted methods of business valuation that have been tested in practice and in the courts.
- There is a difference between value and price. A value can be determined analytically; the price paid is the result of negotiation.]

REQUIREMENT 3: The objective of this requirement is for students to select and apply the most appropriate of the five valuation methods discussed in Requirement 2. If students choose an earnings-based approach, they will have to compute normalized income. If they choose an asset-based approach, they must prepare fair-value balance sheets. And, if they choose a cash-flow method they must calculate the cash flow amounts.

In making these calculations, students will need to use their financial accounting knowledge and the case material to select appropriate normalizations adjustments for income and assets. Students will be able to approximate the cash flows for Cirr from the data given, but there is no evidence of an approximate “terminal value” needed to complete the discounted cash flows method. Therefore, even if students select this as the most appropriate method (see method discussion above) it will be impossible to implement. [Core Competencies: Decision-making, measurement, industry/sector perspective, and communication]

[Instructor Note: Students can be given as much or as little guidance in this area as the instructor deems necessary. Most students should quickly realize that the liquidation value and fair value of net assets methods are clearly not appropriate here. There is every indication that Cirr Grocery will continue to prosper after the owner buyout. The company seems to have substantial going-concern value based on good management and well-established vendor and customer relations. Also, students will have problems trying

to implement the discounted cash flows approach due to lack of data on cash flows and “terminal” value” several years into the future.

The most direct intervention by the instructor would be for one method to be selected, or decided on, by the whole class. The other extreme is to offer no help on method selection and let students make their own choices. This latter approach maximizes development of the competencies incorporated into this exercise but may result in many unproductive and frustrating hours of work by the students. Class level, student experiences and time constraints will all affect this decision.]

In actuality, several different valuation methods were applied to the Cirr Grocery valuation. However, in the cause of simplicity, only the excess earnings method and the capitalized earnings method will be used here. Instructors should include in their discussions the following points:

- The capitalization of earnings method seems appropriate since future operations are not likely to change in the near future after Darryl is bought out. Therefore, current normalized earnings are expected to continue.
- The discounted cash flows method is not appropriate here. Cirr’s cash flows can be approximated from the information given. However, there is no information about an expected terminal value nor is there any guidance on how to calculate it.
- The excess earnings method is appropriate since normalized earnings show substantial evidence of goodwill value.
- The conditions in the Cirr Grocery situation were not conducive to using the other two methods since future operations are unlikely to change, there is evidence of goodwill value and the company is not being liquidated.

Instructors may elect to have students compute only one of these two methods to simplify the calculations and shorten completion time. However, using both methods in combination with one another, as is often done in practice, adds realism and completeness to the case.

On their own, students will likely to select one of the first four methods in Requirement 2. Many will be attracted to the fair value of net assets method since the calculations are the least complicated. The liquidation method is clearly not appropriate here since there is no evidence that Cirr Grocery is in danger of closing.

Students selecting the capitalized earnings or excess earnings methods will first have to prepare normalized income statements for the five year period presented. To compute normalized earnings, students will likely propose earnings adjustments in two areas - specific adjustments based on items already presented in the case and general areas of GAAP.

The following normalized statements and calculations could be handed out to reduce student preparation time and allow more discussion on the issues. The case only specifically identifies, and gives dollar amounts for adjustments related to salaries, profit sharing, personal travel costs and personal use of cars. Based on these items, the

normalized income statements are presented below. For year 2001, the original amounts, adjustments and normalized amounts are shown; for 1997 – 2000 only the final, normalized amounts are shown:

- Adjustments A and C: Adjust owner compensation to 2 percent of sales. In the case, Jess suggests that owner compensation should not exceed an industry average of 2 percent of sales. Therefore, officer salaries for each of the five years should be reduced to that amount (2% x Net Sales). Also, since Profit Sharing is additional owner compensation, \$60,000 (\$20,000 @ owner) should also be eliminated to keep owner compensation to a total of two percent of sales. [Instructor note: The RMA size category for Cirr (Sales \$10-\$25 million) shows average compensation of 1.7 percent of sales. Some students may want to use that as the industry average. Jess' estimate at 2 percent seems reasonable.
- Adjustment B: Remove depreciation for personal use of cars by owners and spouses. Appendix II shows that one-half of the owners' car use is personal and that the company pays all of the expenses for the spouses' cars. Depreciation expense should be reduced by \$10,000 (\$20,000 x 50%) for the owners' personal use and another \$10,000 for the spouses' cars.
- Adjustment D: Remove personal travel expenses paid by the company. Appendix II shows that Cirr pays \$6,000 (\$2,000 @ owner) of personal travel expenses for the shareholders. These should be eliminated since they are not typical business expenses.
- Adjustment E: Adjust income taxes to 40% of normalized pre-tax income. The 40 percent rate must be determined from the tax expense data for years 1997 – 2001.

CIRR GROCERY COMPANY
NORMALIZED INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2001

	As reported		Adjustment	Normalized Amounts
Net sales	\$17,037,000			\$17,037,000
Cost of Sales	<u>15,314,000</u>			\$15,314,000
Gross Profit	<u>1,723,000</u>			\$1,723,000
Operating Expenses				
Compensation of Officers	939,000	a	-598,260	\$340,740
Salaries and Wages	217,000			\$217,000
Bad Debts	21,000			\$21,000
Telephone and Utilities	73,000			\$73,000
Insurance	18,000			\$18,000
Advertising	7,000			\$7,000
Maintenance and Repairs	43,000			\$43,000
Profit Sharing Plan				
Contributions	91,000	c	-60,000	\$31,000
Employee Benefit Programs	23,000			\$23,000
Depreciation	42,000	b	-20,000	\$22,000
Meals, Travel, and				

Entertainment	12,000	d	-6,000	\$6,000
Taxes	40,000			\$40,000
Dues and Subscriptions	3,000			\$3,000
Gas and Oil	5,000			\$5,000
Legal and Accounting Fees	18,000			\$18,000
Licenses and Permits	2,000			\$2,000
Supplies	18,000			\$18,000
Office Expense	9,000			\$9,000
Miscellaneous	2,000			\$2,000
Interest	<u>45,000</u>			\$45,000
Total Operating Expense	<u>1,628,000</u>			<u>\$943,740</u>
Income (Loss) before Tax	95,000			779,260
Income Taxes	(38,000)	e		<u>(311,704)</u>
Net Income (Loss)	<u>\$57,000</u>			<u>\$467,556</u>

Adjustments:

a - reduce owner comp. to average of 2% of sales

Sales	\$17,037,000
Industry Avg.	<u>2.00%</u>
Avg. Owner Compensation	340,740
Less: Actual Compensation.	<u>939,000</u>
Adjustment	\$ 598,26

b - remove depreciation for personal use of cars

Owner depreciation	\$ 20,000
Personal Use %	<u>50%</u>
Personal depreciation	10,000
Plus: Spouse depreciation.	<u>10,000</u>
Adjustment	\$ 20,000

c - remove excessive owner contributions (3 owners @ \$20,000)

Adjustment	\$ 60,000
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d- remove personal travel expenses (3 owners @ \$2,000)

Adjustment	\$ 6,000
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e - income taxes: 40% x IBT

	<u>2000</u>	<u>1999</u>	<u>1998</u>	<u>1997</u>
	Normalized Amounts	Normalized Amounts	Normalized Amounts	Normalized Amounts
Net sales	\$15,921,000	\$11,508,000	\$11,932,000	\$10,502,000
Cost of Sales	\$14,129,000	\$10,239,000	\$10,721,000	\$9,241,000
Gross Profit	\$1,792,000	\$1,269,000	\$1,211,000	\$1,261,000
Operating Expenses				
Compensation of Officers	\$318,420	\$230,160	\$238,640	\$210,040
Salaries and Wages	\$234,000	\$183,000	\$178,000	\$164,000
Bad Debts	\$25,000	\$16,000	\$31,000	\$34,000
Telephone and Utilities	\$75,000	\$71,000	\$78,000	\$71,000
Insurance	\$16,000	\$16,000	\$12,000	\$2,000
Advertising	\$10,000	\$7,000	\$5,000	\$5,000
Maintenance and Repairs	\$38,000	\$25,000	\$41,000	\$24,000
Profit Sharing Plan				
Contributions	\$36,000	\$22,000	\$9,000	\$3,000
Employee Benefit Programs	\$19,000	\$14,000	\$13,000	\$12,000
Depreciation	\$26,000	\$21,000	\$6,000	\$3,000
Meals, Travel, and Entertainment	\$6,000	\$5,000	\$7,000	\$3,000
Taxes	\$37,000	\$34,000	\$27,000	\$25,000
Dues and Subscriptions	\$3,000	\$3,000	\$3,000	\$2,000
Gas and Oil	\$5,000	\$5,000	\$7,000	\$6,000
Legal and Accounting Fees	\$28,000	\$17,000	\$23,000	\$15,000
Licenses and Permits	\$2,000	\$2,000	\$2,000	\$1,000
Supplies	\$11,000	\$11,000	\$11,000	\$10,000
Office Expense	\$9,000	\$9,000	\$8,000	\$7,000
Miscellaneous	\$0	\$0	\$0	\$1,000
Interest	\$40,000	\$24,000	\$33,000	\$31,000
Total Operating Expense	<u>\$938,420</u>	<u>\$715,160</u>	<u>\$732,640</u>	<u>\$629,040</u>
Income (Loss) before Tax	853,580	553,840	478,360	631,960
Income Taxes	<u>341,420</u>	<u>(221,536)</u>	<u>(191,344)</u>	<u>(252,784)</u>
Net Income (Loss)	<u>\$512,160</u>	<u>\$332,304</u>	<u>\$287,016</u>	<u>\$379,176</u>

Students may propose a variety of other potential adjustments, such as depreciation, obsolete plant and equipment, inventory costing methods and write downs, bad debt allowances, unrecorded sales, unrecorded liabilities (e.g. potential lawsuits), and inadequate operating accruals such as interest, taxes, wages or benefits. While the GAAP basis for their choices may be worthy of consideration and class discussion, there is no direct evidence that any of these items are substantially out of line at Cirr Grocery.

[Instructor note: There are a variety of GAAP issues that might be discussed here, although most of them really aren't vital to the adjustment process. Instructors may want to use this chance to review some basic GAAP concepts such as cash versus accrual basis (is Cirr full or only partial accrual?), periodicity and cut-offs (are all revenues booked and expenses accrued?), conservatism (what amounts did they use for depreciable lives?), reliability (have these statements been audited?) and materiality (does it really matter whether we use 2 or 1.7 percent of sales?).]

Capitalized Earnings Approach: The calculations for this method are: average expected future earnings / appropriate capitalization rate. In the case, Jess suggests a 40 percent cap rate when he predicts that there will be no major changes in operations for the next two and one-half years ($100\% / 2 \frac{1}{2} = 40\%$). Some students may use the three year estimate (Jess gave a 2 $\frac{1}{2}$ to 3 year range) and use a 33 $\frac{1}{3}$ percent cap rate. This is a good opportunity to discuss the use or conservatism in business valuation work. Of course, the lower the cap rate, the higher the value assigned to the assets. When in doubt, valuers like to err on the conservative side of their estimates which builds a bit more risk premium into the valuation numbers.

After the normalized earnings are computed for years 1997 – 2001, the valuator must decide which, if any, of these years are representative of future trends. In three of these years, Cirr did not have the chain store customers that now account for a large percentage of their sales. And, the year 2000 earnings are unusually high and probably not typical of long-term trends. Therefore, a conservative estimate of Cirr's value can probably best be found by capitalizing only the year 2001 earnings. This gives a value of approximately \$1,168,890 ($\$467,556 / 40\%$). Students using the lower cap rate will get a value of \$1,404,072 ($\$467,556 / 33.3\%$).

In short, the business valuator is estimating that to get a 40 percent return on an investment in Cirr Grocery, one would need to pay \$1,168,890.

Excess Earnings Method: Although this method is summarized in the case conversation, students might want to revisit the CCH Toolkit Web site (Appendix III) for a review.

The excess earning method has the following steps:

1. Determine the fair value of net assets (assets minus liabilities)
2. Compute normal earnings (fair value of assets times normal rate of return)
3. Compute excess earnings as actual average earnings minus normal earnings
4. Capitalize the excess earnings using an appropriate capitalization rate
5. Compute the company value as: fair value of net assets plus capitalized excess earnings.

Cirr Grocery Company
Normalized Balance Sheet
December 31, 2001

	As Reported	FMV Adjustments	Market Value
ASSETS			
Cash	\$ 841,000		\$ 841,000
Accounts Receivable	424,000		424,000
Inventory	230,000		230,000
Loans Receivable	-		-
Prepaid Federal Tax	-		-
Advances	-		-
Land	20,000	44,000	64,000
Buildings	530,000	(150,000)	380,000
Machinery & Equipment	299,000	(91,000)	208,000
Furniture & Fixtures	14,000	(7,000)	7,000
Autos & Trucks	226,000	(120,000)	106,000
Less: Accumulated Depreciation	(670,000)	670,000	-
Other Assets	37,000		37,000
Total Assets	\$ 1,951,000	\$ 346,000	\$ 2,297,000
LIABILITIES & EQUITY			
Accounts Payable	\$ 609,000		\$ 609,000
Notes Payable	115,000		115,000
Accrued Payroll Taxes	1,000		1,000
Accrued Federal Taxes	-		-
Long-term Debt	617,000		617,000
Stockholders' Equity	609,000		609,000
Market Value Adjustment		346,000	346,000
Total Liabilities & Equity	\$ 1,951,000	\$ 346,000	\$ 2,297,000

The calculations are:

- The fair value of Cirr's net assets is \$955,000 (Assets \$2.297 M minus Liabilities \$1.342 M).
- Using Jess' imputed normal rate of return of 18 percent, normal earnings for net assets of \$955,000 are \$172,000 ($\$955,000 \times 18\%$).
- Cirr's normalized earnings for year 2001 are \$467,556. Excess earnings are \$295,556 (actual \$467,556 minus normal \$172,000).
- Using Jess' estimate of two and one-half years, the capitalization rate would be 40 percent ($100\% / 2 \frac{1}{2}$ years). Capitalized excess earnings are \$738,890 (excess earnings $\$295,556 / 40\%$ cap rate).

The company's value is approximately \$1.64 M (fair value of assets \$955,000 + capitalized excess earnings \$738,890).

At this point the valuator must come up with a final value for the company. Since both valuation methods were considered appropriate here, the final estimate would include both amounts - the capitalized earnings estimate of \$1.17 million and the excess earnings estimate of \$1.64 M. One approach is to mathematically weigh each amount equally which is the simple average of the two amounts, or \$1.41 million [$\{ \$1.17 + \$1.64 \} / 2$]. Or, the valuator may use the amounts only as guidelines and select some other value based on their professional judgment. In most cases, some mathematical approach is used.

Not all valutors weight the amounts equally. For example, some might use a 60% weighting for the capitalized earnings method and 40% weighting for the excess earnings method. This gives an approximate business value of \$1.36 million [$(\$1.17 \times 60\%) + (\$1.64 \times 40\%)$]. Weighting of final values is subjective. Individual valutors consider such variables as reliability and timeliness of the data, nature of the business, past experience with different methods and other consideration. For Cirr Grocery, only substantial differences in the weighing values (e.g. 90% vs. 10%) will make a material difference in the final valuation. In the final valuation report, the mathematical precision indicated by the weighting procedure should be downplayed.

[Instructor Note: The cash flows for Cirr can be approximated from the income statements and balance sheets given in the case. However, to make the statements balance two assumptions are needed: depreciation expense is the balancing amount in the Accumulated Depreciation account (rather than the expense reported) and in 1999 Cirr scrapped \$108,000 of fully depreciated equipment. The cash flow statements for 1998 – 2001 are presented below.

This is, however, as far as students will be able to pursue the discounted cash flows method since there is no information or estimated amounts for the terminal value. To save time, and student frustration, this information might be shared with the students before the cash flow calculations are made.]

CIRR GROCERY COMPANY

Cash Flows

FYE December 31, 1997-2001

	2001	2000	1999	1998
Reported Earnings	\$ 57,000	\$ (74,000)	\$ 27,000	\$ 7,000
Adjustments:				
(Increase) Decrease in Accounts Receivable	(\$219,000)	(\$1,000)	(\$101,000)	(\$38,000)
Depreciation expense	145,000	46,000	121,000	24,000
(Increase) Decrease in Inventory	(\$125,000)	17,000	(18,000)	(53,000)
(Increase) Decrease in Loans Receivable	10,000	120,000	(108,000)	40,000
(Increase) Decrease in Prepaid Taxes	2,000	(1,000)	(1,000)	0
(Increase) Decrease in Advances	15,000	(15,000)	0	0
Increase (Decrease) in Accounts Payable	347,000	23,000	77,000	88,000
Increase (Decrease) in Notes Payable	(204,000)	110,000	(53,000)	(52,000)
Increase (Decrease) in Accrued P/R Taxes	0	(1,000)	2,000	0
Increase (Decrease) in Accrued Federal Tax	0	(\$29,000)	0	\$298,000
			(1,000)	(\$82,000)
	1,000	\$10,000		
Cash from Operating Activities	28,000	224,000	(55,000)	17,000
Investing Cash Flows				
(Buy) Sell Machinery & Equipment	36,000	(118,000)	(26,000)	(119,000)
(Buy) Sell Autos	(5,000)	(41,000)	(100,000)	0
(Buy) Sell Other Assets	(5,000)	26,000	(11,000)	(170,000)
	5,000	(121,000)	5,000	(114,000)
Financing Cash Flows				
Issue (Repay) Long Term Debt	617,000			
Net change in cash	671,000	54,000	(176,000)	(97,000)
Beginning Cash	170,000	116,000	292,000	389,000
Ending Cash	\$841,000	\$170,000	\$ 116,000	\$ 292,000

Other issues While researching the various valuation methods, students may likely discover several of the many other issues that may be relevant in small business valuations. Among these are majority interest premiums, minority interest discounts and use of sanity checks on final valuation estimates. The instructor can raise these issues on their own if time, and student interest, permits.

One final step in arriving at the final estimate is applying “sanity checks” to the calculated amounts. For example, the valuator might ask: “Based on my knowledge of the industry and competitors, is this price reasonable?” “From an investment perspective, would an outside investor be willing to pay this amount?”

In the appropriate circumstances, the business valuation may require an adjustment for a majority or a minority interest. If a majority interest in the business is being acquired (or sold) the value may be greater than its true proportional share. For example, the control inherent in a 60% ownership interest would indicate that a buyer would pay a premium above 60% of the estimated company value. On the other hand, a less than proportional share might be discounted for the opposite reason (lack of control or influence). For Cirr Grocery, family ownership shares are equal before the buy-out (each owns 1/3 of the company) and will be equal after the buy-out (each will own 1/2 of the company). So, majority and minority interest adjustments are not warranted.