## [M/S -17]  Fair Market Value Estimate #1

http://fastbooks.solutions/website-tutorial-ss-17
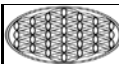
| | |
|---|---|
| 1 -Capitalization of Earnings Method  -See cell [F31]: | 5,739,059 |
| 2 -Discounted Future Income Method -See [M/S -18] cell [J30]: | 5,886,540 |
| Average of the [2] Estimated [F-M-V] Appraisal Calculations: | 5,812,800 |
| Internal Return Rate -[Calculation]: | 10.9% |

*Note: As with all yellow highlighted cell; both the financial rates and financial criteria used in the*
*above [build-up-method] matrix can is replaceable with either different percentages or criteria.*

An essential step within the calculation of estimating an [F-M-V] for a [non-public] service
based business is to subtract the current total payroll and related expense for the business
owner. This cost then replaced with an estimate entered in the cell [C20] of a fair market value
compensation package for the business to hire a person to perform the current duties of the
current business owner. *(Leave cell [C20] blank if not applicable.)*    **150,000**

The matrix below is known as the [build-up-method] used to create a Capitalization-Rate:

| | |
|---|---|
| Risk- Free Rate (Long-term Treasury Bond Yield) | 6.000% |
| Equity Risk Premium (Stock over Bonds) | 3.170% |
| Risk Premium For Size (Small Stock Risk Prem.) | 4.330% |
| Industry Specific Market Value Risk Premium | 1.000% |
| A - Discount Rate: (Risk) | 14.500% |
| Projected Growth in G.N.P. (Real Growth) | 1.000% |
| Moving Average (12 mos) Inflation Rate (Growth) | 1.500% |
| Undefined growth or (contra) rate | |
| B - Perpetuity Growth Rate: | 2.500% |
| Capitalization Rate -sum of [C19.C23]: | 12.000% |

### Definition of Fair Market Value:

The price at which a business will sell when offered for sale by a willing seller
and purchased by a willing buyer, allowing reasonable time in which to find such
a buyer and acting prudently with full knowledge of the related facts, neither being
under compulsion.

### Definition of Discount and Capitalization Rates:

The Discount and Capitalization rates are needed for estimating the value of
businesses. Both rates are used to convert income measures into value
estimates and are particularly useful for valuing closely held businesses.  The
main difference between the two is that a Discount Rate is applied when the
discounted future income method is used for valuation purposes whereas a
Capitalization Rate used when the capitalization of income method is applied.
The two, however, are related since a Capitalization Rate is essentially the
Discount Rate without the projected long-term growth rate of future income.

### Developing a Discount Rate:

The method used above is the build-up method.  This method simply says that a
discount rate is the sum of a "risk-free" return (such as)  U. S. Treasury notes
or bonds).  Plus, the additional risk premium required by the market to invest in
stocks in general, plus a risk premium for any additional risk inherent to the
specific industry valued.

### Definition of Perpetuity Growth Rate:

Accounts for the value of Free Cash Flow that continues into perpetuity in the
future, growing at an assumed constant rate.

### Definition of  Free Cash Flow:

A measure of financial performance calculated as operating cash flow minus
capital expenditures.  Free Cash Flow (FCF) represents the cash that a company
can generate after spending the money required to maintain or expand its asset
base. FCF is important because it allows a company to pursue opportunities that
enhance shareholder value.  Without cash, it's tough to develop new
products, make and pay dividends and reduce debt.

### Definition of Business Owner Normalization Compensation Adjustment:

A [non-public] Service Based Business evaluates profitability after accounting for
the base salary of the business owner before considering business profits.
The excess business income after compensating the owner for performing
business services belongs to the owner.

The owner may perform revenue-generating services; however, accounting
for their total compensation allows the value derived from business
ownership to be evaluated separately from the total profit derived from the
enterprise.  The software provides a methodology for the owner's total
compensation be fixed at an appropriate dollar value to consider the future
value of the businesses ownership in the [Fair Market Value] calculation.

## 1 -Capitalization of Earning Valuation Method:

This method capitalizes the Net Income from the business at a rate
at represents a Fair Return for a similar practice at a particular time,
considering the risk involved.  The key elements are the determination
results of this calculation reflected in cell both cells [F25] and [C4]:

| | |
|---|---|
| Revenue: -[Activity Base #1]: | 6,000,000 |
| Payroll and Related Expenses: (See Note -1) | 2,858,133 |
| *Subtract: Owner Normalization Compensation Adjustment:* | (160,136) |
| Dental Supplies and Lab Fees Expense | 812,908 |
| All Other Business Expenses: | 2,172,408 |
| Add Back: | |
| Depreciation Expense: | 240,000 |
| Interest Expense: | 132,000 |
| Amortization Expense -The [4] unassigned acct #'s [19 -17-20] are intended for | |
| similar uncommon expenses.  *Enter:  -Annual Amortization Expense in cell [F24]:* | |
| Ordinary Business Income (loss): | 688,687 |
| Federal Tax -*Enter Federal Tax Rate:* | |
| Calculated Federal Taxes | 0 |
| Net Income from Operations after  Federal Tax: | 688,687 |
| % of Revenue: | 11.5% |
| Capitalization Rate: | 12.0% |
| F-M-V Estimate under the Capitalization of Earning Method: | 5,739,059 |
| % of Annual Revenue Forecast: | 95.7% |

### Definition of Capitalization of Earning Valuation Method:

The capitalization of earnings method looks to the actual historical results
of business as an indicator of results in the future.  This technique typically
involves dividing a business's annual historical earnings by a "capitalization
rate" which incorporates risk (the discount rate) and a factor for future annual
growth.  The measure of income that capitalized is most frequently the after-
tax income of the business, although the approach can use with pre-tax
earnings, earnings before interest and taxes, measures of cash flows, and
other measures.  In this model, we selected the "Operational Net Income"
of the business to capitalize.

### Definition of Operational Net Income:

After-tax income (excluding depreciation, amortization and interest expense).
The reason we selected Operational Net Income as the numerator was that
for a service based businesses it is the best measurement that approximates
"Free Cash Flow" without undergoing an in-depth balance sheet analysis that
could get down to analyzing journal entries.

### The Formula for Free Cash Flow:

Net Income from Operations After Tax
- Changes in Working Capital
- Capital Expenditures
= Free Cash Flow

Some believe that Wall Street focuses myopically on earnings while ignoring
the "real" cash that a firm generates.  Accounting gimmicks often cloud
earning, but it's tougher to fake cash flow. For this reason, some investors
believe that FCF gives a much clearer view of the ability to generate cash
(and thus profits). For this software, we felt that it would also be appropriate
to add back Interest Expense because we felt it does not reflect on a service
based business ability to generate cash flow.

It is important to note that negative FCF is not bad.  If FCF is negative, it could
be a sign that a company is making large investments.  If these investments
earn a high return, the strategy has the potential to pay off in the long run.

When applying a Capitalization Rate to a business appraisal, the following
following business factors is important to consider.  The Capitalization Rate
is analogous to a "return on investment."  Bear in mind that the healthier the
business, the lower the capitalization rate, resulting in a lower overall risk in
business which increases the value of the investment.