



Approaches and Methods

Income Approach

The Income Approach is the most widely used approach due to RR59-60 suggesting that the earnings capacity of the business be considered. Obviously, if the business has more assets than it has revenue, the revenue may not accurately reflect the value of the business. Remember, RR59-60 deals with tax related matters and requires Fair Market Value (both were discussed in earlier education pieces).

Within the Income Approach, there are two widely accepted methods to calculate the opinion of value. They are the Single Period Capitalization Method and the Multiple Period Discounting Method. Both methods begin with the normalized revenue stream.

Single Period Capitalization Method

The Single Period Capitalization Method is used when the revenue stream is projected to grow at a constant rate. Example: Widget Co. believes their gross revenue will increase 10% every year over the next 5 years. The formula to calculate the opinion of value using the Single Period Capitalization Method is below:

Current year normalized revenue stream		\$1,000,000
Projected constant growth rate	+	<u>10%</u>
First year projected revenue stream		\$1,100,000
Capitalization Rate	/	<u>36%</u>
Control, Marketable Basis		\$3,055,555

In short, the single period capitalization method is simply taking a current revenue stream and capitalizing it to a future date.

Multiple Period Discounting Method

The Multiple Period Discounting Method is used when you do **not** have a projected constant growth rate. This method has two stages. The first is a discrete forecast of a certain number of years discounted to present value. The second stage is a method of estimating the terminal value, which is the value existent at the end of the discretely forecasted years.

The complicated and difficult part of either method is supporting and defending your projected growth rate, discount rate, and capitalization rate. If you remember nothing else, remember that you would not use both methods in the same appraisal. In theory, the same value would be calculated regardless of the method you used. Normalized revenue stream, capitalization and discount rates, and control/marketability discounts will be covered in a later education piece.

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