

VALUATION

RMA Annual Statement Studies, Valuation Edition: New Tool for Business Valuators

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Appraising a business interest requires a thorough examination of the subject company, the environment in which the business operates, and the trends and forces expected to act on the business in the future. One of the major activities an appraiser should perform during his or her analysis is to assess the risks of an investment in the business from the perspective of a potential investor.

Since valuation is all about risk, this analysis is an important part of a business appraiser's conclusions. Without a clinical, dispassionate, and objective assessment of the risks inherent in an investment in the subject company, the conclusion of value will be missing a strong and vital link. A thorough assessment of business risk includes many aspects, including an analysis of the economic environment and the industry in which the subject company operates. The appraiser also examines the company's operating results and trends over time, known as trend analysis.

Understanding the company's results over time, however, is not sufficient by itself. The company's results must also be placed in the proper context, by comparing them to results of the industry as a whole, in a process called comparative analysis. Jim Hitchner wrote in *Financial Valuation, Applications and Models*:

Comparative analysis is a valuable tool for highlighting differences between the subject company's historical performance and industry averages, pointing out relative operating strengths and weaknesses of the

subject company as compared to its peers, assessing management effectiveness, and identifying areas where the company is outperforming or underperforming the industry.¹

Without this analysis, the risks of ownership of the subject cannot be placed in context, and a proper assessment of risk cannot be made. The risk assessment, in turn, has a significant influence on the selection of a discount rate in the case of the income approach, and the selection of a pricing multiple in the case of the market approach. Ultimately, the results of the comparative industry analysis comprise a major determinant of the ultimate conclusion of value.

Only in this way can the historical performance of the subject company and, more importantly, the expectations for its future, be properly assessed. A careful review and analysis of the subject company's historical results is only a small part of the picture. This exercise only compares the company to itself, and provides only a narrow view of the company's performance.

¹ James R. Hitchner, *Financial Valuation, Applications and Models*, Second Edition, John Wiley & Sons, 2006, page 79.

For example, we may observe that, over time, the subject company has enjoyed gross profit margins that have increased from, say, 20 to 25 percent. Taken in isolation, we may be tempted to conclude that the company's operating results are good, and improving. However, if we discover that over the same time period the companies with which the subject competes have enjoyed gross profit margins of 35 percent, our assessment of the company's performance, and the risks associated with an investment in it, would likely be quite different. This, in turn, would likely lead to a different discount rate and pricing multiple, changing our valuation conclusion significantly.

The availability and use of industry trends and ratios comprise the cornerstone of comparative analysis, and are a necessary part of any thorough business appraisal. To enhance the comparison, these figures are typically expressed in "common size" format; that is, as a percentage of revenues in the case of the income statement, and as a percentage of total assets in the case of the balance sheet.

There are several widely used sources of such data to compare the subject company, including BizMiner, Integra, the IRS Corporate Ratios Database, and the Risk Management Association's annual publication *RMA Annual Statement Studies*. Because RMA

has been publishing the *Annual Statement Studies* for more than 85 years, it has become one of the primary sources of information that business appraisers use in evaluating a company's financial performance against its industry peers.

For business appraisers, the long-standing use of the traditional, print version of the *Annual Statement Studies* has been improved upon dramatically by the recent advent of the software version of this database. In 2006, ValuSource, through a licensing agreement with RMA, began publishing a more comprehensive set of data, based on the success of the *RMA Annual Statement Studies*, and provided additional data that is useful to business appraisers and other financial analysts. The *RMA Annual Statement Studies Valuation Edition*² permits a more finely tuned analysis that is not available in the printed version that business appraisers and bankers have been using for decades.

The *Annual Statement Studies Standard Edition* contains comprehensive information on more than 740 industries, and the data are searchable by NAICS Code or industry keyword. The data are assembled from more than 265,000 financial statements submitted to RMA member institutions. From this information, composite balance sheets and income statements are developed.

The resulting data present the averages of the balance sheets and income statements of the industry, broken down by size, as measured either by total assets or revenues. Common size statements are also available.

The *Valuation Edition* includes a number of improvements over the *Standard Edition* that are of special interest to appraisers, including the abil-

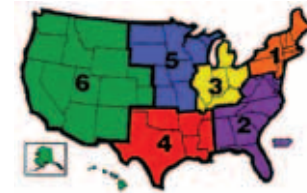
ity to break down the data into deciles. This permits a much more precise comparison of the subject to the industry. With other industry databases, comparisons can be made only against the industry average. Even RMA's *Standard Edition* allows comparison only against industry averages, or, in the case of financial ratios, medians or quartiles. Thus, the appraiser could only conclude that the subject is performing better or worse than the industry average only within broad boundaries that provided no further insight into where the subject ranked along the performance continuum, or how widely spread the continuum was.

With the *Valuation Edition*, the appraiser can assess the subject against its peers with greater precision, identifying the specific decile in which the company falls. This greater analytical detail can make for a much more precise analysis and a more persuasive valuation conclusion. It should be noted that quartiles, quintiles, and deciles are useful only if there are a sufficient number of companies represented in the data. For example, there are 74 companies represented in the data for NAICS #238310 Drywall and Insulation Contractors with \$5 million to \$10 million in sales; but only 23 companies with revenues less than \$1 million. Decile breakdowns will be useful in the first instance, but not in the second.

Here is another way in which the *Valuation Edition* permits a greater degree of analysis: The appraiser can examine the industry ratios on either a national or regional basis (see Figure 1). This functionality is not available in other industry databases, including RMA's *Standard Edition*. So the appraiser can assess how the subject matches up against companies not only competing

in the same industry, but competing in the same geographic region.

FIGURE 1:
SIX GEOGRAPHIC REGIONS IN
THE VALUATION EDITION



(1) NORTHEAST

Connecticut, Delaware, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, Vermont

(2) SOUTHEAST

Alabama, Florida, Georgia, Maryland, North Carolina, Puerto Rico, South Carolina, Tennessee,* Virginia, Washington, D.C., West Virginia

(3) CENTRAL

Illinois, Indiana, Kentucky, Michigan,* Missouri,* Ohio

(4) SOUTH CENTRAL

Arkansas, Louisiana, Mississippi, Oklahoma, Tennessee,* Texas

(5) NORTH CENTRAL

Iowa, Kansas,* Michigan,* Minnesota, Missouri,* Nebraska,* North Dakota, South Dakota, Wisconsin

(6) WEST

Alaska, Arizona, California, Colorado, Guam, Hawaii, Idaho, Kansas,* Montana, Nebraska,* Nevada, New Mexico, Oregon, Utah, Washington, Wyoming

*State spans two regions

² Available at www.nacva.com and www.valusourcesoftware.com.

As with the decile information, this regional breakdown permits a more narrowly focused comparison, enabling the appraiser to fine-tune the comparative financial analysis. The decile analysis is available across the size parameters of either total assets or revenues. That is, for a selected NAICS Code, the *Valuation Edition* presents decile data for companies with revenues of up to \$1 million, for companies with revenues between \$1 million and \$3 million, etc. The appraiser can make the most relevant comparisons possible between the subject company and a highly focused industry subgroup.

In addition to the industry's balance sheets and income statements, the *Valuation Edition* also presents 19 financial ratios, in the areas of liquidity, activity,

coverage, and profitability. Other industry databases show only average ratios, while RMA's *Standard Edition* shows ratios broken down by high, medium, and low. As with the financial statements, however, the *Valuation Edition* presents financial ratios by decile, again allowing a greatly enhanced analysis.

Table 1 presents data from the *Valuation Edition*, for NAICS 238310, and for revenues between \$5 million and \$10 million. The first column shows the average figures for companies in this revenue range. In the other columns, the appraiser can see that the ninth decile (or the ninetieth percentile) for gross profit was 40.6 percent of revenues, that the ninth decile of operating expenses was 36.2 percent, etc. It should

be noted that there are many instances where the median (i.e. the 50th percentile) is significantly different from the average, meaning there are outliers in the data, so that using the average can be misleading. The potential problem of using averages is resolved by using the median or any of the other decile values reported in the *Valuation Edition*. (The deciles are ranked based on their independent values, and the amounts in a column will not sum.)

The improved analytical tools of the *Valuation Edition* allow a more thorough and more supportable assessment of the risk of a company as compared to its industry peers. This, in turn, results in a more defensible and more credible valuation conclusion.

TABLE 1: Decile Income Statement (Percentages)

General Information		Statement Counts	
Data Source	RMA Annual Statement Studies™ 2009–2010	Type of Statement	#
NAICS Division	CONSTRUCTION - GENERAL	Unqualified	2
NAICS Title	Drywall and Insulation Contractors	Reviewed	34
NAICS Code	238310	Compiled	12
SIC Code(s)	1742, 1743	Tax Returns	9
Geographic Section	National	Other	17
Data Sorted By	Sales		
Data Range	5MM-10MM	Total	74

Current Annual Data											
	5MM-10MMAvg	10th	20th	30th	40th	50th	60th	70th	80th	90th	Std Dev
Net Sales	100%										
Cost of Sale (Calculated)	74.6%										
Gross Profit	25.4%	12.1%	16.2%	18.7%	21.3%	23.2%	25.2%	28.2%	31.3%	40.6%	12.7
Operating Expenses	20.6%	9.1%	11.5%	13.7%	14.8%	18.9%	20.5%	22.4%	28.8%	36.2%	12.8
Operating Profit	4.8%	-1.8%	0.7%	1.5%	2.3%	3.1%	4.7%	6.4%	8.3%	11.5%	6.7
All Other Expenses	0.6%	-0.5%	-0.2%	0.0%	0.1%	0.3%	0.3%	0.5%	1.0%	1.7%	2.3
Profit Before Taxes	4.2%	-2.1%	0.5%	1.2%	1.7%	2.9%	3.8%	5.2%	8.3%	11.6%	7.2

All of the reports available in the *Valuation Edition* are exportable into Excel, making it easy to incorporate the data for the industry group or subgroup into your own financial analysis template. Or, if you prefer, the *Valuation Edition* is compatible with ValuSource Pro and Business Valuation Manager Pro software.³

ValuSource Pro and BVM Pro are integrated business valuation analysis tools allowing the appraiser to apply as many as 18 valuation methods. They are customizable, and carry the financial analysis from initial input to a valuation conclusion. The ability to import industry data from *RMA's Annual Statement Studies Valuation Edition* (except the decile data) into ValuSource Pro and Business Valuation Manager Pro or

your own analytical spreadsheets can be a great time saver.

Irrespective of the spreadsheets to which the data are exported, the *Valuation Edition* represents a new and useful analytical tool for business appraisers. **VE**



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³ Business Valuation Manager Pro software is available from NACVA.



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Rod Burkert, CPA/ABV, CVA was a member of and a lead instructor for NACVA's Training Development Team for 10 years. Rod is a past chairman of NACVA's Executive Advisory and Education Boards. He received many NACVA instructor awards, including the Circle of Light and Instructor of the Year, and is one of NACVA's Outstanding Members.