Rules of Thumb Defined

SSVS defines rules of thumb as,

> A mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay, or a combination of these: usually industry specific. SSVS states, a rule of thumb is typically a reasonableness check against other methods used and should generally not be used as the only method to estimate the value of the subject interest.[1]

Dangers of Using Rules of Thumb

The following research illustrates the multitude of issues in relying on rules of thumb. <u>This research is intended to advise the reader of the inherent dangers of using rules of thumb</u>.

Concerning rules of thumb, Jay E. Fishman ASA, states:

> We have found that most industry formulas or rules of thumb are not derived from actual transactions in the marketplace. Industry formulas are commonly derived from textbooks, trade publications, verbal representations or other similar sources of information. Clearly, these sources of information will not provide the expert with sufficient information to render a meaningful opinion of value for the enterprise using these formulas. There are at least three fundamental problems associated with the industry formula "quick fix" approach.
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> 1) The lack of knowledge concerning the actual transactions that comprise the industry formulas will lead to confusion concerning the property acquired by a buyer during a particular transaction.
> 2) The lack of an adequate database can lead to considerable confusion over the actual purchase price paid for a comparable entity…. Without knowledge of the actual transactions underlying a given group of comparables, the experts would be unable to determine the real purchase price paid for the comparable enterprises.
> 3) Most industry formulas in textbooks, trade publications and other sources presume a typical or average entity. Lacking knowledge of actual transactions results in distortions due to differences in profitability, capital structure, management and other important considerations inherent in what a buyer would offer for a business entity…. The insufficient information base would make it impossible to gauge whether the subject enterprise is typical or atypical, and accordingly, would command a price superior or inferior to the typical multiple displayed in the industry formula.[2]

Ronald Rudich states the following concerning the application of rules of thumb:

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[1] AICPA Valuation Services, VS Section, Statements on Standards for Valuation Services (SSVS), VS Section 100, International Glossary of Business Valuation Terms, p. 36.

[2] Fishman, Jay E, Shannon P Pratt, Clifford J Griffith, and James R Hitchner. "The Problem with Rules of Thumb in the Valuation of Closely-held Entities." In *PPC's Guide to Business Valuations*, by Thompson Reuters/PPC, Fort Worth, TX, Feb 2018: 7-52 to 7-52.

Rules of thumb should be employed with extreme caution. More often than not, they do not give reliable answers because they will not give adequate consideration to many factors that may have either a negative or positive impact on value. In addition, they are misleading and inaccurate with respect to minority interests since the yardstick is based on the whole enterprise.[3]

Shannon Pratt states the following concerning the application of rules of thumb[4]:

- Rules of are often classified within the market approach to business valuation because they are thought to have their origins in transactions in the industry. However, their actual origins can vary anywhere from pure folklore to (rarely) actual transaction studies.
- Rules of thumb are just that – they are guesses. They can make great sanity checks, "ballparks" for pricing, but they should not be used for valuing or anything that is even close to a valuation or appraisal.
- Formulas values are not substitutes for careful consideration of other appropriate valuation methods that are applicable to the business being appraised.
- To the extent that rules of thumb are used, they generally apply to small businesses and professional practices. They generally assume that the sale of the business would be on an asset sale basis rather than on a stock basis. It is generally assumed that the rule represents the transfer of the operating tangible assets and intangible assets, but not real estate or current assets or liabilities (for example, cash, accounts receivable, inventory, accounts payable). Often a covenant not to compete is also included, and sometimes an employment agreement.
- A major problem with rules of thumb is that they are not clear as to exactly what business assets they purport to represent. Furthermore, they do nothing to deal with the essential valuation factor of relative risk and growth prospects.
- Rules of thumb are not cash equivalent prices. The values indicated by rules of thumb are intended to indicate face values of the transactions, not necessarily (or even usually) cash equivalent values. That is, most of the businesses are sold on terms and not for cash. Normally, the seller receives a note for the balance, usually at a rate of interest below market rates for comparable credits, and sometimes including contingencies. Thus, if such rules or transactions are used to develop fair market value (which assumes cash equivalency), adjustments need to be made accordingly.

[3] Rudich, Ronald D. CPA/ABV/CFF, MS, CVA, CBA/BVAL/ABAR, CM&AA, CMEA, SBA. "The Valuation: Different Decisions, Different Results." Reisterstown: Business Valuation Group, LLC, 2013: 35.

[4] Pratt, Shannon VFA, ARM, ABAR, FASA, MCBA, BM&AA. Adapted from: "Use rules of thumb with caution, not as a primary appraisal method". Business Valuation Update, Oct 2002.