Katherine Puffer
180 North LaSalle, Ste 3700
Chicago, Illinois 60601
312-235-2866
kpuffer@vhvaluations.com

# *The excess earnings method: When is it appropriate?*

The excess earnings valuation method was developed more than 90 years ago and, although controversial, it remains in wide use today, particularly in divorce cases. Generally, sophisticated valuation professionals view the method as unreliable and avoid using it. But it continues to be appropriate under certain circumstances.

**How it works**

The excess earnings method was developed by the U.S. Treasury Department in 1920 to estimate lost goodwill suffered by breweries and distilleries as a result of Prohibition. The method was never intended to be a business valuation tool, but it became popular because of its simplicity.

Appraisers using the excess earnings method follow these basic steps:

- Estimate the value of the company's net tangible assets.
- Multiply that value by a fair rate of return to calculate earnings attributable to the company's tangible assets.
- Estimate the company's *total* normalized earnings.
- Subtract earnings on tangible assets from total earnings to arrive at *excess earnings* — that is, earnings above a fair return on the company's net tangible asset value.
- Divide excess earnings by an appropriate capitalization rate to calculate the value of goodwill and other intangible assets.
- Combine the tangible and intangible asset values to determine the company's overall value.

Although the excess earnings method is relatively simple, it's not reliable. IRS Revenue Ruling 68-609 states that the method "should not be used if there is better evidence available from which the value of intangibles can be determined."

**Why it's unreliable**

The excess earnings method artificially divides a company's earnings into two separate earnings streams: one for tangible assets and one for intangible assets. The problem is that these assets don't generate earnings by themselves. Rather, a company's earnings are derived from a combination of tangible and intangible assets working together.

There is no market data to support an objective determination of a fair rate of return for tangible assets or a reasonable capitalization rate for intangible assets. So, application of

Katherine Puffer
180 North LaSalle, Ste 3700
Chicago, Illinois 60601
312-235-2866
kpuffer@vhvaluations.com

the excess earnings method is highly subjective and susceptible to manipulation. Also, the type of earnings to be used isn't clearly defined.

Income-based valuation methods — such as discounted cash flow and capitalized earnings — are more reliable. Valuators have access to a variety of market data sources from which to derive discount and capitalization rates.

**When to use it**

Despite its flaws, the excess earnings method is appropriate under particular circumstances. It can provide a "sanity check" against other valuation methods. And some judges require experts to use it in certain cases.

Also, a modified version of the method may be useful in valuing certain professional practices or small businesses. For example, in a recent Indiana divorce case (*Burnett v. Burnett*), a valuation expert successfully applied an "excess compensation" method to value the husband's interest in an anesthesiology practice's goodwill. (The expert also concluded that all of this goodwill was enterprise, rather than personal, goodwill and, therefore, subject to division.)

The expert used industry data to calculate the amount by which the husband's normalized earnings exceeded the earnings of anesthesiologists with comparable production levels, applied a capitalization rate (similar to those used under the income approach) to arrive at the present value of goodwill, and added his share of the practice's net tangible assets. Arguably, by using a single earnings stream and a market-based capitalization rate, this method is more reliable than traditional excess earnings methods.

**Know the method**

In most cases, the excess earnings method is less reliable than other valuation approaches. Nevertheless, it's still widely used, so it's a good idea to develop an understanding of the method, its shortcomings and its legitimate uses.



If you have any questions call Katherine Puffer at 312-235-2866 or email at kpuffer@vhvaluations.com