Valuation of
Test Company Not Real Data

Contents

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Introduction

This valuation report is based on information provided to us (unverified) via our website and only upon the most recent 3 years of financial information. We believe that this is appropriate to approximate the value of Test Company Not Real Data if it were to be offered for sale in an “arm's length” transaction.

We based our calculations in this report on a weighted average of financial information provided to us for fiscal years ending, 2011 , 2010, and 2009. We weighted the years as follows:

Year Ending	Weighting
December, 2011	0.60
December, 2010	0.30
December, 2009	0.10

The weighting is designed to account for the sales and profit trend and to give more weight to more recent financial performance results for the company. The weighting applies only to the profit & loss information. Balance sheet information (assets and liabilities) are also an important component of valuation. However, we used the most recent balance sheet information available to us as there is no reason to weight this information. Our use of the profit & loss and balance sheet information is explained more fully below.

I. Method of Valuation—Excess Earnings

There are a number of different methods that can be used to place an estimated value on a business. Different methods can yield different results. In fact, even the same method can yield different results because different appraisers will make different assumptions.

The excess earning method of valuation uses the income being earned by the owner(s) of the business as the basis for valuation. It also adds in the fair market value for the assets owned by the business that will be included in the sale (such as equipment, inventory, etc.).

In valuing Test Company Not Real Data, we used the *excess earning* method of valuation. We feel that this method offers a good estimate of value for small to mid-size businesses that are earning money.

Ib. Recasting Your Profit & Loss Statement

All income being earned by the owner(s) is considered for valuation purposes. That is, we consider salary, profit, non-cash expense (such as depreciation calculated for tax purposes that is in excess of actual decrease in value), and other *non-essential* expenses of the business. To consider all forms of income flowing to the owner(s), we need to *recast* your financial statements. Financial statements are usually prepared to minimize taxes by using legal techniques to present income as low as possible. Recasting essentially involves presenting the financial statement to show the true earning of the company.

Ic. A Note Regarding Owner's Salary

As the owner of your company, you can set your own salary, providing of course, there is enough money available to meet that salary. In valuing your business, we have to estimate a market rate salary for the work that you do for your company. The estimate(s) that we used in the case of the company are:

Total Fair Compensation	Year
$220,000.00	2011
$220,000.00	2010
$220,000.00	2009

Owner's salary of course is an expense for your company and needs to be considered as an expense whether it is being paid to the owner or to a non-owner. Rather than use your actual salary, we adjust salary expense up or down based on the estimated market rate salary. For example, if your salary is $10,000 more than estimated market rate for the work you are doing, we will add $10,000 back to earnings for the company. Likewise, if your salary is $10,000 less than market rate, we will, for valuation purposes decrease earning by $10,000.

The adjustments made to earnings based on owners' compensation were:

Adjustment to Earnings for Compensation	Year
$295,338.00	2011
$240,478.00	2010
$144,829.00	2009

Id. A Note Regarding Depreciation

Financial statements are typically prepared using an accelerated depreciation schedule as allowed by IRS rules. That is, fixed assets are depreciated more quickly for tax and income reporting purposes than their actual decrease in market value. In addition, small businesses are allowed to depreciate some assets in the year they are purchased regardless of their anticipated longevity.

For this reason financial statement prepared for tax purposes often show fixed asset value to be a good deal lower than their actual fair market value. You estimated the current value of the machinery, equipment and fixtures at $1,000,000.00 so we added $273,745.00 to the balance sheet. We also added back the non-cash depreciation expense in the income statement recasting.

Ie. Opportunity Cost

The excess earnings method of valuation takes into account the fact that a buyer will have to tie up some money in the business being bought. A buyer may purchase the firm with his or her own cash, with borrowed money, or with some combination of the two. To borrow money, a buyer would have to pay interest at a rate of 1 to 4 points over the current prime interest rate. If a buyer uses his or her own money, an opportunity cost for the money must be considered. That is, the same money can be put into any number of alternative investments and earn a return in the form of interest, dividends, or both.

To put the cost of money on a *level playing field*, we use a value that disregards whether it is obtained on a borrowed or opportunity cost basis. Instead we use the current prime rate and add 2 points to it. We call this value the *underlying interest rate*.

This underlying interest rate is applied to the amount of money that needs to be tied up in working capital on a continuous basis. To approximate this amount, we used the net worth of this business (assets minus liabilities) as it is shown on the most recent balance sheet. This amount is adjusted if necessary, to account for a net worth that is not in line with the needs of the business. For example if the business is carrying too much cash on hand, or too much inventory for its needs, an adjustment is made. The adjusted amount is an estimate of the tangible net worth of the business for a new owner, after the acquisition is completed.

Debt that incurs interest charges, even long term debt that will likely be assumed by a new owner is subtracted from the Balance Sheet at this stage. We do so to make the opportunity cost reflect all of the money that will be borrowed or provided by the new owner, so that the opportunity cost reflects all of the money that will be tied up in the business. The amount necessary to pay off these loans will be added back to the value of the business in the final step of our analysis.

Note also that any interest expense that the business is currently incurring is added back to profit in estimating value. The buyer's opportunity cost is a more fair value to use than the current owner's interest expense.

We calculated an opportunity cost of $6,002,409.50 and deducted that amount from earnings for valuation purposes. (Prime rate is 5% so we used the following: 6,002,409.50 X (5% +2 points))

For the purpose of calculating opportunity cost we adjusted the Balance Sheet as follows:

	As reported	Adjustment	Recast
Cash and Bank Balances	5,305,038.00	(4,403,385.25)	901,652.75
A/R	2,094,283.00	(290,977.50)	1,803,305.50
Inventory	378,469.00	0.00	378,469.00
Other Current Assets	820,635.00	0.00	820,635.00
Real Estate	0.00	2,000,000.00	2,000,000.00
PP&E	1,273,745.00	(273,745.00)	1,000,000.00
Other Fixed Assets	0.00	$0.00	$0.00
Total Assets	**9,872,170.00**	**(2,968,107.75)**	**6,904,062.25**
A/P	3,875,718.00	(2,974,065.25)	901,652.75
Current Portion of LT Debt	0.00	0.00	0.00
Other Current Liabilities	0.00	0.00	0.00
Long Term Liabilities	673,669.00	(673,669.00)	0.00
Total Liabilities	**4,549,387.00**	**(3,647,734.25)**	**901,652.75**
Net Balance Sheet for Opportunity Cost	**5,322,783.00**	**679,626.50**	**6,002,409.50**

The receivables were high, so we have adjusted the A/R to reflect approximately 2 months' sales. We will add the A/R we took out here back later.

The Accounts Payable were high, so we have adjusted the A/P to reflect approximately 1 months' sales. We will add the A/P we took out here back later.

RE, PP&E, and Other Fixed Assets are adjusted to fair market value and depreciation brought to zero.

If. Balance Sheet at Close

In the final step of valuing the business we will need to make adjustments to the balance sheet to reflect the true value of the business as we did in the opportunity cost section above. This adjustment leaves out many of the balance sheet adjustments that were made for calculating opportunity cost, so that the value of the Balance Sheet at close accurately reflects the value of the assets and liabilities of the business at the time of closing. Of course, the balance sheet will change over time and so the value of the business needs to be adjusted at the time of close to reflect any changes in assets or liabilities that occur between the valuation and the date that a deal closes.

To get from an Opportunity Cost Balance Sheet to a Net Balance Sheet at Closing we added back the adjustments made to the Opportunity Cost Balance Sheet except for the adjustments of RE, PP&E, and Other Fixed Assets. The adjustment made to the Opportunity Cost balance sheet to add back Cash, A/R, and A/P adjustments is -1,046,628.50.

II. Excess Earnings and Return on Investment

A company's excess earnings for valuation purposes is its sales minus its adjusted expenses (adjusted as explained above).

Ultimately, a business buyer is seeking a return on investment (ROI) for the money he or she is investing in a business. As noted previously, a fair salary paid to the owner is not part of the ROI calculation. For example if the owner of a business is earning a total of $100,000 including salary, profit, and non-essential expenses) and the estimated fair market rate value for the work that owner is performing is $60,000, the excess earning for that business is $40,000 ($100,000 - $60,000).

The excess earnings is the basis to calculate return on investment. Investors (including business owners and business buyers) express ROI in percentage terms. For example, if you invested $10,000 and one year later closed that investment and received $11,000, your $1,000 profit equaled an ROI of 10%. In the case of a business sale, we have to do a reverse calculation. In the example in the paragraph above, we know the expected dollar return is $40,000 per year, so the question is "how much is $40,000 worth to an investor?" The answer to that question becomes the value of the business based on the excess earnings method. If an investor decides a 20% return is appropriate then he just needs to calculate:

$40,000 is 20% of what amount?

The answer is $200,000. However calculating an appropriate ROI is not just a mathematical exercise. Some investments merit an ROI of 40% or more where others merit an ROI of less than 5%. In general the safer and surer an investment is the lower the ROI an investor will demand, US Government bonds, widely regarded as the safest of investments currently pay a return of about 1%. On the other end of the spectrum, there are some high risk stocks that investors won't buy unless they can be convinced their return will be 40% or more <u>if</u> the investment works out as planned.

Small businesses tend to be on the riskier end of the spectrum. They also are not liquid investments, meaning that a small business owner can't just sell his stake in his company at will like he could an investment in a government

or corporate bond, or shares of stock in a public company. Therefore, investors demand higher return potential in buying a small company.

Many small businesses use cash basis accounting. That is revenue is not recognized until payment is received and expenses are recognized as they are paid. This method is simpler, but may not accurately reflect the performance of the business. If data was input based on cash basis financial statements the software adjusted it to accrual basis. Adjusting from cash basis to accrual basis can be complex and involves examining individual transactions that may span a year end. For example, a paycheck may include monies earned in both December of one year and January of the next. For purposes of valuation, however, we are only concerned with items that are likely to have a material impact on the earnings. These include large changes in accounts receivable, inventory, and accounts payable. So, we adjusted these accounts as follows:

- Adjusted Gross Sales = Gross Sales + Accounts Receivable at end of period - Accounts Receivable at beginning of period
- Adjusted Cost of Goods Sold = Cost of Goods Sold + Beginning Inventory - Ending Inventory
- Adjusted Overhead Expense = Overhead Expense + Accounts Payable at end of period - Accounts Payable at beginning of period

Once recast and adjusted for opportunity cost we calculated the excess earnings of the company to be $1,565,757.20

The Calculation is as follows:

Year Ending: December, 2011

	Amount
Gross Sales	10,819,833.00
Less COGS	8,793,675.00
Less Overhead Expenses	1,407,392.00
Plus (minus) Owners Salary and Benefits Adjustment – including any rent adjustments	295,338.00
Plus Contributions	152,945.00

Plus Interest Expense	18,068.00
Plus Depreciation Expense	0.00
Plus Amortization Expense	159,206.00
Adjusted Income	1,244,323.00

Year Ending: December, 2010

	Amount
Gross Sales	10,144,322.00
Less COGS	7,435,601.00
Less Overhead Expenses	1,414,288.00
Plus (minus) Owners Salary and Benefits Adjustment – including any rent adjustments	240,478.00
Plus Contributions	151,885.00
Plus Interest Expense	5,450.00
Plus Depreciation Expense	0.00
Plus Amortization Expense	149,734.00
Adjusted Income	1,841,980.00

Year Ending: December, 2009

	Amount
Gross Sales	11,909,062.00
Less COGS	8,165,310.00
Less Overhead Expenses	1,526,190.00
Plus (minus) Owners Salary and Benefits Adjustment – including any rent adjustments	144,829.00
Plus Contributions	153,470.00
Plus Interest Expense	7,944.00
Plus Depreciation Expense	0.00
Plus Amortization Expense	141,889.00

Adjusted Income	2,665,694.00

III. Earnings Multiplier

Ultimately, an investor's return on a business acquisition hinges primarily on the future performance of that company. One of the main indicators an investor has on the future performance of a company is its past performance. There are other factors that an investor will consider when evaluating a small company for acquisition.

The factors that we consider here for valuation purposes are listed below. Each of thee factors is rated on a scale of up to 6. A higher number means a better rating. Ratings are based upon the information that you provided, industry projections, industry performance statistics, and our own judgment.

The factors we used for Test Company Not Real Data (which are the same we use for most companies) are:

Here are the factors we used to compute multiplier for Test Company Not Real Data:

Competitiveness	2.90
Company	4.01
Risk	5.09
Desirability	2.97
Average factor **(Average of above, used as multiplier)**	3.74

Based on our website interview with you we assign a value of up to 6 for each category. We then average the assigned value and use that number as the multiplier. The multiplier is multiplied by the excess earning value, to calculate the value of the excess earning of the business.

The excess earnings value of Test Company Not Real Data is the excess earnings times the earnings multiplier.

IV. Final Step, Value of Test Company Not Real Data

Add *excess earnings value* plus *net asset value*.

The final step in calculating a value for your business is simply to add the excess earnings value (recast excess earnings * multiplier as explained above) to the actual net asset value being transferred as part of the business sale. The net asset value is simply the fair market value of all assets being transferred minus the value of the liabilities that the buyer is assuming.

Note that the value of assets (and liabilities) being transferred may be different than the balance sheet assumptions used for calculating opportunity cost (Section Ie). For example, cash on hand is seldom transferred in an acquisition. Nevertheless, a new owner will need to inject his or her own cash to provide working capital for the business. Therefore, there is an opportunity cost for the cash being tied up even though that cash is not part of the sale.

When we recast the balance to calculate opportunity we did so to create a balance sheet that might more accurately reflect how much money the new owner would have tied up in the business after closing. To do so, we subtracted assets (such as excess cash and accounts receivable) that the new owner would not need, and adjusted liabilities to a level that would reflect normal operating levels. However, the cash, receivables and other assets have real value and loans must be repaid, so when we adjust the balance sheet to calculate it's fair value for the purpose of the sales price we do not include those adjustments. We do, however, still adjust the balance sheet so that it reflects the fair market value of all assets that are present at closing.

The value of Test Company Not Real Data based on the above is:

Year	Recast Net Income	Weighting	Weighted Net Income
December, 2011	1,244,323.00	0.60	746,593.80
December, 2010	1,841,980.00	0.30	552,594.00
December, 2009	2,665,694.00	0.10	266,569.40

Total	1,565,757.20
Less Opportunity Cost	$420,168.67
Adjusted Weighted Income	1,145,588.53
X Multiplier	3.74
	4,284,501.10
Plus Net Balance Sheet	6,002,409.50
Less (plus) Adjustments to B/S	-1,046,628.50
Net Worth (from Section If)	
Valuation	11,333,539.10

Valuation is not an exact number. In the best of circumstances it is a range. In our opinion, the fair market value of Test Company Not Real Data is between $10,200,185.19 and $12,466,893.01 based on the explanation and calculations shown in this report and based upon a Fair Market Value of Tangible Assets (less liabilities) of 6,002,409.50 prior to close. It also assumes 6,002,409.50 that in tangible assets at fair market value (equipment, furniture, etc.) will be included in the sale (net of liabilities transferred or paid off).