

# **Business Valuation**

## **by Stanford Meisner**

### **What is a Business Valuation?**

A business valuation determines the estimated market value of a business entity. A valuation estimates the complex economic benefits that arise from combining a group of physical assets with a group of intangible assets of the business as a going concern. The valuation, which is part art and part science, estimates the price that hypothetical informed buyers and sellers would negotiate at arms length for an entire business or a partial equity interest.

### **Valuation vs. Appraisal: How Do They Differ?**

Valuation and appraisals are similar, but they are not interchangeable. Most people are familiar with appraisals in their personal lives. Often times people will have appraisals performed on a house, a car or a piece of jewelry. The key difference between a valuation and an appraisal is that a valuation includes both tangible and intangible assets, while an appraisal just includes tangible or physical assets.

### **Business Valuation: Art or Science?**

A business valuation combines quantitative financial techniques with qualitative analysis of the business, the industry and the economic conditions in general.

### **Why Do a Valuation?**

#### **Lack of an Efficient Market**

Despite the commonly held belief that markets are efficient, an efficient market does not exist for privately held businesses and certain fractional equity interests. Unlike the NYSE or the NASDAQ there is no place to buy and sell privately held businesses aside from the business brokerage community, which is small in scope. As a result, it is very difficult to determine what a privately held business is worth in the marketplace. This lack of an efficient market presents a critical need for valuation services.

#### **Exit Strategy**

The business owner needs to develop a strategy to enable him or her to obtain value from the company when he or she decides to sell. If a potential buyer is able to invest fewer dollars on his or her own and duplicate the seller's business the potential buyer would obviously be better off starting a new business than buying an existing one.

### **Business Valuations are Usually Performed for Five Primary Reasons**

1. To establish a price for a transaction
2. Business planning

3. Attract capital
4. Aid in estate and gift planning
5. Meet governmental requirements

### **Establishing a Price for a Transaction**

Valuations help business owners in the sale of a business by determining a reasonable asking price. A valuation can also be used in a merger/acquisition transaction as a due diligence consideration.

### **Business Planning**

Often times a valuation can help business owners negotiate buy/sell agreements. A sound valuation can become part of the actual buy/sell agreement. A valuation that is prepared prior to the occurrence of a liquidation event can save both time and money.

Business owners can also use a business valuation as one of the cornerstones of a long-term financial plan to enhance the value of their business. Business owners often use management consulting to improve strategies and tactics through a particular function (e.g., marketing, operations.) Business valuation consulting focuses on how strategies and tactics create value for business owners.

### **Attract Capital**

Valuations are often an important part of obtaining debt or equity financing.

### **Estate and Gift Planning**

If an interest in a closely held company is material to a person's net worth a valuation of that investment should be an integral part of the person's estate planning. When a person dies a posthumous valuation of a closely held business is often done as part of the estate's tax return. These valuations are important because the IRS audits most estate tax returns even if the value of the closely held business is of modest value.

Also, if an owner of a closely held business wants to make a charitable gift of a business interest the IRS requires a valuation.

### **Governmental Requirements**

The IRS requires a valuation for employee stock ownership plans (ESOP's) and in conjunction with the conversion of a C corporation to an S corporation. Many states also require valuations in divorce proceedings or minority shareholder actions.

## **The Components of a Business Valuation**

IRS Revenue Ruling 59-60 states that valuations should address the following issues:

- The nature and history of the business
- The general economic outlook and the conditions of the specific industry
- The book value of the stock
- The financial condition of the company

- The earnings capacity of the company
- The dividend paying capacity of the company
- Whether the company has goodwill or other intangible value
- Previous sales of stock
- The market price of publicly traded companies who are engaged in the same or similar lines of business

### **Historical Performance**

The past and future earnings power of a business is often the single most significant factor in the valuation of a business. The quality and completeness of the company's accounting and financial records also have a significant impact on the valuation. An incomplete set of financial records will cause the valuator to have to make significant "normalized" adjustments to reflect the true financial position of the company.

### **Company Management**

The quality and depth of management is obviously a critical factor in the value of a business.

### **Company Ownership**

The size of the ownership interest being valued has a significant impact on the valuation. A minority interest in a business might have to be adjusted for a lack of control discount, while a controlling interest may be given a premium for having control.

### **Conditions of Operations**

The physical aspects of a business are important as well. A company with current systems and new equipment will have a higher value than a company that has deferred investment in infrastructure and equipment for several years.

### **Proprietary Products and Services**

Proprietary products, services or processes add significant value to a business. These legal rights can insulate a company from its competition and allow it to charge higher prices in the market.

### **Industry**

The macroeconomic condition of the company's industry is also an important consideration in a business valuation. A company in a high growth industry will have a higher value than a company in a mature industry.

### **Competition**

As all business owners know, the company's position in the competitive marketplace has a significant impact on the overall financial performance of the business. Valuators put a great deal of stock in market share and on the basis in which the company competes in the markets that it operates in.

### **Government Regulation**

As laws change so do their effects on businesses. Unfortunately many laws and

regulations are designed for Fortune 1,000 companies. As an example, General Electric may be able to easily comply with certain environmental laws, but these same laws may be a significant burden to a small business. The valuation must consider these regulatory roadblocks.

## How is a Business Valuation Conducted?

The business valuation process can be broken down into four components.

1. Engagement process
2. Research and data gathering
3. Analysis and estimate of value
4. Reporting Engagement Process

There are several issues that must be addressed at the start of the business valuation process.

- Definition of the legal interest to be valued - (e.g., 100% of the company's common stock)
- Valuation date - the date of the estimate of value
- Purpose of the valuation (e.g., estate tax, sale of a business, business planning, etc.)
- Define standard of value: **Fair market value** - the value in an exchange between a willing buyer and a willing seller with a reasonable understanding of the facts. Fair market value is the most common standard of value and the IRS requires it; **Investment value** - the value to a particular investor based on individual investment requirements. This standard is often used in merger transactions.
- Define the premise of value: **Value as a going concern** - this is the value of a business assuming it will continue to operate as a going concern; **Liquidation value** - this is the value of a business that is not operating as a going concern, but has commenced an orderly disposition of its assets.
- Form and content of the report

## Research and Data Gathering

At this point the valuator will request certain information from the client. This request may include the following.

- Financial statements
- Tax returns
- Accounts receivable, accounts payable and inventory detail
- Contracts/leases
- Budgets/forecasts
- Board of directors minutes
- Organization chart
- Marketing material/price lists

While this information is being gathered the valuator will be performing industry and comparable company research.

### **Analysis and Estimate of Value**

During this phase the valuator puts together and analyzes all of the internal company information in conjunction with the industry and comparable company research. This analysis will then enable the valuator to synthesize an estimate of value.

### **Reporting**

In the reporting phase the valuator will issue his or her report. There are three basic types of reports.

- Oral report - issued when time does not permit a written report to be issued
- Limited scope report - provides a well-documented estimate of value that can be used for many purposes, while taking into consideration the cost of the report preparation.
- Full scope report - the most detailed and costly estimate of value. This type of report is often used for litigation purposes.

At the end of the valuation process the valuator will ask the client to sign a client representation letter that states, in effect, that everything that the client supplied to the valuator is true and accurate to the best of the client's knowledge and abilities.

### **Role of the Valuator**

Unlike legal counsel who is ethically obligated to be the client's advocate, the valuator is independent. In the past valutors were often hired by legal counsel to support a particular preconceived position. Although this practice still exists it occurs less frequently today. In the long run, the advocacy bias creates tension between parties trying to reach a good faith agreement on the value of a business. Even if the valuator has to provide expert testimony in a court proceeding the valuator's ultimate responsibility is to document and support his or her estimate of value. The IRS, AICPA, SEC and the DOL all have various rules regarding independence and the advocacy position of the valuator.

As a general rule our firm will not accept a valuation engagement, in which the valuation report will be used by a third party, or for a client for whom we do audit or tax work.

### **Role of the Client**

The key to a successful valuation is establishing a relationship of mutual trust among the valuator, the client and the client's professional advisors. It is in the client's best interest to be open and forthcoming with the valuator in order to avoid errors and reduce costs.

### **What a Valuation is not**

A valuation is not an audit or review. The valuator is not providing any form of assurance, as defined by the AICPA, on his or her estimate of value. The valuation is also not a strategic plan or a long-term financial forecast.

### **What Affects the Price of a Valuation**

The three biggest factors that affect the price of a valuation are the type of report to be issued, the availability, completeness and organization of the company's financial records and the purpose of the valuation. As an example, a valuation prepared for estate planning purposes with a limited scope report will cost significantly less than a valuation prepared for a high net worth divorce case that requires a full scope report and expert testimony in a court proceeding.

### **How to Reduce the Price of a Valuation**

There are four key steps that a client can take to reduce the cost of the valuation engagement. The two most important steps for the client are to be open and honest with the valuator during the engagement and to keep detailed and organized financial records. Clients should also consider having valuations done on a periodic basis. This will significantly reduce the time spent by the valuator in the research and data gathering phase.

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