PLACING a VALUE on BUSINESS

After deciding to have a valuation of your business done, now comes the hard part—finding someone to do it, and getting through it with your wits intact

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In the first part of this series (March '04), we presented the various purposes for having a business valuation, and what information is needed to complete the valuation. In part two, we will discuss the qualifications of an appraiser, how the valuation is done, and what to expect from the valuation.

After all, when you acknowledge that a valuation is a necessary aspect of operating a business, you should know how to go about it and how it is done.

An appraiser's qualifications

It is important, when selecting a qualified appraiser to value your company, that you deal with someone who not only knows the correct methods to apply, but also is knowledgeable about your industry, and is competent and reliable. Many attorneys and professionals will claim to

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be qualified appraisers, but this is one area of business that is highly technical and requires a tremendous amount of experience. The following factors should help identify a qualified appraiser:

- A qualified appraiser should be knowledgeable in accounting, preferably a tax and financial specialist who also is a CPA.
- The individual should be knowledgeable about your business and industry.
- The person should not be someone who prepares the tax returns and financial statements for the company, as there will be a lack of independence, and an inability to objectively determine the adjustments necessary to the financial statements used in the valuation.

THE MOST IMPORTANT ELEMENT IN SELECTING AN APPRAISER IS THAT THEY BE KNOWLEDGEABLE IN THE INDUSTRY, AND KNOW THE PRODUCTS AND THE SPECIAL ASPECTS OF THE BUSINESS.

- The individual should be a member, in good standing, of one of the national organizations that deal with valuation specialists, and should have experience and continuing education regarding the changes in valuation methodologies, as well as keeping abreast of the tax and labor laws affecting valuations.

This list is not definitive, as many appraisers will have substantially more qualifications than stated above. It is important to research your choice of an appraiser carefully to select the right one for your company. Remember, the most important element in selecting an appraiser is that they be knowledgeable in the industry, and know the products and the special aspects of the business. The Internal Revenue Service has stated many times, as have the courts, that if an appraiser is not knowledgeable about the industry, it would be difficult for the appraiser to be "qualified."

How the valuation is done

It is important to first understand the eight factors that must be considered to help establish a range for the valuation. The factors are stated in a Revenue Ruling, issued by the IRS, and have been used for years as the key factors to understand in valuation analysis.

1. The nature and history of the business.
2. The company's economic outlook.
3. The company's earning capacity.
4. The company's goodwill for intangible value.
5. The company's dividend paying capacity.
6. The company's asset value.
7. Any sales of the company's stock that have taken place in the past.
8. The price of comparative corporate stock sold on the open market.

These eight factors are then reduced to mathematical calculations with one of five methods: Capitalization of Earnings Method, Adjusted Book Value Method, Excess Earnings Capacity Method, Cash Flow/Leveraged Debt Method, and Comparables Price Method.

The Capitalization of Earnings Method determines the future earnings of a company based upon past earnings history. This method uses historical data to project future earnings. It involves examining the past several years of earnings, and adjusting for non-operating and nonrecurring items to obtain a weighted average annual earnings figure. The consensus among appraisers is that the capitalization of earning power is the most important single factor in the valuation of most operating companies.

The Adjusted Book Value Method, also referred to as the Underlying Asset Value Method, is especially useful in valuing operating companies. This method considers tangible assets and the underlying asset value of all properties needed to successfully operate the company. It does not consider any intangible assets such as goodwill. It should be understood that this is not the book value of a company; it is a variation of book value.

The Excess Earnings Capacity Method is based on the theory that the value of a company is equal to the value of the net tangible assets, plus the value of the excess earnings (such as goodwill, patents, trademarks, copyrights, etc.). The goodwill factor, though hard to quantify, must not be forgotten when determining the value of the business.

The Cash Flow/Leveraged Debt Method determines a value of a business based on the normal cash available from operations together with the cash at the beginning of the year. The cash flow is capitalized using a rate determined by several factors, including the overall growth rate of the company, the cost of capital, industry and market growth projections.

Finally, the Comparables Price Method involves two types of methods, the Direct Market Data Method, and the Guideline Company Method. The Direct Market Data Method uses transactional data of all known acquisitions involving businesses of the same type as the company being evaluated. In order to effectively utilize this method, you must have data from at least three different companies. This information is then used to compare the company data with the "overall market" to arrive at a market value.

The Guideline Company Method compares the financial data of the company with a small number of companies in the industry based upon similarity in operations. The key to this method is to select companies that are related in operations and in markets to the company being valued. These methods are used to verify the results of the other methods and not used as stand-alone methods.

No single method will provide the absolute value of a company. The courts and the IRS have determined that more than one method must be used to value a closely held corporation. In addition, this is a key reason why the appraiser not only should be knowledgeable about the company, but also should be knowledgeable about the industry. The appraiser must determine which methods will receive the greatest weight. The appraiser will consider the type of company, the purchaser, the characteristics of the industry and the reason the company is being valued in reaching this determination.

What to expect

Many clients often wonder what to expect from a valuation. Common questions involve price, amount of time to completion, what is required for future updates to the valuation, and the time and price commitment for future updates. Many of the answers to these questions depend on the individual company involved and the purpose for which the valuation is being completed.

For the majority of valuations, expect the professional fee to be in the range of $6,500–$15,000, and the time frame to consist of approximately two months. Within the first month, the purpose and format of the valuation is determined, and the essential data is gathered. The materials' gathering usually requires an on-site visit from the appraiser. The second month is typically reserved for the analysis of the material and the preparation and presentation of the report. Again, an on-site visit is usually made by the appraiser when presenting the results of the valuation. This is done to help answer any questions or concerns that arise from the results presented.

Once an initial valuation has been completed, it will be less expensive to update the valuation in future years—if major changes have not occurred within the company. However, if events such as expansion or contraction have occurred, or key employees have been retained or fired, an updated valuation will be slightly more time consuming and costly. Naturally, when more events or changes have taken place, the valuation must account for each and every change starting from the bottom up.

This takes time as well as a reevaluation of the current position of the company and the methods that were used to calculate the original value. But overall, updating an existing valuation yearly is considerably less expensive than completing entirely new valuations every three years.

A most important step

You have just read about the importance of the qualifications of the appraiser, how the valuation is done, and what to expect from the valuation. As you can tell, the material and analysis can be complex. It is important that you feel comfortable with your appraiser so you can relay information that may be important to the valuation, and be assured that the valuation process is being completed in an efficient and competent manner. A business valuation is the most important step you can take when planning the future course for your company.

As we told a recent seller after we successfully sold his business—the valuation was the first step, but we were able to proceed to a successful closing because we knew what the company was worth and how to show that value to the buyer.

If you have any questions or would like more information regarding business valuations, please contact The Center for Financial, Legal, & Tax Planning, Inc. at (618) 997-3436, or via e-mail, to b-basi@taxplanning.com.

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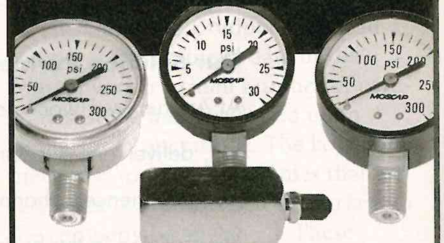

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