THE BUSINESS VALUATION PROCESS: BUYING/SELLING A BUSINESS

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According to the article in Small Business Forum, ***I Want to Sell My Business, Where Do I Begin***?, before a business can be valued the purpose of the valuation must be determined. Different purposes result in different values. "The need to value a business occurs for various reasons, including buying or selling a business, gift or estate taxes, stock liquidation or transfer, divorce, key person life insurance, employee stock ownership plans, going public, and obtaining financing" (Petersen p. 1). For example, in a divorce settlement the valuation is governed by various state statutes, but many of these statutes fail to define the value. Also, when family businesses are sold to the next generation, there is less concern with the greatest value obtainable. The primary concern is staying in accordance with the tax authorities.

There is no one right way to determine a value. "It is impossible to assign one true and absolute value to a business because the selling price is influenced by so many factors" (Peterson p. 2). One of the best standards of value is fair market value. Valuation methods only attempt to determine the fair market value. "Fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the facts" (Reinardy and Stover p. 15). The fair market value depends upon who is viewing the business.

Where to Begin

A good place to start the business valuation process is by visiting a professional appraiser. Shannon Pratt, a widely recognized authority on business valuation, states that professional appraisers are recommended for several reasons. They include:

- An appraiser won't rely on rules of thumb because they aren't based on fact and tend to be overly optimistic.

- Conditions change and they can change for the whole economy or for a specific area of the economy. An appraiser can help evaluate these changes.
- An appraiser can also help business owners understand the trade-offs between cash and terms.
- There's a greater tendency toward lawsuits so people have to be more careful. The buyer may want to come back and sue the seller if the business goes bad after the sale. An appraiser can also provide a more sophisticated analysis that can stand up in court (Stover pp. 29 & 34).

How to Select an Appraiser. . .

Select an appraiser from the American Society of Appraisers. There are accredited senior appraisers in business appraisal, located in almost every city in the United States. To obtain a directory listing of 500 appraiser members, call **1-800-272-8258**. It is important that the appraiser has a formal academic education, but more critical are the appraiser's professional credentials. The primary professional credential is A.S.A. which stands for Accredited Senior Appraiser of the American Society of Appraisers.

. . . and a Broker

After the appraisal process is finished, a good business broker should be contacted to help with the sale of the business. An appraiser will often be able to refer you to a good business broker. A reputable broker would be a member of either the International Business Brokers Association or of the Certified Business Counselors.

Factors that Influence Value

There are two important factors that affect small business valuations. **The number one factor is how much money the business can earn**. This should be stated in terms of cash flow or how much cash the business can generate. **The second factor is determining the availability of the assets.**

There are also other significant factors that influence the business's value. Conditions do change and the economy can drastically change from time to time especially for particular kinds of businesses. As interest rates go up and as money gets tighter, the value of the business goes down. Businesses also follow the rule of supply and demand. When there are a lot of businesses for sale in a particular industry and few buyers, the value goes down. When there are a lot of buyers and few sellers, the value goes up. The bargaining position between the buyer and seller is also a factor that follows the supply and demand rule. For example, if a seller needs to sell a business immediately in order to take advantage of another opportunity, and a buyer has ready access to financing, the buyer has a bargaining advantage over the seller. (Petersen p. 2)

As mentioned earlier, the purpose of the valuation determines the price. Owners of a closely held or family owned business selling to the next generation don't expect to receive the going market price. Or in a divorce settlement, one party may want a higher value to receive what they believe is their fair share of the business. Also, a buyer's perception of benefits derived from purchasing a business will affect the price.

Additional Factors to Consider in the Valuation Process:

1) **Nature and History of the Business**. Such things as how long the business has existed, the business's reputation, if there is a need to replace or update equipment, the geographical location of the business, and major competitor information are all important factors in determining a business's value.

2) **General Economic and Industry Outlook**. There are many sources that will project key economic statistics for future periods. Ask your librarian to help you locate those sources for specific economic projections or those projections relating directly to your industry. Some sources include: U. S. Industrial Outlook, Index of Leading Economic Indicators, Directory of Industry Data Sources, and Data Sources for Business and Market Analysis. Comparative historical data and other sources of composite financial data can be found in Annual Statement Studies from Robert Morris Associates. Other economic and industrial trend information may be obtained through analysis of County Business Patterns. You can often receive more information by contacting a trade association for your specific industry. Also, check the larger banks in your area to see if they have an economic forecaster that may be able to provide you with assistance.

3) **Book Value and Financial Condition**. Book value is the total net assets of the business (historical cost of the assets minus the accumulated depreciation) minus the total liabilities. An analysis of the income statements and balance sheets will help determine the book value and financial condition.

4) **Earnings Capacity of the Business**. How much cash a business can generate or earn in terms of cash flow.

5) **Dividends Paying Capacity of the Business**. The share of profits given to the stockholders.

6) **Goodwill and Other Intangible Assets**. Goodwill is the excess earnings over and above a fair return on equity. "While such factors as the prestige of a business, the ownership of a trade or brand name, and the record of successful operation over a prolonged period and a particular locality are supportive, they must be able to quantify in the form of excess earnings to substantiate marketable goodwill." (Reinardy and Stover p. 18)

7) **Market Price of Stocks of Comparable Companies**. Sales information relating to similar trading companies may help to provide discounts. Discounts need to be applied to make the stock of one

company comparable to a publicly traded company's stock. But, be cautious when using comparisons of publicly traded companies and closely held businesses because there are great differences between the two. Discounts would be applied for key persons, minority interest and/or lack of marketability.

8) **Value of Prior Sales of the Business Equity of Stock of Corporation**. In considering actual stock sales for valuation purposes, it must be determined that the ownership interest was traded in an arm's length transaction. When trading ownership between family members, this assumption is invalid and of no use to determining a value.

9) **Purpose of Determining a Company's Worth**. There are different reasons for valuating a business; therefore, the valuation process will be different. Various reasons include the following:

- **Valuation for Tax Purposes**
  Taxes may be levied on fair market value of the business's stock or subjected to inheritance or estate taxes if passed on to an heir or estate. If the stock is a gift, the value will be subject to gift taxes. Property taxes are levied as a percent of the property value so it is essential to have an accurate assessment of the business.
- **Valuation for Ownership Transfer**
  Appraisals can be useful in buy-sell agreements to help minimize problems when an owner wants to sell out. Appraisers are important in acquisition and divestiture plans. They can estimate a value or range of values, act as a consultant, and identify valuation parameters and certain tax-related issues. They will also allocate the purchase price among the assets acquired.
- **Other Valuation Issues**
  An appraisal may be necessary for financing or insurance purposes. If a firm wants to use its assets or collateral for a business loan, the lender may require that the assets be appraised. Also, appraisers will make insurable-value studies to establish or verify that the insurance adequately covers the assets.

Business Valuation Methods

There are numerous business valuation methods. Choose a method or methods based on your particular valuation need. These methods have been categorized into four major groups.

***Market-based Methods*:**

These methods use data from comparable business sales, and involve using "rules of thumb." Actual data from sales of comparable closely held businesses may be difficult to obtain. Also, "rules of thumb" are in some cases valid and in other instances invalid. For small, closely held businesses, market-based valuation methods are not used frequently because of the difficulties with their application.

***Income-based Methods*:**

Income-based methods determine probable future income of the business and capitalize this income stream to determine the business's value. The adjusted or normalized income stream, which is the probable future income stream, can be determined by adjusting each revenue and expense item on the income statement (to its probable future value over the near term.) Capitalizing the income stream means determining an appropriate discount rate to apply to the income stream to arrive at its present value. The present value of the income stream in a profitable business is what gives the business its highest and best value. In a profitable, closely held business, income-based methods are usually the best to use.

***Asset-based Methods**:*

These methods include adjusting each asset and liability on the balance sheet to fair market value, then the values are summed. This approach ignores the earnings of a business and should receive minimal attention when valuing on-going closely held businesses which generate earnings by selling products or rendering services. Asset-based methods are appropriate for businesses such as bank holding companies whose principal function is to manage income-producing assets.

***Hybrid Methods*:**

Hybrid methods normally consider both income-based and asset-based valuation techniques. The most popular hybrid valuation method is the excess earnings method. Under this method, a business's excess earnings, or earnings over the norm, are determined. These excess earnings are then capitalized to determine the goodwill present in the business. The goodwill value is added to the fair market value of the net tangible assets in the business to determine an overall business value.

Actions to Consider

There are other possible actions and ideas to consider when purchasing a business. According to the article, "I Want to Sell my Business, Where Do I Begin", you should consider the following:

- Ask a lawyer, accountant or banker for the names of people who are in the merger and acquisition business such as appraiser and brokers. Get references!
- Ask an accountant for a tax analysis of various selling scenarios.
- Most importantly, recognize that the sale may take up to 12 or 18 months. If you rush, mistakes will occur! (Reinardy and Stover p. 28)
- Why is the business being sold?
- Do you have a description in writing of exactly what is being sold?
- Do you have the skills and experience to manage this type of business?
- Is there a market demand for this product or service? Who are the main competitors?
- What is the current financial condition of the business?

- Is the purchase for assets only, or are you assuming the liabilities of the existing company? Do you have a current credit report?

Following is a checklist of documents and information that professionals advise asking for in valuing a business.

Financial Statements

____ Balance sheets, income statements, statements of changes in financial position, and statements of stockholders' equity or partners' capital accounts for up to the last five fiscal years, if available.

____ Income tax returns for the same years.

____ Latest interim statements if valuation date is 90 days or more beyond end of last fiscal year and interim statement for the comparable period the year before.

____ List of subsidiaries and/or financial interests in other companies, with relevant financial statements.

Other Financial Data

____ Equipment list and depreciation schedule.

____ Aged accounts receivable list.

____ Aged accounts payable list.

____ List of prepaid expenses.

____ Inventory list, with any necessary information on inventory accounting policies (including work in progress, if applicable).

____ Lease or leases (if lease does not exist or is not transferable, determine what new lease or rental terms will be).

____ Any other existing contracts (employment agreements, covenants not to compete, supplier and franchise agreements, customer agreements, royalty agreements, equipment lease or rental contracts, loan agreements, labor contracts, employee benefit plans, etc.

____ List of stockholders or partners, with number of shares owned by each or percentage of each partner's interest in earnings and capital.

____ Compensation schedule for owners, including all benefits and personal expenses.

____ Schedule of insurance in force (key-man life, property and casualty, liability).

____ Budgets or projections, if available.

Company Documents

____ If a corporation, articles of incorporation, by-laws, any amendments to either, and corporate minutes.

____ If a partnership, articles of partnership, with any amendments.

____ Any existing buy/sell agreements, options to purchase stock or partnership interest, or rights of first refusal.

Other Information

____ Brief history, including how long in business and details of any changes in ownership and/or bona-fide offers received.

____ Brief description of business, including position relative to competition and any factors that make the business unique.

____ Marketing literature (catalogs, brochures, advertisements, etc.)

____ List of locations where company operates with size, and whether owned or leased.

____ List of states in which licensed to do business.

____ If customer or supplier base concentrated, list of major accounts, with annual dollar volume for each.

____ List of competitors, with location, relative size, any other relevant factors.

____ Resumes of, or list of, key personnel, with age, position, compensation, length of service, education and prior experience.

____ Trade associations to which company belongs or would be eligible for membership.

____ Relevant trade or government publications.

____ Any existing indicators of asset values, including latest property tax assessments and any appraisals that have been done.

____ List of patents, copyrights, trademarks, and other intangible assets.

____ Any contingent or off-balance-sheet assets or liabilities (pending lawsuits, compliance requirements, warranty or other product liability, etc.)

____ Any filings or correspondence with regulatory agencies.

____ Information on prior transactions.

Source: Willamette Management Associates, Inc. Reprinted from ***Valuing Small Businesses and Professional Practices.***

Any opinions, findings and conclusions or recommendations expressed in this publication are those of the author(s) and do not necessarily reflect the views of the U. S. SMALL BUSINESS ADMINISTRATION.

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