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The Methods Behind a Valuation, Part I

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Introduction

Along with deciding to engage in business succession planning and finding a successor, it is necessary to value a business. A valuation is necessary whether the business is to be transferred to an heir or third party or for retirement purposes. If the business is transferred to an heir, it is critical that the fair market value of the business be established in a well-supported form. If the business is to be sold to a third party, a valuation will ensure maximum value will be achieved.

A business valuation is a report written by a qualified appraiser for purposes including business succession, estate and tax planning, litigation, buy-sell situations and many other purposes. Given that purposes behind business valuations differ, methodologies also differ. Some methods are imposed by the Internal Revenue Code, others by common law, some by contractual agreement, and others by industry. The following is a brief discussion of different valuation methodologies that are used by appraisers.

Comparables Price

The comparable price method operates under the assumption that there are other companies comparable to the business being valued that are either publicly-held or privately-held that recently sold. The IRS suggests that when using this method, at least three comparable companies must be used. Once the comparables have been found, the net income, cash flow, EBITDA, and the price/earnings ratio is used to compute a benchmark value. The individual company values can then be weighted and an industry benchmark can then be established. Many appraisers use this method to verify their own work using some of the following methods.

Capitalization of Earnings

The consensus among appraisers is that the capitalization of earning power is "the most important single factor in the valuation of most operating companies, such as manufacturers, merchandisers,

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A CASE STUDY

Guaranteed Payments

The Tax Court ruled that guaranteed payments were subject to self-employment tax in a case where the two partners in a Limited Liability Company were husband and wife. In this case taxpayers were husband and wife. The wife owned a 60% in the partnership and made some management decisions and allowed the use of her credit to secure loans. Her management decisions included signing documents. The partnership made 300,000 and $380,000 in 2000 and 2001 restively.

Ordinary income was reported at 12,000 and 18,000 respectively and guaranteed payments of $165,000 and $259,000 respectively as well.

The IRS's position was that the taxpayer wife was not a passive member of the partnership as she was allowing her credit to be used and was making management decisions. The taxpayer's position was that the wife was a passive member of the organization. The Court ruled for the IRS because of exactly the facts as professed. She was making management level decisions.

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Cover Story

and companies providing various services." At the end of the life of a company, the total worth of that company can be found in the ability it had to generate earnings. This method uses historical data to project future earnings. The method goes back up to a maximum of five years and projects the earnings potential for up to five years in the future, using a growth rate, present value calculation, and expected earnings figures.

Adjusted Book Value (Net Tangible Assets)

This method, also referred to as the underlying asset value method, is especially useful in valuing holding companies versus operating companies. Investment houses and real estate companies are examples of holding companies. This method is also useful for liquidation purposes because it provides the "adjusted" asset value which relates to the fair market value of assets. It is also useful in valuing capital intensive businesses that rely on their asset base to perform work and generate income and create goodwill. An excellent example of this is a construction company. The company's machinery is vital to their operations. This idea can be contrasted with a law practice whose income generating ability does not rest on physical assets of the firm but, rather, on personal ability.

The key to this method is to determine the fair market value of all useful assets versus the value as stated on the books of the company.

Conclusion

Next month will be part II of this article, and it will cover three more methods!

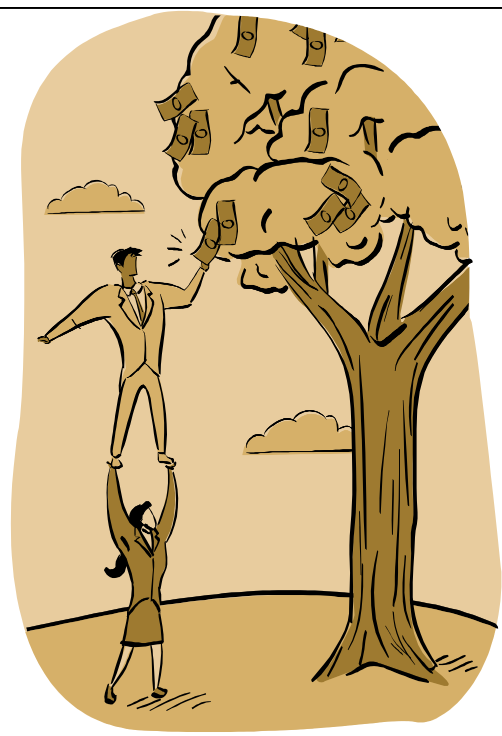
Several methods of valuing a closely-held company have been presented in this article. Each method has its advantages and disadvantages. Furthermore, no single method provides the absolute value of a company. The courts, as well as the IRS, have determined that more than one method must be used to value a closely-held corporation. The appraiser must determine which method will receive the greatest weight based upon the relative importance of each method to the overall success of the company. The type of company, the purchaser, and the reason the company is being valued are important factors when determining the weights assigned to the various methods presented in this situation.

For more information and/or to determine a value for your company, contact the professionals at The Center for Financial, Legal & Tax Planning, Inc.

Dr. Bart A. Basi is an attorney, CPA, and the Senior Advisor of The Center for Financial, Legal & Tax Planning, Inc, a full service company specializing in financial, legal & tax matters. Basi is a nationally recognized author, lecturer, and advisor on how to structure deals to minimize taxes. Tax structure makes the difference between getting the deal done and watching the deal fall apart. Many of you may be familiar with Basi and the topics he covers in the Financial, Legal & Tax Advisory which may be read in various industry-specific trade publications.

Points of Interest

- **If the business is transferred to an heir, it is critical that the fair market value of the business be established in a well-supported form.**
- **The consensus among appraisers is that the capitalization of earning power is "the most important single factor in the valuation of most operating companies**
- **Each method has its advantages and disadvantages. Furthermore, no single method provides the absolute value of a company.**



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A CASE STUDY CONTINUED:

Editor's Comment: This case is important because it shows how abusing mechanisms to limit self-employment tax can backfire if used under the wrong circumstances: I.e. giving guaranteed payments when the shareholder is clearly an active member of the organization.

The applicable law states that guaranteed payments to a passive, limited partner are not self-employment tax, but are ordinary income subject to self-employment tax. We recommend that in this situation, taxpayers should analyze whether the ownership / employment arrangement are legitimate enough and whether further action should be taken to protect the interest of the partnership and the taxpayer.

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Are You Prepared When An Acquirer Comes Calling

You may be eager to sell your business, and happy to have an acquirer at your doorstep, but are you prepared for what happens when an acquirer starts looking "under the hood" of your business?

Most professional acquirers will have a checklist of questions – both objective and subjective – that they need answered before getting serious about buying your company.

Examples of objective questions include:

- When does your lease expire and what are the terms?
- Do you have consistent, signed, up-to-date contracts with your customers and employees?
- Are your ideas, products and processes protected by patent or trademark?
- What kind of technology do you use, and are your software licenses up to date?
- What are the loan covenants on your credit agreements?
- How are your receivables? Do you have any late payers or deadbeat customers?
- Does your business require a license to operate, and if so, is your paperwork in order?
- Do you have any litigation pending?

Then they'll try to get a subjective sense of your business, including figuring out just how integral you are personally to the success of your business. And that requires some investigative work as well as some expert probing. For example:

1. Mystery shopping

   Acquirers often conduct their first bit of research before you even know they are interested in buying your business. They may pose as a customer, visit your website, or come into your company to understand what it feels like to be one of your customers. Make sure the experience your company offers a stranger is tight and consistent, and try to avoid being personally involved in finding or serving brand new customers. If a potential acquirer sees you as the key to wooing new customers, they'll be concerned that business will dry up when you leave.

2. Checking to see if your business is "vision impaired"

   An acquirer may ask you to explain your vision for the business, which is a question you should be well prepared to answer. However, he or she may ask the same question of your employees and key managers. If your staff members offer inconsistent answers, the acquirer may take it as a sign that the future of the business is in your head.

3. Asking your customers why they do business with you

   A potential acquirer may ask to talk to some of your customers. He or she will expect you to select your most passionate and loyal customers and will therefore expect to hear good things. The customers may be asked a question like 'Why do you do business with these guys?' The acquirer is trying to figure out where your customers' loyalties lie. If your customers answer by describing the benefits of your product, service or company in general, that's good. If they respond by explaining how much they like you personally, that's bad.

You may not be expecting an acquirer any time soon, but it's never too early to ask yourself – and prepare for – the questions an acquirer would be asking you – and your employees and your customers.

If you know of a business owner who's thinking of selling or buying a business and who might benefit from a free, confidential, consultation with us, have them contact me directly.

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Frequently Asked Questions…

Q: My father just passed away. Will I have to pay estate taxes on the value of the estate?

A: Generally, the heir does not pay the estate tax. If there is an estate tax due, the estate is responsible for the estate taxes due on the gross value of the estate. This year, the estate tax exemption is $5,340,000.

Q: How do I deduct expenses from an estate to arrive at the true value of the estate?

4:   The estate can deduct estate expenses from the estate itself using form 706 or it can use form 1041 to deduct expenses from the income of the estate.

Q: Can a business be passed from one generation to the next by the use of a simple will?

A: It is a really bad idea to approach business succession in this manner. If a business is passé down through a will, it could be subject to probate, a process that takes 6 months or longer. Also, details emerge in the transition process which are best dealt with during the life of the owner.