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The Importance of Knowing What Your Business is Worth

There's one question many business owners should ask themselves: "What is the true value of my business?" It's an important question because, whether you realize it or not, the value your business will have a big impact on both personal and professional aspects of your life. So, Knowing the answer is vitally important.

Your business may be you most valuable asset, so it is important that you develop a proper understanding of its value. When you know what your business is worth, you have a more realistic perspective from which to plan for the future direction of the business, as well as the future income needs of you and your family. Once you know the value, you can put in place more effective plans and strategies for future growth, business continuation, succession planning, and retirement planning.

Do You Really Know What Your Business Is Worth?

According to the 2015 MassMutual Business Owner Perspective Study, just over half of business owners say they have had their businesses valued in the last three years.

However, our research leads us to believe that many business owners, even the ones who say they've had their businesses valued, don't know what their businesses are truly worth. That's because one out of every three business owners say they valued their business themselves.[1] And, when business owners value their businesses themselves, they tend to over or under value it by as much as 59%![2]

A proper business valuation is not a "rule of thumb" or a figure agreed to with a handshake; it's thoughtfully crafted by a credentialed appraiser after thorough research and is documented in writing. Be sure that any firm or individual you hire to value your business has the proper credentials, such as: Certified Valuation Analyst (CVA), Accredited Senior Appraiser (ASA), or Accredited in Business Valuation (ABV).

\What are Different Ways to Value a Business?

There are different ways to value a business, and the purpose of the valuation will dictate the method that is most appropriate. Here are a few of the more common methods:

- ***Book Value*** equals the value of a business's total assets minus its intangible assets (such as goodwill) minus liabilities. Credentialed valuation firms can include intangible assets, such as goodwill, in the valuation to provide a business owner with a truer sense of the total value.
- ***Capitalized Earnings Value*** takes into account future cash flows and earnings growth in determining the total value of a company.
- ***Fair Market Value*** is the value based on what a knowledgeable, willing and unpressured buyer would pay to a knowledgeable, willing and unpressured seller in the market.
- ***Liquidation Value*** is what one may expect to receive for the business if the assets must be sold quickly to satisfy debts and creditors. This figure is derived by applying a discount to the value of outstanding accounts receivables, inventory, and depreciable assets.

When Do You Need to Know What Your Business Is Worth?

According to the 2015 MassMutual Business Owner Perspective Study, the top three reasons why business owners want to know what their businesses are worth are to:

- *Have another measure of business health/ success*
- *Know if the business has value in the marketplace*
- *Prepare the business for sale.*[1] All business owners have a desire to know if their business model is working and what better way to gauge that than to look at the changes in value over time. However, business owners may not understand all of the roles a business valuation can play in effective business planning.

There are other critical times in the lifecycle of a business when it may be appropriate to have an accurate business valuation. The following are important business valuation milestones:

Funding a buy-sell agreement – If you are obligated to buy out your business partner, or his/her spouse, through a buy-sell agreement, you need to agree on a value that everyone (both the buyers and the sellers) is comfortable with ahead of time and have it documented in writing in the agreement.

1 2015 MassMutual Business Owner Perspectives Study, conducted by HawkPartners for MassMutual.
2 SPARDATA, survey of business owner clients, conducted 2010.

Evaluating retirement income needs – Your business is most likely your largest asset and a key component of your retirement plan. A valuation can help you reconcile your future retirement income needs with the currents value of your business to help identify any shortfall.

Estimating any potential estate tax obligations – The Federal Estate Tax exemption has helped to make estate taxes less of an issue. But for some, planning for a potential tax burden and the impact it could have on the next generation is critical for the long-term success of the business.

The Roles Business Valuation Can Play in Planning

Business Continuation Planning
Knowing the value of your business is an important first step toward building a sound business continuation plan to keep the business viable, and your loved ones protected, following the unexpected loss of an owner. It helps you and your business partners adequately fund a buy-sell agreement equal to the current value of the business, and it allows you to develop a personal protection plan to help replace lost value to the family following the death or disability of the owner.

Consider how your business, and its value, would be impacted if you were no longer around to run it. Would it stay profitable? Would key employees leave? Would clients leave? Unfortunately, the loss of an owner can lead to the end of the business. And if you or your family is forced to sell off the business in pieces, you could receive pennies on the dollar for the business you work so hard to build.

Most business owners say they want to either transition their businesses to a family member or sell it to an outside buyer or key employee when they are ready, or forced, to step away. Very few say that liquidating the business is their desired exit strategy.[1]

However, even though liquidation may not be in your transition plans, it still needs to be considered in case it is the eventual outcome. It's not uncommon for businesses to go into a "forced" liquidation following an owner's unexpected death or disability and there is no one in the business or family to successfully take the reins. Knowing the liquidation value of the business can provide insight into how much value your business partners or loved ones may need to replace should the unexpected occur.

Retirement Planning

There are many sound business reasons for knowing what your business is worth, but there are also personal ones. If your business is a key component of your retirement income strategy, then having an accurate picture of its value is critical. You've no doubt worked hard to build your business and one day you'll look to enjoy the fruits of your labor in retirement. But what if the value of your business is less than what you think it is?

According to the MassMutual Business Owner Perspective Study, many business owners haven't given the idea of when they plan on retiring much thought. However, what they did tell us is how they plan on funding that retirement when they time comes. Roughly 40% of business owners have no retirement assets outside of the businesses. These business owners will be heavily reliant on their businesses in some capacity to fund their retirements – either using proceeds from the sale of the business or continuing to receive income from the business post-retirement.

When estimating your retirement income needs as a business owner, you need to consider all benefits the business is funding – health insurance, life and disability insurance, entertainment and meals, etc. – not just your salary. This total amount equals the income replacement value of the business. If your goal is to maintain your current style of living after exiting the business, knowing the true value of the business will help you understand if there is a discrepancy between the income replacement value and the family's retirement income needs. The sooner you know that amount, the faster you can take steps to create other sources of retirement income outside of your business if you need to.

Estate Planning

The Federal Estate Tax exemption has helped make estate taxes less of an issue for many business owners. However, if you underestimate the value of your business, other serious issues can arise. If something unexpected happens to you – or your business partner – would you or your family be prepared to address any potential tax liabilities created by your business?

When the owner of a business dies, the family or estate may have to pay taxes based on the value of the business being passed down. And if there isn't already a certified business valuation, there may be a greater likelihood the IRS will determine the value itself.

By knowing the value of the business ahead of time, you may be able to put a plan in place that will provide the estate with enough funds, usually through life insurance, to eliminate the need to liquidate business assets to fund that potential tax burden.

Eliminating the "Value Gap"

At some point in time, everyone exits their business – either by design or by default. So when you exit your business either at death, disability, or retirement, think about what value will be used:

⇒ what you think it's worth

⇒ what the family needs it to be worth to maintain their standard of living

⇒ the forced liquidation value.

The common discrepancy between these numbers can create a "Value Gap" – the gap between what you and your loved ones need the business to be worth and what it is actually worth based on the manner in which you exit the business.

The good news is proper planning can help reduce potential value gaps created by an owner's over- or under- estimation of the business's value. For example, having assets outside the business, such as qualified retirement plans and other investments, can help reduce the value gap between what you think the business is worth and the income replacement value. In addition, insurance products, such as life insurance and disability income insurance, can help address the value gap created if a business goes into forced liquidation following the death or disability of an owner.

By knowing what your business is work, you can help protect the business you've dedicated your life to building, and help ensure that you and your loved ones receive the full value for a lifetime's worth of hard work sacrifice and sweat equity.

A Courageous Decision is a Good Decision

Choosing the path of business ownership is truly an honorable and courageous endeavor. A successful business begins with planning for and building a strong financial foundation. Business planning is not something that's done overnight, but having an understanding of the true value of your business is a smart first step toward helping set your business on the road to a more financially secure future.

At MassMutual, we recognize the challenges you face and are equipped to help you prepare for the future with more confidence. Our goal is to help you prepare for the future with more confidence. Our goal is to help you stay focused on the task at hand – running your business – while working in concert with your trusted advisors to help you create a financial road map for the long term success of your business.

Put our qualities of strength, experience and stability to work for your business. To learn more about how we can help you protect what you've worked so hard to build, please give me a call to set up an time to talk.

Provided by Bruce Wernick, a financial representative with Metro New York, a MassMutual Agency; courtesy of Massachusetts Mutual Life Insurance Company (MassMutual)

1 2015 MassMutual Business Owner Perspectives Study, conducted by HawkPartners for MassMutual.

2 SPARDATA, survey of business owner clients, conducted 2010.

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