A STRATEGY SPOTLIGHT

Approaches to Business Valuation

Business owners may wonder why it is important to know the fair market value of their business. Simply put, personal estate planning and business planning are intertwined to the point where estate planning cannot be correctly done without knowing the value of the largest potential asset of the business owner. The fair market value (FMV) is defined as "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 relevant facts."

This definition clearly establishes the finish line. However, choosing the right roads to get there and traversing them safely can present major challenges, especially since the process is a combination of art and science.

KEY POINTS

1 | Factors affecting a business valuation

2 | Various techniques can be used to value a business

3 | Why the final value is a combination of art and science

Business valuations may also contain a subjective element. There are many reasons for a buy-sell arrangement — minimizing estate taxes is merely one. Selling the business for maximum profit to a competitor is another. The two would result in a marked difference in value. The former would be lower, the latter higher. Thus, two or more people or entities may want to establish different but reasonable value consistent with meeting their own objectives. And remember, the Internal Revenue Service (IRS) has a stake in the valuation.

For example, an owner may seek a lower, but reasonable value to reduce estate taxes otherwise payable at death. The IRS may well seek the opposite. While courts may sometimes "split the difference", other times the court will either adopt one side's value or a value close to it. Fair market value can obviously vary based upon the eye (and intent) of the beholder.

Different Types of Business Valuation

Based on the type of business being valued, the purpose of the valuation, and the ownership share, all techniques are applicable. One or two valuation methods may be far more indicative of value than the others. For example, a services business may rely very heavily on the "goodwill" built over the years to establish its true value. The retail business may rely more heavily on the value of its assets in excess of liabilities.

Six common valuation methods are generally explored when a business is professionally valued:

1 | **Book Value** — Book value can be defined as the depreciated value of what you own less what you owe. In business terms, these are your business assets less your business liabilities. Book value is derived from information found on a business balance sheet and is applicable only for that point in time. Regardless, it is still a crucial valuation tool. The portion of assets in excess of debts is referred to as business equity.

In establishing book value, some balance sheet items may need to be adjusted to more accurately reflect their true value. For example, depreciation may cause unrealistic asset value totals. Sometimes depreciation tracks closely with the declining value of an asset. Other times, it is way off the mark. In the latter situation, a change should be made.

2 | **Liquidation Value** — The full book value of the business may not be realized if the assets have to be sold quickly to satisfy debts and creditors. To develop this figure, you would generally adjust the value of the accounts receivables, inventory, and depreciable assets by applying a discount based on the amount that is expected to be realized.

3 | **Value as a Source of Income to the Family** — This technique attempts to value the business as a stream of income and is based on the amount of cash taken out of the business annually. It would include salary, pension contributions and other company-paid benefits.

4 | **Book Value Plus Goodwill** — Business earnings come from the returns on tangible and intangible assets. An interest rate is assigned to the net tangible assets to determine the earnings attributable to them. The remaining earnings are then attributed to the intangible assets and this amount constitutes business goodwill.

A company's good name and its attractiveness to existing and potential customers are examples of intangible goodwill assets. When a business factors in goodwill to its total value, the amount is multiplied by the number of years it is expected to continue after the business changes hands. The book value is then added to this total to arrive at the fair market value estimate using this method.

5 | **Book Value Plus Capitalization of Excess Earnings** — This method starts out similar to the previous valuation approach, but the annual earnings from goodwill are instead characterized as excess earnings. Part of this includes owners' salaries in excess of salaries that would be paid to employees hired to replace them. The excess earnings are subsequently assigned an overall value when they are divided by a capitalization rate, which somewhat serves as a risk–reward factor. It is largely based on the rate of return an investor would expect to receive on the intangible assets of the business for the investment to be worth the risk of buying. The more risky or unstable the business, the higher the capitalization rate applied. This results in a lower overall valuation total. The book value is then added to this total to establish the estimated fair market value using this approach.

6 | **Straight Capitalization of Earnings** — With this method, a capitalization rate is applied to the total adjusted earnings to estimate the FMV of the business. There is no distinction between earnings attributable to tangible or intangible assets. As above, the capitalization rate is based on the expected rate of return on earnings and business risk. A number of industries have developed their own suggested capitalization rate ranges to help make more reliable valuation estimates possible.

The Bottom Line

Determining the value of a business is part art and part science. The buyer and seller are approaching the transaction from different perspectives and may use different methods to determine the value. It is important to realize that even though the parties may agree to a value at a point in time, the value may fluctuate because of business or economic circumstances. Constantly updating the value (once every three years for example) may help to eliminate needless stress and litigation at the time of sale. As well, it is important to work with your tax advisor and legal advisor when looking to implement any strategies previously discussed.

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