Valuing A Business

John M. Mathias
John E. Barrett, Jr.
Gregory A. Porcaro
Steven C. Spirito

1) What is a business valuation?

In his book, Valuing Your Privately Held Business, Irving Blackman states that "a valuation is a determination of the value of the business on a certain date for a specific purpose." While this definition appears to state the obvious, it does introduce two variables, date and purpose, which may have a significant affect on determining the worth of a closely-held business for which there is no established market.

2) What are the reasons for doing business valuations?

Some of the situations that require business valuations are:

- Buy/Sell Agreements
- Charitable Contributions
- Estate and Gift taxes
- Dissenting Shareholder Actions
- Divorce
- Liquidation and Reorganization
- Mergers and Acquisitions
- Sale of a Business

3) What are the essential elements of a valuation engagement and should they be addressed in an engagement letter?

The following are the essential elements of a valuation engagement and should be addressed in an engagement letter:

- The identity of the client
- The identity of the valuator
- Identification of the entity and /or the interest in the entity to be valued
- Effective date of the valuation
- Date the valuation was performed
- Purpose of valuation
- Standard and premise of valuation
- Type of expected work product
- Schedule for performance of work
- Fee arrangement
- Contingent and limiting conditions

4) What factors must be considered in valuing a closely held business?

Revenue Ruling 59-60, which was originally issued in the context of valuing a closely held business for estate and gift tax purposes, has evolved into the conceptual foundation for valuing a closely held business for all purposes. The Ruling cites eight factors that should be considered in a valuation of a business:

- The nature and history of the business
- The economic outlook in general and the industry condition and outlook in particular
- The book value of the stock and the financial condition of the business
- The company's earning capacity
- The dividend paying capacity
- The enterprise's goodwill or intangible value
- Sales of the stock and the size of the block of stock to be valued
- The market price of the stock of corporations in the same or similar businesses which are traded in a free and open exchange

5) What are the different standards and premises of value that may be used in valuing businesses?

Fair market value is the most widely recognized and accepted standard of value. This standard uses the "willing buyer, willing seller" concept introduced by Revenue Ruling *59-60*.

The term, *fair value,* is usually a statutory standard of value used in dissenting shareholder situations. As a statutory standard of value, this term gets its meaning from state law applicable to the legal action.

Investment value, according to Shannon Pratt, is the "specific value of an investment to a particular investor." *Investment value* tends to be higher

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than *Fair market value* because this standard incorporates synergistic value inherent in related companies.

6) What are the traditional methods and approaches employed to value businesses?

The traditional methodologies used in business valuations are categorized into three broad approaches:
- Income
- Asset
- Market

Under the income approach the ongoing earning power of the business is the prime determinant of the business's value. The valuator may choose different earnings streams to determine value. Those earnings streams may include either after or pre tax income, EBIT or EBITDA. To determine the ongoing earnings of the subject business, the valuator may use either historical information "normalized" for nonrecurring, extraordinary items or reliable projected financial information. Earnings derived from historical information is divided by a capitalization rate, while earnings based on projected information is divided by a discount rate. There are established methodologies for developing capitalization and discount rates such as the "build-up" or CAPM methods. Due to space limitations, this article will not explain those methods.

The essence of the asset-based approach is that a business is worth the value of its assets less its liabilities. This approach is appropriate for non-operating, asset intensive companies such as real estate holding companies. This method revalues all assets and liabilities to fair market value, identifies and values all off-balance sheet tangible and intangible assets and liabilities, and records those off balance sheet assets and liabilities on the balance sheet. As a result the net book value represents the fair market value of the entity's equity.

The "hybrid" or "Treasury" method of Revenue Ruling 68-609 is both an asset-based and income approach. This method capitalizes earnings that exceed the expected earnings resulting from a fair rate of return on the entity's tangible assets. Capitalizing the excess earnings quantifies the entity's intangible value. That intangible value is then added to the adjusted fair value of the entity's net tangible assets to determine the total fair market value of the entity's equity.

The Market approach uses sales transactions of companies similar to the subject company as parameters in valuing the subject company. Finding transactions of companies comparable to privately owned companies is extremely difficult. As a result, relying solely on market information is generally unwise.

7) What are discounts?

According to Shannon Pratt, "the sum of the parts does not necessarily equal the whole" in a business valuation. This theory is certainly applicable when valuing a minority ownership interest. Since a minority ownership interest generally has no ability to direct or influence the operations of a business, it is worth less than its pro-rata share of the entity's value. The valuator, therefore, must reduce the pro-rata value by a factor called a discount. This discount is called a *minority interest* discount.

Another frequently used discount is a *marketability discount.* This discount refers to the ease with which the ownership can be converted to cash. Since there is not an established market for interests in privately held companies, a reduction in value of the ownership interest is warranted due to the illiquidity of the ownership interest.

The *minority* and *marketability* discounts, which are the most common, are applied one after the other and are multiplicative and not additive.

8) What is a control premium?

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As empirical studies have indicated, buyers are willing to pay an amount in excess of market value to acquire a controlling interest in an entity. This excess paid over market value is called a *control premium.* A valuator must make a careful analysis of the subject company before applying a *control premium.*

9) What should a valuation report discuss?

A valuation report should include:

- Identification of the entity being valued
- Effective date of the valuation and date of issuance
- Purpose of the valuation
- The standard and premise of value
- Description of the equity interest being valued
- History and background of the entity
- Economic and industry outlook
- Financial review
- Valuation methods considered but rejected
- Valuation method used
- Conclusion of value
- Limiting conditions
- Signature of valuation analyst
- Supporting calculations and financial information

10) What type of training and certification does a business valuator need?

In recent years the *art* of business valuation has become very sophisticated and evolved into a professional discipline. While it is important to have an educational background in either accounting or finance, it is vital to have specific training in the field of business valuation. Such training is available through the following professional organizations;

- American Institute of Certified Public Accountants
- American Society of Appraisers
- Institute of Business Appraisers
- National Association of Certified Valuation Analysts

Upon the completion of educational and testing requirements, these organizations will confer a professional valuation designation. Since many valuation reports and their authors find their way into a courtroom, a professional designation may be a necessity for recognition by the court as an expert. ◆

Elder Care Forum
A Systematic Approach to Developing an Elder Care Practice
On
Wednesday, May 12, 1999

Marriott Hotel

7:45 am
(Continental Breakfast)

1) Elder Care Services:
What does the client need?
8:00 am – 10:00 am
Corinne Calise Russo, MSW
– Case Management of RI, Inc.
Jill Bazar – Whytebrook Terrace
Maribeth Hayes, RN – Cherry Hill Manor

2) Medicare, Medicaid and Social Security Issues
10:15 – 12:00 noon
Renee Evangelista, Partner
– Edwards & Angell

3) Long Term Care Insurance
1:15 pm– 3:00 pm
Thomas Alfano, VP
– Travelers Long-Term Care

4) Elder Care Law:
What are the Legal and Tax Issues?
3:15 pm – 5:00 pm
Leon C. Boghossian, III, Esq.
– Hinckley Allen & Snyder
Anthony Mignanelli, Esq.
- Mignanelli & Associates

To register, contact the RISCPA office at 331-5720.