Advanced **Markets**

Because you asked

Business valuation

Business valuation is a process that helps determine the value of a business. A good business valuation may reduce future disagreements about the value of the company and is usually necessary when the parties enter into a buy-sell arrangement. A business valuation may produce a value that can be relied upon for federal estate tax purposes, as well as to determine an appropriate amount of life insurance needed to fund the buy-sell arrangement.

Types of business valuations

- Fixed price method
- Book value method
- Discounted earnings method
- Capitalization of earnings method
- Appraisal method
- Cutthroat method
- Book value and capitalization of earnings method

When is business valuation needed?

There are several instances when business valuation is important. Proactive planning can help to avoid future disagreements, confusion, and possible litigation expenses of a valuation dispute. Business valuation may be necessary in the following situations:

- Sale of a business interest
- Death of a key owner
- Retirement or disability of an owner
- Estate planning and current gifting of shares of an interest in a business
- Divorce of an owner
- Bankruptcy or insolvency of an owner

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Types of business valuation

Fixed price

The shareholders periodically fix the price by agreement. This method is the simplest. However, since the price may not be adjusted for changes in value, the purchase price may prove to be unfair to the selling shareholder. It also may not be controlling for estate tax purposes.

Book value

This method uses the book value of the business as recorded on the company books and financial statements. It will usually produce the most reliable result when book value is determined by an independent audit. The book value valuation method takes the net assets and subtracts the net liabilities to determine the value of the business (assets – liabilities = book value). This method can also use a multiple of book value, since historical records may not reflect the actual value of the business. One main advantage of using this valuation method is that parties typically cannot dispute the valuations (an audited value of the balance sheets contains the amount of assets and liabilities at any given time). The main disadvantage of this method is that it may not reflect the true market value of the business.[1]

Discounted earnings

One of the most common valuation methodologies, this method identifies future cash flows to be generated by the asset or company being valued and discounts those earnings to present value. The discount rate used reflects the total expected return that a buyer would demand on the purchase price of an ownership interest in the company, given the risk of that interest. The discounted earnings method is generally used when future returns are expected to be substantially different from current operations.

Capitalization of earnings

This approach multiplies historical earnings by a capitalization factor. This factor is usually determined by:

(1) taking the same discount rate used in the discounted earnings method, but subtracting the company's expected long-term growth rate, or;

(2) analyzing the price-to-earnings ratios of comparable businesses in the same industry for a specific period of time.

This method is most appropriate when a company's current operations are indicative of its future operations. The time frame to consider earnings is usually between five and ten years. One disadvantage to this method is that comparable business considerations in the same industry may not be appropriate.

Appraisal

An outside third party appraises the value of the business, typically, the outside appraiser will issue a report which discusses the various valuation options available. A primary advantage of an appraisal is that a history and trend of the industry can be obtained from a survey group of accountants, economists, and investment professionals. One disadvantage is that the appraisal report is just one opinion, and it is unlikely that two experts will agree on the same value.

Cutthroat

This valuation method is used at the time of sale. A shareholder that is selling their interest in the business will offer shares to the other shareholders at a price determined by the seller. If the other shareholders do not purchase the shares at this price, then the seller must buy the shares of the other shareholders at that price. In theory, this method sets a fair price; however, it favors the shareholder with the deepest pockets. This typically works best for the lifetime sale of businesses with two equal or almost equal owners.

Book value and capitalization of earnings

This is a combination of the book value and capitalization of earnings methods. It potentially gives equal weight to each method to arrive at a value of the business. One advantage of this method is that it gives the owners more flexibility to derive a purchase price. One disadvantage is that it requires additional consideration and agreement by all parties involved.

Conclusion

The process of determining the value of a business can be as complicated, or as simple, as the owners want it to be. It all depends on what type of method works best in any given situation.

1. Generally accepted accounting principles (GAAP) require the use of historical figures. A detailed discussion of GAAP is out of the scope of this piece. Please consult your accountant for more information.

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