# Seven Points To Know
## About Business Appraisals




Magellan Advisors, Inc.

**Business Transition Specialists**

If you're the owner of a small business, someday you may need an independent valuation appraisal of the entity. Reasons for apraisal include divestiture, strategic planning, estate taxes, gift taxes and divorce settlement, to name a few.

Business appraisal can be an intimidating task for most entrepreneurs who have never had exposure to this niche endeavor. Unlike a publicly traded company that has a published market-driven share price, the value of a privately owned company must be calculated using both qualitative and quantitative analysis. The appraisal process is subjective, time consuming and requires highly specialized professional skills.

The generally recognized basis for valuing a closely-held business is set forth in IRS Revenue Ruling 59-60, issued specifically to establish valuation guidelines for federal estate and gift tax returns. Although this ruling discusses the fundamental factors to be considered in the valuation process, it provides no instructions on how to assemble the puzzle.

The specific factors identified for consideration are: the nature and history of the business; the economic outlook and the condition of the industry; the financial condition of the business; the earnings and dividend-paying capacity of the business; the existence of goodwill and other intangible assets; the sales of stock and the size of the block of stock to be valued; and the market stock price of similar businesses.

At the heart of this ruling is a concise and well-respected definition of fair market value, the most common standard used to establish business value: *"Fair market value... (is) the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.*"

In theory, no one can actually calculate fair market value because it's determined by future events. The value of a business calculated by an appraiser is *assumed* to be fair market value until the facts prove otherwise.

Business appraisers are well aware that the majority of their clients know little, if anything, about the valuation process. Before you sign an appraisal contract, it's important that you demonstrate some basic knowledge and lay down some ground rules about the scope and procedures for the engagement. Otherwise, the appraiser is apt to cut corners or make assumptions that can be to your detriment down the road.

Here are seven key points to keep in mind when looking for a professional to appraise a closely-held business:

**1. Valuation standards don't exist.** The accounting profession, the IRS and the courts all have in some way a direct involvement in business valuation. However, none of these bodies has developed formal rules or guidelines to calculate the value of a specific business. The kitchen has many chefs but no recipes. A business appraisal is in fact the *opinion* of the individual appraiser, and the appraiser has significant flexibility in formulating an opinion.

Revenue Ruling 59-60 recognizes this dilemma and states "*No general formula may be given that is applicable to the many different valuation situations arising in the valuation of (closely-held) stock.... Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science.*"

It's difficult to gauge valuation accuracy without standards. Being realistic is perhaps a more appropriate objective. For an appraisal to be realistic, the appraiser must be independent, have in-depth knowledge of business valuation theory and exemplary skills in interpreting financial statements. Furthermore, the appraiser must be willing to commit the time to analyze the financial data and other pertinent information because the true value of a business may be hidden in the numbers.

**2. Entity value is driven by assets and earnings.** Regardless of the valuation methodology deployed, the value of any business boils down to the value of its assets plus the value of its earnings.

Given your investment of time and your personal sacrifices to develop your business, you may perceive value in terms of "sweat equity." Unfortunately, this is not a recognized valuation parameter. You don't get rewarded for working hard; you get rewarded for building assets and earnings.

Earnings value, also known as *goodwill*, is recognized when assets generate a financial return over and above their standalone value. When selling a business, it's the goodwill that determines the real financial gain of your investment.

It should be obvious that the starting point of a business valuation is a comprehensive analysis of balance sheets and income statements. However, assets may be intangible and off the balance sheet, and earnings may be impacted by extraordinary transactions and discretionary spending. These are some of the issues that the appraiser must sort through. To complicate matters, historical accounting for many small businesses is often lax and unreliable.

**3. Entity value is inversely proportional to business risk.** The concept here is simple: every business has a certain level of inherent risk and the higher the risk, the lower the entity value. This fact is demonstrated every day in the stock market.

Under the Schiltz model of business valuation, a business risk premium factor of 6% to 25% is added to a risk-free market rate of return to arrive at a total capitalization rate that is incorporated into the valuation calculation. If, for example, a business is assigned a moderate risk premium factor of 15% and the current interest rate for thirty-year Treasury bills is 5%, then the capitalization rate is 20%.

Poor judgment in quantifying risk will lead to an unrealistic valuation conclusion. As 59-60 puts it: "*A determination of the proper capitalization rate presents one of the most difficult problems in valuation.... Wide variations will be found even for companies in the same industry.*"

Prospective buyers tend to assume higher levels of risk to hedge their investment. The appraiser really needs to evaluate the various individual factors that affect business risk rather than pulling an aggregate number out of the air. This is an area where the appraiser and client need to work together to make an intelligent decision.

**4. Valuation is calculated based on three generally accepted methods.** Despite the myriad of techniques available, the valuation process is reduced to three basic methods: the assets-based approach, the market-based approach and the earnings-based approach. All business valuations prepared within generally recognized guidelines are a derivation of, or a combination of these three basic methods.

The assets-based approach establishes a value for each major individual asset owned by the business. It can be overly detailed for most requirements and may require special appraisal skills or even multiple appraisers depending on the nature of the assets. This approach is used most often when the business is not a going concern, and therefore, lacks significant intangible assets.

The market-based approach establishes an aggregate entity value by comparison to other firms of similar nature. This approach is the least labor intensive and the least costly. Many appraisers favor market-based valuations because of the simplicity and appeal to cost-conscious clients. Notwithstanding their partiality, this valuation methodology is inherently flawed due to the limited availability of valuation data for privately owned companies as well as the inability to assess the subjective factors affecting historical transaction prices. From a technical standpoint, market-based appraisals provide at best only a rough valuation estimate and should be used with extreme caution.

The earnings-based approach establishes an aggregate entity value by analyzing the operational performance of the business as a standalone enterprise. It provides an intrinsic value of the firm's core assets as a group. It's considered to provide the best balance of appraisal cost and valuation accuracy. As a business becomes more complex, earnings-based valuation becomes more relevant.

The biggest mistake you can make in commissioning a business appraisal is not specifying the valuation method.

**5. Valuation is established for a specific purpose and at a specific point in time.** Valuation is relative to purpose. Therefore, the calculated value of a business will vary depending on how it's intended to be used, and the differences can be substantial. The value established for tax purposes or for litigation is not the same value established for divestiture. The difference here is due to divestiture value being based on anticipated future earnings, not historical earnings. The timing of valuation is also crucial because value will change over time with fluctuating interest rates and asset levels.

The parameters of purpose and time are so important, they are key disclosures within the valuation report, and the appraiser will insist on knowing your intentions.

**6. A going concern business has a minimum turnkey value.** Both the IRS and the courts are adamant on this point. If a business is capable of sustaining future operations, it has certain intangible assets such as customer base, reputation and employee resources that have intrinsic value for the entity. Known as *going concern goodwill*, it exists even without demonstrated earnings, and there are ways to establish its worth.

When an enterprise is financially distressed or only marginally profitable, the appraiser may blindly accept the entity value returned by the calculations, but fails to recognize the higher minimum turnkey value. This is one of the primary reasons for the under-valuation of small businesses.

**7. Valuation may be challenged.** Don't assume that your neatly-bound, thirty-page valuation report will give you an air-tight conclusion. Keep in mind that an appraisal is an opinion. As such, it may be challenged by an opposing party who also has a stake in the valuation outcome. An appraisal prepared for an estate tax return may be challenged by the IRS. Likewise, an appraisal prepared for divestiture may be challenged by a prospective buyer.

A point of contention could be establishing value based on only one year of financial results without showing that this single period is indicative of typical performance. Another point of contention could be failing to provide a reserve for inventory obsolescence.

A good appraisal is a *defensible* appraisal. This means that the potential challenges of opposing parties are recognized and addressed within the appraisal itself, if possible. The appraiser must provide adequate documentation and discussion to support the opinion. The more structure that is added to the valuation report, the more difficult it becomes for someone to tear it apart. It's not the bottom-line number you're paying for, but the detail behind it.

In summary, given the subjective and labor intensive nature of business valuation, you are well advised to do some homework before committing to an appraisal engagement. It's also a good idea to request the appraiser's biography up front. Look for corporate accounting and financial planning experience.

When complex issues are involved, face-to-face client consultations may be unavoidable, so be prepared to allocate some time to assist with the analysis. Be skeptical of mail order and low cost appraisal offers because they usually take shortcuts that are not in your best interest. This is especially true when the business has a high level of tangible assets or discretionary spending. You get what you pay for, and business valuation is no exception.

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