What's your BUSINESS worth?

It pays to know the value of your business

For many business owners, a business appraisal or "valuation" can furnish vital planning information and help mitigate risk. Consider the following:

- Establishing a verifiable value for your business can show whether assets have appreciated at a reasonable rate. If not, the firm's strategy may need to be adjusted.

- Business valuations furnish documentation to support new financing. Lenders need strong evidence that their loans are properly secured, and a business appraisal can supply that evidence. An independent evaluation of business assets also may encourage lenders to offer favorable interest rates.

- If you decide to sell the business, a valuation can mitigate risk by helping you establish a reasonable selling price. Without a detailed and defensible appraisal, owners sometimes entertain unreasonably low offers. On the other hand, a valuation can keep owners from overpricing the firm and thus discouraging potential buyers.

- What happens if one owner dies or otherwise leaves his or her share of the business to others? In some cases, litigation follows. To ensure that the remaining owners' interests are protected, the business needs to be appraised beforehand.

- A valuation can also support proper estate planning. If the estate is audited, the IRS is more likely to accept valuations that include a clear and reasoned appraisal. In fact, if discounts are adequately supported by an appraisal, estate taxes may be reduced.

Three Valuation Methods

There are three main approaches to valuing a going business: 1) the market approach, 2) the asset approach, and 3) the income approach. Mind you, there are several variations on each of these approaches. And there are some very complex computations for which you will need professional help. But you might use one of the following approaches to value your business.

- **The market approach** relies on finding recent sales of businesses similar to yours to determine what others have paid for your type of business. The challenge is in finding comparable businesses in your area. As a result, the other two approaches are more common.

- **The asset approach** would seem to be of most interest where a business has little or no profit, but it has a list of valuable assets. Perhaps one of your competitors wants your assets and is unconcerned with your lack of profits. If your business has a track record of profits, you are more likely to value it based on the income approach.

- **The income approach** is based on the future cash that will be available to the buyer. Assuming that your business doesn't have some hidden problem or an impending industry downturn, your track record of profits should serve to arrive at some rough valuation.

Using the income approach to valuation

The year-end profit and loss statement (P&L) for the past three years will likely be used to help determine the future cash flow a buyer might expect if he/she were to buy a business. Most P&L's will require some adjustments to determine the proper cash flow for the business.

Most family owned businesses need to "recast" some expense items that the new owner would not necessarily see on his P&L. Here are some examples of items that should be added back to the net profit:

- Excess salary paid to the current owner (amount above a replacement manager's salary).
- Family member salaries that the business could really do without.
- Personal perks such as an automobile, insurance, etc.
- Large extraordinary expenses that will not recur, such as legal fees or settlements.
- Large one-year equipment write-off permitted under the tax law.

Once the P&L has been recast, decide what multiple of earnings should be applied to determine an estimate of the sale price. The multiplier varies depending on the industry (manufacturing, retail sales, service business, etc.). The multiplier could be anywhere from 1.5 to 10 times net profit. Most businesses probably fall in the 3 to 6 range. On personal services businesses, you will often see the sales price based on a multiple of gross billings instead of net profit.

There are many variables taken into consideration in valuing any business. It is unlikely that any two appraisers will arrive at the same value.

Be prepared for IRS scrutiny

If you're considering getting your business appraised, you'll want to be aware of the IRS rules and guidelines about business valuations. Several types of taxes may come into play: capital gains taxes, estate taxes, and gift taxes, for example.

The IRS uses several factors to determine the value of a business for tax purposes. First, they'll consider the nature of the business. A new business run by a sole proprietor, for example, may have less chance for future success than an established manufacturing company. The IRS will also consider the firm's economic outlook and the condition of the industry in which the business operates. The IRS will scrutinize certain financial information used to value the business, such as the firm's net book value (assets minus liabilities), historic and projected earnings, and overall financial condition.

An expert business valuation will lay out these factors in a clear, reasoned, and convincing way. A proper valuation report should make the case so clearly that the valuation will withstand IRS challenges.

IRS challenges to business valuations are not uncommon. All in all, it makes sense to engage an experienced and reputable valuator who will consider all these factors and give you an honest and impartial value for your business.

If you have questions or would like assistance with placing a value on your business, please call us.

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