

What's the Bottom Line?

Do YOU Know What Your Business Is Worth? WHY YOU NEED A COMPANY VALUATION

By Bella Vita Associates, LLC

There are many instances when the value of business assets is needed, and creating a solid financial landing for your business may be critical to its future. The following may require a Company Valuation:

- **Creating a market** for the sale of your business
- Determining **proper insurance** for buy-out purposes
- Determining **property settlement** for a divorce
- Establishing the value of an estate for **tax protection** in the event of your death
- Redeeming a **dissatisfied owner's** share
- **Strategic management** and business planning
- Wanting to **gift a portion** of the business from your estate

What is a Company Valuation?

Determining the worth of most of our valuables is generally not that difficult. However, although a closely-held or family-owned business is often one's principal source of income and may represent the majority of one's total worth, placing an accurate value on it is never easy. Since, by definition, the ownership of a closely-held business is held by only a few individuals and is rarely traded in the marketplace, there is no established market price making it difficult to determine its worth.

A company valuation, therefore, is the process of determining the economic value, or fair dollar amount, of a business entity or ownership interest of a closely-held company.

Uses for a Company Valuation

BUSINESS EXIT PLANNING

There comes a time in the life of many a small businesses when the owner wants out. There can be a variety of reasons: retirement, the call of a new opportunity or simply boredom. This is the point where the owner calls in his accountant and asks that dreaded question "How much is my business worth?" Only then can the business owner make an educated decision about how to proceed and whether the business can be sold for an amount that is adequate to the owner.

BUY-OUT AGREEMENT

Also a form of business exit planning, it is important to have detailed plans and procedures for the sale or transfer of ownership at the time of the **death, disability or retirement** of a shareholder or partner in a closely held firm. Without such procedures, the departure of one major shareholder could also signal the end of a business.

Buy-out, or buy-sell, agreements spell out the terms governing sale or transfer of ownership to an outsider and thus protect control of the company. In many instances, these agreements allow co-

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owners to buy out heirs or other shareholders in the event of death or disability. In order to be considered valid for estate tax purposes, a buy-sell agreement must meet several conditions, including a "full and adequate consideration" provision.

1. **Death:** Life insurance is generally used to provide the funds to purchase the shares of a closely held company if one of the owners dies. There are two basic types of buy-sell agreements:
 - **Cross-Purchase Agreements:** With a cross-purchase agreement, the owner separately purchases a policy on the other owner (or owners).
 - **Redemption Agreements:** With a redemption agreement, the corporation is obligated to redeem the stock at a price set in the agreement if any of the business owners die.

NOTE: Make sure that you are adequately protected in the event of loan payoff provisions with debtors, which could leave you without adequate coverage in the event of death.

2. **Disability:** The prolonged disability of a principal can also present serious difficulties for closely held firms. A long-term disability buy-out agreement can provide a cushion to protect the disabled principal's interests during recovery. The first step in implementing such an agreement is to determine how long the company should be without the disabled partner's services before a buyout is activated. It is recommended that an actual buy-out of ownership interest be postponed at least 12 months, but not more than 24 months after the infirmity occurs.
3. **Retirement:** In the case of retirement, a succession plan must be put in place to determine transfer of ownership.

NOTE: In the case of the death or disability of a shareholder, a buy-sell agreement often contains the conditions for selling to an outsider or buying out a co-owner. A buy-sell agreement can be used in the valuation of a closely-held business if properly set up under IRS Code Section 2703. A key provision of Section 2703 is that for a buy-out agreement to be used as a factor in valuation, its terms must be comparable to a similar agreement that is made in an arm's length transaction.

ESTATE AND TAX PLANNING

At your death, the value of your estate is subject to estate taxes. Your business assets are part of your estate. Therefore, the higher the value of your business in your estate, the more estate taxes you will pay. The Internal Revenue Service will attempt to value your business at the highest reasonable level, while your heirs will try to minimize the value of your business. Nevertheless, valuation of a closely-held business must stand up to IRS scrutiny.

STRATEGIC MANAGEMENT AND BUSINESS PLANNING

Having a company valuation allows business owners to assess what really drives value in their companies and turns a normally static company valuation into a strategic business management tool, instead of just a "point-in-time" number. Periodic updates allow the business owners to track progress of the company.

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Commonly Used Valuation Methods

One of the major concerns associated with closely-held firms is the determination of their value. This uncertainty is largely due to the fact that shares of a closely held business are owned by a small number of shareholders, and often by members of a family. Because there is no established market for the shares, it is difficult to establish the value of the shares in an estate or gift tax situation.

Without a marketplace that reflects the price arrived at by both buyer and seller, the security prices of a closely held firm must be set by calculation, comparison, and the use of financial ratios. Valuation techniques that have evolved fall into three principal categories:

MARKET (PRICE-EARNINGS) METHODS

- **Price/Earnings Multiple:** This valuation method is the most popular. It takes the profit of the company, adjusts for any one-off issues and multiplies by a PE (price to earnings) ratio.

NOTE: PE ratios can vary enormously. Smaller businesses often have PE ratios of around 3 to 5. Larger businesses can have PE ratios of maybe 12. Ratios also vary by sector and by country.

- **Dividend Approach:** This method is similar to the capitalized earnings approach above. Look at the business' dividend history and capitalize the dividends based on the dividend payments of similar but public companies. Again, selecting a comparable business is difficult. Furthermore, the payment of dividends by a closely-held business is often more dependent on the subjective decision of a few key shareholders, rather than the actual profitability of the business. Therefore, the dividend capacity of the business is more important than its past history of payment.
- **Market Approach:** The market approach looks at comparable public companies in either the same or similar lines of business with the assumption that such companies would have a similar value. Of course, you need to make adjustments for any differences in the companies. In the past, when a good comparison has been found, this method has generally been accepted by the courts.

CASH FLOW METHODS

- **Discounted Cash Flow (aka Discounted Future Earnings):** This method takes the future ongoing cash flows that the business will generate and discount them to a net present value. It is a "return on investment" calculation.
- **Income or Earnings Approach:** In order to properly project the business' future earnings, you can look at cyclical trends in its past earnings, usually over the past five years. This makes sense as a future investor would naturally look at past earnings to predict future income streams.

Another approach is to capitalize a five-year history of the business' earnings and multiply this by the price/earnings ratio of a similar, but public, corporation to determine the company's present fair market value. The difficulty in this latter approach is the selection of a comparable company.

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BOOK VALUE (BALANCE SHEET) METHODS

- **Book or Net Asset Value:** This is one of the easier methods to apply as you simply use the historical cost of all assets, less any depreciation, and then deduct the business' total liabilities. However, a problem with this approach is it doesn't factor in any appreciation in the value of the assets, nor does it consider any intangibles of the business such as goodwill. It simply takes an open market or replacement valuation of what assets the business owns, less any liabilities. Basically, it represents what could you get for the building, equipment and inventory.

IRS GUIDELINES

Further, whatever method is used for valuing a closely-held business, it must be able to stand up to the scrutiny of the Internal Revenue Service (IRS). It is logical, therefore, to look to the IRS for guidance on how the value of such stock should be determined.

According to the IRS, the proper estimate of value should be based on the price at which a property would change hands between a willing buyer and a willing seller, with neither party under any compulsion to buy or sell and with all relevant facts available to both parties (the fair market value standard). The IRS valuation criteria for closely held businesses are generally accepted by appraisers and the courts.

The basis for how to determine the value of the stock of a closely-held business is found in IRS Revenue Ruling 59-60. Because each situation is somewhat unique, there is no general formula that can be used. In fact, the revenue ruling clearly states that the valuation of the stock of a closely-held corporation "is not an exact science." All available financial data, as well as all other relevant factors, should be considered. Revenue Ruling 59-60 lists fundamental factors that should be considered:

- The nature of the business and its history since its inception.
- The general economic outlook and, in particular, the condition and outlook of the specific industry.
- The book or asset value of the stock and the financial condition of the business.
- The earning capacity of the business.
- The dividend-paying capacity of the business.
- Whether the business has goodwill or other intangible value.
- Sales of the stock and the size of the block of stock to be valued.
- The market price of the stock of similar corporations whose stock is regularly traded.

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Closely-Held and Family-Owned Companies

For definition purposes, closely held corporations are those in which a small group of shareholders control the operating and managerial policies of the firm. More than 90% of all businesses in the United States are closely held. These firms differ from most publicly held companies, in which ownership is widely disbursed and the firm is administered by professional managers.

Many closely held firms are also family-owned businesses. Family businesses may be defined as those companies where the link between the family and the business has a mutual influence on company policy and on the interests and objectives of the family. Families control the operating policies at many large, publicly traded companies. In many of these firms, families remain dominant by holding senior management positions, seats on the board of directors, and preferential voting privileges even though their shareholdings are significantly less than 50 percent.

Proactive Management Is Your Best Risk Mitigation Policy

The business is generally an owner's most valuable asset, however an economic downturn may create a financial gap between the actual market values and capital planned for a business exit or personal estate. Likewise, an increase in market conditions may leave you exposed and under-protected.

Developing a proactive management style will enable you to mitigate risk and exposure for you and your business, and using proper contingency planning and asset protection methods is your best policy. Make sure that you have the necessary protections in place, thus it is important to have an updated Company Valuation, as well as Buy-Sell Review.

Contact Information

Bella Vita has an Advanced Solutions team with the expertise to provide a valuation of your business using five of the most commonly used valuation methods. Then, we can help you determine a plan of action to meet your business objectives and goals.

Call (954) 446-7420 or (561) 244-2540 or email info@bellavita.us. You may also download the Request for Proposal online at www.bellavita.us.

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