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With four specific services, The Center provides complete unbiased planning. The Center does not sell any products; its main purpose is to provide advice. Local experts are retained to implement the plans developed by the Center. The Center for Financial, Legal & Tax Planning is located at 4501 W. DeYoung Street, Suite 200, Marion, Illinois 62959. Phone 618-997-3436; Fax 618-997-8370.

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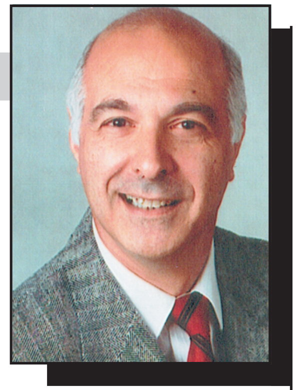

Bart Basi

Business Succession and the Valuation

This article is the third article in a seven-part series on business succession, the process, and documents necessary to achieve success in succeeding or transferring your business. the first two articles are available on our website at www.taxplanning.com.

Introduction

Along with deciding to engage in business succession planning and finding a successor, it is necessary to have your business valued. A valuation is necessary whether the business is to be transferred either to an heir or third party. If the business is transferred to an heir, it is critical that the fair market value of the business be established in a well supported form. If the business is to be sold to a third party, a valuation will ensure that maximum value is achieved.

A business valuation is a report written by a qualified appraiser for purposes including business succession, estate and tax planning, litigation, buy-sell situations and many other purposes. Given that purposes behind business valuations differ, methodology also differs. The methods used for each valuation purpose differ. Some methods are imposed by the Internal Revenue Code, others by common law, some by contractual agreement, others by industry. Following is a brief discussion on different types of valuation purposes and the applicable methodologies used to value businesses.

Reasons for Valuations

Business Succession (Sales and Purchases)

Purchases or sales of a business to or from a third party require valuations that represent the fair market value of the business with variations reflecting investment value, unique circumstances, and motivations of the buyer or seller. Fair market value in this context is a relative term and IRS standards, statute, and common law standards are not necessarily applicable.

In these types of valuations, sellers will see their businesses as being worth more to them based on their own feelings and thoughts about the business. This is called intrinsic value. However, the seller must also recognize that the market will view the business from a different perspective.

Buyers on the other hand tend to see businesses as being worth less than what the seller thinks the business is worth. Buyers also tend to comparison shop, and have different motives for buying a business. For example, sometimes buyers will merely want the real estate which a business sits on and have absolutely no interest in the actual business being conducted. Not only must buyers recognize their reasons for valuing a company, they must also take into account the seller's intrinsic value for the business.

When valuing a business for succession planning (sale or purchase) you must be aware of the seller's perception as well as the buyer's reasons for the purchase. This awareness results in using an asset method with goodwill as well as a comparable market approach coupled with a weighting factor.

Estate Tax Planning

Valuations are necessary for estate and tax planning purposes. This area of valuation is largely dictate to appraisers by the IRS and court precedent. Precedent for valuing assets for estate and tax purposes is the most plentiful of any appraisal purpose for the obvious reason that there is plenty of room for tax avoidance. Much of the precedent for this purpose comes from Revenue Ruling 59-60 and related rulings. In the Revenue Ruling, the IRS states that Fair Market Value is the applicable standard in these types of appraisals. Generally, fair market value is what a willing buyer under no compulsion would pay for the business. Even though it is simple to state, many complex methods are used to arrive at the value and no one formula can be used. Specifically, at least two methods must be used, i.e., the earnings capacity approach and the asset approach. However, in reality, other methods are observed together with a trend analysis of earnings and cash flow for up to five years. When valuing a business for estate taxes, be sure to use a recognized expert in the field.

Litigation

Divorce and tort damages are included in valuations when litigation is anticipated. Because litigation tends to be more emotionally driven and less about business purpose, courts have wide discretion to determine whether a valuation is fair and whether an equitable distribution will be achieved using the valuation methodology. There is virtually no statutory law available to guide appraisers for the purpose of litigation valuations. A careful review of common law must be performed in order to ensure that a court will respect a valuation which is submitted to the court. With that said, it is also accurate to say courts will pay a large amount of deference to valuations performed under recognized methodologies as long as they are fair to both parties. With this in mind, appraisers should follow closely the tax guidelines and consider several methods so that a fair appraisal is provided that can be defended in court.

Buy Sell Arrangements

This is typically agreed upon when a business is created, bought, or sold and multiple partners or married couples are involved. When a married couple or any other pair or group of people create, buy, or sell a business, it is absolutely imperative to have a buy-sell agreement. This prevents a court from having discretion as in a valuation for litigation purposes as discussed above. Generally, buy-sell agreements will be followed unless they are declared to be fraudulent, unconscionable, or subject to another contractual offense. The methods used can be anything that is agreeable to the parties. However, the parties should not leave the methodology to be determined at a later date. That is when problems arise. When the Buy-Sell Agreement is written is the proper time to state the methodology in the agreement. Too often, a general statement is made and then when problems arise, more money is spent arguing over what methodology should be used to value the business. If you have a Buy-Sell Agreement, review it and, if a valuation methodology is not stated, redo the Buy-Sell Agreement and state the methodology before trouble occurs.

Blended Valuations

Frequently any one purpose discussed above will intersect with another. In those circumstances, careful consideration must be paid to which purpose predominates, whether an equitable result will be achieved, and whether the client will be well represented. As such, methodologies will blend as the professional sees fit. Remember; never rely on only one method to value a business. Several methods are available, and of these, at least two methods should be applied.

Valuation Approaches

Comparable Price

The comparable price method operates under the assumption that there are other companies comparable to the business being valued that are either publicly held or privately held that recently sold. The IRS suggests that when using this method, at least three comparable companies should be used. Once the comparables have been found, the net income, cash flow, EBITDA, and the Price/Earnings ratio can be applied to compute a benchmark value. The individual company values can then be weighted and an average industry benchmark can then be established.

Capitalization of Earnings

The consensus among appraisers is that the capitalization of earning power is "the most important single factor in the valuation of most operating companies, such as manufacturers, merchandisers, and companies providing various services." At the end of the life of a company, the total worth of that company can be found in the ability it had to generate earnings. This method uses historical data to project future earnings. The method goes back through three to five years and projects the earnings potential for up to five years in the future, using a growth rate, present value calculation, and expected earnings figures.

Adjusted Book Value (Net Tangible Assets)

This method, also referred to as the underlying asset method, is especially useful in valuing holding companies as well as operating companies. Investment houses and real estate companies are examples of holding companies. This method is also useful for liquidation purposes because it provides the "adjusted" asset value which relates to the fair market value of assets. It is also useful in valuing capital intensive businesses that rely on their asset base to perform work and generate income. An excellent example of this is a construction company. The company's machinery is vital to its operations. This idea can be contrasted with a law practice whose income generating ability does not rest physical assets of the firm but, rather, on personnel. The key to this method is to determine the fair market value of all useful assets versus the value as stated on the books of the company. In addition, goodwill (as stated below) can be added to the adjusted value of the "hard assets" to arrive at an overall value for the company.

Excess Earnings Capacity (Goodwill)

This method is based on the theory that the value of a company is equal to the value of the net tangible assets plus the value of excess earnings (e.g., goodwill, patents, trademarks, copyrights, etc.). Eight factors are typically considered when calculating goodwill: age of the company, employee turnover, the value of the suppliers and the products sold, market area, potential growth, inventory efficiency, company location, and banking relationships. Excess earnings attributable to intangible assets are the foundation of the value of goodwill. Once this calculation is made, the result is added to the adjusted asset value as determined above.

Present Value of Future Income Stream (Cash Flow/ Leverage Debt Method)

A variation of the capitalization of earnings method is referred to as the "Leveraged Debt Concept." This concept takes into consideration the fact that an outside party may leverage an acquisition of the current company and use all of the income to pay interest on borrowed money. Currently the cash flow method is becoming more important in valuations as companies tend to use "free cash," i.e. earnings before interest, taxes, depreciation, and amortization (EBITDA) to determine the value of a company based upon an expected return on their investment (ROI). The end result is referred to as a multiplier.

Net Income Residual Approach or Divided Paying Capacity

This method looks at the income that is left over for the stockholders as it relates to a company's return on investment. Effectively, it can be referred to as the ability of the company to pay dividends to the stockholders using income that is not needed to operate the business in the future. Dividends are based on earnings after taxes as they related to investment (stockholder's equity) at the beginning of the year. Dividends represent the after-tax earnings that are distributed to the stockholder instead of being kept in retained earnings to help finance future projects. This is a key method used to determine what an investor would pay for participating in the ownership of a privately held company.

Valuation Contents

Appraisers Qualifications

This section should include the appraiser's name, address, taxpayer ID # and qualifications. This section lends credibility to the remainder of the report. Be sure to review the qualifications of the appraiser. It is important that the appraiser have the proper education and be knowledgeable of the industry as well.

Purpose

As discussed above, valuations are used for different purposes. The purpose will affect the methodology, rules, and the opinion of value. The Purpose section contains and overview, description of the property, nature and purpose of the appraisal, date of valuation, sources of information, and references. For example, an appraisal is needed for estate tax purposes when someone dies or when a sale of a business is taking place, the seller must know the value of the business.

Company Data

Company Data is contained in the report to give the potential buyer, seller, judge, court, or other critical party a background on the company. This section should contain the organization of the company, overview and history of the company, products, customer base, services, key competitors, and personnel of the company.

Economic Conditions

The Economic Conditions are critical to the report as well. The economic conditions should contain a) an Overview of the National Economy, b) Overview of the Economy where the company is located, c) Overview of the Industry, d) General Outlook for the Company, and e) Concluding Remarks. This section should present data from the general economy down to the specific company in question, arriving at a conclusion as to the future outlook for the company.

Assumptions

The assumptions are one of the most important parts of the report. If the assumptions are not valid and founded on fact, the calculations are meaningless. Assumptions such as cost of capital, the expected return on investments, and growth potential of the company are critical to the calculation.

Valuation Methodologies

There are various valuation methodologies and the methodologies cannot be based upon a simple multiple. Some methodologies include the a) Earnings Capitalization Method, b) Underlying Asset Method, c) Cash Flow/Leveraged Debt Method, and d) Comparables Method. The tax laws stipulate that more than one method should be used in all valuations and the methods should be weighted based upon their relative importance to the company.

Value Per Share

This section is a mathematical calculation based upon the value of the company divided by the number of outstanding shares. If there is more than one class of stock, the stock is assigned values accordingly.

Statement of Limiting Conditions

A Statement of Limiting Conditions is required to be in the report. The statements express what the report is, evidence it is based on how it can be used, and on limitations that may affect value.

Summary Letter

The Summary Letter should include a statement by the appraiser, the results, and signatures with a date.

Appendices

In the Appendices, it is useful to include a) financial statements, b) tax return, c) pictures, and d) product line cards, if any, in order to substantiate the opinion expressed.

Conclusion

Valuation methodology cannot be boiled down to simple formulas or gratuitous multiples as recommended by some people. Determining the profit calculated for tax purposes and then tripling the tax profit will not provide an accurate value for any purpose.

Several methods of valuing a closely-held company have been presented in this section. Each method has its advantages and disadvantages. Furthermore, no single method provides the absolute value of a company. The courts, as well as the IRS, have determined that more than one method must be used to value a closely-held corporation. The appraiser must determine which method will receive the greatest weights based upon the relative importance of each method to the overall success of the company. The type of company, the purchaser, and the reason the company is being valued are important factors when determining the weights assigned to the various methods presented in this situation. The Center routinely performs valuations for varying purposes. If you would like to have your business valued, contact The Center at 618-997-3436.