Business Valuation:
Unlocking the Value of Your Biggest Asset

Is now the right time for a professional valuation of your company?

Understanding the method of valuation that is right for your company

Gleaning insights from a business valuation that can help you build value for the future

GT Reilly & Company
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Business valuations benefit owners in different circumstances, from divorce to partner disputes

Business valuation is a hot topic these days, as the Baby Boom generation ages into retirement and prepares to exit the businesses many of them have built over the past 40 years. But there are many reasons for obtaining a business valuation that have nothing to do with retirement, and savvy business owners should know when an independent valuation can benefit them.

Most business owners think they know what their businesses are worth, or at least what they want them to be worth. But there are many situations in which an independent business valuation, determined by measuring a set of financial performance metrics, enables an owner to realize greater value in a variety of situations. Following are the most common reasons business owners seek independent valuations.

**Divorce**
Unfortunately, a business owner’s impending divorce is one of the most frequent catalysts for a business valuation. The business is a marital asset and needs to have a value assigned to it in order for the couple to equitably divide their assets upon the dissolution of their marriage. Sometimes the business is owned by the husband; sometimes by the wife. And occasionally, the business is owned by both of them. It makes no difference which spouse is the owner, or if it is owned jointly, the business still needs a value placed on it. Sometimes the owner-spouse has co-owners and might even be a minority-owner. This creates additional complications in the valuation process. In most divorce situations a valuation is performed for both the owner-spouse and the non-owner-spouse, since in these situations, neither spouse is particularly trusting of the other and each has an attorney representing them. It should be noted that whether the valuation is being performed for the owner-spouse or the non-owner-spouse, the procedures should be the same, and the valuation results similar.
Employee benefits and retention plans
Other reasons for obtaining a business valuation include allowing for a stock bonus plan for key employees, or enticing potential key employees to join your business. Having a base value to start from can help to figure how much value a key employee brings to the company over a period of time, or to compensate them for their contributions to increased value upon a sale or merger transaction in the future. There are many types of plans that this can work with, including stock option plans and phantom stock plans.

Shareholder or partner disputes
Frequently, shareholder or partner disputes culminate with a split-up where one of the owners demands to be bought out. In order to arrive at a fair price a business valuation is required. A major difference between a valuation for a shareholder/partner dispute and one for a marital breakup is that in an ownership dispute, usually both parties are more aware of the business operations and value than when there is an owner and non-owner spouse situation, where the non-owner spouse is less knowledgeable of the business.

Death and taxes
Business valuations also need to be performed for estate tax purposes. When the owner of a business passes away, the business that he/she owns is an asset that must be reported on the Estate Tax Return, just as the value of ownership of any publicly-traded stock must be reported. The difference is that the value of a publicly-traded stock can be ascertained by a quick check of a stock quote published by many sources, while the value of a closely-held business must be determined by a valuation study. Internal Revenue Service rules require that the business be valued by a “qualified” appraiser and that, if any discounts are reflected in the value (and they generally are), they be disclosed in the report attached to the Estate Tax Return. The methodology used in formulating the value must also follow well-established IRS guidelines to pass scrutiny.

Since the value of a closely-held business is an asset of a decedent, it makes sense that many business owners, at some point, plan ahead for the impact the value of the business will have in their estates and have a valuation done to assist in their estate planning. The result might be that they give away a portion, or all, of the business to family members before they die to reduce the value of their estates. Or, knowing what the value of the business is and not wanting to give away ownership or control of it, they make decisions to give away other assets of value to reduce the size of their estates. (However, there are tactics to give away the value of the business without giving away control.)

Continued
Performing a business valuation can help to disclose weaknesses that could be corrected in time to increase the value to a potential buyer in the future.

**Mergers and acquisitions**

Here, there are three potentials: buying a business, selling a business or merging two or more operating businesses. If you were buying a business you might want to have some assurance that the asking price is reasonable. If you were selling your business, you would want to have a good idea of what a reasonable person would pay for it. And if you were contemplating merging your business with another, there would need to be a way to determine an equitable share of ownership of the resulting entity, based on the value of the two businesses before the transaction.

**Retirement**

Additionally, if you were contemplating selling your business at some point in the future, it would be important to know what it is worth now and how that value might be enhanced in the period between now and when you were considering selling. Performing a business valuation can help to disclose weaknesses that could be corrected in time to increase the value to a potential buyer in the future.

**ESOPs**

If you wanted to implement an Employee Stock Ownership Plan (ESOP), you would need a business valuation done at the start to set an initial value for shares to be sold to the plan. Then you would need annual updates to the valuation as additional shares were acquired by the plan and as shares were assigned to participating employees.

*It is important to remember that the methodology of determining a business's value can differ depending on the purpose of the valuation. A trained and experienced valuation expert will know the appropriate methods and procedures most applicable in your scenario and be able to apply them to arrive at a defensible value for your business.*
Business owners who are looking ahead to estate planning would be smart to obtain a business valuation as part of the process. Whether you, as a business owner, plan to sell or gift a business to your heirs, the business likely represents the most valuable asset in your estate. If its value pushes the estate above federal and state exclusion levels, your heirs could be stuck with a large tax bill. But there are many ways to create an estate plan that allows for paying estate taxes, or avoiding them altogether.

Federal and state exclusions
Under our current estate tax regime, for many business owners the value of a business is not as important as it used to be, due to the $5.34 million exclusion for federal estate tax calculations. For a married couple, the exclusion could reach $10.68 million.

Thus, if your estate, including the value of your business, is less than the exclusion amount you might not have to worry about minimizing federal estate taxes. But if the value of your business could put you above that threshold, you do have federal estate taxes to be concerned about. Additionally, since the Massachusetts estate tax kicks in at only $1 million, that remains a consideration.

Planning ahead to pay estate taxes
Let’s suppose you are in the category where estate taxes are a concern. Knowing the value of your business can help you to determine what your estate taxes might be and how to plan ahead to pay the taxes, or avoid them.

Your estate must be liquid enough to pay the taxes if you do nothing to avoid them. If you plan to leave your business to family members, you don’t want to burden them with paying estate taxes to the extent that their personal lifestyles or the business may suffer. Knowing the value will help you estimate the estate taxes and plan for payment. Strategies for paying estate taxes can include using other assets or acquiring life insurance.

But do you really want to give the federal and state government all that money if there are ways to avoid it?

Planning ahead to avoid estate taxes
Knowing the value of the business can help you and your advisors plan to reduce the estate by giving away a portion of the business, or some other assets of a like value, while the owner is alive.

Gifting a portion of the business
If the plan is for the business to remain in the family, gifting a portion of the business while the owner is alive might be the appropriate course of action. Depending on the value, this would usually not require the owner to give up control. It is also likely to be an asset that will appreciate over future years, making it more appropriate to give than cash, for example, in keeping the estate from becoming taxable as years pass.
If you plan to leave your business to family members, you don’t want to burden them with paying estate taxes to the extent that their personal lifestyles or the business may suffer. Knowing the value will help you estimate the estate taxes and plan for payment. Strategies for paying estate taxes can include using other assets or acquiring life insurance. But do you really want to give the federal and state government all that money if there are ways to avoid it?

Gifting other assets
If there is no plan to keep the business in the family, and there is an apparent estate tax problem due to the value of the business, knowing the value can help to determine what other assets might be given to family members to reduce the size of the taxable estate. Other investments, real estate, collectibles, etc., might be given to family members, while the business is retained.

Life insurance
If the estate cannot be reduced enough to avoid the estate tax by giving away other assets, then life insurance might be a solution (assuming reasonably good health of the owner). Knowing the value of the business helps to know how much life insurance might be necessary. Ownership of the life insurance can be established in such a manner that the insurance itself does not become an asset of the estate.

Using IRS-approved valuation method
A business valuation for estate planning purposes should be performed in the same manner as a valuation for estate tax purposes, since the value arrived at for planning purposes needs to be the same as that for tax purposes or it would not be meaningful for planning. This means that it should be performed by a “qualified” valuator using a method that the IRS would approve for estate tax purposes. Methodologies should include adherence to applicable Internal Revenue Rulings and Procedures. Such compliance would be important if the valuation were to become part of the supporting documentation attached to a gift tax return resulting from the planning process. The value arrived at would be “Fair Market Value” and would likely be subjected to a discount for lack of marketability and, for potential gift tax purposes, to a discount for lack of control (or “minority interest”).

Update business valuation periodically
It would be prudent to update the valuation periodically to ensure that the plan you have chosen is still working for you. A profitable and growing business is likely to increase in value as time passes, so adjustments may need to be made, as estate planning is a continuing process.
When it comes to determining the value of a business, not all valuation methods are created equal. The value of a food manufacturer that has been in business for 70 years and has national distribution cannot – and should not – be determined by the same method used with an intellectual property business that is less than 10 years old.

Using the right method for a business valuation – or the right combination of methods – can yield more reliable information for a business owner and enable him or her to achieve the desired objective, such as realizing a higher gain from a sale of the business.

**Cost approach, market approach, income approach**

There are generally three business valuation approaches: the cost approach, the market approach and the income approach. A valuation analyst will typically consider and try to apply all three approaches in a valuation, since the use of all three approaches would provide multiple value indications. These multiple value indications can often reconcile into a reasonable range of values which can be used to support the final value conclusion.

However, often there is insufficient data to actually use all three approaches. In this case, a business valuation analyst will typically select the approach:

- for which there is the greatest quantity and quality of available data,
- that best reflects actual transactional information of the particular industry,
- that best fits the characteristics of the subject of the valuation, and
- that is the most consistent with practical experiences and professional judgment of the analyst.
Cost approach, market approach, income approach....
A business valuation professional will almost always try all three approaches to determine a range of values for a company.

**Cost approach**
Cost approaches are based on the basic economic principle of substitution. That is, the value of a business is influenced by the cost to create a substitute of its assets. This can work well for a manufacturing company, for example. Determining the value of its machinery and equipment in place can help in the determination of the value of a manufacturing company. The problem here is that many times a business consists of unique assets that cannot be replaced. This situation may occur in the case of intellectual property such as a patent, copyright, trademark or trade secret. The cost approach is difficult to apply in such cases.

**Market approach**
Market approaches are based on two economic principles: efficient markets and supply and demand. That is, the value of a business may be estimated by reference to prices paid in the marketplace for the arm's-length sale of a comparable (or guideline) business entity. A comparable business would be one that is in the same line of business, of comparable size, and have other meaningful similarities such as relative growth rates, profit margins, returns on investment, etc. The biggest problem in using this approach is that, when valuing closely-held businesses, it is frequently difficult to locate truly comparable companies, since most of the available information comes from large, publicly-traded businesses, which, almost by definition, are not comparable.

**Income approach**
Income approaches are based on the economic principle of anticipation. That is, the value of a business is the present value of the income that can be anticipated to be generated by that business. The most frequent methods used here involve a projection of future income or cash flow that can be expected. If the business has been in existence for some time, prior earnings can be utilized to generate an average income that can be capitalized to determine value. Or, if the business has either not been in existence for long, or the intention is to change its operations, income projections can be utilized to generate a discounted future earnings value. A business valuation professional will almost always try all three approaches to determine a range of values for a company, but ultimately, the income approach often yields the most reliable value.

If you would like to explore how a business valuation can help you, please contact Charles Sandy Kennedy Jr., CPA/PFS/ABV, at 617-696-8900 or CSK@gtreilly.com
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