MONETARY

Know Your Value

The boring but critical importance of business valuations

By **Philip** Josephson

"If business schools could offer just one course, it would not be on stock trading, the efficient market hypothesis or modern portfolio theory. Rather, B-schools should be encouraging students to learn the boring, but critically important, discipline of business valuation."

– Warren Buffet, 2012 Berkshire Hathaway Annual Meeting

Every business will require a valuation at some point in its business lifecycle. The reasons that prompt a need for a business valuation vary from tax and non-tax reasons as well as voluntary and non-voluntary reasons. It is important for business owners to understand the need for business valuations and, moreover, the principles of business valuation. From here, the owners can better understand that value of their business, plan for the growth of the business and execute their exit plan strategy.

Many business owners perceive a business valuation may be required if they sell their business or their ownership interest in their business. Of course, upon the sale or proposed sale or transfer of the business or the ownership, a valuation is suggested as the buyer of that business or interest will likely conduct its own valuation. But also the business may need to seek a loan or similar financing at some point in its lifecycle, and the lender will need to value the enterprise. Similarly, if the company seeks to raise capital, a business valuation is suggested in order to support the terms and the promised returns of the company's offering.

Other businesses may want to institute deferred compensation arrangements with its key people in the form of stock appreciation rights, phantom stock, or options in order to provide additional financial incentives. Here, the business and the plans will need to have a baseline value to use in the calculation of the deferred compensation, as growth can only be measured if there is a known starting point. Also, ESOPs are required to have a valuation each year.

Estate planning for business owners is of key importance as the business owner will someday retire or leave the business, and family members may need to be considered. Here, a valuation of the business will be required for estate tax forecasting. Further, the IRS will have an interest in the value of the business or the ownership upon the transfer from one party to another whether in a sale, gift or estate transaction.

In addition, unfortunately disagreements among the owners of a closely held enterprise may lead to owner disputes and the need for a business valuation in any buy-sell arrangement or in any litigation that may arise between the owners.

Scenarios That Can Require a Business Valuation

Voluntary (Actions that a business can make happen)	**Involuntary** (Actions that can occur to the business)
Outside capital	Death
Exit planning	Divorce
ESOP, Compensation plans	Bankruptcy
Earn outs	Owner dispute
Transfer to family/insider	Forced restructuring
Sale or purchase	

For exit planning purposes, a current business valuation helps to identify what reasonable exit objectives are achievable, what drivers need to be in place to achieve those results, and provides a guide to keep the business on track to build value and execute its desired exit strategy. All exit plan success starts with a beginning value, which a valuation provides.

The business valuation process has its origins in an IRS Revenue Ruling from 1959. In this ruling, it was determined that the date of the valuation, the valuation's purpose, the premise of value considered in the valuation, and the standard of value to be applied – fair market value, fair value or investment value – are vital factors in the business valuation process. From here, the factors that are viewed to strongly determine the value of a business in the valuation process include the history and nature of the business, micro and macro-economic factors that affect the business, the company's financial condition and history, the dividend paying and earnings capacity of the company, and the existence of any company goodwill and intangible assets. The business valuation process incorporates those factors and uses one or more common and accepted approaches to business valuation – asset approach, income approach or market approach – as it works to determine a calculation or conclusion of value.

Uses for Business Valuation

Negotiation – Improve position in purchase or sale scenarios

Management – Identify and promote efficiencies/develop sound practices

Compensation – Determine baseline to establish deferred compensation plans

Strategy – Develop, implement and execute exit plans

Business valuation is a combination of art and science, and thus it requires a professional, qualified appraiser to conduct and provide a valuation. An accredited business valuation analyst performs the calculation in accordance with prescribed rules and accepted methodologies which provides a respected and accepted calculation for the owner or those that then rely on the valuation report. It is not enough or prudent for an owner to "run their own numbers" for valuation purposes, especially as they try to defend their calculations to the IRS or state taxing authorities.

A business valuation is an important and necessary undertaking for nearly every business. The valuation has many uses and can serve different purposes. A valuation can be used as a negotiation tool in the sale of a business, it can be used as a management tool to promote efficiencies and to develop sound practices that increase business value, it is used in compensation plans, and it should be a part of strategy and exit plans for the business and the business owners.

Philip Josephson is a Certified Valuation Analyst (CVA) as certified by the National Association of Certified Valuation Analysts. Philip is the founder of Sterling Business Law where he and the firm deliver corporate legal and business advisory service to clients across the United States. Philip holds a Finance degree and a J.D. from the University of Miami, an M.B.A. from Columbia University; he is a Registered Investment Advisor (RIA); he is a member of the Florida Bar, the Arizona Bar, and the Federal Communications Bar; and may be contacted at pjosephson@sterlingbusinesslaw.com. Nothing written above is intended to be legal advice.