HOW MUCH *is* YOUR BUSINESS WORTH?

BUSINESS VALUATION GUIDE

FIDUCIAL®

KNOWING THE VALUE OF YOUR BUSINESS GIVES YOU A HEAD START IN PLANNING FOR THE FUTURE. WHETHER YOU ARE INTERESTED IN BUYING OR SELLING A BUSINESS, KNOWING THE TRUE VALUE OF THE ENTITY PROVIDES YOU WITH AN ADVANTAGE AND WILL HELP YOU MAKE AN INFORMED DECISION.

How is the value of the business determined?
How do I use that information to my advantage?
What will the tax consequences be?

This document provides some of the answers to those questions and identifies a few key issues to be considered.

DO YOU WANT TO KNOW *the* REAL VALUE *of* YOUR BUSINESS?

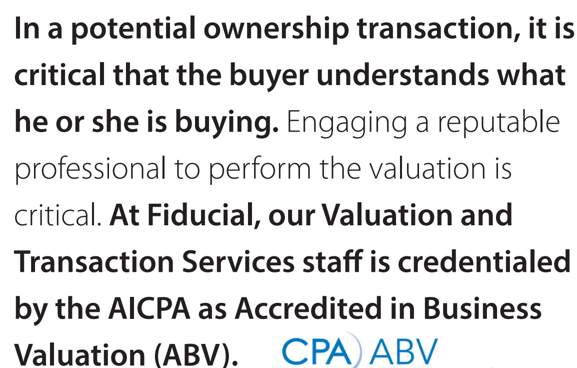
There are many reasons that knowing the value of a business is necessary. In the situation of gifting and estate settlement the value is important to ensure compliance with IRS rules. In preparing to sell your business it is necessary to set a realistic and fair asking price. When buying a business, it is critical to ensure that the business operations being purchased will support the purchase price.

Business valuations are useful for ownership transition, establishing buy/sell agreements, converting to a new business structure, financing purposes, gifting, estate planning, litigation, and many more situations. They are also a powerful business management tool and can help business owners identify strengths and weaknesses in their businesses which can be corrected to enhance the value of the business.

The reason for a valuation can determine the approach, premise and standard of value. Most transactions should be at fair market value. If a business is undervalued the IRS could consider the change of ownership a gift and subject the transaction to gift taxes. On the other hand, if a transaction occurs above market value, the purchaser may not be able to continue making payments and repossession could be forced to occur.

Depending on the reason for a valuation, the timing of the valuation can be very important. For instance, in the event of death, a value as of the date of death should be used in an estate settlement or as the amount established as the stepped up basis for successors. In other cases, it may be necessary or advisable to wait until the close of the current fiscal year to accurately depict the value as of the end of that fiscal period.

In a potential ownership transaction, it is critical that the buyer understands what he or she is buying. Engaging a reputable professional to perform the valuation is critical. **At Fiducial, our Valuation and Transaction Services staff is credentialed by the AICPA as Accredited in Business Valuation (ABV).**



This credential is accepted by the Small Business Administration as a "qualified source of business valuations for lenders."

Approaches

Valuation approaches are standard and commonly accepted within the appraisal/ valuation profession. There are three standard methods used to value a business: Asset Approach, Market Approach and Income Approach.

The Asset Approach focuses on the balance sheet. It values each component of the business, including liabilities, separately at fair market value. The asset approach is most commonly applied to asset-intensive companies, holding companies, and other companies whose primary value lies in its tangible assets.

The Market Approach emphasizes the principle of substitution. The values of comparable substitutes are determined and used to estimate a value for the subject being appraised. The market approach is generally considered the most fundamental approach, however, it is also generally the most difficult to apply due to the difficulty associated with obtaining truly comparable data to the subject of the appraisal, when considering small, closely held businesses.

The Income Approach considers the earning capacity or cash generating ability of the company. The fundamental theory behind the income approach to valuing a business interest is that the value of an investment is equal to the present value of the sum of the future benefits it is expected to produce. The income approach is best suited for service businesses, whose value is based on the ability to generate earnings and cash flow.

What does *it* mean?

One of the biggest challenges is understanding the results of the valuation. A standard business valuation will typically yield a result representing the **Value of Net Cash Flow**. This value is determined by applying analysis to a benefit stream and determining the value. An example of this is a multiple of Earnings Before Interest, Taxes, Depreciation, Amortization and Rent (EBITDAR). Basically, the result represents the buying power of the projected EBITDAR cash flow stream, and a pricing point for a purchase of the assets used in generating that benefit stream, including the real estate.

In some situations, the **Equity Value** or "enterprise" or "stock" value is needed. The total value of the entity owned; assets less the total value of its liabilities equals equity value. This can be a rather simple calculation, but there are several things to consider that could make this more complex. Those factors include ensuring that all balance sheet items are adjusted to fair market value. Understand that non-operating holdings such as cash and investment accounts that are legally owned by the corporate entity will be included in this value. Additionally, the value will be reduced by any debt the corporation is obligated to pay.

WHAT DO I DO WITH *it?*

There are various options for structuring an ownership transaction. Each option includes pros and cons, as well as various tax implications. The basic transaction types are discussed below:

Asset Transaction

An asset transaction typically includes the core operating assets of the business and the real estate used in operations, and goodwill. The asset transaction should be based on a pricing point developed from the Cash Flow Value.

EXAMPLE: Cash Flow Representation

Value of Net Cash Flow (PRICE)	**$ 1,000,000**
Allocation to Operating Assets	
Inventory & Supplies	(10,000)
Furniture & Equipment	(40,000)
Automotive Equipment	(50,000)
Real Estate	(400,000)
Goodwill	**$ 500,000**

**Numbers are for demonstrative purposes and are not derived from any specific financials*

This type of transaction is the most common when the buyer and seller are not related parties. It involves more steps, and has specific tax consequences.

The steps include the buyer first establishing their own corporate entity, as an asset transaction only includes the assets. This new company purchases the operating assets from the selling company, establishes its own tax identification number and its own set of books, and starts operating the business.

The selling company records the sale of the assets and recognizes the gain or loss.

The selling company then pays its final bills, files its final payroll and tax reports and is liquidated. A liquidation means that all of the unsold assets (which includes the sale proceeds), net of the liabilities are then distributed to the owners via a distribution or dividend, depending on the type of entity.

Equity Transaction

An equity transaction is typically an easier process of transferring ownership; however it is usually done only in situations of related parties, partnership buyouts, or key employee transactions.

In an equity transaction, stock can be sold or redeemed. In a stock sale the buyer purchases the stock of the Company from the current owner. The paperwork is updated to reflect the change. In a redemption, the corporate entity buys the stock from the current owner.

An equity transaction should be based on a pricing point developed from the determination of the Equity Value of the business. An important note is to ensure that pricing is adjusted to reflect the outgoing owners' withdrawal of funds because the initial equity value determined has included ALL corporate owned assets & liabilities.

EXAMPLE: Equity Value

	Per the Valuation Report	Owner Withdraws Assets before Sale	Adjusted Value
Corporate Assets			
Cash	$ 200,000	(150,000)	$ 50,000
Accounts Receivable	150,000		150,000
Inventory & Supplies	10,000		10,000
Furniture & Equipment	40,000		40,000
Automotive Equipment	50,000		50,000
Real Estate	400,000		400,000
Goodwill	500,000		500,000
Cash Surrender Value Life Insurance	250,000	(250,000)	0
Total Assets	**$ 1,600,000**	**$ (400,000)**	**$ 1,200,000**
Less Corporate Liabilities			
Accounts Payable	$ (25,000)		$ (25,000)
Notes Payable	(150,000)		(150,000)
Mortgage Payable	(250,000)		(250,000)
Equity Value (before discounts) (PRICE)	**$ 1,175,000**	**$ (400,000)**	**$ 775,000**

**Numbers are for demonstrative purposes and are not derived from any specific financials*

Tax Implications

The tax implications of an asset or equity transaction are based in part on how the transaction is structured and the entity types involved.

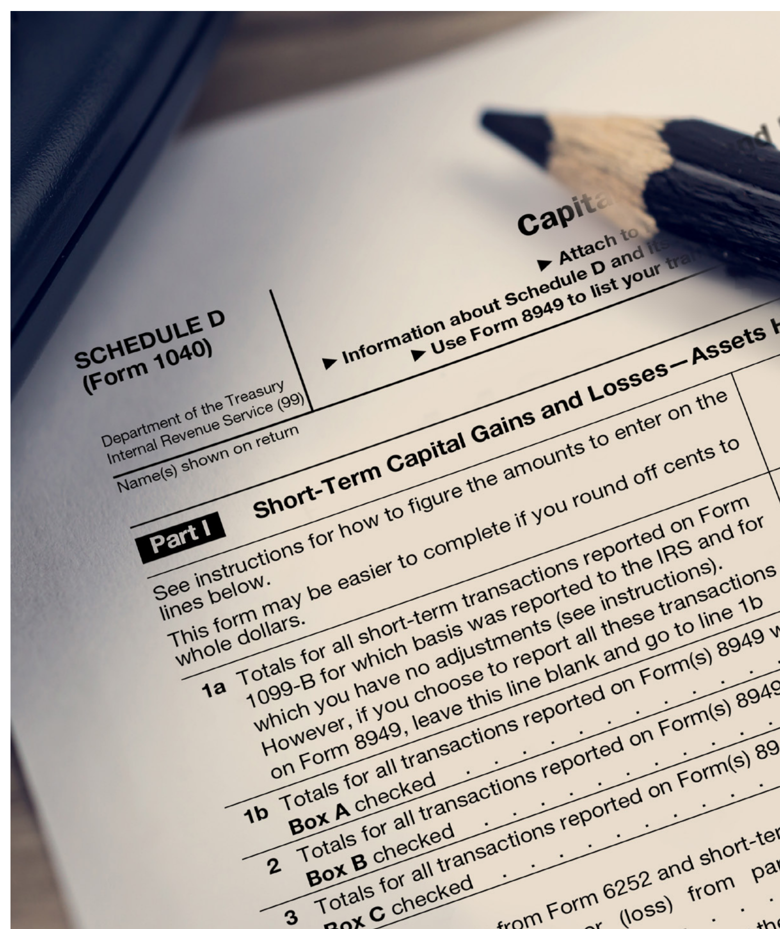
In an asset transaction the selling company records the gain or loss from the sale of the assets onto the corporate books. In a C Corporation, that gain is taxed with the corporation's net income for the year. In a flow-through or pass-through entity, the gain is reported on the K-1 and "flows through" to the shareholder's personal income tax return.

When the selling entity is closed down and liquidated, the owners of the entity receive a liquidating distribution or dividend. In a C corporation, the liquidating dividend is offset against the stock basis and the remainder taxed on the personal tax return as dividend income. This is what is often referred to as the "double taxation."

In a flow-through entity, the income that is taxed on the personal level adds to the shareholder's basis, and the basis is then applied against the liquidating distribution. Any distribution above the owner's basis, is taxed at the capital gains rate.

The buyer of the assets records the assets onto the new entity's books, and is able to depreciate the assets over their useful life, even if the assets were depreciated by the selling company.

In an equity transaction the seller recognizes the selling price less basis, and the gain or loss is taxed at the capital gains tax rate.



OTHER *Important* CONSIDERATIONS

Projected EBITDAR

Valuation approaches are standard and commonly accepted within the appraisal/ valuation profession. The key assumptions used in applying these standard approaches are what significantly impact the resulting values. Lengthy discussions regarding issues such as what multiple of earnings to use, etc. consume significant time and overshadow the real factor – what are the earnings that should be multiplied.

It is commonly accepted that EBITDAR represents the real cash flow stream of the business, and this number is commonly used to determine the value of a business as a going concern. Most appraisers/ valuation analysts prepare a "Projected EBITDAR," which is supposed to represent the expected future financial performance of the business. **The question is…what is included in the Projected EBITDAR? Are these projections realistic?**

Revenues – only revenue from the business operations should be included, if the business's financial statements and/or tax returns are prepared on the accrual basis of accounting, uncollected receivables must be considered. For example, the company books may show $1 million of revenue each year, but if the company is only able to collect $900,000 of that and no adjustments or write offs have been recorded on the books, the EBITDAR for that year is really overstated, which results in an inflated business value.

Expenses – Operating expenses that are normal and necessary to conduct the business should be included.

In most small businesses, personnel costs represent the largest operating expense. In order to determine the real value of a business, personnel costs should be adjusted to actual market rates. Year-end bonuses to lower profits and large retirement plan contributions should all be likewise adjusted. Additionally, situations where owners that take lesser salaries or whose spouses work in the business for no pay need to be adjusted. The key to the real value of the business is knowing what the REALISTIC expectations of these operating costs are.

There are several other operating expense categories that can be impacted by discretionary items. These include advertising/promotion, automobile, facilities, etc. An example of this is a very profitable business whose owner was passionate about contributing to the community. The owner had very high advertising, promotions and contributions expenses because he sponsored various community and school events. These types of expenditures need to be adjusted for because the overstated expenses result in understated EBITDAR, which falsely lowers the value of the business.

Alternative Transaction Types

There are a few other options to consider when the goal is to transfer ownership. One choice is to gift stock. A gift of less than the annual gift tax exclusion amount can be made without triggering gift tax reporting requirements. Additionally, the full value of the business could be transferred without tax implications if you have not met your lifetime exclusion amount.

Another option is to have the company's shares transferred via your estate. A positive for doing it this way is that the beneficiary gets an increased basis in the stock.

A couple other tax strategies to consider are an installment sale, and allocating a portion of the purchase price to a non-compete agreement or personal goodwill.

Summary

There are many reasons that knowing the value of a business are necessary. In the situation of estate and gifting the value is important to ensure compliance with IRS rules. In the situation of preparing to sell your business it is necessary to set a realistic and fair asking price. In the situation of buying a business, it is critical to ensure that the business operations being purchased will support the purchase price.

DO YOU WANT TO KNOW *the* REAL VALUE *of* YOUR BUSINESS?

FIDUCIAL®

FIDUCIAL OFFERS BUSINESS VALUATION SERVICES BY CPA/ABV CREDENTIALED STAFF.

How does this help you? Our valuation reports are developed and calculated according to the AICPA's standard rules, as outlined in their Statements on Standards for Valuation Services. The higher standards we follow allow us to meet the stringent requirements set forth by the Small Business Administration for lending under their loan programs as a **"qualified source of business valuations for lenders." With Fiducial, you can be assured that you will receive the highest standard of service in the industry.**

FIDUCIAL OFFERS SUCCESSION PLANNING SERVICES.

What is the process? The process begins with identifying and understanding your goals and business plans. Next, we'll explain the various options available to meet your goals. Based on your decisions, we will structure a plan that accomplishes your business transition goals.

Why choose Fiducial? By combining our expertise and our standards-based services we provide you the **opportunity to buy or sell a business at the right price.** Marketing or buying a business at a fair price will help expedite the transition process. Our credentials represent the higher standards we follow in valuing your business and are your guarantee that we provide an impartial report that will reflect the true value of your business.

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