Business Valuation

Since there generally is not a ready market for the sale of a closely-held business interest, a business valuation method is frequently used to determine the value of the business...a value that can then be used to satisfy a variety of estate, business and financial objectives.

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Why Do You Need to Know the Value of Your Business?

There are many reasons why the owners of closely-held businesses need to know the value of their business interests, including:

- For **estate planning purposes**, the value of the business interest may have a substantial impact on any estate taxes payable at the owner's death. In addition, the value of the business in relation to other estate assets can determine whether a deceased owner's estate is eligible for certain tax relief provisions, such as Section 303. Finally, a business valuation that meets certain requirements may fix the value of the business for federal estate tax purposes.
- For **business continuation planning purposes**, it is important to be able to determine the price at which a closely-held business interest will be sold at an owner's death, disability or retirement.
- The owners of closely-held businesses who plan to gift all or a portion of their ownership interests must know the value for **gift tax purposes**.
- A realistic business valuation can assist in obtaining **additional business loans**.
- Knowing the value of the business can be helpful in justifying to the IRS the **reasonableness of compensation** paid to owner-employees.

What Is the Value of Your Business?

The value of a business is usually defined in terms of **market value** or **fair market value**.

This means that the value of a business is the amount that a **willing buyer** would pay a **willing seller** for the business, assuming that both parties have knowledge of all material facts and neither is under any compulsion to buy or to sell.

In the case of **publicly-traded corporations**, value can be determined by the price that willing buyers will pay for the corporation's stock on a stock exchange.

In the case of **closely-held businesses**, however, there is generally no such ready market for the sale of the business interest. As a result, a business valuation method is frequently used to determine the value of a closely-held business...a value that can then be used to satisfy a variety of estate planning, business planning and financial needs and objectives.

IRS Guidelines for Business Valuation

In Revenue Ruling 59-60, the IRS set forth a series of factors for the valuation of a closely-held business. Those **eight factors** are:

1. **Nature and history of the business**, including factors that will affect the value of the business.
2. **Business environment**, including the national economic outlook and the ability of the business to compete within its industry.
3. **Company's financial position**, including book value and its growth.
4. **Earning capacity**, including earning trends.
5. **Capacity of a corporation to pay dividends**, considering the ability of shareholder-employees to substitute salaries and bonuses for dividends.
6. **Intangible values**, such as goodwill.
7. **Any previous sales of a corporation's stock.**
8. **Comparison with the value of similar companies**, such as publicly-traded corporations in the same line of business.

Since there is no one recommended approach to valuing closely-held business interests, these guidelines and their relative importance to the type of business should be closely considered. For example, the IRS tends to place considerable weight on earning capacity in valuing a business, particularly one that sells products or services.

What Methods Can You Use to Value Your Business?

There are a number of methods available for use in estimating the value of a closely-held business. These methods fall into four categories:

Fixed Price Method

After considering the valuations arrived at by other methods, the owners select a specific dollar amount at which each would be willing to buy or sell the business interest.

Book Value Method

The value of the business is equal to business assets minus liabilities. Book value can also be adjusted to reflect asset appreciation or depreciation.

Formula Methods

There are a variety of formulas that make use of business earnings and intangibles, such as goodwill, in valuing the business. These include:

- Straight Capitalization
- Capitalization of Earnings
- Years' Purchase or Discounted Goodwill

Combination Method

Several of the other methods are averaged together to arrive at a business valuation.

Let's see how these business valuation methods relate to your business. The valuations that follow must be considered illustrative. In order to accurately establish the value of your business, you should consult a professional with a specialty in business valuation.

Sample Business Valuation Profile

This is the information that has been used in developing the illustrative business valuations that follow:

Net Worth Information

Total Assets (Balance Sheet Value):	$	7,500,000
Total Assets Adjusted for Appreciation/Depreciation:	$	6,000,000
Total Liabilities (Balance Sheet):	$	2,500,000

Average Annual Adjusted Earnings

(Earnings net of taxes and ordinary business expenses, but adjusted for any extraordinary expense or income items and for owners' compensation in excess of replacement costs; most recent five years or number of years in business if less.)

2018:	$	9,000,000		
2017:	$	8,000,000		
2016:	$	7,000,000		
2015:	$	6,000,000		
2014:	$	5,000,000		
	$	35,000,000	÷ 5 =	$7,000,000

Capitalization Factor: 5

1-3 Unpredictable Earnings
4-6 Somewhat Predictable Earnings
7-9 Predictable Earnings

Reasonable Expected Rate of Return on Capital: 12%

8%-10% Low Risk Business
11%-15% Average Risk Business
16%-20% Speculative Business

Years Goodwill Expected to Last: 2

2 to 10 years

Using the Fixed Price Method

After considering book value and other valuation methods, the owners agree on a price for which they would be willing to buy or to sell the business interest.

Advantages

- This method is **fair** in that the price results from head-to-head negotiations between the owners.
- If provision is made for periodic adjustments, the fixed price method can be **flexible** enough to reflect changing economic conditions.
- This method is **straightforward** and **free of complex terms and formulas**.
- With a fixed dollar amount, it is possible to keep a buy-sell agreement **adequately funded at all times.**

Disadvantages

- Unless all pertinent factors that affect the value of the business are considered, the fixed price method may be little more than a **"guesstimate."**
- Quickly changing economic conditions can **invalidate** a fixed price, making fairly frequent re-determinations of the price more important.

Fixed Price Value

Based on your estimate, $5,000,000 is the fixed price value of this sample business.

Using the Book Value Method

A book value valuation is equal to business assets less liabilities, as listed on the balance sheet. Book value is essentially the liquidation value of a business.

Advantages

- An **easy-to-use** method of business valuation.
- A good **starting point**.
- May be **most suitable** for an investment or holding company, or for companies in which the death of an owner would cause goodwill to vanish immediately.

Disadvantages

- Unless all pertinent factors that affect the value of the business are considered, the fixed price method may be little more than a **"guesstimate."**
- Unless adjusted, does not take into account **asset appreciation or depreciation**.
- Ignores the value of **goodwill**.
- **Seldom a true measure** of the value of a business as a going concern, particularly when business earnings are based on the sale of products or services.

Book Value

Based on the information you provided, $5,000,000 is the illustrative book value of this sample business.

Balance Sheet Assets	$	7,500,000
Balance Sheet Liabilities	-	2,500,000
Book Value	$	5,000,000

Using the Straight Capitalization Method

The straight capitalization method estimates the value of the business as a going concern by taking intangibles such as goodwill into account. The value of the business is defined by the amount of capital that, given the predictability of business earnings, will produce the same earnings that the business has produced over the past several years (usually five). To be accurate, the capitalization factor, or multiplier, used should reflect the predictability of business earnings...the more predictable the earnings, the higher the earnings multiplier that should be used.

Advantages

- A **simple formula** that is easy to understand.
- Estimates the value of the business as a **going concern**.

Disadvantages

- **Does not recognize** the difference between net earnings and realized income **unless** earnings are adjusted to reflect only the replacement cost portion of owners' salaries.
- Selection of the **capitalization factor** is usually, at best, an **educated guess**.
- A **relatively small change** in the capitalization factor used can have a **substantial effect** on the business valuation.

Straight Capitalization Value

Based on the information you provided, $35,000,000 is the illustrative straight capitalization value of this sample business.

Average Annual Adjusted Earnings	$	7,000,000
Capitalization Factor	x	5
Straight Capitalization Valuation	$	35,000,000

Using the Capitalization of Earnings Method

Similar to the straight capitalization method, capitalization of earnings values the business by breaking down the company's value into two components: one attributable to tangible business assets (capital) and the second attributable to intangibles such as goodwill and management talent. A fair rate of return on adjusted book value (capital) is assumed. Any earnings above this return on capital are then attributed to intangibles and capitalized at a rate appropriate to the company's stability.

Advantages

- Takes into account both **book value** and **intangibles**, such as goodwill.
- **Adjusts book value** to reflect asset appreciation/depreciation.
- **Described by the IRS** in Revenue Ruling 68-609 as a way to value goodwill.

Disadvantages

- A **more complex** formula.
- **Guesswork** is involved in selecting a fair rate of return on capital and the capitalization factor, both of which can substantially impact the business valuation.

Capitalization of Earnings Value

Based on the information you provided, $36,400,000 is the illustrative capitalization of earnings value of this sample business.

Total Adjusted Assets	$	6,000,000	Average Annual Adjusted Earnings	$	7,000,000
Total Liabilities	-	2,500,000	Return on Capital	-	420,000
Adjusted Book Value	$	3,500,000	Earnings Attributable to Intangibles	$	6,580,000
Fair Rate of Return (12%)	x	.12	Capitalization Factor	x	5
Return on Capital	$	420,000	Capitalized Value of Intangibles	$	32,900,000
			Adjusted Book Value	+	3,500,000
			Capitalization of Earnings Valuation	$	36,400,000

Using the Years' Purchase or Discounted Goodwill Method

Similar to the capitalization of earnings method, the years' purchase method assumes that the value of intangibles such as goodwill does not extend beyond a specified number of years (2 to 10) after the business interest has been transferred to another party. To accomplish this, the capitalized goodwill figure must be discounted.

Advantages

- Takes into account both **book value** and **intangibles**, such as goodwill.
- **Adjusts book value** to reflect asset appreciation/depreciation.
- May be a **more realistic estimate** of the value of intangibles such as goodwill.

Disadvantages

- An even **more complex** formula.
- **Guesswork** is involved in selecting a fair rate of return on capital, the capitalization factor and years goodwill will last, all of which can substantially impact the business valuation.

Years' Purchase Value

Based on the information you provided, $29,727,551 is the illustrative years' purchase value of this sample business.

Total Adjusted Assets	$	6,000,000	Average Annual Adjusted Earnings	$	7,000,000
Total Liabilities	-	2,500,000	Return on Capital	-	420,000
Adjusted Book Value	$	3,500,000	Earnings Attributable to Intangibles	$	6,580,000
Fair Rate of Return (12%)	x	.12	Capitalization Factor	x	5
Return on Capital	$	420,000	Capitalized Value of Intangibles	$	32,900,000
			Discount Factor (2 years at 12%)	X	.0797190
			Discounted Value of Goodwill	$	26,227,551
			Adjusted Book Value	+	3,500,000
			Years' Purchase Valuation	$	29,727,551

Summary of Illustrative Business Valuations

		Illustrative Business Valuations
Owner's Fixed Price Estimate	$	**5,000,000**
Book Value Method	$	**5,000,000**
Straight Capitalization Method	$	**35,000,000**
Capitalization of Earnings Method	$	**36,400,000**
Years' Purchase Method	$	**29,727,551**

Combination Method

With the combination method, book value and the three formula methods are averaged together with the owner's estimate of business value.

Using the illustrative business values shown above, $22,225,510 is the illustrative average estimated value of this sample business.

Another Alternative: The Professional Appraisal

For those business owners who are uncertain about the value of their business and cannot come to a common agreement on the best valuation method, a third-party professional appraisal may provide the solution.

Advantages

- Owners are **relieved** of the periodic time-consuming analysis of valuation factors and methods.
- Periodic reevaluations are **not** necessary if the appraisal is to be done at an owner's death.
- An appraisal may yield a **more realistic valuation** based on a variety of techniques and factors.

Disadvantages

- **Appraisal fees** can be substantial.
- If the value of the business is not determined until after an owner dies, it may **not** be possible to develop estate, retirement and/or business continuation plans that provide the needed funding.

Important Information

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