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Certified Public Accountants

Business Valuation: 5 Reasons Why It's Important

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If you subscribe to the belief that it's not where you start, it's where you finish that's important, you'll agree that it is in your best interest to know how far you must go to reach your finish line. In Exit Planning, your finish line is the amount of cash you need from your company on the day that you sell or transfer it.

If neither your starting point nor the distance to the finish interest you, ask yourself this question: Do you think a sophisticated buyer will acquire your business without first determining its worth? No qualified buyer will do so. Thus, we strongly recommend that you not sell or transfer your business to anyone without *first* determining its worth.

Reason 2: Test Your Exit Objectives

As stated earlier, one of the first questions you'll answer as you set your Exit Objectives is, "How much will I need from the sale of my company to maintain the lifestyle I want for myself (and my family) in retirement?" The companion question should be, "Is the business worth enough (on an after-tax basis) to support those needs?" You must know this answer before you can successfully proceed down any Exit Path.

Let's assume that you decide that your finish line (financial objective) is to receive $7 million (after taxes) from the transfer of your business interest. You also want to complete your race in three years (timing objective). An estimate of value will tell you whether the distance between today's value and the finish line is too great to reach in three years. If a growth rate is unrealistic for your business, you must either extend your timeline or lower your financial expectations.

Reason 3: Basis for Tax Planning

As you consider various Exit Paths (e.g., sale to a third party or a transfer to insiders), understand that each Path has different tax implications. Without appropriate tax planning, taxes can take a huge bite out of your sale proceeds.

For example, in a transfer to key employees, a common transfer technique (designed to reduce both the owner's and buyer's tax liabilities) is to initially transfer a minority interest at a discounted value. Using a rule-of-thumb valuation to support a minority discount simply will not fly when the IRS asks you to justify the discount. You must depend on the valuation of an independent valuation specialist who is able and willing to defend the valuation before the IRS.

Given that tax-mitigation strategies often take years to implement, it is critical that you start planning well before you exit and that you use an accurate estimate of value.

Reason 4: Litmus Test

Suppose an owner is ready to leave the business, but only if that exit yields financial security. That owner must calculate the amount of cash needed to assure financial security and subtract the value of the business today from that number. The resulting gap tells the owner how much value he or she needs to create to meet his or her objectives. It also shows where he or she needs to concentrate his or her time and effort. Instead of growing value just for fun, dedication to a goal enables many owners to exit sooner and with the same amount of after-tax cash than owners who do little or no planning. Exit Plan success always begins with a starting value. Let's look at two other factors that determine the accuracy of your litmus test.

Target Buyer

It surprises many owners to learn that business value is relative, not fixed. It can vary based on the owner's choice of successor or the conditions under which a transfer is made. For example, an appropriate business value for a third-party sale may be significantly higher than the value established for a transfer of the same business to key employees over time or the value of a gift of the business to children. Business-valuation experts understand this; rules of thumb don't.

If you are contemplating a sale to a third party, the business value is dependent on not only the intrinsic value of the business but also the "external" condition of the mergers and acquisitions (M&A) market for that type of business in that particular geographic area. The M&A cycle is continually changing based on a variety of factors, such as the cost of financing, the state of the stock market, and the availability of capital. The market can dictate not only your EBITDA (earnings before interest, tax, depreciation, and amortization) multiple but also the terms of a possible third-party deal (e.g., how much of the deal price is to be paid in cash, a seller carry-back note, or earn-outs).

Buy-Sell Agreement

Value is not only relative based on successor choice; it also fluctuates depending on how the owner plans to use the valuation. In co-owned companies, unless owners periodically update the business value established in their buy-sell agreement, one owner may receive too much or too little upon death, disability, or departure while the other may pay too much or too little. Outdated valuations often result in litigation (and subsequent loss of business value), as the slighted owner often chooses to go to court.

Reason 5: Provides Owners (and Employees) an Objective Basis for Incentive Plans

An important part of any Exit Plan is to grow business value. Whether you contemplate a transfer to insiders or a sale to outsiders, you must motivate and keep your management/key employees within the company.

To keep key employees from exiting with them, owners use incentive programs that both motivate and "handcuff" employees to a company. These plans are typically based on formulas, and the most successful of these incentive programs (whether cash- or stock-based) use formulas that link the size of a bonus to growth in business value.

Participating employees are justifiably interested in knowing how the business' value was established, how it is measured, and whether the value is fair. Relying on an outside appraiser is often the best way to dispel management/key employee concerns.

If you are considering a transfer to key employees, do you expect your employees to accept an unsupported valuation? Understand that they likely have little sense for what the business is worth or how its value should be determined. Even though you may decide to sell the business at a low value (for tax and other reasons), employees may not consider the "low" value to be low to them. Anticipate these concerns and use an independent valuation to allay them.

Cost

The cost of an estimate of value can range from $0 to $25,000, depending on who performs the valuation. If you use a free online valuation software, it may be free. If you use transaction intermediaries, non-certified advisors, or certified business appraisers, the cost can fluctuate depending on, among other factors, the level of expertise you seek. The cost for an estimate of value can also reflect the complexity of the business and the region of the country in which your company does business.

For a "normal" business with $10 million or so in revenue, a valuation typically costs $5,000–15,000, and an estimate of value costs 60–75% of that amount. When the value calculation is upgraded (usually just prior to the sale), the valuator will likely charge an additional 25%.

With many experts clamoring for your business, who should you use? Look for a **credentialed valuation expert**, unless you own a very small business that has no proprietary technology, such as a small retail store, franchise restaurant, or service business with only a few employees. Common certification designations include certified valuation analyst (CVA), American Society of Appraisers (ASA), accredited in business valuation (ABV), and certified business appraiser (CBA).

Failure to Value

The cost of a valuation may seem too high or just plain unnecessary at first glance. However, compare it to the cost of the following:

1. Leaving money on the closing table because you underestimated the company's value.
2. Appearing before the IRS to defend a rule-of-thumb value that is unprotected by a proper valuation.

An estimate of value at the outset of planning helps you target your value-building efforts and move efficiently toward a goal. Don't let the initial costs frighten you, because the costs of failing to obtain an accurate valuation can make the initial costs look like pocket change.

Conclusion

At some level, we all recognize that we will leave our businesses some day. While you may not yet have a vision for your life after the business, you do understand that your exit from your business is likely to be the largest, most important financial transaction of your life. Does it make sense to go into that transaction and life after business without an objective understanding of your company's value? We don't think so, and we'd like to help you plan for the most important financial decision of your life today.

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