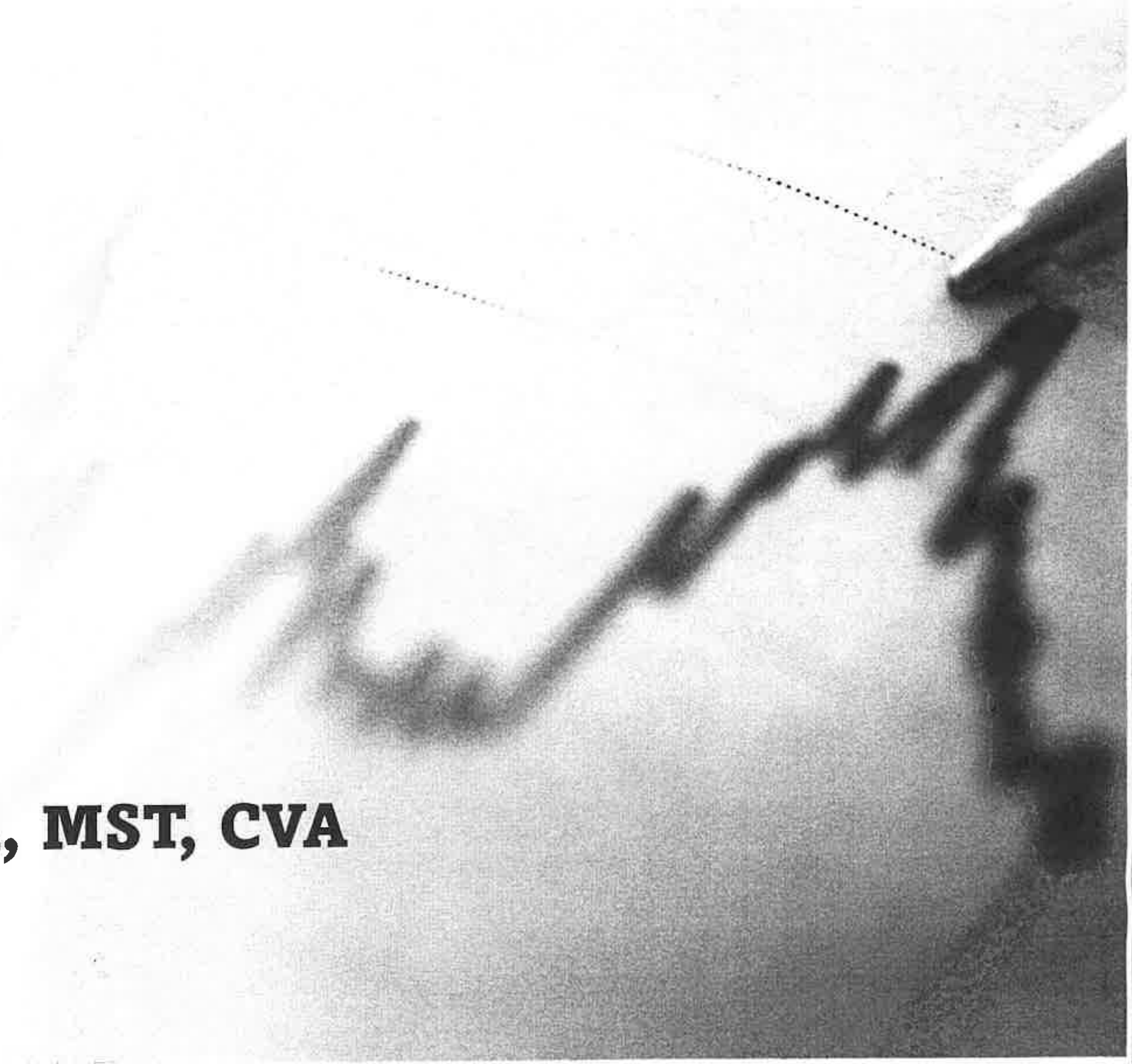
Business Valuations



Tony Wimperis, CPA, MST, CVA
Tax Director

Business Valuations In General

- Purpose: To determine an objective, supportable value of a business
- Deliverable: Formal valuation report - includes a full analysis of all factors and details supporting the resulting value
- Valuation methodology is both art and science!
- Valuation principles rely on basic finance theory, IRS Revenue Rulings, tax court cases, and other sources

Definitions of Value

1) Standards of Value

- **Fair Market Value** – Most widely used for estate and gift valuations under Revenue Ruling 59-60 – willing buyer, willing seller under no compulsion to buy/sell and all parties have relevant knowledge of facts
- **Fair Value** –Similar to above-but definitions differ based on various authorities– including FASB (U.S. GAAP), state governments, and others
- **Strategic/Investment Value** – Value an individual investor is willing to pay for a company based on their subjective goals/opinions

2) **Premises of Value**

- **Going Concern Value** – Value of a business expected to continue operate in the future
- **Book Value** – Assets minus liabilities according to a company's balance sheet
- **Replacement Value** – Current cost of similar new property
- **Liquidation Value** – Amount of cash received if business assets sold piecemeal

Valuation Approaches

1) Income Approach – Value determined on the annual income a business earns for the owner

- Simplest Method for Value = Benefit Stream/Discount Rate (function of risk)
- Benefit Stream - amount of cash profits that business owner provides to its owner
- Discount Rate- measure of risk/time value of money

2) Market Approach – Value determined based on meaningful comparisons of what other businesses are selling for using:

- Data from completed sales of private companies
- Data/metrics from publicly-traded companies in same industry/markets

3) Asset Approach – based on value of all assets on company's balance sheet – minus liabilities.

Quick Example

ABC Company generates $100,000 per year for its owners, and will earn approximately the same amount per year in all future years as a going concern. If the valuator assesses a discount rate of 10%, what is the company worth?

$100,000 cash flows/10% discount rate = <u>$1,000,000</u>

The Discount Rate = The Key to Value

- **Biggest factor that drives value up or down**
- **Measures the risk of a business on time value of money basis-- no risk, no reward!**
- **Valuation professionals compute the discount rate based upon:**
  - **The long-running performance of S&P 500 PLUS**
  - **Company Size**
  - **Industry-Specific Risks**
  - **Company-specific risks, such as:**
    - **Quality of management**
    - **Ability to access capital/financing**
    - **Quality of customer base**

Valuation – Business Owner Tips

- **Value depends on decisions you make to reduce risk (discount rate) and/or increase cash flows.**
- **Most valuations are based on past five years of earnings**
- **Industry rules of thumb are helpful guides for reasonableness ONLY**
- **Formal business valuation reports are expensive/time consuming – but:**
  - **Provide solid ground for value for sale negotiations**
  - **Required for estate/gift purposes**
  - **You learn more about your business in the process!**

Questions?

Contact Tony Today!

Tony Wimperis - CPA, MST, CVA | Tax Director
90 Grove Street, Suite 101, Ridgefield, CT 06877
51 Locust Avenue, Suite 301, New Canaan, CT 06840
Direct: (203) 518-4989
Tonyw@reynoldsrowella.com

Learn more about our services at reynoldrowella.com

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