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## Who Pays When a Retailer Is Hacked?

# The Art of Business Valuations

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***"A great business at a fair price is superior to a fair business at a great price"***

***- Charlie Munger***

Charlie Munger's intriguing quote is one that begs two questions: what type of business and what is it worth? Businesses can be considered great for a variety of reasons. They may have superior products or services, an exceptional salesforce, or attractive real estate holdings. All of these things may be attractive to potential buyers, but how do they know what these things are worth and how do they know they are getting a fair price when purchasing a business interest? Many of us deal with this challenge in our daily lives. Whether we are shopping for a flat screen television, buying a new car, or buying stock, determining something's value and making sure we are getting a good deal can be a daunting task to say the least. While it may be impractical to pay someone to help us determine the value of small personal items, when large sums of money are at stake, a prudent buyer should employ a seasoned valuation professional to perform a detailed business valuation to assist them in making their decision. Not only will the buyer develop greater comfort over the purchase price, the valuation report may help them secure the necessary financing for the purchase.

Most people hear "Business Valuation" and think they can calculate value by using three times EBITDA, five times sales, or some other arbitrary metric. Employing these bar napkin approaches is often as useful as throwing darts at a dartboard. Approaching a business valuation in this way can lead to a grossly over or understated value. A proper business valuation not only considers multiples of past performance, but also incorporates a great deal of non-financial data into calculating value, making the process much more of an art form than a science.

**Valuations can be used to assist with these scenarios, to name a few:**

- Mergers and acquisitions
- Sales and divestitures
- Loan applications
- Personal financial statements
- Martial dissolution
- Buy/sell agreements
- Fairness opinions
- Shareholder transactions
- Raising capital
- Employee Stock Ownership Plans (ESOPs)
- Litigation support
- Expert testimony
- Estate planning and tax
- Gift taxes
- Allocation of purchase prices
- GAAP valuations for financial statements
- Bankruptcy cases
- S corporation elections for the built-in gain potential

When performing a business valuation of a closely held entity, IRS Revenue Ruling 59-60 is among the most important and often cited revenue rulings and provides valuators with the most authoritative guidance. This ruling gives professional business valuators guidelines that must be followed and methods that must always be considered. Key methods cited in this 1959 ruling still hold true today. The ruling instructs valuators to consider all of the following methods each time they are performing a valuation engagement: comparable price, asset or income method. Each method takes a different approach in calculating value and each is appropriate under different circumstances.

Prior to considering any of the methods outlined the most critical and often most overlooked item when performing a business valuation is identifying the purpose. Valuations are classified as either tax (estate tax, gift tax, ESOPs, etc.) or a nontax valuations (purchase, sale, buy/sell agreements, etc.). Matching the purpose of the valuation to the methods selected is critical and highlighted best by Pratt, Reilly, and Schweihs in Valuing a Business – 4th edition, McGraw-Hill:

> "No single valuation method is universally applicable to all appraisal purposes. The context in which the appraisal is to be used is a critical factor. Many business appraisals fail to reach a number representing the appropriate definition of value because the appraiser failed to match the valuation methods to the purpose for which it was being performed. The result of a particular appraisal can also be inappropriate if the client attempts to use the valuation conclusion for some purpose other than the intended one."

After identifying the purpose of the valuation classifying it as a tax or nontax valuation, the valuator will need to know the terms under which the valuation is to be performed. Valuations are defined by two different sets of parameters: the standard of value and the premise of value.

There are three different standards of value as defined below:

1. Fair Market Value which is defined by IRS Revenue Ruling 59-60 to be "The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."
2. Fair Value as defined by the Financial Accounting Standards Board: "Fair value is the price that would be received for an asset or paid to transfer a liability in a transaction between marketplace participants at the measurement date"
3. Strategic or Investment Value is defined as a unique value to an individual based on their specific requirements and expectations, or on a strategic basis, such as eliminating competition in the marketplace or vertical integration.

After the standard of value is selected, the premise of value must be determined. The premise of value falls into four main categories as listed below; they may also be broken down into various subsets as well:

1. Book Value – the difference of the total assets and total liabilities on a balance sheet
2. Going Concern Value – the value of a business that is expected to continue operating into the future
3. Liquidation Value – the value of the business if terminated and the assets sold off, either in an orderly or forced manner
4. Replacement Value – the cost of similar new property that is nearest to the property being valued (value to replace)

After understanding the reason for the valuation, the standard of value, and the premise of value, it is now appropriate to gain an understanding of the entity that is being valued. Understanding the business plays a pivotal role in a valuation and can on occasion cause nonfinancial facts to become as relevant as or even more relevant than financial facts. For example, what does the sales force look like in a small family business? Is the owner the only sales person? If the business gets purchased, who is left to sell their products or services? What does employee turnover of key personnel look like? Is there a concern because upper management seems to be changing every six months? Answers to these questions can

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cause doubt about an entity and its ability to survive a purchase or question the ability of the business model to generate future revenue from existing assets if there are inherent issues that the financial statements themselves would not address.

Don't misunderstand – financial information is important, VERY important! Yet financial information isn't quite as useful unless it can be compared or benchmarked to industry data. Closely held businesses are not like publicly traded stocks. Luckily there are service providers who offer comparable data such as the Risk Management Association (RMA), which provides comparable industry data based on the North American Industry Classification System (NAICS), and the Standard Industrial Classification (SIC) codes. These data sources, like many others, give valuable comparable balance sheets, income statements, and financial ratios that can be used to benchmark a company's financial information with peers above or below them.

Another major issue valuators face with financial information is the accounting method, Generally Accepted Accounting Principles (GAAP), used for preparation because it relies heavily on historical cost. As a CPA, there are two words that get spoken more than any other: tax and GAAP. Yet GAAP is not very helpful when it comes time for a business valuation. In fact, it can make the job of valuing a business harder and perhaps more costly. Why, you might ask? Let's consider a building that was purchased in 1965. The GAAP financial statement says the building is worth very little, yet in reality the owner could probably sell the building at a much higher price. Value needs to be today's value, not yesterday's and yesterday's value is what GAAP presents to its readers. What does this mean for a valuation? Valuators need to convert historical information to fair market value. The costly part comes into play because any assets need to be converted to fair market value (potentially) based on the approach taken by your business valuator. Imagine you own a lot of commercial real estate. Now imagine the price you are paying to get each property valued? GAAP could have just potentially increased your cost a few thousand dollars!

If all of the steps above have been considered, i.e., the reason for the valuation, the standard of value, the premise of value, a thorough understanding of the company and its financial position, it is now time to address the valuation methods to be applied. As stated previously, each valuation under IRS revenue ruling 59-60 needs to consider an asset method, comparable price method, and income method but within each category are a gamut of options to consider. Let's take a look at each method, circumstances under which it would be used, and the various approaches under each.

The Asset Method is considered by many to be the "base line" or bottom to a value of a business. The asset method seeks the economic worth of the tangible and intangible, recorded and unrecorded assets, less the outstanding liabilities of a company. The asset method is valuable for developing a base line value for a business but is often rejected by a valuation analyst since it does not take into account the ongoing business operations. This method is often used, however, in the situation of a holding company. The two most commonly used approaches for the asset method are the book value method and adjusted net asset method. The adjusted net asset method adjusts all assets and liabilities (including deferred taxes and built-in gains tax) to their fair market value in determining the value whereas the book value method simply uses the equity of a company as the value.

The Income Method is defined in the International Glossary of Business Valuation Terms as "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount." The means of coming up with a benefit stream to turn into a value can take multiple shapes. Some common methods are:

- Capitalization of earnings method
- Discounted cash flow method
- Gordon Growth Model

These methods try to accomplish the same goal of using projected income or cash flow and discounting that back to the present value. This method is widely accepted and most easily utilized. The disadvantage is the amount of subjectivity used in selecting a discount rate and a growth rate used to determine the value of the income or cash flow.

The Comparable Price Method or Market Approach utilizes comparable guideline companies for already completed and known transactions and applying multiples from those transactions to the company being valued. This approach is difficult to utilize due to the limitation of the availability of reliable data. However, if reliable data (both timely and comparable) is available, this method is appropriate in most situations since it relies on actual market data. Once data is selected, parameters must be selected on the data to be able to compare to the valued company to arrive at a price. Some common examples of parameters used are as follows:

- Revenues
- Gross profit
- EBITDA
- EBIT
- Debt-free net income
- Debt-free cash flow
- Cash flows
- Pretax income

After calculating values under each method, many additional adjustments for discounts need to take place. Control and lack of marketability discounts are the two most commonly used other discounts below may also be appropriate given the circumstances:

- Key person discount
- Investment company discount
- Information access and reliability discount
- Lack of diversification discount
- Restrictive agreements discount
- Small company risk discount
- Specific company risk discount
- Built-in gains tax discount

Valuations are an art form that is developed from experience and education. If knowing the approaches, learning the skills, and developing your own art form isn't enough, valuations are like tax law where there are a constant flow of new court cases modifying current approaches and offering completely new ones. For these reasons, it is important to have a valuator who is knowledgeable and well-versed in this art form and it is your client's best chance at having a valuation report hold up, whether in court or with the IRS.

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