# What is your business worth?

## An overview on business valuations?

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**Authored by our Business Advisory Services Team**

## What is a Business Valuation?

A **business valuation** is a determination of the worth, or fair market value of a business. It's a way to measure how much your business is worth. Understanding how your business is valued ensures you are maximizing your return on investment so when transitions happen, you can get the most value for your ownership interest.

# What Are Some of the Factors that Create Value for a Business?

Some of the most common value drivers in any company, which – when proactively addressed – are building blocks that may improve the company's financial health. A few of the most important driving factors are consistent cash flow, a strong management team, and growth. Some things that can subtract from your value are lower industry comparisons, non revenue producing assets, working capital deficit, or borrowing on your line of credit more often compared to others in your industry.

What does the impact of aging equipment or real estate have on business value? Does that matter to a valuation? Yes, it does. When valuing a business, we compare the cash flow generated from the operating assets to the fair market value of the operating assets. This allows us to identify whether your business is getting the best return from your operating assets. This can help a company determine if you have under producing or impaired operating assets.

## What Are the Two Different Types of Business Valuations?

### » Calculation Engagement (Calculated Value)

For this method, the valuation professional and client must agree in advance on the approaches and methods that will be used to value the business. The value may be either a single amount or a range. Independence is not required. Independence means that the Certified Valuation Analyst (CVA) or valuator who conducts the valuation and the organizations they represent have no financial interest in and are otherwise free from conflicts of interest regarding the business they value. This type of engagement does not require all of the valuation approaches required for a conclusion of value engagement.

### » Valuation Engagement (Conclusion of Value)

The expert needs to be independent. It involves the valuator using all three valuation methods (asset-based, income-based, and market-based) and picking which one they think is most appropriate for that valuation. This method holds more weight with the courts and IRS. Because this method requires more detailed analysis and results in the valuator giving an opinion of the value, it is typically more costly. The valuation expert is expressing an independent conclusion of value, applying all applicable approaches and methods that are deemed necessary. The results of the valuation are expressed as a conclusion of value, and the conclusion can either be a single amount or a range.

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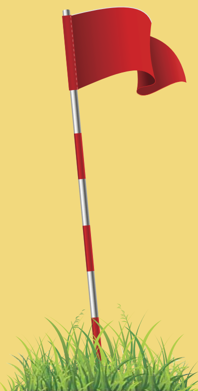
CDS also provides transactional guidance with an **"indication of value" or an abbreviated summary** that can be used as a consulting tool to guide owners during transitions or to plan for the future. We're here as advisors to help you with a transaction or help you to fine tune your balance sheet to look the best it can to get the most value for your company.



## What Are Common Red Flags to Look for in a Valuation?

### Errors from non-experts

- A CPA is not qualified to value a business, however some CPAs also have their valuation credentials (most commonly CVA or ABV)

### Errors from CVAs

- Selection of inappropriate income stream
- Failure to normalize income and expenses
- Failure to match income stream and cap rate (pre or post tax)
- Not establishing a clear understanding of the entity

# When Should a Company or an Owner Obtain a Valuation?

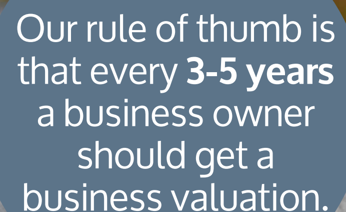
Business valuations can be divided into two different groups:

1. Business valuations that "must" be done in reaction to an event like dispute, divorce, death, or gifting purposes.
2. Business valuations that "should be" done by proactive management searching for ways to maximize value, make better business decisions, develop succession plans, and prepare for possible future events. The best time to conduct a valuation engagement is long before a triggering event occurs – as the first step in succession planning rather than the last.

**Business Valuations and Litigation Consulting Services Are Most Commonly Required in Conjunction with:**

- Estate & Gift Tax Planning
- Buy/Sell Agreements
- Purchasing a Business
- Equity or Debt Financing
- Marital Dissolution
- Succession Planning
- Retirement Planning
- Litigation Support
- Employee Stock Ownership Plans (ESOPs)
- S Corporation Election
- Spin-Offs
- Charitable Contributions
- Specialized Tax Matters

To summarize, sometimes valuations are required based on some proposed transactions or events, while other times they are provided as a guide to help make better business decisions or long before a triggering event such as the first step to succession planning. Our rule of thumb is that every **3-5 years** a business should get a business valuation. If owners are considering selling a business, a business valuation should be completed **3-4 years** prior to selling.



# What Are the Primary Valuation Approaches?

There are three acceptable methods that valuation analysts can use to perform a business valuation: the asset approach, the income approach, and the market approach. Each method may at times appear more theoretically justified in its use than others.

## Asset Approach

This method uses the fair market value of the assets of a business, less any related liabilities. In most cases, the analyst considers the value of the net assets in the context of a business that will continue to operate. If the business includes real estate or specialized equipment, separate appraisals for those assets may be needed.

The asset-based approach usually does not incorporate the value of certain intangible assets, such as reputation, brand, customer relationships, and a well-trained workforce. These are often referred to as goodwill or "blue sky". As a result, it frequently results in the lowest value of the three methods and may be used to set a "floor" for the value of the business.

**Example:** A good example that uses the asset approach is a real estate holding company.

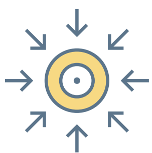
## Income Approach

The income approach determines the value of a business based on its ability to generate future income for the owners of the business. If the trajectory of future earnings will be stable, the analyst can use capitalization of benefits methodology. This method involves applying a fixed growth rate to a single measure of future income. If some variability is anticipated, the discounted future benefits method is generally used. This method involves building a two-stage model consisting of a forecast period and a terminal period or period of performance expected to continue in perpetuity.

Once the future income stream is determined, the valuation analyst applies a discount rate to the future earnings stream. This discount rate must be developed and applied carefully, as small changes in the discount rate can produce significant changes in value.

A discount rate is determined using a normal rate of investment return and risks specific to the industry the entity operates in, as well as entity specific risks such as size, management experience, and customer concentrations.

**Example:** A good example of an industry that uses the income approach is manufacturing.



## Market Approach

The market approach is a method of determining the value of a business based on the selling price of comparable businesses by size and location. The analyst can use either data on publicly traded companies, or data on the sale of comparable privately owned companies. This method generally relies on pricing multiples, usually of revenue or some measure of profit to determine the value.

**Example:** This method works well for franchises such as restaurants with good comparables.

## We're Here To Help!

We highly recommend revisiting your valuation annually to determine whether any business or operational changes might have an impact on the value. If needed, consider getting a new valuation. If you have any questions or need help analyzing your business situation, feel free to reach out to us at (888) 388-1040 or visit our website at cds.cpa. You have access to an accredited team of 5 CVAs with over 20 years of combined experience.

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- We provide a wide range of services at a level that exceeds your expectations.
- G400 CPA firm, serving clients across the country.

Listen to our two-part podcast series on business valuations. Visit our website at:
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