



10 Things Every Client and Advisor Should Know about Business Valuation

A Business Valuation is a unique and significant undertaking, and the initial communications between client, advisor(s) and the business valuator are critical to getting the valuation process started in an efficient manner. HBK's Valuation Group offers these "up front" considerations from the Business Appraiser's perspective.

1. **Clearly Describe the Proposed Valuation:** In order to understand the Client's specific needs, and estimate engagement fees and time required to complete the analysis and prepare the report, the valuator needs basic information, including:
 - The reason for the valuation (gift, sale, etc.), and a summary of the business and current ownership interests; and an explanation of how the report will be used
 - A description of specific ownership interest(s) to be appraised (included number of shares/units and percentage interest)
 - The level of value for the interest being valued (control or lack of control); do not hesitate to discuss and clarify this important factor
 - A specific valuation date
 - Consideration of any relevant assets or other ownership interests requiring appraisal

When you are working for the first time with a business appraiser, besides clarifying the engagement, review of these issues establishes rapport and lines of communication necessary in the subsequent valuation process.

2. **Establish the Standard of Value:** Different standards of value are called for under certain circumstances depending primarily on the reason for the valuation. Gift and estate tax compliance valuations are based on "fair market value". Certain legal jurisdictions require "fair value" in dissenters' rights and divorce cases. "Investment value" may be appropriate when considering the sale or acquisition of a business; and "liquidation value" may be appropriate in certain cases. The standard of value dictates certain assumptions and estimates to be considered by the appraiser that significantly impact estimates of value.

3. **Be Familiar With Levels of Value:** Ultimately, an estimate of value will reflect the control authority inherent in the ownership interest being valued, or it will reflect the lack of control inherent in a minority interest. Simply stated, within one business, a share of stock or partnership unit has varying levels of value depending upon whether a control, or minority,

owner holds it. Typically, real or hypothetical transactions take place at the control (higher) level of value or at the non-marketable minority (lower) level.

4. Get the Valuator Involved: An experienced and qualified valuator may be able to provide some insight and explanation on valuation related issues with respect to drafting documents and agreements.

5. Distinguish Between a Business Appraisal and Another Type of Appraisal: Typically, business valuers are not qualified to appraise tangible assets such as Real Estate or Machinery and Equipment. Business Valuation focuses on earning power, quality of management, competitive position and the ability to sustain an adequate return to the owners over time. However, there are circumstances in which value is based more on underlying asset value and less on earning power or cash flow. For valuations of asset holding entities (such as limited partnerships and investment companies), and for some businesses with minimal earnings but owning appreciated tangible assets, tangible asset value takes on greater significance. Asset value may be greater than value based on low earnings or cash flow. A business valuation engagement may require a real estate appraisal or other tangible asset appraisal; and this issue should be discussed early on.

6. Study, Analysis and Reporting Take Time: The valuator is subject to meeting professional reporting requirements; and a valuation is a comprehensive study of many factors. HBK offers two articles, *The Valuation Process* and *Factors Considered in the Valuation of a Closely Held Company*, describing the broad and in-depth nature of this specialized work. Typically, and after receipt of requested information and a lengthy management interview, the valuation process takes at least thirty days until a draft report is completed. Avoid rushing a valuation engagement. On the other hand, avoid allowing the process to drag on: the valuator should push to complete the draft report on time. Initial communication (see #1 above) and frequent, on-going communication during the process is a key to completion on schedule.

7. Be Familiar With Business Valuation Methods: Business valuation is dependent on qualitative analysis and the valuator's judgment, including the most appropriate valuation methods for a particular assignment. Income approaches to valuation are most common and include an estimate of future benefits to stakeholders converted to present value through application of a discount rate built up by the appraiser. The discount rate is the required, risk-adjusted return adequate to attract capital to a relatively risky small company. A seller's discretionary cash flow method may be appropriate for smaller companies in which the underlying economic premise is value is based a job, not a return on investment. Market approaches to valuation are less common because of the limited private company data available and the complexity and expense when applying a guideline public company method. However, the valuator is required by professional standards to consider the market approach; and the federal tax courts prefer market-based valuations. Asset-based approaches were mentioned in #5 above and usually require information from brokers of other appraisers. Advisors can sanity check the methods and risks considered by the valuator and add value by asking: "Did you consider ...?"

8. Is a Comprehensive Valuation Worth It? A well-prepared valuation report including substantiation and documentation of all key valuation information directly addresses the needs of a client in various circumstances. It is a critical part of an estate plan, and the client's best defense against adversarial scrutiny by the IRS or opposing legal counsel. A business valuation can be a key component in long-term business and strategic planning; and it may help investment advisors evaluate rates of return and the performance of assets in the client's portfolio. The cost of service compared to the costs at risk or profit potential are often very small. Fees are usually market-based and competitive; and in almost all circumstances clearly cost effective. Do not hesitate to discuss fees and "cost-benefit" with the appraiser; and beware of low fees logically indicative of poor quality and unreliable work. Written valuation reports that reflect quality, persuasiveness and reliability are a bargain. Poorly written and unsubstantiated reports reflecting obvious lack of expertise may become extremely expensive.

9. Litigation Support Issues: Help to preserve the valuator's independence. Tax Court opinions refer to the unpersuasive and biased testimony of valuers viewed by the Court as mere mouthpieces for their clients. Do not expect the valuator to be an advocate or results-oriented.

10. Adequate and Relevant Market Data: Nothing distinguishes a solid and reliable valuation report from a weak and unpersuasive report more than the valuator's use, analysis and presentation of capital market data. The essence of valuation is the combining of rates of return, risk assessment and good judgment in credible fashion throughout the valuation report. Whether estimating company value or quantifying an appropriate minority or marketability discount, use of proper data and effective analysis techniques mark the reliable, credible valuation report.

How Can We Help You? Contact Us

The business valuation profession is attempting to spread the word that valuation knowledge and methodologies can be powerful business planning and problem solving tools. HBK business valuation experts are using valuation techniques and resources to add value to existing client services.

The Hill, Barth & King LLC web Site address is www.hbkcpa.com. Information about our firm and the Valuation Group is available. Our firm headquarters are located at 7680 Market Street, Boardman, Ohio. The telephone number is (330) 758-8613.

Please send any e-mail to jevans@hbkcpa.com with questions or comments.

Inquiries to discuss specific valuation or transaction advisory matters are welcomed.

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