



Business valuation is a process that helps determine the value of a business. A good business valuation may reduce future disagreements about the value of the company, and is usually necessary when the parties enter into a buy-sell arrangement. A business valuation may produce a value that can be relied upon for federal estate tax purposes, as well as to determine an appropriate amount of life insurance needed to fund the buy-sell arrangement.

WHEN IS BUSINESS VALUATION NEEDED?

There are several instances when business valuation is important. Proactive planning can avoid future disagreements, confusion, and possible litigation expenses of a valuation dispute. Here are a few examples of when business valuation is needed:

- Sale of a business interest.
- Death of a key owner.
- Retirement or disability of an owner.
- Estate planning and current gifting of shares of an interest in a business.
- Divorce of an owner.
- Bankruptcy or insolvency of an owner.

TYPES OF BUSINESS VALUATIONS

There are several different business valuation methods, including: fixed price, book value, capitalization of earnings, appraisal, cut throat, and a combination of the book value and capitalization of earnings methods. Depending upon the circumstances, one type of valuation method may work better than the other methods.

Fixed Price Method

In the fixed price valuation method, the shareholders periodically fix the price by agreement. This method is the simplest. However, since the price may not be adjusted for changes in value, the purchase price may prove to be unfair to the selling shareholder.

Book Value Method

This method uses the book value of the business as recorded on the company books and financial statements. It will usually produce the most reliable result when book value is determined by an independent audit. The book value valuation method takes the net assets and subtracts the net liabilities to determine the value of the business (assets – liabilities = book value). This method can also use a multiple of book value, since historical records may not reflect the actual value of the business. One main advantage of using this valuation method is that parties typically cannot dispute the valuations (an audited value of the balance sheets contains the amount of assets and liabilities at any given time). The main disadvantage of this method is that it may not reflect the true market value of the business.¹

Capitalization of Earnings Method

The capitalization of earnings method multiplies earnings by a capitalization factor. This factor is generally obtained by analyzing the price-earnings ratios of comparable businesses in the same industry for a specific period of time. The time frame to consider earnings is usually not less than five years and not more than ten years. This method works best when business earnings remain stable for a period of time. One disadvantage to this method is that comparable business considerations in the same industry may not be appropriate.

Appraisal Method

In the appraisal valuation process, an outside third party appraises the value of the business. Typically, the outside appraiser will issue a report which discusses the various valuation options available. One of the advantages of this method is that a history and trend of the industry can be obtained from a survey group of accountants, economists, and investment advisors. One disadvantage is that the appraisal report is just one opinion, and it is unlikely that two experts will agree on the same value.

Cut Throat Method

The cut throat valuation method is used at the time of sale. A shareholder that is selling his or her interest in the business will offer shares to the other shareholders at a price determined by the seller. If the other shareholders do not purchase the shares at this price, then the seller must buy the shares of the other shareholders at that price. In theory, this method sets a fair price. However, it favors the shareholder with the deepest pockets. This valuation method typically works best for the lifetime sale of businesses with two equal or almost equal owners.

Book Value and Capitalization of Earnings Method

This method is a combination of the book value and capitalization of earnings methods. This method potentially gives equal weight to each method to arrive at a value of the business. One advantage of this method is that it gives the owners more flexibility to derive a purchase price. One disadvantage is that it requires additional consideration and agreement by all parties involved.

CONCLUSION

The process of determining the value of a business can be as complicated, or as simple, as the owners want it to be. It all depends on what type of method works best in any given situation. John Hancock has a Buy-Sell illustration system, which illustrates four of the methods discussed above: book value, appraisal, capitalization of earnings, and the combination of book value and capitalization of earnings.

1. Generally accepted accounting principles (GAAP) require the use of historical figures. A detailed discussion of GAAP is out of the scope of this piece. Please consult your accountant for more information.

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