

Abstract: Whether it's an impending ownership transfer or just a need to learn more about one's company, every business owner needs to establish reasonable expectations of what a valuation provides. This article answers several insightful questions about the process and goes on to dig deeper into this important management tool.

Be ready for anything with regular business valuations

Do you know the current value of your business? Even if you're not considering selling your company or otherwise transferring its ownership right now, it could happen sooner than you think.

In some cases, an ownership transfer becomes suddenly appealing when a company struggles to the extent that a sale becomes the best avenue for starting over. But more positive circumstances can drive the decision, too. For example, a small to midsize business might do so well that it receives an acquisition offer that's too good to pass up.

Whether it's an impending ownership transfer, or just a need to learn more about your company, it's important to establish reasonable expectations of what a valuation provides.

Answering the right questions

Some owners mistakenly believe that the balance sheet tells how much a company is worth. But most businesses possess goodwill and other intangible assets — as well as unreported liabilities — that don't show up on the financial statements.

In truth, cost-based valuation metrics aren't often used in real-world transactions. Instead, the most popular methods for valuing private businesses include the discounted cash earnings, guideline company transactions and capitalization of earnings techniques. Calculating value under these methods requires the expertise of an outside valuation professional.

To better understand the valuation process, answer these basic questions:

What's the purpose? It could be as clear-cut as an impending sale. Or perhaps a divorce is on the horizon, and the owner must determine the value of the business interest that's includable in the marital estate. In other cases, the valuation may be driven by tax, estate or strategic planning.

What's the appropriate standard of value? Generally, business valuations estimate “fair market value” — the price at which property would change hands in a hypothetical transaction involving informed buyers and sellers not under duress to buy or sell. But some assignments call for a different standard of value.

For instance, say you're contemplating selling to a competitor. In this case, you might be best off determining the “strategic value” of your company — that is, the value to a particular investor, including buyer-specific synergies.

What's the appropriate basis of value? There's a hierarchy of different types of value based on the degree of control and marketability an interest carries. Investors place premiums on the abilities to 1) control business decisions and 2) sell the interest on the “market” as quickly and inexpensively as possible.

Digging deeper

Defining the appropriate basis of value in a business valuation isn't always straightforward. Suppose a business is split equally between two partners. Even though each owner has some control, stalemates could impair decision making.

On the other hand, a 2% owner might possess some elements of control if the remaining shares are divvied up equally between two 49% owners. Definitively establishing the basis of value requires careful consideration of who owns the rest of the business — and how that allocation affects value given applicable state laws and ownership agreements.

Getting it done right

Regular valuations can be an important management tool — particularly if you plan to sell or transfer your interest anytime soon. We can explain the valuation process to you further and work with an appraiser to get the job done right.

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