

## **Anatomy of a Business Valuation**

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At some point or another, private business owners invariably have a need to determine the value of their company shares. Circumstances may include selling your business, gifting shares for estate planning purposes or securing additional equity or debt financing from an outside source. Whatever the reason, attempting to determine a reliable figure can be very challenging.

Conducting a qualified business valuation is much more than just looking at last year's financial statements. In order to develop a thorough, reliable and defensible valuation, business owners are encouraged to hire the services of a business valuation professional.

To be accepted by the courts and various government agencies, including the IRS, business valuation reports must be prepared in compliance with various professional standards that govern the business valuation industry. To be compliant with these standards, a typical business valuation report will be comprised of several sections, the most common of which are as follows:

### ***Purpose***

In order to determine what a practitioner is attempting to value, one needs to determine the purpose for the valuation. This is an important step because a business value can change depending on the purpose of the valuation. For instance, a company being valued for acquisition holds a different value than one that is being valued for liquidation.

### ***Define Intended Users of the Report***

Practitioners need to determine who will be using the business valuation report in order to cater the final report to the needs of the user, without comprising their objectivity. For example, a report which will be used to support the value of a gift of shares for estate planning purposes may be used by the IRS in the event of a tax audit. In other circumstances a report may be used in a court of law to help determine the value of a company in a divorce case. In each circumstance, different valuation best practices are used and can change the value of the subject company depending on the intended user of the report.

### ***Establish an Effective Valuation Date***

As anyone can attest, the value of a dollar today is likely not the same as the value of a dollar tomorrow. The same argument can be made in business valuation. As a company continues to operate from one day to the next, its financial health can change. Establishing an effective date of a valuation ensures that the users of the valuation report know the value of the business at a specific time interval.

### ***Define the interest being valued***

A business valuation report can be prepared for many different interests, for example; the value represented could be for voting or non-voting stock. It could be for a majority or minority interest. It could be for preferred stock or common stock. The report must indicate the specific equity ownership interest being valued in order to have a meaningful conclusion.

### ***Business Description***

It goes without saying that in order to value a particular business, the practitioner must establish a thorough understanding of the business entity being valued. A comprehensive business description which includes a discussion about the company's history, customers, products or services and a variety of other issues is an essential part of any business valuation report.

### ***Economic Discussion***

There is one common denominator with any business and that is the fact that they all operate in an economic framework. A qualified business valuation report would include a discussion and understanding of the general economic conditions that affect the business entity which may include current interest rates, construction housing starts, wholesale pricing trends and raw material supply markets to name a few.

### ***Industry Discussion***

Beyond an economy-wide discussion, a thorough business valuation report includes a discussion of the industry in which the subject company operates. This section allows both the practitioner and the user of the report to understand specific industry issues that might affect the value of the subject company. For example, if an industry trend is to outsource manufacturing offshore to cheaper Chinese labor markets, a company that is not participating in this trend may be subject to higher future risks, and likely an implied lower business value.

### ***Financial and Operational Analysis***

The business valuation practitioner will have collected several pieces of data regarding the company's operations including, but not limited to, historical tax returns, historical financial statements, articles of incorporation, copies of any contracts with suppliers or customers, lease agreements etc. All of these pieces of information will help to develop the financial and operational section of a qualified business valuation report.

### ***Valuation Methodology***

After a detailed discussion about the business, the general economy and the specific industry in which the subject business operates, a typical valuation report will discuss the valuation methodology employed to determine the value of the business. The most common valuation techniques can be classified into three approaches: A) The Cost Approach, B) The Market Approach, and C) The Income Approach. Each approach has various sub-methodologies which are employed where appropriate. Important to note is that not all valuation reports will use all three methods to compute a given value. In fact, in most circumstances, only one or two of the various methodologies are used in a given circumstance, the selection of which is based on the particular business' future prospects and historical performance. The proper selection of a valuation methodology and its applicability to the underlying business is often times a very challenging part of a business valuation and underscores the importance of hiring a trained valuation professional.

### ***Valuation Discounts***

Often overlooked by those lacking experience in valuation matters, discounts play a very important role in determining the ultimate value of a business. The most common discounts include minority and lack of marketability discounts and can range from a low of 0% to as high as 65% in some cases.

### ***Valuation Conclusion***

The valuation conclusion is a culmination of all of the financial and operational analysis developed throughout the report. If drafted correctly, the valuation conclusion will tie in directly with the purpose of the valuation and it will describe only those ownership interests included in the valuation report.

As evidenced above, a qualified business valuation report can be a complex task. Since valuations often help business owners make some very important decisions, hiring a competent business valuation professional may be one of the most important parts of your decision making process.

If you would like to learn more on how we may be able to help you value your business, please contact Gregg Hamilton-Piercy at 781-547-8800 x 3266.