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9 Questions You Should Be Asking About Business Valuations

Insights from a Certified Valuation Analyst

Preparing a business valuation for your company is an exciting and intimidating time. Regardless of what prompted the valuation process, you'll be eager to know what the business is worth and how it impacts future business decisions.

Here are nine common questions business owners have (or should be asking) about valuations from a Certified Valuation Analyst (CVA) at Hall, Kistler & Company.

What is a Business Valuation?

First, the basics… What is a business valuation? A simple definition is as follows:

A business valuation assesses the economic value of part or all of a business.

That's it. The entire goal here is to accurately assign a value to the portion of a business that is owned by a specific individual or group.

- **For business owners** - If you are a business owner and you own 100% of the operation, your valuation will represent the assessed value of the whole business.
- **For partial owners** - If you own a portion of the company, a valuation can be performed that will determine what your portion is worth in the current market.

While valuation is a simple concept, the reality of assigning a dollar value to a business gets a bit tricky. There are many different pieces of this puzzle to consider, which is why training and experience in the field are so important. A proper valuation will consider both a financial analysis of the company as well as the greater economic conditions of the surrounding market.

What Events Generally Trigger a Business Valuation?

Normal business operations don't warrant a formal valuation. There will typically be a trigger for this valuation to occur, something going on in the business that requires an accurate understanding of its worth. Some of the common triggers include the following:

Preparing for a Sale - If you are getting ready to sell your business, or even if you are just considering the possibility, having the business valued will be an important starting point. Before selling the business, you need to know its value; you don't want to sell it for less than it's worth.

Tax Issues - There are certain tax situations that will require you to have an accurate accounting of how much your business is worth, such as gifting. You don't want to

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guess on the value of the business when making tax decisions, as any discrepancies could lead to a surprise tax bill later on.

Establishing a Partnership - Are you thinking of bringing a partner into your existing business? Or maybe you are going to enter a partnership with someone else who owns a current operation? Either way, knowing the present value of the business will guide you toward a fair deal in the new partnership.

Divorce Proceedings - Splitting up assets in the process of a divorce is notoriously difficult, and the value of your business will be one of many things that need to be determined.

Settling an Estate - In the case of the death of a business owner, it's likely that the business will need to be professionally valued so the estate can be settled in accordance with the owner's wishes.

What is Discounting and How Will That Affect the Valuation?

The valuation of a business has a lot to do with the value of other similar businesses in the same market. Sales of comparable businesses will go a long way toward "setting the bar" for what the others are worth.

Discounting comes into play when there are reasons to lower the value of a business as compared to its peers. For example, if you own less than half of the company and do not have the ability to make management decisions, a discount may be applied because of the lack of control a buyer would have over business operations. Or, if the business is one of many competing on price and does not have anything unique or patent-protected that will shelter it from competition, that too could impact the value.

Why is My Valuation Higher or Lower Than Expected?

Most business owners go into the valuation process with some general idea of what they think the business is worth. Sometimes these expectations are on track and in other cases, they are off-base. Business owners often expect their valuation to be much higher than it is, simply because they have worked so hard to build the business and feel that their hard work should be worth more than market value.

It's hard to set aside your personal biases when trying to get a clear view of how much the business you have created is worth on the open market. This is why trusting a qualified firm is so important. You can get an accurate valuation and have any questions answered about why the company is worth more or less than you thought.

What Documents Are Needed to Perform a Valuation?

Good documentation will go a long way towards making this process as easy as possible. If you can turn over ample paperwork that includes the details of how the business has been performing over recent years, your CVA will be able to turn that information into an accurate picture of the worth of your company. Here's what you will need to provide:

Financial Data for the Last Five Years - This is the core foundation of what you'll need to have a valuation performed. The tax returns that have been filed for your business are necessary, in addition to all of the financial statements. While you should have all of these documents available in your accounting department, going back five years to assemble everything could take a bit of time. Start working on documentation as soon as possible so no surprises come up later on that require you to scramble and look for key pieces of information.

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Buy-Sell Agreements - Any buy-sell agreements that are in place will have an impact on the value of the business, so these will need to be provided, as well.

Operating Agreements - The operating agreement sets forth how the business will be run, and this is another piece that can impact what the business is worth to a future buyer.

Fixed Asset Listing - The fixed assets owned by a business are a part of what it is worth, so an up-to-date schedule of all of these assets is a document that will need to be produced at the time of valuation. If a recent appraisal of the real estate and equipment is available, these should be included.

Note: *Once you start to work with a CVA on this process, you'll likely be asked to produce some other pieces of documentation based on the specifics of what your business does and what elements may add to or subtract from its value.*

What are the Different Approaches to Business Valuations?

There are various methodologies to valuing a business. Work with your CVA to determine which approach is appropriate for your situation.

Income Approach

The aim of the income approach is to anticipate future cash flows and equate that to a present value that can be assigned to the business.

There are two main components that must be tackled to arrive at an accurate valuation using this technique:

1. First, future cash flows must be estimated based on the past, current, or anticipated performance of the business.
2. Also, a discount rate must be selected to adjust those future earnings into current value. This rate measures various risk factors to apply to cash flows. The higher the rate (or risk) the lower the value.

For a valuation to have any meaning, it needs to be prepared by a professional firm with the proper training for the task. To be useful to your business, a completed valuation will need to be signed by someone with the right credentials for the job.

Asset-Based Approach

The asset-based valuation technique focuses on the assets possessed by a business at the time of the valuation. This tends to be the easiest type of valuation for business owners to understand because it is based on the here and now; it's not a projection into the future.

With that said, even an asset-based approach comes with plenty of complicated factors. Specifically, there is the challenge of determining what each of the assets is worth, as typical depreciation used for accounting purposes might not fairly represent what the assets are worth on the open market.

Market Approach

This approach does not always apply to the typical small business. The metrics used for a market approach are usually based on publicly traded companies, which operate on a scale that is not comparable to what the average small business experiences. Some private company benchmarks do exist, but may not be reliable. So, while this is a useful technique for the right situation, it's not going to be relevant in all cases.

What Adjustments Can Be Anticipated?

There are typically adjustments required to the value of a business after it has been analyzed based on the documentation provided and the state of the market. These adjustments can cause the value of a business to go up or down depending on what factors are at play.

The goal of adjustments is to get the final valuation to a number that will closely represent fair market value for what is being analyzed.

As one example, some small business owners fall into the habit of running some of their personal expenses through the business, so the numbers will need to be adjusted to clean that up and make sure the valuation only reflects business operations.

Can I Do My Own Valuation?

No, you cannot do your own business valuation. For the valuation to have any meaning, it needs to be prepared by a professional firm with the proper training for the task. While you are deeply familiar with the ins and outs of running your business, you aren't able to accurately value the business in a non-biased way without the knowledge and training of someone who works in this field.

To be useful to your business, a completed valuation will need to be signed by someone with the right credentials for the job—like a CVA. If you take the time to find some comparable businesses to yours that have sold and you base a valuation off of those numbers, you might have a ballpark idea of what the company is worth. But only a formal, professional valuation will suffice for tax or sale purposes.

How Should I Prepare for a Valuation?

As soon as you know that a valuation is coming, the first thing you should do is work with whoever is in charge of the accounting department of your business to collect and clean up your books and records. For a small business, it might be the owner who handles all of the accounting tasks. In a bigger operation, this responsibility typically falls on a CFO, controller, or someone with a similar title.

Good records are necessary for an accurate valuation. However, it's relatively common for small businesses to fall behind on some accounting tasks. Allow some time to get everything caught up and prepared for the CVA to use.

Get Professional Help

A business valuation is only useful if it is prepared by a knowledgeable, experienced CVA like those we have here at Hall, Kistler & Company. Our team will be happy to discuss this project with you and explain how the valuation process will play out from start to finish. Reach out today to request a consultation.

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