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Understanding Business Valuation Practices

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Commercial real estate brokers and appraisers are often confronted with questions involving the valuation of a business. Real estate assets usually comprise a significant portion of the value of most businesses. While there are some exceptions, individuals engaged in selling a business or business opportunity must be licensed as a real estate agent or broker. Commercial appraisers are also often confronted with the question of how to estimate the value of an operating business where the real estate is an integral component of the business. The total assets of the business (tangible and intangible) play a critical role in the determination of the value of hotels, restaurants, manufacturing companies and several other businesses where the real estate assets are an integral part of the ongoing business. Establishing a value or price incorporating all tangible and intangible assets as if they were valued in aggregate is a challenging proposition. If we think about this concept of disaggregating the real estate from the other assembled components of the business such as labor, sales, business goodwill, management, patents, equipment and the like, it is easy to see the complexity of placing a value on an ongoing business.

The professional practice of estimating the value of a business has been an evolutionary process. This progression of measurement techniques runs the gamut from owner and investor rules of thumb to determine the fair market value of a business (or interest in a business) to methodologies and procedures formulated by the Internal Revenue Service and professional business appraisal organizations. Indeed, the American Institute of Certified Public Accountants (AICPA) has announced new standards for CPAs involved in the valuation of a business, business ownership interests, security or intangible assets. The AICPA standards take effect on January 1st and apply to a variety of business valuation considerations involving business sales, financing, taxation, financial reporting, mergers and acquisitions, management and financial planning and litigation. This may be good news for investors who relied on the valuation reports on sub-mortgage fund values or of the valuation and ratings reports of derivative funds that invested in the sub-prime mortgage funds.

Similarly, the Internal Revenue Service (IRS) has made numerous contributions to business valuation theory and techniques and is often regarded as the primary theoretician in the area of valuing closely held companies. The IRS became involved in business valuation issues in the 1920s when a method was needed to determine the business losses incurred by business owners as a result of prohibition. The IRS involvement lead to a method to assist taxpayers in determining the amount of intangible value lost in businesses that were previously in the alcoholic beverage industry. Prior to this many businesses were sold based on tangible asset value because business owners did not understand that their business may have had intangible value as well. Since the 1920s the IRS has made numerous guideline statements regarding the valuation of: closely held companies, estates, gifts, tangible and intangible business property, discounts for lack of marketability and non-control, stock options and restrictions.

Business valuation techniques have many forms and applications depending upon the purpose and method of the approach to value. From a non-tax perspective a business valuation could consider a purchase or sale of a business, financing, a merger, buy/sell agreements, asset allocation and litigation issues in partner and shareholder disputes, insurance claims, divorces, business interruption, contract disputes and breach of contract lawsuits. Business valuation reports are used in valuing employee stock ownership plans (regulated by the Department of Labor) estate and gift taxes, charitable contributions, purchase price and capital gain calculations.

The process that business appraisers use depends on the purpose of the report, the nature of the interest being valued, relevant standards of value for the asset, and application of appropriate dates, regulatory or legal requirements. The appraiser evaluates the financial, economic and industry environment as well as the physical business. This leads to a review of the benefit stream and a determination of the degree of risk under which the business or business interest operates. The greater the business risk the greater the return. Business appraisers should consider the following three approaches to value when estimating the worth of a business or business interests:

1. Asset based approach---value of the business assets less liabilities. In this case the appraiser adjusts the book value of the business assets to reflect the assets' fair market value. In most cases when an asset or an adjusted net asset approach is used by the appraiser the fair market value is a replacement of liquida-

tion value. This approach is perhaps most applicable to a non-operating business or a business soon to be liquidated because of its inability to earn a profit.

2. The income approach---this approach provides an indication of value for a business, business ownership interest, or even a security by using methods that convert anticipated future economic benefits into a single present value. Common income based approaches include the capitalization of earnings method which considers an asset's ability to generate future earnings or cash flows. This method denotes a relationship between the future earnings or cash flows, the required rate of return on equity or invested capital and the estimated value of the business asset. The discounted cash flow method is also used as an income approach to estimate the value of a business asset. This approach evaluates business cash flow and is based on the idea that the value of the business asset is a function of the present value of projected future cash flows, in addition to the present value of the asset at some future date. This method requires that a terminal or residual value of the asset be made by the appraiser. The future cash flows and the business asset's terminal or residual value are discounted to the present using a discount rate.

3. The market approach---this approach to valuing a business asset is based on the idea that value can be estimated in relation to comparable sales of similar companies (or assets) that have recently sold. This approach is logical, easily understood, uses actual data and does not rely on the complex income and cash flow projections required in the income approach. However, the disadvantages include: the possibility of limited comparable sales data, inability to document buyer motivations and pricing decisions on comparable sales, a need to adjust the financial components of the comparables to the subject business to assure that a reasonable comparability exists between the businesses being valued and the comparables and reliability of comparable sales information.

There is much to consider when valuing a business or business asset. It is important to recognize that the three approaches to value briefly described above should be considered and if relevant and practical, be used in determining business or business asset value. The field of business valuation is complex and comprised of skills that involve both an art and science. While this article began with new developments in the field of business valuation, older recorded appraisals can be found in the Book of Genesis, "The land is worth 400 shekels" or from Publius in the 1st century B.C.: "Everything is worth what a purchaser will pay for it."