

# VALUING YOUR BUSINESS

By Shannon P. Pratt, DBA, CFA, ARM, ASA, MCBA, CMBC, CM&AA<sup>1</sup>



**Shannon P. Pratt, CFA, ARM, FASA, MCBA, MCBC, CM&AA**, is a well-known authority in the field of business valuation and has written numerous books that articulate many of the concepts used in modern business valuation around the world.

Shannon Pratt is Chairman and CEO of Shannon Pratt Valuations, Inc., a business valuation firm headquartered in Portland, Oregon. He is also a member of the board of directors of Paulson Capital Corporation, an investment banking firm that specializes in small cap IPOs.

Over the last 35 years, he has performed valuation engagements for mergers and acquisitions, employee stock ownership plans (ESOPs), fairness opinions, gift and estate taxes, incentive stock options, buy-sell agreements, corporate and partnership dissolutions, dissenting stockholder actions, damages, marital dissolutions, and many other business valuation purposes. He has testified in a wide variety of federal and state courts across the country and frequently participates in arbitration and mediation proceedings.

He holds an undergraduate degree in business administration from the University of Washington and a doctorate in business administration, majoring in finance, from Indiana University. He is a Fellow of the American Society of Appraisers, a Master Certified Business Appraiser, a Chartered Financial Analyst, a Master Certified Business Counselor, and is certified in mergers and acquisitions.

Dr. Pratt's professional recognitions include being designated a life member of the Business Valuation Committee of the American Society of Appraisers, a life member of the American Society of Appraisers, past chairman and a life member of the ESOP Association Advisory Committee on Valuation, a life member of the Institute of Business Appraisers, the Magna Cum Laude in Business Appraisal award from the National

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Association of Certified Valuation Analysts, and the distinguished service award of the Portland Society of Financial Analysts. He recently completed two three-year terms as trustee-at-large of the Appraisal Foundation.

Dr. Pratt is the author of *Valuing a Business*, 5<sup>th</sup> edition, and co-author of *Valuing Small Businesses and Professional Practices*, 3<sup>rd</sup> edition, both published by McGraw-Hill. He is the co-author with Roger Grabowski of *Cost of Capital: Applications and Examples*, the co-author with Jay Fishman and William Morrison of *Standards of Value*, author of *The Market Approach to Valuing Businesses*, 2<sup>nd</sup> edition, *Business Valuation Body of Knowledge*, *Business Valuation Discounts and Premiums*, and co-author with the Honorable David Laro of *Business Valuation and Taxes: Procedure, Law and Perspective*, all published by John Wiley & Sons, and *The Lawyer's Business Valuation Handbook*, published by the American Bar Association. He is also co-author of *Guide to Business Valuations*, 18<sup>th</sup> edition, published by Practitioners Publishing Company.

He is publisher emeritus of a monthly newsletter, *Business Valuation Update* (primarily for the professional appraisal community).

Dr. Pratt develops and teaches business valuation courses for the American Society of Appraisers and the American Institute of Certified Public Accountants, and frequently speaks on business valuation at national legal, professional, and trade association meetings. He also developed and often teaches a full-day seminar (sometimes divided into two partial days) on business valuation for judges and lawyers.

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Every business owner should have his business valued by a qualified professional business appraiser at least once every five years and when business circumstances change significantly.

## REASONS TO VALUE THE BUSINESS

The owner may die some day. The heirs probably would benefit by having a credibly-based idea of what the business is worth. If the business is substantial, there may be estate taxes. Knowing what the business is worth can assist the owner in arranging adequate liquidity (usually through life insurance) to cover the estate taxes. The owner may want to minimize or avoid the estate taxes by a program of gifting shares of stock to eventual heirs (see later section on Gift and Estate Taxes).

The owner may want to sell the business. Having an idea of what it is worth may influence the decision as to whether or when to sell, and one side benefit of a professional appraisal is to get advice on what to do to make it easier to sell and to maximize the sale price. (See later section on Selling the Business).

The owner may wish to sell minority interests to employees or outside investors. (See later sections on Minority Interests and Employee Stock Ownership Plans).

Unfortunately, statistics show that about 50% of marriages end up in divorce. The owner might like to have an idea of what it would cost him to get divorced.

## VALUE IS FORWARD LOOKING

A buyer buys a business or an interest in a business for what is expected of that business in the future. Recent past history is often useful as a guide to what to expect in the future. The buyer will largely discount the potential unless the business has a proven track record.

## APPROACHES TO VALUE

The appraisal profession has recognized three broad approaches to valuing a business:

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1. The income approach.
2. The market approach.
3. The asset approach.

Any single one of the above or a combination of two or even all three may be appropriate for valuing a particular business depending on the facts and circumstances.

### **The Income Approach**

The income approach values a company by estimating some measure of its earning power in the future and converting that measure to a value based on an investor's required rate of return on the investment considering the risk of the investment.

The measure of earning power most frequently used is "net cash flow," which represents the amount that an owner could take out of the business over time without jeopardizing it as a going concern. For a business with no long-term debt net cash flow is calculated as:

Net income

Plus noncash charges (depreciation, etc.)

Minus capital expenditures

Minus additions to working capital

### **The Market Approach**

The market approach involves valuing a company by reference to what other similar companies or interests in companies have sold for relative to some fundamental variable in the subject company, such as sales, net income, EBITDA (earnings before interest, taxes, depreciation and amortization), etc.

Several databases are available which provide details of sales of private companies (e.g., Pratt's Stats, BIZCOMPS, Done Deals, etc.). "Pricing multiples" are developed such as price/sales or price/net income and applied to the subject company's comparable fundamental to arrive at a range of potential values.

Sometimes such pricing multiples are also developed from the market prices of public companies.

### **The Asset Approach**

The asset approach values a company by adjusting its assets and liabilities to fair market value and the difference represents the value of the company. The procedure is to adjust each asset and liability item on the balance sheet to its fair market value. Any assets or liabilities not on the balance sheet should also be valued and brought onto the balance

sheet. This approach is usually not applicable to a profitable going concern because in that case the value lies largely in the earning power.

## **INFORMATION NECESSARY TO VALUE THE BUSINESS**

Exhibit 1 is a generalized list of the documents that a business may be asked to produce for a valuation. Not every document will be necessary in every case. For some special cases, additional documents may be required. In addition to the production of documents, a representative of the appraiser will usually do a site visit and interview management.

## **SELLING THE BUSINESS**

When contemplating selling a business, an appraisal should be done as early as possible, preferably three years or more before the contemplated sale time. This will be helpful in planning the timing of the sale and also in identifying strengths and weaknesses and capitalizing on the strengths and curing the weaknesses.

To maximize the sale price, it is desirable to forecast revenues and expenses out at least a year and have a record of how accurate the forecasts were. Buyers like dependability. It is desirable to have the books and records in tip top shape. Buyers like transparency.

Minimize the personal expenses going through the company's books. Take retired Grandma off the payroll. Sell any assets that could be considered nonoperating or excessive (e.g., the company airplane, a hunting retreat, etc.).

Hire the best possible business broker and follow his advice. A good business broker has the wisdom born of experience to work the market to your best advantage.

While it is generally good if the broker can find a buyer that has synergies with your company, don't expect the buyer to pay the full value of the synergies. A synergistic buyer will probably pay a little more than a strictly financial buyer, but usually less than half of the value of the synergies.

## **TRADEOFF BETWEEN CASH AND TERMS**

Most sellers would rather get all cash and most buyers would rather have a low down payment and long, easy terms. Most sale transactions meet somewhere in the middle. The lower the down payment, the larger the pool of potential buyers and, therefore, the more marketable the business will be.

The more qualified the buyer and the higher the down payment (usually at least 30% of the price) the more likely the sale is to succeed. Projected cash from the business should have a good margin to cover the payments. A buyer can be qualified in two dimensions: 1) financial wherewithal and stability and 2) the acumen to run the business profitably.

When selling on terms, it is important that the seller have good security. This security can come in three forms: 1) personal guarantees, 2) collateral (usually the assets of the business), and 3) restrictive covenants on operations (limits on compensation withdrawals, limits on liquidation of assets, etc.). When selling for stock of the acquiring company, it is important to have provisions for eventual liquidity.

## **MINORITY INTERESTS**

The fair market value of a minority interest in a business usually is somewhat less than a proportionate share of the business as a whole. This is because the minority owner does not have control over important things like dividends, compensation, policies, and even selling out or liquidating.

Consequently, when valuing a minority interest, there is usually a discount for lack of control from the enterprise value. And minority interests are hard to sell. Consequently, there usually is another discount for lack of marketability. These discounts often total to 50% or more from a proportionate share of the value of the business as a whole.

## **GIFT AND ESTATE TAXES**

For an estate or gift tax return, the value should be supported by a qualified business appraiser and the appraisal report should be a complete report that complies with the Uniform Standards of Professional Appraisal Practice (USPAP). The standard of value for estate and gift taxes is always fair market value, as defined in the U.S. Treasury Regulations.

If one wishes to pass the company to heirs minimizing estate and gift taxes, one should do so by means of a series of gifts of minority interests. As explained earlier, minority interests under the standard of fair market value are valued at a substantial discount from a proportionate share of the business as a whole. *Every gift is valued on its own, without regard to the holdings of the donor or donee.* If a donor has three heirs to whom he wishes to pass the company, he could even give them 33 1/3% interests all at the same time, and each would be valued as a minority interest.

## **EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)**

An ESOP is a tax-advantaged vehicle for employees to own a share of the company. The ESOP may own anywhere from less than 1% to 100% of the company. If the ESOP owns a minority interest, the shares must be valued as minority shares. However, the discount from a proportional share of the enterprise value is usually only 10% to 15%, because it is offset by a mandatory “put” option by which the employees have the option to sell the shares at fair market value on termination of employment.

The ESOP may acquire the shares either from an existing stockholder or by the company issuing new shares to the ESOP. If the company issues new shares to the ESOP, it can

take a deduction from its taxable income for the fair market value of the shares issued. The ESOP must have a qualified appraisal of the shares at least once a year.

## **BUY-SELL AGREEMENTS**

Many companies with two or more owners enter into buy-sell agreements. These give the company or other stockholders the option or obligation to purchase the interests of other owners under some specified circumstances such as termination of employment, retirement, or death.

All such agreements must contain a valuation provision which either sets a price or provides a mechanism for setting a price and also terms of payment when the triggering event occurs. I highly recommend hiring a couple hours of a valuation professional's time for consultation when drafting the buy-sell provision and to explain the ramifications of the provision when the parties sign the agreement, because much misunderstanding and ill will can arise when the triggering event occurs and one party to the agreement had a different understanding than another party.

For example, many buy-sell agreements say that the price will be "fair market value of the shares" as determined by a qualified business appraiser. As was explained earlier, fair market value usually implies a hefty discount from a pro rata share of the value of the company as a whole. Many minority owners do not understand this and are shocked to learn it too late when a price that is less than what was expected is binding on them.

The valuation provision might call for a proportionate share of the fair market value of the company, or a proportionate share of the fair market value of the company less some specified percentage, perhaps 20%. The provision may be different pursuant to different triggering events.

Even when the standard of value is specified, there frequently can be disagreement over the amount, so the valuation provision should specify a means of resolving the price. I have served as an arbitrator or expert witness in many such disagreements. The valuation agreement should specify a means of selecting an arbitrator or arbitrators in case of disagreement. In order to assure fairness to all parties, the provision should specify that the arbitrator or arbitrators be qualified business appraisers.

## **MARITAL DISSOLUTION**

The statutes governing valuing businesses for marital dissolution vary from state to state. They tend to be unfortunately vague regarding criteria for valuation, so the business appraiser must look to the case law that establishes relevant precedent for standards and criteria for valuing for marital dissolution in that particular jurisdiction.

It is common for the nonoperating spouse to think that the business is worth more than the operating spouse thinks it is. Sometimes the ratio exceeds ten to one. Unfortunately, most family law judges have little expertise or experience in business valuation, so when

there is a dispute over the value of the business in a divorce, it pays to retain the best possible business appraiser who can convincingly educate the judge.

Most states these days distinguish between enterprise goodwill (that which arises from the business itself and thus is transferable in a sale) and personal goodwill (that which arises from the operating spouse's talents and efforts). In a divorce, the portion of value attributed to enterprise goodwill is part of the marital estate and the portion attributed to personal goodwill is excluded from the marital estate.

## **SUMMARY**

There are many reasons to have the business valued by a qualified professional business appraiser. Professional accreditations in business appraisal are conferred by the American Society of Appraisers, the AICPA (most CPAs are not qualified business appraisers but the AICPA offers the designation CPA/ABV, accredited in business valuation), the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts.

When the owner has the business valued for any litigation purpose, it is wise to have the opposition's business valuation report as well as the owner's expert business valuation report reviewed by an independent qualified appraiser.

## **BIBLIOGRAPHY**

All of the following books are available from [www.BVResources.com](http://www.BVResources.com).

*Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th edition, with Alina V. Niculita, McGraw-Hill, 2008.

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*The Lawyer's Business Valuation Handbook*, Chicago: American Bar Association, 2000.

*Business Valuation and Taxes: Procedure, Law, and Perspective*, with Judge David Laro. Hoboken, New Jersey: John Wiley & Sons, 2005.

*Standards of Value*, with William Morrison and Jay Fishman. Hoboken, New Jersey: John Wiley & Sons, 2007.

*Business Valuation Discounts and Premiums*, Hoboken, New Jersey: John Wiley & Sons, 2001.

*Cost of Capital: Applications and Examples*, 3<sup>rd</sup> edition, with Roger Grabowski, Hoboken, New Jersey: John Wiley & Sons, 2008.

*Business Valuation Body of Knowledge: Exam Review and Professional Reference*, 2nd edition, Hoboken, New Jersey: John Wiley & Sons, 2003.

**Exhibit 1<sup>3</sup>**  
**Preliminary Documents and Information Checklist**  
**for Business Valuation of Typical Corporation**

**Financial Statements for Typical Corporation**

Balance sheets, income statements, statements of changes in cash flow, and statements of stockholders' equity for the last five fiscal years or economic cycle  
Income tax returns for the same years  
Latest interim statements and interim statements for comparable period(s) of previous year

**Other Financial Data**

Summary property, plant, and equipment list, depreciation schedule, and capital budget  
Aged accounts receivable summary  
Aged accounts payable summary  
List of marketable securities and prepaid expenses  
Inventory summary, with any necessary information on inventory accounting policies  
Synopsis of leases for facilities or equipment  
Any other existing contracts (employment agreements, covenants not to compete, supplier agreements, customer agreements, royalty agreements, equipment lease or rental contracts, loan agreements, labor contracts, employee benefit plans, and so on)  
List of stockholders, with number of shares owned by each  
Schedule of insurance in force (key person life, property and casualty, liability)  
Budgets or projections, for a minimum of five years, business or strategic plan, if available  
List of subsidiaries and/or financial interests in other companies  
Key personnel compensation schedule, including benefits and personal expenses  
Details of any transactions with related parties

**Company Documents**

Articles of incorporation, bylaws, and any amendments to either  
Any existing buy-sell agreements, options to purchase stock, or rights of first refusal  
Franchise or operating agreements, if any

**Other Information**

Brief history, including how long in business and details of any changes in ownership and/or any bona fide offers recently received  
Brief description of the business, including position relative to competition and any factors that make the business unique  
Marketing literature (catalogs, brochures, advertisements, and so on)  
List of locations where company operates, with size and recent appraisals  
List of competitors, with location, relative size, and any relevant factors  
Organization chart  
Résumés of key personnel, with age, position, compensation, length of service, education, and prior experience  
Personnel profile: number of employees by functional groupings, such as production, sales, engineering/R&D, personnel and accounting, customer service/field support, and so forth  
Trade associations to which the company belongs or would be eligible for membership  
Relevant trade or government publications (especially market forecasts)

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<sup>3</sup> Pratt, Shannon, with Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th edition, with Alina V. Niculita, McGraw-Hill, 2008, p. 77.

Any existing indicators of asset values, including latest property tax assessments and any appraisals that have been performed  
List of customer relationships, supplier relationships, contracts, patents, copyrights, trademarks, and other intangible assets  
Any contingent or off-balance sheet liabilities (pending lawsuits, compliance requirements, warranty or other product liabilities, estimate of medical benefits for retirees, and so on)  
Any filings or correspondence with regulatory agencies  
Information on prior transactions in the stock or any related party transactions