

Preparing Your Business for Valuation

Margaret D. Nowicki

Eric E. Lewis

Jeffrey W. Lippitt

There is a tremendous need for the valuation of small businesses. Oftentimes, small businessowners do not have the wherewithal to gather the data and keep it up to date for use in situations that require valuation. Formal valuations are necessary because they provide objective evidence of value, in contrast to value set by markets on which public companies are traded. This article focuses on some factors that impact the valuation of the business and will help small businessowners feel more comfortable talking with financial professionals about how the business might be valued.

Whether for tax, legal, or business reasons, there is a tremendous need for the valuation of small businesses. Oppressed minority shareholder suits and equitable distribution actions are the most common legal reasons for valuations, while purchases and sales of companies are common business reasons. Oftentimes, however, small businessowners do not have the knowledge or the wherewithal to gather the data and keep it up to date for use in situations that require valuation.

Small businesses are usually controlled by few people and shares of stock are not regularly traded on any exchange. Nevertheless, formal valuations are necessary because they provide objective evidence of value, in contrast to publicly traded companies where value is set by the markets on which they are traded. Owners often develop expectations concerning the value of their company by utilization of "Thumb Rules," such as a multiple of gross fees, a multiple of the number of hotel rooms, or a multiple of the number of seats in a restaurant. These approaches are very imprecise and often overlook important factors effecting value (Howe and Lippitt 1997). Consequently, when the outcome is quite different from the owners' expectations, owners are often surprised and dismayed at the result of the formal valuation. Much of the surprise can be taken out of the valuation if the owners are willing to plan for it well in advance and if they are familiar with the factors that impact the valuation of the business. Careful preparation for the valuation can yield additional benefits such as a lower cost for the valuation and an earlier completion date. Owners can do a number of things that will directly impact the valuation outcome and they can make some basic calculations that should give "ballpark" indications of that outcome.

This article highlights some financial topics that businessowners would be well advised to pay attention to as they

plan for the valuation of their business. The article focuses on some of the factors that impact the valuation of the business and will help small businessowners feel more comfortable talking with financial professionals about how the business might be valued.

Though the valuation calculation is generally quite complex because it involves the consideration of many factors and because the approaches used to value businesses are varied, significant insight can be gained through understanding a few simple concepts. Regardless of the particular methodology employed, the value of a business is ultimately dependent on the following factors:

- magnitude and duration of future economic benefits,
- risk associated with the future economic benefits,
- marketability of the business, and
- nature and extent of the contributions of the owner/manager(s) to the business.

Valuation Model

One of the most commonly used approaches to valuing companies is the earnings capitalization approach (Howitt 1993; Mastracchio 1991; Pratt 1989). This method is an example of an approach that bases the value of a business on the future benefits that accrue to the owners of the business. The earnings capitalization approach bases the value of a business on the earnings that it is expected to generate. The expected future earnings stream is converted into a value by "discounting" it using a capitalization rate, as follows:

$$V = E / C$$

Where:

V = the estimated value of the firm

E = the expected earnings of the firm

C = the capitalization rate

Expected earnings (E) are generally evaluated by reference to the most recent five years of adjusted accounting earnings. Earnings over this period are generally summarized through the use of a simple average or, if a growth pattern or trend is evident, a weighted average. The capitalization rate (C) is a financial measure that indicates whether an investment will yield an acceptable return. It is based on the valuator's evaluation of the business's risk level and on the expected earnings growth pattern. This method yields a "going concern" value (V) for the firm and includes any "goodwill" value that results from above normal earnings rates. It is important to note that the capitalization rate can

be converted into an earnings multiple by taking its reciprocal (e.g., a capitalization rate of .10 yields an earnings multiple of 1/.10 or 10 times earnings as the value of the business). Hence, to increase the calculated value, either earnings must increase or the capitalization rate must decrease. To detail the valuation process more clearly, Figure 1 serves as a flowchart overview of the valuation process used with the earnings capitalization method.

The Importance of Earnings and Earnings Adjustment

Financial accounting statements and tax returns are important sources of information for developing expectations about earnings. Although economic theory suggests that the value of a business is derived primarily from the expected future benefits associated with ownership, to form a convincing basis for valuation, expectations must be grounded in the objective evidence of the business's past financial performance. The first step in developing the earnings base of the business is to adjust the accounting earnings for related party transactions and for differences between accounting and economic values. Related party transactions are transactions between parties but they are not at arm's length. For exam-

ple, the salary of an owner-employee is not at arm's length nor is a loan to and from officers. This is important for there is no assurance that the non-arm's length transactions are set at market price. Consequently, income of the business can be easily manipulated by changing related party transactions when these transactions are restated to market price. This, however, does not affect firm value. Differences between accounting and economic values often result due to the purchase of assets from years ago and from the market value change that has since resulted. Depreciation charges on historical values will not represent the cost of using assets in business so the costs must be adjusted. Quite often, this adjustment reduces reported earnings and reduces the value of the business. Consequently, related party relationships, such as related party salaries, must be reviewed and adjusted to market rates and amounts.

Related Party Salaries

Many owners of small businesses are in the dual roles of owner and manager. This duality is common and is often fundamental to the success of the business. One job of the valuator is to carefully separate the financial implications of these two roles. While the benefits of ownership and employment

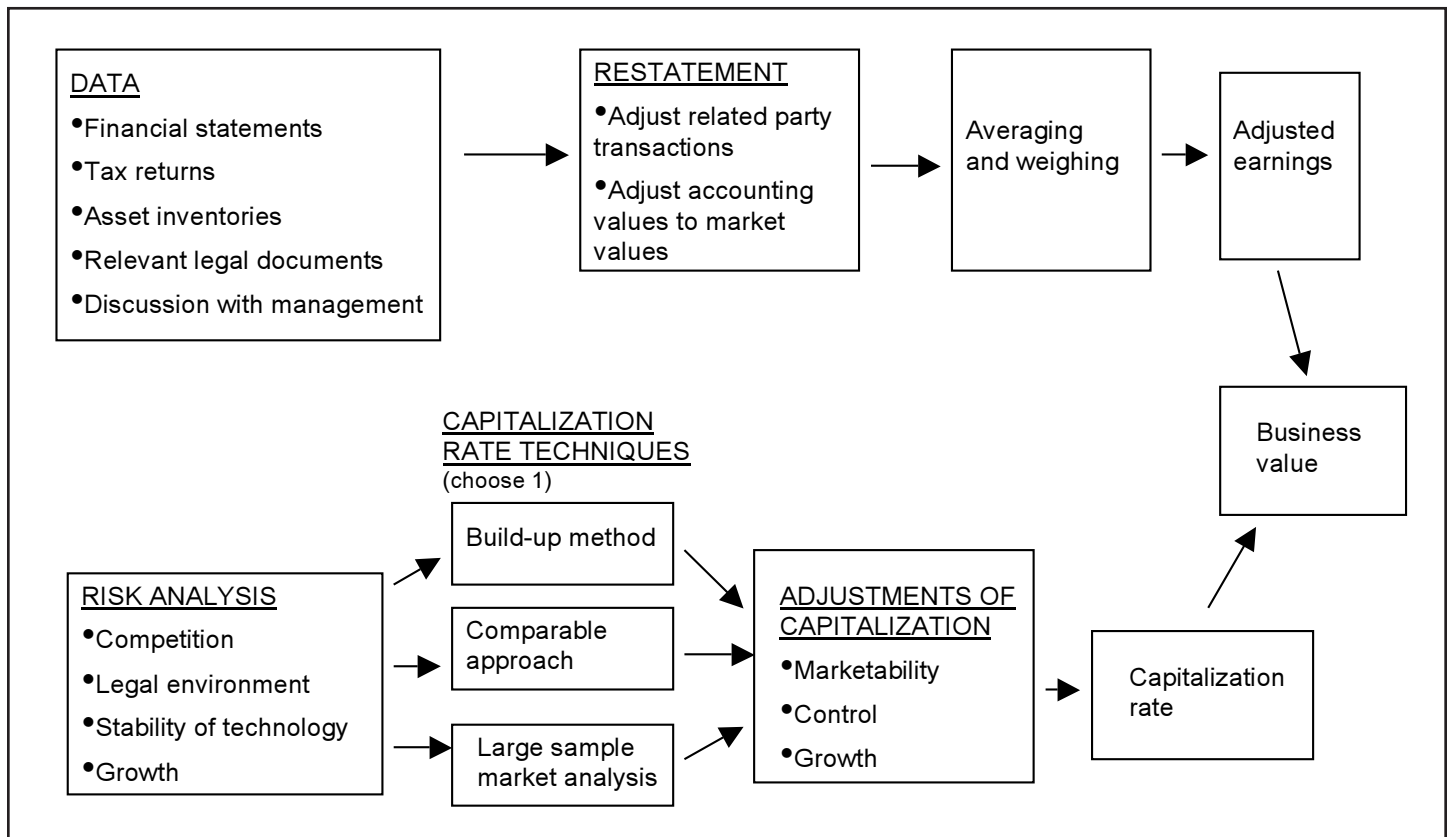


Figure 1. Valuation Process Used With the Earnings Capitalization Method

flow to the same person, their implications for the valuation are quite different. The salary paid to the manager is a cost of the business and reduces both earnings and value. The business income distributed to the owner is the primary benefit of ownership from which the value of the business is derived. The valuator will generally not rely on the salary levels set by the business to distinguish between ownership returns and employee compensation. Instead, the valuator will estimate market salary levels based on reference to the salaries of nonowner managers within the same business or in similar businesses or to an independent salary survey (Lippitt and Mastracchio 1993).

Many owners take great pride in the enormous commitment of time and energy that they dedicate to the business. While this pride often results from general beliefs that “hard work is a virtue” and that “commitment is an important part of what made this business a success,” these beliefs have an important impact on value. That is, the greater the commitment of time necessary to manage the business, the greater the cost of the “market salaries” that are subtracted from the earnings of the business—hence, the lower the value of the business. It is important for owners to be efficient in their work and to look for ways to economize their time without endangering the stability of the business to increase the value of their firm. From the perspective of the valuation, the owner’s time has a real cost and should not be used when other less expensive or more efficient resources can be used to accomplish the task.

The Importance of Fair Market Value Adjustments

Accounting statements are based on historical transaction prices to a great extent so it is necessary to make adjustments to them to reflect market values as of the date of the valuation (Pratt 1989; Mastracchio 1991; Blackman 1992). Differences between accounting values and market values can arise for a number of reasons including inflation, changes in technology, and changes in supply or demand for an item. When significant, both the cost of sales and the depreciation expense are adjusted based on appraisal values. The adjustments commonly result in increased expenses, which decrease both the earnings and the value of the business. A small businessowner has little influence to make an adjustment in his or her favor. Consequently, it is important that the small businessowner be informed that it is likely to happen and should adjust personal expectations accordingly. It may also be in the small businessowner’s favor to begin gathering information of market values to provide to the valuator.

The Importance of Documenting Miscellaneous Earnings

It is clearly in the best interest of businessowners contemplating the sale of the business to be certain that all of the

earnings of the business flow into the financial records. In addition to the obvious legal, ethical, and moral consequences of alternative courses of action, every additional dollar of earnings is likely to add many dollars to the value of the business. “Under the table” income and unreported bartering transactions, if not included in the valuation income stream, can cost the owner a significant portion of the true value of the business.

The Importance in Understanding the Capitalization Rate

The calculation of the capitalization rate is affected by many factors including the risk level of the firm and the expected growth in earnings. All business enterprises endure some level of risk. It is the assumption of risk that affords businessowners the right to have an expected return on invested capital greater than lower risk investments. Higher risk results in higher discount rates, whereas higher growth results in lower discount rates. The larger the capitalization rate, the lower the resultant value of the business. Valuators will typically use one of three approaches to generate a capitalization rate: the build-up method, publicly traded comparables, and large sample market rate estimation techniques. The build-up method begins with a risk-free rate of return, which usually is the 90-day treasury bill rate. The valuator will add a premium to this rate for the generally higher return of bonds over treasury bills, and another premium for the higher return of equity over bonds, yielding a general equity rate. Finally, an adjustment is made to reflect the unique set of risks and opportunities facing a business and its industry, after considering many or all factors including industry-level risk, firm-specific risk, growth, marketability, and capital expenditures. An alternative approach to this process is to use publicly traded comparables to obtain a rate. If the valuator can identify a publicly traded firm with the same level of risk, the capitalization rate can be obtained by using the inverse of the price/earnings ratio (Howe, Lippitt, and Lewis 2002). Data to support this process is available through Risk Management Associates, Research Insight, and the SEC’s Edgar database along with a wide variety of other electronic and hardcopy sources. A final alternative is to use a large sample of publicly traded firms from the same industry as the firm being valued and then complete a data analysis that will extract capitalization rates (Lippitt and Mastracchio 1993). The build-up method is perhaps the most commonly used and easiest to understand. The remaining discussion refers to factors related to the build-up method.

Associated Risk: Industry-Level

Industry risks must be considered by valuators when they assess the overall risk level facing a business. These risks can include sensitivity to any number of elements such as the

prices of complementary or component products, government regulations, economic indicators, or normal business cycles. They can also include some of the environmental and product-related concerns discussed below. A careful review of recent issues of trade publications can usually give owners a good starting point from which to begin a list of factors that tend to impact all businesses in their industry. An understanding of these risks can help the owner mitigate the negative impact on firm value.

Associated Risk: Firm-Specific

As valuers attempt to quantify the risk level that a particular business operates under, there are several common considerations. Competition is a very common risk to both large and small businesses. The competition may be realized as actual or potential. Potential competition is given greater weight when barriers to entry in the business's industry are very low. The greater the ease of entry by new competitors into a market, the more at risk is the profitability and growth of an existing enterprise. Actual competition can exert downward pressure on the growth potential of a business. A business that is often found defending its market presence against an aggressive competitor can suffer decreased margins and other problems that reduce its ability to grow and impede its long-term profitability. Alternately, if a firm enjoys a sustainable competitive advantage, this can dramatically increase the value of the business. Such advantages can include special relationships with suppliers and/or customers, protected technologies, or control of preferred operating locations.

Product liability considerations can create significant uncertainty regarding the future earnings of a business. Due to the inherent uncertainty regarding the outcomes of litigation surrounding this issue, unresolved claims of product liability can loom as doubt regarding the long-term profitability and ultimate viability of an enterprise. If owners seek to increase the value of the business, it is often best to resolve these claims and other types of litigation prior to the valuation.

Environmental concerns can present significant risk to businesses whose manufacturing or delivery systems create hazards that could result in levies or other sanctions by regulatory agencies. Retailers and wholesalers of petroleum products, chemical manufacturers, dry cleaners, and many others can face significant risks regarding the value of potentially contaminated property that is used as a delivery point for their products or a disposal point for their waste.

Financial leverage is another factor that valuers must consider when adjusting the equity capitalization rate that the build-up method yields. Modigliani and Miller (1958) proposed an adjustment to reflect the additional risk that leverage imposes on the equity holders of a business relative to a

pure equity situation. The adjustment uses the debt-equity ratio of a business to increase the capitalization rate for companies that carry debt. The more debt relative to the business's equity, the higher the capitalization rate premium for leverage and the lower the resulting value of the business.

Overall, it is important for owners to consider and understand the unique risks that the business faces in order to assist the valuator.

The Importance of Growth

Businesses that have experienced significant earnings growth in the past are likely to be valued at a premium if that growth is expected to continue in the future. There are several ways of handling growth in the valuation process. One way to get an idea of the impact on value is to subtract the growth rate from the capitalization rate. The lower capitalization rate will result in a larger value. Many valuers are reluctant to reduce the capitalization rate for the full amount of the growth rate, due to concerns that the growth is not sustainable indefinitely. Hence, the small business owner should remember that growth is great and will increase the valuation, but it is growth in adjusted earnings that matters, not accounting earnings.

The Importance of Marketability

The more that the business is known for its services and products independent of the owner, the less difficult it should be to maintain the value of the business when it is transferred to a new owner. In some circumstances, it is advantageous to give high visibility to carefully chosen key employees. Employees who remain with the business after the transfer of ownership can provide important continuity for customers and help maintain goodwill.

The Importance of Capital Expenditures

The need for future capital expenditures to maintain the current earnings stream decreases the value of the firm (Lippitt and Mastracchio 1993). Selecting an appropriate strategy regarding capital expenditures preceding a valuation is a challenging task. Capital investments that would not make business sense if the current owners were planning to retain the business are unlikely to contribute positively to firm value just prior to sale. On the other hand, upgrading productive capacity to incorporate more efficient technology or increasing capacity may increase value by far more than the expenditure, particularly if there is time to generate a track record for the new equipment.

To a certain extent, capital expenditures just prior to sale impose the decisions of the old owners on the new owners. For example, consider a couple preparing their residence for sale. If the house needs painting, the current owners must decide whether to paint the house themselves or to leave

that task for the new owners. The new owners may not want to have to worry about painting along with the other chores that go with the move; however, they might really have preferred to choose their own color and quality of paint. Consequently, it is important to consider the following:

- *How clear are the choices that must be made?* If the choices involved in the project are fairly clear, it favors the current owners making the capital expenditure because the loss of flexibility for the new owners will be minor. The greater the range of choices and the implications for the future of the business, the stronger the argument for deferring the expenditures.
- *Who is in the best position to make these choices?* The more that the decision depends upon the particular circumstances of the business, the more likely that the current owners should make the expenditure. The current owners have experience with the firm including its equipment and suppliers. New owners will need time to acquire the necessary experience to make a good decision.
- *How much risk is involved in the changes?* Risk is very much the foe of value. If current management is in a better position to deal with the risk associated with the expenditure, they should probably take care of it. The new owners may be reluctant to undertake the risk and therefore may be willing to pay less if they must shoulder the responsibility.

Summary of Issues

Factors that Enhance Business Value

- Established growth trends
- Capital projects with short-term payback
- Resolving uncertainty such as lawsuits or employee disputes
- Higher earnings due to more efficient operations

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- Establishing clear evidence of sustainable competitive advantages

Factors that Impair Business Value

- Negative growth trends
- Capital projects with high front-loaded cash outflows
- Dependence on a small number of large customers
- Difficulty of transferring goodwill to new owners

A discussion of preparing your business for valuation should not end without a mention of the materials that will generally be required for a valuation. These items include:

- tax returns for last five years;
- financial statements for last five years;
- detailed listing of fixed assets (appraisals may be necessary);
- information on industry norms from independent parties such as trade organizations;
- list of related parties and a description of all significant related party transactions;
- job descriptions of all related party employees;
- history of the business;
- copies of franchise agreements, leases, and distribution agreements;
- history of the significant events of the business;
- copies of the minutes of board of director meetings;
- copies of deeds;
- list of competitors, new entrants, and any companies that have gone out of business; and
- information of any similar companies that have changed hands.

Keeping these items nearby as the businessowner takes an active role in preparing himself or herself for a valuation of the business will further facilitate the valuation process and enable the owner to not be surprised when the valuation outcome is handed down.

About the Authors



MARGARET D. NOWICKI (mnowicki@ithaca.edu) is an assistant professor of business administration at Ithaca College. She teaches organizational behavior and human resources.



ERIC E. LEWIS (elewis@ithaca.edu) is associate professor and department chair of accounting at Ithaca College. He wrote his doctoral dissertation in the area of business valuations and has written extensively on the topic. In addition, Dr. Lewis has been a partner in a consulting firm specializing in business evaluations for the past 14 years.



JEFFREY W. LIPPITT (jlippitt@ithaca.edu) is an associate professor of accounting at Ithaca College. He has focused his research primarily in the area of business evaluations and has published extensively on that topic. In addition, Dr. Lippitt has been a partner in a consulting firm specializing in business evaluations for the past 14 years.