



Pharr Valuation and
Business Services, LLC

Business Valuation

Who Wants It? Who Needs It?

What's Involved?

Business Valuation – Who Wants It? The answer to this question is easy and straight forward. For the most part, no one really wants one. They are generally not inexpensive, and in the case of gifting or estate planning or estate taxes are a necessary evil at best.

Who Needs It? When it comes to family owned or closely held companies, business valuations are required by the Internal Revenue Service to support the value of the business interest that is to be included on a gift or estate tax return for the purpose of transferring the business to the next generation or other heirs.

Business valuations are used to determine an estimate of value when a company is being bought or sold. There is no requirement that a valuation be done in this case, but it is to the seller's advantage to know the value of the business. The seller doesn't want to sell for less than the company is worth and may lose the interest of potential buyers if the price is too high. The same holds true for the buyer, but from the opposite perspective. In a purchase situation, the bank may require a valuation of the business being acquired if financing is involved. The same basic reasons for a business valuation also apply in merger situations.

Another unfortunate reason for a valuation of a family owned business arises when a husband and wife decide to divorce and a business is part of the property settlement. In these cases the business owner usually thinks the business is not worth much and the spouse thinks it is worth a lot. A valuation analyst would provide an independent estimate of value of the business in question.

The allocation of the purchase price of a business to the various assets or segments acquired, partner disagreements or stockholder disputes are other reasons for a valuation.

What's Involved? A business valuation, performed by a certified or accredited business valuation analyst, is an independent valuation of all or part of a business interest. It is not an appraisal of specific real estate, equipment, or inventory. Those values are provided by management, or better yet, an independent professional appraiser with expertise in the asset

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being valued. The business valuation analyst is valuing the company or business interest taken as a whole.

Depending on the size, type and complexity of the business, a valuation of a family owned, closely held business will normally take 40 to 80 hours of work to complete,. The valuation engagement will span a period of 4 to 6 weeks. Valuations are generally performed on a fixed fee basis. The fee is based on the amount of time the valuation analyst estimates it will take to complete the engagement. Contingent fees are a violation of professional ethics, as it is inappropriate to charge a fee based on a specific or desired outcome.

The first step is to establish the purpose of the valuation. The premise of value would then be determined. Will the business be sold as a going concern where the company will continue operating in the future, or will it be sold on a liquidation basis and the assets sold as a whole or as separate pieces?

The next step is for the valuation analyst and owner to determine the standard of value to be applied. The first four standards of value generally apply when a going concern premise of value is used. The fifth standard of value is used with a liquidation premise of value.

1. Fair market value must be used when estimating value for gift and estate planning purposes. It is also used when selling or buying a business to a hypothetical or non-specific buyer or seller.
2. Investment value would be used if the valuation is done with a particular purchaser in mind who can gain efficiencies by combining operations and eliminating costs. This would also be true if the purchaser wanted to gain market share or eliminate a competitor.
3. Intrinsic value is the value of the property itself without any special attributes which might alter its market value. For instance, the intrinsic value of 18K gold inventory would be the value of the gold it contained.
4. Accounting or book value is seldom used as it often will not reflect the true values of the assets, liabilities and earnings of the company being valued.
5. Liquidation value can be either an orderly liquidation where the assets will be sold over a period of time that would allow for reasonable and normal exposure to their primary and secondary markets either as a whole or on a piecemeal basis. A forced liquidation would assume a shorter period of time and less exposure to the markets.

Establishing the premise and the standard of value will lead the valuation analyst to the valuation method which would be most appropriate in the circumstances. The valuation analyst analyzes the financial statements, tax returns, various financial ratios and the cash flows of the subject business interest. The valuation analyst then makes valuation adjustments to bring assets, liabilities and certain expenses to reflect current values. By using information obtained from outside databases and research, the valuation analyst compares the company being valued to industry data and to similar companies within the same or a closely related industry. Other factors, such as the history of the particular company, the industry in which it operates, and the state of the national, regional and local economy are also factors that must be considered.

There are three basic approaches used to value a company or business interest: the asset approach, the market method and the income approach.

1. The asset approach uses the net asset values of the company to determine value.
2. The market approach uses data from similar public companies or sales of similar companies and applies ratios derived from these companies and transactions to the subject company. It is often difficult or impossible to find publicly traded companies or other sales transactions that are truly comparable to a closely held private company.
3. The income approach uses cash flow and the application of capitalization or discount rates to establish value. This is the approach that is most often used.

The valuation analyst will review all three approaches to determine which is most appropriate in the situation. Once the approach has been chosen, various discounts and premiums may be applied as the circumstances warrant. A control premium or minority interest discount could be applied based on the business interest being valued. A premium would be added to the value of a controlling interest and a discount would be subtracted from a minority interest. Marketability is then considered. If an investor holds shares in a publically held company and wants to sell, he simply calls his stockbroker, places a sell order and has his money in three days. The sale of a privately owned company or business interest takes a considerably longer time. A marketability discount, based on historical data and empirical studies, is applied to account for this timing difference.

After all pertinent information has been gathered and analyzed; the valuation analyst determines his estimate of value of the company or business interest being valued. Arriving at this estimate of value is an application of both art and science.

Having a business valuation performed by an independent credentialed valuation analyst with a valuation certification from a recognized certifying organization is the most reliable way to determine the value of your business. A business valuation will put you in a better negotiating position and give you confidence that you are not selling your business for less than its value or paying too much for a company you wish to acquire.

Daniel Pharr is the President of Pharr Valuation and Business Services, LLC. He is a CPA and Accredited in Business Valuation (ABV) by the American Institute of Certified Public Accountants. He is a Certified Valuation Analyst (CVA), a certification awarded by the National Association of Certified Valuation Analyst (NACVA). Dan has 30 years of jewelry industry experience as an auditor, EVP and CFO of a manufacturing company, and business valuation analyst. His practice focuses business valuation of family owned and closely held companies within the jewelry industry. He may be contacted at Dan@PharrValuation.com or 804-332-5458.