

**Suite 506****VALUATION PRINCIPLES**

*Valuation Principles*  
*How to Value a Business*  
*Goodwill and Intangibles*  
*Equipment Valuation*  
*Real Estate Valuation*

**Introduction**

The regulatory and income tax environment is becoming ever more complex and difficult to navigate safely, especially for the global player. Within the last decade, tax authorities around the world have redoubled their scrutiny of transactions that cross international boundaries. Multi-state tax planning is also under attack by state authorities. Anti-trust and damage litigation is on the rise, not only domestically but around the world. Should you be involved in preparing for such an event, remember that credibility of the advice you receive will be the key to a successful outcome if challenged by tax and regulatory authorities.

Valuation services can provide: International Transfer Pricing and Tax Planning, Multi-State Tax Planning and Anti-Trust Analysis including Litigation Support and Damages Analysis. Select your valuation appraisals with care.

**506.01 FAIRNESS & SOLVENCY OPINIONS****Fairness Opinions**

Even the appearance of a conflict of interest can be a deal-killer, especially in situations involving major equity and/or debt transactions. It may even lead to litigation, an outcome no party to a deal generally relishes. The most effective proactive strategy to prevent that from happening is to obtain a fairness opinion before completing certain transactions.

A fairness opinion provides an independent objective analysis of a proposed deal's financial aspects from the point of view of one or more of the parties to the transaction. Any number of factors in deals involving both public and private companies can trigger the need for a fairness opinion. These documents are frequently used to protect the interests of company directors, stockholders, investors and involved parties with any kind of fiduciary responsibility. Fairness opinions are often requested in deals involving public offerings, leveraged buyouts or major refinancing/restructuring.

**Solvency Opinions**

A secured lender assumes it enjoys a priority position in the event of a bankruptcy filing by one of its debtors, and rightly so. However, a lender might find that priority position cancelled by the bankruptcy court unless it can present clear evidence of future solvency. The only effective means for a lender to protect its secured position in the event of a debtor's bankruptcy is with a solvency opinion.

In the past, accounting firms were permitted to issue solvency letters, but that is no longer the case. Accounting analyses using “agreed-upon procedures” and historical performance review do not meet the test of clear and convincing evidence of future solvency now demanded by the bankruptcy court. In contrast, the solvency opinions provided by Professional Appraisers can represent the kind of detailed analysis of critical financial variables the court requires. This can be accomplished primarily by a focus to demonstrate a sufficient cash flow to operate the business and service debt, even under adverse conditions. Not coincidentally, that is also the bankruptcy court’s focus.

As part of the analysis there must be a detailed review of the critical business risks, contingent liabilities, and the market value of assets. Among the resolutions of the completed solvency opinions reached are:

- That the fair market value of the company’s assets would exceed its stated liabilities and identified contingent liabilities
- That the company would be “able to pay its debts as they became absolute and mature”.
- That the capital remaining in the company would be reasonable for the business in which it is engaged.

### **HOW TO VALUE A BUSINESS**

Valuing a business can be one of the most worrying parts of buying an existing business.

To get a general idea of how healthy the business is, look at:

- The history of the business
- Its current performance – sales, turnover, profit
- Its financial situation –cash flow, debts, expenses, assets
- Why the business is being sold

As part of your investigations, talk to the vendor and the business’ existing customers and suppliers. They may be able to give you information that affects your valuation.

For example, if the vendor is being forced to sell due to decreasing profits, your valuation will be lower. They may also be able to give you general market information about conditions affecting the business.

The most difficult part is valuing the intangible assets. These are usually difficult to measure and could include:

- The company’s reputation
- The relationship with suppliers
- The value of goodwill
- The value of licences
- Patents or intellectual property

You should consider how the value of these assets could be affected if you decide to buy the business.

The list below details other factors that will affect the value:

- Stock
- Assets
- Products
- Debtors
- Creditors
- Suppliers
- Employees
- Premises
- Competition

Once you have considered all these factors you can then decide how much you want to offer, or whether you want to buy it at all.

If you do decide to make an offer, and agree a price with the seller, a period of time is allowed for you to verify that all of the information you have been told is accurate. This is known as due diligence.

## 506.02 DETERMINING VALUE

A realistic business valuation requires more than merely looking at last year's financial statement. A valuation requires a thorough analysis of several years of the business operation and an opinion about the future outlook of the industry, the economy and how the subject company will compete.

**Most people believe that a business should be sold for Fair Market Value. The term Fair Market Value is defined by the U.S. Tax Authorities (IRS) (at Rev. Ruling 59-60) as follows:**

“the price at which the property would change hands between a willing buyer and willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

There are a number of different methods to determine a fair and equitable price for the sale of the business. The following lists a few methods to determine the price:

- **Capitalized Earning Approach** – This method refers to the return on the investment that is expected by an investor.
- **Excess Earning Method** – This method is similar to the capitalized earning method except that this method splits off return on assets from other earnings.
- **Cash Flow Method** – This method is usually used when attempting to determine how much of a loan the cash flow of the business will support. The adjusted cash flow is used as a benchmark to measure the firm's ability to service debt.

- **Tangible Assets (Balance Sheet) Method** – This method is based upon the buyers buying a wanted intangible asset versus creating it. This method also takes into consideration valuing the Good will of the business.

### Assessing business value

Buying anything for the best price is a matter of skilful negotiation. But it is advisable to apply one of the following methods of valuing the target business.

- **Net Asset Value** - The value of the business' assets on the open market, minus outstanding liabilities to creditors, bank borrowings, tax authorities and redundancy payments due.
- **Entry Costs** - The cost of starting up a similar business, which might include the assets, product development, employment and marketing cost, and including any savings you can foresee by merging the business with your own.
- **Cash flow** - Forecasted cash flow for a number of years, discounted to net present value. An industry expert will be able to advise on how to apply discount factors.
- **Price/earnings ration (P/E)** - The most common formula used to value a public business. It is calculated using information that is readily available in the financial press and can be adapted to value any small private business. Divide the company's share price by its earnings per share, so if the company's share price is \$30 and it is earning \$3 per share, its P/E ration is ten.

To use P/Es to value an unquoted business, look up the P/E ratio for the relevant sector, then apply a discount of at least 30 per cent because the target business is not on the stock market – shares in a public company are much more liquid and seen as more valuable.

A business run by one person is generally valued at around half the value of a comparable private company run by a team of three or more experienced managers. Customers are probably loyal to the owner manager and may not come to any new owner.

The economic cycle also affects private business valuations. At the bottom of the cycle – a downturn – small private companies sell on multiples of between six and eight on average. At the top of the cycle – a boom – the same company may sell for between ten and 12.

See the private company price index on the BDO Stoy Hayward website.

Accountants, lawyers and tax advisers often have extensive experience in valuations – using their experience will reduce the danger of you paying too much or owning unforeseen debts.

## 506.03 TANGIBLE ASSETS

Accurate, defensible valuations of tangible assets play a critical role in many business situations, ranging from the mundane to the esoteric. Real and personal property valuations are important for tax and financial reporting, asset monitoring, property insurance, ad valorem taxes and replacement budgeting. At

the other end of the spectrum, valuation of assets can be an indispensable tool in establishing prices, justifying positions to stockholders and satisfying governmental concern in the course of corporate mergers, acquisitions, refinancing and restructuring.

Real property includes industrial, commercial and municipal land, building improvements, and easements. Personal property refers to machinery, equipment, inventory, motor vehicles, trade fixtures, furniture, computer equipment, wiring, piping and the like.

## **GOODWILL AND INTANGIBLES**

### **506.04 GOODWILL - AN ASSET**

Goodwill and intangible assets often represent a considerable portion of an enterprise's net worth, and recent changes to Financial Accounting Standards Board (FASB) rules for treating goodwill and intangible may have an important effect on the valuation of some companies. The implications for past, pending and future mergers, acquisitions and other deals are significant, so it is important that business owners be familiar with these new rules, FASB Statements 141, Business Combinations, and 142, Goodwill and Intangible Assets.

FASB 141 requires all business combinations to be evaluated using the purchase method of accounting, and it specifically prohibits use of the pooling-of-interests method. It also provides recognition criteria for intangible assets other than goodwill, along with general guidelines for assigning values to assets acquired and liabilities assumed. FASB 141 defines an intangible asset apart from goodwill as:

- An asset arising from a contractual or legal right, such as a patent, trademark or copyright.
- An asset other than contractual that can be sold, transferred, licensed, rented or exchanged individually or in combination with a related contract, asset or liability.

Under FASB 141, parties to a business combination are required to estimate the fair value of acquired intangible assets in the following manner. First, intangible assets must be categorized by type, such as customer list, trademarks, patents, software, intellectual property, etc. Second, intangible assets with an identifiable remaining useful life must be separated from those with an indefinite useful life. The latter are then classified as goodwill and must be subject to a two-step test for impairment under FASB 142, which companies were required to adopt by January 1, 2002.

### **Amortization Eliminated**

The major change of FASB 142 is that amortization of goodwill will no longer be permitted, although it will still be recognized as an asset. Instead, goodwill and other intangibles will be subject to an annual test for impairment of value. Not only will the change affect goodwill related to acquisitions completed after the effective date, it will also effect any balance of goodwill from previous deals that has not already been amortized. In the past, goodwill has been amortized over its useful life, up to a period not to exceed 40 years.

Instead of amortizing goodwill, companies will now have to test goodwill at least once a year for impairment. Businesses must perform this testing in new reporting units, develop valuation methodologies for those units and subjectively value identifiable intangible assets. FASB 142 requires businesses to perform a Transitional Impairment Test on all goodwill within six months. The calculated amounts should be measured as of the first of the year. If this first step indicates that goodwill is impaired, any impairment loss should be calculated and recorded as soon as possible prior to year-end.

### **Two-Step Process**

After the initial Transitional Impairment Test is conducted, businesses must perform the Goodwill impairment Test on an annual basis (with certain exceptions) under FASB 142. This process must be conducted at the reporting unit level, defined as the lowest level of an entity, i.e. business units, subsidiaries, operating units, division, etc. There are two steps to the process:

1. Identify potential impairments by comparing the fair value of a reporting unit to its carrying amount, including goodwill. Goodwill is not considered impaired as long as the fair value of the unit is greater than its carrying value. The second step is only required if an impairment to goodwill is identified in step one.
2. Compare the implied fair market value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair market value, an impairment loss is recognized. That loss is equal to the carrying amount of goodwill that is in excess of its implied fair market value, and it must be presented as a separate line item on financial statements.

Historically, accounting for business combinations has been one of the most controversial issues in financial reporting. With the rapid pace of change in today's marketplace driven by technological advances, new business models and other factors-the role of financial reporting in maintaining stability of capital markets will only increase. FASB 141 and 142 are intended to address critical issues of currency and accuracy in financial reporting.

## **506.05 INTANGIBLE ASSETS**

Intangible assets such as brands, intellectual property and licenses now comprise a greater percentage of the economic value of successful businesses than ever before. Some economists argue that intangibles represent the main performance drivers in the current transition from a traditional financial economic structure to a new knowledge-based economy.

The value of identifiable intangible assets are important to:

- Shareholders and their advisors, for use in assessing the true worth of their companies
- Management, as a useful tool for measuring performance, for taxation purposes and in the event of an acquisition or disposal
- Financiers, for use in assessing the borrowing capacity of a company when arranging funding facilities. Sophisticated lending institutions now recognize the value of certain intangible assets as security for loans.

Because businesses are often worth far more than the sum of their hard assets and working capital, a crucial aspect of a valuation involves assigning value to intangible assets. Among the various types of intangible assets assigned value are:

- Patents, copyrights and licenses
- Customer lists and relationships
- Non-compete agreements
- Favorable financing
- Software
- Trained and assembled workforces
- Contracts
- Leasehold interests
- Unpatented proprietary technology
- In-process R&D
- Databases
- Trademarks/trade names

You must attempt to find the true value of your accumulated patents, trademarks, copyrights, domain names, and other forms of proprietary information and intellectual property.

Transfers can occur for many reasons. For example, a company may realize certain tax benefits by **transferring intellectual property** into a holding company. In other instances, commercializing a new technology may involve the transfer of intellectual property to a joint venture. Moreover, negotiating licensing and royalty agreements are also circumstances where valuing intellectual property may become an issue. Whatever the case, creating a reliable technique for establishing the value of intellectual property requires a combination of specialized skills, which are embodied by professionals. Intellectual property is unique by definition, and therefore a single blueprint approach is unable to provide you with an accurate representation of its value.

## **EQUIPMENT VALUATION**

### **506.06 THE THREE BASIC APPROACHES**

Equipment appraisals and valuations are a vital part of financial reporting, property taxes, insurance planning, asset based lending, and more. On a broader scale, equipment appraisals give your business the information it needs to establish values, satisfy governmental requirements in connection with mergers and acquisitions, facilitate loans, and retain the proper insurance coverage. Accurate equipment appraisals are critical and may include analyses that determine the useful and remaining life of your equipment. This can be very helpful in helping with business planning for future equipment acquisitions and capital outlays.

There are three basic approaches to value equipment. In the valuation process, all approaches are considered, and usually, one or two are applied (depending on the asset). The goal is to guarantee a well researched, documented approach to value that could be relied upon by all intended users.

## **Sales / Market Approach**

Values can be estimated by comparing the subject with similar items that have recently sold or are currently offered for sale in the marketplace. Within these items, factors such as capacity, age, location, date of sale, are all adjusted towards the subject property in order to arrive at a reasonable value. This approach is preferred when many sales of like items have occurred in the marketplace as all factors of depreciation have been included in those prices.

## **Cost Approach**

This is an estimate of present replacement cost of the subject less all accrued depreciation. Depreciation includes loss in value due to physical deterioration, functional and economic obsolescence. This approach must be performed by a knowledgeable appraiser as he is predicting adjustments made by the marketplace. This approach is employed when sales data is not available for like items. This is usually the preferred approach to value plants, specialized machinery and equipment, and software.

## **Income Approach**

This is an application of the capitalization of the future of income the item will produce. In order to apply this approach, a clear indication of the income from the asset is required along with all the support equipment and other costs incurred. This approach is used once sales comparison is not available and it is more appropriate than applying the cost approach. Typical uses are for rental equipment (construction, transportation), Patents and certain software applications.

# **REAL ESTATE VALUATION**

Whether a company leases space or invests in its own land and building, the value for the real estate is of concern to several parties. These parties include potential lenders, other partners or shareholders, the small business owners themselves and the landlords who rent space to the business.

## **506.07 OWNERSHIP VALUE CONSIDERATION**

Beyond the "commonsense" criteria of investing in real estate for the business (price and value, location, size and utility), the business owner also must consider that determining real estate value is important when preparing business plans for financing purposes.

Regardless of how valuable the location may be perceived by a business owner, the amount of the real estate financing is directly linked to the property's appraised value from an independent third party's point of view. Typically, a conventional lender will lend up to approximately 75 to 80 percent of the appraised value of the property. This means that the business owner must have the financial capability to finance the remaining 30 to 25 percent plus the required closing costs and other out of pocket expenses involved in financing the transaction.

In preparing business plans and required cash flow projections, many small businesses fail to consider the additional working capital required for financing or buying commercial real estate.

In addition to good faith deposits and down payments, these additional costs may include bank fees and points (one point equals 1 percent of the loan amount), legal fees, appraisal costs, environmental studies, additional fit-up or construction costs, brokerage fees and deed transfer taxes and recording fees.

## 506.08 AGAIN - THREE METHODS

Appraisers consider real estate value from three points of view and determine an estimated value based upon weighing the three valuation methods. These three methods are **comparable sales method**, **income approach**, and **cost approach**.

Quite simply, the **comparable sales method** determines an approximate value based upon sales of similar properties within a reasonable recent period of time. Similarities include type of property, age, location, size and other tangible criteria. Value adjustments are made (either positive or negative) for the subject property relative to the sold property. For example, if a sold property was in better condition, or newer, than the subject property, then the adjustment would be made to lower the sold property's actual value to make it more comparable to the property being appraised.

The **Income approach** determines an estimate of total real estate value based upon the rate of return from potential net operating income from the property (assuming it was leased to a third party). In this method, an appraiser would estimate an annual income rate for the property based upon similar rates for similar users. For example, the appraiser might determine that a retail store might rent for a rate of \$9 per square foot per year. This rate should be comparable to other retail spaces in the vicinity (which should be documented in the appraisal document).

Once this lease rate is determined, the property's value is estimated using a type of multiplier known as a capitalization rate, or cap rate. Historically, cap rates are subject to several factors including the strength of the type of tenant, the level of landlord involvement, economic conditions and type of industry. However, for illustrative purposes, a property with a good tenant in a good location might command a cap rate of 12 percent in a good market.

The value of the real estate is determined by multiplying the net rental rate by the reciprocal of the cap rate. In the example given, the value would be calculated by multiplying \$9 per square foot by 8.3 (100 percent divided by a 12 percent cap rate). This would mean that the investment value of the real estate would be equal to \$74.40 per square foot.

Often, these figures are further adjusted to consider other variables such as vacancy rates, property management costs and other investor related factors.

The **cost approach** evaluates the replacement value of the property by analyzing the cost component of the specific land and building. The variables involved in estimating value are contingent upon location, geographic region of the country, labor and material costs.

Factors that are considered include costs for land acquisitions, site preparation, utilities, types of building materials, tenant improvements and soft costs (architectural and engineering costs, legal and brokerage fees and other similar related costs).

### **Reconciliation of the three methods**

All methods are then summarized, reconciled and compared to each other to evaluate their relative values.

In a perfect business environment, the three variations of value would likely produce relatively similar results. Quite often, however, each method may produce somewhat different values from one another. This occurs because all real estate is unique, general economic conditions may vary by region and time and good market information is not readily available to buyers, sellers, landlords and tenants in the real estate market (as compared to stock markets).

Because of these general principles, the valuation of commercial real estate is an educated estimate based upon several factors. These include the collective experience and expertise of the appraiser, available and relevant information in the market, the willingness of the lender to accept the estimates and the ultimate agreement of the buyer and the seller on the property's price and terms in an independent, arm's length transaction. Copyright 2002 NHBDC

### **Helpful Links re Real Estate Valuation:**

International Association of Assessing Officers:

[http://www.iaao.org/education/non\\_traditional\\_programs.asp](http://www.iaao.org/education/non_traditional_programs.asp)

Real Estate and Appraisal Organizations/Associations/Societies/Institutes/Councils

<http://www.propertyvalu.com/comweb.htm>

Office of Real Property Services (New York):

<http://www.orps.state.ny.us/assessor/valuation/index.htm>

Commercial Property Register (United Kingdom):

<http://www.compropregister.co.uk/>

Commercial Software to monitor, measure and report the financial performance of commercial real estate assets:

<http://www.argussoftware.com/products/insight/>

Factors to Consider When Looking at Commercial Real Estate:

Rules for location, Factors to Consider in Reviewing Your Business Location, Know Your Lease Types, Business Terms and Negotiations and Basic Advice:

[http://www.nhsbdc.org/Article2\\_Real%20Estate%20Location.htm](http://www.nhsbdc.org/Article2_Real%20Estate%20Location.htm)