Business Valuations and Why They are Needed

David E. Consigli, Jr., CPA, ABV, CPVA, CDFA

WHAT IS BUSINESS VALUATION?

Establishing a Value of an Interest in a Business or Professional Practice

Reasons for a Business Valuation

Reasons for a Business Valuation

Succession and Shareholder Planning
- Estate and Gift Tax
- Buy/Sell Agreements
- Stock Options
- Stock Buybacks

ESOP and ERISA
- Formation
- Annual Valuation
- Follow-on Deals
- Exit

Financial and Tax Reporting
- Purchase Accounting
- Goodwill impairment testing
- Portfolio company valuations
- Realignment or reorganization of subsidiaries

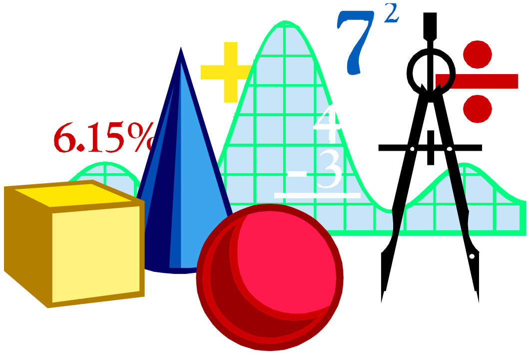
Transaction Advisory
- Formation
- Annual Valuation
- Follow-on Deals
- Exit

Litigation Advisory
- Shareholder dispute
- Bankruptcy proceedings
- Family law matters
- Shareholder oppression actions
- Expert witness/lost profits/damages calcuLations

Standards of Value

Fair Market Value Definition:

The price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties have reasonable knowledge of the relevant facts. (Revenue Ruling 59-60)



Standards of Value

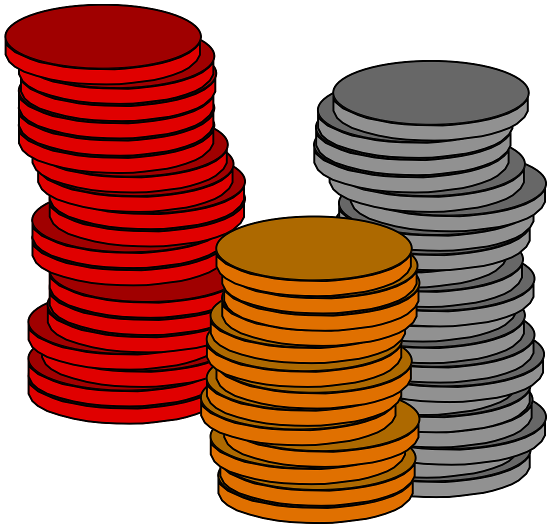
Fair Value

Investment Value

Intrinsic Value

WHAT ITEMS AFFECT VALUE?

Marketability



WHAT ITEMS AFFECT VALUE?

Minority Interest

Key Man

Control Premium

The Valuation Process ...

- Recast historical financial statements
- Determine appropriate valuation method
- Project future performance of business
- Analyze general economy and specific industry
- Synthesize value conclusion

Recast Historical Performance …

- Review cost structure
- Normalize expenses, as necessary
- Determine real earnings capacity *(realize more emphasis is placed on cash flow)*
- Segregate non-operating assets and liabilities and value separately

VALUATION METHODS

Income Approach

Market Approach

Asset Approach

INCOME APPROACH CONSIDERATIONS

- *Value is equal to all future economic benefits that will inure to a holder of an asset over an investment period, reduced to a present value at a particular date of valuation.*
  - Two Primary Methods Under the Income Approach
    - Discounted Cash Flow
    - Capitalization of Free Cash Flow

INCOME APPROACH CONSIDERATIONS

- Model Selection and Application
- Free Cash Flow Calculations
- Risk (Discount) Rate Implications

The Income Approach ...

Value today is PV of future benefits

■Considers time value of money and risk

■Use history to project future cash flows

■Capitalize or discount cash flow

The Income Approach …

Value today is PV of future benefits

- Considers time value of money and risk
- Use history to project future cash flows
- Capitalize or discount cash flow

MARKET APPROACH

- Definition

  "...a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold."

  Practical Application

  Apply market-based multiples to subject company metrics

MARKET APPROACH

- *Methods*
  - Guideline transaction (merged and acquired) method
  - Guideline public company method
  - Past completed transactions method,
  - Rules of thumb

The Market Approach …

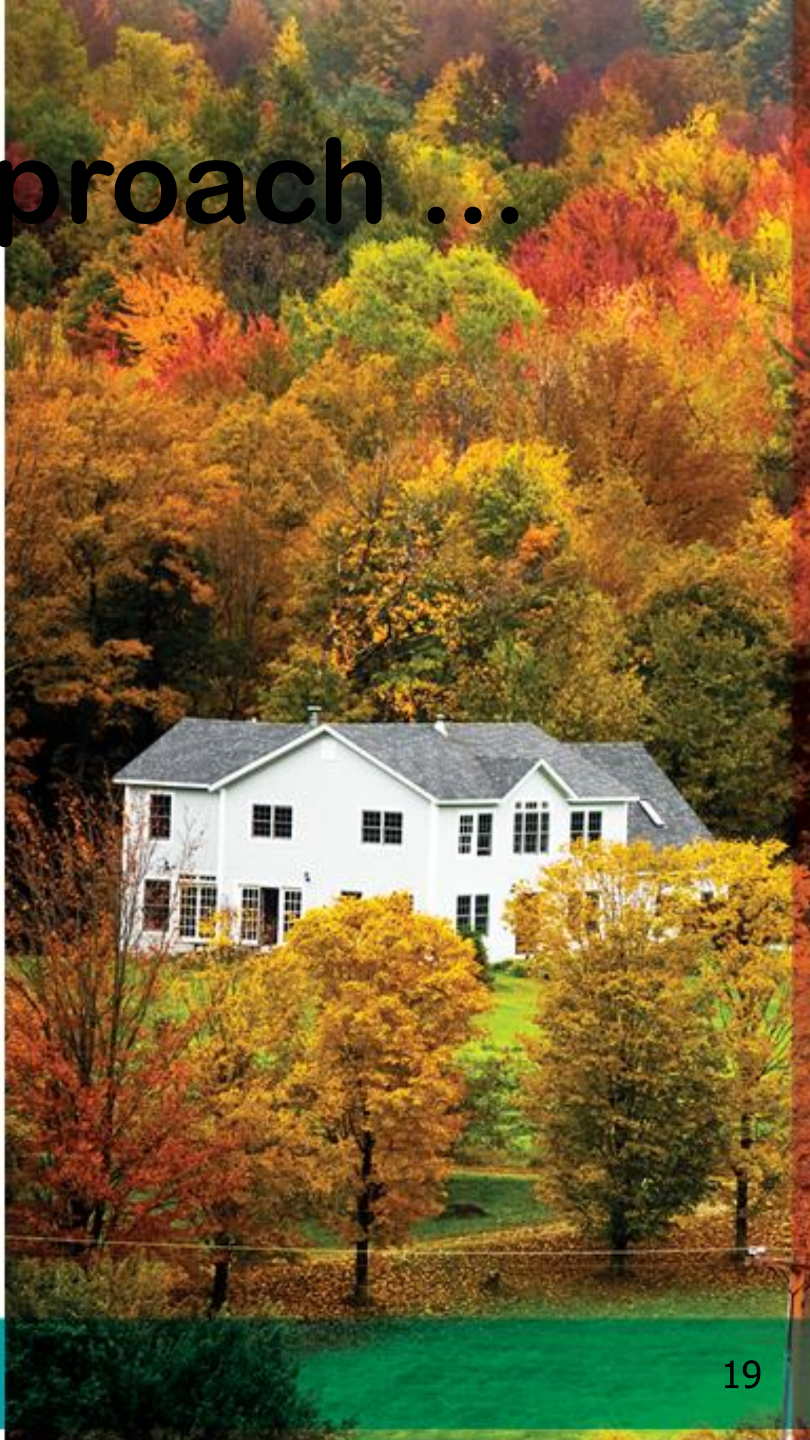
Guideline public companies

- Valid if you can find public companies of similar size and/or activity
- Price to revenue, book, earnings multiples applied to same measures of your company

The Market Approach …

Consolidator activity

- Happening across a broad spectrum of industries
- Often, price offered/paid has no correlation to value
- Useful only if there is a chance it could happen to you



ASSET APPROACH CONSIDERATIONS

- *Methods under the Cost/Asset Approach:*
  - Asset Accumulation Method
  - Excess Earnings Method
  - Rules of Thumb (Asset-Based)
  - Sellers Discretionary Cash Flow

The Asset Approach …

- An itemized appraisal of all tangible assets and identifiable intangibles
- Seldom used for operating companies
- Method of choice for real estate or investment holding companies

How Will Tax Reform Impact Business Valuations?

1. Reduce Corporate Tax Rate From 35% of 21%

    Reduced tax rates will lower current taxes and increase cash flow

    Deferred tax assets, like the value of a net operating loss, will be reduced in value

    Deferred tax liabilities will be reduced

    Book/tax differences in depreciation

    For contractors, the tax liability on deferred income under the completed contract accounting method will be reduced

    Cash basis taxpayers will have a reduced deferred tax liability on its unreported income

2. Limits on Deduction of Net Operating Losses (NOL)

    In addition to the reduced value of NOLs because of tax rate decreases, NOLs may no longer be carried back and can only be used to offset 80% of a company's income, resulting in a lower current tax benefit.

3. Faster and More Liberal Rules on Depreciation of Capital Equipment

    This allows for an immediate deduction for property placed in service, resulting in a reduced current income tax liability.

4. Net Interest Expense Deduction is Limited to 30% of EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)

    This limitation of deductibility will increase current income tax liability

    The limitation may cause a consideration of adjusting the capital structure ratio between debt and equity

5. Repeal of the Corporate Alternative Minimum Tax (AMT)

    While this would generally decrease current taxes, based on our experience, most private companies do not end up subject to the AMT.

Official estate and gift tax limits for 2019

- The estate and gift tax exemption is $11.4 million per individual, up from $11.18 million in 2018.
- An individual can leave $11.4 million to heirs and pay no federal estate or gift tax, while a married couple will be able to shield $22.8 million.
- The annual gift exclusion amount remains the same at $15,000.

Estate Planning Transfer Valuations

- Estate planning transfer valuations may be affected. While the high exemptions make this irrelevant for most taxpayers, for the wealthy still affected by the estate tax, assumptions in valuation models that increase values may make planning more challenging. This is important as many ultra-high net worth taxpayers seek to shift wealth before the possibility of a change in tax laws under a future administration if there is a change in composition in Washington.
- For example, a client with $100 million business interest may view the current estate tax environment as a window of planning opportunity to act on before a different administration may enact harsher tax legislation. The impact on values of the TCJA may affect the structure of that transaction. For example, a larger value might trigger a need for a guarantee whereas at a lower valuation level that may not have been required. For more moderate wealth taxpayers seeking to take advantage of the current high temporary exemption (the new temporary exemptions decline in 2026 from a basic exclusion of $10 million to $5 million) may be affected by changes in valuations. It may be advantageous for only one spouse to make a gift to preserve the exemption of the other spouse.

ESTATE TAXES

2017

approximately 6,500 estates paid estate taxes

2018

Estimated only 1,890 estates will pay estate taxes.

2017

exemption amount was $5.49 million per person

2018

exemption amount is $11.18 million

Cuts are scheduled to expire after 2025, meaning the estate tax exemption will revert to its inflation-indexed base of $5 million

https://www.posticbates.com/blog/estate-and-gift-tax-limits-2019

Types of Engagements

Calculation of Value

- Limited use/internal
- Used for planning/what if scenarios
- Early stages of divorce, shareholder litigation
- Range of value

Conclusion of Value

- Specific value as of…….

What Type of Reports

Written – Detailed

Written-Summary

Written-Calculation

Oral Report

Benefits of Hiring a CPA Firm for Your Business Valuation

- By working with a business valuation services practice that is part of a full-service CPA firm, you'll benefit from multidisciplinary expertise, enabling us to focus not just on the science of the valuation, but also on the art of the process. In addition, we can help you with post transaction services so there's continuity of relationships and knowledge.

Five red flags to be aware of in business valuation appraisals

1. Discount rate inconsistent with type of cash flow

When applying the income approach correctly, the discount rate must be matched with the type of cash flow being valued. For example, equity cash flows should be discounted using an equity discount rate while a weighted average cost of capital should be used for discounting invested capital cash flows. In addition, this mistake is commonly seen in valuations of S Corporations (i.e. after-tax discount rates are applied to pre-tax cash flow streams). Incomparable cash flows and discount rates will lead to errors in valuation.

2. Exclusion of necessary working capital estimates

When estimating the future growth of a company, it is important to forecast necessary investments in working capital to accommodate such growth. Many times, appraisers will increase cash flow projections to reflect sales growth; however, they will fail to reflect the cash outflows for working capital investments to support those sales forecasts.

3. Failure to reconcile depreciation and capital expenditures

Net cash flows include add-backs for non-cash items (i.e. depreciation and amortization) while capital expenditures must be subtracted. Depreciation can exceed capital expenditures in the short run; however, depreciation cannot exceed capital expenditures in the long run as the assets would be depleted and the business would not continue operations as a going concern.

Five red flags to be aware of in business valuation appraisals

4. Lack of consideration for non-operating assets and liabilities

Assets and liabilities that are held by a company but do not support their operations should be considered separately from operating value. For example, consider a manufacturing company that holds undeveloped real estate not currently used in the business and which is also encumbered by a mortgage. Since the asset and liability are not utilized in operations, they do not contribute to the operating value of the company and the value of these assets and liabilities, as well as related income and expenses, should be eliminated to calculate the operating value of the business. However, the value of the non-operating items must still be considered; therefore, the value of the non-operating asset, less the liability, should be added to the company's operating value.

5. Use of valuation multiples from synergistic transactions

Under the "fair market value" standard, which assumes a hypothetical willing buyer and seller, synergistic transactions should generally not be considered when using the market approach/guideline company transactions method. Revenue or cost synergies that are created due to a particular buyer, not available to other market participants, would produce a transaction that is considered "investment value." Consequently, multiples that are drawn from these types of synergistic transactions should generally not be applied to a subject company's earnings stream for purposes of calculating "fair market value." The exception to this general guidance may exist if the pool of hypothetical buyers in the market is solely comprised of synergistic buyers

Questions & Comments

AAFCPAs great minds | great hearts

David E. Consigli, Jr., CPA, ABV

774-512-4005

dconsigli@aafcpa.com

Thank You!

- For more information, visit: www.aafcpa.com