

Valuation of a Closely Held Business

Over the years, you have invested your time, energy and money to help develop and grow your business. Now your business is the source of your family's livelihood and has become a major portion of your estate. Your business achievements are also a great source of pride and satisfaction. For all of these reasons, proper management of the business is vital. Determining the value of your business is an essential step for any well-run company positioning for success. But valuation is a subjective process and there are a number of different ways to approach the task.

The intent of this brochure is to take the mystery out of business valuation methods and to point out the important role business valuation plays when you are making strategic decisions for your business.

Purpose of a Business Valuation

You may need to determine the value of your business for a variety of tax or legal purposes. A professional valuation of your business may be needed to determine the:

- *Value of your estate at death for purposes of calculating federal estate tax liability. (Penalties from 20% to 40% may be imposed on the estate for understating the value of an asset on the federal estate or gift tax return).*
- *Potential gift tax liability when the business is given or sold to family members for less than fair market value.*
- *Value of the business interest at the time a gift of that interest is made.*
- *Value of the business or business assets at the time of sale or purchase.*

- *Value of the business for loans or other debt transactions.*
- *Income tax liability at the time a C corporation is converted to an S corporation.*
- *Annual value of company stock that is part of an Employee Stock Ownership Plan (ESOP) or used as the underlying value for a phantom stock program.*

How to Determine the Value of Your Business

There is no single method of determining a business's value. Various methods may be used for different purposes. It is important for the business owner to understand that estimating the value of a closely held business is not a science. The Internal Revenue Service has offered some guidance in this area by providing factors that it may consider in valuing a business interest. The factors set forth in Revenue Ruling 59-60 are:

- *The nature and history of the business*
- *The economic outlook of the industry in which the business is engaged*
- *The book value of the business and its financial condition*
- *The business's earning capacity*
- *If a corporation, its dividend-paying capacity*
- *The existence or absence of goodwill and other intangible values*
- *Prior sales of stock and the size of the block of stock to be valued*
- *The market price of stock in comparable companies*



Although all of these factors are important in determining the fair market value of a closely held business, some factors may be more important than others because of the unique facts and circumstances of your business. There is no rule of thumb for determining the weight given to each factor. All of the factors should be considered or explained in a business valuation conducted by a professional appraiser.

Methods of Valuing Interest

The three basic approaches to business valuations are the asset approach, income approach and market approach.

Asset Approach

The asset approach assumes that the value of a business is based on the underlying value of the business assets.

Generally, the assets and liabilities are adjusted from the book value on the balance sheet to their respective fair market values. The resulting excess of the value of the assets over the liabilities of a business is the fair market value of the business.

The fundamental problem with the asset approach is that it looks at the business assets as valuable in and of themselves, without regard to their impact on the business as a going concern. However, a business generally holds assets primarily as a means of generating future income.

Except in the rare case where an investment in a business is made with the intent of liquidating the company, one might argue that the only real value in business assets lies in their ability to enhance a company's earning power.

Revenue Ruling 59-60 provides some guidance as to the use of this valuation methodology stating that it is most suitable for business entities that hold

significant nonoperating assets such as financial investments and/or real estate.

Income Approach

The income approach is a commonly accepted method of estimating fair market value. It examines the flow of income from the business and converts that income stream into a value for the business. This approach is useful when the company is a reliable income producer for the owners.

There are a few variations on the income approach. Adjustments must be made under each variation to account for items such as nonrecurring or unused items, nonoperating assets, depreciation, related party transactions, and excess, or in some cases, inadequate salaries to owners.

Variations on the income approach include:

■ CAPITALIZATION OF INCOME METHOD

The capitalization of income (or earnings) method is one of the most commonly used methods of valuing a closely held business. This method rests on the concept that the value of the business is a function of its income stream. Typically, an average (or weighted average) of at least five years of after-tax adjusted earnings is used as a starting point. Next, an appropriate capitalization rate must be determined. The capitalization rate is a percentage used to convert income into a value. Ideally, this rate would be determined by analyzing capitalization rates of various publicly traded companies. Where capitalization rates for comparable companies are not available or appropriate, a guideline is to use a rate of 10% for medium risk businesses and adjust from there (e.g., 20% for businesses that are less financially stable, lack management depth,



have little capital, and are generally high risk). The inverse of this rate is the capitalization factor, which is multiplied by the average earnings to reach an estimated value for the business.

■ DISCOUNTED FUTURE RETURNS METHOD

The discounted future returns method is a complex method of valuing the business based upon the net present value of earnings that the business expects to generate in the future. This involves forecasting future earnings, which is somewhat speculative, but there are sophisticated mathematical models that help to determine future earnings. Future earnings are then discounted to obtain the net present value. The rate used to discount is also known as the opportunity cost or “fair return” - the profit rate that an investor would expect to receive on his or her investment.

Revenue Ruling 59-60 tends to place more emphasis on valuation methodologies that look to past earnings/cash flows, rather than valuation approaches that employ a projection of the future that may never materialize.

■ EXCESS EARNING METHOD

The excess earnings method is another variation of the income approach. This method uses a capitalization approach to determine the value of the business’s goodwill and adds it to the adjusted book value of the other assets. The excess return attributable to goodwill is generally capitalized at a higher rate than might typically be used to reflect the fact that basing returns on goodwill is speculative.

Goodwill is generated by such variables as the reputation of the business or product, the personalities of key persons, and the ability of the business to provide reliable service to its

customers. Although not easily defined, an attempt needs to be made to value

Market Approach

The market approach (also known as the “comparative method”) involves valuation based on the prices of actual sales of similar or comparable companies, with the assumption that similar companies will have similar relative values. This approach requires finding a sufficient number of companies with similarities to the business being valued. The businesses selected would be from the same industry or line of business, and consideration must be given for size, growth expectations, diversity, capital structure, earnings, geographic location, market similarity, and market position. Having identified a similar business, adjustments need to be made for differences between the comparable company and the closely held company. Although this is the favored approach of Revenue Ruling 59-60, this method is difficult to use with small closely held companies because of the difficulty of identifying publicly traded “comparable companies.”

The Need for Valuation Experts

A business owner can often gain an approximate idea of what the value of the business is worth by using a formula that is used in the industry with which the business is associated. However, while formula approaches provide a basis for beginning the valuation process, the need for expert judgment overshadows these mechanical approaches when an important decision relating to tax, compliance, or the sale of a business is being made. In situations such as these, business owners should seek the counsel of a credentialed business appraiser.



There are four major professional organizations in the United States and one in Canada that offer accreditation in terms of a professional designation in business valuation. The chart below lists the four U.S. organizations and their designations along with the requirements for accreditation.*

Business Valuation Credential Comparison				
Organization	Credential	Prerequisites	Courses/Reports	Experience in BV
American Society of Appraisers (ASA)	AM—Accredited Member	-College degree or equivalent	-Completion of four 3-day courses with a half-day exam following each course, or the successful completion of one eight-hour challenge exam. -Successful completion of a one-hour ethics exam. -Completion of a course on Uniform Standards of Professional Appraisal Practice including a one-hour USPAP exam. -Submission of two actual reports to the satisfaction of the Board of Examiners.	-Two years full-time or equivalent experience. Requirement is reduced by one year if applicant is a CPA, CFA, or CBI with 5 or more years of practice in that field.
	ASA—Accredited Senior Appraiser	-College degree or equivalent	-Must have met requirements for an Accredited Member as shown above.	-Five years full-time or equivalent experience. Requirement is reduced by one year if applicant is a CPA, CFA, or CBI with 5 or more years of practice in that field.
	FASA—Fellow of the American Society of Appraisers	Designation is awarded to an ASA only when voted into the College of Fellows on the basis of technical leadership and contributions to the profession. If awarded, this replaces the ASA..		
American Institute of Certified Public Accountants (AICPA)	ABV—Accredited in Business Valuation	-College degree -AICPA membership with a current CPA license	-45 hours from life-time learning (CPE, college credits, lecturing, etc.) -Eight-hour exam	-150 hours of experience in business valuation.

Chart continued on next two pages.

*Information obtained from organizational websites, September 2008.

Business Valuation Credential Comparison (continued)				
Organization	Credential	Prerequisites	Courses/Reports	Experience in BV
Institute of Business Appraisers (IBA)	AIBA—Accredited by Institute of Business Appraisers	-College degree or equivalent	-Must have completed IBA Course 8001, an 8-day (64 hours) workshop in Valuing Closely Held Businesses or hold a journeyman level designation in business valuation from an organization recognized by The Institute of Business Appraisers. -Must pass a 4-hour proctored exam. -Must submit one business appraisal.	-None specified
	CBA—Certified Business Appraiser	-College degree or equivalent	-90 classroom hours of upper level coursework or have 10,000 hours of active experience as a business appraiser. -All applicants must complete IBA's 16-hour course 1010, report writing. -Must pass a comprehensive 6-hour written examination but can exempt out of the exam if one holds a BV credential from NACVA, ASA, or AICPA. -Must submit two business appraisals.	-Must have 10,000 hours active experience as a business appraiser or have completed 90 classroom hours of upper-level coursework.
	MCBA—Master Certified Business Appraiser ABAR—Accredited in Business Appraisal Review	These credentials are given to members of great distinction, experience and contributions to the association.		
National Association of Certified Valuation Analysts (NACVA)	AVA—Accredited Valuation Analyst	-College degree in a field of business	-40 hours of optional training. -5-hour proctored exam and a take-home exam (40 to 60 hours to complete) that includes a Case Study . -A client business valuation report can be used in lieu of the Case Study.	-Two years or more of fulltime experience in business valuation and related disciplines or ten or more business valuations or can demonstrate substantial knowledge of business valuation.



Business Valuation Credential Comparison (continued)				
Organization	Credential	Prerequisites	Courses/Reports	Experience in BV
National Association of Certified Valuation Analysts (NACVA) (continued from previous page)	AVA—Accredited Valuation Analyst—for government employees	-College degree -Must be employed by a federal or state government agency and have a minimum GS-12 or comparable rating (exceptions considered upon written request by supervisor).	-40 hours of optional training -5-hour proctored exam and a take-home exam (40 to 60 hours to complete) that includes a Case Study	-The equivalent of two years of full-time experience in business valuation
	CVA—Certified Valuation Analyst	-College degree and CPA designation	-40 hours of optional training. Can exempt out if one holds a Business Valuation credential from another BV credentialing organization. -5-hour proctored exam and a take-home exam (40 to 60 hours to complete) that includes a Case Study	-None, however two years other work experience is required for CPA designation

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