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Business Valuation 101

What to Expect During the Process

If you are thinking about selling, merging, or expanding your business, a business valuation is essential. A business valuation is an assessment of the economic value of part, or all, of the business. It is a complex process that requires the valuator to consider many internal and external factors that affect how much the business is worth.

It also is somewhat subjective, as it is based on the judgment of an individual or group. Preparing for a business valuation can make the process less overwhelming. Here are some items to understand going into the valuation process and what you should expect when working on this with a CPA.

Common Mistakes When Valuating a Business

01 | CONDUCTING A VALUATION ON YOUR OWN

Some business owners may decide to perform a valuation themselves. However, it is highly recommended that you seek out a CPA who has an Accredited in Business Valuation (ABV) credential. An accountant can look at your business without clouded judgment and examine the company's management, capital structure, future earnings, and market value of its assets to determine the worth of the business. Using their understanding of your type of business and its financial history, an accountant can help employ the most suitable valuation method to identify your business's true value.

02 | HAVING UNREALISTIC EXPECTATIONS

For many owners, their business is their pride and joy and they have worked diligently to make it successful. When an owner has such a deep emotional connection, they may be biased about its value. You may believe that your business is worth more than it is, leading to unrealistic expectations about the price you'll want to sell to a buyer. The same can be true when you are considering a merger with another business. You may believe that the two companies will make greater profits when combined than either company could on its own, without adequately considering market realities and integration challenges.

When going through the valuation process, it's helpful to be flexible and understand that you may not be offered the value that you originally expected. Your CPA is likely to offer a general price range of what your company could sell for rather than a fixed value. This range is based on the value of the company as it stands by itself. It also is important to remember that the valuation range that you receive now will likely change over time as market conditions, new regulations, and sales trends can disrupt the company's value.

03 | NOT BEING TRANSPARENT WITH YOUR CPA

When you hire a professional to conduct your business valuation, it is in your best interest to be fully transparent about the inner workings of your business. The accountant will need a comprehensive picture of the entity's financial history, contracts, operations, intellectual property, market position, shareholder agreements, and budget to make a fair assessment of its value. The financial history review process likely will entail the evaluation of three to five years of financial information, such as income statements, balance sheets, cash flow, tax returns, and annual profit and loss summaries. Ultimately, this will help provide accounting professionals with the knowledge needed to employ the right valuation approach.

What to Expect from Your Accountant

Your accountant will likely employ one of these common methods for determining the worth of a business. The three methods are: an asset-based method, earning value method, or market value method.

1. **Asset-Based Method:** Using this method, a CPA will subtract the total liabilities from the total value of a company's assets to determine its net asset value. This method is ideal for corporations rather than sole proprietorships due to the fact that in a corporation all assets are owned by the company, while in sole proprietorships, the assets can be in the name of the sole proprietor, which will make the valuation more complex.
2. **Earning Value Method:** The earning value method is an approach used to evaluate the ability of a business to produce wealth in the future. This approach is more suited for a business that is considering a merger with another company. A CPA might carry out this method by either looking at the company's use of past earnings, normalizing them, and then multiplying the expected normalized cash flow by a capitalization factor. Alternatively, they might estimate the value of a business using its expected future cash flow.
3. **Market Value Method:** The market value method estimates how much a company is worth based on similar businesses that have been sold recently. This is similar to a process in the real estate industry where the realtor looks at comparable home sales to determine a home's fair market value. However, the challenge with this method is that a business can sometimes be over or undervalued because this approach doesn't account for nuances like the worth of specific assets of the business.

While an accountant handles the valuation, your financial advisor plays a crucial role in positioning your business for an exit, sale, or merger. Before selling, business owners should consider factors that could enhance the entity's value and appeal to potential buyers. A financial advisor can offer guidance on making these business improvements. Additionally, advisors can help you develop a succession plan to ensure a smooth ownership transfer and can help minimize tax obligations from the sale's profit.

Please reach out to see how we can help you prepare for the valuation process.

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