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Editor's Note: The following article, which was written by Mr. Beane, is believed to have been originally published in the early 1990s in an IBBA newsletter. At that time, he was the Founder and President of Connecticut-based New England Business Advisors, Inc. He is now happily retired and living in Maine. Although this article was written more than twenty years ago, his words still ring true.

### **Realistic Grasp of Market Value is Key to Selling Businesses**

In today's increasingly adversarial, litigious and complex business world, there are a growing number of circumstances where a private company should be professionally appraised before important economic decisions are made.

Such occasions may include taxation issues, estate planning, ESOP transactions, purchase or sale, property settlements and stockholder agreements. For purposes of this article the terms "appraisal" and "valuation" are considered interchangeable.

An important part of the valuation issue is in its definition. "Fair Market Value," the most widely recognized and accepted standard of value, applies in all federal and state tax matters. It is the legal standard of value in many, though not all, valuation situations.

Its theoretical definition is "the cash or cash-equivalent price for which property would change hands between a willing buyer and willing seller, both being adequately informed of all relevant facts, and neither being compelled to buy or sell." In contrast, "intrinsic" or "investment value" is a very subjective concept to a particular individual or group. It may be more than, less than or equal to fair market value, as strictly defined.

In the instance of purchase and sale, a recent national study of the 3.7 million companies included in the Small Business Administration's database revealed that less than 20 percent of those companies offered for sale are actually sold. Most experts believe the biggest single reason for this high incidence of failure is that owners offer their companies for sale without having a realistic understanding of their value.

Determining the value of small, privately-owned companies is made especially difficult because there are often no ready market comparables.

Factors making stock market data a poor or inappropriate yardstick include such things as relative size and financial strength, different mixes of business, and management depth. And unlike real estate sales, there is no public record of the financial aspects of private company sales.

For example, in one situation the owner of a business rewarded a dedicated young associate with a 10 percent ownership interest in the firm. The owner reasoned that by doing so, he would further develop the young man's incentive and would groom him as his future buyer. His instincts were admirable, but his action caused a big income tax problem for his young associate. Why?

The owner used a "quick and dirty" approach to establishing the value of his company - one that had no real foundation or objective support. His associate was hit with back income taxes and interest on the difference between the owner's notion of value and the contentions of the Internal Revenue Service. A professional appraisal could have served to remove this costly pitfall from an otherwise laudable plan.

In Revenue Ruling 59-60, the IRS specifies that "all relevant financial data, as well as relevant factors affecting the fair market value, should be considered." The ruling goes on to detail the following eight fundamental factors requiring careful analysis in order to qualify for acceptance under their review procedures:

- 1) The nature of the business and the history of the enterprise from its inception;
- 2) The economic outlook in general and the condition and outlook of the specific industry in particular;
- 3) The book value of the stock and the financial condition of the business;
- 4) The earning capacity of the company;
- 5) The dividend-paying capacity;
- 6) Whether or not the enterprise has goodwill or other intangible value;
- 7) Sales of the stock and the size of the block of stock to be valued; and
- 8) The market price of corporations' stocks engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

The relatively new professionals who are properly qualified to perform business appraisals in accordance with such comprehensive guidelines are generally found in three places:

- 1) Specialized appraisal firms;
- 2) Specialty divisions of large public accounting firms; and
- 3) Investment banking firms.

Increasingly, appraisers are seeking business valuation certification similar to the Certified Public Accounting (CPA) designation. Such certification is conferred by only two professional organizations: The American Society of Appraisers, headquartered in Washington, D.C., and the Institute of Business Appraisers, headquartered in Boynton Beach, Fla.

Certification is based on education, experience, professional references, specialized study, comprehensive testing, acceptance of actual written appraisals and recertification of members every five years. Both certifying bodies require members to conform to their Code of Ethics and their Standards of Professional Practice. The two societies in total have approximately 350 members certified in Business Valuation in the United States and Canada. There are three such certified business appraisers in Connecticut.

The cost of professionally-prepared business appraisals for small, private companies will depend on many factors, including the purpose and scope of the assignment, the size and complexity of the company to be appraised, the client's time requirement and the size and overhead of the appraisal organization retained. In general, hourly billing rates for certified appraisers will approximate those of experienced accountants and attorneys, and assignment fees will range from \$5,000 to \$35,000.

A final note on business valuation is the need for appraisal independence. An appraiser should be able to value a company with complete independence of mind. The fee should always be determined on either an hourly or assignment basis, and under no circumstances should an appraiser's compensation be contingent upon either the amount of the appraisal or its effect on other events. Nor should the appraiser's work be steered to gain

personal advantage. Whatever the numerical outcome of an appraisal, it must have integrity to be of value.

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