

Business Valuations Can Be Good for Your Business

By Gregory Pearl, President, Alteris LLC

There are over 10 million small businesses in the United States. At any given time at least 10% of these businesses are facing a business transition issue. Most of those businesses facing a transition issue need valuations for tax reasons or for optimum financial planning.

The number of businesses facing transfer of ownership issues will continue to rise over the coming years as more baby boomers hit the age at which they would rather be on the golf course than in the office. Baby boomers' children and new outside owners will be the new owners of those companies, which means there will be a great deal of money in motion. And money in motion places the highest demands on the business owner and advisors.

Small-Business Transfers

| Business Revenues | Total Businesses | Businesses in Transition |
|--------------------------|-------------------------|---------------------------------|
| Less than \$1 Million | 8,500,000 | 879,200 |
| \$1 – 10 Million | 1,917,000 | 283,800 |

Tom West, 2001 Business Reference Guide, Dun & Bradstreet, Inc.

By one estimate, 70% of people with over \$1 million in assets have the majority of their assets in their small business. Even though it is the most significant part of a wealthy person's portfolio, the true value of that business is often not known.

Valuations Can Help Improve Your Business

Imagine for a minute if you, as an individual, do not know the value of the stock in your portfolio. Wouldn't it be much tougher to conduct financial planning? How would you know when to sell or buy? Or make other important business decisions?

Yet, that is often the situation with a client's small business. And, it is often his biggest asset.

Admittedly, business valuations can be expensive. Fortunately, there are now lower cost alternatives – but first a little background on business valuations.

The 59-60 Valuation

Business valuations are costly because the standard valuation performed today is "The 59-60" valuation". It has been the standard valuation since IRS Ruling 59-60 was issued in 1959 (as the 60th ruling of that year and hence, the name "59-60"). It became the standard methodology because valuations are often done for tax reasons. In fact, for valuations to be acceptable to the IRS, they must follow the IRS 59-60 guidelines.

There are a number of guidelines for 59-60 valuations, but to simplify these, there are three key elements:

1. Consideration of an income approach
2. Consideration of a market approach; and
3. Consideration of an asset-based approach.

Without going into great detail, an income approach uses a methodology such as capitalization of earnings, to value the company's income stream. A market approach tries to calculate a value for the subject company based on the value of other similar companies whose value has been made public (or it could be based on a similar public company). An asset-based approach looks at the value of the company's assets to determine its value.

As noted above, a 59-60 valuation is only required when filing a tax return (and would be strongly advised when involved in courtroom litigation). However, many if not most, valuations are not performed for tax reasons. But they often still follow 59-60 guidelines, and, hence, they incur high costs.

The result: Many people avoid having valuations. By avoiding valuations they risk making uninformed business decisions.

"The greatest transfer of wealth in history will occur in this country over the next decade; an estimated \$10 trillion is expected to change hands, and much of this wealth is tied up in family business stock."

--Robert Avery and Michael Rendall, Cornell University, referenced in the Wall Street Journal, June 1996.

The Alternative: A Planning Valuation

A planning valuation can cost much less than a 59-60 valuation. It is an excellent alternative in many circumstances.

A planning valuation follows similar guidelines to a 59-60, but does not consider all the possible valuation methodologies and other factors. Often a good planning valuation focuses on a market approach. That approach uses an analysis of recent market transactions of small, private companies in the same industry to determine market value. Since a business is worth what the market will pay, it is an excellent method for determining value. Also, the quality of the databases of market transactions is now better than ten years ago (when they were just beginning) and getting better every day.

When a planning valuation has been completed and the value of the small business incorporated into the financial and business plan, is your work completed? It would be very beneficial to obtain an annual or periodic update. These ongoing valuations allow you, the business owner, to understand changes in the market and your company's business. You can then adjust your plans accordingly to create the highest value for your business.

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