

# BRAD BORNCAMP, CPA, LLC

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## *Business Valuations*

### *Concepts and Applications*

#### **Definition**

- Types of engagements - to value an ownership interest in a business entity
  - calculation - a value based on limited procedures agreed to in advance
  - valuation - a conclusion of value based on all applicable methods.
- Appraisal vs Valuation - can be synonymous, appraisal may involve the use of specified standards and apply to property other than an ownership interest.

#### **Types of Certifications and Associations**

<b>Certifications</b>	<b>Association</b>
CVA, GVA, AVA	National Association of Certified Valuation Analysts
ASA, FASA, AM	American Society of Appraisers
BVAL, FIBA, MCBA	Institute of Business Appraisers
ABV	American Institute of Certified Public Accountants
CBV, FCBV	Canadian Institute of Chartered Business Valuators

#### **Role of the Valuation Expert**

- Independent appraiser - performs an objective valuation, can also be an expert witness
- Advisor - determines a negotiable value which is beneficial to client, not objective

#### **Reason for Business Valuations (Purpose)**

- Selling/buying some or all of an interest in a business
- Gift and estate taxation and planning
- Determining the amount of life insurance
- Operation of a buy/sell agreement
- Corporate or Partnership dissolution
- Funding employee stock ownership plans
- Obtaining financing
- Shareholder suits
- Marital dissolution (divorce settlement)
- Determining damages
- Charitable contributions

## **Important Dates**

- Valuation date - the date used to estimate the value, measures the transaction
- Report date - the date of the opinion letter prepared by the valuation analyst

## **Premise of Value**

- Going concern premise - expectation of continued operations and future earnings
- Liquidation premise - liquidation of assets, could be forced or orderly

## **Standards of Value**

- The word value means different things in different situations
- Fair market value - hypothetical value, applies to most types of taxes matters
- Market value – comparable sales, applies to most real property appraisals
- Fair value - legal term defined by statute, may apply in divorce & shareholder dispute
- Investment value - synergistic value, specific value to a particular investor or buyer
- Book value – net equity, an accounting term for assets in excess of liabilities
- Intrinsic value - based on perceived characteristics, used by securities analysts
- Insurance value – salvage value, used to reflect insurance coverage
- Collateral value - used by lenders for security on a loan

## **Fair Market Value**

IRS Revenue Ruling 59-60 assumes sale to a hypothetical buyer:

"the amount at which property would change hands between a willing seller and a willing buyer when neither is acting under compulsion to sell or buy and when both have reasonable knowledge of the relevant facts."

## **Approaches to Valuing a Business Interest**

- Income approach - future economic benefits accruing to the owner
- Market approach - comparable sales of comparable companies
- Asset based approach - valuing the assets, assumes earnings are immaterial

## **Methods of Valuing a Business Interest**

Income Approach:

- Capitalization of earnings - multiples of current earnings
- Capitalization of cash flows - multiples of current cash flows
- Discounted future earnings - discount future earnings
- Discounted cash flows - discount future cash flows
- Other methods - rule of thumb, multiples of earnings, company specific methods

Market Approach:

- Comparable companies - using multiples (ratios) of similar sales transactions
- Publicly traded companies – using price per share times number of shares.

Asset Based Approach:

- Net asset value - value of assets in place (systems, workforce, inventory, etc)
- Liquidation value - orderly sales value, forced sales value

## **Capitalization and Discount Rates**

- Capitalized earnings - used when earnings growth is moderate and predictable  
converts benefit stream into a value  
 $\text{value} = \text{expected returns} / \text{cap rate}$
- Discounted earnings - used when future earnings expected to increase significantly  
converts future return to present worth  
 $\text{value} = \text{future returns} / \text{discount rate}$
- Both rates reflect a composite of risk factors unique to the target company
- Cash flows can be substituted for earnings, depending on valuation method

## **Discounts and Premiums**

- Minority interest discount - reflects lower value due to lack of control
  - Minority discounts equate to the risk related to investing in the ownership interest
  - The larger the risk, the larger the discount
- Marketability discount - reflects costs to sell the ownership interest
  - The harder it is to sell the ownership interest the larger the marketability discount
- Discounts are not cumulative, but applied successively, minority then marketability
- Control premium - reflects increase in value to majority interests
  - An increased value is applied to a controlling ownership interest

## **Tax Consequences**

- Important to be consistent in using pretax or after tax earnings and rates
- Some discounts may be allowed for the tax on gains from liquidation
- Income taxes do not effect the valuation in all cases

## **Valuation Reports**

- Valuation reports can be in the form of a written report or oral communication
- Three types of written reports for valuations are based on what the client needs
  - Detail report - shows the data, reasoning, and analysis for the conclusion of value
  - Summary report - much shorter version to explain the conclusion of value
  - Calculation report - only used with the calculation engagement to show the results

Thank you for allowing me the opportunity to provide you with information on valuations. The concepts and applications presented above apply to a variety of situations and should be reviewed by a qualified business appraiser before implementing. Please feel free to call me to discuss your situation and the level of services that may be appropriate.

Sincerely,

Brad Borncamp, CPA, CVA, CFP