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Research Paper Management

Business Valuation

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ABSTRACT

In the wake of economic liberalization, companies are relying more on the capital market, acquisitions and restructuring are becoming commonplace, strategic alliances are gaining popularity employee stock plans and regulatory bodies are struggling with tariff determination. In these exercises a crucial issue is! How should the value of a company or a division the re for be appraised?

The goal of such an appraised is essentially to estimate a fair market value of a company. So at the outset, we must clarify what is meant by "fair market value "and what is meant by "a company ". The most widely accepted definition of fair market value was laid down by the Internal Revenue Service (IRS) of the US. It defined fair market value as "the price at which the property would change hands between a willing buyer an a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." When the asset being appraised is "a company ", the property the buyer and seller are trading consists of the claims of all the investors of the company. This includes outstanding equity shares, preference shares, debentures and loans.

But note that, 'fair market value' (FMV) is not designed with any particular individual in mind, nor the 'real' transaction for that matter. FMV is a hypothetical value for the 'model' transaction. The governing condition in this ideal concept is full knowledge and freedom to act.

KEYWORDS

Economic liberalization, Capital market, Acquisitions, Regulatory bodies, Crucial issue, Asset valuation, Capitalization of income valuation, Owner benefit valuation, Multiplier or market valuation

Introduction

Business valuation is a process and a set of procedures used to estimate the economic value of an owner's interest in a business. Valuation is used by financial market participants to determine the price they are willing to pay or receive to consummate a sale of a business. In addition to estimating the selling price of a business, the same valuation tools are often used by business appraisers to resolve disputes related to estate and gift taxation, divorce litigation, allocate business purchase price among business assets, establish a formula for estimating the value of partners' ownership interest for buy-sell agreements, and many other business and legal purposes.

Definition

"BUSINESS VALUATION is the act or process of determining the value of a business enterprise or ownership interest therein by determining the price that a hypothetical buyer would pay for a business under a given set of circumstances.

Meaning: Gaining financial freedom is the reason why people put up a business. Many focus on just earning profit but do not how it is earned. This causes business to go bankrupt in just a short span of time. Entrepreneurs should learn that the business standing in the trading market has an effect on both its production and marketing output.

Methods

There are a number of instances when you may need to determine the market value of a business. Certainly, buying and selling a business is the most common reason. Estate planning, reorganization, or verification of your worth for lenders or investors are other reasons.

Valuing a company is hardly a precise science and can vary depending on the type of business and the reason for coming up with a valuation. There are a wide range of factors that go into the process -- from the book value to a host of tangible and intangible elements. In general, the value of the business will rely on an analysis of the company's cash flow. In other words, its ability to generate consistent profits will ultimately determine its worth in the marketplace.

Here are some of the common methods used to come up with a value.

- Asset valuation
- Capitalization of income valuation
- Owner benefit valuation
- Multiplier or market valuation

Asset Valuation

Asset valuation is used when a company is asset-intensive. Retail businesses and manufacturing companies fall into this category. This process takes into account the following figures, the sum of which determines the market value:

- Fair market value of fixed assets and equipment (FMV/FA) - This is the price you would pay on the open market to purchase the assets or equipment.
- Leasehold improvements (LI) - These are the changes to the physical property that would be considered part of the property if you were to sell it or not renew a lease.
- Owner benefit (OB) - This is the seller's discretionary cash for one year; you can get this from the adjusted income statement.
- Inventory (I) - Wholesale value of inventory, including raw materials, work-in-progress, and finished goods or products.

Capitalization of income valuation

This method places no value on fixed assets such as equipment, and takes into account a greater number of intangibles. This valuation method is best used for non-asset intensive businesses like service companies.

The average of these factors will be the "capitalization rate" which is multiplied by the buyer's discretionary cash to determine the market value of the business. The factors are:

- **Owner's reason for selling**
- Length of time the company has been in business
- Length of time current owner has owned the business
- Degree of risk
- Profitability
- Location

- Growth history
- Competition
- Entry barriers
- Future potential for the industry
- Customer base
- Technology

Again, add up the total ratings, and divide by 12 to come up with an average value to use as the capitalization rate. You next have to come up with a figure for "buyer's discretionary cash" which is 75% of owner benefit (seller's discretionary cash for one year as stated on the income statement). You multiply the two figures to determine the market value.

Owner benefit valuation
This formula focuses on the seller's discretionary cash flow and is used most often for valuing businesses whose value comes from their ability to generate cash flow and profit. It uses a fairly simple formula -- you multiply the owner benefit times 2.2727 to get the market value. The multiplier takes into account standard figures such as a 10% return on investment, a living wage equal to 30% of owner benefit, and debt service of 25%.

Multiplier or market valuation
This approach finds the value of a business by using an "industry average" sales figure as a multiplier. This industry average number is based on what comparable businesses have sold for recently. As a result, an industry-specific formula is devised, usually based on a multiple of gross sales. Here are a few industry multiplier examples, as mentioned in "The Complete Guide to Buying a Business" by Richard Snowden (Inacom, 1994)

- Travel agencies - 05 to 1 X annual gross sales
- Ad agencies - 75 X annual gross sales
- Retail businesses - 75 to 1.5 X annual net profit + inventory + equipment

To find the right multiplier for your industry, you can try contacting your trade association. Another option is to utilize the services of a broker or appraiser who specializes in businesses such as yours.

Process
1. Initial Conversation
Every engagement starts with a confidential, no-obligation discussion to understand the specifics of your situation, what services you need, and how we can help you. This usually takes 15 to 30 minutes. We will need to know the nature of the business and the percentage and type of interest to be valued, as well as the reason for the valuation (e.g., taxation, transaction, litigation, regulatory compliance, or some other reason.)

2. Selecting an Appraiser
Based on our conversation, we will recommend the most appropriate ABA professionals for you: the individual or team that has the right expertise and experience for your situation.

3. Engagement Phase
We will prepare an engagement agreement that describes the assignment, including the date of the opinion of value, what is being valued, the time needed to complete the assignment, and the fees involved.

4. Valuation Phase
We will gather the data necessary to complete the assignment, including information provided by you, data on the industry, any relevant economic information, and information from the financial markets.

5. Report Phase
We will provide verbal or written reports as you direct. The report will explain the appraisal process followed, the research performed, the valuation methods employed, assumptions made, the ultimate conclusion, and its reasonability.

Planning
The Business Valuation professionals at Sickish employ a wide variety of financial skills to assist the legal and business communities. Opinion and consulting engagements are completed for many purposes including:

The client is served by accounting and finance professionals who, by education and experience, have earned valuation specific credentials and designations including:

Practice areas of business valuation
Complex business disputes often require detailed and precise business valuation analyses that can withstand legal scrutiny. Stone Turn's Business Valuation professionals not only utilize proven and tested valuation techniques, but are also experts in litigation, arbitration and mediation. We understand the critical importance of preparing thorough and credible analyses in a dispute setting. Furthermore, our professionals have extensive experience providing clear and defensible explanations of analyses through expert reports and expert testimony.

Additionally, in disputes where the true financial performance of a business is not transparent, Stone Turn can utilize its extensive experience with forensic accounting techniques to provide a more complete and accurate understanding of the facts.

We look beyond the numbers and work cohesively with counsel and clients to develop solid and defensible analyses and strategies. In our experience, working closely with counsel throughout the process creates efficiencies and seamlessly integrates a comprehensive approach into the overall case strategy.

Estimates of business value
The evidence on the market value of specific businesses varies widely, largely depending on reported market transactions in the equity of the firm. A fraction of businesses are "publicly traded," meaning that their equity can be purchased and sold by investors in stock markets available to the general public. Publicly-traded companies on major stock markets have an easily-calculated "market capitalization" that is a direct estimate of the market value of the firm's equity. Some publicly-traded firms have relatively few recorded trades (including many firms traded "over the counter" or in "pink sheets"). A far larger number of firms are privately held. Normally, equity interests in these firms (which include corporations, partnerships, limited-liability companies, and some other organizational forms) are traded privately, and often irregularly.

A number of stock market indicators in the United States and other countries provide an indication of the market value of publicly-traded firms. The Survey of Consumer Finance in the US also includes an estimate of household ownership of stocks, including indirect ownership through mutual funds. The 2004 and 2007 SCF indicate a growing trend in stock ownership, with 51% of households indicating a direct or indirect ownership of stocks, with the majority of those respondents indicating indirect ownership through mutual funds. Few indications are available on the value of privately-held firms. Anderson (2009) recently estimated the market value of U.S. privately-held and publicly-traded firms, using Internal Revenue Service and SCF data. He estimates that privately-held firms produced more income for investors, and had more value than publicly-held firms, in 2004.

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