The role of valuation in business planning

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THE VALUATION of a family-owned business plays an important role in the day-to-day management and longer term success of a business and its owner.

The need for valuation breaks down into three categories: corporate/management uses, wealth creation, and ownership succession and transfer. The role of valuation will vary depending upon the purpose for determining a value. More important, the use of business valuation in one context can influence value in others. One constant, unvarying factor, whatever the purpose for the valuation, is the need for reliability and independence of the work product.

By understanding the uses of valuation and its impact on value creation, business owners will make better day-to-day decisions and leave a greater business legacy.

Corporate/Management Uses

Knowing the value of your business and its assets is an important management tool for both the short and longer term planning of your company. In the day-to-day management of a business, owners make decisions about the cash cycle needs, investment in property, plant and equipment, business growth strategies, income tax planning, and compensation for themselves and key employees. Often these decisions are made in “the heat of the moment” rather than as part of a process of value creation.

Understanding value and value creation can enhance the success of financing and strategic decisions. For instance, valuation should play an important role when a borrowing decision is under consideration. At risk in a borrowing decision is not only the pledge of business assets to secure the debt but also the requirement for the owner’s personal guarantee. Knowledge of valuation and value of assets places one in a better position to negotiate with lenders.

More importantly, valuation can be a tool to understand better the impact of the decision to borrow versus the decision to invest additional capital into the company. The discipline of the valuation process helps owners examine each decision’s effect on the cash cycle, profitability, and on current and longer-term growth in value of the company. This understanding leads to better decision making by owners and their board.

Valuation can play a role in income tax planning for businesses in high income tax states. Where a company’s revenue stream is directly attributable to a brand name, trademark or other intellectual property owned by the business, it may consider establishing a Delaware Holding Company subsidiary to own the registered trademarks, brands or other intellectual property. Through valuation of the intellectual property, a royalty payment is determined. The payment of the royalty by the parent company to the holding company is a deduction for state income tax purposes. To avoid the scrutiny of state taxing authorities, it is important that royalty payments be determined by an independent appraisal firm experienced in such strategies and in the objective valuation of intellectual property.

Valuation plays a role in a company’s financial reporting. As a result of increased questioning about the quality of financial reporting and the series of corporate scandals reported over the last several years, the Financial Accounting Standards Board issued three new Statements of Financial Accounting Standards in 2001: SFAS No. 141, Business Combinations; SFAS No. 142, Goodwill and Other Intangible Assets; and, SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets. Each statement discusses how values are to be reported on financial statements. For businesses required to present their financial statements in accordance with Generally Accepted Accounting Principles, these statements represent a major change in reporting requirements that impacts both public and non-public companies.

These three accounting changes reflect the recent trend towards reporting assets and liabilities at fair value as opposed to historical or book value. They also reflect the growing importance of intangible assets as a resource for many companies. In light of the many scandals exposed in the last several years, it is important that the valuation and impairment tests be based on supportable, well-documented and credible analyses.
prepared by independent, reliable valuation specialists.

There are also strategic planning reasons for knowing the value of a business, including opportunities to grow the company, acquisition or divestiture decisions, partnering, consolidating control, bartering, joint venture decisions, performance benchmarking and measurement, and compensation for owners and key non-family managers.

The options for growing a company will generally include borrowing, acquiring another company, seeking additional capital from outside sources, or joint venturing. Each approach has certain actual monetary and psychological costs involved. The monetary cost may be as simple as the interest rate paid to finance growth or the assets restricted under a pledge as collateral. It can also include the dilution of one’s percentage ownership (and possibly control) as a cost to attract an outside investment. Valuation of the company in the context of each situation allows an owner to evaluate possible alternatives in the context of return on investment, the timing involved to achieve the return, and the personal cost to current owners to achieve their growth goals.

Whether or not a family business is for sale, the most successful companies are run as if they were for sale today. This approach to managing a business focuses decisions on strategies that create the highest value for the business. Common strategies include the determination and use of best practices, benchmarking and regular performance measurement.

Business valuation is a critical tool that provides the baseline against which best practices, benchmarks and individual or group performance are measured. The valuation also allows for the development of phantom stock and other compensation plans for key non-family managers.

**Wealth Creation**

When a business is successful, wealth is created through the increased value of the business. Just as a concentrated position in a publicly traded company subjects the stockholder to greater risk than a diversified portfolio of stocks and bonds, financial advisors to many business owners suggest that value trapped in the business come out over time to allow for diversification.

There are a variety of ways to accomplish this diversification. Some are more or less tax efficient. The more common methods include salary and bonus payments, retirement plans, payment of dividends or distributions, or the sale of some or all of the company. The aim in each instance is to diversify the concentration of wealth inside the business by creating liquidity outside of the company.

Important to the strategy’s success is that cash comes out in a manner that does not interrupt the growth of the company. Salary and bonus planning are the easiest ways to get cash out of a company. In addition, the payment of dividends for C corporations has improved with the new lower dividend tax rate passed this year. The ongoing use of valuation as a management tool facilitates the analysis needed to achieve the goal of a good diversification strategy.

More complex approaches of creating liquidity include the use of an ESOP and an equity partner buy-in. In these situations, an owner is creating liquidity through the conversion of a minority position to cash through a tax-advantaged transaction. The more a business has been managed by a value creation process, the greater the likelihood that a satisfactory liquidity event will result.

**Estate & Transfer Planning**

One of the major goals of estate planning is to ensure a smooth transfer of the family business to the next generation either prior to or at death. Another goal is to find a way to treat fairly, if not equitably, family members who are not in the family business. In all cases, the goal is to accomplish the plan in as tax efficient a manner as possible. These goals may be achieved through a gifting program, through the use of a buy/sell agreement, or many other strategies.

In each instance, the amount gifted or the price determined is driven by the value of the company. Given that the plans generally involve related parties (family members), the valuation report must be prepared by a reputable appraiser, demonstrate independence, and provide objective evidence in support of the value conclusions.

The strategic use of valuation as an important management and wealth creation tool allows an owner to consider gifting and estate planning strategies at an earlier stage of life when greater future value can be transferred at a lower cost. Remember, at death, valuation is no less important since it influences the amount of both federal and state death taxes paid.

Understanding valuation and value creation in the context of the family business is an important element of wealth creation. Investment advisors say that there is a discipline to wealth creation: begin early, invest over time in whatever amount is possible, and keep with it for the long term. This advice is equally applicable to the family-owned business. After all, it is one of the highest risk investments you can make, with the greatest possibility of failure. Thus, one needs to focus on value early and remain disciplined over the long term.

While the purpose and use of a business appraisal may vary, its value as a management tool for running a business is often overlooked. Whether assisting in negotiating financing, in deciding on acquisitions or divestitures, or in management reporting and performance measurement, the valuation report provides critical information for decision-making. Used appropriately, valuation helps an owner focus on wealth creation and facilitate the ability to diversify concentrated wealth in a tax efficient manner. A valuation report is only as good as the appraiser retained to complete the study. Business owners will want to select an appraiser who understands the scope of the project, brings a broad experience and understanding of valuation to the specific assignment, and is disciplined in his approach to providing a defensible work product that easily stands up to the scrutiny of board members, buyers, and taxing authorities.

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