BUILDING VALUE

SUCCESS THROUGH COLLABORATION

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A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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PLAN NOW IF YOU INTEND TO SELL LATER

First time entrepreneurs, take notice: The most important decision you should make when starting a business is how and when to leave it.

Many entrepreneurs start a new business with one goal in mind: grow it and sell it. Unfortunately, too many business owners put off thinking about selling their business until they are ready to retire.

Selling a business owner's "pride and joy" can be a painful experience if inadequately planned. Through careful planning, however, you can improve both the emotional and financial payoff. At a minimum, sellers should consider the following 10 critical issues:

1. Obtain professional help at the front end. Hiring a lawyer, financial advisor, and CPA with experience in buying and selling businesses can help you get the best price and terms. Don't "step over a dollar to pick up a dime" by trying to do everything yourself.

2. Be sure to consider the tax ramifications. The "tax monster" can take a huge bite unless your advisors can effectively structure the sale.

3. The terms of the sale are very important. *How* you get the money and *when* you get it are sometimes more important than how much you get. As the saying goes, "a bird in the hand is worth two in the bush." A million dollars to be received in two years that is secured only by the business may be less desirable than $500,000 in cash immediately.

4. Let the buyer "fire the first shot." You can negotiate up from the buyer's offer, but it is very difficult to increase a price that the seller has named.

5. Understand the buyer. Each buyer has different objectives, preferences, and motivations. What is it about your business

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AN IRS AUDIT AND A SUBSEQUENT EVENT

A Rock and a Hard Place

It is a phone call appraisers dread — news that the IRS is questioning an old appraisal where the company was sold several months after the valuation date for substantially more than the appraisal.

While every situation (not to mention every IRS agent and every Tax Court judge) is different, there are several ways to approach the support of an appraisal of a company which has undergone a subsequent transaction that, at face value, seems to contradict the appraisal.

The tax regulations are very specific in describing the method for determining the fair market value of securities based on the price of sales on or near the valuation date.

The tax regulations are very specific in describing the method for determining the fair market value of securities based on the price of sales on or near the valuation date. In cases in which there have been no sales on the valuation date, the fair market value is determined using the transaction prices nearest the valuation date, both before and after. However, the date of the nearest transaction must be "reasonably close" to the valuation date.

The Tax Court has stated *"… subsequent events are not considered in fixing fair market value, except to the extent that they were reasonably foreseeable at the date of valuation."* Therefore, the appraiser should consider what was known and reasonably knowable at the valuation date.

There are some key questions to ask in such situations.

Were potential acquirers inquiring in the months preceding the valuation date? What were the most recent offers at the valuation date? Depending upon the circumstances which caused communications to terminate, the most recent offer prior to the valuation date may provide a more relevant indication of fair market value at the valuation date than a subsequent sale.

What were the terms of the offers? What is the fair market value of the offers? The acquirer's stock may require a discount to its nominal value in determination of its fair market value, depending on the length of time the stock is restricted and the volatility of the stock. Restrictions can arise from the federal securities laws or contractual agreements. Preferred stock of the acquirer may require a discount as well, depending upon the economic characteristics of the underlying company and the expected dividend yield as it compares to other similar investments.

What is the acquirer's cost of equity? Premia for illiquidity and lack of marketability, along with more specific risk premia, may be appropriate. Promissory notes may require a discount from face value to determine fair market value. Consider the interest rate on the note compared to market interest rates.

What is the acquirer's cost of debt? What is the payment stream of the note? Consider corporate bond interest rates as a base for a build-up of a discount rate for the note. Similar premiums to those considered in the build-up of a required rate of return for preferred stock noted above may be appropriate. Non-compete agreements may also require adjustments

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"Plan Now if you Intend to Sell Later"
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that appeals to the buyer? Where does the buyer see the business in 5 to 10 years? Knowing what makes the buyer tick will enhance your effectiveness as a negotiator.

6. The price is right! Don't sell for the wrong price, which usually means too low. A higher price is rarely wrong. An owner's emotional attachment to a business can make it difficult to price the business objectively, so it pays to get a professional business valuation that will help establish a reasonable price for the business.

7. It's ok to be selfish. Sometimes, business owners are overly concerned with employees. Remember that the sale of the business is the payoff for the years of financial risk, sleepless nights, family birthdays on the road, and other unpleasantness. Concern with what happens to loyal employees is commendable, but don't let the deal rise or fall on the fortunes of employees.

8. Don't limit the pool of buyers to local people only. Many out-of-area buyers have strong reasons for buying a business in a particular location.

9. Don't rush the sale. Pressuring buyers can make them feel that you are overly anxious to sell, which must mean that something is wrong. The sale of a business can take several months to perhaps a year.

10. Keep your emotions in check. Too much emotion can cause the seller to overlook details and make mistakes. Just think about what you are going to do with all of your spare time.

Perhaps the most important thing for a business owner to remember is to think "frequently" of selling from the very beginning. This will force you to look more carefully to the future. If you don't care about how profitable your business is as long as it provides for you, you are in for a rude awakening when you discover that many buyers decide on a purchase price based on a multiple of earnings.

The greatest financial asset a business owner usually possesses is the business. Remembering these few simple guidelines can help make the difference between looking back at the business fondly and regretting a sale that failed to provide you fair compensation for your hard work and sacrifice.

— Kevin R. Yeanoplos, CPA/ABV, ASA

"An IRS Audit and a Subsequent Event"
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to the nominal value of the transaction in order to derive the fair market value.

If the transaction was a stock transaction, determine what was happening in industry stock prices between the valuation date and the date of the sale. Often industry price movement or movement in the acquirer's stock will affect the price that the acquirer is willing to pay.

If it was a cash transaction, determine if favorable stock price movements in the acquirer's stock strengthen the acquirer's ability to pay more.

What were the initial terms of the offer from which the final deal was negotiated? The initial offer would provide an indication of value which is nearer to the valuation date, though still a subsequent event. Depending upon the length of time over which the negotiations took place, the date of the initial offer may well be considered "reasonably knowable," while the final transaction price may not.

Understand the major negotiating points of the transaction. The answer will often point the appraiser in the direction of important issues as identified by both the acquirer and the seller which may affect value.

If the negotiations took place over a period of several months, earnings cyclicality of the subject entity may have played a part in determining the final price.

If the performance or outlook of the subject entity changed between the valuation date and the date of sale, transaction price movements may have occurred. One caveat for this line of reasoning is that enhanced performance due to factors that were foreseeable at the valuation date will likely not be considered an appropriate explanation for differences between the appraised value and the subsequent sale price.

Were there motivations unique to the buyer—did the transaction take place at a strategic control level of value? Could the subject entity have sold to another buyer for a comparable price? If the transaction had unique qualities which enhanced value to the specific buyer over and above the value to others in a possible pool of acquirers, the transaction may have taken place at a unique level of pricing.

An important issue is whether management intended to sell the business and if there was any indication of this, at the valuation date. Hindsight points toward a seemingly obvious answer, but this may not be the case. Documentation of interview notes, as well as calendars and notes of the business owner, can help sort out this issue. However, if the appraiser can reconcile his appraised value with the value of the proceeds from the subsequent sale through explanation of the course of events which caused the increase in value between the two dates, this could become a moot point.

In murky valuation issues such as subsequent events, it is helpful to look to previous Tax Court cases for guidance. However, as with many such issues, the Tax Court's response is as varied as the facts and circumstances of each case. In some cases, the Tax Court has rejected subsequent events as not reasonably knowable, and in others, the Court has relied heavily upon subsequent events to determine fair market value. We believe that the best course of action is to present the facts and circumstances, both before and after the valuation date, in order to explain the change in value between the two dates.

— Janet Gerber and Kenneth W. Patton, ASA

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