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Valuation Report

Business Valuation Trends and Strategies

Winter 2017

Selling Your Business

How to Get Your Company Transaction-Ready

Why do business buyers buy? And what do business buyers want? For those involved in business valuation, there are several answers to these questions. Most involve access — to customers, suppliers, employees, technology or a brand.

But making a company attractive to buyers seeking this kind of access is not always easy. Sometimes, access to just one of these assets drives a sale. As as a seller, you must determine what each potential buyer's hot button might be.

For example, one type of buyer might value an established presence — or access to customers and brand — as their number one priority. In this case, it's your job to make your customers and brand shine bright.

Closing the Gaps

A gap analysis serves as a good framework for assessing where you might need to build business value. This process identifies business strengths and weaknesses and shows where a "gap" might lie between what buyers are seeking and what you're offering. Once gaps are identified, you can accentuate the strengths of your business and develop plans for bolstering weaknesses in order to close these gaps.

Even the best-run businesses have areas that are primed for fine-tuning. Take an honest look at the following five areas to determine where there might be gaps:

1. Management team and employees: Sometimes buyers plan to keep the management team and key employees, and sometimes they don't. Either way, a robust management team backed by strong employees is a sign of a healthy company.

You want to show potential buyers a deep "bench" of smart and savvy executives who are ready to lead. You also want to boast a breadth of knowledge and skill among team members and highlight good working relationships within the team.

Also important is a meaningful succession plan. Again, the buyer may or may not use it, but the fact that you have a viable and thoughtful plan is a sign that you take the business seriously and recognize a need to prepare for the future.

Where's the gap? Where does your company stand with regard to your management team and employees? A comprehensive training program and executive development plan will help get your team ready for what's next and carry your company into the future — with or without you.

2. Good company "hygiene": Many executives and owners are so busy running the business that they don't pay attention to what they consider the "small stuff." But small stuff can turn into big problems if not addressed and managed. Here are a few housekeeping items to consider as you ready your business for sale:

• ***Clean financials*** — It's no surprise that buyers want clean financials. This is the sign of a tight ship. Comb through the books to ensure that the accounts receivable are actually collectible, that there's no obsolete inventory and that personal finances are separated from the business.

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Tax Update

IRS Suggests Restricting Estate Valuation Discounts

One of the most controversial discussions in the valuation world today involves proposed IRC Section 2704 regulations. If approved, these regulations would dramatically affect the discounts now widely used in the valuation of family-controlled businesses or business interests.

A Little Background

Section 2704 is one of several sections of IRC Chapter 14. This was passed by Congress in 1990 with the objective of limiting valuation discounts for gift and estate tax purposes in cases of family-to-family transfers of interests in family-owned or closely held businesses.

As it stands currently, IRC Chapter 14 provides, among other things, a safe harbor for family-to-family transfers as long as they are made as a bona fide business arrangement, not simply as a way to transfer assets to family members at a reduced value.

Section 2704 has two broad parts, both of which apply to family-owned businesses. Section 2704(a) essentially causes a taxable event to occur when liquidation or voting rights lapse. Section 2704(b) says that when valuing assets for estate and gift tax purposes, certain restrictions on the ability of an entity to liquidate can be disregarded. Section 2704(b) also gives the Treasury the ability to issue regulations to cause certain other restrictions that reduce valuation to be disregarded.

Preventing Rule-Bending

One of the underlying premises of the proposed regulations is an assumption by the IRS that families will engage in a wide range of rule-bending practices to preserve wealth. To prevent such maneuvering, the proposed regulations include elements that would curtail valuation discounts for family businesses, including:

Lapse of voting or liquidation rights — The current law basically states that the lapse of a voting or liquidation right is taxed as a transfer subject to gift or estate taxes if the individual holding such rights immediately prior to the lapse (and members of his or her family) control the entity.

The new regulation says that when a person transfers an interest in a way that creates a lapse of the transferor's voting or liquidation rights or power — and the transfer happens within three years before the transferor's death — there is an additional transfer that is potentially subject to tax.

The effect of this change would be significant limitation or elimination of the lack of control and minority discounts for these transfers.

Restrictions on redemption or liquidation — Under current law, certain restrictions are disregarded when valuing an interest in a family-owned business when the interest is transferred within the family. This is the case if the restrictions limit the ability of the corporation to liquidate and the restriction can be removed by the family.

The new regulations include additional "disregarded restrictions" that go beyond the current applicable restrictions in situations where the family would retain control after the transfer.

What the Analysts Say

The proposed regulations have attracted enormous attention from valuation professionals — most of it unfavorable. At a recent AICPA valuation conference, a representative from the IRS (speaking for herself and not the IRS) addressed the controversy by saying:

"The regs are still a work in progress … we are anxious to review all of the comments we've received in order to get a better understanding of the public's concern so we can improve this guidance. It is certainly not in the best interests of the Treasury or the IRS to put out something that will get overturned by the courts and humiliate all of us."

After considering the public comments and input, will the Treasury establish final regulations or withdraw them? We will have to wait and see.

If you'd like to learn more about these proposed new regulations, please give us a call to discuss them in more detail.

Getting Your Company Ready for a Transaction

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• ***Clean legals*** — Start with contracts and legal agreements, including non-competes. If you have significant ongoing, pending or potential lawsuits, do what you can to bring them to a close as quickly as possible.

• ***Clean brand*** — Your reputation is everything. If you are experiencing ongoing public relations issues, employee disputes or other difficulties with your corporate image, address them now. Buyers don't want to pay for your problems.

• ***Clean customer and supplier relations*** — Get these essential relationships in order because they can make or break your business. Work on securing long-term contracts or agreements that indicate strong vendor support and customer loyalty.

• ***Clean labor relations*** — High employee morale and low turnover are signs of a clean bill of labor health.

Where's the gap? Corporate hygiene is an ongoing job. Making inroads in these areas takes time and effort. Commit to tackling each area with gusto long before you list your business for sale.

3. Positive trends: A trend is your friend only if it's going in the right direction. The company's historical and projected sales, profits and growth are a strong selling point if they're growing — especially compared to industry standards. Increasing tenure and qualifications in your workforce are also a strong draw, as are trends like increasing production capacity and improved technology.

Of course, the most important trend for buyers is positive and growing cash flow. It's imperative to get capital-related trends moving in the right direction if you want to attract business buyers.

Where's the gap? You can't overstate the importance of trends, but trends happen over time. So give yourself enough time to effect change in these crucial areas.

4. A compelling narrative: Owners often overlook the qualitative "story" of their business, but many business brokers and financial pros believe this is the most important element of the buyer's offer.

What is the vision of the company? What makes the business special or unique? What does the company represent and stand for? Each business has a story to tell. Your job is to refine your company's story in a way that will be appealing to the next owners — and then hone it to appeal to specific buyers' hot buttons.

Where's the gap? Many established businesses could use a fresh story. The good news is that developing a crisp and exciting narrative can be fun.

It gives you a chance to cast your company in the most interesting light and underscore the values and decisions that brought the company to its present state. If yours is a family business with an engaging history, or a start-up that's beaten the odds, be sure to bring this story to light.

5. Documented processes: No business thrives without sound processes in the following areas:

• ***Marketing*** — A good customer relationship management (CRM) system is essential for every company.

• ***Operations*** — Enterprise resource planning (ERP) automates and interprets many of the functions related to inventory management, product planning and purchasing, and other areas.

• ***Quality control*** — Whatever the quality level of your products, it must be consistent and reliable. A robust quality control system shows that your company cares about your customers' needs.

• ***Administration*** — Are you actively capturing hours and costs? Tracking the right metrics? Is your financial department running smoothly?

Where's the gap? Note the word "documented" above. Processes are not processes unless they are replicable by new owners and employees. Gather a cross-functional team to review and update your company's processes.

Get Started Now

Transaction readiness won't happen overnight. In fact, just getting a handle on the gaps and how to close them will take time — so don't delay.

While it may seem daunting, methodically working though the list of "must-do's" is the best way to build business value, attract buyers and reap the rewards of years of hard work.

Our firm has helped many companies build value in anticipation of a sale. Contact us today to discuss next steps.

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AICPA Introduces New Fair Value Credential

The American Institute of Certified Public Accountants (AICPA) recently introduced a new valuation credential for CPAs and finance professionals who perform fair value measurements for entities and intangible assets for U.S. public company financial reporting purposes.

Known as the CEIV — Certified in Entity and Intangible Valuations — the credential was designed to enhance consistency and transparency in the fair value measurement process. This includes estimating the fair value of entities or entity interests for goodwill impairment testing and stock compensation purposes, and the fair value of intangible assets for purchase price allocation and impairment testing purposes.

Developed by the AICPA in collaboration with the American Society of Appraisers (ASA) and the Royal Institution of Chartered Surveyors (RICS), the new credential has been in the works for several years. It was introduced widely to CPAs involved in valuation at the 2015 CPA Forensic and Valuation Services Conference. Since then, the collaborating organizations issued a mandatory performance framework to be applied by all CEIV credential holders.

Now finalized, the CEIV requires two exams. The first is the valuation exam issued by the valuation professional organization of the analyst's choice. These exams include the AICPA's ABV Exam or the Valuation Principles Exam for Financial Professionals; the ASA's Accredited Senior Appraiser Exam; the RICS Assessment; the CFA Institute's Chartered Financial Analyst (CFA) Exams; or the Canadian Institute of Chartered Business Valuators' Chartered Business Valuators (CBA) Exam.

The second exam is the CEIV exam itself, offered by all of the collaborating valuation organizations. The credential also requires valuation experience and fair valuation measurement experience. Once credentialed, valuation specialists also participate in ongoing engagement-level, risk-based quality review.

The goal of this new credential is to give stakeholders more confidence in the fair value measurement work performed by CEIV-credentialed specialists.

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