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Top Ten Business Valuation Questions for Business Appraisers

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Robert M Clinger III asked:

Having performed business valuations for a variety of purposes, I have been asked a number of questions from clients. The following top ten business valuation questions have been compiled in an effort to briefly address some of the

most frequent concerns clients have regarding a business appraisal.

1. What approaches do you consider in valuing the business?

Income Approach-The Income Approach derives an indication of value based on the sum of the present value of expected economic benefits associated with the company. Under the Income Approach, the appraiser may select a multi-period discounted



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future income method or a single period capitalization method.

Market Approach-The market approach derives an indication of value by comparing the company to other similar companies that have been sold in the past. Under the market approach, the appraiser may utilize the guideline publicly traded company method or the direct market data method.

Asset Approach-The Asset Approach adjusts a company's assets and liabilities to their fair market values and adds to the value of intangible assets and any contingent liabilities.

2. What discounts may be applicable?

The discounts typically used in the valuation of a closely held business interest include a discount for lack of control, discount for lack of marketability, discount for lack of voting rights, blockage discount, portfolio discount, and key person discount. The most common discounts applied in business valuations are discounts for lack of control and discounts for lack of marketability.

3. What are the standards of value?

For most operating businesses, the standard of value will likely be fair market value, fair value, or investment value.

Fair Market Value is the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant fact.

Fair Value is a legal standard of value that has been established by the courts for use in issues ranging from marital dissolution to dissenting shareholder suits.

Investment Value is the value to a particular investor based on individual investment requirements and expectations. Investment value is typically used for transactional purposes when an acquirer is assessing the value of the target company, including the potential synergies of the deal.

4. What is the difference between an appraisal and a fairness opinion?

Full/formal business valuations typically consider all relevant approaches and methods that the appraiser considers appropriate in determining a value. These valuation reports typically include research on the subject company's industry, economic conditions, trends, etc.

Fairness opinions provide the expert's opinion of whether the proposed value of the transaction is "fair" for the shareholders. Fairness opinions do not typically provide an estimate of value or value range.

5. What are the main credentialing bodies for business valuation, what designations do they offer, and what designations have you earned?

The four main credentialing bodies in the business valuation profession are the National Association of Certified Valuation Analysts (NACVA), the Institute of Business Appraisers (IBA), the American Society of Appraisers (ASA), and the American Institute of Certified Public Accountants (AICPA).

NACVA offers the Certified Valuation Analyst (CVA) designation (for Certified Public Accountants only) and the Accredited Valuation Analyst (AVA) designation.

The IBA offers the Master Certified Business Appraiser (MCBA), the Certified Business Appraisers (CBA), Accredited by IBA (AIBA), Business Valuator Accredited for Litigation (BVAL), and Accredited in Business Appraisal Review (ABAR) designations.

The ASA offers the Accredited Member (AM), the Accredited Senior Appraiser (ASA), and the Fellow Accredited Senior Appraiser (FASA).

The AICPA offers the Accredited in Business Valuation (ABV) designation.

6. Why should a business have an annual valuation?

The most common benefits of an annual business valuation policy include:

Accountability and Performance-An annual business valuation enables the shareholders to see the value that is being consistently created or destroyed by the management of the firm.

Estate Planning Purposes-Many shareholders have on-going estate planning strategies aimed at protecting wealth for heirs.

Buy-sell situations-For those firms that do not have buy-sell agreements in place, annual business valuations are a good way of avoiding disputes that may arise when a shareholder seeks to sell his shares to the other shareholders.

Facilitate Banking-Many firms effectively utilize leverage to invest in value-creating projects. The ability of a firm to borrow based on the value of the goodwill or the value of the company's shares may expand the universe of value-creating investment options available.

Expands the Investment Options-Closely held firms suffer from a lack of liquidity and the inability to use the company's shares as currency when seeking acquisitions. An annual business valuation may enable the management of the company to use the shares as acquisition currency.

7. What is the difference between enterprise value and equity value?

Enterprise value is often referred to as the value of the invested capital of the business which includes the value of the equity and the value of the firm's liabilities. This value represents the total funding of the asset side of the balance sheet for all fixed assets, cash, receivables, inventory, and the goodwill of the business. Equity Value is the enterprise value less all liabilities of the business and represents the value that has accrued to the shareholders through retained earnings, etc.

As various professionals may define these levels of value differently, it is important to understand exactly what a definition of a level of value includes or excludes under the specific circumstances.

8. Do you use rules of thumb when valuing the business?

Rules of thumb are simple pricing techniques that business brokers typically use to approximate the market value of a business. Rules of thumb typically come in the form of a percentage of revenues or a multiple of a level of earnings, such as seller's discretionary cash flow. For example, a rule of thumb for pricing a widget manufacturer may be 40% of annual revenues plus inventory or two times seller's discretionary earnings. Rules of thumb fail to consider the specific characteristics of a company as compared to the industry or other similar companies. In addition, rules of thumb do not reflect changes in economic, industry, or competitive factors over time.

Widely-accepted business appraisal theory and practice does not include specific methodology for rules of thumb in developing a value estimate. However, rules of thumb can be useful in testing the value conclusion arrived through the appraiser's selected approaches and methods.

9. What role do court rulings have in developing an indication of value?

While Tax Court rulings may reflect the proclivity of certain courts to accept various discounts or levels of discounts in case-specific circumstances, these rulings may or may not play a role in the business appraiser's analysis and value conclusion. The business appraiser must consider the relevant facts in the subject valuation and make a reasoned, informed decision regarding the discounts and level of discounts in developing an indication of value.

With respect to case law, business appraisers should be aware of general issues that may impact a valuation. Often times, the business appraiser consults the client's legal counsel for their position on specific case law issues. Again, the business appraiser must use reasoned, informed judgment in developing an indication of value, considering the case-specific facts relevant to the valuation.

10. What are the main factors that impact the value of a business?

The value of a business interest is impacted by a number of factors, many of which may change from year to year, including:

Financial performance-If a business has poor earnings capacity, the value of the business may be negatively impacted.

Growth prospects-Just as too high a rate of growth may lead to negative operational and financial consequences, too low a growth rate may also have a negative impact upon the business and its ability to achieve profitability. Revenue growth drives all opportunities for the business to expand.

Competitive nature of industry-If the industry in which the business is operating has become more competitive due to the entrance of new competitors, the value of a business may be impacted as a result of lost market share, lower revenue growth, shrinking margins, and lower profitability.

Management-Management of a business influences the value of the firm. A highly experienced management team and an organization with managerial depth is more highly valued by a willing buyer than an organization with only one manager or key executive.

Economic and industry condition-The strength of the economy impacts all businesses in one way or another. If adverse economic conditions translate into long-term lower growth and profitability for a business, the value may be negatively impacted. Industry conditions are also impacted by the state of the economy but are also influenced by various other factors such as competition, technological change, trends, etc.

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