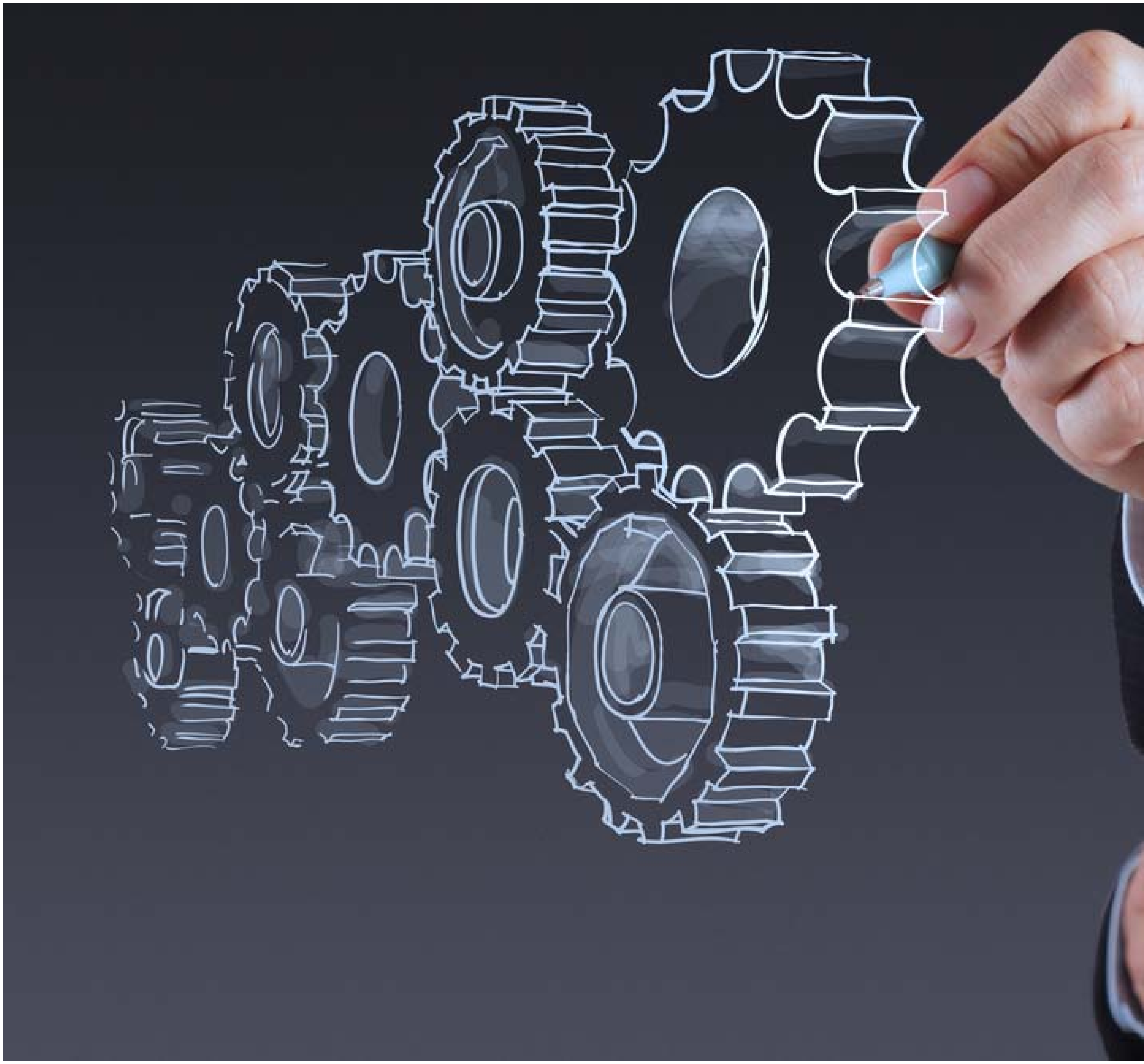
Buy-Sell Agreements That Rely on Cookie-Cutter Valuation Formulas



If you need a highly qualified, accredited and certified valuation specialist call **Ronald J. Adams, CPA, CVA, ABV, CBA, BCA, CFF, CGMA, FVS**
at **(508) 878-8390 - mobile**, or **(774) 719-2236 - office**
or e-mail him at adams.r@foxboro-consulting.com.

We continue this series on the seven common failures of business continuity agreements (aka Shareholder/ or Partnership **Buy-Sell Agreements**) with the fifth on the list: **they rely on valuation formulas that are not suited to the needs of the owner or business.**

It's easy to criticize valuation clauses in most **buy-sell agreements** (B-SAs) as being inadequate, "too cookie-cutter". They can be. It's much more difficult to suggest an adequate *and* cost-conscious alternative to the go-to remedy: a full-blown valuation from a credentialed and or accredited business appraiser.

Today we outline the menu of valuation options from most rudimentary to sophisticated. You'll note that the list also follows businesses through their stages of growth or maturity.

Valuation Types, Costs and Degrees of Reliability

Valuation Type 1: Agreed-upon Value

Method: The owners agree upon a value—often net book value.

Cost: **$0**

Reliability: Low, but for small businesses that are 100% reliant on owners for revenue, this valuation method might be adequate. There is very little, if any, value to the company apart from its asset value.

Valuation Type 2: Rule of thumb

Method: Owners (or perhaps an advisor) choose a valuation method common to the particular industry.

Cost: **$0**

Reliability: Low. Most owners are familiar with at least one rule-of-thumb measurement of value for their industry. Too many owners of business with millions of dollars of annual revenue use them. In our view, "Beauty is in the eye of the owner of the thumb." **This methodology works well if you are valuing a thumb**.

Valuation Type 3: Software-Generated

If you need a highly qualified, accredited and certified valuation specialist call **Ronald J. Adams, CPA, CVA, ABV, CBA, BCA, CFF, CGMA, FVS**
at **(508) 878-8390 - mobile**, or **(774) 719-2236 - office**
or e-mail him at **adams.r@foxboro-consulting.com.**

Method: Owners/advisors use an app. These programs vary greatly in sophistication.

Cost: **$0-$1,000**

Reliability: Questionable, especially if used by advisors not trained in valuation principles. Regardless, this method is unlikely to be as accurate as the types described below. These valuations should be reviewed by an owner's CPA or CFO. Still, this type of valuation is more accurate than agreed-upon or rule-of-thumb valuations. This type of valuation may be suitable for small businesses that cannot afford (or whose owners will not pay for) a credentialed and or accredited business appraiser.

Valuation Type 4: Calculation of Value

Method: A credentialed business appraiser provides a *calculation* rather than an opinion of value, usually by selecting a single standard of value (e.g. a multiple of EBITDA) to calculate a value. This type is not a complete valuation and owners and their advisors should not rely upon it for transferring ownership. It is very useful, however, for planning purposes: Exit Planning, gifting, estate tax calculations, etc.

Cost: **$4,500-$5,000** or more

Reliability: If the appraiser is experienced, reliability is likely to be substantially greater than any of the types described so far.

Valuation Type 5: Opinion of Value

Method: A credentialed business appraiser provides a full valuation.

Cost: **$5,000-$50,000** or more

We suggest you ask the appraiser for a cost estimate.

Reliability: Varies with the experience of the appraiser. We suggest you include a well-experienced credentialed appraiser in your network of advisors. For example, an appraiser who has completed 100 valuations in the past five to ten years has much more experience upon which to base his opinion than does an appraiser who performs one or two valuations per year. Business valuation is an area in which

If you need a highly qualified, accredited and certified valuation specialist call **Ronald J. Adams, CPA, CVA, ABV, CBA, BCA, CFF, CGMA, FVS**
at **(508) 878-8390 - mobile**, or **(774) 719-2236 - office**
or e-mail him at **adams.r@foxboro-consulting.com.**

experience and informed judgment count. Reliability increases above other valuation types if you use such an appraiser.

Note: **As advisors, we can recommend which type of valuation best suits a business, but that doesn't mean owners will agree with us.** Even owners of very successful businesses may not be willing to pay for an Opinion of Value when preparing a buy-sell agreement. And they may not need to.

What's the Point?

In addition to matching the sophistication of the valuation type to the sophistication of the business (and the owner's willingness to pay), advisors recommend the appropriate valuation type based on the purpose of the valuation.

For business continuity planning (and funding) purposes, we advisors need a good grasp on *likely* value. A B-SA can require a Type 2 or Type 3 (Software-Based or Calculation of Value) for that purpose. In that case, the B-SA should then require an Opinion of Value (Type 5 or a "full valuation") at the time ownership is transferred unless all of the parties agree otherwise.

If a client's company is worth millions of dollars today, you can suggest that they obtain an Opinion of Value when they execute the B-SA. You can also suggest that they retain the same valuation firm to perform periodic valuation updates—perhaps using a Calculation of Value methodology or an updated Opinion of Value.

Owners will likely rely on your judgment about which type of valuation is appropriate for their business. With this list as your guide, you can discuss the valuation type appropriate to the size of your client's business. Using a valuation approach other than an Agreed-Upon or Rule-of-Thumb approach will generally produce more reliable valuations. From that point, consider using the most sophisticated and accurate valuation method your client will pay for.

In our next article, we will discuss the problems raised by outdated buy-sell agreements.

Credentialed & Accredited Appraiser

Ronald J. Adams, CPA, CVA, ABV, CBA, BCA, CFF, FVS, CGMA, Managing Director – Valuation Services Group, will serves as the Executive-in-Charge and Client Service Executive. Ron manages, directs, reviews and approves all critical aspects of the valuation due diligence work, and maintains communications with the Client Company on all valuation engagements. Mr. Adams is both a certified public accountant (CPA) and a certified valuation analyst (CVA) credentialed by the National Association of Certified Valuators & Analysts (NACVA). He is a certified business appraiser (CBA), credentialed by the Institute of Business Appraisers (IBA), and is certified (BCA) by the International Society of Business Appraisers (ISBA). He is also accredited in business valuation (ABV), and he is certified in financial forensics (CFF), he is certified in forensic & valuation services (FVS), and he is a chartered global management accountant (CGMA) all designations sponsored by the American Institute of Certified Public Accountants (AICPA).

He has advised numerous clients in specialized areas of business enterprise and intangible asset & intellectual property valuations, bankruptcy processes & proceedings, mergers and acquisitions, income tax planning, financial accounting and reporting, asset divestiture, financial and operational due diligence, gift and estate tax planning, fraud investigations, shareholder dissent lawsuits, new business planning and development, equity buy/sell shareholder agreements and business negotiations, valuation of convertible preferred stock & common stock, warrants, options and partnership member units, marital assets in dissolution proceedings, and economic and financial feasibility studies.

Mr. Adams has managed numerous valuation engagements involving intangible assets & I/P, stock and option valuations, FAS 141 & 142 Business Combinations & Goodwill Impairment - valuations for financial accounting & reporting, income tax planning & reporting, gift and estate tax planning, and in merger and acquisition situations for companies