

Part II

Getting Familiar with Valuation Tools, Principles, and Resources

The 5th Wave

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"The investors liked our business plan — particularly the in-depth assesment of our competition, which is who they've decided to invest with."

In this part . . .

Although we don't drown you in numbers and computations, we do get a little deeper into the valuation process in this part. We talk more about what various experts do throughout a valuation and what you should know about a company's financial data going into the process. We also introduce a key resource that many people use as a starting point for a business valuation: rule-of-thumb data.

Chapter 6

Getting Familiar with a Typical Valuation Report

In This Chapter

- ▶ Understanding the goal of the valuation
 - ▶ Uncovering the basic offerings of a valuation report
 - ▶ Deciphering what each part of the report means
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We've said it before and we'll say it again: Valuations aren't driven by bricks and mortar sitting on a piece of land. They're driven by the reason someone wants to acquire a business or get rid of one. An asset's value is ultimately driven by the rationale for a transaction. And the goal of any valuation (regardless of the purpose) is to answer the question "What would happen in the market?"

In this chapter, we discuss the basic elements of a business valuation report, with the understanding that no two reports, like no two business valuations, should ever be the same. The best valuation reports tell a story about the history of a business, its pros and cons, and most importantly, its potential.

Understanding what a finished product should look like is always helpful before you start a process, so this chapter also lays out the general elements of any business valuation report that you'd pay for from a business valuation consultant or appraiser. Reports can vary in length and complexity based on the complexity of the job. Here, we give you a very basic starting point so you can see how reports present the essential information of valuation.

Note: This chapter, like most of the book, is focused on working with a valuation professional in determining what a business is worth. But in watching the habits of appraisers, accountants, and estate and tax attorneys, you should be gaining insight, too. So as you read, put yourself in the shoes of a trained valuation professional each step of the way — you'll start to figure out which facts to focus on and which questions to ask.

What a Valuation Report Is Supposed to Do

A good valuation report, like any piece of quality research, should open your mind to possibilities you've already considered and maybe a few you haven't thought about. As we mention throughout this book, putting dollar signs in your eyes isn't the job of a quality valuation professional. Nor is it her job to search in every corner for value or for data, events, or hidden matters that may take value away.

A good appraiser's job is to provide a third-party, objective opinion on what would actually happen if the subject company were for sale on the open market. You get a median valuation as the result, but if the appraiser or valuation professional is doing her job, you get what's known as a *range of values*, a compilation of opinions based on various methods of valuing those assets.



Always ask valuation professionals how many different methods they may potentially use to value your particular business and how they'll communicate those results to you.

A valuation report may contain very good news for you and your company or for the company you're hoping to buy. Or it may contain some bad news that sends you back to the drawing board but prevents you from making some expensive mistakes in the end.

Outlining a Typical Valuation Report

Every valuation professional may have a particular style, but most valuation reports follow a certain structure. We cover each section of the report in greater detail in the following subsections. For now, though, take a quick look at the setup:

- ✓ Cover
- ✓ Valuation summary (including assumptions and limiting conditions)
- ✓ Table of contents
- ✓ Executive summary
- ✓ Valuation summary
- ✓ Valuation assignment
- ✓ Economic outlook
- ✓ Industry outlook

- ✓ Business overview (including cost of capital, discounts, and premiums)
- ✓ Conclusion of value
- ✓ Appendixes (charts, footnotes, glossaries, and more)

A valuation report has no set number of pages. The length depends on the complexity of the assignment and the valuation possibilities based on the valuation goals being sought.

Cover

A cover's a cover, right? Well, in addition to looking at all the key information about the valuation firm, its contact information and where it's located, and its cool logo, you need to check one piece of key information and make sure you understand it: the date. Know whether the printed date is simply the date when the report was turned over to you or whether it reflects the official date of the valuation.



You need to be very clear about all the critical dates in any valuation you commission. The valuation date is critical because if this report is being done for tax reasons or eventually becomes evidence in a lawsuit or divorce action, the time sensitivity of the analysis becomes all the more important, depending on the circumstances of the case.

We talk a lot in Chapter 7 about planning for a sale or any other valuation-related transaction. Depending on what your plans are, when you do the valuation is a critical step in the process. Valuation isn't just about the dollar sign at the end of the transaction — it's also about timing.

Valuation summary

Unlike mystery novels, you don't have to flip to the end of most valuation reports to figure out what happens. You can pretty much flip past the cover and the table of contents, and then, boom — you find the number you've been waiting for. It looks something like this:

The fair market value of XYZ Co. is \$1.2 million based on a weighting of income and market valuation methods.



Note the phrase “weighting of income and market valuation methods.” This particular company was valued based on the income approach and market-based comparisons. This fact may not be true for every business, which is why you need to do your homework about what kind of valuation approaches and methods best fit a business in your situation. Talk over these choices with a valuation specialist. We cover approaches and methods in Chapter 4.

Your report will probably also indicate a high/low range for the value of the business, based on various valuation approaches and control premiums and special situations (including minority ownership, if it applies in your case).

The rest of this section of the report usually delivers the following kinds of information.

The assumptions and limiting conditions of the business

This section is a statement of assumptions and conditions on which an appraisal is based that the appraiser may or may not have verified. A standard valuation may contain a statement that describes items such as the following:

- ✓ That the title and legal description of the business are correct
- ✓ That the property is free and clear of liens
- ✓ That the current management and ownership have been verified and declared responsible for the business
- ✓ That the factual information received from others in the course of creating the report is reliable
- ✓ Notes on the illustrative material
- ✓ Any environmental impact statements that may be relevant
- ✓ That all licenses necessary to operate the property have been obtained
- ✓ That there is evident compliance with zoning and land use regulation

Executive summary

Everyone likes summaries. The executive summary enables you to see the critical points in the valuation process.

Purpose of the valuation/ownership structure

This section tells you the assumption of ownership upon which you're basing the valuation. If this business is a target company and you want to own 100 percent of it, that situation requires certain assumptions and valuation methods of its own. Of course, if you're valuing a portion of the ownership instead of 100 percent (if you'll have a business partner or two, or if you'll own jointly with a spouse or other family members, for instance), you'll see more details on what discounts or premiums have been added to the computations to affect that total valuation.



In the business valuation context, discounts or premiums are facts that either enhance or diminish the salability of a business and, therefore, the amount of value.

Major mistakes that show up on valuation reports

Understanding potentially big gaps in a valuation report is important — after all, you're paying for it. Such problems may include the following:

- ✔ Failing to state the date of the valuation and the date the report was prepared; both may be critical in a court proceeding
- ✔ Leaving off — or failing to consider — the purpose of the valuation
- ✔ Not listing the standard of value for the valuation (fair market and so on)
- ✔ Never doing a proper site visit
- ✔ Not detailing proper assumptions about the business and the purpose of its valuation at this time
- ✔ Not detailing the industry and the marketplace trends the company will be affected by, as well as its current and future economic prospects
- ✔ Not reviewing all valuation methods necessary for this particular situation
- ✔ Not defining the kind of earnings used in computation, if using the income approach
- ✔ Not going far enough with guideline company data, if using the market approach for comparison
- ✔ Failing to apply the proper discount or capitalization rates necessary for the valuation methods chosen
- ✔ Failing to disclose all sources of data used for comparison

Standard of value

The standard-of-value section can be combined with one of the opening sections. Regardless, you need a statement of the standard of value used to create the valuation. Fair market value, fair value, strategic value, and intrinsic value all result in different value conclusions based on the type of company being considered. (For info on standards of valuation, see Chapter 3.)

The subject of valuation and standard of value also helps determine whether you need to take various discounts, including discounts for lack of control and lack of marketability, as in the case of valuing minority interests in a company.



If you've had your business valued in recent years, keep in mind that the same standard of value and methods may not apply based on your goals for this valuation. In other words, let the goals and the current structure of the company govern which methods to use to complete the valuation. Don't make decisions based on decisions you made before.

The valuation date

This section covers the particular date the valuation was done. All valuations must be set on a particular date to allow the valuation professional to freeze a company's conditions and financials at a moment in time.

Valuation assignment

Yes, describing the assignment after seeing the numbers may seem a little backward, but admit it — you wanted to see that dollar figure first, right? This section of the report talks more about the features of the company itself.

The valuation key assumption

In a report that aims for clarity, you see something here called the *valuation key assumptions*. Granted, you may want to value a business because you're thinking of selling, but valuation professionals think a little differently. They look at all the assets you have and make an assumption based on what they think is the best way to monetize those assets. The valuation professional may state here that the sum total of assets would be best sold as a whole — as in a sale of the company outright — or may state that the assets would attract more cash if sold separately.

The assigned valuation date

We start this chapter by discussing how important the valuation date is. Who sets the date? Optimally, you or your representative does.

Competent valuation professionals don't set the date because it's not their job to decide the critical facts of the valuation, and the valuation date may be among the most critical. Timing issues should be the purview of buyers and sellers, not people who value companies.

In other words, companies that are planning to go on the block immediately may want the most recent numbers for the company figured into their valuation picture, particularly if those numbers are perceived to enhance the value of what they're selling. Companies that want to obtain bank financing or equity participation in their business may want to set different timelines.



If a valuation professional offers to help you set the valuation date, be wary. Qualified valuation professionals typically insist on a written recommendation from the client or the client's attorney specifying the exact valuation date. That way, they never have to redo the assignment; if the date is wrong or changes for any reason, the client or the client's attorney then must start the process all over again.

As we often note, dates can be a critical factor in the valuation process. Divorce, estate, and gifting issues are examples in which valuation dates certainly matter. As for the ordinary buying and selling of companies, the date doesn't matter as much, but a date must be set at some point. For example, the initial valuation of a company may be based on the last full year of financials for analysis in a report, but eventually, the year-to-date performance of a company will have to be communicated to be part of the report or not.



A smart buyer or a banker considers any data more than 90 days old to be outdated.

Economic outlook



Don't hire any valuation professional who doesn't watch how world and domestic economic factors affect your industry. Anyone can watch business channels and read as much as possible about the general state of the economy, but a business valuation professional has to know how to apply that macro view to the micro world of your business.

Today the most successful companies — even ones that are tiny right now — are global, thanks to the reach of the Internet and what it enables even the smallest companies to do. Even the smallest manufacturer can develop a supply chain that reaches all the way to Central Asia or the Far East. A small consultancy can have clients halfway around the world.

When various segments of the world economy experience either good times or downturns, valuation professionals can't turn a blind eye to those trends. They must pay full attention to anyone a company is doing business with or competing against.

In a valuation report, you should see detailed notes on how the economy is playing out, both in general and in particular in your sector of business. You'll probably see economic terms such as the following:

- ✓ **GDP:** The *gross domestic product* is the value of all the goods and services produced within a given year. The GDP is a crucial way of measuring how free businesspeople feel to invest in their businesses and increase production.
- ✓ **Interest rates:** People watch the Federal Reserve Board closely for a reason: It sets the general course of what borrowers will pay at all levels of the economy. Banks, businesses, and ordinary individuals find it easier to borrow and increase their spending when credit is looser; when credit is tighter, they slow down. Valuation professionals should bring this trend down to the level of the client who has to borrow in a particular economic climate.

- ✔ **Commodity prices and exchange rates:** If a business works with particular raw materials, such as metals, foodstuffs, or energy products, it needs to know how costs for those particular items will affect the cost of production in the business's area. Likewise, exchange rates — a reflection of the value of world currencies — can have a detrimental or a positive effect on a company's operations overseas. Valuation professionals need to know where these trends are heading and whether those measurements will increase or decrease valuations over a stated term.
- ✔ **What Washington plans to do:** Political and policy considerations are also important drivers of the economy. What the president and the nation's legislators hope to do with regulatory, tax, and energy policy is crucial to business. Again, valuation professionals need to know how federal legislation will affect state legislation that deals specifically with the business in question.
- ✔ **Key measurements:** Depending on the size of your business and its industry, you probably follow a market indicator that measures how your sector of the economy is doing. These indicators may include the following:
 - **The NFIB *Small Business Economic Trends* report:** The National Federation of Independent Business produces a series of research reports that describe how small companies feel about their businesses right now.
 - **Industry-specific indexes:** Pick an industry, and you'll find an index. Many trade publications have developed their own economic indexes to measure economic activity.



Equally important, a valuation professional must understand how your competitors are doing. If you don't get the sense that a valuation professional is asking enough annoying questions about who your competitors are, how they're doing, and whether they're gaining on you, he's not working to learn enough about your business.

- ✔ **The state of capital spending:** Capital spending is a driver of economic growth. You want to see whether companies anticipate spending more to make investments in their business. Even more important is seeing where they're going to make those investments.
- ✔ **The state of business financing in general:** Most businesses need to have some relationship with credit. As we write this book, sources of credit are very tight. In preparing to buy or sell a business, a valuation professional needs to keep the overall credit environment in mind.

Industry outlook

Valuation professionals are supposed to shine the cold searchlight of truth on the state of the subject company's industry. To value a company properly, it's important to know what the leaders in the industry are doing,

what their products are, and what their growth prospects are. Valuation professionals use news stories, database material, and a host of public and private company data to create this story.

As with the rest of the valuation assignment, the industry story isn't told in a snapshot view of what's going on during the latest year of business. You should see comparisons of revenue and operating profit growth for the industry over a certain period or whatever is appropriate in the context of that industry so you can get an idea of possible three- to five-year prospects going forward.

Other factors you see in the industry outlook section of the report include the following.

Growth prospects

The valuation professional's job is to give you an opinion on where your company stands on that growth path, but doing due diligence on that front is your job as well. If you're a thoughtful participant — or potential participant — in an industry, you owe it to yourself to know something about that industry's growth prospects and where the business in question ranks. Otherwise, how can you really trust the information other experts are providing you?

Potential threats and benefits for the overall industry

If the company being valued is a manufacturing company in a particular industry, such as computers or toys, you'll likely see a comparison made to the overall growth of manufacturing businesses in the United States (or internationally as well, if that's a necessary point of comparison).

Some valuation firms develop their own proprietary systems and formulas to further analyze this issue; others simply report what they're seeing in the news and from other trade sources that closely follow the industries. One is not necessarily better than the other.

Business overview

Yes, you may know the business you're in, but you want to see how the valuation professional describes what you do. You want to know how much they know about you. This section explains the parts of the report's business overview.



The *median value* is just a convenient midpoint; it doesn't represent the revenue multiple for any actual transaction. It indicates that half of the revenue multiples are below the median value and half are above. Median values depend on the attributes of the firm and the outside data points an expert uses to value it.

Your overall financial performance

The overall-financial-performance section usually consists of a one-year summary of your target company's financials, but the report also makes many references to the company's financials over a multiyear period. It may be accompanied by a chart of three to seven years of the company's financial performance.



Using outside professionals can be invaluable in discovering what your business is worth, but try to identify and make friends with people who own businesses similar to yours who aren't competing directly with your company. Buy them a meal or coffee and talk to them about what they hear similar businesses are going for in your area. If you don't feel you can just call someone up (you really should get over this fear, by the way), try joining a chamber of commerce or an industry association that serves your type of business. If nothing else, you'll get to know your competition even better.

How financials were adjusted/normalized (and for what purpose)

Valuation professionals adjust financial figures to accomplish certain goals or to facilitate certain valuation methods. These adjustments may be for one-time nonrecurring expenses such as a rare lawsuit or maybe capital expenditures from a flood or fire.

The adjustments are typically derived from control adjustments. Put in simpler terms, one of the tax advantages of owning a privately held business is the ability to run certain expenses "through the business." Owners may have family members on the payroll who aren't essential to the operating of the business. Or they may be burying certain personal items that aren't essential to day-to-day business operations. Examples include the following:

- ✓ Cars and car insurance (also boats, airplanes, and vacation homes)
- ✓ Personal travel and entertainment
- ✓ Country club dues
- ✓ Healthcare for family members



When maximizing deductions for tax purposes, these control adjustments are common. As long as taxpayers are using them properly under the U.S. tax code, all should be well. But potential sellers should be prepared to open up their books because, many times, these control adjustments are major factors in getting to the cash flow used for the income approach. If people are playing fast and loose with how they're preparing their taxes because they're being overly aggressive with running personal items through the business, they probably need to take a year or two to clean up the financial statements before a sale or valuation. If you want a buyer to pay you for cash flow that isn't readily apparent on the books, you need to be willing to show where "the bodies are buried."

Owner's compensation

Assuming that this company is a small business with a single owner, the owner's-compensation section is where you see the company's top salary benchmarked against that of executives at similarly sized companies in the same field. If this salary is above the range, it may be valued outside the expense side of the company's normalized financials: If the business changes hands, a new chief executive walking in the door may not need to be paid as much. In larger firms with more top officers, you may see a broader benchmarking of salary data.

And what happens if a business owner isn't paying herself a fair market wage for the size of her company or business? That in itself may indicate poor stewardship of the company you may be planning to buy. And that's another important reason to analyze compensation.

Conclusion of value

The scope and depth of the valuation assignment determine how many valuation methods the professional employs in the valuation of the company. The report's conclusion-of-value section devotes space to why each method was used and what computations were used to establish the standard of value.

You should see a narrative description of each method, along with a chart of the computations used in each method.

Methods examined and accepted/rejected

This section discusses the approaches and methods considered and rejected (and reasons why), as well as the approaches and methods considered and accepted to provide a reasonable conclusion of value.

Explanation of weighting each valuation method

Weighting is an indicator of importance — a ranking. Some valuation methods weight certain methods to reach a conclusion of value. Other reports do not. That decision depends on the school of thought or philosophy of the individual appraiser.

The next stop may be discounts and premiums. That depends on the scope, depth, and purpose of the assignment — and may also depend on the appraiser's philosophy. In some instances, the discount and premiums are calculated within the method. And in some cases, they're applied after determining the overall value. If they appear after the conclusion of value, the professional sets numbers for the following:

- ✔ **The firm's control premium:** This premium represents what an interested suitor — or existing shareholder — would pay to get majority control of a firm.
- ✔ **The firm's marketability discount:** This discount, a factor that actually decreases the value of a company, is tied to various factors that make a business tougher to sell.

Marketability discount is a natural issue for private companies because their shares do not trade on public markets and their value isn't set publicly on a daily basis. Experts can apply various methods to come up with the discount that must be applied, including the restricted stock method, the IPO method, and the option pricing method.

You may also hear about the *liquidity premium* — it's an extra reward that investors demand for tying up money in the firm for a longer period of time than they may otherwise choose.

Appendixes

Here you see specific information describing the expert and the valuation firm he works for, notes on exhibits and charts, and other descriptive material you'd see in any report. Some valuation firms list a specific glossary in the appendixes to make sure everyone understands the terms discussed throughout the report.

Chapter 7

Meeting the Supporting Players in the Valuation Process

In This Chapter

- ▶ Discovering situations in which you may need experts
 - ▶ Knowing the kinds of experts who can be useful in a business valuation
 - ▶ Seeing how valuation experts are trained
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Whether you end up doing the valuation yourself or enlist help is up to you. Yet we're big believers in getting help, as long as you do your homework beforehand and get the *right* help. We're not saying that you have to bring in a squadron of experts to do a simple valuation, but you should consult certain professionals before you do anything based on your situation. In fact, in a lot of situations, you definitely don't want to try this at home. This chapter focuses on the key professionals in this process, what kind of situations they fit, and how to hire the best people.



Your business finances and personal finances are inextricably linked. If you've never been in business, this fact is one of the first things you find out. So what does that have to do with valuation? When you start thinking about business valuation, your number one objective is to know not only how the value of your business affects the course of your business strategy but also how it influences your personal finances, including the people you may need to hire along the way. No one ever went into business to get poor, so your valuation strategy has to complement any particular tax, estate, or retirement strategy you've built. If you've never thought about this stuff, then start. We talk much more about the link between business and personal finances in this chapter and throughout the book.

Getting Help in Valuing Your Business

As some people whined through grammar school, high school, and college, "Math is hard!" But valuation goes beyond math. It's the assessment of a business's hard and intrinsic assets to determine its moneymaking power in

the hands of the same owner or a new owner years from now. Not all those items can be totaled up on a calculator (we get more into that issue in Chapter 8, where we discuss financial statements).

Business valuation occurs when offers or deals are on the table, of course, but business valuation is best used as an ongoing strategic tool to determine the best time to expand, contract, enter, or exit a business. Valuation can be necessary in light of many other circumstances — such as succession, divorce, death of a founder, or erosion in markets — that may signal a good time to sell or liquidate a business. Keep in mind that “sale” reasons for an owner may indicate a “buy” opportunity for the right outsider.

But back to the need for help: Why bother with experts? Very few people can keep their business and personal finances at their fingertips. Small-business people are busy and often distracted. A trade-off occurs in focus between business finances and personal finances, as well as in the lifestyle issues that necessarily fill your time — family, friends, and sometimes even leisure. People who have the skills to toggle among all these areas with all the information they need to make the right decisions are rare.



People with the right money skills may still lack a quality essential to the valuation process: objectivity. Asking an owner to value his business objectively is a bit like asking a parent to identify which of his kids is smartest. Most entrepreneurs are too close to their businesses to value them without bias, so you need detached experts and sources of information to rely on. This is why the valuation process rests on the shoulders of people who understand not only the financial aspects of your business but also its future value and what effect a sale or other transaction may have on your estate, your retirement plans, or your plans to get involved in a new business.

Here’s a quick list of the people who commonly participate in the business valuation process. We list them in alphabetical order — Hollywood style — so you don’t get the idea that one is more important than another. Having all these professionals show up in a single deal is rare, but it happens.

- ✓ Accountants and auditors
- ✓ Appraisers
- ✓ Business brokers
- ✓ Business consultants
- ✓ Business intermediaries
- ✓ Divorce and family-law attorneys
- ✓ Employee stock ownership plan (ESOP) attorneys
- ✓ Estate attorneys

- ✔ Financial planners and advisors
- ✔ Tax attorneys

Generally, you can break this list down into four categories based on the type of help you need. The Big Four are

- ✔ Appraisers
- ✔ Accountants
- ✔ Attorneys
- ✔ Brokers

We discuss the Big Four in more detail later in this chapter. First, though, you need to know how to pick out the best people to help you.

Recognizing situations that call for valuation experts

Almost more valuation situations exist than one can count, but here are the most common situations that require the help of professionals who are familiar with valuation processes:

- ✔ **Everyday sales and purchases of businesses:** Valuations are made at the time when businesses are bought and sold — or when companies plan to merge.
- ✔ **Purchase price allocation:** *Purchase price allocation* is the process of assigning fair values to all major assets and liabilities of an acquired company as part of a merger or purchase. This issue should be addressed early enough to ensure that all the parties understand the deal and that there's a meeting of the mind on how each party will be affected from a tax perspective.
- ✔ **Estate and gift taxes:** This situation involves establishing the fair market value of gifts and bequeathed assets that may fall under the scrutiny of the Internal Revenue Service.
- ✔ **Marital dissolution (better known as divorce or annulment):** This situation involves valuing assets that will be split between a couple.
- ✔ **Employee stock ownership plans (ESOP):** An ESOP is a tax-qualified plan that an owner can use to meet her goals in business succession, diversification of assets, estate planning, or property settlements in a divorce, or as an exit strategy from a business.

- ✔ **A company's liquidation or reorganization:** Valuation occurs when a company fails or is forced to file for bankruptcy protection (also known as *reorganization*).
- ✔ **Buy/sell agreements:** Buy/sell agreements are made between partners or co-owners, spelling out the circumstances and terms under which shares of the business or partnership will be transferred to one owner from the other.
- ✔ **Stockholder disputes:** In public companies, stockholders may take issue with the pricing of various assets in merger or sale deals, and valuation may be required as a defense in court.
- ✔ **Financing:** Lenders want proof of the value of assets as collateral if they plan to loan a company money.
- ✔ **Ad valorem taxes:** For most people, ad valorem taxes involve a garden-variety method of computing property taxes on residential and commercial property. Yet businesses like to confirm that they're not being overtaxed, so they frequently do valuation for this purpose.
- ✔ **Incentive stock options:** Accounting regulations require more rigorous valuation of incentive stock options to hold up in court when employees and shareholders dispute their value.
- ✔ **Initial public offerings:** Before public stock can be issued, investors like to see the certification of value of both tangible and intangible assets in a company.
- ✔ **Damages litigation:** When lawsuits are filed for any number of reasons, both defendants and plaintiffs may need assistance with valuation.
- ✔ **Charitable contributions:** For tax reasons, people may need to put a valuation on various assets donated to charitable institutions.
- ✔ **Eminent domain actions:** If a property owner finds her land or facilities condemned by the government, she definitely wants to challenge the government's fair-value estimate of that property before she agrees to an amount.

Finding the experts you need

Keep in mind that good professionals know other good professionals. For fledging entrepreneurs, the best professionals in the valuation process may come from the following sources:

- ✔ **Professionals you're already working with:** If you're working with a tax expert such as a Certified Public Accountant (CPA) or a tax attorney, start talking to that expert about people who are best qualified to help you with various stages of the valuation process.

- ✔ **People you network with:** Granted, valuation is something you don't want to broadcast too loudly — unless you really want someone to know that you're planning to buy or sell a business. Start working with discreet people you trust in professional or industry groups and even in alumni groups in which you're active.
- ✔ **Local professional associations:** Local societies for attorneys, financial planners, appraisal organizations, and accountants typically list specialists in various disciplines.

Seeking the qualities your experts should have

As you begin the valuation process, it helps to understand the concept of self-interest when you're bringing in experts to help you value your business. These experts are professionals with their own interests at heart: They're in business for themselves.

They also need to understand your motivations for valuation, and they need to demonstrate the following traits:

- ✔ **Independence/objectivity:** As much as you want to see an asset grow in value, you need professionals to appraise and value those assets without bias. That means that in reviewing your financial statements, interviewing executives, and eyeballing the physical aspects of your business, they need to rely on recognized standards of value — not merely on your influence because you're paying them.
- ✔ **Confidentiality:** Even if you're paying for honest, unbiased advice, you need to make sure that your goals are protected from people on the outside who could interfere with your plans. The professionals you bring into the process need to gather and process information legally, but they also need to be savvy about your need for discretion and confidentiality.
- ✔ **Industry awareness:** Experts need to know the current market backward and forward. There's really no single correct price for a business, but the experts have to price your assets fairly, relative to the market.
- ✔ **Clarity about fees:** Cost isn't the only factor involved in selecting professional help, but an understandable fee structure is key.
- ✔ **Clarity about dispute resolution:** The best valuation processes may not be dispute-free. Before you enter into any professional agreement, discuss how both sides will handle disputes and differences if they happen. You ask not because you anticipate trouble but because you want to prevent it.



One point about disputes over valuation: Many professional-services firms write specific language about arbitration or mediation into any contract you sign to hire them. This language may mean that you won't be able to sue the firm later for results that you find inadequate. Arbitration is a common dispute-resolution technique in many industries, so make sure you understand the process.

As you zero in on the valuation process, certain experts who do very specific things. The next section introduces a few.

Appraising What Appraisers Do

Appraisers are trained to analyze and set the value of a particular kind or category of asset. The best appraisers aren't utility hitters; they're specialists who not only have specific training in finance and accounting techniques but also have deep experience in certain industries or ownership situations that call for valuation, such as divorce, lawsuits, or bankruptcies.

Why can't the CPA who does your taxes do a business appraisal? He may have a sharp eye for figures, but in most cases, appraisal is a separate discipline. Appraisal involves many of the same basic financial skills that accountants and other finance majors are trained in, but appraisers also need other skills. They need to be able to do the following:

- ✓ Read and dissect a balance sheet so that they can compare and analyze various assets for current and future value
- ✓ Behave like detectives, questioning officers, management, and staff members about the current and future value of various assets
- ✓ Measure the value of both tangible (physical) and intangible (idea-based) assets
- ✓ Function under significant time pressure in many cases
- ✓ Write clear, extensive, detailed reports on findings
- ✓ Be able to defend their findings in court if they're challenged

Most chief financial officers (CFOs) and accountants don't have the time or the skills to do what qualified appraisers do. Nor are they truly independent of the organizations being valued. A CFO is to an appraiser what a police chief is to a crime-scene investigator: The top financial officer of a company oversees the big picture on valuation, whereas an appraiser gets called in to go over financial evidence with a fine-toothed comb. Simply put, appraisers strap on the gloves and do the detail work.

Where rule-of-thumb valuations come in

The purchase of even a simple business can get pretty complex, and in all financial transactions, people have a natural need to simplify what's going on. (Hey, that's the hallmark of a *For Dummies* book: making the complex simple!) So in the valuation world, where things can get mighty complex, you hear the phrase *rule-of-thumb valuation* a lot.

A *rule-of-thumb valuation* is a guideline that people use in a particular industry or line of business to value a company when it's bought or sold. The greatest thing about using rule of thumb is that it's a great way to jump-start your valuation research. You can get up to speed on businesses in a particular industry so that your research and work with professionals can continue in more depth.

In Chapter 9, we work with some examples from the annual *Business Reference Guide*

(Business Brokerage Press), by leading valuation author Tom West, to show you what rule-of-thumb valuations look like. Jim also adds his own commentary. *Business Reference Guide* is a leading encyclopedia of rules of thumb on valuing businesses ranging from private accounting firms to wireless communication franchises.

You'll also hear the term *benchmarking*. In the context of valuation, this term means everyday costs and expenses particular to a category of business, such as the kind of wages people get or certain performance measurements.

Rules of thumb are guidelines, nothing more. Throughout this book, we talk about working with experts who can help you with valuing a business for a variety of scenarios.

In reality, most appraisers don't get called in to do what they do for companies with less than \$1 million in revenue, because local standards of value or written guides provide benchmarks for these kinds of deals.

Before you hire an appraiser, know exactly what you're going to need to appraise. Individual appraisers generally specialize unless they're in a rural area, where they may have to know and evaluate several kinds of businesses. If you have a rural farm-implements dealership, bring in someone who knows that business, not someone who just does real estate or retail stores. If you have a variety of assets to appraise, however — such as intellectual property, land, property, and equipment — an appraisal firm or valuation practice may need to subcontract out your job.

How appraisers are trained and certified

Most business appraisers have four-year college degrees with majors in accounting or finance. Their career paths can take several forms. These individuals may eventually operate as independents, but they may initially join appraisal firms or sign on as full-time or contracted experts with law firms that need valuation services.

One of the most important reasons for appraisers to join an existing firm is for continuing education. New graduates generally don't have a specialty, but over time and with funded education, they develop one, and that specialty boosts their value in the marketplace. (See, careers can be valued as well.)

New college graduates with a background in finance need class time and work hours to qualify for a particular valuation certification. According to the American Society of Appraisers (ASA), such certifications include the ones we list in Table 7-1.

<i>Appraisal Organization</i>	<i>Professional Designation</i>	<i>Requirements</i>
American Society of Appraisers (ASA)	AM — Accredited Member	College degree and two years of appraisal experience; must pass four courses and an exam and perform peer review of appraisal reports
	ASA — Accredited Senior	Same requirements as those for the AM designation, plus three years of experience
	FASA — Fellow	Same requirements as those for the ASA designation, plus election to the ASA college of fellows
Institute of Business Appraisers (IBA)	CBA — Certified Business Appraiser	College degree, completion of one appraiser course and exam, peer review of two appraisal reports, and completion of at least two appraisal assignments
	MCBA — Master Certified Business Appraiser	Same requirements as those for the CBA designation, plus ten years of business practice experience, credit for published writing or lecturing, and references from four other MCBAs
	FIBA — Fellow	Same requirements as those for the MCBA designation, plus election to the college of fellows on the basis of leadership and contributions to the appraisal profession

<i>Appraisal Organization</i>	<i>Professional Designation</i>	<i>Requirements</i>
National Association of Certified Valuation Analysts (NACVA)	AVA — Accredited Valuation Analyst	Business degree, completion of analysts exams, and two years of experience or completion of at least ten business valuations
	CVA — Certified Valuation	College degree, completion of Analysts One course and exam, and CPA certification
American Institute of Certified Public Accountants (AICPA)	ABV — Accredited in Business Valuation	AICPA membership, Business Valuation license, completion of one-day exam, and involvement in ten business valuations
The Canadian Institute of Chartered Business Valuators (CICBV)	CBV — Chartered Business Valuator	College degree, completion of six valuator courses and exams, and two years of full-time experience

What appraisers cost

Business appraisers primarily charge based on the complexity — and the time constraints — of the valuation required. If you’re looking for a rough estimate, a rule of thumb is a basic starting point (For details, read Chapter 9).

Business valuation isn’t all about green eyeshades and sweat equity. As in most industries, computerization has made a huge difference in business valuation, bringing tons of information to valuation experts via databases and making critical computations easier. Ask a potential valuation professional how much of her work she does on a computer and whether the computer frees her to do more onsite work or other hands-on tasks.

For business valuations tied to specific situations, however — potential purchases or sales, divorce valuations, partnership dissolutions, and so on — the appraiser spends much more time analyzing corporate figures (which may require an audit by a CPA), inspecting assets, and talking with executives about those assets. Depending on the size of the company and the challenges to be met, the fee for the appraiser can easily be thousands of dollars — and sometimes tens of thousands of dollars.

Some valuation professionals charge fixed fees based on particular types of valuation assignments, but you aren’t limited to that fee if the process takes longer for any reason. Know in advance what may “unfix” a fixed-fee arrangement.



Appraisals that are certified by the appraiser usually cost more because they tend to be more detailed. A certified appraisal may include items such as the following:

- ✔ An overview of local, national, and international economic factors that affect this particular company and its industry, and what factors may affect the company and industry in the future
- ✔ A review of five years' worth of financial statements, as well as a review of tax returns and other financial documents for clarity and accuracy
- ✔ A balance-sheet analysis and review of the depreciation schedule, including adjustments for machinery, equipment, and other assets to come up with fair market value
- ✔ A detailed presentation of the valuation of a company based on several valuation methods that a future buyer or seller may demand
- ✔ Onsite visits to gather data and present findings

Anyone hiring a business appraiser should talk to at least two or three prospects to get an idea of his fees and his work process (which we cover in the next section).

How to examine a business appraiser's work process

Work process is all about the assignment — the actual thing or company that needs valuation.

The size and scope of an appraisal assignment determine the appraiser's work process in establishing the fair market value of a single asset or a whole company. Size and scope define the time that the appraiser needs to spend on the job, as well as the number of assets and related issues that she needs to review as part of the valuation process.

The simplest valuation assignments don't require a face-to-face meeting; a phone call and a few keystrokes into a database later, a very general dollar amount emerges as the value of a particular company. But when the company's revenue exceeds \$1 million and the reasons for doing the valuation are more complex, the assignment requires the following tasks:

- ✔ Extensive research of the company's industry and its prospects
- ✔ Interviews with company officers
- ✔ Onsite visits to see the physical facilities and assets being valued

- ✓ Exchange of information with company attorneys and tax experts
- ✓ Creation of reports and presentations on intermediate or final findings
- ✓ Possible after-valuation activities, including testifying in court or in deposition, usually priced as a separate item



The best valuation efforts are planned and comfortably scheduled for the scope of the project. When interviewing valuation professionals, ask them how long a typical valuation process takes and what they consider a rush job; otherwise, you may end up paying more for a quick valuation that doesn't give you as much depth as you need. Of course, smart valuation professionals know their limits and communicate them.

What to ask a prospective business appraiser

Much of how your valuation will go is determined by the questions you ask a professional before you hire him. Here are some basics:

- ✓ What's your specialty? (Ideally, you've checked this information beforehand, but let the prospect describe his expertise to you.)
- ✓ What are your training and certification?
- ✓ What basic information will you need from me to estimate the job, and what kind of information will you need from me on an ongoing basis?
- ✓ What do you think the features of this appraisal will be, and how long could the appraisal take?
- ✓ Is there a cost range you're prepared to offer at this time? If not now, when?
- ✓ Will you need to call in other experts to complete the valuation based on the assets I need you to value?
- ✓ How much experience have you had in valuing companies like mine (or like the one I want to buy)?
- ✓ I have specific reasons for valuing this company. Have you dealt with those circumstances in other valuations you've done?
- ✓ What did you find out about my company and me before we got here?
- ✓ Offhand, do you know what valuation methods you might use in computing fair market value for my company?
- ✓ How will we deal with each other during the valuation process, and how will I be apprised of your progress?

- ✔ Can you show me an example of what a finished appraisal report will look like? Will you meet with me and my colleagues when you're done and present those results?
- ✔ What happens if I have a problem with your results? What dispute-resolution process do you typically follow?



Beware of any valuation professional who automatically dismisses any valuation as “simple” without asking pointed questions about what you're trying to do.

Taking Account of Accountants

Granted, most people generally know what accountants do, but accountants are key to the valuation process for one critical reason: They're part of an essential checks-and-balances system that you need to guarantee the integrity of your results.

Accountants find themselves in a variety of roles and subspecialties, but here are the major work areas for accountants who are involved in the practice of valuation:

- ✔ **Public accountants:** They do basic accounting, auditing, tax, and consulting activities for individuals, companies, government entities, and nonprofit organizations.
- ✔ **External auditors:** These are the detectives of the accounting profession. Their job is to certify the integrity of an organization's or an individual's financial results. The specialty of forensic accounting (which we cover later in this list) also falls into this category. In most cases, auditors hold the CPA designation.
- ✔ **Internal auditors:** Internal auditors work inside a company (usually a large company) to verify the effectiveness of the organization's internal controls and to check for mismanagement, waste, or fraud. Their job is to ensure the integrity of the company's records and financial systems. Subspecialists may audit a firm's technology, environmental, or compliance functions.
- ✔ **Management accountants (also called cost, managerial, industrial, corporate, or private accountants):** These people record and analyze financial data for the companies that employ them. They prepare financial reports for stockholders, creditors, regulatory agencies, and state and federal tax authorities. They also prepare the reports that outside valuation professionals will review.
- ✔ **Tax accountants:** These are perhaps the best-known variety of accountants. They confirm that a company's or individual's tax filings are completed with accurate and truthful information and are compliant with local, state, and federal tax guidelines.



✔ **Forensic accountants:** Forensic accountants are accounting professionals who may be brought in to investigate potential fraud or mismanagement in a business. These professionals combine their knowledge of accounting and finance with law and investigative techniques to determine whether an activity is illegal. Sometimes, they work for or with law enforcement. Their investigative skills may be specific to a particular kind of firm, so they may be very specialized in what they do. For more on how forensic accounting works, turn to Chapter 17.

Blame it on *CSI*: In 2007, *U.S. News & World Report* ranked forensic accounting as one of the 20 hottest jobs in the country.

Assuming that they're doing their jobs correctly, accountants are critical in verifying that a company's finances, assets, procedures, and controls are exactly what they say they are on both sides of a transaction.

Accountants also get training to do business valuations. In fact, over the past 20 years, many more have sought certification to provide those services within their firms. The American Institute of Certified Public Accountants (AICPA) has drafted a new set of operating standards to make sure services are uniform. Go to the AICPA's Web site at aicpa.org for more information.

For most small-business people, accountants are indispensable parts of their advisory team, not just on valuation issues but also on all aspects of business planning. For many small businesses, the outside accounting firm is the company's finance and planning brain trust, so questions about a firm's approach to valuation services should be part of the hiring mix.

How accountants are trained

In the past 25 years, the specialization boom in general business training has extended to financial jobs. Whereas Bob Cratchit may have been a typical accountant more than two centuries ago, simply recording transactions in and out of a business nonstop on a daily basis, today's accountants are prepared not only to handle numbers but also to interpret and position those numbers strategically for the future of the business.

In most larger businesses, the CFO's job has gone from being largely a background position to a key strategic post. Before, CFOs were primarily the guys — and most *were* guys — who told the chief executive officer and the board whether any money was available to do what they wanted to do with the business. That situation has changed significantly in the age of Enron. Businesses that have high transparency — numbers that a person can make sense of quickly — get high marks for honesty and reputation.

Today's CFOs may have used their accounting skills during tours of duty in marketing, planning, information technology, and many other departments in a typical company. The need for financial controls has become much more prevalent on all levels of a business.

Dare we say it? Have accounting skills become sexy in the 21st century? At the very least, they've become much more critical to a business's reputation and identity.



If the Enron era has taught American business anything, it's the importance of the need for financial controls. Good financial controls in any business, large or small, are critical to any business valuation. If the numbers can't be trusted, it's difficult to put a fair price on the business.

Today's accountants get their training at all levels. Many start with basic bookkeeping courses in high school and move on to two-year and four-year accounting degrees at the college and university level, which prepare them for entry-level jobs in government, corporations, and dedicated accounting firms.

Accounting training has moved up the specialization scale in most recognized college business programs, particularly at the master's level. The most highly ranked Master of Business Administration programs in the country have a recognized finance track that goes beyond basic accounting into training in dealing with domestic and foreign assets. As the business world has gone global, accountants need to be able to manage the finances and assets of global industries.

How accountants are certified

According to the U.S. Department of Labor, any accountant filing a report with the Securities and Exchange Commission (SEC) is required by law to be a Certified Public Accountant (CPA). This requirement includes senior-level accountants working for or on behalf of public companies that are registered with the SEC.

CPAs are licensed by state boards of accountancy. Any accountant who passes a national exam and meets the other requirements of the state where she practices can become a CPA.

The Department of Labor reports that as of 2007, 42 states and the District of Columbia required CPA candidates to complete 150 semester hours of college coursework — 30 hours beyond the usual four-year bachelor's degree. CPAs don't have an easy certification process. All states use the four-part Uniform CPA Examination prepared by the American Institute of Certified Public Accountants (AICPA).

The CPA examination is tough; fewer than half of those who take it each year pass every part they attempt on the first try. Candidates aren't required to pass all four parts at the same time, but most states require candidates to pass all four sections within 18 months of passing their first section.

The CPA exam is now computerized and is offered two months out of every quarter at various testing centers throughout the United States. Most states also require applicants for a CPA certificate to have some accounting experience, but requirements vary by state or jurisdiction.

For CPAs, the AICPA offers the option to receive any or all of the Accredited in Business Valuation (ABV), Certified Information Technology Professional (CITP), and Personal Financial Specialist (PFS) designations:

- ✓ The ABV designation requires the completion of a written exam and at least ten business valuation projects that demonstrate the candidate's experience and competence.
- ✓ The CITP designation requires the achievement of a set number of points awarded for business technology experience and education.
- ✓ Candidates for the PFS designation also must achieve a certain level of points based on experience and education, pass a written exam, and submit references.

Other certification programs are available to accounting specialists in auditing, tax preparation, government accounting, and forensic accounting.

What accountants cost

We're going to sound like a broken record again: The cost depends on the job you're paying an accountant to do. Most accountants are like attorneys in that they charge by the hour rather than a fixed fee for a particular task. Some require an annual retainer to serve your business and add specific fees based on regular tasks or jobs that crop up suddenly.

Even tax preparation — which used to be a steady, fixed-fee business — has moved away from that pay structure due to the complexity of many individuals' finances. To a certain degree, retail tax preparation firms such as H&R Block have kept those fees low.

As we indicate earlier in this chapter, valuation training is now part of life at many accounting firms, and if you think you'll have a need for those services, they should be part of your shopping process. Any time you hire an accountant, list every possible service you may need and ask him to explain whether you can negotiate pricing based on that package of services and what activities still need to be priced à la carte.



The dominance of computer-based financing programs such as Quicken have made it possible for most small businesses to track their own finances, which is definitely a good thing. But computer-based programs really provide basic bookkeeping. Unless you have specific training in finance and tax issues, it's probably better to turn those numbers over to an accounting professional, not only for tax reasons but also to help determine a growth and exit strategy for your business.

How to examine an accountant's work process

Depending on their assignment, accountants may see you once a year and work with your numbers intensively for a few weeks at tax time, or they may be regular contacts year-round. If you have an accountant working within your business, that contact can be daily. But most small businesses work with outside accountants either annually or quarterly (for those that are incorporated and want assistance filing their quarterly reports).



Do you really need an accountant? If your business is small and relatively uncomplicated and all you need is someone to handle your tax filings, you may want to consider hiring an enrolled agent instead — someone who's trained specifically by the IRS to handle tax returns. The good thing about experienced CPAs is that they tend to have more experience working with financial planners and estate specialists in helping you form an overall financial plan.

With computerization, most accountants never have to walk into your offices to do their job, and with the Internet, you may never need to walk into theirs. Digital tracking, shipment, and computation of financial data has made the whole accounting and financial planning process simpler and more widespread, and accountants have their own computer programs that help speed their jobs along. Although accountants definitely burn the midnight oil at tax time, their volume of business is now significantly larger thanks to the digital revolution.

What to ask a prospective accountant

Because this book is about valuation instead of overall accounting tasks, we base our suggested questions on how an accountant will factor into your valuation strategy (if you want to find out more about accounting, we'll refer you to *Accounting For Dummies*, by John A. Tracy, CPA):

- ✔ What are your qualifications and training?
- ✔ Based on my size and type of business, what kinds of valuation services do you recommend, and when should I have them done?
- ✔ From a tax and accounting perspective, what can be done over the course of time to boost the value of my business?
- ✔ What experience does your firm have in valuing sole proprietorships, corporations (C and S), partnerships, and companies with significant operations outside the United States?
- ✔ What valuation methods would you apply to my operation if I were to put it on the block tomorrow?
- ✔ Tax planning is great, but what can you do to help my business grow? Will you help me set benchmarks that measure how my business is doing and when I should either quit or sell?
- ✔ Will your firm offer advisory services for my personal finances as well as my business finances? Can you also do legal referrals?
- ✔ Will you work with computerized files, or can you still work with paper documents and paper receipts (the old shoebox method)?

Hiring Advocacy: Attorneys

Attorneys are paid advocates. They may work in any of dozens of specialties. In the context of business valuation, they may have nothing to do with the actual appraisal work that goes into a valuation ordered by you or another party, but it's their job to make sure that valuation findings are legitimate and that they serve your best interest.

Several legal specialties are prevalent in valuation:

- ✔ **Estate attorneys:** These folks help you formulate wills, trusts, and other power-of-attorney documents that guide both your personal and business lives. They have the skills to work with accountants and other personal finance professionals to create a seamless financial strategy that serves your personal and business lifestyles. They care about business valuation because the business is what's funding your family and your future.
- ✔ **Divorce attorneys:** Divorce attorneys administer the breakup of a marriage and, often, the breakup of a business. Although those who specialize in family law may defer to other attorneys and accountants who are more immediately familiar with your business and personal finance strategies, they should have basic training in coordinating any movements with your business assets in divorce court.

- ✔ **Tax attorneys:** Tax attorneys understand state, local, and federal tax codes. They handle tax challenges from the government and devise legal planning strategies that minimize the taxes that a business has to pay. They need to care about valuation because assets are taxed based on value.
- ✔ **Bankruptcy/liquidation attorneys:** The valuation question comes into sharp focus in troubled companies. Bankruptcy attorneys help clients get fair market value on assets that must be sold to repay debt, court settlements, and other amounts.
- ✔ **Corporate attorneys:** These people help entrepreneurs draw up papers to establish the structure of a business, which can be important for how assets are valued.

In the context of valuation, attorneys may assist in the following tasks:

- ✔ Purchase or sale of a business
- ✔ Separation of property during a divorce
- ✔ Creation of an estate plan
- ✔ Ownership assignment of assets in a prenuptial agreement
- ✔ Creation of ESOPs
- ✔ Structure and draft partnership agreements
- ✔ Defense of clients in litigation challenging the value of a company, organization, or partnership
- ✔ Drafting of wills, powers of attorney, and various directives affecting the future of a business after the owner is incapacitated or deceased
- ✔ Defending tax challenges from local, state, and federal authorities

How attorneys are trained and certified

Attorneys are trained at law schools with a typical three-year course of study, though some colleges offer graduate training to create dual graduate degrees in the law and other areas, such as JD(Juris Doctor)/MBAs, better known as a combined law degree and MBA degree. Other attorneys may also train as accountants and gain a considerable amount of expertise in calculating valuation.

Most lawyers, however, come out of school with very little direct training in business and certainly not in valuation. For those attorneys, such training generally takes place after employment; they may train through apprenticeship at their law firms or seek outside training in the certification programs we mention in Table 7-1, earlier in this chapter.

Attorneys really aren't certified in the practice of law; rather, they're cleared for the practice of law by taking the bar exam of the state in which they plan to practice. Attorneys may elect to train for certification in valuation.

What attorneys cost

Unlike valuation experts, attorneys typically charge by the hour, not by the job. Market rates, the attorney's prominence, and the complexity of the assignment affect the fees, which can total hundreds of dollars per hour. It's not possible to give a price range for attorney fees for any particular aspect of a business transaction, which is why you need to quiz attorneys about their fees when you interview them.

How to examine an attorney's work process

An attorney's work process very much depends on the assignment. If an attorney is a specialist in family law and the issue is the splitting up of the family business in a divorce, the assignment will require not only a valuation of the business (likely contracted out to a valuation professional) but also the attorney's advice on how the business will be split based on that valuation and supervision of the negotiations going forward. If the divorce is a relatively friendly one, that friendliness may save thousands of dollars in attorney fees.



When you consider an attorney to handle a dispute, ask whether any part of the process could be contracted out to a licensed mediator. Most law firms recommend local licensed mediation firms if both parties are inclined to do their own talking. The mediator records the results. This process is generally cheaper than having attorneys handle negotiations.

What to ask a prospective attorney

Hiring an attorney can be daunting, particularly if you anticipate that this person will be advising your business over a long period of time. But it can be even more difficult if you're dealing with a stressful situation such as bankruptcy or divorce. Here are some general questions to ask a prospective attorney before you hire her:

- ✓ What is your approach to your specialty?
- ✓ How do you work with valuation? Are you certified to judge valuation questions, or do you need to subcontract with experts?

- ✓ Do you have an opinion on how my company should be valued?
- ✓ Do you deal with companies in my situation often? Is there anything different about the way you'd handle my business?
- ✓ What is your fee, and is there a way for me to control expenses?
- ✓ What other experts do you need to bring into the process?
- ✓ What do I need to do in this process?
- ✓ What timetables do I need to be aware of?

Brokers: One-Stop Valuation and Sale Services

Business brokers are unique among valuation players because they may or may not represent your interests. Take a step back and think about the meaning of the word *broker*. A real estate broker can work for you — if you hire him — or work against you if he's working for the opposing buyer or seller.

Whenever you work with any kind of valuation expert, you always need to understand whether that expert's interests mesh with your own. Business brokers are one-stop valuation and sale services for businesses. They do the following things:

- ✓ Help buyers and sellers of privately held business complete a buy or sell transaction
- ✓ Help clients price and market a business, including providing valuation services
- ✓ Specialize in particular industries, which allows them to get closer to particular valuation questions
- ✓ Work with both sides of the transaction in preparing a property for sale, bringing in potential buyers, facilitating due diligence, and negotiating with both parties

Brokers may also hold real estate licenses in case their clients need to market real estate assets.



In some states, businesses can be sold only by registered real estate agents. Be aware that if the business broker you work with does not have a real estate license, the real estate may have to be marketed by another professional.



Brokers like to close. That's true of all brokers, even reputable ones. Disreputable ones make big promises they can't keep. Steer away from those who are fuzzy on fees or those who promise that they can get your asking price without doing a full valuation of your assets. Also, if your broker can't explain in simple language how she would perform your valuation, move on.

People hire business brokers for most of the same reasons that they hire real estate brokers: They're busy and don't want to be bothered with all the details of selling a business themselves. Business brokerages generally work on private transactions in excess of \$1 million in annual sales and operate mainly locally or regionally, which is what you want — brokers who really understand your local market. You may be able to get good recommendations through your attorney or accountant.

Here's what business brokers do:

- ✓ Value your company
- ✓ Identify prospects and market your company to them, including the creation of brochures and other relevant marketing materials
- ✓ Help you set a price that makes sense for the market
- ✓ Negotiate the deal, prepare the paperwork, and help you close



Understanding how a business broker will work for you is particularly important. Is the broker packaging your business for sale to an established group of leads that he has in his files, or is he attempting a sale effort to buyers who make particular sense for you?

How business brokers are trained and certified

Most business brokers are trained through industry associations such as the International Business Brokers Association (IBBA) and the American Business Brokers Association (ABBA). You may ask whether a broker has a related financial background or specific training in valuation or accounting. The IBBA also accredits business brokers with the title of Certified Business Intermediary (CBI).



You definitely want to know whether your state licenses these types of brokers, because not all states do.

What business brokers cost

Like most brokers, business brokers charge a percentage of the total sale price. Fees can run as much as 10 percent for a company selling for less than \$10 million or a few percent on companies selling for more. You need to check whether the fee is based on the overall amount of the sale or whether other fees are charged à la carte.

Also find out whether there's any chance that you'll be charged if the business doesn't sell after a certain period. In states with no licensing or limited licensing for business brokers, checking makes sense.

How to examine a broker's work process

Like other professionals, a broker's work process very much depends on the assignment. Is the broker just going to list the business on a business-for-sale Web site? Or is she going to create a market by launching a controlled auction? What if the seller is sensitive to confidentiality and wants to approach only a few hand-selected buyers? Many factors, such as the company's size, industry, and confidentiality, determine a marketing strategy for selling a company. Understanding the marketing strategy the broker follows, or finding out whether the broker is experienced in crafting different marketing strategies, is a crucial factor in choosing a broker.



When you consider a broker, ask for a proposal that includes the specific services that will be provided and the marketing strategy that will be employed.

What to ask a prospective business broker

When you're hiring any professional, always come armed with a list of questions. If you don't like an answer you receive for any one of these questions, you may want to consider looking elsewhere for a broker:

- ✓ Aside from your certification, what training do you and your staff have in all areas of the business sale process?
- ✓ What's your success rate in closing deals, and can you document it?
- ✓ What's the full range of services you provide?
- ✓ May I speak to the owner of the brokerage?

- ✔ How will you market my business, and how will I be kept informed of that progress?
- ✔ How long is your typical engagement with a client? May I see the contract you require clients to sign?
- ✔ How do you charge for your services?
- ✔ Will you work with my attorney or tax professional?
- ✔ How will we communicate?
- ✔ What if I'm unhappy with the offers you present to me?
- ✔ May I see examples of brochures, Web sites, and other marketing materials that you've presented for clients?

Chapter 8

Understanding Financial Statements

In This Chapter

- ▶ Understanding the financials necessary to value a business
 - ▶ Seeing how a balance sheet works
 - ▶ Knowing what an income statement does
 - ▶ Understanding how cash flow works and translates into value
 - ▶ Recognizing key valuation ratios
-

In the first part of this book, we tell you that valuation isn't all about the numbers. But frankly, neither you nor a valuation professional can do valuation without the blasted things. We're going to make an assumption that you're not experienced in accounting (and point you toward a great title to rectify that situation: *Accounting For Dummies*, 4th Edition [Wiley]). But all we really focus on in this chapter are the basic sources of financial data necessary to measure the financial performance of a business and, therefore, the numbers necessary to do a valuation.

We talk about how important these numbers are in judging the short- and long-term health of a company you're considering buying or investing in. The chapter's a good primer for starting a business from scratch as well.

These reports are easy to get if you're looking at a public company, but for private companies, you usually have to present yourself as an interested party in a possible transaction, and very likely, you'll have to sign a confidentiality agreement to get access to this information in the due diligence process, which you find out about in detail in Chapters 12 and 16.



If you're starting a business and haven't received any training in finance, marketing, or any other aspects of starting a company, consult your community college system to see which basic courses it offers. Reading is a good companion to hands-on coursework, and best of all, you may be able to deduct the cost of the courses from your taxes!

Gathering the Financial Data You Need

Optimally, you need three to five years' worth of financial statements from the target company to do various calculations and adjustments to test the company's financial health and prospects. Here are the basic financial statements and records that you (or your valuation professional; refer to Chapter 7) need from the target company:

- ✓ Balance sheet
- ✓ Income statement
- ✓ Cash-flow statement
- ✓ Statement of retained earnings

These documents aren't the only ones you need to craft a full valuation of the company, of course — we get into those documents at several points in the book — but they're the foundation of any company's valuation process.



If you're considering starting or buying a business and you use an experienced Certified Public Accountant (CPA) to do your personal taxes, why not set up some time with her after the April 15 tax deadline to discuss basic business recordkeeping? This meeting is a good way to discuss which business structure is best for you to choose, as well as to review the basic financial statements and filings you'll need to make when you're in business. You can discuss setting up financial recordkeeping on your computer as well.

Looking into Support Data

We bring the point into sharper focus as the book goes on, but beyond the basic financials, the kind of company you're looking at defines the kind of additional data you need to establish the value of the company. That's when market data, transactional information, and consumer and supplier intelligence become important. Following is a small sampling of other data that smart valuation professionals gather.

External data

External databases are a great place for prospective business owners to research the industry they're considering entering or buying into. This is where individual business owners can start developing the knowledge necessary to work with all the professionals in the valuation process:



- ✔ **News databases:** These databases may be useful to detail outside analysis on a target company, as well as events and developments affecting the fortunes of the industry in which the target company operates.
- ✔ **Business databases:** These databases contain critical and detailed information on companies and their suppliers. Even if the target company is a small, private competitor that isn't listed, these resources can be good sources of background information on which to base decisions.
- ✔ **Valuation databases:** In Chapter 9, we discuss so-called rule-of-thumb databases that help you get a general idea of how categories of businesses are valued. They don't replace professional valuation as a way to correctly value a company, but they're an excellent starting point for understanding the factors that determine value in various kinds of companies.

Business databases are generally expensive, so check with public and university libraries where you have access to see whether you can do a search for free.
- ✔ **Trade journals:** Like business and news databases, trade journals may provide a sweeping overview of an industry, but because these journals often cover their industries microscopically, they can have an advantage over more general databases.

Internal data

Certain internal data may or may not be disclosed prior to due diligence. Typically, the seller provides a summary of key financial and business data in its offering memo, but these numbers represent the tip of the iceberg of what you or your valuation professional need to dig for.

When you're in the due diligence phase, this information needs to be available in full detail so that the numbers can be verified. For example, an offering memo may mention payroll as a percentage of sales, so you have a rough idea of that information going in. But you need to know that it's surface information. You start asking the tough questions and crunching those numbers during due diligence.

Here are key examples of that data:

- ✔ **Sales and customer spending data:** This information helps you understand the quality of customers that an organization has — how long they've been doing business, how creditworthy they are, and why they spend, for example. Smart valuation professionals representing buyers talk to customers and even competitors of a target business to gather this intelligence.



The bigger the organization, the more detailed the valuation process is. For businesses worth less than \$1 million, you'll probably be leaning on rule-of-thumb estimates for value. For businesses above the \$1 million level, get advice from your existing tax and estate expert on how detailed the valuation should be to keep your costs and time commitment reasonable.

- ✔ **Any history of lawsuits or legal challenges over internal or external practices at a company:** It's not enough to know just that a company was sued and then won, lost, or settled the case; you also need to know why the company was sued and how it handled the suit. Legal problems can linger for new buyers as well.
- ✔ **Payroll and employee turnover data:** Payroll typically is an organization's number one expense, so understanding the employee base from the standpoint of pay, benefits, and placement is critical. Yet payroll goes beyond what a company pays people. Keeping great talent within an organization is a major valuation issue, but protecting company secrets when employees leave is important, too.
- ✔ **Product evolution:** Is a steady stream of new products, services, and enhancements coming out of a company over time, or does it cling to old successes? Research and development (R&D) is part of every organization; even a restaurant updates its menu and prices from time to time. If a company isn't constantly working to update its offerings and tracking that process, you should be suspicious.

Taking a Look at Financial Statements

To determine the value of any business, you need to have access to that business's financial documentation. If you're valuing a public company, a company's financials are generally accessible because the law requires it. For private companies, however, you need to be at a relatively serious point in a negotiation before a potential seller will open its books to you. But no matter whether you're looking at a public or private company, you need to see the balance sheet, the income statement, a statement of retained earnings, and as much supporting documentation behind these financial results as possible.

The balance sheet

Also called the *statement of financial condition*, the *balance sheet* summarizes a company's financial position at a specific time. In simplest terms, it tells you what a company has, what it owes, and what's left for the owners. This is often expressed as a formula:

$$\text{Assets} = \text{Liabilities} + \text{Shareholders' Equity}$$

Public company annual reports: Basic training in financial analysis

The U.S. Securities and Exchange Commission (SEC) requires that public companies make public disclosure of all the financial documents that we refer to in this chapter. Although private companies don't have to make this disclosure, they have to have a system set up for sharing documents if a buyer comes sniffing around.

Because you're at the start of your valuation education, dissecting a public company's annual report is good general training in understanding valuation at any company. Just remember to ignore all the pretty pictures and words in the front of the annual report and turn to the back where all the boring numbers are. Look for the following:

- ✔ **The 10K:** This document, filed with the SEC, contains a detailed explanation of a business (it's often packaged with the annual report). It offers a more detailed view of financial statements than does an annual report. It allows you to see the amount of stock options awarded to executives at the company, as well as a more in-depth discussion of the nature of the business and marketplace.
- ✔ **The 10Q:** This is the quarterly version of the 10K. If the company is planning a merger announcement, changing its dividend policy, facing a lawsuit, or worse, it may not issue a press release but rather slide it into the 10Q.

Why analyze a balance sheet? It's the doorway to the inner financial workings of a company. The numbers contained in this statement give important smoke signals of whether business is good or sliding into trouble.

The balance sheet includes assets, liabilities, and stockholder equity. Read on.

Assets

There are two classes of assets — current and long term. Current assets are those that can be converted into cash during a stated period of operations, known as the *operating cycle*. Long-term assets are those that are seen as usable for more than one year, and they're depreciated annually based on their expected useful life.

What falls under current assets? Items that are liquid — which means they can be sold quickly. They include the following:

- ✔ **Cash:** You've heard it before — cash is king. Cash as stated on a balance sheet is money that can be accessed quickly, such as money in a cash box in the office or hopefully inside a bank. Cash held in long-term reserve to buy company shares or extinguish other debt is considered separate from this category because it's earmarked for a specific purpose, not a general one.

Keep in mind that there's no one single format for presenting consolidated financial statements at any company. What you see here are general structures, and depending on the company and industry it's in, the level of detail will change.

- ✔ **Marketable securities:** This is money in short-term bank certificates of deposit or government obligations (such as bonds) that can be accessed within a one-year period of operations. You may not be able to get your hands on it today without a penalty, but you'll definitely be able to do so within a few weeks or months.
- ✔ **Accounts receivable:** This is money that should be coming in the door within a short period of time. Accounts receivable are amounts billed to your customers for the goods and services you create. All accounts receivable should be labeled separately for accounting purposes (not every account receivable appears on the balance sheet because it's mainly a summary), but a potential buyer or investor will definitely want to see a list and aging report of all of your accounts receivable. This information can tell a lot about the quality of who you're doing business with.
- ✔ **Inventories:** These are goods (mainly physical items) that are available for sale, items already on the assembly line, and raw materials not yet part of the manufacturing/assembly process.
- ✔ **Prepaid expenses:** This might not sound like an asset, but it is. Prepaid expenses are the result of a business making payment for necessary goods and services to be received in the near future. This is stuff like prepaid rent for facilities and business insurance.

What falls under long-term assets? Obviously, assets that may need more than a year to liquidate fall under long-term assets. Here's what they include:

- ✔ **Investments:** These go into two categories on the balance sheet — short term and long term. Generally, long-term investments are those that a company plans to keep for more than a year (the definition is actually true for individuals, too), and they may consist of stocks or bonds of other companies, real estate, and cash set aside for a specific project or reason. Long-term investments also include money that's held for a pension fund. Short-term investments are those in non-cash accounts that can be liquidated within a year. These may include marketable securities or specific properties meant for short-term resale.
- ✔ **Plant assets:** These are also called *fixed assets*. They include plants and equipment as well as land, buildings, machinery, and other items intended to be used in business operations over a relatively long period of time. These are generally not assets you'd rush to convert into cash — their value comes from the goods and services they produce for sale in the business.



- ✓ **Intangible assets:** Our favorite. These are assets you can neither see, taste, or touch, and they consist mainly of valuable rights, privileges, or other advantages and perks. This category of assets can be the whole ballgame as far as the value of some companies goes, particularly technology companies that produce ideas that travel digitally (see Chapter 5 for details).

Sometimes the most valuable intangibles in a business don't land on the balance sheet. We're talking about internally developed brands, trademarks, and copyrights.

- ✓ **Other assets:** This is a bit of a catchall category. When any company prepares a balance sheet, it finds assets that can't be classified easily under any of the categories we've stated. What falls into this category? Pay advances made to company officers, the cash surrender value of life insurance on officers, the cost of buildings in the process of construction, and the miscellaneous funds held for special purposes.

Liabilities

Liabilities are what a company owes. Company obligations come in the following forms:

- ✓ **Current liabilities:** Current liabilities are those you'll pay off or otherwise discharge within your normal operating cycle or within your operating year. This is likely to include amounts owed to trade creditors in accounts payable. Other current liabilities may include income taxes and payroll, as well as utility bills, payroll taxes, local property taxes, and other services.
- ✓ **Long-term liabilities:** These are generally notes, bonds, and mortgages — debts that usually take more than a year to pay off. Of course, if you have long-term debt that's coming due within the operating year, you need to move it to the short-term debt column.
- ✓ **Deferred revenues:** Customers sometimes make advance payments for merchandise or services, sometimes in exchange for a discount or other incentive. Revenues are booked when merchandise or services are actually delivered.
- ✓ **Provisions for legal settlements:** These are reserve amounts to cover potential losses from court disputes that aren't yet official.

Stockholders' equity

Also called *owners' equity* or *capital*, *stockholders' equity* is in essence the net worth of the company from an accounting standpoint. It's the third stage of the balance sheet.

Why footnotes are important

Good reading glasses are a necessity in understanding financial reports. In any set of financial statements, it's critical to read the small print in footnotes throughout. There's a lot of good stuff in there, such as

- ✔ **Big changes in accounting policies and practices:** In both private and public corporations, accountants are generally brought in to do the taxes and certify that the company is operating under generally accepted accounting principles. There are, however, situations in which outside accountants and finance executives have to issue warnings and clarifications on their results, and you should keep an eye out for such notes. This may be a key smell point for trouble in an organization, or it may be important when judging trends over several accounting periods.
- ✔ **Taxes, taxes, taxes:** Footnotes can provide significant information about a company's

current and deferred income taxes on the local, state, federal, or international level.

- ✔ **Pension data:** As you may know, retirement obligations are considerable responsibilities at most companies. Footnotes can tell you about the assets and costs of these plans and whether they're overfunded or underfunded and why. Why is this a valuation issue? Retirees can have a significant claim on a company's assets if their plans aren't backed up, and state and federal governments may have to get involved.
- ✔ **The handling of stock options:** Recent news reports on the handling of stock options within many public companies are a cautionary message for companies of all sizes. Investors and potential buyers need to know what stock options have been granted to officers, staff, and employees and how those stock options will be accounted for in the company's results.

Say you started a business and your initial investment was \$25,000. That amount is recorded in a capital account, also referred to as an owners' equity account. In publicly traded companies, outstanding preferred and common stock also represents owners' equity.

The income statement

The *income statement* helps you zero in on the quality of revenues and earnings in a business. Also called the *profit-and-loss (P&L) statement*, this document helps you see first the amount of revenue (also referred to as "sales" in some businesses) brought in by a company over a period of time as well as the cost of sales, operating expenses, and taxes that whittle down that total to what hopefully will be a positive number at the end: a company's net earnings or profit.

Stock and the private company

When a company goes public — that is, when it offers its stock for sale on the public markets — a lot of fanfare and considerable preparation surrounds that day. But for more than 90 percent of the companies operating in America, there's never going to be an initial public offering (IPO) date because most companies don't want to go public.

That said, the issuance of private stock in a company is a serious matter and deserves the right expertise going in. Simple business structures like sole proprietorships don't have to consider this issue, but if you plan to incorporate, you should consult a tax expert, an experienced incorporation attorney, and possibly an estate attorney on how many shares you should issue and allocate to the various owners of the business or keep in the corporate treasury.

This is a unique issue for every company, and it should be tied to your growth plan. For instance,

some states price their incorporation fees on the number of shares of stock a company issues, so that may drive the decision in concert with an owner's desire to bring in other investors or possibly go public at some point.

The bottom line? Even if you're a sole business owner who plans to stay in full control of your business for a lifetime, you may decide to do things differently later. You may get married and have kids you want to involve in the business someday. You may involve partners or other owners in growing the business. Circumstances always change.

So if you incorporate or create a partnership, a share of stock isn't just a share of stock. It's key to your planned — and sometimes your unplanned — possibilities for your business in the future. Get the full range of help you'll need to make stock decisions wisely.

Profit is also expressed in a different way. Operating profit is sometimes called *earnings before interest, taxes, depreciation, and amortization (EBITDA)*, *earnings before interest and taxes (EBIT)*, *net profit*, *cash flow to equity*, and so on. Cash flow to equity is the calculation that tells investors how much money they'd receive if the company decided to distribute all the net earnings for the period. This really doesn't happen — companies tend to reinvest profits back in the business — but if you watch or listen to the stock market report on TV or radio, you'll hear commentators comparing current per-share results to year-ago results as a way of saying earnings have gone up or down.

The income statement explains the route to the bottom line of any company and what got it there — not only annual increases in revenue but smart money and people management that allowed the company to hang on to every penny of profit at the end of the day.



You need to know where the IRS is concentrating its efforts in any given year. Since 2001, IRS investigators have been triggering audits at companies over the handling of their employee pension plans and executive compensation — stock options and severance agreements, specifically. Always ask whether a target company has been audited and why.

Income statements are structured like a funnel. At the top you see the gross revenues of a business. As you go down, you see those numbers get smaller as you deduct costs and operating expenses that were needed to generate that big number at the top. By the end, you get to the spout and see how much is left — the net earnings for the period. Obviously, if nothing drips out, that's a loss.

So that's the picture. Following are the numbers you see on the way down the income statement.

Revenues

Revenues are the receivables of a company, generally what's paid by customers in exchange for a company's products or services. Depending on the business, however, it can include other gains for the period. The revenue segment of the income statement includes the following:

- ✓ **Net revenues:** Again, this depends on the structure of the company and its operations, but some companies accept returns on certain products or allowances of some sort, so those are subtracted from the gross revenues and expressed as net revenues.
- ✓ **Cost of goods sold (COGS):** This is the total expense of manufacturing, creating, and delivering a product. It includes the cost of raw material and production. Typically, these costs are *variable costs* (that is, they're a function of sales).
- ✓ **Gross profit:** Gross profit is the cost of goods sold subtracted from the revenue. Here's a common formula that expresses it:

$$\text{Gross Profit} = \text{Total Revenue} - \text{Cost of Goods Sold}$$

- ✓ **Gross margin:** This is the ratio of gross profit to sales revenue. It's a measure that shows how efficient a company is at turning raw materials into income. For a retailer, it measures their markup over their wholesale price. Here's the formula:

$$\text{Gross Margin} = \frac{(\text{Revenue} - \text{Cost of Goods Sold}) \times 100}{\text{Revenue}}$$

Expenses

The expenses section of the income statement notes several critical expense categories (some are semivariable costs; some are fixed costs):



Acceptable debt

Is debt bad? Boy, is this a controversial topic! Although a solid credit record is a good thing for people and businesses to have, it's best for businesses to think in terms of how they can fund their operations from money they make doing what they do.

How do you know when a company has too much debt? Generally, if a company has solid cash flow and a return on investment (ROI) that's significantly greater than the percentage it is paying on borrowed funds, it's probably going to be okay.

- ✔ **General and administrative expenses (G&A):** These expenses are tied to the overall running of the company, not to specific product lines.
- ✔ **Sales and marketing expenses:** These are promotional, advertising, and other selling costs (for example, sales commissions) for the entire company, though some organizations break these down among divisions.
- ✔ **Depreciation or amortization expense:** Depreciation happens to virtually any hard asset in a business subject to wear and tear — furniture, vehicles, machinery, computers, you name it. Companies spread the cost of these assets over the periods in which they're used.
- ✔ **Research and development expenses:** Check to see how much the company is investing in R&D and whether that's paying off in building the business.

Earnings

In earnings, you're finally getting close to figuring out the bottom line. Again, there are some intermediary steps:

- ✔ **Operating income:** This is the first stage of earnings you see when you subtract all the operating expenses from gross profit.
- ✔ **Operating margin:** Here's another important ratio. This measures what proportion of a company's revenue is left over after paying for variable costs of production such as wages, raw materials, and other related costs. Here's the formula:

$$\text{Operating Margin} = \frac{\text{Operating Income}}{\text{Net Sales}}$$

- ✔ **Income before taxes:** This comes after the company deducts any interest paid on its outstanding debt, which is the amount of earnings on which the company expects to pay taxes.

- ✔ **Taxes:** These are the taxes a company has paid to local, state, and federal officials.
- ✔ **Net income from continuing operations:** This is the net profit that comes from continuing business activities. It's the amount earned by a company before any adjustment for preferred dividends, discontinued operations (such as divisions that have been sold or closed), and extraordinary items (such as unusual costs from natural disasters or things that rarely affect operations).
- ✔ **Profit margin:** This is yet another critical ratio — a measure of how good a company is at cost control. The higher the net profit margin is, the better it is at converting revenues into actual profit. Here's the formula:

$$\text{Profit Margin} = \frac{\text{Net Income (continuing or net)}}{\text{Net Sales Revenue}}$$

Net income

Net income is the big one — the amount of profit left over after taxes and all expenses. If you see this amount in brackets, it's not a profit — it's a loss.

- ✔ **Earnings per share:** This is net income divided by each share of stock in the organization. It's a useful measurement to compare results quarter-to-quarter or year-to-year.
- ✔ **Shareholder dividends:** Many companies pay dividends to shareholders on an annual basis. If any dividends have been paid during the reporting period, they're noted on a per-share basis here.

Statement of retained earnings

A *statement of retained earnings* represents a company's earnings since day one, minus any money deducted or distributed to the owners of the company. If retained earnings keep going up over the course of time, it indicates that company officers are electing to put more earned income into the business to support operations. The more self-generated investment, the less need a company has to rely on outside financing to grow the business.



GAAP (generally accepted accounting principles) is the main framework of guidelines for the U.S. accounting industry. It governs how accountants and other finance professionals prepare financial statements.

The balance sheet, the income statement, and the statement of retained earnings — these are the major financial road maps in any company, and valuation professionals use several years' worth of those numbers not only to compute how the company has performed over past years but also to project how it may behave in future years. They make such projections by adjusting those numbers (see Chapters 3 and 4 for more on such adjustments).

Activities boosting valuation

Numbers reveal behavior. So what exactly is value-building behavior in a company? Here are some ideas:

- ✓ A strong management team with longevity
- ✓ Hot products with plenty more in the pipeline — research and development spending that's paying off
- ✓ Customers in a love affair with the company
- ✓ A plant and equipment in top shape
- ✓ Consistent upward trends in revenues and earnings — no big swings or extremes
- ✓ Low employee turnover and high marks for its workplace
- ✓ A wide variety of customers without anyone accounting for more than 5 percent of the company's sales or earnings
- ✓ A history of an appropriate level of advertising

Cash-flow statement

The third piece of financial data necessary for valuation is the cash-flow statement — again, it should cover a period of years. For many people, the words *cash flow* trip off the tongue, but nobody realizes the true meaning of the concept until he's in business for the first time: Cash flow is both food and oxygen to a business. Without it, companies die.

A company's cash-flow statement explains its relationship with the outside world. It shows several things:

- ✓ The flow of cash into the company through the sale of goods and services
- ✓ The flow of cash into the company from investment (sale of stocks and bonds)
- ✓ The flow of cash from the company to vendors, employees, and other activities representing investment in the company's own growth

The good news that everyone's looking for in a cash-flow statement is the news that the company can finance its own spending with money it makes from operations. An income statement can tell you whether a company made money, but a cash-flow statement tells you whether the company had a bloodstream of cash keeping it going.

The sources of information for the cash-flow statement are the balance sheet and the income statement.



In accounting terms, cash isn't just about the greenbacks. *Cash* refers to cash and cash equivalents, including currency, bank deposits, U.S. Treasury bills, money market accounts, and commercial paper. So what's *not* cash? Stocks, bonds, and other securities.

The cash-flow statement's bottom line shows the net increase or decrease in cash for the period. The statement is divided into three parts, indicating cash flow from three types of activities:

✓ **Operating activities:** This section is all about cash generated by the day-to-day operations of the business — incoming revenue from the sale of goods or services and most kinds of outgoing payments. What it doesn't include is principal paid on or received from loans.

No transaction is considered to be cash flow unless cash was actually received or paid; amounts in accounts receivable or payable don't qualify. Any cash activities appearing on the company's income statement qualify for the operating-activities section of the cash-flow statement. The same is true of cash activities related to accounts receivable, inventory, accounts payable, and movements in asset values that have a *contra account* (an account that offsets another account) on the income statement and on the balance sheet.

✓ **Investing activities:** Investment of cash and cash equivalents creates more cash for use in the business. Investing activities can include the purchase or sale of property and equipment, the purchase or sale of securities and related investments, and loans made to other businesses.

Interest and depreciation are classified as operating cash flow, as are net gains or losses on investments.

✓ **Financing activities:** This section is all about the company's liabilities and shareholder equity, noting how the company obtains its capital and enhances the value of its stock. A company can issue bonds, pay back debt, pay dividends, and issue and buy back its own stock.



Stock buybacks happen in both public and private companies. Stock buybacks are notable tactics in business valuation because they involve a company's realizing that buying back stock is an advantageous strategy. This can happen for a number of reasons that are unique to the company itself.

Figuring your cash flow

Two methods allow people to compute cash flow: the direct and indirect methods. The *direct method* is pretty much what it sounds like. All cash-flow information is pulled from cash receipts and payments that cover the following:

- ✓ Cash from customers
- ✓ Interest and dividends received by the company
- ✓ Cash paid to employees and suppliers of goods or services (including suppliers of insurance, advertising, and so on)
- ✓ Interest paid
- ✓ Income taxes paid

The *indirect method* involves pulling information from the balance sheet and income statements based on changes noted in both. Instead of reporting the total cash received from customers, an indirect statement lists only the change in cash received from the previous period. This method pulls information from the following sources:

- ✓ Net income
- ✓ Depreciation and amortization
- ✓ Deferred income taxes
- ✓ Interest income
- ✓ Change in accounts receivable
- ✓ Change in accounts payable
- ✓ Change in inventories

What a cash-flow statement looks like

Most cash-flow statements contain two sets of figures: source of funds and use of funds. Here are the elements that may appear under both headers:

Source of Funds

Beginning cash
Sales services income
Sale of assets
Customer deposits
Loans made to other companies
Contributed capital
Total cash in: _____

Use of Funds

Salaries

Other operating expenses

Payments for the company's own loans

Capital expenditures

Tax payments

Total cash out: _____

Cash management is a serious issue for all companies, particularly for young ones that may not be bringing in much — or any — revenue. If you don't have specific training in company accounting or managing business funds, talk to a trusted accountant or advisor about how the following issues work:

- ✓ How the target company manages its cash
- ✓ How the company deals with cash shortfalls when customers pay late or in other circumstances that affect the flow of cash into the business
- ✓ What the company does with excess cash
- ✓ What kinds of accounts the company uses to hold any excess cash and whether it uses efficient, low-cost methods to do this. Are those funds allocated in properly insured accounts?



One of the best ways to maximize cash flow is to have effective on-time-payment and collection strategies for customers. Companies that have the cash flow to do so may negotiate specific discounts and other advantages for paying bills early. Be aware of these practices in the companies you're looking at; they're a sign of good business practices.

Ratios and formulas for valuation

New ways of number crunching are born every day, so what you're about to see are some of the most common valuation ratios used today. In the real world of business valuation, there are considerably more-complex ratios that allow people to deal with specialized situations, and as the book continues, you get to see a few of them. The vast majority of these ratios never see the inside of an annual report, but you may see them referenced in outside resources like stock listings and analysts' data on particular companies.

But you should understand some of the most basic ratios used in valuation so you have a base of knowledge to work from. We're sure you've already seen a few of these and probably calculated a few.

Valuation ratios tell you whether the company is inexpensive or costly on an absolute basis. Your job is to find companies that are bargains relative to their profitability, growth rates, and financial strength. Remember Graham's purchase trigger: If you can find a stock with a value that's 50 percent above the stock price — buy.

Note: We mention some target numbers for these various formulas, but we're going to paste on a caveat: Just as valuation professionals use certain computations to fit the operation, target numbers for these formulas may vary based on the industry. And as much as it bugs us to say it, sometimes the appropriate answer for target numbers is "it depends."



Value Line is an easy-to-understand source of valuation data on public companies, but it's a good one to get familiar with. This investment research service is available online for a fee (www.valueline.com), but it's also available in most public libraries. Again, it's a good way to test out your valuation knowledge.

Price-to-earnings ratio (P/E)

The price-to-earnings formula is

$$P/E = \frac{\text{Share Price}}{\text{Earnings per Share}}$$

Where to find it: P/E is a ratio included next to most individual stock listings online or in daily papers. Also, you can find annual P/E ratios in Value Line, including comparisons to other stocks within an industry. Its main source is in the company's income statement.

If the P/E Ratio of a company is less than its industry average P/E, the company is selling at a discount valuation to its peers. When you hear someone refer to a "low P/E," they're referring to an investment that may be worth a look because it's priced lower than other companies in its industry (also known as its *peer group*).



Some people think buying a stock with a 15 P/E is better than buying one with a 40 P/E because the latter company's earnings are so much further below its stock price. Sometimes people do get too excited about a company, but others may find that it has the potential to support such a valuation. That's further proof that the truth may not rest solely in the numbers.

Price-to-sales ratio (P/S)

Price-to-sales is a way of valuing companies that aren't earning money or are so young they're practically in the startup phase. In the technology sector, many acquisitions have been based on P/S because buyers want to know that revenues are headed up. Here's the formula:

$$P/S = \frac{\text{Current Market Capitalization}}{\text{Last 12 Months' Total Revenues}}$$

Where to find it: You can find the market capitalization by multiplying the number of shares times the market price. The last four quarters of revenue are in Value Line or in the last four 10Q statements from the company.



Check P/S against the working capital ratios (later in this chapter) just to make sure that management is using the company's assets the way they should. It's a leap of faith that management will control costs and eventually produce earnings because the bottom line, not revenues, is what supports a company's value.

Price-to-tangible-book-value ratio (PTBV)

The tangible book value, or net asset value, is a rough estimate of what a company would be worth if it were liquidated. Here's its formula:

$$\text{Tangible Book Value} = \text{Total Assets} - \text{Intangible Assets and Liabilities}$$

You can use that calculation to find the price-to-tangible-book-value ratio (PTBV):

$$PTBV = \frac{\text{Stock Price}}{\text{Tangible Book Value}}$$

Where to find it: Book value is listed in the consolidated balance sheet portion of the balance sheet, or it's listed separately in Value Line.

If this calculation is below 1.0, then the company is selling below book value — technically below liquidation value. If this happens, you've found either the bargain of the century or a problem company, so take a fine-toothed comb to its operational history. Generally, though, a low PTBV ratio relative to the rest of that company's competitors is considered a positive sign for investment.



Price-to-tangible-book-value is one of the most controversial value ratios because investors like to argue whether the assets posted at their original (or "book" value) could be sold at roughly the same value today. Check the industry before you use a computation like book value; traditional rust-belt companies with lots of machinery may have a book value that's too high because its technology is obsolete.



You really need to understand the assets of a company before you rely on a traditional measurement like book value. Widen your collection of resources — read analysts' reports on the company if they exist, and if they don't, read voraciously about the industry.

Debt-to-equity ratio (D/E)

Companies need to borrow on a regular basis to fund short-term needs and long-term expansion. Like people, companies can create a good credit rating that stands them in good stead when it's time to borrow affordably for big events like mergers and acquisitions. But as the country has discovered with subprime mortgages and credit cards, debt can go very bad very quickly. Debt-to-equity (D/E) lets you look at a company's borrowing behavior. Here's the formula:

$$D/E = \frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$$

Where to find it: You can find the D/E ratio already figured in Value Line under your chosen company. But if you want to do it yourself, turn to the consolidated balance sheet in the annual report, look for the total liabilities and shareholders' equity, and grab the calculator.

The standard D/E ratio for most companies is 50 percent, meaning investors want \$1 of equity for every 50 cents of debt so they won't lose everything in liquidation. Value investors like to see this number a little lower.

Companies take on debt for different reasons. The best reason is for expansion that will attract higher sales and earnings to pay off that debt in a hurry. The worst is to keep payroll and other basic expenses covered — that's a company in trouble.



Want another way to check a company's relationship with debt? Check out its corporate bond rating in Moody's or Standard & Poor's, the leading bond rating services. Provided the ratings services are doing their jobs, a good rating means you have nothing to worry about; a bad rating means you're taking a chance putting your money in this company.

Working capital (net current asset value)

Working capital is the amount of money a company uses to cover expenses from daily operations, ranging from the price of raw materials to finished goods and sales. Here's the formula:

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Where to find it: Go to the current assets and current liabilities section of the consolidated balance sheets in the annual report. Current assets include cash, accounts receivable, and inventory.

Essentially, this measurement shows that a company's assets can pay for its liabilities and is a reflection that management has things under control. It's also a rough measure of liquidating value for a company should it close its doors today.

Current ratio

Again, you want to know that management has assets generating enough capital to fund liabilities. Current ratio is another way to gauge that. Here's the formula:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Where to find it: The current ratio is always in Value Line, but if you want to figure it out yourself, gather your information from the balance sheet.

Consensus has a desirable current ratio at 2, meaning that there's no more than \$1 in liabilities for every \$2 of assets. A current ratio higher than 2 means that the company is controlling its inventory well and is collecting revenues quickly.

Quick ratio

If revenues were to stop or severely decrease for a period of time, could this company continue to pay for daily operations until they start again? Use the quick ratio to find out. Here's the formula:

$$\text{Quick Ratio} = \frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

Where to find it: The balance sheet and, of course, Value Line.

Consensus is that a quick ratio of 1 or higher indicates that a company could meet those obligations.

Chapter 9

Using Rule-of-Thumb Valuations for Mom-and-Pop Businesses

In This Chapter

- ▶ Why rules of thumb are good starting points but never endpoints
 - ▶ What general business valuation can tell you
 - ▶ Ten examples from Tom West's *Business Reference Guide*
-

The folks at Merriam-Webster Online have it right about the expression *rule of thumb*, which they define as “a general principle regarded as roughly correct but not intended to be scientifically accurate.” We like that definition. It means a rule of thumb is intended to be helpful and educational but shouldn't be the final word on a decision, particularly one that involves a life's savings or the potential risk of tens or hundreds of thousands of dollars' worth of borrowed money.

This chapter deals with rules of thumb in business valuation and how people should use them. We have the privilege of introducing one of the leaders in researching and gathering business-valuation rules of thumb. Tom West is a founder, past president, and former executive director of the International Business Brokers Association (www.ibba.org), and for the past 18 years, he's been the author of the *Business Reference Guide*, an annual bible on pricing hundreds of categories of independent businesses and name-brand franchises.

In this chapter, we feature rules of thumb on ten specific kinds of businesses from data from entries West compiled for the *Business Reference Guide* and listings he features on his subscription Web site, Business Brokerage Press (www.bbpinc.com).

What Rules of Thumb Do in Business Valuation

Rules of thumb are starting points. You have to thoroughly investigate the rest of the information that you need on your own and with the right help, but here are some key points:

- ✓ The rules provide general price guidance on categories of businesses. In West's guide, the rules of thumb come in two formats that most valuation experts recognize.
- ✓ The rules provide buyers and sellers a ballpark figure on what average companies in a certain industry are worth.

The first rule of thumb for pricing a business is simply a percentage of annual sales. If the total sales of a business last year was \$100,000, for example, and the multiple for the particular business was 40 percent of annual sales, the price based on that particular rule of thumb would be \$40,000.

The second rule of thumb is a multiple of earnings. An earnings multiplier makes the most sense to prospective buyers because it directly addresses the buyer's motive: making money by achieving a return on investment.

What kinds of earnings are involved in this calculation? In many small companies, this multiple is commonly used against the *seller's discretionary earnings (SDE)*, which are earnings before accounting for the following items:

- ✓ Income taxes
- ✓ Nonrecurring income and expenses
- ✓ Nonoperating income and expenses
- ✓ Depreciation of an amortization
- ✓ Interest expense or income
- ✓ Total compensation for one owner/operator after the total compensation of all owners is adjusted to market value

Earnings are also designated with earnings before interest, taxes, depreciation, and amortization (EBITDA). You can use EBITDA to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions. People use EBITDA in evaluating a company's ability to earn a profit; it's expressed as follows:

$$\text{EBITDA} = \text{Operating Revenue} - \text{Operating Expenses plus Other Revenue}$$

Earnings before interest and taxes (EBIT) is expressed as follows:

$$\text{EBIT} = \text{Operating Revenue} - \text{Operating Expenses} + \text{Nonoperating Income}$$

West's listings are based on a consensus among valuation professionals who deal with those particular kinds of companies. With the basic information you gather through rules of thumb, you turn into a private detective.



Rules of thumb are best used as baselines. Every one of West's rules is nothing more than a general approximation of what you may pay for a particular kind of business based on general data about its category. The rules of thumb don't account for critical local details (such as the value of location); the effect of the local or national economy on that business; or most importantly, how an actual business in that category is owned and managed.

Valuation is not just about crunching numbers. It's also about asking the right questions — and then asking more questions. If you want to know more about selling a business or prospecting for one, we invite you to read Parts III and IV of this book closely.

2008 Rules of Thumb from the Business Reference Guide

The following examples are based on the listings in the online version of the *2008 Business Reference Guide*, with permission from Business Brokerage Press. We keep the examples short in the interest of space and *For Dummies* style, but they should give you an idea of what you see in some of the leading business categories to which entrepreneurs gravitate.

Full-service restaurants

Description: This industry comprises establishments that engage primarily in providing food services to patrons who order, are served while seated (via waiter/waitress service, for example), and pay after eating. These establishments may provide food services to patrons in combination with selling alcoholic beverages, providing carryout service, or presenting live nontheatrical entertainment.

Rules of thumb:

- ✓ 30 to 35 percent of annual sales plus inventory
- ✓ 2 to 2.5 times sellers' discretionary earnings (SDE) plus inventory
- ✓ 2 to 3 times earnings before interest and taxes (EBIT)
- ✓ 2.5 to 4 times Earnings before Interest, Taxes, Depreciation and Amortization (EBITDA)

Pricing tips from valuation professionals:

- ✓ "There are five critical criteria for restaurants to meet. First is location: busy location, high traffic, booming business in the area and finally mid- to high-income population. Second is rent: it should not exceed 10 percent of gross revenue. Third is conversion potential: can the restaurant be converted into another concept that will not compete with other restaurants within same particular center? Fourth is condition of equipment: are they National Sanitation Foundation (NSF) approved and in good condition? Since they are expensive, we shouldn't overlook that. Fifth is asking price: the most important is percentage of gross revenue, which shouldn't exceed 30 to 40 percent, that's what experienced restaurant owners/buyers look for; and the gross annual revenue shouldn't be less than \$500,000 for a full-service restaurant, otherwise it should sell as an asset sale. If you have all these 5 criteria, the business will sell for market value."
- ✓ "Lease terms and liquor license are important factors that can affect the value. If the facility is relatively new and up to current codes, it can be sold as an asset sale even with negative cash flow."
- ✓ "Occupancy cost should not exceed 10 percent of annual gross sales. Restaurant operators tend to drag vendors out to 60–90 days. If cost of sales exceeds 35 percent, there is probably some skimming going on."
- ✓ "Currently a buyers' market: must be profitable or will sell for depreciated asset value only. Lease obligations are a large part of negotiations."
- ✓ "Two times EBITDA plus value of furniture, fixtures, and equipment (FFE) plus Liquor License plus Inventory"
- ✓ "Be wary of comparing industry statistics against smaller mom and pops who do not have equal purchasing power. Fuel surcharges are pushing costs much higher."

General information:

- ✓ "It is much better to buy an existing franchise rather than start one with no sales and high costs."
- ✓ "Most 'rules of thumb' regarding valuation of restaurants don't apply across the board. Each is very individual unless the restaurant is a franchise."

- ✔ “Very rare to find a restaurant that is absentee owned and profitable. Some can do it but must gross over \$1.5MM.”
- ✔ “Checking online reviews such as Yelp.com can provide insight to a restaurant’s operations and success that an owner may accidentally overlook while profiling their business.”
- ✔ “It’s all in the lease! It’s Location, Location, Location. Books must be well kept and make sense.”
- ✔ “In a slow economy it is important for restaurateurs to sharpen their prices, service, cleanliness and don’t stop advertising (just have to look for the best results).”
- ✔ “Don’t do it, unless you can commit to seven-day work weeks and long hours.”
- ✔ “When going into this business, in my opinion, you need to plan to be there a lot. There are two kinds of bartenders out there. The ones that steal from you and the ones that steal from you a lot.”

Bars

Description: This industry comprises establishments known as bars, taverns, nightclubs, or drinking places that engage primarily in preparing and serving alcoholic beverages for immediate consumption. These establishments may also provide limited food services.

Rules of thumb:

- ✔ 35 to 40 percent percent times annual sales — business only plus inventory
- ✔ 2 to 2.5 times SDE plus inventory
- ✔ 2 to 2.5 times EBIT
- ✔ 2 to 2.5 times EBITDA
- ✔ 4 times monthly sales plus game revenue (net) plus inventory
- ✔ 4 times monthly sales plus liquor license and inventory

Pricing tips:

- ✔ “Main variable is the fair market value of the liquor permit, as some areas have a high number of available permits which results in the permit having no, or limited, additional value, while in other areas limited number of available permits may cause the permit to have a substantial value. One will need to research type of permit and its availability and if in fact a market exists for the permit itself. I have seen liquor permits being sold for as high as \$150,000, which obviously impacts the value of the business.”

- ✔ “The location, lease rate, and restrictions on the conditional use permit or liquor license will largely impact any given operation’s value. As some licenses are valued at \$75,000+, there is always some ‘floor’ value regardless of profitability.”
- ✔ “Factor in liquor license, understand what equipment is actually leased, make sure the restaurant is up to code and salable before investing time.”
- ✔ “Location, lease, and liquor license dictate the value of a bar. The concept is usually changed with a new buyer, and a significant investment is made to improve the premises.”
- ✔ “Recently in the Denver market we have seen 50 percent of sales as a rule of thumb; more if easily operated (fewer employees).”
- ✔ “You really need to understand if the liquor and beer costs are in line and how much the establishment is selling versus food.”
- ✔ “Drinking places, or bars or taverns, are always in high demand. The most important factors in assessing the value of the business are the location and the lease (how long remains), when and at what rate will the options be exercised, etc.”
- ✔ “Discretionary cash flow [DCF] can be very different from deal to deal. There is one very important DCF item that should be identified: Does the bar or taproom have any vending? (Examples of this are video poker, tobacco, jukebox, pool tables, etc.) If the answer is ‘Yes,’ then the next question should be, is there a vendor arrangement, or does the seller own the machines? A vendor arrangement means that the vendor owns the machines and collects a portion of the proceeds. If the seller owns the machines, the seller collects all of the proceeds, and can use these funds to reduce their cost of goods sold (COGS) and labor considerably. In each case (with the seller as owner or the vendor as owner of machines), OFF BALANCE SHEET seller financing or vendor financing can be a very powerful source of funds.

“There are a few little things that can alter the valuation in a bar or taproom. Generally, these types of establishments derive a lot of revenue from draft beer. (COGS for draft beer 25 percent to 30 percent, gross profit 70 percent to 75 percent.) If the establishment is operating on an antiquated draft system, glasses may not appear clean, spouts look discolored . . . this could warrant a discount. Most states require that draft system/draft lines are cleaned weekly.

“A potential buyer should ask for vendor beer invoices to determine the ‘popular’ products of the establishment. This is important if the buyer has a potential age group in mind as the primary patrons. This is a forward cash flow assumption that should be acknowledged. If vendor beer invoices are not made available, check the trash dumpster on a regular basis, it is an excellent source of information.

“If liquor is being served, the pouring routine should be observed. Measured shot or free pour can materially change COGS. 750ML bottle yields 26 ounces, which is 14 shots at a 1.75-oz free pour, and 21 shots at a 1.25-oz measured shot. This difference could be the cost of 1.5 bottles. (Generally these establishments sell mostly beer/draft beer, but this scenario should be included in forward cash flow assumptions).”

- ✔ “You have to factor in the location, lease term or property sale, equipment, and the ease of someone taking over without having to put a lot of funds in.”

General information:

- ✔ “State changes in gambling legislation are making these types of businesses more attractive where there has been an allowance of on-premise gambling.”
- ✔ “Neighborhood corner locations will always be valuable.”
- ✔ “Owners must understand this is a business and the purpose is to make money, not be a place to ‘hang out.’”
- ✔ “You have to understand how liquor licensing works in your state.”
- ✔ “High degree of owner involvement on a day-to-day basis. Ability to contain costs and prevent ‘shrinkage.’ Creating a customer-friendly environment which provides good value. Owner usually must have excellent people skills, not a business for introverts.”
- ✔ “Number of licenses in town, length of lease, percent of food sales, percent of liquor sales, entertainment costs, if any. Watch for ratios that are out of industry standards.”
- ✔ “Never trust the books. Check sales tax returns, bank statements, etc. Also, check the price points and compare to the actual COGS. Are the comps legitimate on the profit-and-loss statement (P&L)? Are COGS high due to the owner skimming, or are they giving the house away? We never address a value to skimming and never represent it to buyers. Experienced buyers will recast the financials using their own labor percentage, etc.”
- ✔ “Food costs must be controlled. Lots of businesses fail due to ineffective food and liquor cost controls.”

Gift shops

Description: This industry comprises establishments that engage primarily in selling new gifts, novelty merchandise, souvenirs, greeting cards, seasonal and holiday decorations, and curios.

Rules of thumb:

- ✓ 2.5 times SDE includes inventory
- ✓ 1.5 times SDE plus inventory
- ✓ 35 percent of annual sales includes inventory
- ✓ 3 to 4 times EBITDA

Inventory at cost plus FFE plus 1 to 2 times SDE

Pricing tips:

- ✓ “Inventory should be valued separately and include any costs associated with shipping inventory to the point of sale and preparing it for sale. Example: Beads are bought in bulk. They are heavy and require extra costs to ship and require time and cost to re-package and weigh into smaller sellable units.”
- ✓ “Location weighs heavily. Products are very important in relation to value. Is the store a card plus gift shop? Does it carry high-end American crafts and upscale gifts, gifts plus toys? The mix is important along with profit margins.”

General information:

- ✓ “Companies with multiple store locations have a much higher survival rate. Buyers will not pay for obsolete inventory.”
- ✓ “You need to understand which segment of this industry you are working with (craft type). Also, are you working with the retailer, the distributor, or the manufacturer?”

Medical practices

Description: This industry comprises establishments of health practitioners who hold an MD (Doctor of Medicine) or DO (Doctor of Osteopathy) degree and engage primarily in the independent practice of general or specialized medicine (except psychiatry or psychoanalysis) or surgery. These practitioners operate private or group practices in their own offices (such as centers or clinics) or in facilities such as hospitals or health maintenance organization (HMO) medical centers.

Rules of thumb:

- ✓ 40 to 45 percent of annual gross sales plus inventory
- ✓ .05 to 1.5 times SDE includes inventory

- ✓ 2 to 3 times EBITDA
- ✓ 1.5 times EBIT

Pricing tips:

- ✓ “Very wide range of values depending on numerous characteristics. Primary care practices tend to sell for higher multiples (35 percent to 50 percent) than specialty practices. Need to be especially cognizant of current compensation range for medical specialty in question. Some specialties may think a cash flow of \$200,000 is good, other specialties won’t consider practice with cash flow less than \$400,000. Payer mix/ contracts is important. Revenue deriving from inpatient work (i.e., hospital work) may not count toward value as the hospital and not the selling doctor controls that revenue stream. Some specialties very susceptible to changes in technology. Stark Laws and Anti-Kickback Statutes can impact sales price/terms. The more specialized the doctor — or the more the practice relies on personal reputation of doctor — the harder to sell and lower value.”
- ✓ “The transferability of the value from the seller to the buyer is essential! Excellent clinical technology, management systems and managers, and effective relationships add value. A successful transition is critical to transferring value from the seller to the buyer.”
- ✓ “Entirely dependent on facts and circumstances of SUBJECT PRACTICE, e.g., specialty, percent ancillary services and technical component revenues, payer mix, etc.”
- ✓ “1 to 1.35 times SDE plus inventory and accounts receivable are not included.”
- ✓ “[. . .] SDE, EBIT and EBITDA multiples really no longer apply. The best current formula is 2.5–4 times (SDE minus compensation for owner labor). The 2.5 multiplier is for insurance-based practices, and the 4 multiplier is for the best of cash practices. Insurance reimbursement trends are downwards, hurting values significantly. The reason AGS, SDE and EBITDA don’t apply is the owner might be active or passive. It is illogical to think that a practice with \$1,000,000 AGS has the same value to ownership if the owner works there 50 hours per week or is an absentee owner; which is why you have to subtract the market-rate comp for owner labor prior to applying the multiplier. Many specialties have merely liquidation value or close to it because of shortages, the ease of opening a competing practice, and hospital income and overhead guarantees via forgivable loans in lieu of practice purchase. Value issues are very, very localized. Rule of thumb: the sale should pay for itself to the buyer within 5 years with profits above comp for labor.”

- ✔ “EBITDA is most important; percent of Annual Gross Sales is generally irrelevant since profitability varies so widely. Rural practices are getting almost impossible to sell because of physician shortages. Watch out for big insurance reimbursement changes in 2008–12 due to Medicare changes and PPOs [preferred provider organizations] following their pricing. 501-C3 ‘not-for-profit’ buyers will require formal appraisals. Maybe have to adjust value for lack of electronic health care record if it is needed locally within 1–2 years; \$25,000–\$40,000 per doc, reduces profits.”

General information:

- ✔ “Pricing of professional practices is less amenable to ‘rules of thumb’ because of wide disparities in reimbursement, costs, physician manpower availability, and challenges of transferring the intangible elements of value to a successor owner, etc.”
- ✔ “Billing turnaround is very important.”
- ✔ “Be very careful about state licensure, state laws, and federal Stark, Medicare and Medicaid laws. Many docs don’t know when they are in violation of laws that don’t make sense. Use a specialist attorney on every deal to minimize errors and omissions (E&O). Many illegal medispas popping up now and trying to bail out via sales.”
- ✔ “Labor includes physicians and support staff. This is a labor-intensive service business.”
- ✔ “Heavy Medicare/Medicaid practices very susceptible to federal government payment structure from year to year. Depending on specialty and year reimbursement may be up/down considerably. Technology can also have significant impact on future practice earnings. Brokers should have familiarity with Stark and Anti-Kickback Statutes. Brokers should make sure that buyer/seller attorneys have medical practice transaction experience and knowledge of Stark and AKS.”

Auto repair shops

Description: This industry comprises establishments that engage primarily in providing a wide range of mechanical/electrical repair and maintenance services for vehicles such as passenger cars, trucks, vans, and trailers; or engine repair and replacement.

Rules of thumb:

- ✔ 25 percent to 30 percent of annual sales plus inventory
- ✔ 2 times SDE plus inventory

- ✓ 1.5 to 2 times EBIT
- ✓ 2 to 2.5 times EBITDA

Pricing tips:

- ✓ “Most service centers need minimum eight bays to show higher revenues and strong cash flow.”
- ✓ “Many auto centers with sales revenues under \$500,000 per year have closed their doors due to little or no profit. Consumers are driving less due to the high price of gas and this directly affects sales revenues. Rents continue to escalate and it becomes increasingly more difficult to find good managers or top-line techs. Major auto dealerships are also becoming more aggressive in their service departments and have taken some of the sales revenues away from the independent auto centers. Conversely the auto centers with sales exceeding \$1 million per year continue to show good profits and will benefit from the smaller auto centers who close their doors. The above multiples do not include inventory, at cost; the multiples do include equipment, FFE.”
- ✓ “Rent can be added to the SDE if the seller also owns the building and is selling the building with the business. If the seller hires too many employees, it is sometimes possible to show the buyer why the business can be run with fewer employees, and add the soon-to-be-terminated employee’s salary to the SDE.”
- ✓ “Sometimes I will use 2.5 times SDE. This depends on if the business is located on a prime corner, how much equipment the business has, and how new the equipment is. A shop that has a very low SDE, or possibly is losing money, is able to sell for between \$100K to \$135K just for its location, build out, and equipment.”
- ✓ “Smaller auto centers can be the most difficult to sell due to the very personal nature of the business. It is very helpful if the owner stays for 1 to 2 months to ease the buyer into the business especially creating a comfort level with the customers.”

General information:

- ✓ “Good technicians are always hard to come by, but with a busy and nice looking shop it makes it easier to attract them.”
- ✓ “Most auto repair shop owners focus too much on offering the lowest prices rather than providing excellent customer service. If you provide excellent customer service, customers are willing to pay for it. Most people think the number of bays is important. The number of parking spaces is a lot more important than the number of bays.”

- ✔ “Eighty-eight percent of my automotive purchasers are buyers with no prior experience. The multiple on this type of business has dropped from previous years. Why? Lack of skilled technicians, overabundance of service centers, low unemployment. Most buyers in today’s market are not looking for a business that falls under the heading of a low-paying job. Rule of thumb is applicable for Franchise or Non-Franchise Centers.”
- ✔ “Demand for this service business has gradually decreased over the last four years. The smaller (Mom and Pop operations of \$35,000 gross/month or less) are becoming non-existent in many larger cities.”
- ✔ “Factors to look for: the gross profit of the business pre-wages, equipment leased vs. free and clear, management and certification of techs, percentage of wages, the length of lease and terms. The business should do a minimum of \$30K per month in sales revenue (excluding smog Certs). Any special licenses required? Does the owner work as a mechanic? Things to add to value: volume exceeds \$50K per month, the owner works only in administrative capacity, number of bays (minimum 6 bays), all equipment is free and clear, all mechanics have at least two years’ experience, rent is eight percent of sales or less, strong manager in place, gross profit exceeds 60 percent. Things to subtract from value: owner is active as mechanic, monthly sales under \$25K per month, appearance, location, most equipment on lease, the age of the equipment, lack of professional management, inexperience of mechanics, unable to expand in capacity or sales, rent high, short term lease.”

Day-care centers for children

Description: This industry comprises establishments that engage primarily in providing day care for infants or children. These establishments generally care for preschool children but may care for older children when they’re not in school and may also offer prekindergarten educational programs.

Rules of thumb:

- ✔ 40 to 45 percent of annual sales includes inventory
- ✔ 3 times SDE includes inventory
- ✔ 2.5 to 3 times EBIT
- ✔ 3 to 4 times EBITDA
- ✔ 2 times SDE includes inventory (most child-care centers are acquired with the real estate; the 2 multiple of SDE is after the debt service required to buy the real estate)

Pricing tips:

- ✔ “State laws, regulations and market rate have large impact on price.”
- ✔ “Site location is critical; curb cuts and ease of access in/out of center is very important; proper side of road for traffic flow during rush hour; tenure of center, tenure of teachers and their level of secondary education; strong director/mgr very important; quality centers with consistent earnings achieve price points in the higher end of the price range than other centers.”
- ✔ “Based on gross sale, is 2 to 3 times sales. Based on license capacity, it runs \$10,000 to \$14,000 per child.”
- ✔ “Size matters. Licensed capacity less than 75 expect a 2.5 to 3 times EBITDA, over 100 expect a 4 +/- EBITDA multiple.”
- ✔ “The larger the business, the higher the multiple of earnings. A 4 times multiple is the maximum for a large center (licensed for 100+). Smaller businesses, depending upon how well they are maintained, can achieve 2.5 times sellers discretionary cash flow (SDCF).”
- ✔ “Price is a direct effect of cash flow. The amount the business provides the seller needs to cover debit service and provide a return to the buyer. Banks look for a debit service ratio of 1.25 to 1.50. Price is also determined by the number of students and the income they provide to the school. For example, childcare centers sell from \$10,000 per child (license cap) to as low as \$6,000 per child. Price is also sometimes 2 times gross income.”
- ✔ “Much of the value of a childcare center is based upon number of children enrolled, gross revenues, net operating income, and what percent of revenues are subsidized by the state.”
- ✔ “Multiples of EBITDA vary depending upon the size of the operation and depth of management. The larger the operation, the higher the multiple. Smaller operations will sell for over 2 times EBITDA, while larger operations with competent management will sell for in the 3 to 4 times EBITDA range. Reconstructed EBITDA should include adjustments to fair market value (FMV) for arm’s length transactions (salaries, rent, etc.).”

General information:

- ✔ “State and government programs can positively impact earnings but are not guaranteed long term; high staff turnover is a common trait; ones which have lower turnover rates are favored by buyers; high-quality centers with consistent earnings and good visibility and access demand highest price points.”

- ✓ “First, the childcare industry is strong and important to the employment picture in areas where it is provided. In the adult-education business, it is important to have a trained work force.”
- ✓ “There is need for both ‘mom and pop’ operations as well as larger ‘institutional’ type businesses. Each can serve their own niche and be literally right next door to one another. A good, clean, quality service provider can be profitable in almost any competitive environment.”
- ✓ “Striking the right balance between quality and profit is critical to long-term success. Many parents will place cost as a secondary consideration to quality and reputation.”
- ✓ “Check out licensing authority for complaints against the business. Understand frequency of rate increases. (Rate increases should be annual if only a couple of dollars.) Look at staff longevity to understand the caring nature of the business, which is critical to the reputation of the business.”
- ✓ “Check to see if state-subsidized.”
- ✓ “People look for unique program structure and location which they deem desirable (which vary by buyer). As birth rates stabilize and decline, program will be what keeps the progressive centers open and thriving in the future.”

Dry cleaning

Description: This industry comprises establishments that engage primarily in one or more of the following activities:

- ✓ Providing dry cleaning services (except coin operated)
- ✓ Providing laundering services (except linen and uniform supply or coin operated)
- ✓ Providing drop-off and pickup sites for laundries and/or dry cleaners
- ✓ Providing specialty cleaning services for specific types of garments and other textile items (except carpets and upholstery), such as fur, leather, or suede garments; wedding gowns; hats; draperies; and pillows

These establishments may provide all, a combination of, or none of the cleaning services on the premises.

Rules of thumb:

- ✓ 70 to 80 percent of sales plus inventory (plants with on-site laundry equipment get a higher multiple; plants with over-the-counter sales of \$35,000 get a higher multiple)
- ✓ 2.5 to 3 times SDE plus inventory

- ✔ 2 to 3 times EBIT
- ✔ 2.5 to 3 times EBITDA
- ✔ 2 times SDE for a poor unit, 2.5 times SDE for a so-so business, 3 times SDE for a good store, 3.5 times SDE for a hot unit with a good lease and equipment, and 4 times SDE for a real winner

Pricing tips:

- ✔ “70 percent of annual gross sales if equipment is under 5 years old. If equipment is between 6 and 10 years old, it will be 60 percent of annual gross sales. If equipment is over 11 years old, it will be between 40 percent and 50 percent of the annual gross sales.”
- ✔ “Purchase price ranges from 70 percent of annual sales to 100 percent. Single stores with full garment pricing (no discounts, no coupons) and having monthly retail sales over \$35,000 will achieve the higher multiple. Retail pick-up stores (no equipment) 25 percent to 50 percent of annual sales.”
- ✔ “One can get 3 times cash flow (SDE) if the owner is a manager and does not perform a specific job such as counter, dry cleaner, or presser. If the owner does perform a specific job, such as dry cleaner, etc., the cash flow should include the owner’s salary and the business would be valued at 2.5 times that cash flow.”
- ✔ “Dollar for dollar (100 percent of sales) on a plant that has dry cleaning equipment and a single buck or double buck shirt unit, assuming all sales are over-the-counter, not from pick-up stores or hotels or other cleaners. 75 percent of sales for plant w/o shirt unit, and 50 percent of sales on pick-up stores, assuming sales are \$125,000 or more.”
- ✔ “75 to 100 percent of annual gross sales for complete retail plants, must be able to verify. Pick-ups (drop stores) go for 30 to 50 percent of annual gross sales. Routes vary greatly, but can sell for 25 to 50 percent of actual paid gross sales.”

General information:

- ✔ “Stores that have no discount cleaners in the area are the way to go.”
- ✔ “Dry cleaning analysts say Zoots faced an uphill battle from the start, trying to turn a mom-and-pop industry with razor-thin profit margins on its head.

“Over the years, attempts to build large dry cleaning chains with company-run stores like Zoots have largely failed,” said Bill Fisher, chief executive of the Dry Cleaning and Laundry Institute, a trade group. Unlike fast-food chains that standardize all the food and cooking techniques, dry cleaners deal with thousands of different garments with unique issues on a daily basis.” Source: “High Concept Cleaner in Tatters” by Jenn Abelson, *The Boston Globe*, May 13, 2008.

- ✓ “With approximately 30,000 dry cleaners in the United States, dry cleaning is one of the largest industry sectors that is still recognized as a ‘mom-and-pop’ small business. Although the size of dry cleaners varies, most commercial dry cleaners are single-facility, family-owned operations. An average number of five employees work at a plant. Commercial dry cleaning is not a high-profit business, with the median annual revenues below \$250,000.” Source: International Fabricare Institute (IFI), September 2007.

Coin laundries

Description: This industry comprises establishments that engage primarily in operating facilities with coin-operated or similar self-service laundry and dry cleaning equipment for customer use on the premises, and establishments that engage primarily in supplying and servicing coin-operated or similar self-service laundry and dry cleaning equipment for customer use in places of business operated by others, such as apartments and dormitories.

Rules of thumb:

- ✓ 3 to 5 times SDE plus inventory (higher multiple for newer equipment and long lease)
- ✓ 100 percent of annual sales plus inventory
- ✓ 1 to 1.5 times annual sales plus inventory
- ✓ 5 times EBIT
- ✓ 3 times EBITDA

“Generally 2.5 to 5.0 times annual SDE; depends on various parts of the U.S. — California, for example, sells between 4 to 5 times SDE, whereas in Nebraska it’s 1.5 to 2.5 times SDE.”

Pricing tips:

- ✓ “Coin laundry business is predictable. It does not jump up and down or respond to marketing as quickly as, say, a restaurant would. Having said that, the flat trend, old but functional equipment and slightly run-down interiors, get about 5 times the SDE; the newer equipment, crisp and clean interior with slight uptick in historical volume trend, tends to get high multiples. The annual sales number around \$180,000 seems to be almost magical. Over that amount of annual sales, demand is huge, since they can be flowing around \$100,000+ in profits.”

- ✓ “Location and demographics. It’s important to study the surrounding area for city planned changes or housing changes that may affect business performance.”
- ✓ “Larger multiplier number used for newer equipment and long-term lease.”
- ✓ “Depending upon the market or location of the Laundromat, pricing can actually range between 1 and 1.5 times gross annual sales.”
- ✓ “Age of equipment a huge factor in price determining. Fold and wash service available?”
- ✓ “They typically sell for 100 percent to 125 percent of the annual sales. Location, age of machines, total appearance very important.”
- ✓ “Typically laundries sell for between 55 and 65 times monthly net.”
- ✓ “Net Income should = $\frac{1}{3}$ of Gross Income. Sales price is $5+ \times$ Net.”
- ✓ “Coin-operated laundries typically based on a 20 percent return on capital.”
- ✓ “Try and achieve a 25 percent return on capital; not including owner’s salary.”
- ✓ “Utility costs are the single largest operating expense in a coin laundry.”
Source: Coin Laundry Association.
- ✓ “Higher multiplier for businesses with newer equipment (3–4 years) and long-term lease (10+ years) increase business value.”
- ✓ “Here are the steps used to calculate how many times the washers would have to be used to use all the water reflected in the water bill: (1) Get the water bills for the last year, (2) Since water bills are usually in cu. ft., you will have to figure out how many gallons of water were used (there are approximately 7.5 gallons per cu. ft.), (3) Find out how many gallons of water the particular washer type uses, (4) Calculate how many times the washers have to be used to use all the water based on the bill. That should give you the number of washes. Multiply that by the cost per wash. The national average for ‘turns’ is 5 — the number of times the washer is used. Dryer income is generally half that used of washer income, and vending income can produce 10 percent of total.”
- ✓ “Historically, laundries have been priced to sell at some multiple of their annual gross. Primarily because of tradition, this multiple varies from one section of the country to another, but normally it’s within the 90 percent to 150 percent range. [. . .] Variations on the annual gross formula include such rules of thumb as 12 to 18 times monthly gross, or three to five times annual net income (before taxes).”

General information:

“Location is very important. Good locations are in densely populated areas with high percentage renters and low-to-mid income.”

“Rising utility costs are an issue. I would recommend an analysis of the cost per wash and dry load, to ensure a reasonable profit per turn.”

“Population demographics within 1-mile radius should show high percentage renters (50+ percent), low-to-mid income, limited competition, larger family size.”

“If it is too good to be true, run!”

“Listed below are many of the different points that will require additional cash before you get in the door.”

- ✔ “A rent deposit, which may include up to three months’ worth in some cases.”
- ✔ “Utility deposits — in many cases, if you have never owned a business, they can be as much as \$3,000.”
- ✔ “Quarters for coin changer, which typically run somewhere between \$1,000 to \$3,000.”
- ✔ “Soaps and supplies. If you’re selling over-the-counter goods, you’ll need an additional \$2,000 or so.”
- ✔ “You should have some cash set aside for marketing, and, coming out of the box, it will be about \$2,000 and up.”
- ✔ “Most laundries don’t have security cameras, and I highly recommend you get them. That will range somewhere between \$2,000 to \$6,000.”
- ✔ “Legal fees, which typically run \$2,000 to \$5,000, depending on how complicated things get, and I have never seen a deal go through without some spiders.”
- ✔ “There will be some closing costs and/or bank fees, which will vary on each deal.”
- ✔ “Miscellaneous expenses, which can include mops, buckets, cleaning supplies, paint to spruce up the place, new TVs, uniforms, and more. This normally falls into the \$3,000 to \$5,000 range.”

Source: “Do You Have Enough Money to Buy an Existing Coin Laundry?” by Robert Renteria, WashProUSA, www.AmericanCoinOp.com, May 15, 2008

Bookstores

Description: This U.S. industry comprises establishments that engage primarily in selling new books.

Rules of thumb:

- ✓ 15 percent of annual sales plus inventory
- ✓ 1.6 SDE plus inventory

General information:

“Two surveys released over the past several weeks put the share of the consumer book market controlled by online retailers at between 21 percent (R.R. Bowker) and 30 percent (Fairfield Research), growth that has been fueled, in large part, by the expansion of Amazon.” Source: “As Amazon Soars, Bookstores Creep” by Jim Millot, *Publishers Weekly*, April 2008.

“Average profit margin is 4 percent.”

Bed-and-breakfasts

Description: This U.S. industry comprises establishments that engage primarily in providing short-term lodging in facilities known as bed-and-breakfast inns. These establishments provide short-term lodging in private homes or small buildings converted for this purpose. Bed-and-breakfast inns are characterized by a highly personalized service and inclusion of a full breakfast in the room rate.

Rules of thumb:

- ✓ 550 percent of annual sales includes inventory and real estate.
- ✓ 4.2 times gross room sales for small B&Bs (fewer than eight rooms), 4.5 for dinner-service inns (for businesses as opposed to real-estate-driven small properties).
- ✓ 8 times SDE includes inventory and real estate.

Pricing tips:

- ✓ “\$50,000 to \$100,000 per guest room. In the Midwest, the year-round larger inns are selling from \$80,000 to \$100,000 per guestroom. 3 times net operating income plus \$20,000 to \$40,000 for the aesthetics and tax benefits plus value of real estate and furnishings.”

✓ “The larger inns are selling for 8 (w/o seller financing) to 10 times (w/ seller financing) adjusted net operating income. The base real estate value of the smaller B&B contributes to a large part of the value. In small, supplemental income B&Bs, their value is typically \$25,000 to \$50,000 more than the base real estate value as a house or other real estate use. There are probably more supplemental income B&Bs than cash flow inns of the 20,000+ U.S. B&Bs. Gross Rent Multiplier is in the 5 to 6 range.”

General information:

“Innkeeping attracts educated, sophisticated and prosperous folks for whom many are seeking a bridge between career and retirement. While buying a B&B is a lot like buying a house, there are some differences. If you’re more than 6 mos. from making your move, you should be reading the B&B books and magazines, attending a B&B seminar, visiting B&B’s as a guest, vacationing in your area of interest, and volunteering your time at a local B&B to experience the ‘feel’ of innkeeping. Once you’re within 6 mos. of moving, you should put your house up for sale and begin looking at B&B’s for sale. If you slightly overlist your house, the worst that can happen to you is that someone may pay you more than you thought it was worth and you may move twice. We’ve had a number of B&B dreams crushed when the buyers couldn’t sell their house during the time they needed to. Why let the past control your future?! If you’re thinking about relocating to an unfamiliar area, you should consider renting in that area for a year so that you experience a full cycle of your dream spot — not just a 1 week vacation.”

“An IRS Audit Technique Guide (Market Segment Specialization Program — MSSAP) is available for this type of business. It is an excellent source of information and is available at bookstore.gpo.gov (search under IRS-IRS Audit Technique Guides).”

“Breakdown of B&B’s: The following definitions attempt to codify what is presently being used in the field. They are only approximations and will vary by region or individual innkeeper.”

✓ “Bed and Breakfast Inn (B&B): Both a home for its owners and a lodging establishment usually operated at a higher level of professionalism than a home-stay. Some B&Bs have the word ‘inn’ as part of their name. A professional B&B meets all the appropriate tax, fire, building, zoning, and health requirements. Many B&Bs have been inspected by a state association or an inspection rating service such as AAA or the Mobil guides. The owners advertise and may legally post a sign. Breakfast

is served to overnight guests and may be quite lavish. Many smaller B&Bs provide a part-time or seasonal occupation for their owners, who do most of the work, often with some help for housekeeping and other chores. Most larger B&Bs (eight rooms or more) require the full-time year-round attention of one or more owners. There is always a high degree of personal service to guests. Reservations may be made directly with the property or through a service. The inn may host events such as weddings or family reunions. Increasing numbers of inns also cater to the business traveler and have facilities to host small business meetings.”

- ✔ “Country Inn: This kind of lodging property has all the characteristics of a B&B inn, but serves an evening meal in addition to breakfast. Some country inns serve dinner to overnight guests only, and the cost of dinner and breakfast is generally included in the room rate (called the Modified American Plan). A country inn with a ‘full-service restaurant’ serves meals to the general public. Generally, the owner or owners are actively involved in daily operations of the inn, and often live on site. To be a country inn, a property does not have to be located in a rural area, though historically, restaurants were added so travelers in remote locations could enjoy a good evening meal. Most country inns have 10 or more rooms.”
- ✔ “Bed and Breakfast Hotel: These are properties in which the historic structure, unique decorating components, guest amenities, and breakfast offering provide the atmosphere of a B&B. Many of these properties formerly were standard hotels, apartment buildings, or other commercial structures in urban or rural areas; some have been built specifically as bed and breakfast hotels. Most of these B&B hotels have fewer than 40 rooms.

“No matter the type of property, innkeepers seek to provide the following to B&B travelers:

- ✔ “A high level of service with a personal touch from the owner or owners
- ✔ “Generous hospitality and good value
- ✔ “Unique ambiance and surroundings
- ✔ “Architecturally interesting or historic structure
- ✔ “Individually decorated rooms that are clean and comfortable”

Source: Professional Association of Innkeepers International (PAII)

“Smaller B&Bs (less than eight rooms) are usually real-estate driven.”



Finding additional information

The *Business Reference Guide* isn't the only game in town, but it's the most basic guide for showing prospective small-business owners the ropes of valuation. Among other popular paid transaction databases are Pratt's Stats, BIZCOMPS, and Mergerstat (www.bvmarketdata.com). The first two look at smaller transactions among privately held companies; Mergerstat tends to look at transaction data in public companies.

When you're looking for information on companies and business communities, you can't stop at databases. Here are other resources you should put on your reading list:

- ✓ **Trade journals:** Trade journals and publications follow the fortunes of the particular industry in which you either own a company or are thinking about buying one. If you've operated a company for years, maybe you already do a pretty good job of keeping up with industry news, but if you're looking to sell, it's best to do a lot of reading to keep on top of recent news on the state of the business and on the selling prices that comparable businesses are attracting.
- ✓ **Local business publications:** See whether you can look up your target company in the local press, online, or in print. If you can't find it, see what stories exist in the local industry or neighborhood where you hope to operate a business. The same applies to stories about how local lenders are behaving (are they lending money or not?). Finally, it's always a good idea to look at local and national stories on the economy to see how your potential customers are spending — or not.
- ✓ **Business books and Web sites:** If you're a first-time business owner, you need to become a student of the business operations process. Wiley publishes two particularly good books on the subject: *Small Business For Dummies*, 3rd Edition, by Eric Tyson, MBA, and Jim Schell; and *Accounting For Dummies*, 4th Edition, by John A. Tracy, CPA (Wiley). Also, for a great general overview of the business process, check out the "Small Business Planner" page of the U.S. Small Business Administration's Web site (www.sba.gov/smallbusinessplanner).