

How the IRS Values A Family Business

**For Business Owners, Executives, Family
Members, Heirs, Successors, and Minority Owners**

- **What Are the IRS' Valuation Criteria?**
- **How Do You Adjust the Financial Statements To Properly Reflect Assets and Profits?**
- **Which of 8 Valuation Methods Should You Use?**
- **How Do You Value Goodwill?**
- **How and When Do You Use Discounts?**
- **How Do You Arrive at a Final Value for the Business?**

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The existence of goodwill creates an excess rate of return in a business which must be valued.

**Use IRS Revenue Ruling 59-60
When You Want To...**

- ❑ Gift, sell, or transfer ownership to family members or others.
- ❑ Issue stock options to key executives or effect an employee stock ownership plan.
- ❑ Determine an estate tax liability.
- ❑ Effect a buy-sell agreement between stockholders (cross purchase) or with the company (stock redemption).
- ❑ Raise capital by giving options to buy stock or convertible securities, e.g., a venture firm lends a business \$500,000 with the right to convert the loan to common stock.

***Why documentation is essential:* You may not be around to defend the value you placed on the business or the discount you used to lower the value.**

How the IRS Values a Family Business

Let's start with the scare tactic approach: You will not be around when the IRS reviews and questions the value of a business left in your estate *or* ownership gifts you made to your family while you were alive *or* a buy-sell agreement made with a partner or other owners that takes effect on your death.

And you also won't be around to defend the discount you took — or should have taken — on the business' value (explained later on page 6). So become familiar with the IRS' guidelines on valuing a business, which are further explained in IRS Revenue Ruling 59-60, and the documentation you should prepare now to substantiate the value and discounts you established.

Although we use stock ownership in our examples, the criteria listed below should be considered when valuing *any* ownership position in a closely held business (sole proprietorship, partnership, corporation, limited liability company, etc.) and for *any* reason, including ownership gifts, transfers, and sales to executives within the business, outside investors, and your children and other family members. The criteria are appropriate when valuing your own business and also one you are interested in acquiring. Review this listing carefully.

1. The history and nature of the business being valued. *Example:* A manufacturer will usually command a higher price-earnings multiple on its earnings than a distributor. *Note:* That multiple, further explained later, is applied to a company's net income and/or its EBIT (earnings before interest and taxes).

2. The economic outlook in general and, in particular, the condition and outlook of the specific industry. *Axiom:* The faster the industry is growing, the higher the value, since earnings should also grow at a faster rate.

3. The net book value of the company (assets less liabilities), also referred to as a company's net worth or stockholder's equity. The IRS and others, e.g., the buyer of a business, will also adjust a company's assets (upward or downward) to reflect each asset's fair market value. When these adjustments are made, it's called the *adjusted* net book value, in contrast to the company's *reported* net book value.

4. The overall financial condition of the business, e.g., its debt-to-equity ratio, working capital level, cash position and cash flow, agings of accounts receivable, trade debt and inventory, reliance on one or a few customers, etc.

5. The historical and projected earnings of the company, particularly its earning potential and rate of growth over the next three to five years.

6. Whether the stock being valued is voting or non-voting. Since non-voting stock lacks control and a voice in management, it is less valuable than voting stock and thus can be discounted.

7. The company's ability to pay dividends and provide an annual return to its stockholders. A business that pays cash dividends to its owners will command a higher multiple and value.

8. The existence of goodwill or other intangible assets can add greatly to the value. *Examples of goodwill include:* Licenses to purchase or market a product, an established niche, customer and supplier contracts extending longer than one year, favorable leases, franchises, patents, and location, e.g., a retail store located in a busy mall or approved zoning variances to operate and expand the business.

9. Prior sales of stock and the issuance of stock options to others (e.g., an employee, venture firm, or other investors). If the purchase/sale of stock or the price used in an option agreement is effected on an arm's-length basis, e.g., with non-related outsiders, the prices used in these transactions will help establish or support the fair market value of the stock and thus the value of the company.

10. The size of the block of stock to be valued, e.g., minority or a controlling block of stock. If it's a minority position, a discount of 20% to 40% can be applied to the value; see example on the next page. Or conversely, a premium, usually not more than 25%, can be applied to a controlling block of stock.

11. The stock price (multiple of earnings and value) of companies engaged in the same or similar lines of business, whose shares are publicly traded in a *free* and *open* market, either on a stock exchange or over the counter. *Example:* If public companies in your industry are selling at 12 times net income (the price-earning's

multiple), the value of your net income would be 12 times *less* the discount explained below.

12. Restrictions on the sale of the stock, e.g., federal and state laws or the existence of a buy-sell agreement which establishes a price for the stock and restricts its sale to others. Sometimes a company's bylaws or corporate charter may also restrict the owners from selling their stock *without* the prior approval of other owners; that will lower the value of the owner's stock.

There's more — Revenue Ruling 59-60 further states that "*all available financial data*" and "*other relevant factors affecting the fair market value of the stock*" also must be considered. With that wording, the IRS can question *any* aspect of a business it deems relevant, including the value the owner placed on it.

How to Use Discounts to Lower The Value of a Business

A discount of 20% to 40% can be applied to the value of a closely held ownership position to lower its value for gift and estate tax purposes and minority ownership positions. Again, the discount applies to corporate stock, limited liability companies, partnership interests (including a family limited partnership), sole proprietorships, and other business ownership positions.

Reasons for discount: An ownership position in a closely held business

- is illiquid — there is no public market to sell the securities;
- generally carries no dividend and thus no current yield;
- can be restricted from sale (e.g., federal and state laws, a buy-sell or succession agreement, or a company's bylaws or charter);
- has greater risks when compared to stock ownership in larger, better-capitalized businesses with good management depth and financial substance; and
- may represent a minority position and consequently lack of control by that minority owner.

In addition, the loss of a business' only or principal executive — the driving force behind the company — also will support a discount, the assumption being that the business is heavily reliant on the owner and that future sales and profits will be negatively affected by his or her absence.

Discount example: Let's assume a minority stockholder dies or wants to sell his or her 20% ownership position and the total value of the business is \$1 million. Using a 30% discount, here's the value of that 20% ownership position:

Value of Business	<u>\$1,000,000</u>
Value of 20% Ownership Position	\$ 200,000
Application of 30% Discount	<u>-60,000</u>
Net Value of 20% Ownership Position	<u>\$ 140,000</u>

Thus, this ownership position is worth \$140,000, not \$200,000.

As indicated, that same discount of 20% to 40% is generally applicable to other minority ownership positions, including stock gifted to family members directly or through a trust. A discount also can be applied to shares owned by an estate since the principal owner and drive behind the business is no longer around. *Caution:* Be sure you can document the discount and that it is reasonable. The IRS can question any discount which reduces the value of your estate, a gift, or other ownership transfers below fair market value.

Eight Ways to Value a Business

Here are the basic valuation methods by which businesses are valued. You want to use as many valuation methods as possible. The more you use, the more accurate your average and final, weighted values.

■ *Reported net book value:* This value is prepared by your accountant; it's simply the company's reported assets less all liabilities. To determine *tangible net book value*, simply subtract intangible assets, e.g., goodwill and capitalized financing costs, from reported net book value.

■ *Adjusted net book value:* This method increases the company's net book value to the extent that certain assets (principally real estate, equipment, and inventory) exceed the cost basis of the assets as shown on the company's balance sheet. This approach usually increases the value of the assets and thus the company's net book value.

■ *Replacement value:* This method writes up all assets to their replacement value and then subtracts the liabilities. It can substantially increase a company's value and is principally used when selling a business to company executives or to another company which wants to get into your line of business.

■ *Price-earning's (p/e) multiple:* Here, you simply apply a multiple, say 12, to the company's net income after taxes. If the net income is \$200,000, the value of the company is \$2.4 million. The faster the growth rate, the higher the p/e multiple. This is how most publicly held companies are valued.

■ *Earnings before interest and taxes:* Referred to as EBIT, this method is similar to the p/e method described above. You determine the company's EBIT and apply a multiple to it, usually 4 to 8, principally depending on the company's growth rate, its profit margin on each dollar of sales, proprietary products, and balance sheet substance. Some appraisers and analysts add depreciation and amortization expenses to the formula for what is referred to as EBIT-DA.

■ *Liquidation value:* This value assumes liquidation of a company's assets and payment of all liabilities. It is used to determine the *absolute* minimum value of a business. For example, you might apply a 25% liquidation value to inventory, 70% to accounts receivable, 50% to equipment, etc. You then subtract all liabilities to determine the final liquidation value of the company.

■ *Dividend value:* This method assumes the company pays out a certain percentage of its net income, say 50%. You average the last three years' net income, say, \$200,000. Then divide the \$100,000 dividend payout (50% times \$200,000) by a desired annual return, e.g., 8%, which results in a value of \$1,250,000 (\$100,000 dividend payout divided by 0.08).

■ *Projected value of capitalized earnings:* This method applies a present

value rate of about 15% to a company's projected net income. Basically, it is *today's* value of projected net income, usually over the next three to five years. The value can be recalculated to include depreciation and amortization expenses for a total *projected cash flow* value. This valuation method usually results in the highest value for a business whose earnings are expected to increase substantially in the near future. It is particularly appropriate for young companies which are growing very fast.

* * *

Valuation adjustments: When determining a company's earnings or net income, most valuation experts adjust the earnings for the following: (a) excessive owner compensation and fringe benefits, (b) extraordinary writeoffs of bad debts, unusable inventory, etc., and (c) the recapture of non-recurring expenses incurred in one year which benefit the company over future years (e.g., establishing another sales office, research and development costs).

Many times, an average of the last few years' earnings are used or they are weighted, e.g., a 50% weight to the company's current earnings, 30% to last year's earnings, and 20% to the prior year's. You can do the same, particularly if the company's earnings are increasing every year. That will help maximize the value of the business. For more information on this subject, please see *Exhibit 1: How to Adjust the Financial Statements*, page 12.

Weighted value: The final step is to list the results from each valuation method and apply a "weight" (percentage allocation) to each value. An example is shown on the next page, using three of the eight valuation methods explained on pages 7 and 8. *Note:* To get a conservative reading of the company's value, we applied a greater weight to the adjusted net book value method, which is also less volatile than the other two methods because it doesn't involve earnings, which are more uncertain.

You want to use several valuation methods and then weight them for a final value on the business.

Weighted Value of the Business

<u>Valuation Method</u>	<u>Value</u>	<u>Percent Weight</u>	<u>Weighted Value</u>
Adjusted Net Book Value	\$1,000,000	40	\$ 400,000
Price-Earning's Multiple	\$1,200,000	30	360,000
Projected Earnings	\$1,500,000	<u>30</u>	<u>450,000</u>
Weighted Value		<u>100</u>	<u>\$1,210,000</u>
Average Value without Weights			<u>\$1,233,333</u>

As computed, the weighted value of this business is \$1,210,000. That's the final value before applying any discount to the shares being valued (see page 6 for application of discounts).

However, *before* accepting the \$1,210,000 weighted value, it should be compared to the average value of \$1,233,333 (total values of \$3,700,000 divided by three) and the median value of \$1,250,000. Here are the comparisons. The final weighted value of \$1,210,000 represents:

- 98% of the average value of \$1,233,333.
- 97% of the median value of \$1,250,000.

As a general rule, when the weighted value is within 80% to 120% of the average and median values, you have a reasonable, defensible value.

There also are instances when you must account for goodwill and other intangible assets in your value calculations. The most common instance is when your company's performance outpaces that of competitors in the same industry. If a company has earnings in excess of the average for its industry, those excess earnings must be valued, preferably by the net tangible assets/capitalized income method favored by the IRS (see Part Two, page 15). The IRS' reasoning is that those excess earnings are evidence of an edge or advantage the company has gained in the marketplace, whether because of reputation or expertise or any other factor, and that edge has a value just as much as the company's plant and equipment.

The IRS, like any potential buyer, is interested in all the assets that add value to your company, whether tangible or intangible. You want to be careful not to overlook any assets in your valuation process and to document all those you do identify.

Reminder: When valuing a business for family transfers and potential gift and estate taxes, remember that you will no longer be around to defend the value. So document that value in writing, including all the reasoning and calculations. As further substantiation, you might also consider obtaining a third-party value from an expert independent appraiser. □

References —

Exhibit 1: How to Adjust the Financial Statements, next page

Part Two: How to Value a Company's Goodwill and Its Intangible Assets, page 15

How to Adjust the Financial Statements

Even if you're not in the market to value or sell your business today, the concepts and examples illustrated in this **Resource Report** are crucial in understanding how you will set a value and selling price in the future. They work in reverse also, to help you determine the best purchase price for a business you're interested in buying or to project potential gift and estate taxes.

The process: Before starting the valuation, you must adjust the company's financial statements. That's especially critical for closely held businesses because owners of these businesses typically keep *reported* profits as low as possible to minimize taxes. The techniques owners use to lower their company's taxable income include increasing salaries, declaring bonuses, setting aside more retirement money, starting and investing in affiliated businesses, and writing off bad inventory.

Fact: On average, a company's *adjusted* profits will be 80% above its *reported* profits. Its *adjusted* stockholder's equity (net worth or net book value) is usually 40% to 60% above *reported* equity. So don't penalize yourself today or limit the value of your business just because you made salary, tax, and cash flow decisions which lowered your profits in the past and reduced your stockholder's equity account. In most cases, the impact of those decisions can be explained and illustrated to a potential buyer or lender by showing them the adjustments you make to reflect your company's true profitability and equity position. And that should be done *before* starting the valuation process.

Income Statement Adjustments. Adjustments to a company's earnings should add back to earnings: (a) excess compensation paid to the company's owners/officers and family members above reasonable amounts, (b) extraordinary tax writeoffs of bad debts, unusable inventory and equipment, etc., (c) unreasonably high fringe benefits, and (d) any nonrecurring expenses incurred in one year which benefit the company over future years (e.g., printing sales brochures, mailing lists,

research and development costs, establishing a new sales office, etc.).

Example of add-backs: If the company's *reported* pretax income is \$90,000 (\$60,000 after taxes) and these adjustments total \$70,000, the company's *adjusted* pretax income is \$160,000. To this figure, apply a corporate tax rate (say, 35% overall) to obtain the company's *adjusted* net income of \$104,000 (65% times \$160,000). Thus, the company's *reported* aftertax income was adjusted from \$60,000 to \$104,000. Now, to determine the value of the business, let's apply a simple 10 price-earning's multiple (p/e) to both numbers:

Reported Net Income: $\$60,000 \times 10 \text{ p/e} = \$600,000$

Adjusted Net Income: $\$104,000 \times 10 \text{ p/e} = \$1,040,000$

Added Company Value = \$440,000

The added value of \$440,000 represents a 73% increase in value above the value based on the company's *unadjusted* financial statements. That shows you the importance of adjusting the company's financial statements *before* starting the valuation process and/or setting a price tag for selling the business.

Balance Sheet Adjustments. Do the same to the assets on the balance sheet, e.g., inventory, real property, leasehold improvements, equipment, and investments in affiliated companies. The reported net book values of those assets also are usually *understated* and must be adjusted upward or downward to fair market or replacement value. The extra values are then added to the company's net worth or stockholder's equity account.

Example: Let's assume that on the company's latest balance sheet, your accountant reports that its net plant and equipment value (after accumulated depreciation) is \$220,000. However, you do some research on current pricing and you find that the current fair market value (FMV) of the plant and equipment (if sold as is) is \$300,000. Thus, you have an *increased value* of \$80,000, which would be added to the company's stockholder's equity account, which correspondingly increases the overall value of the business.

What about the replacement value? This computation is also important since it values the plant and equipment as if they had to be totally replaced today. With rising costs over the years, as well as depreciation of the assets each year, the replacement value could be substantially higher than the FMV since that value

assumes the assets are sold today in their current used condition. Thus, using an assumed replacement value of \$400,000 in our example above, the company's increased value is \$180,000 (\$400,000 replacement value *less* the accountant's reported net book value of \$220,000). That \$180,000 represents an 82% increase above the accountant's reported value of \$220,000.

Who's interested in replacement values? Potential buyers of your company who want to get into your line of business *or* company-employed executives who want to buy the business from you. *Your selling position is:* It would cost them \$400,000 to duplicate the equipment and get to where you are today. Furthermore, the equipment is in place, de-bugged, and fully operational. Those are very strong arguments to use in valuing these assets above the accountant's reported net book value.

Final comments. *First*, if the company is a sole proprietorship, partnership, S corporation, or limited liability company, you must adjust the income statements as if it was a regular (C) corporation with applicable corporate, not personal, tax rates.

Second, if the company owns an affiliate, that affiliate must be valued separately. *Reason:* The value on the balance sheet is the company's net cost basis, which could be substantially lower than the affiliate's fair market value. Again, that *excess* value is added to the company's stockholder's equity account. □

Adjust the company's profits upward so you can apply a multiple to higher profits.

Part Two — Case Study

How to Value a Company's Goodwill And Its Intangible Assets

- **What Are the Components of Goodwill?**
- **Identifying Intangible Assets**
- **Adjusting Earnings and Assets**
- **Valuing Goodwill and Intangible Assets**
- ***Case Study: Smith Electronics, Inc.***

Every business, by the simple fact that it is established and operating, has some goodwill attached to it.

Goodwill can represent a significant portion of any business' overall value. But establishing a dollar value for that goodwill is never a clear-cut task. It is a difficult process but the dollar impact on the final value can be substantial and worth the effort.

Part Two of this **Resource Report** discusses a company's intangible assets, including goodwill, that can increase its value and explains how to use the tangible assets/capitalized income method to value those assets and goodwill.

What Is Goodwill?

Goodwill is principally the *intangible assets* of a business, such as an established customer base, marketing knowledge, or arrangements with suppliers or creditors that have been negotiated and are in place. It includes patents, trademarks, trained employees, reputation, history — elements that contribute to the success and worth of a business but that may not be recorded or even reflected in a company's financial statements. Although these intangible assets may have no dollar value on the balance sheet, they often have a considerable operating value and therefore should be included when calculating a *total* value for a business.

Because it is intangible, goodwill is hard to define without resorting to specific assets and examples. In judicial disputes, many courts have used the following language to define goodwill:

"Goodwill is the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or from celebrity or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessities or even from ancient partialities or prejudices."

In general, goodwill is comprised of those components of a business that convince customers to remain as customers and that, as a result, allow the business to generate a profit or a rate of return on investment that exceeds the return that might be expected solely from the assets that the company has available.

For example, *A&D Medical Company*, a successful drug company, earns high profits and has a higher rate of return on its assets and stockholders' equity than many other companies with the same level of assets and net worth. These "excess earnings" come partially from the goodwill that A&D has generated. This goodwill

can be further defined in A&D's case, for example, as the high level of research it has developed, its established customer base, and its consistent ability to increase revenues and overall profitability.

For many companies, goodwill also has been defined as the value that is at least equal to *the total capital a new business would require to get where an established business is today*. This obviously includes many intangible assets, as well as the replacement value of a company's tangible assets, such as equipment, autos, real property, and inventory.

Components of Goodwill

A company's intangible assets generally can be divided into two categories: (1) intangible assets that *cannot* be separated from the business, and (2) intangible assets that *can* be separated from the business.

Let's take a closer look at each category.

#1 — Intangible assets that *cannot* be separated from the business

The following are included in this category:

- Start-up costs that the company already has funded and expensed.
- An established customer base.
- Operating and production facilities already in place.
- Advantages accruing to the company's physical location.
- Internally developed computer software programs.
- Promotion and advertising campaigns already underway.
- The reputation of the company and its owners, managers, and employees in running the business.
- Accounting systems and controls that are in place and functioning.
- The general experience and skills of employees in such areas as overall management, customer relations, administration, and employee relations.
- How the company got to *where it is today* and *where it's headed*.

#2 — Intangible assets that *can* be separated from the business

In this category, the following are included:

- Trade and domain names, trademarks, copyrights, patents, and secret production methods and product formulas.
- Mailing and customer lists, supplier contracts.
- Franchise, licenses, exclusive territory, product rights, and established distribution network.
- Manufacturing processes, drawings, dies, toolings, and leasehold improvements.
- Long-term contracts, including purchase, sales, rental, noncompete, and employment contracts.

All of these "goodwill" assets contribute to the success of the business and therefore to its value. But they are intangible and don't, in many cases, show up on the company's financial statements. *So, how can they be valued?*

Setting the Stage for a Valuation

Before starting the valuation, you must adjust the company's earnings to reflect its real profitability. That's especially critical when valuing a closely held business because owners of these businesses typically keep reported company profits as low as possible to minimize taxes. These adjustments, as explained in more detail on page 12, almost always substantially increase the company's real earnings, sometimes double or triple the earnings reported on its tax return.

Adjustments to company earnings should add back to earnings: (a) any "excess" compensation and benefits paid to the company's owners/officers above reasonable amounts, (b) extraordinary writeoffs of bad debts, inventory, equipment, etc., and (c) any nonrecurring expenses incurred in one year which benefit the company over future years, e.g., establishing a new sales office, research and development, computer software programs, etc.

You also need to pay attention to the tangible assets on the balance sheet in making your earnings adjustments, e.g., inventory, real property, leasehold improvements, and equipment. The reported net book values of these assets also are usually *understated* and must be adjusted to fair market or replacement value. These extra values are then added to the company's net book value.

Note: The term *net book value* (assets less liabilities) as used in the Case Study which follows is the same as a company's net worth or stockholder's equity.

Now onto valuing goodwill by using the net tangible assets/capitalized income method.

Many intangible assets, because they have already been expensed, have little book value but considerable operating value.

Case Study: Valuing Goodwill

Net Tangible Assets/Capitalized Income Method

The net tangible/capitalized income method for valuing goodwill is one of the most important because, if a dispute arises with the government over the valuation of goodwill, this is one of the methods on which the IRS often relies. It's also one of the most comprehensive of the goodwill valuation methods since it values the *entire* company and its overall profitability.

The value derived by using this method is based on the concept that *the existence of goodwill creates an excess rate of return in a business*, which must be given a dollar value. This method is designed first to isolate that excess return and then to put a value on it. The steps to computing the value are as follows:

1. The value of the company's net tangible assets (net book value less intangible assets) and its net income are averaged for the last three to five years. (Average net book values and earnings are used since goodwill is built up over time.)
2. You then determine what industry the company is in and that industry's average return on net book value (say, 10%).
3. You multiply the industry's 10% return by the company's average net book value (tangible assets less all liabilities).
4. To determine the company's *excess* earnings, the result of Step 3 is deducted from the company's *actual* average net income.
5. The result in Step 4 is then capitalized, normally at a 10% to 20% capitalization rate. For our example, we use a capitalization rate of 15%.

Valuation comment: Even if a company's profits are nominal, goodwill still can be established by identifying and writing up select intangible assets to fair market value. For example, it may have cost you \$80,000 to obtain exclusive distribution rights to a product. Even though that \$80,000 has been fully written off for tax purposes, it should be added back when calculating the net book value of the business.

Valuation Example

Let's assume the following financial data for *Smith Electronics, Inc.*, a manufacturer of electronic relay components. (The averages are based on the company's financial statements for the last three years.)

Average Total Assets	\$1,500,000
<i>Less:</i> Average Intangible Assets	100,000 ⁽¹⁾
<i>Less:</i> Average Liabilities	<u>600,000</u>
Tangible Net Book Value	<u>\$ 800,000</u> ⁽²⁾
Average Net Income	\$ 140,000
Industry Return on Net Book Value	10%
Goodwill Capitalization Rate	15%

(1) Includes items such as deferred financing and product development costs which were capitalized on the balance sheet solely to be written off over the term of the financing or the life of the product.

(2) Tangible net book value is the same as a company's tangible stockholder's equity or tangible net worth, i.e., the equity account less all liabilities and intangible assets.

Using the facts above for *Smith Electronics*, the value of its goodwill is calculated as follows:

Step 1: Company's average tangible net book value
= \$1,500,000 *minus* \$600,000 liabilities *minus* \$100,000 intangible assets
= \$800,000 tangible net book value

Step 2: Determine industry's return on net book value = 10%

Step 3: Company's average net book value *times* industry's return on net book value
= \$800,000 *times* 10% = \$80,000

Step 4: Company's average net income of \$140,000 less industry's return on net book value
 = \$140,000 *minus* \$80,000
 = \$60,000 excess net income

Step 5: Excess net income *divided by* the capitalization rate of 15%
 = \$60,000 *divided by* 15% (0.15)
 = **\$400,000 value of goodwill**

Total value. Using this method, the value of *Smith Electronics'* goodwill is \$400,000. This \$400,000 value is then added to the company's tangible net book value of \$800,000 to arrive at the company's total value.

Value of Tangible Net Book Value	\$ 800,000
Value of Goodwill	<u>400,000</u>
Total Value of the Company	<u><u>\$1,200,000</u></u>

Goodwill has a high value in this company; it represents 33% of the total \$1.2 million value. While its industry is earning a return of only 10% on tangible net book value, *Smith Electronics* is earning 17.5% (\$140,000 average earnings divided by \$800,000 tangible net book value). Therefore, this superior performance must be due to the company's intangible components — perhaps its strong customer base, sophisticated technology, or superior management.

Comparison to Profits and Net Book Value

The total value of the company (including its goodwill as calculated by this method) should be compared with the values arrived at by using other valuation methods. *Reference:* For an explanation of the other valuation methods, please see *Eight Ways to Value a Business*, page 7.

An example: Let's assume that *Smith Electronics'* actual net income for last year was \$150,000, not the \$140,000 *average* we used in our case study. This means that the company's total value of \$1,200,000 would be equivalent to 8 times earnings

— a price-earning's multiple (p/e) of 8. Now, an 8 p/e multiple may be low when compared to other smaller companies trading on NASDAQ or the American Stock Exchange. However, if the average p/e of similar companies in the industry is 12, then *Smith Electronics* could be valued at \$1,800,000 (12 p/e times last year's \$150,000 net income) — still well above its reported tangible net book value of \$800,000 and 50% higher than the \$1.2 million using the tangible assets/capitalized income method.

That's why a comparison of the values arrived at by other methods is very important. All valuation methods are, after all, merely tools. The final, and best, valuation figure often is arrived at by merging the values calculated by a variety of methods. □

About *The Business Library*

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The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

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