

Valuations for Small Closely Held Businesses

By Mike Meegan

The valuation of a small closely held business is a complicated calculation because there are numerous qualitative and quantitative factors that affect the value of a company. Qualitative factors to consider are the quality of the current employees, location of the business, the industry's legislative environment, competition, and the stability and longevity of the company. Quantitative factors include the company's historical and projected financial statements, industry statistics, and other financial information that is relevant to the company.

The approach used will depend upon the seller's intentions. If the seller wishes to pass on the business to a family member, the valuation is for tax purposes and must be based on fair market value. The owner wishing to sell to a third party will want to maximize the sale price. Because market conditions can change rapidly, a valuation may not be relevant if not used within a certain time period.

Business valuations may be completed for a variety of reasons. Many are conducted for estate planning or, on the opposite side, post-death estate taxes. The valuation is particularly important in the cases of estate or gift taxes. The IRS requires valuations of closely held corporations to be at fair market value, instead of book value. Fair market value is defined as the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. If the IRS finds that the sale of a company has been undervalued, this could create a tax liability for those involved in the transaction.

Businesses may use a valuation to obtain financing from a bank, or to determine the amount of insurance necessary for its key owners/executives to carry. Oftentimes a valuation is completed in divorce situations because there is a requirement to value certain interests. In most cases, it is used when any interest in a company is going to be sold.

Ownership control plays a large role in valuation. There are three types of ownership interest values: controlling interest; marketable, non-controlling interest; and non-marketable, non-controlling interest. A marketable, non-controlling interest in a company is similar to equity in a publicly traded company. A non-marketable, non-controlling interest is similar to minority interest in a closely held company. Generally, there is a premium attached to ownership control, while there is a discount attached to lack of control or marketability.