

Business Valuation

Valuing the Operations and Assets of Privately Held Companies

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What do business valuation (“BV”) experts do?

Business valuation experts value companies that are privately held (not publicly traded). The value of a publicly traded stock can be found by looking at its price in the stock market. For a privately held company, the BV expert is acting in the role of the market. BV experts also value partial interests in companies or partnerships and the intangible assets of a company, such as customer relationships, intellectual property and trade names. Many also provide forensic accounting, litigation support and expert witness testimony for disputes.

Why do executives hire BV experts?

Executives and business owners hire BV experts at critical points in a company’s history. Those events include:

- buyout of a major shareholder or partner.
- disputes over the value of a business when the owner is getting divorced.
- estate and gift tax planning.
- acquisition or sale of a business.
- strategic planning and benchmarking to increase the value of the business.
- valuing stock options and deferred executive compensation arrangements (especially in start-up companies).
- litigation over economic damages to a business.
- fair value reporting under Generally Accepted Accounting Principles.

What are major issues in private company valuation that might not apply to public company stocks?

The several issues that need to be considered are:

- separating the income a business owner gets for working in a business from the income received from owning the business.

- separating the value of the business from the value of the real estate if the business owns the building from which it operates.
- removing non-business expenses and separating out the value of non-business assets.
- determining whether related-party transactions and expenses, such as rents and salaries, are at market rates.
- separating the income attributable to physical assets from the income attributable to intangibles, such as trade names or technology.
- determining discounts for lack of control and lack of marketability for partial interests.
- determining the appropriate standard and premise of value.

Do I need audited financial statements when undergoing a business valuation?

No. The BV expert often works from tax returns and internal general ledgers. Even audited financial statements, however, might not represent true economic income. The BV expert will use his forensic accounting skills to adjust the financial statements. Doing so might include converting cash basis accounting to accrual accounting, removing non-business expenses from the financial statements (vacation houses, etc.) and adjusting expenses that are not at market rates (family employees who are under- or over-paid, etc.). Then the true economic income of the business is revealed, which is one foundation of its value.

What are “standards of value” and “premises of value?”

The standard of value is the set of rules under which the business is being valued. Usually this is fair market value in valuations for transactions or tax purposes. In certain cases, such as shareholder disputes and divorce valuations in New Jersey, the standard might be fair value. The premise

of value reflects the operating condition of the business. It usually is going concern value, but might be liquidation value or another premise in certain circumstances.

What is the discount for lack of control (“DLOC”)?

A DLOC is a discount applied to the value of a partial interest in a business to reflect that the owner of the interest does not have 100 percent voting control regarding the decisions made by management.

What is the discount for lack of marketability (“DLOM”)?

A DLOM is a discount applied to the value of privately held business to reflect that it usually cannot be sold as quickly or easily as stock in a publicly traded company. Many privately held companies and partnerships have restrictions on the sale of interests to people outside the original investor group.

Why are DLOMs and DLOCs important?

Applying these discounts will make a partial interest worth less than its prorata share of the whole. That can generate significant tax savings in estate and gift planning. ■



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