Importance of Valuation in Employee Ownership

Having a surface level understanding of the concept of business valuation is an important skill for your toolbox. Understanding business valuation is also important when conducting an internal valuation during the first steps of transitioning your business to an employee owned model. It will be important to know the terms presented and what values indicate about the state of your company. In certain financing situations a third party evaluation is required by law. These situations include when the amount being financed minus the appraised value of real estate and equipment is greater than $250,000, if there is a close relationship between buyer and seller, and when the lender's internal policies and procedures require an independent business appraisal from a qualified source. Even if a third party is handling the evaluation, it's beneficial to understand how to read the information presented so you can look out for red flags and ensure the third party is delivering what you ask for. A properly conducted valuation is priceless information for the business owner, the employees, and the company itself— especially when considering future decisions.

Why a fair valuation is important

A fair valuation is important for a number of reasons, all of which ensure the overall financial health of the company. It helps ensure the owner is compensated properly, that the company isn't overburdened with debt it cannot pay back, and that the company functions well enough that new employee owners receive the benefits. Valuations become particularly necessary when a company requires financing from outside sources, which is often the case during transitions. Valuations can be required by law and, even in situations where they may not be legally required, conducting one is to the benefit of all stakeholders.

It's also important to note that valuation analysts often will provide for more projections than your company's current financial trajectory. They will speculate on different possible variables, such as revenue and profit, to create a variety of potential scenarios that can aid decision making. You should expect to consider projections for optimistic, pessimistic, and zero growth scenarios. The unpredictable nature of the market makes considering possible future scenarios in addition to your company's current scenario important. Knowing how to evaluate the information provided by valuation analysts is an important skill for directing the future of your business, regardless of what that may look like. These are just a few of the terms you should familiarize yourself with, and you should note there are plenty of supplemental resources like the Business Valuation Glossary[1] that can aid with unfamiliar terms that may arise.

Third party valuations

In certain scenarios, particularly when the amount being financed minus the appraised value of the company's physical assets is over $250,000 or if there is a close relationship between buyer and seller, a third party evaluation is required by law. It's important to note that the Small Business Association considers an employee/employer buyout to be a close relationship. There are a variety of valuation options available out there, and choosing the right one depends on the level of detail you are looking

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[1] 2022. **"Business Valuation Glossary."** Corporate Finance Institute.

for. Third party conclusion of value reports are the most thorough of valuation analysis reports, but there are also calculated value reports and internal valuation reports. Typical third party valuations are 90-100 pages with an add-back proof appended, while calculated value reports that are used for internal valuation purposes are around 40 pages with no add-back proof appended and internal valuation reports are around 15 pages. Add-back proof is a detailed proof of add back expenses. An add back is an expense that will not be included in the buyer's future P&Ls for the company, for example excess Owner Compensation or personal expenses of the owner. Third party valuations also include market, asset, and income approach analysis while calculated value reports usually do not include the income approach.[2] While third party valuations are required by law in certain situations, it's also a viable option for those seeking greater depth of analysis regarding the state and future of their business.

Conclusion

Business valuations come in a variety of forms that serve a variety of purposes. Determining the right valuation requires assessing the level of depth of analysis you desire as well as the legal requirements for certain scenarios. Regardless of their form, valuations are a useful tool for making important decisions and getting a clear picture of the inner workings of your business that are not immediately apparent. Thus, learning how to interpret and navigate valuations is a necessary skill. It may take some time to familiarize yourself with the nitty gritty of an extensive valuation, but doing so will ensure you are getting the most out of the process.

[2] 2022. **Reliant Business Valuation**.