

WHEN SHOULD A BUSINESS BROKER RECOMMEND THAT A CLIENT OBTAIN A FORMAL BUSINESS APPRAISAL?

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One of the first challenges a broker faces when inking a new listing is the establishment of an asking price for his client's business. As we all know, successful business intermediaries are quite adept at developing appropriate valuations for their clients, especially those who specialize in a particular industry. For example, a business broker or associate who has successfully shepherded the transfer of ownership of scores of restaurants during his or her career will have developed a thorough understanding of the performance standards and risks that are prevalent in the family restaurant business as well as the affect market conditions can have on price. This experience allows the broker to establish an asking price that will eventually lead to the successful sale of the business.

As we all know, there are a number of appraisal methods utilized by business brokers to estimate the value of small "main street" businesses. These include rules of thumb, the multiple of discretionary cash flow method and the fair market pricing method, among others. These methods used in conjunction with good judgment and common sense have served the business brokerage industry well for many years. But under what circumstances might it be appropriate for a broker to recommend to a client that he or she obtain an independent appraisal and what kind of appraisal is appropriate?

If the subject business has less than \$750,000 or so in gross revenues and meets certain other criteria, your client may find that a limited scope appraisal will meet his or her needs. A limited scope appraisal invokes the departure rule of The Uniform Standards of Professional Appraisal Practice in order to provide a low cost alternative to those who desire an independent appraisal performed by a Certified Business Appraiser or similarly credentialed professional. This appraisal is often suitable when a client desires an independent valuation to justify an asking price. The resulting certified appraisal report also provides valuable information that can be used in price negotiations and may be especially helpful when neither the seller nor the buyer are particularly knowledgeable about value concepts, which is often the case. A limited scope appraisal might also be

utilized in cases where the seller has an unrealistic expectation of the value of his or her business. Or perhaps the seller perceives the broker, who would like to have his listing, to have a conflict of interest and would like to the appraisal to be performed by an independent, third party. Another instance where an appraisal may meet a broker's needs is in conjunction with Article Eleven of the Code of Ethics of the International Business Brokers Association which states that "The business broker should not undertake to make an appraisal that is outside or beyond the scope of his experience without first obtaining the assistance of an authority of such types of property unless the extent or lack of experience of the business broker is fully disclosed to the client." Of course, no intermediary cares to be in the position of having to explain to their client that they have a "lack of experience."

Although a limited scope appraisal may meet the needs of many sellers and buyers of small businesses, there are often situations where a formal valuation should be recommended. The primary indicator should be size. Companies with over \$750,000 or so in gross revenues, are typically more complex than main street businesses. To arrive at a reasonable estimate of the fair market value of a business enterprise of this magnitude and complexity both internal as well as external factors that influence value must be taken into careful consideration. These factors are outlined by the IRS in Revenue Ruling 59-60 which states that an appraiser should conduct a careful analysis of: a) the nature of the business and the history of the enterprise; b) the economic outlook in general and the condition and outlook of the specific industry; c) the book value and financial condition of the business; d) the earnings capacity of the company; e) the dividend paying capacity (cash flow) of the company; f) goodwill and intangible value; g) the size of the company, and; h) the market price of similar publicly owned companies that have sold. The analysis of these and other factors, in conjunction with valuation methods which are more rigorous than those typically employed by business brokers, are used to develop a formal estimate of the fair market value of the subject company.

Another indication that a formal valuation should be recommended might be a function of the industry in which the business operates. For example, professional firms, such as those of physicians, engineers and architects have unique financial/accounting issues and practices that must be addressed when developing an estimate of value. In

addition, some industries, such as auto and recreational vehicle dealers for example, have developed industry-specific valuation methods that should be included in the analysis. If a broker is not familiar with these methods, a qualified appraiser should be recommended.

Although formal appraisals may be expensive, they can substantially reduce the likelihood that a company is over- or under-priced. This will be of utmost importance to those of your clients who are particularly concerned about leaving money on the table. Further, a prospective buyer of a company with an asking price of over \$500,000 or so is likely to be more sophisticated than the typical buyer of a main street business and may well have a formal appraisal of the target company performed on his own behalf before making an offer. A seller who has not engaged a qualified business appraiser could find himself seriously lacking at the negotiating table.

Professional, well-trained business brokers have a long history of providing valuable services to their clients in the development of appropriate asking prices. However, it is important that brokers and associates alike understand that an estimate of the value of a larger, more complex company derived from main street business appraisal methods may be materially different than the company's true fair market value, which can be determined only through a formal valuation.

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