Buy-sell agreements

The need for a fair and current value

Take steps now to mitigate risks
Are you prepared for the transition of your business? Does your buy-sell agreement include an accurate value for your company? These are questions to ask yourself to make sure you’re prepared when the buy-sell agreement kicks in. Knowing the value of your business is key.

Valuation is critical to effective buy-sell agreements

There’s a lot at stake when planning for a successful transition of your business. If you have a buy-sell agreement in place, you may think you’re set. But, if it doesn’t reflect a current value of the business, there can be unintended negative financial consequences. Only 5% of the buy-sell agreements reviewed by Principal® reflect a current value of the business. But there are steps you can take to prepare now.

Determining the value of your company

When finalizing a buy-sell agreement, it’s important to think about the valuation method that makes sense for you and your company. The buy-sell agreement valuation method should maintain a value that’s consistent with the economic position of your business. Our experience shows most agreements use one of four methods to determine company value. Let’s take a look.

**Agreed value method** – This is the most common form of valuation found in agreements we review. Each year after receiving the company’s financial results, the business owners will meet to agree upon either 1) a value per share or 2) an overall company value. The newly agreed upon value is posted to a schedule attached to the agreement. The current agreed value is used to determine the purchase price if any sales of the business occur within a stated period.

This can be an effective approach, but it should be updated annually. Our experience is that almost 60% of business owners using this method haven’t updated the recent agreed upon value, which could lead to difference between what they expect to receive and what they will be paid.

Valuation analysis for “agreed value” agreements

19% Current valuation and back-up method
28% Current valuation but have no back-up method.
36% No current valuation but have back-up method
17% No current valuation and no back-up method

**Important tip:** A back-up method should be included in case the agreed value isn’t current.
**Formula and appraisal methods** – Some buy-sell agreements include a formula or require an appraisal to establish a current value. The value is typically not determined until the actual triggering event. Not knowing the value of the company ahead of time makes buy-sell funding more difficult and can leave business owners wondering what the value of their company is until a business transition event occurs.

Also, there are a few things that can impact a formula or appraisal valuation method. For example:

- Should a control premium be included in the purchase price for a majority owner?
- Are discounts for lack of marketability or minority interest included?
- Does the agreement indicate how a formula or appraisal should address any life insurance death proceeds?
- If appraisal is the valuation method, does the agreement provide direction to the appraiser about the desired valuation standard for assets?

**Book value method** – A book value determination of company value is pretty easy to create and understand. But it tends to significantly understate the value of most companies because:

- It typically excludes any value for company goodwill. For a lot of companies, this could be financially meaningful.
- Certain assets listed on a company’s balance sheet reflect acquisition cost value, not an updated current value.

Plus, without appropriate adjustments, book value is generally not an acceptable method of determining a company’s value for taxation purposes. From an IRS perspective, goodwill is one of the factors it believes should be considered in establishing a company’s fair market value. IRS guidance on company valuation, beginning with Revenue Ruling 59-60, indicates it’s best to look at a variety of factors in arriving at a company’s fair market value.

**What’s next?**

Setting and maintaining a reasonable and current company value should be a top priority. And Principal® offers two complimentary services to help — the **Informal Business Valuation and Business Planning Report** and the **Buy-Sell Review**. Determining the value of your business and reviewing your buy-sell provisions can help you be more prepared and mitigate risks. Contact your financial professional today to request customized reports for your business.
Let’s connect | Contact your financial professional or go to principal.com.