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Business Valuation & Litigation Support Trends

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Key Person Considerations

Does your business depend on a key person? Whether this person is the company's founder or a leading salesperson, one important risk to consider in a business valuation is the impact losing him or her will have on cash flow – both revenues and expenses.

Analyzing the Risk

The purpose of a valuation affects the risk analysis. If you are the key person and you are selling the business, try to maximize the sale price by working to increase the likelihood that strategic relationships will transfer to the buyer. A succession plan may have transferred these strategic relationships before an owner or manager's departure, but an orderly transition period is less likely where there is no plan in place.

How Losing a Key Person Affects a Business

In addition to cash flow, here are

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Value-Based vs. Traditional Accounting

Traditional accounting methods work fine for measuring a company's financial well-being, but only to a point. Value-based management methods, on the other hand, provide alternative performance indicators and, ultimately, tools for enhancing your company's value.

In This Corner: Value-Based Accounting

Value-based management tools assess the financial well-being of a business by looking at true cash flow in terms of dollars and timing. They also compare a company's returns to its cost of capital. Two value-based measures that can directly show improvements in shareholder value are the net present value (NPV) and internal rate of return (IRR).

To measure performance using NPV, an analyst converts future cash inflows and outflows into their present values. Then he or she totals these present values into one number, the NPV. If the NPV is positive, an investment is acceptable (it will earn more than the cost of capital) – and the higher the NPV, the better the shareholder value. Conversely,

investments projecting a negative NPV are typically rejected.

IRR is similar to NPV, with a few differences. For example, IRR's net present value is zero. But like NPV analysis, IRR calculations are complex, requiring a spreadsheet or financial calculator.

Value-based tools look at returns from the investor's viewpoint. This involves calculations factoring in cost of capital and time value of money. These calculations are complicated, requiring a more in-depth knowledge of the company's cash flow. Like any other tools, they're best employed by those trained and experienced in their use.

The Challenger: Traditional Accounting

Traditional accounting measures, such as an investment's payback period, assume no difference in value from one period to another. Similarly, they don't compare a company's investment returns to its capital costs. They are short-term focused, thereby ignoring a company's long-term outlook.

For instance, return on equity (ROE), a traditional financial-performance measure, examines one year's net income. ROE, which is calculated by dividing annual net income by the book value of equity, has another problem: Net income, the numerator, differs from

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Key Person Considerations

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some other aspects of a business that may suffer if a key person leaves:

Sales: If one person has the sole working relationship with most major customers, maintaining the sales level after his or her departure may not be possible. Assessing this risk is part of the valuation process. The valuator reviews sales and evaluates whether each relationship could be transferred to someone else, whether the competition can take these sales away and what sales level the company can expect in the future.

Operations: Reviewing vendor relationships can help determine the stability of the company's gross profits. If only one person knows where to buy raw materials

at the best prices or has a unique relationship with the vendor, the gross profit margins may not be sustainable if he or she departs.

Workforce: Employees whose loyalty stems from a relationship with the owner may leave if the business is sold.

Assess the Impact

Evaluating the risk of reliance on a key person is an important consideration in many business valuations. Owners should address this when preparing to sell their businesses. Proper analysis of its impact on value is essential. Please call if you have questions about how the loss of a key person may affect the value of your business or any other aspect of valuation, we would be glad to help.

Value-Based vs. Traditional Accounting

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true cash flow. It includes noncash items, such as depreciation and amortization, without considering many other cash items, such as debt service, capital expenditures and working capital changes.

The book value of equity, the denominator, is one more ROE problem. The book value of equity is the difference between a company's assets and liabilities. Although the values of most liabilities usually parallel their market

values, asset book value is recorded at the lower of cost or market value. In other words, book value typically rests on an asset's acquisition cost, which ignores an asset's current value and cash flow-generating abilities.

Value Wins

Incentive programs rewarding managers who improve short-term accounting indicators often do so to the detriment of long-term financial performance and value. Instead, introduce incentive programs that reward employees for improving value-based indicators. To help ensure long-term success, please call us for help integrating value-based management analysis into your company's strategy.

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