

# IT'S YOUR LIFE

## Don't Take a Chance – Valuation Methods for Buy-Sell Agreements

A Buy/Sell Agreement helps a business owner “lock in” a value for the business. The Agreement does this by using a “valuation formula.” The formula you use could mean the difference between receiving liquidation value or fair market value. Does your valuation formula lock in fair market value?

### **Common Valuation Formulas for Buy/Sell Agreements**

#### **Option 1 – Book Value**

The book value method (also known as net worth or owner's equity) is simply the total assets minus the total liabilities as shown on your financial statement. This method is sometimes referred to as the “liquidation” method. This method usually understates the true fair market value of your business, as it does not account for goodwill, profitability, or recapture of accelerated depreciation.

Fair Market value of ABC Inc. = \$1.4 million  
Book Value = \$450,000  
Loss in value = \$950,000

#### **Option 2 – Agreed Value Method**

With this method, owners periodically meet and set the value of the business in writing. This new value is then amended in the Buy/Sell Agreement. If you utilize this type, how long has it been since you documented a new value? If you have not adjusted the value to reflect today's current value, you can lose.

Fair Marketing Value of ABC Inc. = \$1.4 million  
Last Documented Value (2003) = \$800,000  
Loss in Value = \$600,000

#### **Option 3 – Appraised Fair Market Value Method**

This method has a stated process to formally or informally appraise the business. To arrive at fair market value, it factors in several things, such as the current value of assets, liabilities, goodwill, and profitability. This method ensures all interested parties receive the full value they deserve.

Appraised Fair Market Value of ABC Inc. = \$1.4 million  
Loss in Value = \$0

Make sure your valuation method locks in the fair market value of your business. Take advantage of Federated's *Agreement Evaluator*<sup>SM</sup> to receive an informal review on the strengths and weaknesses of your valuation formula along with the other terms of your Buy/Sell Agreement.

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