Valuing a Privately Owned Business

Fair market value is defined as the price at which the business would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both having reasonable knowledge of relevant facts, and with both seeking their maximum self-interest.

What does that really mean? The value of a privately owned business depends on a number of factors including its financial strength and profitability, strength of the industry, competitiveness, dependency of the business on the owner and future viability of the company.

There are three common approaches typically used by certified business appraisers to perform a business valuation, although there may be other approaches used. The American Society of Appraisers has developed appraisal standards for the Asset Based Approach, the Market Approach and the Income Approach.

The Asset Based Approach

The Asset Based Approach, sometimes referred to as the Cost Approach, is asset-oriented. Each component of a business is valued separately and then summed to derive the total value of the business. The book value of each asset must first be determined – original cost minus depreciation works for some assets, cash and marketable securities are valued at face value and inventory values vary by type. The value is estimated based on the cost of duplicating or replacing the individual assets. The next step is to adjust these values to reflect their fair market value, which results in an adjusted book value. Next, deduct liabilities – short-term debt at face value, long-term debt at a discount. Last, subtracting the liabilities from the adjusted book value, results in the value of your business.

The Market Approach

The Market Approach is based on an analysis of the purchase price of similar businesses in the market. Financial ratios are used to compare the subject company to other companies and then a set of appropriate multiples are developed to be used in the valuation. An earning period is then selected (usually the last 12 months, but may include up to 36 months) and earnings and cash flow are analyzed over these periods using the multiples. Then, a value is selected based on how the company compares with the others.

The Income Approach

The Income Approach focuses on the earnings of the business. The value is based on an estimate of the income the purchaser could reasonably expect from the business. The computations generally determine that the value of the business is equal to the expected future income of the business divided by the rate of return.

There are several income approach methods commonly used in business valuations today. They all use some selected level of earnings and match it to the corresponding conversion factor. When performed properly, each of the methods should produce similar values. The Multiple of Discretionary Earnings approach is widely accepted and is conducted in two steps. First, the discretionary earnings likely to reoccur in the near future is determined by either averaging the last several years or using only the last year, if the most recent year better reflects the projected earnings of the company. Discretionary earnings is defined as reported pretax earnings, plus the owner's salary, interest expense, depreciation and any personal expenses run through the business. The second step is to select a multiplier. The discretionary earnings value (used in step one) times the multiplier produces the value of the business.

Valuation Conclusion

In conclusion, a Business Valuation expert will determine a relative weight to be assigned to each of the various methods used or they may decide that the value should be derived from a single method. One or more approaches may not be relevant to the particular situation. Typically, the rationale will be included for the selection of weighting of the method or methods used in reaching the final value.

Properly determining the value of a business is a complicated process. Consult with a professional business valuation expert that has technical and business experience, the ability to select the appropriate valuation techniques, and a thorough understanding of today's tax laws, corporate finance and market conditions. An unbiased business valuation serves as a benchmark, minimizes ownership disputes and provides a realistic, credible and defendable valuation for any business owner.