

Business Valuation

While not an everyday topic, there are two times when you will probably be concerned with the value of a business: when you are thinking of purchasing a business or selling a business. There are three main methods of determining the value of a business: the liquidation approach, rule of thumb approach and the price approach.

Liquidation Approach

This approach is actually quite simple. To arrive at a value, you would need to determine the market value of the assets (how much you could sell them for). You could do this by consulting: commercial appraisers, auctioneers, real estate agents or equipment dealers. Then subtract all payables the business has (eg selling and disposal costs, creditors, taxes payable). The resulting amount would be the selling or purchase price (liquidation value).

Rule of Thumb Approach

This is used to estimate the value of a service business. It is calculated by taking two times the annual after-tax earnings and then adding that to the estimated fair market value of the fixed assets and vehicles.

Price Approach

- 1) Determine the current market value of all assets and subtract the liabilities.
- 2) Estimate how much could be earned annually by investing the amount of the asking price elsewhere.
- 3) Add this to the normal yearly salary of the owner. This combined figure provides a reasonable estimate of what the buyer could earn by placing his money and effort elsewhere.
- 4) Determine the average earnings of the business (before taxes) for the last three years. Have they been rising, falling or fluctuating wildly. Adjust the earnings to reflect trends.
- 5) Subtract 2) and 3) from 4) which will give you the extra earning power of the business.

- 6) Use this figure to estimate the value of the intangibles. This is done by multiplying the extra earnings by what is termed the years of profit figure. This figure depends on a few different factors such as: How unique is the business? How long would it take to set up a similar business? What expenses and risks would be involved? How will a change in ownership affect customer loyalty? If the business is well established a figure of 5 may be used, if medium established a figure of 3 and if the business is relatively new a figure of 1 may be used.
- 7) The final purchase price is arrived at by adding 1) and 6).

A qualified accountant should be consulted whenever a business valuation is needed.