THREE BUSINESS
VALUATION METHODS

All known business valuation methods fall under one or more of these fundamental approaches:

- Asset approach.
- Income approach
- Market approach.

What is an 'Asset-Based Approach'

An asset-based approach to business valuation looks at the company's net assets at 'fair-market value' of its total assets minus its total liabilities, to determine what it would cost to recreate the business. Because market value of assets is subjective, there is some room for interpretation in the asset approach. Some consideration must also be given to what assets are company assets and which are excluded from the sale.

You might use this approach if the business is winding down or if the asset value is high.

The real value of assets in an asset-based approach for valuing a business may be much greater than simply adding up the recorded assets. There are Intangible assets, which may not appear on the balance sheet like IP, unique processes, special product, all of which have some value. If your business has leases on the assets, which guarantees future cash flow you would also look at goodwill. Pricing those offerings as part of selling a business may be difficult due to their intangible value.

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Adjusted Net Asset Method

The asset-based approach is used when a business is not generating substantial profit or has been generating losses, and the company's focus is holding investments in tangible assets like plant or equipment and real estate. The adjusted net asset method is commonly used for estimating the value of the business. The difference between the fair market value of the company's total assets and the fair market value of its total liabilities determines the fair market value of the business.

Determining Fair Market Value of Assets

The asset-based approach begins by creating a financial picture of the company through information on the balance sheet. Current asset values may differ dramatically from the assets' acquisition costs. Although the balance sheet lists assets and liabilities at historical cost, accurately using this method depends on recasting those costs and capturing the current value.

Assets are appraised and the fair market value of each is obtained. For example, plant may have been depreciated on the balance sheet, but the actual market value is much higher than the depreciated value, in this instance the appraised value is used for the purposes of valuation of the business. The process is repeated across all of the assets.

In contrast, liabilities are typically already stated at fair market value. In most cases, no additional calculations are needed. The fair market values of the assets are added up and the total liabilities are subtracted from the total. The difference is the estimated value of the business.

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Income Approach

The income approach identifies the fair market value of a business by measuring the current value of projected future cash flows generated by the business in question. It is derived by multiplying cash flow of the company times an appropriate discount rate. This business valuation method embraces the idea that a business's true value lies in its ability to produce wealth in the future.

One of the methods used to help the valuation process is **Capitalising Past Earnings.** With this approach, a valuator determines an expected level of cash flow for the company using a company's record of past earnings, normalises them for unusual revenue or expenses, and multiplies the expected normalised cash flows by a capitalisation factor.

The capitalisation factor is a reflection of what rate of return a reasonable purchaser would expect on the investment, as well as a measure of the risk that the expected earnings will not be achieved.

Discounted Future Earnings is another earning value approach to business valuation where instead of an average of past earnings, an average of the trend current and future earnings is used and divided by the capitalisation factor.

Any valuation of a service oriented sole proprietorship needs to involve an estimate of the percentage of business that might be lost under a change of ownership. Note that this can be mitigated in many cases, such as when a trusted family member (who may already be familiar with the client list) takes over the business.

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Market Value Approaches

Market value approaches to business valuation attempt to establish the value of your business by comparing your business to similar businesses that have recently sold. Obviously, this method is only going to work well if there are a sufficient number of similar businesses to compare.

Assigning a value to a sole proprietorship based on market value is particularly difficult. By definition, sole proprietorships are individually owned so attempting to find public information on prior sales of like businesses is not an easy task.

The Market Comparison approach to a business valuation is based upon current conditions amongst active business buyers, recent buy-sell transactions, and other fairly comparable business entities. Financial attributes of these comparable companies and the prices at which they have transferred can server as strong indicators of fair market value of the subject company.

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