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Whether a business is a sole proprietorship, partnership or corporation, business owners often need to determine the value (net worth) of a business for acquisition, sale, or financing purposes. The valuation method used for a buy/sell agreement may be different from the method used for obtaining a loan. Understanding how the value of a business is determined will help in making decisions whether to buy, sell, finance or invest in a business.

Most common valuation methods:

Book value. The accounting net worth of a business – total assets minus total liabilities. Assets are valued at their adjusted cost basis minus depreciation. The book value does not take into consideration certain unrecorded assets and liabilities such as the current value of goodwill, customer lists or lease obligations.

Tangible book value. Book value minus intangible assets (goodwill, covenant not to compete, etc.). This method only records the assets that can be collateralized. It is most often used by financial institutions.

Adjusted tangible book value. Adjusts the tangible assets up or down to their fair market value. It tells what the liquidation value of a business is most likely to be. It is sometimes used in place of book value for buy/sell agreements.

Earnings approach valuation method. Rather than value the assets and liabilities of a business, this method is based on the present value of expected future earnings.

Several ways to do this are:

- ❑ Analysis of average earnings over the last several years.
- ❑ Analysis of projected future cash flows.
- ❑ Analysis of projected future earnings.

These valuation methods give potential investors an idea of what kind of return they can expect on their investments.

Business Valuation Methods

Market approach method. Compares a business to publicly traded firms in similar lines of business. The market price to earnings ratio of the public firm is applied to the earnings or cash flow of the business being valued to arrive at a value.

Blended valuation method. Combines all of the other valuation methods by assigning a percentage to each. The value under each method is multiplied by its applicable percentage rate (or weighted value). The total of all weighted values is the business value, depending on the importance placed on each method. This blended approach can overcome some of the shortcomings of the other methods by considering strengths and weaknesses of each.

Factors Affecting Value

- ❑ Presence of buy/sell agreements, succession plans or other shareholder arrangements.
- ❑ Contracts in place with customers or suppliers.
- ❑ Key individuals – their importance to the operation and the likelihood they will stay with the company.
- ❑ Marketability – sellers of unique or unusual businesses often have a difficult time finding buyers.
- ❑ Business activities' reliance on current trend or fad popularity.
- ❑ Current tax effects and anticipated tax law changes.
- ❑ Presence of noncompete agreements.
- ❑ Future involvement of the seller, such as sales price based on a percentage of future profits, seller financing and agreement by seller to act as consultant for a period of time after the sale.
- ❑ Pending lawsuits.
- ❑ Potential for problems with environmental regulations.
- ❑ Type of business entity.
- ❑ Presence of any other liabilities that may transfer with the purchase of the business.

Valuations are a complex exercise in accounting, so be careful applying “rules of thumb”.

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