Business Valuation – A Confusing and Misunderstood Concept

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Want to know the value of your business? Pose the question to your closest friends and advisors. Write your own answer down and that of your spouse. You will be amazed at the range of responses. For further amusement, ask each how their answer was determined.

Despite that value and valuation is foundational to our entire economic lives and free-market system, the concepts remain misunderstood and are constantly misapplied. It can be said that only a precious few possess a true working knowledge of valuation. From these few come the capitalists that earn 99 percent of the wealth of our day. They do so by combining their knowledge with risk capital and putting both to work. The personalities are on the front pages of our newspapers and financial journals.

There should little wonder why valuation is shrouded in confusion. Our high schools and colleges don't teach it … outside of basic microeconomic theory. Contrary to common belief, the basic curriculum for accountants and attorneys do not include business valuation. Most graduate business schools only cover the valuation of publicly traded securities. And many would be surprised to find that bankers aren't trained in business valuation, and they almost never look at business value when assessing a loan.

However, regardless of the above, business valuation has some inherent characteristics that foster confusion and misinformation. The reasons include the following:

Value Is Subjective
Valuation is not exact, but rather very subjective. It is like beauty, as they say, " in the eyes of the beholder." What is the value of the watch on your hand? Or the diamond ring that your spouse gave you? What is the value of the old 1971 Lincoln Continental that has been sitting in your backyard, unprotected, for the past eight years? It was your father's last car and his prized possession.

Few People, Even Business People, Are Exposed To Factual Business Sale Data
The fact that so few of us own businesses means that few experience the purchase or sale of a business first hand. Businesses are not bought and sold as frequently as real estate or cars. And when they are, the data is much more complex and usually protected as confidential. Conversely, real estate sale data is of public record and is automatically recorded, typically at the county government level.

High Interest and Little Factual Data Breeds Misinformation
For whatever reason, people in our culture are immensely interested in both people and money. Business sale transactions involve people and, often, a lot of money. Therefore, there is much interest in the terms of sale. Combined with the fact that business sale data is not typically made available, and is usually held tightly, misinformation quickly fills the void. This phenomenon is well documented in research studies. Add to this the fact that the buyer or seller may allow or even seed false data that may put him or her in a favorable light.

Complexity of Business Sale Transactions, and Prevalence of "Terms"

Unlike cars and houses, businesses usually don't sell for 100 percent cash at closing. And it is very common for the price to ultimately be contingent on certain events occurring after the date of sale. The portion of a purchase price that is not paid at closing is referred to as "terms." As such, the actual sale price is often very difficult to determine. In these cases, the actual sale price can only be determined after all contingent events occur and the "terms" payments are calculated and paid.

Each Business is One-of-a-Kind

Most things we buy have identical or close substitutes. Even a used car or most houses can be considered to have very close substitutes. This makes the task of valuing any one much easier because we can compare it to others with similar characteristics. In contrast, businesses are almost all unique. They rarely have close substitutes. Therefore, applying the "comparable sales" method is much more challenging.

Finally, the coup de gras of confusion is the fact that the question, "What is the value?" has no definite answer unless the business is actually sold … and sold in a certain manner. Since the valuation task is often separate from an actual sale, value can only be estimated. In fact, this is precisely what is the valuation task. But to do so we must first answer three important questions: 1) Value to whom? 2) What definition of value? 3) Value as of what date? These concepts will be covered in future issues of *The Business Owner*.