### Determining The Value Of A Business

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The most difficult step in buying or selling a small business is probably determining what the business is worth as a going concern.

Many judgment decisions must be made. Yet before negotiations can continue successfully, a value must be established. The value must be acceptable to both buyer and seller, or further negotiation is fruitless.

It must result from the logical and objective efforts of all the parties involved.

## Valuation Methods

There are two basic methods of determining the value of a business. The first is based on expectations of future profits and return on investment. This method is preferable by far. It forces the buyer and seller to give at least minimum attention to such factors as trends in sales and profits, capitalized value of the business, and expectancy of return on investment.

The second method is based on the appraised value of the assets at the time of negotiation. It assumes that these assets will continue to be used in the business.

This method gives little consideration to the future of the bushiness. It determines asset values only as they relate to the present. It is the more commonly used, not because it is more reliable, but because it is easier. The projections needed to value the bushiness on the basis of future profits are difficult to make.

**Looking Ahead**

Whichever method is to be used to value the business, the buyer should ask the seller to prepare a pro-forma, or projected, statement of income and profit or loss for at least the next 12 months. For this, the seller will prepare a sales estimate for this period along with a matching estimate of the cost of goods sold and operating expense.

The projected statement will reflect the net profit the seller believes possible. The buyer should then make his own estimate of sales, cost of goods sold, operating expenses, and net profit for the next year at least, and as far into the future as possible.

In preparing these statements, the buyer should start by analyzing the actual statements of profit and loss for at least 5 years back. He should be sure that the past and projected statements provided by the seller are correct and are consistent with the buyer's proposed future operation. He should also study general and local economic changes that will affect future business. This includes competition.

If the buyer is not qualified to prepare projected financial statements, he should consult an independent accountant. This will involve some expense, but the cost will be small compared to the loss he might incur if he invested in a small business with a doubtful future.

Financial statements and their analysis and market analysis are discussed elsewhere in this section.

## Forecasting Sales

The most important projection to be determined in the projected income statement is the sales figure. After this number has been established, the cost, expense, and profit figures are easier to acquire. The data for projecting sales will come from past sales records of the business. The more accurate and systematic these records are, the more confidently they can be used in estimating future sales.

**How long a forecast?**

A basic question is this: "Over how long a period of time is it necessary or possible to forecast sales?" Any forecast is uncertain, and the farther a forecast is projected into the future, the greater the uncertainty. While it may be possible to exercise at least reasonable control over the internal operation, the external economic and market factors make forecasting difficult because of lack of control.

Perhaps the best way to approach the length of the forecast is in terms of the expected return on investment. Suppose it is estimated that the business should bring a 20 percent return on initial investment. The investment, then, should be returned in 5 years. At this point, the owner would just break even on his original investment. It seems logical to project sales and profits over a span of time comparable to that estimated for return on investment - in the above illustration, 5 years.

Any such forecast, however, should give careful consideration to expected changes either in the economy or in the industry market that might affect the pattern of sales change. Mathematically, it is possible to forecast sales with some precision. Realistically, however, this precision is dulled because vital market and economic factors cannot be controlled.

**Methods of forecasting sales.**

There are numerous methods by which sales forecasts can be made. Most of them take their lead from the past sales performance of the company. For establishing trends or averages, 5 years of sales history is better than 3, and 10 is better than 5.

Perhaps the simplest method is to assume that the percentage increase (or decrease) in sales will continue and that no market factors will influence sales performance more in the future than in the past. Suppose, for example, that the rate of yearly average increase for the past 5 years has been 4 percent, and that each year has shown about this rate of increase. Then it might be assumed that sales for the next year will be 4 percent greater than the current or most recent year.

But what about the year following? The year after that? Can it be assumed that these years will also increase at about 4-percent level? Each additional year into the future reduces the certainty of the predictions.

If these negative influences limit the accuracy to such an extent, why try to forecast beyond the immediate future (1 year)? Because such a forecast forces the person making it to give at least a little attention to economic and market factors that might influence the future operation - that might, in fact, indicate that the purchase or sale of the business would not be wise.

With forecasts covering more than 1 or 2 years, a more detailed forecasting technique is needed. Such technique should be designed to weight out extreme variations in year-to-year sales and to give a trend or level of sales change that is more realistically oriented to probable future sales patterns.

No method of forecasting can set any value on external market conditions, because there is no guarantee that these conditions will carry over into the future with the same relative significance. Nevertheless, their possible influence should be considered.

## Risk and Return on Investment

If a buyer wants to invest money in a business that is being sold, he should be concerned about receiving a fair return on his investment.

Many businesses can make a profit for a short time (1 to 5 years) ; not so many operate profitably over a longer period of time.

From the buyer's point of view, what is a fair rate of return from an investment in a small business? The rate of return is usually related to the risk factor - the higher the risk, the higher the return should be.

The buyer of a small business should try to determine the risk factor of the new business, though this is difficult at best and in many cases impossible. In attempting to assess the risk factor, the buyer should project the profits of the business as far into the future as possible. He should ask himself how high the risk should be normally and look for conditions that would be likely to affect the sales and profit-making capability of the business.

In any event, he should consider carefully the minimum return on investment that he is willing to accept. This concept of risk is important in valuing the business by capitalization of future earnings.

## Valuing the Business by Capitalizing Future Earnings

The price to be paid by the buyer should be based on the capitalized value of future earnings. Instead, however, in most small business buy-sell transactions, price is based on the purchase and sale of assets, Profits are made by utilizing assets, of course, but actually the assets purchased are only incidental to the future profits of the new business.

Capitalized value is the capital value that would bring the stated earnings at a specified rate of interest. The rate used is usually the current rate of return for investments involving a similar amount of risk. The capitalized value is found by dividing the annual profit by the specified rate of return expressed as a decimal.

Assume for the moment that the future profits of a business have been projected for the next 5 years and are estimated to average $20,000 a year. (This is in addition to compensation for the services of the buyer and any members of his family.) What should be the sales price for the buy-sell transaction?

If this investment were as safe as Government bonds that yields 6 percent, the buyer should be willing to pay 333,000 ($ 20,000 / 0.06 ). If the investment is considered as safe as an investment in an excellent corporate stock that earns 10 percent in dividends and price increases, the buyer should be willing to pay $200, 000 ( $ 20,000 / 0.10 ).

Very few small businesses, however, have as low a risk factor as these two investments. What rate, then, should be used in capitalizing the earnings of a small business? Usually, 20 to 25 percent is considered adequate. This means that the buyer should pay between $80,000 and $100,000 for this business. If it earns the projected $20,000 a year, the buyer will recover his initial investment in 4 or 5 years. This time will be extended by income taxes to be paid on the income, but this would also be the case for most alternative investments except nontaxable securities.

In using a computation such as this, the importance of long run profits should be kept in mind. Unless profits are possible over a long period of time ( 10 to 15 years), investment in a small business may be a poor decision. The trend of profits is also important. If all other factors are the same, a company whose profits are declining is worth less than one whose profits are increasing.

## Valuing the Business on the Basis of Asset Appraisal

The majority of buy-sell transactions are based on a value established for the assets of the company. This approach is not recommended, but if it is to be used, the suggestions that follow should be considered. A most important point is to find out early in the transaction just what assets are to be transferred. Usually, the seller has some personal items that he does not wish to sell. Prepaid insurance, some supplies and the like, in addition to cash, marketable securities, accounts receivable, and notes receivable usually are not sold. If the buyer does purchase the receivables, the seller may guarantee their collection, but such a guarantee should be established.

The assets most commonly purchased in a small business buy-sell transaction are merchandise inventory, sales and office supplies, fixtures and equipment, and goodwill.

**Evaluating goodwill.**

One of the assets that must be considered in a buy-sell transaction is goodwill. Goodwill, in a general sense, arises from all the special advantages connected with a going concerns good name, capable staff and personnel, high financial standing, reputation for superior products and customer services, and favorable location.

From the accounting point of view, goodwill is the ability of a business to realize above-normal profits as a result of these factors. By above-normal profit is meant a higher rate of return on the investment than that ordinarily necessary to attract investors to that type of business. The value of goodwill can be computed in either of the following ways:

**1. Capitalization of average net earnings.** As explained above, the amount to be paid for a business may be determined by capitalizing expected future earnings at a rate that represents the required return on investment. The difference between this amount and the appraised value of the physical assets may be considered the price of goodwill.

This method uses only earnings in computing the price to be paid for the business, For that part of the calculation, it ignores the appraised value of the assets.

**2. Capitalization of average excess earnings.** This method recognizes both earnings and asset contributions. It starts with the appraised value of the assets and computes what would be a fair return on that value. If the estimated future earnings are higher than this "fair return," the difference between the two figures - the "excess earnings" - is capitalized at a higher rate, and the amount thus obtained is considered the goodwill value. This figure is added to the appraised value of the assets to give a price for the business.

Payment of excess earnings is often stated in terms of "years of purchase" instead of in terms of capitalization at a certain interest rate. Capitalization of average earnings at 20 percent is the same as payment for 5 years' excess earnings.

As the above discussion shows, the determination of goodwill usually reflects the value of profits that will be realized by the buyer above the normal rate of return; that is, the excess profits. But most small businesses that are for sale do not have excess profits. They usually show nominal profit or none at all. Often the seller makes an offer that seems quite good, but the buyer must be able to eliminate the seller's emotions and reduce all facts to workable relationships.

If there are excess profits, goodwill is usually valued by capitalizing them at a fixed percentage established by bargaining between the seller and the buyer. The capitalization percentage needs to be high because profits higher than a normal return are difficult to maintain. Excess profits of $4,000 capitalized at 10 percent will give a goodwill value of $40,000 ( $4,000 / 0.10 ). Capitalizing the same excess profits at 20 percent gives a goodwill value of $20,000 ( $4,000 / 0.20 ).

Though goodwill valuation is the first asset valuation to be discussed here, it is normally the last to be computed. Since few small businesses being sold are producing excess profits, the problem of goodwill value is not a pressing one in most buy-sell transactions.

**Merchandise inventory.**

In a service business, placing a value on the inventories is a minor problem; but in distributive and manufacturing businesses, the inventory is likely to be the largest single asset. A manufacturer, for example, has three inventories - raw material, work in process, and finished goods - and each of them presents different problems in valuation. The distributive company has only one inventory, called merchandise inventory.

The financial statements presented by the seller will probably reflect an inventory value different from the one assigned in a buy-sell transaction. Inventories are usually carried on the books either at cost or at the lower of cost or market. Market is defined as the current replacement cost to the seller.

In determining the value of inventories, the seller has to chose a method of arriving at cost. The most common costing methods are first-in-first-out (FIFO), last-in-first-out (LIFO), and average cost. These methods may give very different values and the buyer and seller must arrive at some value agreeable to both. The most common methods used in valuing inventories for buying and selling small businesses are cost of last purchase and current market price.

The quantity of the inventory is usually determined by a physical count. The physical inventory procedures should be decided before the count, and each inventory team should include one representative from the buyer and one from the seller. It is easy to omit items from the inventory count, and here the seller is usually in a more vulnerable position than the buyer. There is more danger of omitting items from the count than of double counting them.

It may be that some items of inventory are not to be sold. If so, these items should be segregated before the count begins. Another problem is determining what quality of items are to be included in the inventory. The buyer needs to be cautious when examining the inventories - in most buy-sell situations there is some inventory that is not salable. This is one reason why the buyer should employ as his representatives on the inventory team individuals who are acquainted with that type of inventory. If the buyer and the seller disagree on the value of certain items, the seller will remove these items from the list of inventory for sale.

When the inventory is being priced, be very careful in matching price to quantity. Be sure that the units in which the quantity is recorded and the units priced are the same. The physical count should be recorded in duplicate so that buyer and seller can each make separate extensions after all prices have been listed. After independent extensions, the two inventories should be reconciled.

**Manufacturer's inventory.**

When a manufacturing company is being exchanged, the raw materials inventory is taken and priced like the merchandise inventory of a distributive business. The work-in-progress and finished-goods inventories may present a problem. Usually, there is no market price or cost of last purchase to relate to these inventories; consequently, the seller’s cost is generally used for establishing prices.

If the seller has unused plant capacity or if his plant is inefficient, his costs may be inflated. Such a situation requires the help of an accountant with a good knowledge of cost accounting.

**Store supplies and office supplies.**

These two items are usually quite small. They should present no problem, though some of them may have no value to the buyer if the name of the company is to be changed. After the usable supplies have been determined, a physical inventory should be taken and priced as in the case of the merchandise inventory.

**Property assets and accumulated depreciation.**

The property-asset account normally reflects the cost of the assets reduced by a provision for depreciation. In many small business buy-sell transactions, no real property is exchanged, because the plant site is leased. The problem of establishing a value on real estate is not as acute, anyway, since the market value for real property does not fluctuate as widely as the market value for personal property, It is customary to have an independent appraiser establish a value for real property.

Appraisers' findings on real property are usually more acceptable to both parties than personal-property appraisals - the real property may have multiple uses, whereas personal property consists of single-purpose assets. The book value of real property will be close to the appraisal value unless the property has been held for a long period of time or unusual circumstances have caused sudden and drastic changes of real-property values.

**Personal-property assets.**

The buyer may feel that he knows going values of the personal property and decide not to retain an independent appraiser. In addition, many individuals believe that cost or book value is a good place to begin negotiations for personal property. However, because of the many methods of computing depreciation and also because of conflicting ideas about capitalizing costs, the cost or book value may not reflect a value that is agreeable to both parties.

It is difficult to assign a value to personal property equipment because these assets have little value if the company is liquidated. Therefore, a going-concern value should be determined. The price to be paid for this equipment should be somewhere within the range of the cost of new equipment or the cost of comparable used equipment. For this reason, an independent appraiser can be useful, particularly if he is acquainted with the type of equipment being sought or sold.

The seller should realize that he may own assets that do not appear on the fixed-asset schedule. Many companies have a policy of not capitalizing any assets below some arbitrary amount ($200 or $300). A complete physical inventory should be taken.

If the assets are numerous and geographically dispersed, the seller may be asked to prepare a certified list of the assets giving description and location. The buyer can then test the list by verifying only selected assets at the time of the sale, but with plans to verify all of them within a certain period of time.

The value of personal-property assets is usually decided after considerable bargaining. It is better to assign values to individual assets rather than to make a lump-sum purchase of assets. In a lump-sum purchase, there is more chance of overlooking some asset values.

The buyer should try to determine the condition of the assets as well as repair and replacement requirements. If he doesn't establish the condition of the assets individually, repair and possible replacement costs may create an unexpectedly heavy drain on his working capital.

## Income Tax Consequences

Income tax consequences of the buy-sell transaction may be an important bargaining issue if the buyer and seller are aware of them. The seller should be concerned about the amount of tax he will have to pay on his gains from the sale. The buyer should be concerned about the tax basis he will acquire as a result of the transaction. These concerns almost inevitably lead the buyer and seller into conflict in valuing the business.

The income-tax laws are highly technical, and the possible variations in a buy-sell situation are infinite. Because of this, a discussion specific enough to be really helpful is impossible here. Both buyer and seller should study the applicable tax laws ; and if an important decision in the buy-sell agreement is to be based on income-tax consequences, the advice of an income-tax expert should be sought. The key to tax savings is tax planning before the buy-sell contract is closed.

The seller should keep in mind that he must report any income-tax liability he incurs by selling a going business. Reinvesting the sales proceeds in another business will not enable him to avoid or postpones his income tax liability.

## A Valuation Example - the Regal Men's Store

This example will help to bring the factors discussed about into better focus. It is not intended to show what should be done but to give some idea of what might be done.

**The buyer and the seller.**

Joe Critser is interested in buying a men's clothing store. He has had nearly 25 years' experience in the men's clothing trade - first as a salesman in retail stores and more recently as a sales representative for Sentinel, a major manufacturer of men's clothing. Now 45 years old, Critser is interested in having a store of his own.

In February, Critser learns that the Regal Men's Store is for sale. James Rombaugh, owner and operator of the store, is now 67 and wants to retire, he says. He has no heirs, and no employee of the store is financially able to purchase the business. Rombaugh started the store in the late sixties and has been the sole owner since than.

**The store.**

Critser's early investigation convinces him that the store has the kind of possibilities he is looking for. Although it has been operated conservatively, it has a good reputation in the community and a creditable standing in the clothing trade. The store has never been particularly aggressive in advertising, the owner has relied on repeat patronage and word-of-mouth advertising.

Critser suspects that part of Rombaugh's desire to sell is due to competitive pressure from more aggressive stores in the community. Sales have continued to increase about in proportion to the market in general, but gross margin and profit have been reduced because of lower overall maintained markup and increasing costs of operation. Rombaugh owns the inventory, fixtures equipment, and operating supplies and leases the building at 5 percent of net sales, with a minimum payment of $ 1,000 a month. The current lease will expire in about 4 years.

**The preliminary discussion.**

Rombaugh has been well impressed with Critser and agrees to furnish necessary financial information. In their discussion to date, Rombaugh has stated that he feels the business is worth about $100,000 for the purchase of inventory, fixtures, equipment, and goodwill. He will retain all accounts receivable, but he is willing to allow the new owner an 8 percent fee for outstanding accounts receivable collected after the transfer of ownership has been completed.

He also wants to keep a few assets for which he has a sentimental attachment, such as a massive roll-top desk purchased when the store was first opened. Rombaugh will assume responsibility for payment of liabilities outstanding at the time of sale.

Critser, on the other hand, feels that the business is worth somewhat less than $ 100,000. It is obvious to him through casual inspection that some of the inventory is worth less than the original purchase price, and he doubts the value that Rombaugh would place on goodwill. He also notes that some of the display equipment is outmoded and needs replacement.

Before accepting or rejecting Rombaugh's price, Critser suggests that he be permitted to make his own evaluation of the business on the basis of past financial records and an appraisal of the assets. Rombaugh agrees. Following are the major elements of Critser's investigation and appraisal :

**Past sales**

XXX1 - $220,000

XXX2 - 228,800

XXX3 - 238,000

XXX4 - 247,600

XXX5 - 257,600

**Forecast sales - XXX6**

$265,000 - Critser's estimate of sales, which includes a somewhat smaller increase than the average of 3.2 percent per year between XXX1 and XXX5.

$268,676 - Rombaugh's estimate based on the average.

**Five-year operating statement**

XXX1 XXX2 XXX3 XXX4 XXX5

Sales $220, 000 $228, 800 $238, 000 $247, 600 $257, 600

Cost of goods sold 139, 980 146, 432 159, 260 160, 940 167, 440

\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_

Gross margin 80, 020 82, 368 78, 740 86, 660 90,160

Operating expenses\* 62, 420 66, 352 62, 674 70, 566 74, 704

\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_

Profit 17, 600 16, 016 16, 066 16, 094 15, 456

\* Includes owner's salary.

**Projected operating statement for XXX6**

CRITSER ROMBAUGH

(Buyer) (Seller)

Sales $265, 000 $268, 676

Cost of goods sold 172, 250 174, 640

\_\_\_\_\_\_\_\_ \_\_\_\_\_\_\_\_

Gross margin 92, 750 94, 036

Operating expenses\* 76, 850 75, 766

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Profit 15, 900 18, 270

\* Includes estimate of owner's salary.

**Balance sheet of Regal Men's Store as of January 31, XXX6**

**Assets**

Cash on hand and in bank $ 20, 000

Accounts receivable $ 32, 000

Less estimated un-collectible $ 4, 000

$ 28, 000

Merchandise inventory $ 49, 214

Sales and office supplies $ 1, 920

Fixtures $ 20, 000

Less estimated depreciation $ 5, 600

$ 14, 400

Equipment $ 19, 000

Less estimated depreciation $ 8, 600

$ 10, 400

Miscellaneous assets $ 1, 280

Total assets $125, 214

**Liabilities**

Accounts payable $ 11, 000

Payroll and sales tax payable $ 1, 300

Total liabilities $ 12, 300

James Rombaugh, capital $112, 914

**Net worth**

Total liabilities and net worth $ 125, 214

**Salable assets**

Inventory at current book value $ 49,214

Sales and office supplies $ 1,920

Fixtures, current depreciated value $ 14, 400

Equipment, current depreciated value $ 10, 400

Total salable assets $ 75, 934

**Valuation of inventory and appraisal of fixed assets**

CRITSER ROMBAUGH

Inventory by physical count $ 47, 514

90 percent valued at current prices $ 42, 762

5 percent valued at 75 percent of current prices $ 1, 782

5 percent valued at 50 percent of current prices $ 1,188

Inventory - appraised value $ 45, 732 $ 47, 514

Usable office supplies $ 1, 680 $ 1, 680

Fixtures - appraised value $ 13, 600 $ 13, 600

Equipment - appraised value\* $ 9, 400 $ 9, 400

Total assets-appraised value $ 70, 412 $ 72,194

\* Independent appraiser. Excludes assets to be retained by Rombaugh.

## How much to pay?

If Critser feels that his return on investment should be capitalized over 5 years, his offering price, based on anticipated profits for the year ahead, would be $79,500 (5 years=20 percent per year; $15,900 / 0.20=$79,500 ). If, on the other hand, the purchase was based on the appraised value of assets only, the purchase price would be $70,412 plus any provision for goodwill.

1. Since both of these figures are well below the suggested price of $100,000, negotiation will be necessary. Here are some questions that might arise :
2. In light of future sales and profit possibilities, are the assets worth more than the sale price?
3. Is the risk less than Critser anticipates? To pay $ 100,000, he would have to reduce his risk level to between 6 and 7 years.
4. Is Rombaugh's price too high in the light of future sales and profit possibilities under new management?
5. How much confidence does Critser have in his ability to realize an acceptable return on his investment?
6. Is the actual value of this business as a going concern closer to $68,000, $80,000, or $100,000?
7. How much is the goodwill of this business actually worth to Rombaugh? To Critser?
8. What kind of compromise might be satisfactory to both the buyer and the seller?