The Importance of Knowing the Value of your Small Business

By Bruce Hakutizwi

Knowing the value of your business is important even if you don't have immediate plans to sell. This is for one primary reason: the financial value of your business is the most accurate way to gauge if you're going in the right direction.

Valuation can be used as a powerful indicator of how you manage your business. Evaluating the worth of a business can reveal the effectiveness of the owner's strategic decision-making process and track performance based on estimated change in value, not just in revenue. Estimated value is also useful for business owners to develop succession, estate or personal retirement plans.

A common saying is that business valuation is an art, not a science.

That's because value depends on many factors, including years in business, number of employees, the amount and condition of the equipment, facilities, supplies and inventory, customers, customer relationships and the stability of earnings.

Types of Valuation

Valuation simply means the process of determining the current worth or value of an asset or company, according to Investopedia. The three most common methods of business valuation are the **asset approach, income approach and the market approach**.

The **asset approach** adds up all the assets and then depreciates them accordingly. Assets include actual physical property such as furniture, buildings and equipment as well as intellectual property including patents, trademarks and even incorporation papers. The challenge with this method is that asset-based valuations can over-simplify the process and neglect the value of the company's earnings potential. That is why asset-based valuation is a common method for the sale of defunct businesses and liquidations, but not as common for thriving companies.

The **income approach** calculates the net present value of the income generated by a business. This method projects future cash flows and discounts them to arrive at their value in present dollars. The discount rate is larger based on the age of the company and future earnings instability. A variation of the income approach entails determining the company's earnings before interest, taxes, depreciation and amortization (known as EBITDA) and multiplying the total figure by a certain factor.

The **market approach** is the most subjective, comparing the business to others of similar size in the same industry. Essentially, it estimates a company's earning potential based on theoretical demand in the market. This approach doesn't project cash flows or calculate rate of return. It evaluates businesses that have actually sold and compares the sales price to a particular business metric, such as revenue or earnings.

For most small businesses, the multiple-valuation method is usually the best because it includes variables that can add significant value. Known as "goodwill," these variables can include an established customer list, market conditions and experienced employees.

Bottom line: The easier it is for a new owner to acquire the business and continue generating revenue, the more valuable the business.

Who Should Determine Value?

If you are seriously thinking about selling, then using an outside, professional business appraiser or broker to value your business is essential.

The cost to conduct a comprehensive business valuation can range from a few thousand dollars to $50,000 or more. It is important for the process to be conducted objectively by a qualified professional based on facts. As economic cycles and market conditions change, so can business value – and it can be useful to update the process and valuation every few years.