Small Business News WASHINGTON

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BUSINESS SOLUTIONS

Putting a price tag on your business

Is there a generally accepted formula for determining the market value of a company? What is it?

Arthur Lander
CPA and attorney
Arlington

There is no one formula for valuing a business. A number of methods are used depending on a host of reasons.

One is the excess-earnings method. Though originally developed by the Internal Revenue Service, it is one of the easiest methods and is used most often to value small businesses.

Take, for example, a company with $200,000 in net tangible assets and projecting $40,000 in earnings next year. The projected earnings include a reasonable salary for an employee to replace the owner-manager.

First, you must find a reasonable rate of return on the company's assets. Consider what percentage you would be charged by a bank to borrow money to buy your assets. In our example, we have assumed 14 percent. Multiply 14 percent times the net tangible assets of $200,000. You have now found the reasonable return: $28,000.

Second, subtract $28,000 from the projected earnings of $40,000. The $12,000 is your excess earnings.

Third, determine your capitalization rate. This is done by valuing your business using a rating scale on certain categories. Examples of the categories are the nature of the business, management quality, market position and reputation. We will use three as a multiple. Now, multiply three times the excess earnings of $12,000, which equals $36,000.

Finally, add the $36,000 to the net tangible assets of the company, $200,000. The value of a business is $236,000.

There are many different methods for valuing a business. We have all heard the joke that you can have five lawyers in one room and six different opinions. Unfortunately, this is one example where valuators are as bad as attorneys.

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