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From: Joe Mierendorf, Sue Cobb, and Mark Reed

RE: **Valuing Your Business**

Business owners will frequently ask "How much is my business worth?" They may be looking towards a sale for retirement or gifting to the next generation. Whatever the purpose, there are several ways to arrive at the answer.

A common approach to determining the value of a business is to use the net cash generated from the business before interest, income taxes, and depreciation (EBITDA.) That amount is then multiplied by a "factor." The factor depends on many things; for example, the type of business, technology changes, business cycles, how the consolidators are affecting prices, and the profitability of the business compared to the industry. Our experience says the factor is generally going to be somewhere between three and eight times the adjusted EBITDA. When these numbers are used, keep in mind that a buyer is looking to the future and calculating how long it will take to pay for the business.

Simply using net income may be deceptive, because every business owner treats discretionary items differently. In a profitable business, owner salaries, benefits, and other discretionary items are typically larger than average, and the reverse is true of an under-achieving business. It is common to find non-operating expenses and/or income that need to be adjusted to arrive at a net income figure that can be utilized in the above computation.

Not all business values are based on net income. We often find that the value of a business with extensive equipment and a modest net income will be based on the net value of the assets. A good example of this is excavators. This valuation approach is called the asset method.

A third approach to valuing a business is the market approach. This method is preferred when there is comparable information on similar businesses that have been sold in the past (the market.) The challenge for small businesses is that public information available is generally for big companies that are traded on the stock exchanges. Noted exceptions to this are statistics gathered by industry organizations.

The three approaches are starting points. To complete the assessment of business value, we need to ask if a controlling interest or a minority interest is being sold. The value of a minority interest is lower than a controlling interest, since a minority owner usually has very little influence over the affairs and decisions of the business. Business value is also affected by the availability of markets for the particular business.

If you have questions about this topic or others in our series, please give our office a call.

*Other memos include:

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