

Determining and Increasing Business Value



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Business owners naturally are interested in the value of their businesses. In this article, we provide a brief description of the primary approaches to valuing a closely-held business (asset, market, and income approaches), elaborate on the income approach, and offer some brief thoughts on how to increase the value of one's business.

Under the **asset approach**, a valuation analyst looks to the underlying assets and liabilities of the business (whether recorded on the company's balance sheet or not) and aggregates them to arrive at a value of the business. An asset approach is instructive for businesses whose primary value is derived from its financial assets and tangible assets (e.g. inventory, equipment, real estate), but it often fails to adequately capture the value of an entity's intangible assets (e.g. customer relationships, trade names, patents, assembled workforce, and goodwill, for example) because they often are difficult to separately value.

The **market approach** relies heavily on comparison and substitution to derive value estimates. Much like a residential real estate appraiser does in valuing houses, a business appraiser attempts to find other businesses (for which there are known trading prices) that are comparable to the business being appraised and then uses those prices to estimate the value of the subject company. Because the values used in this approach are rooted in real-world transactions, this approach often results in the best estimate of fair market value. However, it often is difficult to identify reliable comparable companies or transactions due to the unique features of the subject company and frequent lack of available information about the comparable companies.

Due to limitations of the asset and market approaches, the **income approach** often is the best approach for valuing closely-held businesses. The income approach reflects that the value of a business is equal to the sum of its future cash flows discounted to present value. It recognizes that a buyer is willing to pay a price today in exchange for future cash flows and a seller is willing to forego future cash flows in exchange for a current price. Employing the income approach requires a forecasted stream of future cash flows and a discount rate with which to convert the future cash flows to present value. The discount rate represents a rate of return investors would require considering risks associated with achieving forecasted cash flows.

To derive an appropriate discount rate, the analyst considers rates of return historically required by investors owning similar businesses, taking into account the unique strengths, weaknesses, opportunities, threats, and risks associated with the subject company relative to those of the similar businesses.

Note that higher cash flows and lower risks yield higher values. Thus, a business owner can increase the value of his business by taking steps to increase cash flows and to reduce risks. Ways to increase cash flows include growing revenues, reducing expenses, optimizing working capital levels, and optimizing the capital structure of the business. Risks can be reduced through customer, supplier, and product diversification, cross-training of employees, management succession planning, geographical expansion, and a host of other initiatives. Each of these strategies requires proactive planning, purposeful implementation, and time to realize the benefits.

If you are considering a sale of your business in the next few years or in increasing its value, please contact one of the members of our forensic accounting and [business valuation](#) group.

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