Advantages and Disadvantages of Valuation Methods

There are many different methods for valuing a business, with some better suited to a specific type of business than others. A key task of the valuation specialist is to select the most appropriate method for valuing a particular business. The method chosen should provide a reasonable estimate of value, be suitable for the intended purpose and be able to face legal challenges by the IRS or other opposing parties.

As a part of the process, a valuation specialist will often employ several different methods and average the results to arrive at a “ballpark” estimate. Because each method has strengths and weaknesses, business owners and their advisors should be familiar with the most commonly used valuation techniques.

**Net Asset Value**

The value is based on a sale at fair market value (FMV) of the firm’s assets on a going-concern basis.

- **Strengths**
  - Data required to perform the valuation are usually easily available.
  - Allows for adjustments (up and down) in estimating FMV.
  - Suitable for firms with heavy tangible investments (e.g. equipment, land).
  - Helpful when the firm’s future is in question or where the firm has a brief or volatile earnings record.

- **Weaknesses**
  - Can understate the value of intangible assets such as copyrights or goodwill.
  - Does not take into account future changes (up or down) in sales or income.
  - Balance sheet may not accurately reflect all assets.

**Discounted Future Earnings**

The value of the firm is equivalent to the capital required to produce income equal to a projected future income stream from continuing operations of the firm. The rate of return used is adjusted to take into account the level of risk assumed by a buyer in purchasing the business as a going concern.

- **Strengths**
  - The value of the firm is based on projected future results, rather than assets.
  - Can be used with either net earnings or net cash flow.
  - Useful when future results are expected to be different (up or down) from recent history.
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- **Weaknesses**
  - May understate the value of balance sheet assets.
  - Discounts the valuation based on the level of risk. A business perceived as riskier typically receives a lower valuation than a more stable business.
  - Projections are not guarantees; unforeseen future events can cause income or earnings projections to be completely invalid.

**Excess Earnings (Treasury Method)**

The value of the firm is determined by adding the estimated market value of its tangible assets to the capitalized value of projected income resulting from goodwill.

- **Strengths**
  - Takes into account both tangible and intangible assets.
  - Includes projected future values of income resulting from goodwill.

- **Weaknesses**
  - Relies on estimate of period for which goodwill is expected to last, which is often difficult to assess. Projections based on this value can be unreliable.
  - May understate future revenues or value of intangible assets.
  - Though based on IRS rulings, the IRS cautions that the method can be relied on “only if there is no better basis therefore available.”

**Capitalization of Earnings**

Value is equivalent to the capital (invested at a reasonable rate of return) required to generate an income equal to an average of the firm’s recent, historical results.

- **Strengths**
  - A simplified approach that arrives at an easily determined value.
  - Does not rely on projections, but on an average of results from the recent past.
  - Most useful for businesses with stable, predictable cash flows and earnings.

- **Weaknesses**
  - May understate value for firms using aggressive strategies to reduce taxable income.
  - May overlook value of tangible or intangible assets.
  - Reliance on past earnings may ignore potential future growth.