

Duvall & Associates, Inc.

Taking Care of Business

VALUATION RULES OF THUMB

"A simple rule of thumb...expect the unexpected." Ringo

Business managers often ask about the possible existence of a simple rule of thumb formula by which a business value may be easily (translated - cheaply) calculated. The correct response is generally "well there may be such a formula, but it is simply a guideline, and should never be used in isolation of other methods."

Such formulas typically function best in industries with large numbers of reported transactions, dominated by competitors with similar internal resources, selling products/services which are relatively homogenous in nature. Think food franchises, accounting firms, real estate brokers and even dental practices.

Such formulas tend to be very simplistic in application - as exemplified by accounting practices which are often valued at "one times annual gross revenues plus working capital".

The utter simplicity of the formula is certainly attractive, but its limitations are immediately obvious as well.

Take for example, two separate accounting firms - each with \$500,000 sales - but one earns \$150,000 profit and the other loses money. Under the rule of thumb formula - both would be worth the same \$500,000 (1 X sales) - but clearly the first business is worth more on examination of the profits differential.

Despite these limitations, drilling down into the historical construct of the formulas usually reveal underlying rationales which clarify the source reasoning for the rule of thumb model.

And quite often, the formula itself drives owner expectations, which in turn drives the market. If accounting owners acquired their business for "1 X sales", then they naturally expect to receive "1 X sales" when it is their turn to negotiate a price.

Finally, heed an additional word of caution. Many of these rule of thumb formulas are based upon data which predate the current recession, which has obliterated many financial models in its wake - witness real estate appraisals. This tear in the fabric of history casts another layer of doubt on the current applicability of such historically-fabricated formulas.

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