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Whether New Worth is the "Value" of the Business ?

This is one of the most common questions asked or referred by the client. If we are already preparing the Balance Sheet of our Company, then we know its net worth. So obviously this net worth should be the valuation of the company.

However, the truth is very different. And it is ***"there is vast difference between the Net Worth of the company and its Valuation".*** Before we understand the reasons for the same, let us analyze first the definitions of both these terms –

Net Worth or Net Book Value with respect to a Business Enterprise is nothing but the difference between total assets and total liabilities as they appear on the balance sheet or it is sum of paid up share capital and free reserves.

As against this, Business Valuation is the act or process of determining the value of a business enterprise or ownership interest therein.

Following can be given as the few examples of why there is a vast difference between the Net Worth of the company and the Valuation of the company –

- While net worth or book value is generally based on the historical cost, valuation is generally based on Fair Value or Fair Market Value.
- Contingent assets or liabilities do not appear in the Balance Sheet and hence are ignored for the purpose of net worth calculations unlike valuation exercise where they may be considered.
- Certain internally generated intangible assets viz. branch or R&D costs etc. may not appear in the balance sheet, but for determining valuation of the company these assets are of the crucial element of the business undertaking.
- While Balance Sheet & thereby net worth is based on past performance, valuation exercise looks at the future business potential as well.
- Capital structure and shareholding pattern may not affect the net worth but becomes crucial in valuation exercise depending upon the purpose of valuation.
- Even the human resource capital may also be one of the important aspect which is considered in valuation but is ignored in net worth calculations.
- Several non financial factors viz. obtaining of new license, trade mark or termination of important contracts drastically affect the valuation but may not affect net worth as on particular date.

Then whether it means that Balance Sheet is of no use for the purpose of Valuation ?

This is also not true and we should not discard the balance sheet completely for valuation exercise. Rather, Balance Sheet or the Net worth can be the starting point of the valuation exercise. Valuation exercise generally adopts three approaches, of which Asset based approach is one of the common approach.

Under this approach, adjusted net asset method is popularly used where starting point of the valuation exercise is the net worth of the company based on the latest balance sheet. To this, adjustments are made to assets and liabilities to reflect realizable value, net of tax obligations. While doing so, even the liabilities not provided for or assets not accounted for may also be taken into consideration.