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One Company, Three Values – Science, Art or Magic

The Evolution of Business Valuation

The valuation of closely held businesses had its origin in the 1920's when Prohibition was enacted. Alcohol related businesses were forced to close and needed a method or process to determine their losses. From humble beginnings in the early 20 th century business valuation has developed into a professional consulting service niche in which the certified public accountant has added great value.

There are many reasons for needing to determine the value of closely held businesses. A few of the more common reasons are mergers and acquisitions, buy/sell agreements, capital infusions, ESOPs, gift taxes, estate planning and taxation and eminent domain proceedings.

Conceptually, valuing a closely held business is simple; define the valuation engagement, gather the necessary information, analyze the information gathered, estimate the value of the business and finally prepare and issue a valuation report. Unfortunately we do not practice in a conceptual environment.

The business valuation process has matured over the years. It is part Science and part Art. There is considerable disagreement within the business valuation community as to the actual weight given each component.

What Is Value

There are many types of value: social value, ethical value, moral value, religious value, sentimental value, economic value and commercial value. In an effort to move from art form to a more logical structure based primarily in science the business valuation community has developed three basic Standards of Value: “Fair Market Value”, “Fair Value” and “Investment/Strategic Value”.

Fair Market Value is the most widely recognized and accepted standard of value. It is defined in IRS Revenue Ruling 59-60 as: “The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge or relevant facts.”

Fair Value is a legally created standard and can vary from state to state. The Uniform Business Corporation Act has been adopted by many states. The act defines Fair Value as: “with respect to a dissenter's shares, means the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable."

The International Glossary of Business Valuation Terms defines Investment Value as "value to a particular investor based on individual investment requirements and expectations."

One Company/Three Values

The most critical step in the valuation process is to identify the purpose for which a business is being valued. One company can have multiple values depending on the purpose of the valuation assignment.

To illustrate the point of one company, multiple values, we look at the valuation of a fictitious company. Flushing Corporation is a closely held small business. The company is a plumbing contractor incorporated in the state of Confusion, USA .

Flushing Corporation is owned primarily by Tom and Karen Pipes. The Pipes have controlling interest in company. They hold 90% of the outstanding shares; the remaining 10% is owned by Jim Neversatisfied, who is Tom's brother-in-law.

The business valuation community recognizes three basic methods of valuating a closely held business: the Asset Based Approach, the Income Approach and the Market Approach. Considering all facts and circumstances the valuation professional retained to value Flushing Corporation has determined that the Income Approach is the appropriate method to use.

Gift Tax Purpose

In the first scenario Tom and Karen Pipes wish to "gift" 10% of their holdings in Flushing Corporation to their only child James. For gift tax purposes the IRS requires Fair Market Value as the Standard of Value.

Using the Income Approach (more precisely the "discounted future earnings" method), following generally accepted valuation procedures and applying the "Fair Market Value" standard the valuator determines the value of Flushing Corporation to be $200.00 per share on a control basis.

Again, after considering all facts, circumstances and exercising professional judgment the valuator determine it appropriate to apply a 20% "lack of control" (minority interest) discount and a 35% "lack of marketability" discount. After adjustments for the allowable discounts the value of Flushing Corporation for gift tax purposes is determined to be $104.00 per share.

Stockholder(s) Disagreement

In this scenario Jim Neversatisfied, Tom's brother-in-law and minority stockholder is unhappy. He feels that Tom is not treating him fairly by the way Tom exercises his controlling interest in Flushing Corporation.

Jim and Tom agree to disagree; and the dispute finds its way into state court where Judge Knowitall decides it would be in everyone's best interest for Tom to buy out Jim's 10% minority interest in the company.

As in the first scenario the valuation professional determines that the Income Approach is the appropriate method to use in the process. But the purpose for the valuation changed. Because there is a dispute between a controlling shareholder and a minority shareholder the law(s) of the state of Confusion control the “Standard of Value” that must be applied. By state law the professional valuator is required to use “Fair Value” as the standard.

The valuation process used in the first scenario is repeated in the second scenario; only the Standard of Value changed. The law(s) of the state of Confusion do not permit discounts for “lack of control” (minority interest) or “lack of marketability”. Applying the “Fair Value” standard, as dictated by the law(s) in the state of Confusion, the valuator determines the value of Flushing Corporation to be $200.00 per share.

Mergers and Acquisitions

In scenario three Tom is approached by a competitor, Frank Mustgrow. Frank would like to merge his company with Tom's or make an outright purchase of Flushing Corporation. Tom would like to retire in the near future; therefore, if the price is right he is willing to sell his controlling interest.

The valuation professional selects “Investment Value” as the appropriate Standard of Value. Combining the two companies creates both economy of scale and synergy. The new company will be able to undertake larger projects, exponentially increasing revenues, while at the same time eliminating duplicate administrative and overhead cost.

After taking into consideration the increased projected future cash flow generated by the combined companies the valuation professional applies the “Income Approach” method and determines the “Investment Value” of Flushing Corporation to be $265.00 per share.

Conclusion

There is a multitude of elements that must be considered in the valuation of a closely held small business. The most important of these is to consider the purpose for which the business is being valued.

Conceptually, valuing a closely held business is simple. But in the real world we practice in defining the valuation engagement, gathering the necessary information, analyzing the information gathered, estimating the value of the business and finally preparing and issuing a valuation report is hard work.

It seems almost “magical” for one company to have three different values at the same time. Fair Market Value ($104.00) is calculated to be 48% less than Fair Value ($200.00). Investment Value ($265.00) is 33% greater than Fair Value and two and one-half times greater than Fair Market Value. How can this be possible?

Business valuation practice and theory is influenced greatly by the Internal Revenue Service, the Department of Labor, State and Federal Courts, the Financial Accounting Standards Board, The National Association of Certified Valuation Analysts, American Society of Appraisers, Institute of Business Appraisers , American Institute of Certified Public Accountants and the International Association of Consultants, Valuers and Analysts. The academic community also plays a significant role in the evolution of the business valuation process.

With so many governmental institutions, courts, professional organizations and academicians having significant influence in the business valuation process is there any wonder why we find “one company, three values”.