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ESTABLISHING THE VALUE OF A BUSINESS: HOW THE PRACTITIONERS DO IT

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ABSTRACT

The value of a business can be determined in several different ways. The question posed in this study is whether or not the background of a business evaluator tends to influence the method of valuation. Business practitioners of varying backgrounds were surveyed as to methodologies generally employed. It was discovered that accounting and financial consultants tend to prefer present value techniques using discounted cash flows or multiples. Business and real estate agents and brokers look toward appraisal of physical assets or net worth. Small business owners and managers are also likely to apply asset based methodologies. The strategic implication of these findings suggests that care should be taken when selecting professionals to perform valuation services since varying approaches often yield different results.

INTRODUCTION

Various models have been developed for placing a value on a business, yet the process continues to elude researchers seeking to identify a common methodology. As many as 30 or more model variations have been identified as methods in use ranging from simple rules of thumb to complex cash flow discounting and trend analysis (Waldron & Hubbard, 1991; Burns & Walker, 1991; Martin, 1990).[1] The rationale for the selection of one method over another depends on whether a business is being evaluated for liquidation, inheritance, taxation, bank loans, for sale as a going concern, or for acquisition purposes.

For the small business seller, this implies that too high a value might be placed on a business that had relatively extensive assets, but low cash flow, especially if the value were placed by the owner or a realtor. Long time association with a business may cause focus on the visible assets, and neglect of the somewhat intangible future discounted to the present.

Alternatively, for the buyer of a business, if the value depends mainly on discounted value of future earnings, then knowledge of the discount rate and the rationale for determining that rate become critical. A low rate implies low risk and maybe an excessively high value. Also, physical asset values help limit the downside risk associated with a business. In the event of liquidation, physical assets may cover the debt.

[1] *The Valuation Reference Manual by Thomas J. Martin (1990) lists and describes 28 methods of valuation. Additional methods have been described by other authors.*

Selecting a method of valuation, however, is often left to the discretion of advisors and consultants hired to assist in whatever transactions are pending. Practitioners employed for this purpose may include accountants, bankers, financial advisors, commercial lawyers, business brokers, small business center consultants, and the owners and managers of small business concerns. These practitioners have widely varying backgrounds, experience levels, professional credentials, and business perspectives.

The question posed in this study is whether or not the background of a business evaluator tends to influence the method of evaluation. Stated as a hypothesis, the valuation model utilized is related to the type of practitioner employed in the process. Evidence supports this notion. Implications of such a finding are also discussed.

BACKGROUND

Business valuation preferences among practitioners may depend on their position in the profession. Richards (1986) states that during the valuation process, conflicting information developed by outside consultants frequently differs from the direct experience of managers. DeThomas (1985) points out that the firm's managers or outside analysts are faced with the unpleasant choice of attempting judgmental extrapolations or using conceptually unsubstantiated rules-of-thumb when developing a value estimate of the firm's worth. Owens (1989) notes that appraisers with similar areas of expertise tend to use similar methods of appraisal. Studies conducted by Block (1985) and Waldron and Hubbard (1991) appear to support this hypothesis.

Speyer (1987) feels that persons who sell their business need the kind of third-party advice and guidance offered by professional middlemen to offset the advantages possessed by more experienced corporate buyers. Clugston (1987) stresses the value of employing the services of business brokers and other outside professionals when arranging for the sale of a business. Lammers (1991) illustrates the unique perspective that a consultant can bring to the valuation process.

Recent evidence suggests that when outside advice is desired, the preferred groups of business professionals selected for conducting valuations are Certified Public Accountants (CPAs) and business brokers (see Table 1). Thus, practitioners most likely to be involved in the valuation process may be categorized reasonably as one of three types: (1) accounting and financial consultants, (2) business and real estate agents or brokers, and (3) small business owners or managers. These three categories of practitioners have sufficient differences in business orientation, background, education, or professional preparation to justify their selection as subsets of a population for the purposes of inquiry.

Table 1

Business Professionals Preferred by Owner or Manager Placing a Value on Small Business

Business Professional	Number of Respondents
Certified public accountant	7 (41%)
Business broker	4 (23%)
Financial advisor	2 (12%)
Other (lawyer, small business center, etc.)	2 (12%)
Prefer to do own evaluation	2 (12%)
	n = 17*

**The above responses are based on the question: In choosing someone to place a value on your business, which one of the following would you be most likely to select?*

BUSINESS VALUATION TECHNIQUES

Carland and White (1980) and Waldron and Hubbard (1991) suggest that business valuation techniques can be divided into three categories. While Martin (1990)[2] and others list a variety of methods applied in different situations, they generally constitute a mix or variation of the major categories described below and as noted in Table 2. The survey referred to earlier revealed the following regarding each of the primary methods of valuation.

Table 2

*Major Categories of Business Valuation Techniques**

1. APPRAISAL OF PHYSICAL ASSETS OR NET WORTH:

This category has been referred to as the net asset approach and includes methods involving the appraisal and listing of assets and liabilities as the prime determinants of value. Variations include book value, market value, replacement value, and liquidation value.

<u>Determinants of Business Value</u>	<u>Extent of Use</u>**
Fair market value	(92%)
Replacement cost	(42%)
Book value	(21%)
<u>Physical Asset Valuation Methods</u>	
Independent audit or appraisal	(82%)
Sight count of physical inventory	(52%)
Financial reports	(42%)

2. MULTIPLES OF EXPECTED PROFIT OR REVENUE:

This category has been referred to as the income multiplier or earnings multiple approach. Typically, a factor determined by industry standards is used as a multiple of gross income, net income, profit, or revenue to arrive at value. This approach is based on the idea that the value of a firm can be estimated as some number of years of earnings.

<u>Methods of Computation</u> (Profit or Revenue)	<u>Extent of Use</u>**
Fair market value	(38%)
Weighted average	(29%)
Technique developed in-house	(33%)
<u>Applications of Multiple</u>	
Applied to profit	(75%)
Applied to revenue	(25%)

(Multiples are normally based on industry averages and range from 2 to 10 when applied to profit, or 1 to 6 when applied to revenue.)

* *Entrepreneurship Theory and Practice (1991, Fall), 44-47.*

** *Some percentages total more than 100% due to multiple responses and are based on representative samples from industry practitioners.*

[2] *The methods described in Martin's Valuation Reference Manual (1990) are fixed price, tangible book value, adjusted tangible book value, multiple of earnings, discounted future earnings, liquidation value, and replacement value.*

Table 2 Cont.

*Major Categories of Business Valuation Techniques**

3. PRESENT VALUE OF FUTURE EARNINGS OR DISCOUNTED CASH FLOW:

This category has been referred to as the discounted cash flow or discounted future earnings method. This method and its variations are based on the premise that future earnings can be estimated and discounted to the present value using an appropriate discount rate, or in some cases, a required rate of return.

Methods of Computation (Future Cash FLows)	Extent of Use**
Prior years modified by expected future conditions	(50%)
Prior years adjusted for inflation and growth	(38%)
Prior years projected without adjustment	(12%)
Cash Flow Projections	
Two years into the future	(7%)
Three years into the future	(33%)
Four to six years into the future	(60%)

* *Entrepreneurship Theory and Practice (1991, Fall), 44-47.*

** *Some percentages total more than 100% due to multiple responses and are based on representative samples from industry practitioners.*

Appraisal of Physical Assets or Net Worth

A profile of the degree of importance of various assets emerges from respondents using physical assets or net worth as the primary valuation method. This category is preferred by brokers, agents, and small business owners. The particular assets viewed as most important are physical assets, location, and customer base, with tradename, key personnel, and goodwill regarded as less important.

Multiples of Expected Profit or Revenue

While a smaller number of respondents prefer multiples of expected profit or revenue to place value on businesses, those that do are primarily accounting and financial consultants. According to the survey, they generally require three to six years of past business performance figures, and apply something other than a simple average to determine expected annual profit or revenue.

Present Value of Future Earnings Using Discounted Cash Flow

The number of respondents in this study using present value or discounted cash flow techniques is about the same as the number using multiples of expected earnings. As with multiples, this appears to be a preference among accounting and financial consultants. In this category, three to six years of past business performance figures are generally required. The specific techniques applied by these practitioners include required rate of return applied to future annual earnings, and discount rate applied to future annual earnings. A lesser number used a simple tally or sum of anticipated annual earnings.

PRIOR STUDIES

Two studies deserve special mention for providing strong evidence that valuation methodologies may be influenced by the business orientation of professionals in the field. Block (1985) conducted a survey of 39 small business owners and managers of which 10 used outside consultants to determine business value. Most of the owners and managers performing their own internal valuations preferred asset-based methods (16 out of 29) or simple multiples (9 out of 29). Yet, the consultants favored the present value approach, or a related method known as capitalization of earnings.

Waldron and Hubbard (1991) found similar differences in approach when they selected two groups to evaluate an actual business. One group consisted of investors made up of entrepreneurs, venture capitalists, and investment bankers. A second group consisted of consultants and included business appraisers, CPAs, and valuation specialists. Of the 18 participants, 8 were regarded as investors and 10 were regarded as consultants. All but one of those in the investor category applied an earnings multiple approach to the valuation of the business, while the majority of those in the consultant category used a discounted cash flow method.

From these studies it appears that accounting and financial consultants may be more likely to adopt techniques focusing on financial reports and projections of earnings, while business brokers and real estate agents may be more likely to adopt asset valuation techniques emphasizing net worth. Small business owners, on the other hand, may be less focused on specific techniques and prefer simple multiples of profit or revenue to obtain "rule-of-thumb" notions of business value that can be applied often without extensive analysis. Buying and selling strategies are likely to be affected if alternate valuation methodologies can be associated with business practitioners of varying backgrounds.

METHODOLOGY

A survey of small business practitioners was conducted to determine how professionals in different fields approach the vexing problem of business valuation. A questionnaire was developed and pre-tested with the assistance of local practitioners.

Information from the Small Business Administration and other sources was used, and a mailing list was compiled to include practitioners most likely to be involved in the evaluation of small businesses. It consisted of approximately equal numbers of accountants, financial consultants, business brokers, real estate agents, small business managers and owners. The list of small business owners is a random sample from *Ward's Directory*, and consists of businesses with less than $10 million in sales. The survey included all major regions of the country with names selected at random to assure even distribution. Ultimately, a total of 600 recipients was selected to receive the questionnaire.

Initially, 59 questionnaires were returned (10 percent response rate). A follow-up mailing to a randomized sample of non-respondents brought the response rate up to 12.5 percent. Much of the mailing occurred during the tax season and may have affected response rate. Respondents having no experience with business valuation were excluded, so that the number of acceptable questionnaires was 64.

FINDINGS

The sample included 25 accounting or financial consultants, 22 business and real estate agents or brokers, and 17 small business owners or managers. The valuation process constitutes less than 50 percent of the respondents' business activity. Seventy-seven of those surveyed have more than 10 years experience. Table 3 lists the types of businesses valued in order of percentage response. These professionals are involved in a variety of property and business valuation activities applied primarily to service, retail, and manufacturing firms.

Table 3

Types of Businesses Valued by Practitioners in Survey

Type of Business Valued	Number of Respondents
Service firms	44 (69%)**
Retail firms	43 (67%)
Manufacturing firms	41 (64%)
Commercial structures	21 (33%)
Land	19 (30%)
Residences	12 (19%)
Farms	8 (13%)
Other	10 (16%)
	n = 64*

**The above responses are based on the question: On which of the following types of properties or businesses are you involved in placing a value?*

***Percentages total more than 100% due to multiple responses.*

Of the three primary methods of business valuation, professionals who perform these services are divided as to which they prefer. A cross-tabulation of practitioner category and preferred business valuation technique is presented in Table 4. Business valuation techniques appear to be related to practitioner categories in specialized business services.

Table 4

Cross Tabulation of Business Service Practitioners with Preferred Methods of Business Valuation by Number Responding

Practitioner Category	Appraisal of Physical Assets or Net Worth	Multiples of Expected Profit or Revenue	Present Value of Future Earnings Using Discounted Cash Flows	TOTAL
Accounting & Financial Consultants	3	10	12	25
Business & Real Estate Agents & Brokers	14	5	3	22
Small Business Owners & Managers	10	3	4	17
TOTAL	27	18	19	64

Notes: Chi Square = 8.67 $df = 4$ $p = .07$
(Some cells contain less than five values, thus limiting the significance of a Chi-Square test.)

SUMMARY AND DISCUSSION

This study, applied to a sample of 64 business practitioners, lends further support to the suggestion that different practitioners use different methods when valuing small firms. Accounting and financial practitioners responding to the survey tend to prefer profit and present value techniques, while business brokers, owners, and managers tend to prefer appraisal of assets over other methods. Although these results are limited to the respondents in this study, biases toward a particular valuation approach appear to be a function of familiarity and background. If true, this may be explained by the fact that accountants and financial consultants work regularly with financial records and reports. Their experience may lead them to rely on these documents as indicators of value. Alternatively, real estate agents and brokers, as well as small business owners, focus daily on what they can see. This experience may lead them to prefer physical assets as a major indicator of business value.

These findings are consistent with observations made by Waldron and Hubbard (1991) where investors and financial consultants indicated a strong preference for discounted cash flow and multiple of earnings techniques. By contrast, the majority of participants in the Block (1985) study were owners or managers performing their own internal valuations, and most of them used asset-based approaches.

It may be that specific variations within the major categories of valuation can also be ascribed to different types of users or the types of businesses they value. But this study by itself is not sufficient to conclude that the background or experience of a business evaluator tends to influence the method of valuation. Further research will be needed for these results to be verified.

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