Attorney's Handbook of Accounting, Auditing and Financial Reporting

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CHAPTER 16 Accountants' Support Services to the Legal Community

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§ 16.02 Types of Assistance

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[3] Business Valuations

[a] Overview

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A major investment characteristic is whether the business interest conveys control over the underlying entity or is principally a passive, non-controlling equity investment (often called "a minority interest"). The value of a controlling interest often is greater than a minority interest, as it has the power to direct the operations and financing of the business. The difference between these two values is called either the "premium for control" or the "minority interest discount." Another important investment characteristic is whether the business interest represents an interest in a private company. Both controlling interests and non-controlling interests in private companies may be subject to discounts for lack of marketability, as they are not marketable as similar interests in publicly traded entities.

[b] Methodologies

A business valuation usually consists of three analyses: (i) a "qualitative" analysis through which the accountant learns about the business to understand its strength and weaknesses; (ii) a "quantitative" analysis which consists of a review of the business' historical financial statements for three to five years and its financial projections, to understand the company's recurring earning power and risks; and (iii) a "pricing" analysis.

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The pricing analysis, in turn, has three general approaches: (i) the "market" approach, (ii) the "income" approach, and (iii) the "asset' approach. The selection of a particular pricing method is based on the unique characteristics of the interest being valued and the purpose for which the valuation will be used.

Although the pricing analysis is essentially quantitative, the numbers that result are only as good as the evaluator's business acumen and understanding of the entity and its industry. The more the accountant and attorney involved in a business valuation

can assess future concerns and opportunities, the more useful the estimated values determined are likely to be. For example, certain new environmental laws hold both past and present owners of businesses liable for clean-up costs - sometimes regardless of whether or not they were responsible for any damage - and the professionals who are valuing a business in these circumstances must consider the potential liability. Independent expert advice, (e.g., in the area of environmental law) may be necessary to assist in handicapping and quantifying this contingent liability.

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[c] The Market Approach

In the market approach, the independent accountant determines the value of a business ownership interest through comparisons to similar interests. The two most common methods are the "guideline company" method (also known as the "comparable company" method) and the "guideline transactions" method (also known as the "comparable transactions" method). These methods compare the interest being valued to publicly available information for either publicly traded companies or for contemporaneous acquisitions. Based on these comparisons and the pricing multiples of the guideline companies and the guideline transactions, pricing multiples are developed for the interest.

The independent accountant uses market and transaction data for companies with similar characteristics and activities to the extent that comparable ratios can be found. In some cases, however, it is difficult to locate companies that are, in fact, comparable.

[i][ii] and [iii] [Methodologies related to the Market Approach explained.]

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[d] The Income Approach

The income approach determines the value of a business through capitalizing expected benefits, such as future income and asset distributions.

[i] and [ii] [Methodologies related to the Income Approach explained.]

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[e] The Asset Approach

The asset approach determines the value of a business or business interest using the value of the underlying assets of the business, less its liabilities.

[i] and [ii] [Methodologies related to the Asset Approach explained.]