Business Valuation Explained

By Robin McGregor

It is often said that business valuation is a black-art and that the value of a business is what someone will pay for it. Set out below is an explanation of how the process of valuation is guided by international standards that apply equally to business valuation and the difference between value and the payment made in any transaction.

The process of valuing any asset should follow the principles laid down by the International Valuation Standards Council (IVSC), which are recognised as best practice in most jurisdictions around the World. Here in the United Kingdom, the IVSC principles are enshrined in the property valuations conducted by the Royal Institute of Chartered Surveyors. For business valuation there is no similar organisation in the United Kingdom. However, in Canada the Institute of Business Valuers provides a specific Chartered Business Valuer qualification (CBV) and other international bodies such as The Association of Chartered Certified Accountants (ACCA) also have formal business valuation qualifications (Accredited Business Valuer (ABV), as do the United States based American Society of Appraisers (ASA).

Whatever, the professional body all promote the IVSC definition of valuation as an objective estimate of the worth of an asset at a point in time and is based on the factors that the valuer has chosen to be representative of likely purchasers. However, the price paid by a purchaser may be more or less than the value placed on the asset for a great many reasons, some that should have been considered by the Valuer and others that are known only to the purchaser. Although, a business valuation is likely to include elements of subjective judgement, these should be clearly stated and supported by evidence. If Valuers adopt these principles then it is easy for those comparing valuations to see and understand the impact of changes in the valuation assumptions and for Valuers to agree between themselves the areas of disagreement in a constructive fashion.

What is Value?

There are different measures of value and different approaches to the measurement of those values, which is why the first question that a valuer often asks is, what is the purpose of the valuation. The answer to that question is likely to influence the choice of valuation methodology that is appropriate. For an active trading business, a commonly used metric is ‘fair market value’ and this can be defined as: the highest price, expressed in terms of cash or cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm’s length in an open and unrestricted market, when neither is under any compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. Fair market value implies a calculation that should be carried out in light of the prevailing market conditions at the specific date of the valuation, whereas, ‘Fair Value’, is generally interpreted to cover a broader period of time around the date of the valuation, so that temporary dips or increases in value are discounted.

Value is determined at a specific point in time. As such, it is a function only of facts known and forecasts available at that point in time. This reflects the reality that businesses are fluid and the future is uncertain. The commercial world is in a constant state of flux. A management team can influence or control few of these factors and the wider economic conditions are likely to affect customers and suppliers in different, unpredictable ways. Any of these changes will have an impact on the business and hence on its value.

The value that a potential purchaser ascribes to a business is prospective and reflects the return that they expect to make on their investment. These returns are measured in cash terms so, should be adjusted for any taxes that may be due. Therefore, a purchaser is interested in the future after-tax profitability of a business rather than in its past performance. However, for valuation purposes and business planning generally, past performance is generally regarded as a reasonable basis upon which to base forecasts of

future profitability. In assessing the value of a business, a valuer will discount some of the expected future profitability based on their evaluation of the risks that are likely to either improve or hinder the forecast level of profitability.

Value and Price

In the terminology of valuation, 'price' is factual and can only be established by offering an asset for sale and concluding a bargain. In contrast, value represents the worth of an asset, given the economic and business conditions prevailing at the time, accepting that the asset was not or is not offered for slae at that point in time. These principles apply to all valuations, whether for prospective actual valuations or to a notional valuation being prepared in relation to some date in the past. The variation between value and price arises because, in theory and in practice, each potential purchaser will have different intentions for a business and its assets; a different financing structure; a different tax position and perhaps even a different tax rate. Therefore, the post-acquisition after-tax cash flow is likely to vary been potential purchasers and consequently, the value that each purchaser places on a business will be influenced accordingly.

Additionally, the market for a business is not a perfect one. So, the price that a purchaser is willing to pay is likely to be affected by a range of subjective factors. The starting point will, of course, be the value that the potential purchasers have calculated, but will also reflect the length of time that the business is marketed, the aims and intentions each purchaser has for the business post-acquisition, the level of interest in the business and of course, the respective negotiating skills of the parties. A price can also be heavily influenced by the degree of compulsion on either the buyer or the seller.

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