VALUATION APPROACHES

There are three fundamental approaches to valuing a business entity. They are the Asset Approach, the Market Approach and the Income Approach. Each of these approaches is discussed below.

Asset Approach

The Asset approach values a business based upon the underlying values of its assets. It is typically used when the business owns substantial assets and its value is more attributable to those assets than the value of its earnings stream.   A good example is when a business owns substantial real estate, or machinery and equipment. When applying the Asset approach, typically a market value is assigned to each asset of the business in order to arrive at the total fair market value of assets. This may require separate appraisals for certain types of assets. Once the total fair market value of the individual assets is determined, the liabilities of the business are then subtracted from the total to arrive at the business value. It is typically more appropriate to use the market value for the assets, rather than their book value, since the utilization of book value does not normally represent the amount the owners would be able to realize upon disposition of the applicable Asset.

Market Approach

The Market approach is based upon the premise that the value of an entity can be estimated by utilizing data from other entities sharing similar characteristics. One type of Market approach utilizes the analysis of publicly traded companies that may be similar to the subject entity, which are known as guideline companies. By applying financial ratios and benchmarks attributable to the guideline company, the value of the subject entity is then estimated. A second market based approach involves the examination of sales transactions for similar companies, and applying such to the valuation of the subject entity. The Market approach is difficult to apply when valuing small closely held entities because it is exceptionally difficult to find guideline companies that are truly similar. In addition, it is often quite difficult to find reliable data pertaining to similar companies that have been sold. One reason for this is that most closely held companies, which are sold, do not publish the relevant financial data related to the sale. Accordingly, the Market approach is often difficult to apply to closely held corporations.

Income Approach

The Income approach is based upon the premise that the value of a going concern entity is equal to the present value of the income that it will earn in the future. There are two primary types of Income approaches, which are the Income Capitalization Method and the Discounted Cash Flow (DCF) Method. The Income Capitalization Method calculates the value of the entity by applying a Capitalization Rate to Normalized and Weighted Historical Earnings. It functions under the premise that historical earnings are generally indicative of future earnings and thus are a valid basis for calculating the entity value. In contrast, the DCF Method involves projecting estimated earnings for the future on the basis that they will be substantially different than historical earnings have been. Both the Income Capitalization Method and the DCF Method, function under the premise that the value of the entity is attributable to its future earnings. The distinguishing factor between the two, is that only the Income Capitalization Method works from the premise that the historical earnings are generally indicative of what the earnings will be in the future. Both Income approaches rely on the principle that a buyer of the entity is primarily concerned with the entity's earnings.