The Gambler: Understanding the Risks and Factors in Business Valuations

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1. VALUATION APPROACHES

Businesses generally fall under two categories: those that are viable going concerns, and those that are not viable going concerns. A business will be categorized as a viable going concern when it is expected to continue operations into the foreseeable future. A business will not be categorized as a viable going concern when it is expected to be wound up, it is in financial distress and/or cannot, or it is expected that it will not, be able to meet its financial obligations.

This paper will discuss commonly accepted valuation approaches applicable to the valuation of viable and not viable going concern businesses. Our discussions will consider the methods that business valuators frequently use, and that underlie these valuation approaches. We will also describe the three types of valuation reports that are prepared by Chartered Business Valuators ("**CBV**"), and discuss the differences between each type of report. Finally, we will provide examples of certain inputs, on which valuation conclusions can depend, or to which they may be sensitive.

A. Going concern valuation approaches

Where a business has been determined to be a viable going concern, there are three primary going concern valuation approaches that are often used by business valuators: asset approach, income approach, and market approach.

I. Asset approach

When valuing a business using the asset approach, the main objective is to restate the amounts captured in the business' balance sheet at their fair market values, and in doing so, to reflect the true economic value of all assets and liabilities of the business being valued.

In applying this approach, the business valuator starts with the balance sheet of the business, as reported in the financial statements, and adjusts all assets and liabilities to their fair market value. Next, where applicable, the business valuator makes additional adjustments to the business' intangible value (if any), e.g., from a previous business acquisition.

This approach is most often used in situations where a business' value is primarily driven by the underlying assets of the business (i.e. real estate or financial investments), or said differently, the business has little to no commercially transferrable goodwill.

II. Income approach

Under this approach, the business valuator measures the value of the future cash flow/income expected to be received by the shareholder(s) of the business. Future cash flow/income is estimated

and converted to value using a rate of return appropriate for the risks associated with achieving the expected cash flow/income.

Common methods under the income approach include: the discounted cash flow, the capitalized cash flow, and the capitalized earnings methods.

III. Market approach

Using this approach, the business valuator determines the fair market value of a business based on comparable public companies and/or transactions involving comparable companies/businesses. While this approach can provide practical indications of value, it can be inherently limited due to the difficulty with identifying appropriately comparable public companies and/or transactions involving comparable companies.

B. Liquidation approach

The liquidation approach is almost always used in instances where a business is not viable as a going concern. The liquidation value represents the business valuator's conclusion of the money that will be left over to the owner(s) of the business, on an after-tax basis, subsequent to an orderly disposition of the business' assets, after having repaid the business' liabilities.

2. VALUATION METHODS

A. Asset approach

I. Adjusted net book value method

The Adjusted net Book Value method ("ABV") is the main method used in the application of the asset based valuation approach. It is applied under the assumption that the business will continue as a viable going concern.

When the expected cash flow of a business is insufficient to support a value in excess of the value of the business' net assets (i.e. the business has no "goodwill"), the ABV method is used.

Said differently, the ABV method will be used to value businesses that derive their value from their underlying tangible assets, e.g., a holding company that has no active business operations but owns real estate, cash, public or private company shares, or other financial investments.