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Knowledge of business valuation techniques and methods is often a necessary ingredient in litigation. Valuations may be required in a variety of situations where legal rights are asserted, including divorce, oppression of minority shareholders, other shareholder disputes, partnership dissolution, probate matters, taxation appeals, contractual disputes, etc. This article provides some guidance on the valuation principles, techniques and methods involved in shareholdings in companies, including private closely-held companies.

METHODOLOGIES

There are several different approaches to and methods of company valuation analysis, and an expert should address each of with a view to choosing the method most appropriate to the specific circumstances. It is essential to select the most appropriate methodologies and the relevant types of analysis to achieve a competent valuation.

The courts have recognised that valuation is not an exact science, and that expert valuers can, with perfect legitimacy, hold widely differing opinions as to the value of the same item. For example it has been held that a valuer was not negligent in valuing an asset for more than it subsequently realised where the result was “within a proper bracket of valuation”.¹ In another case,² a margin of 15% was considered a reasonable margin of error where the property was unusual and it was difficult to achieve a level of precision as a result.

APPROACH TO BUSINESS AND SHARE VALUATIONS

To be complete, any description of a method of valuation to be used should specify the appropriate:

- Premise of value;
- Standard of value; and
- Discounts to be applied for lack of control and lack of marketability.

Premise of value

The premise of value depends on the future of the subject business: will it continue to operate as a going concern or will it be liquidated? And if the latter, will it be an orderly liquidation or a forced liquidation? The answers to these questions can have a dramatic impact on value. Before embarking on a detailed valuation exercise, it is essential to decide which of the two fundamental bases is to be used. These are the liquidation basis, which arrives at the value of what remains after all assets are sold and all debts are paid, and the going concern basis, which considers goodwill and the company’s ability to generate cash flow and income in the future.

¹ *Axa Equity & Law Home Loans Ltd v. Goldstack & Freeman*, [1994] 1 E.G.L.R. 175.

² *Private Bank & Trust Company Ltd v. S (UK) Ltd* [1993] 67 P. & C.R. 166.

Valuation standards

Valuation standards include fair market value, open market value, book value, historic cost etc. Each standard has its own advantages and disadvantages.

Various valuation standards, together with the different premises of value, are described in summary terms in Table 1 below.

Table 1: Valuation terminology and standards of value	
Term	Definition
Valuation standards	
• Book value	Value of net assets (<i>i.e.</i> assets – liabilities) as shown in the financial accounts or books of the company, usually on the historic cost basis
• Depreciated historic cost	Book value (see above) on the historic cost basis
• Depreciated replacement cost	Price or cost to replace by purchasing a similar asset equivalently worn out
• Fair value	Value in an arm's length transaction between informed and willing parties
• Fair market value/open market value	Value assuming all willing market participants are informed adequately of the proposed sale and of the details of the property
• Historic cost	Original price paid for the asset
• Intrinsic value	What an asset ought to sell for, considering its potential future cash flow to an investor / owner
• Net present value	Value of future stream of earnings/payments based on today's monetary values
• Net realisable value	Value that could be obtained if the asset had to be sold, less all marketing and selling costs
• Replacement cost / price	Price it would cost to replace assets in the business
• Value in use	Value of asset to the business based on its continued use in the business
Premise of value	
• Going concern value	Price assuming the business will continue in operations and will not significantly curtail its operations
• Forced sale value	Price that could be obtained if seller was forced to sell it now
• Liquidation value	Cash received by owners were business put into liquidation

METHODS OF VALUING BUSINESSES

There are three general perspectives from which to choose, any two or all three of which may be used to establish value: the asset approach, the income approach and the market approach. These approaches and methods of valuation are summarised in Table 2.

Different approaches to valuation give different results. In the US the courts have rejected valuations that did not give appropriate weightings to a variety of factors such as net asset values, earnings and dividend-paying capacity.⁹ US courts have

⁹ *Andrews v. Commissioner* 79 T.C. 938 [1982].

accepted that price earnings multiples of public companies can help to assess the fair market value of a closely held company – but should not be the only method used. A valuation should not rely solely on one method or approach to value, but rather on a combination of approaches.¹⁰

Table 2: Methods of valuing businesses

Asset perspective

Market value

Book value

Adjusted book value

Liquidation value

Income perspective

Discounted cash flow

Capitalisation of earnings

Excess earnings / super profits method

Market approach

Earnings multiple/ price earnings approach

Recent purchase offers, and sales of comparable businesses

Assets approach to valuing businesses

The net asset value approach can be used to value a business either as a going concern or on a liquidation basis. It focuses on the company's balance sheet rather than its income or cash flow. Net assets valuations, incorporating the valuations of the underlying assets or divisions of the business, may be appropriate in some circumstances, *e.g.* when the value of the business is highly related to its assets rather than its performance and earnings. The asset approach is useful for a business that has substantial tangible and intangible assets and whose recent earnings may not reflect its intrinsic value (*e.g.* property companies, banks and start-up businesses).

The net asset value approach values the firm as the net value of the tangible assets (*i.e.* excluding goodwill) of the firm. The advantage of this approach is that the assumptions required by the expert are limited.

Discounted cash flow

Discounted cash flow is a method of valuation based on an income perspective (rather than assets or market perspective). Discounting future cash flows is generally the most comprehensive, and thus most widely favoured, approach (from a theoretical perspective) to determining the fair market value of a business. This approach is based on the generally accepted theory that the value of the business depends on its future net cash inflows, discounted to reflect the fact that they will be received at various times in the future.

¹⁰ *Ronald v. 4-Cs Electronic Packaging, Inc* [1985] 168 Cal App 3d 290, 214 Cal Rptr 225.

The discounted cash flow approach values the business as a going concern, estimating the present value by discounting all future economic income by a rate of return known as a discount rate. It involves sophisticated analyses and restrictive assumptions that require professional judgment. Future cash flows arising from the business are calculated at present value, based on a discount factor that takes into account the risk that the net cash inflows may be delayed or may be less than estimated.

Capitalisation of earnings

An alternative method of valuation based on the income approach is the capitalisation of earnings approach. This method is often applicable to a mature business (*i.e.* those likely to achieve relatively modest growth in earnings and net cash flows), but for high growth companies this method tends to be unacceptable because it only considers history and not future performance.

The capitalisation of earnings approach consists of measuring historic earnings, forecasting future earnings based on the past and then calculating the present value. The difference between this method and the discounted cash flow approach is that, for the purposes of the calculation, the estimated future earnings values are assumed to remain constant from year to year and to continue indefinitely. The assumption that future earnings remain constant allows the present value to be calculated easily.

The capitalised earnings approach requires that earnings be defined and that the appropriate discount rate be selected. In practice, the discount rate selected takes account of risk and can also incorporate an assumed constant rate of growth in earnings (e.g. based on an assumed future rate of inflation). It should be noted that a slight change in anticipated growth rate can have a dramatic impact on value. If the industry and business are performing strongly, it may be appropriate to choose an assumed growth rate higher than the rate of inflation.

Excess earnings / super profits method

This approach to valuing a company divides the value of a firm into two parts: the value of its tangible assets and the value of its intangible elements (*i.e.* goodwill, patents, customer lists, etc.). The value of intangible assets is determined using the excess earnings method. This method requires that, having identified and valued the tangible assets, a reasonable or 'normal' level of earnings, being a reasonable return on those assets, must be determined. This 'normal' profit is then compared with the actual profit of the business, adjusted to take account of once-off or unusual factors. The adjusted maintainable profit less the 'normal' return on the tangible assets represents the before tax excess income. This excess income is then capitalised using an appropriate multiplier and the resulting figure represents a valuation of the intangible element of the business. This is added to the value of the tangible assets to give a value of the company as a whole.

The selection of the appropriate before-tax capitalisation rate to be applied to the excess earnings is a key area of judgment in this approach. This rate or 'multiplier' is in effect an answer to the question: "How many years excess profits am I willing to pay for the intangible value of the business?"

Evidence of goodwill valuation in the courts is sparse.¹¹ There is a long established practice that goodwill should be valued using a multiplier in the range of one to five.¹² The choice within the range depends on a variety of factors including trading record, profitability, trend of profits, nature of the business, etc. If there are comparable companies with significant multipliers, and the company has solid expectations of continued growth and profitability, the market might reward such a company with a large multiplier.

The excess earnings method is particularly apposite where there are large intangible values such as in professional practices or services businesses. However, the method can be somewhat formulistic and should generally be used alongside another valuation method.

Earnings multiple / price earnings approach

The most commonly used method of valuing a business is using price earnings (p/e) ratios. The earnings multiple / price earnings approach is a method of valuation based on a market perspective and is heavily reliant on capital markets data, particularly on price earnings ratios of comparable companies.

The price earnings ratio is the market price per share divided by the earnings per share.¹³ It assumes that earnings (*i.e.* profit after tax) are similar to cash flows, and that the p/e ratio provides an approximation of the present value of future cash flows. Where available, the p/e ratios of comparable publicly quoted companies are used as a basis for the valuation of a company of similar size in the same industry and operating in the same markets. Taking into consideration the inefficiencies in the market, it is clear that quoted p/e ratios can only give a rough approximation to value.

The price earnings ratio is a multiple and represents the number of times' earnings investors are willing to pay for the firm. Earnings per share information is disclosed in the annual accounts of publicly quoted companies and the market price is available from the relevant stock exchange and in the business press.

The earnings multiple valuation approach has the advantage of taking direct market-generated information, and as such may reduce speculation and be more appropriate for use by the expert in assisting the court.

Dividend yield basis

The dividend yield basis is often used to value a minority shareholding. This recognises that minority shareholders are not in a position to direct the company or influence the distribution of dividends or the investment of retained profits. As a result, the cashflow value of such shareholdings generally derives from the right to receive dividends. The dividend yield method involves computing a capital value for

¹¹ *Reed v. Lowestoft Borough Council* [1973] 227 E.G. 835.

¹² McDermott, S. and Woulfe, R. *Compulsory Purchase and Compensation: Law and Practice in Ireland* (Butterworths (Ireland) Ltd, Dublin, 1992) p. 257.

¹³ An accounting standard, FRS 14 *Earnings per Share*, provides guidance on how earnings should be calculated. Earnings for the purpose of earnings per share are those attributable to ordinary shareholders and comprise consolidated profit after tax, minority interests and preference dividends.

the shares such that, when the dividends paid are expressed as percentage of this capital value, it produces a reasonable yield when compared with the yield that could be obtained from a comparable publicly quoted company.

CLOSELY HELD BUSINESSES

The determination of fair market value of shares in the case of a closely held company is more complex than the determination for a widely held public company. Frequently valuers of shares in closely held companies use as a guide the prices of publicly quoted shares of companies in the same industry. Valuation of shares on this basis is in fact a prediction of the future based on facts available at the date of valuation. This is because the prevailing share prices, and hence p/e ratios, of public companies reflect the market consensus as to the future for the company and its industry as well as market sentiment generally.

When shares are closely held, they are traded infrequently in an erratic market. As a result, some other measure of value may be appropriate. Nevertheless, when valuing shares that are not publicly traded, it is acceptable for the valuer to make comparisons with the prices of listed shares of comparable companies in a similar line of business, providing he also takes into account factors reflecting the essential differences between the company being valued and the public entity being used for comparison. In particular, a discount is usually applied to the value, calculated based on comparable quoted companies, to take account of the absence of a ready market for the shares. Other important factors to consider in valuing closely held shares are the company's earnings and dividend payout capacity, the history of the company from incorporation, the general economic outlook and the outlook for the specific industry, the book value of the shares, the financial condition of the business, previous sales of the shares¹⁶ and the size of the block of shares to be valued.

Premiums and discounts in private company valuations

Once the overall value of the business has been determined, a valuation adjustment or discount can be applied to specific ownership interests.

Premium for controlling interest

A controlling interest in a business is sometimes worth a premium over its *pro rata* value. A controlling interest can direct the company, determine compensation, and enforce the implementation of most key decisions. A premium might be paid for a controlling interest to reflect potential economies of scale, reduction in competition, or securing a source of supply or outlet for the company's products. Such a premium attaches to particular purchasers willing to pay over and above what the general purchaser would pay. A US court has, however, held that there should be no premium for a minority shareholding.¹⁷

¹⁶ In *McNamee v. Revenue Commissioners* [1954] I. R. 214, the sales price in a previous sale was taken into account by the judge in deciding a value for the shares.

¹⁷ *Estate of Bright v. United States* [1962] 658 F 2d 393 (Ct Cl).

Discounting valuations

There are at least two types of discount common in the valuation of private companies that decrease value:

- Discount for minority interest reflecting lack of control; and
- Discount for lack of marketability.

These discounts reduce the value of an ownership interest below its *pro rata* share of the business's overall value. Thus, how a company's ownership is divided can have a major impact on the value of any ownership interest. Discounts can range from five percent to over fifty percent, depending on the ownership interests being evaluated. In *re William Courthope deceased*¹⁸ a discount of one-third was applied to a 49% shareholding, whereas in a more recent case¹⁹ a 12½% discount was applied to the same percentage shareholding. In the case of *Re Castleburn Ltd*²⁰ the court upheld discounting of the value of a minority shareholding.

In *McNamee v. Revenue Commissioners*,²¹ Maguire J. held that in estimating the price which shares would fetch if sold in the open market, the court should have regard to the number of prospective purchasers the shares would attract, the earning capacity of the company, the dividend policy of the directors, the resources of the company, its capital and replacement requirements, its business difficulties and competitors, the nature of the trade and the inability to alienate the shares freely, once bought.

It is accepted that share values should not be discounted when sold pursuant to a court order under the oppression of minorities provisions (section 205) of the Companies Act 1963. Nourse J. set out the rationale for this.²⁴ This approach was implicitly approved by Barron J. in *Horgan v. Murray*.²⁵

LEGAL FRAMEWORK FOR VALUING COMPANIES AND SHARES IN COMPANIES

Valuations for litigation purposes must in general be carried out following principles developed through the courts. However, the courts have laid down few overriding principles in this area and the reported decisions of Irish courts have usually been very specific to the circumstances of the case in question. In addition, the basis of valuation of shares where a dispute arises, and the manner in which the valuation is performed, is often specified in a contract between the parties and the agreed terms will normally prevail (*e.g.* see *Horgan v. Murray*²⁶).

¹⁸ [1928] 7 A.T.C. 538.

¹⁹ *Battle v. IRC* [1980] S.T.C. 86.

²⁰ [1991] B.C.L.C. 89.

²¹ *McNamee v. Revenue Commissioners* [1954] I. R. 214.

²⁴ *Re Bird Precision Bellows Ltd* [1984] Ch 409; for the court of appeal see [1986] 2 W.L.R. 158.

²⁵ *Horgan v. Murray* [1997] 3 I.R. 23.

²⁶ [1997] 3 I.R. 23.

In some cases the court will determine the value of shareholdings.²⁷ A court will address the specific circumstances of the case in deciding on the appropriate valuation basis for use in proceedings. The going concern basis of valuation was considered in *Buckingham v. Francis et al.*²⁸ On the other hand, in the case of *Re Clubman Shirts Ltd* O’Hanlon J. said:

“...I take the view that the petitioner’s shareholding as of the 31 July 1980, was unsaleable in the open market; had no value if assessed on a dividend yield or earnings yield basis, and the petitioner must fall back on a net asset valuation basis to support a claim for payment when the shares are to be acquired by the parties resisting the claim.”³⁰

O’Hanlon J. added that the net asset valuation basis he was recommending should be based on a “break-up” basis and not in relation to their value to a company which could continue in business as a going concern”.³¹

Where a shareholders’ agreement or the company’s articles of association provide for an extra-judicial mechanism for valuing shares the courts generally decline jurisdiction and insist that the parties exhaust the ordained procedure.³²

The leading case on fair value is *Dean v. Prince*.³³ In this case, the court considered the valuation because the auditor had, in an attempt to achieve agreement, given reasons for his determination of the fair value of the shares. The auditor, in certifying a fair value for the shares, explained that he had not valued the company as a going concern as this would be inappropriate given the company’s persistent losses. The judge held the valuation invalid and not binding because the auditor had not attributed a premium to the shareholdings when they were a majority and controlling interest in the company. This finding was rejected by the Court of Appeal which supported the auditors view that the shares should be valued *pro rata* to the companies worth, which should not be based on a going concern valuation given the losses.

Concluding comment

It is clear from the discussion in this article that the valuation of businesses is anything but an exact science and is fraught with difficulty and complexity. The purpose of the exercise is not to reveal the exact value of the business – because in fact no such exact value exists – but rather to assist the court in an assessment of the likely value or range of values applicable in the particular circumstances. The courts will recognise readily that precision is not possible and will value greatly the opportunity to test the range of values proposed by reference to a variety of likely scenarios. While this poses a challenge to an expert accountant, as he needs to be extremely well prepared to give the necessary evidence, by the same token it allows him to demonstrate the real value of expert knowledge.

²⁷ *Colgan v. Colgan & Colgan*, HC unrep. 22 July 1993, per Costello J, *Re Clubman Shirts Ltd* [1991] I.L.R.M. 43, per O’Hanlon J, *Irish Press plc v. Ingersoll Irish Publications Ltd*, High Court of 13 May 1994, per Barron J.

²⁸ [1986] 2 All E.R. 738.

³⁰ [1983] I.L.R.M. 43, at 54.

³¹ *ibid.*, at 55.

³² *XYZ Ltd* [1986] 2 B.C.C. 520.

³³ [1954] 1 Ch 409.

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