PREPARING FUTURE-READY PROFESSIONALS

The Challenges in Valuing Small and Medium Sized Entities

The valuation of a small- and medium-sized entity (SME) can be a significant challenge. Valuation standards and business practices are usually founded on large enterprises' cases. Therefore, recognized methods need to be adapted when valuing an SME.

At the same time, small- and medium-sized practices (SMPs) - which are in many cases the professional adviser for small businesses - should comply with recognized standards, such as the International Valuation Standards (IVS) and other local standards, in order to provide their clients with qualified professional support and to provide a value that can be recognized by the parties that are involved.

This requires practitioners to master best practices, consider whether it is feasible to apply the recognized methods and, if so, to adjust the proposed formulas. Critical elements may include collecting all the relevant information, selecting the applicable valuation approach and analyzing the unique characteristics of the entity being valued.

The Collection of Information

The quality and quantity of financial and non-financial information of SMEs can be lower than those of large entities. SMEs, as private businesses, may not have a broad range of stakeholders and may not usually prepare financial reports for the financial community. For example, In some jurisdictions, financial statements are not audited and might represent the "tax value" more than a true and fair view of the entity's financial health.

These elements can reduce the reliability of financial statements and may imply a different perception of risk, especially when valuations are based on financial data. The practitioner should include these considerations in the valuation calculation.

The Selection of the Valuation Approach

Generally accepted business valuation standards (including the IVS), classify the valuation methods into three wide categories: market approach; income approach; and cost approach. The selection of the approach to be adopted can lead to different bases for the derived value.

Practitioners should consider which of the approaches can provide the most reliable value in relation to the characteristics of the entity and the information that has been collected. Each approach might present issues related to its application to SMEs.

The market approach determines the entity value by examining observable transactions of comparable entities (comparable transactions method) or by applying relevant "multiples" of value of comparable entities (guideline publicly-traded comparable method). In many circumstances, SMEs are "unique" and the appropriate comparison cannot be found. The guideline publicly-traded comparable method also starts with the analysis of relevant multiples produced by public companies, which - while considering enterprises that operate in similar markets – can operate differently. This can require some "usual" adjustments, such as the Discount for Lack of Marketability (DLOM).

The income approach, whose most popular and frequently applied method is the Discounted Cash Flow (DCF) method, is based on prospective financial information (PFI). SMEs may not produce a complete set of PFI. In this case, the practitioner should carefully assess whether it is feasible to apply a method requiring this kind of information. In general terms, the absence of reliable PFI precludes the adoption of DCF and other income approach methods.

In case appropriate PFI exists, the practitioner should consider the composition of the elements determining the discount rate to understand whether they should change any value to better reflect the related systematic and unsystematic risks, even if most of the corrections, such as the total beta, do not find a unanimous approval by the literature.

The cost approach is usually adopted by practitioners in specific circumstances or in connection with some measures representing the capacity to realize extra-income in the future. These latter mixed methods "share" the considerations mentioned above for the determination of prospective values and the appropriate PFI.

The Analysis of SME Characteristics

SMEs often present specific idiosyncrasies. In many cases, SMEs are family-run enterprises. 'The Role of SMPs Providing Business Support to SMEs' found that these enterprises often desire to maintain family control and usually attach considerable importance to non-financial objectives (e.g., reputation, image, culture of the business and life-work balance). This requires the practitioner to inquire about the features that could produce biases in the business valuation. This requires "normalizing" the entity.

For illustrative purposes, the board of directors may be composed of more people than necessary, as the members of the board reflects the composition of the family. Therefore, the relating costs might be higher than in normal circumstances. In this case, the practitioner should likely reduce the expenses allocated to the board. At the same time, there could be a confusion between corporate and personal affairs. The practitioner should, in this case, appropriately distinguish between both elements.

The SME could be personally managed by the owner. Will the entity have the same opportunities without that owner? The valuer should obtain appropriate information to express its opinion about this and to include their considerations in the prospective analysis.

Conclusion

In conclusion, valuing an SME can be more complicated than valuing a public company. SMPs should appropriately perform and consider the preliminary analysis that leads to the selection of the most appropriate method applicable to the specific circumstances in order to determine the estimate of the value in compliance with the recognized standards and in accordance with the purpose of the engagement.

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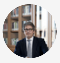
Matteo Pozzoli became a member of the Small and Medium Practices (SMP) Committee in January 2017. He previously served as Technical Advisor to SMP Committee Chair Giancarlo Attolini from 2008 to 2014. He was nominated by the Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili (CNDCEC). Mr. Pozzoli collaborates with CNDCEC's Research Department on national and international professional standards. He is Technical Advisor at the Corporate Reporting Policy Group of Accountancy Europe (formerly FEE), and is Associate Professor at the University of Naples Parthenope. Mr. Pozzoli has a bachelor's degree in business economics in public administration and is a chartered accountant and statutory auditor. He has contributed to numerous professional and scientific publications. See more by Matteo Pozzoli



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Raffaele Marcello is assistant professor in Business Economics at Pegaso Telematic University, where he teaches "Business administration and bankruptcies" and member of the Board of Trustees of the OIV - Organismo Italiano di Valutazione (the Italian Valuation Standard Setter). He has developed an extensive expertise in company law, contracts and tax matters, in the valuation of business units, medium and large joint stock companies, and in both the accounting and management control targeted at business acquisitions. He deals with mergers, acquisitions and winding ups of companies, and provides advice and assistance in the management of bankruptcy proceedings.

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