



## *The Valuation of Interests in Business Entities*

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**R**easonable values can be derived for business interests by adhering to valuation fundamentals and by using common sense.

Most people have heard the axiom that valuation is an art, not a science. This is especially true for business valuations where value depends not only on objective evidence, but on very subjective data such as the strength of management, the ability of the business to attract new customers and hypothetical investors' attitudes about the business.

In one case, the court held that valuation involves a "plaguingly elusive question of fact ... which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement."<sup>1</sup>

In other fields of appraisal, such as real estate, historical performance is often strong evidence of future performance. But in the valuation of businesses, expected future performance is often very different than historical performance. In most businesses, revenues and earnings vary considerably from year to year, making

the estimation of future revenues and earnings difficult. This is one of the reasons that the value of a business is often the subject of litigation.

### *Rules of Thumb*

Business appraisers are often asked "How much are businesses selling for?" (ie how many times net income, revenues, book value, etc.) An experienced business appraiser will answer that there is no one multiple or rule of thumb for which businesses sell. Businesses are as unique and complex as the people that run them, and as such, are not capable of being valued by a simplistic multiple or rule of thumb. Two businesses in the same industry with identical sales and earnings could have very different values. "Easy" valuations usually produce uneasy results.

### *Revenue Ruling 59-60*

Virtually every business appraiser is familiar with Revenue Ruling 59-60<sup>2</sup>. This ruling presents eight general factors that should be considered in the valuation of a closely-held business. Although the context of this ruling is related to gift and estate taxes, it has of-

ten been cited in divorce cases, damage cases, corporate dissolution cases, and a derivation is also used in employee stock ownership (ESOP) valuations.

These eight factors can generally be summarized as follows:

1. The type of business and company history.
2. The status of the national economy, and more importantly, the subject industry as of the date of valuation.
3. The financial position of the company.
4. The company's earnings record and potential.
5. The dividend history of the company, as well as the capacity it has to pay dividends.
6. Prior sales of stock and the size of the block of stock.
7. The existence of, or lack of, goodwill and other intangible assets.
8. The market value of the stocks of similar corporations, if any, whose securities are traded actively on the public market.

Although these eight factors provide some guidance, they are not exclusive. All relevant factors must be considered, utiliz-