

Factors to Consider When Valuing a Closely Held Company

By Michael E. Meegan

In Rev. Rul. 59-60, the Internal Revenue Service describes eight factors that should be considered when valuing a closely held company. These are:

1. Nature of the business and the history of the enterprise from its inception. Stability, growth and diversity of operations are assessed to measure its degree of risk.
2. Economic outlook in general and the condition of the specific industry in particular. Current and future economic conditions of the country's and industry's economies should be evaluated. The company is compared with competitors, and that industry is evaluated to see its competitiveness in the overall economy.
3. Book value of the stock and the financial condition of the business. Balance sheets should be examined for at least two years prior to the valuation. Financial analyses should be made to determine the company's liquid position, gross and net book value of fixed assets, working capital, long-term indebtedness, capital structure, and net worth. Trends should be evaluated. If more than one class of stock exists, voting rights, dividend preferences, and liquidation rights should be considered.
4. Earning capacity of the company. Income statements for at least five years prior to the valuation should be examined to discover basic information about revenues, operating expenses, and dividends paid on stocks. The character of the company's revenues and expenses should be evaluated to identify any activities that might be consistently operating at a loss. If available, future earnings projections are useful.
5. Dividend-paying capacity. Future ability to pay dividends should be considered, but is not necessarily correlated to past dividends paid. If a controlling interest is being evaluated, dividends are not a reliable source for evaluating value because payment of the dividends is determined by controlling shareholders.
6. Whether or not the enterprise has goodwill or other intangible value. Goodwill is primarily valued based on the earning ability of the company, but other factors such as trade or brand names, patents, copyrights, and prestige may also be factors contributing to intangible value.
7. Sales of the stock and the size of the block of the stock to be valued. Comparisons of sales of stock in other closely held corporations should be reviewed to determine whether they represented arms-length transactions. Whether the block is a controlling or non-controlling interest affects the value of the block.
8. Market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. It is helpful to use a comparison of actively traded stocks of similar companies. Similar companies will be in the same line of business, and will also have comparable capital structures and market position.