

THE VALUATION METHODS FOR SMALL AND MEDIUM-SIZED ENTERPRISES¹

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1. Introduction

Micro, Small and Medium-sized Enterprises (SMEs) hold a critical role for the economics of both developed and developing countries, significantly contributing to employment, gross domestic product (GDP) and exports. Firms that operate in Italy belong to the following dimensional classes: 95.2% are micro enterprises, 4.2% are small firms, medium-sized enterprises represent 0.5% and, finally, big companies are 0.1% (Istat, 2012) (according to the European Commission definition of 2003). In terms of contributing to value added, Italian SMEs are aligned to the European average; in fact, they produce 37.4% of value added versus 36.3% of European SMEs. But if the focus is on the individual firm categories, there are important differences between Italy and Europe: Italian micro enterprises produce 29.6% of value added versus 21.2% by European micro firms; Italian big companies make 33% of value added versus 42.3% of the European mean (Monducci, 2013).

The data highlights a clear need to promote both the qualitative and quantitative development of Italian firms, because restricted firm dimension reduces capability to effectively compete in the global markets. Firm growth and development are subjects of all times (Philipsen & Kemp, 2003); in fact, successful development processes would have a strong impact on the economic growth of a country such as the increase of employment, GDP and exports. In Italy, the overcoming of the current economic and financial crisis should have SMEs as protagonists, through their strengthening and development processes, which often need the definition of the corporate value to support strategic decisions and inter-firm aggregation processes.

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2. Research Problem, Objective and Plan

The aim of this work is to verify which valuation methods are used by accountants to define the value of Italian Small and Medium-sized Enterprises, considering the event of a change in the decision-making owner. Moreover, the objective is also to examine if the valuation methods employed in practice coincide with those methods considered theoretically correct and suggested by international bodies like the Federation of European Accountants. An adequate valuation should strongly increase the probability of achieving development corporate processes, through business transfers or rearrangement of ownership structure with the entrance of new partners or the start of entrepreneurial successions.

Specifically, the change in the decision-making owner, through which the business survival is often secured, can take place in numerous cases in which it needs to define the corporate value (a theoretical value useful to identify the exchange value between seller and buyer): 1. entrepreneurial succession with consequent definition of total assets that will be the object of succession; 2. crisis during the SMEs' life cycle in which it is necessary to redefine the ownership structure with the entrance of managers or employees; 3. strategic decisions and strategic plans could require quantifying the value of company or business units; 4. taking part in the company groups calls for the definition of strategic values and exchange values; 5. in the eventuality of insolvency, it is important to compare the corporate value with liquidation value. Moreover, the valuing process of the company and its business units allows us to identify the sources of value creation or destruction within the company. However value should not be confused with price, which is the exchange value defined by mutual consent between the seller and buyer in the market. The definite price depends both on objective and subjective factors concerning two counterparts. Every day a high number of experts and professionals are called on to evaluate small and medium-sized enterprises thereby defining their value.

3. Literature review

The definition of the firm's value is an important topic of accounting and it is a relevant problem among professionals in both Italy and foreign countries. There are significant differences in both theory and practice between Anglo-Saxon countries and European states.

In Anglo-Saxon countries, the corporate valuation is anchored in pragmatic principles that strongly reflect the specific context in which they came into being. The reference context is characterized by very developed financial markets, where the number of daily transactions is high, informa-

tion asymmetry is low, control shareholdings are commonly traded, and finally the number of market operators is significant. This market is inclined to efficiency even if it does not completely reach efficiency: in fact, the market is exposed to speculative operations oriented to short-term, operator decisions are not perfectly rational, information is not fairly distributed among operators, finally minority shareholdings are mainly traded. Therefore, the neo-classic financial theory has developed addressing the public companies, protagonists of the financial markets, in which ownership and governance are separated and the main objective is to satisfy the shareholders' expectations, according to the Shareholder Theory (Friedman, 1962).

It is also important to highlight that the enterprise is considered as a dynamic system of elements, functional to the production of financial and economic resources in the future (Guatri, 1990). Hence it is necessary to define the corporate value considering the financial benefits, and not only, that will guarantee in the future, without considering total assets owned in a specific date by the business. It is therefore obvious that Anglo-Saxon countries attribute importance to forward-looking corporate outcomes.

No consensus exists on the best valuation method: Damodaran (2001) promotes the method of comparables; Sharpe et al. (1999), Brealey and Myers (2000) and Bodie et al. (2005) suggest the discounted cash flows method; while Copeland et al. (2000) and Penman (2003) recommend using accounting numbers with analysis of forecast earnings. However, we can identify the following main valuation methods: *the accounting method* considers the accounting earnings to define the value of the firm that will be earnings times some multiple (in the more complex version, the value is defined discounting the flow of future earnings at a specific interest rate); *the discounted cash flow method* allows determining the value discounting the future cash flows at a rate that reflects the riskiness of investment (Copeland et al., 1994; Frykman & Tolleryd, 2003).

The valuations are directed to mergers & acquisitions, transfers, spin-offs and similar operations, but they are also carried out for fiscal or legal purposes. In particular, the valuations for legal purposes are very widespread because the minority shareholders are strongly protected in the Anglo-Saxon countries and so they often choose to appear before a judge in order to protect their rights after management buy-outs or mergers which involve non-quoted companies. Speaking of which, it is very interesting the study of Chen et al. (2010), who carried out an exploratory empirical study to verify if valuation method choice affects a judge's final appraisal. They examined a comprehensive hand-collected sample of 94 judicial opinions (for the 1947-2008 period) of a Delaware court. The judge is considered the unique neutral subject in the process of corporate valuation. The employed valuation methods are classified into two groups: the historical methods and the forward-looking methods. According to the historical methods, the

definition of equity value is based on an average over capitalized trailing earnings, book value of equity and the liquidation and market value of assets. In our opinion, this method can be considered as a mixed method, because it adds together “flow values” (trailing earnings) with “stock values” (total assets and liabilities). The forward-looking methods use forecast information to estimate the company, consistent with modern valuation theory (Cohen, 1985). In 1983 the Delaware Supreme Court allowed using forward-looking valuation methods, including discounted cash flow method (DFC), while until then the historical methods were only accepted. The findings show that judges did not rely on forward-looking methods for all 19 cases occurred before 1984, while they employed forward-looking methods for 72% of 75 cases subsequent to 1984. In conclusion, since 1984 forward-looking methods are more widespread than historical ones. The authors also verified that judicial valuation-method choice is contextual, in fact it depends on firm characteristics, including the intensity of intangibles, the extent of conservative accounting and the stability of historical performance. In any case, the choice of valuation method does not affect a judge’s final appraisal.

Additionally, an international analysis of historical and forecast earnings in accounting-based valuation methods, realized by Barniv and Myring (2006), supplies significant recommendations. They compare the empirical performance of valuation models using analysts’ forecasts of earnings and historical earnings in 17 developed countries. They identify six accounting regimes with similar accounting systems (Radebaugh and Gray, 1997; Choi *et al.*, 1999). The focus is on the accounting-based valuation methods. Specifically, Ohlson (1995) asserts that the Residual Income Model (RIM) is useful for valuation. This method defines the corporate value as a function of book value and residual income (or abnormal earnings). The historical model uses the book value of equity and actual historical earnings, while the forecast model employs the book value of equity and analyst forecasts of earnings. We can define these accounting-based valuation methods as mixed methods which add together “stock values” (the book value of equity) and “flow values” (historical earnings or forecast earnings). The empirical results suggest that the forecast model provides significantly greater explanatory power for security prices than the historical model in all Anglo-Saxon and North American countries, Finland, the Netherlands, Germany and Japan. The explanatory power of the historical model is similar to that of the forecast model in the Latin countries, two Nordic countries and Switzerland. In conclusion, the forecasted earnings are more significant than the historical earnings in countries with stronger investor protection laws, less conservative accounting standards, greater income conservatism, and more transparent accounting systems.

The European culture has researched, *in primis*, the theoretical basis

and, secondly, it has tried the practice application of prior developed theories. First of all, *the corporate equity value is a unique value that has its roots in the future profit perspectives*. Thus, value is determined by discounted future earnings (Zappa, 1957; Schmalenbach, 1919, 1962). This value has two characteristics: it is a synthetic element that expresses the value of the complete corporate system; secondly it derives from an abstract element represented by future income. Then the corporate value represents the potential price to which counterparts refer in a negotiation.

According to Onida (1970), the measuring of equity value has to start with the definition of current net worth, and to continue through analysis of capability to produce future earnings. In fact, the equity value in a prosperous concern with good income perspectives can be greater than the current net worth. This surplus is called good will. The author introduces an important principle: the *principle of composition*. According to this principle, firstly the fair value estimate of all assets has to consider the contribution of single asset to the process of income formation. Secondly, the income considered in the formula has to be correlated to immaterial and material assets which compose the total corporate capital. Therefore, the correct valuation of a thriving concern is based on both the economic and financial perspectives and total assets with which the company is transferred.

According to the opinion of Guatri (1991), the equity value is a capital measure abstract from the market, and it has to be general, rationale, objective/demonstrable and possibly stable. So the equity value is a general value that leaves aside contingent situations and does not consider subjective components. It seems therefore obvious the distinction between a subjective value and a general value. The first one reflects the position of the single counterpart (buyer or seller); the second one is a neutral value, that does not consider subjective elements. It is a rationale value that must be built through a logical scheme which is clear and sharable. Finally, valuation must be demonstrable which means that quantities used in the formula have to be objective and believable. The enterprise value refers to expected profits on the basis of acquired capabilities and, thus, of probable results achievable in the short term (Guatri & Bini, 2005).

Zanda also contributes to the debate on the definition of equity value. The valuation depends on the specific purpose that the estimator attributes to it. It is possible to speak about the equity value of a firm, as general and neutral value, if there are two premises: an objective requirement and a subjective requirement. The first one refers to the purpose of valuation that is the business transfer with the changing of the decision-making owner, while the second one is relative to the independent position of the estimator. The estimator should be *super partes*, thus he has to define a general and neutral value, that leaves aside subjective positions with reference to buyer and seller. Both requirements have to be present in order to determine the

general equity value of a business (Zanda *et al.*, 2013).

If the estimator considers the subjective position of buyer or seller, the corporate strategic value is defined. This strategic value comprises synergies deriving from inclusion of the enterprise, the object of negotiation, inside buyer's corporate group or, in general, under his control. Synergic advantages can be classified into three principal categories: operating, financial and tax. The benefits, deriving from these synergies, should provide a sustainable competitive advantage for the company through economies of scale, managerial skill transfer, asset restructuring, decrease of risk, lower interest rates, increase of debt capacity and so on (Rappaport, 1986). With reference to the seller, the definition of strategic value measures convenience to transfer or to maintain the enterprise, taking into account the possible loss of synergies that could compromise the economic and financial equilibrium of his corporate group.

In Europe, an authoritative organism such as the *Fédération des Experts-comptables Européens – Federation of European Accountants* (UEC-FEE) has dealt with the topic of business valuation on several occasions. With the last recommendation of 1980, the UEC established that the value of a business is represented by the present value of net cash flows that a buyer expects to earn from the firm. But the estimate of cash flows is uncertain, not objective; for this reason it is necessary to use other methods. The preferred and advised method is represented by capitalization of the future profits that can be long-lasting. Consequently, the use of mixed methods (the average value method or the Anglo-Saxon method with limited capitalization of goodwill) is not advised, since they consider and sum values of different nature. These methods could be employed only if financial and income methods cannot be applied because, for example, the planning system of the company is not reliable. In our opinion, this exception to the general rule is particularly significant, especially if the attention is focused on small and medium-sized enterprises. However, the FEE asserts that the definition of equity value does not depend on the corporate size; valuation principles are the same for both SMEs and large companies.

Additionally, if the estimator measures the value of a business by employing the most appropriate method, the enterprise will have to worry about the creation and diffusion of value. To create value means to increase the equity value, or the corporate value as investment. However it is important not only to create value but also diffuse value, in order that the value can transfer to the share price mainly through communication. American theory and practice have adopted the *Value - Based Planning* as an effective means of corporate management, through which they can identify, for example, the business units that create or destroy value in order to allocate available resources only to deserving units (Guatri, 1991).

This shareholder value approach (Blyth M.L., Friskey E.A., Rappaport

A., 1986) is based on the separation between corporate ownership and corporate governance, typical of public companies. Consequently, this approach cannot be applied to the SMEs, that are not listed on the stock exchange market, and in which the entrepreneur (entrepreneurial group or entrepreneurial family) is the business owner and he also exerts the decision-taking power. Thus, it is indispensable to adapt the value theory to SMEs, which means reviewing this theory taking into consideration the SMEs specific characteristics.

The Italian SMEs are extraneous to the financial markets, since they do not take up bonded debt or share issue to finance their activity. SMEs choose to finance, at first, by resorting to internal resources and if such resources are insufficient, to external sources. Thus, the most important financial resource is the cash-flow produced by the corporate management. If the cash-flow is not sufficient to finance profitable investments, the enterprise resorts to debt and, finally, to equity (the *Pecking Order Theory* of Myers & Majluf, 1984). In fact, the entrepreneur doesn't accept external subjects in the ownership structure, because he wants to maintain the business control. Therefore the preference for inside resources could affect investment choices, leading to the inadequate use of the corporate economic potential, considering that the decision maker favours the projects which require lower financial resources. Consequently, SMEs are characterized by the strong presence of an entrepreneurial figure (represented by a single entrepreneur or an entrepreneurial group or one / more entrepreneurial families), whose values, motivations, goals, risk aversion, personality, preferences, work experiences and aversion to loss of control affect significantly every corporate decisions (Palazzi, 2012) and, thus, future perspectives of the enterprise.

Therefore we propose a synthesis of the main distinctive characteristics of SMEs:

- there is coincidence between corporate ownership and corporate governance, the entrepreneur is the business owner-manager;
- the corporate capital and the personal capital of the entrepreneur are not perfectly separated;
- the entire corporate system is shaped by the entrepreneur;
- they are characterized by a low level of equity and a high level of bank debt;
- they are privately held companies, non-quoted on the financial markets; the shareholdings are rarely traded;
- they do not employ adequate control and planning systems;
- accounting information is often insufficiently reliable, since it is not public, not subject to auditing and it only satisfies fiscal duties.

All these peculiarities are relevant for the valuation of SMEs that are characterized by a mix between the entrepreneur's personal variables and

the firm's objective features. Consequently, firm performance depends on either factors (personal variables and objective features). Thus, the valuing process should take account of these two components, since both contribute determining the business value. In fact, the corporate value, that directly depends on the entrepreneurial figure, will probably run out in a short period of time, in the case of changes in the decision-making owner. On the contrary, this value will remain inside the business, in the event of constancy of ownership arrangement. Our interest is focused on the business value in the event of changes in the decision-making owner.

In conclusion, we have adopted Zanda's definition (2005) of equity value: the corporate equity value is determined by an independent estimator who has to define the value of the whole firm for the purpose of business transfer with the changing of the decision-making owner. Thus, the independent estimator should leave aside subjective positions with reference to buyer and seller.

However, we believe that the definition of neutral value necessarily requires, in the specific case of SMEs, to consider the subjective component, identifiable in the entrepreneur qualities, capabilities, attitudes, competences, relationships and so on, in order to purify the equity value from all non transferable elements, since they concern the private sphere of the entrepreneur.

4. Research design and data collection

We have resorted to a hand-collected sample, using the valuation reports made available by professionals. We have employed two selection criteria: the valuation has to concern a SME, the corporate value has to be defined considering the event of a change in the decision-making owner. We can consider this study as an explorative study because the sample is not random nor stratified since it is not possible to know the entire reference population². The valuation reports of SMEs are hardly accessible documents even when they are public documents deposited in court.

Therefore the findings of this work are based on the analysis of 70 cases, which span the period from 1978 to 2012. We believe that legislative changes concerning balance sheets, realized in the reference period, have not relevance for the valuation method choice by professionals because the expert examines and rectifies the balance sheets for valuation purpose considering applicable regulations at the estimate time.

Moreover the data source is the document analysis - we have analyzed the valuation reports. From these reports, we have extracted information

²Cfr. Chen *et al.*, 2010.

about the following items: company name, year of business valuation, the sector in which the firm operates, the motivation of valuation, typology of valuation, the selected valuation method, estimated value and the professional qualification of the valuer.

The reasons for business valuation can be numerous - however all motivations here considered mainly concern the process of changes in ownership arrangements. The most important reasons for valuation are the following: the contribution of a business or a business unit/ area as a going concern in a new company; the recess of a partner from an enterprise; transfer of a business or a business unit or shareholdings; mergers & acquisitions; the expert's report for civil suit; definition of new arrangements because of the entrepreneurial succession process and monetary revaluation of minority shareholdings (unlisted in the stock exchange market) to benefit of fiscal advantages *ex lege*, informational/ strategic purpose.

The valuation can be classified into three typologies depending on the degree of formalization: informal, formal or official. The informal valuation is voluntary and not binding, whereas the formal valuation is equally voluntary but binding among counterparts. Finally, the official valuation is imposed by a legal authority according to the laws of Italian civil code.

Ultimately, it is very important to specify the selected valuation method adopted by a professional. From a theoretical viewpoint, the corporate value should be defined through capitalization of future earnings. But the practice application of this income statement-based method is not always possible, especially in SMEs, in which planning and budgeting systems are absent. Additionally, the method selection especially depends on the purpose of business valuation.

First of all, the professional can choose between direct and indirect methods. Direct methods employ market prices expressed for shareholdings of the company that have to be estimated or market prices relative to similar companies. These methods measure the equity value of a business on the basis of real market prices which are represented by quoted prices if the enterprise is listed on the stock exchange market or by prices relative to previous negotiations of the same company if it is unlisted in the stock exchange market. In the event that this information is absent, the value is determined by considering data relative to comparable companies for both qualitative and quantitative characteristics. However, the reliability of these results depends on the efficiency of financial markets; only if markets are perfectly efficient, are prices a good means of defining the equity value. But markets are not perfectly efficient, since they are characterized by the presence of speculative operations oriented to short-term, information asymmetry, strong concentration; moreover decisions are also conditioned by irrational factors and control shareholdings are not traded (Paolucci, 2011). In conclusion, we can assert that it is very difficult, if not impossi-

ble, to use direct methods to valuing SMEs, since they have peculiar and unique characteristics that make them not comparable. Thus, comparison among SMEs is not applicable (Wolpin, 2004).

Indirect methods measure the value of a business employing “flow values” (expected cash flows, future earnings, expected dividends) or “stock values” (total assets and liabilities) with reference to the company which has to be estimated. There are three theoretical basic methods based on “flow values”: earnings method, financial method and method based on expected dividends assignable to shareholders.

Earnings theoretical basic method:

$$W = R_1 \cdot v^1 + R_2 \cdot v^2 + \dots + R_n \cdot v^n + P'_n \cdot v^n$$

- W is the value of business;
- n represents the residual life of firm expressed in number of accounting periods;
- R_1, R_2, \dots, R_n are the expected future earnings;
- P'_n is the supposed terminal price at time n ;
- v^1, v^2, \dots, v^n are the discount coefficients.

Financial theoretical basic method:

$$W = F_1 \cdot v^1 + F_2 \cdot v^2 + \dots + F_{n-1} \cdot v^{n-1} + F_n \cdot v^n$$

- W is the value of business;
- n represents the residual life of firm expressed in number of accounting periods;
- F_1, F_2, \dots, F_{n-1} are the net total cash flows for period $t=1$ to $t=n-1$;
- F_n is the cash flow at time n , including the liquidation value;
- v^1, v^2, \dots, v^n are the discount coefficients.

Theoretical basic method based on expected dividends assignable to shareholders:

$$W = D_1 \cdot v^1 + D_2 \cdot v^2 + \dots + D_n \cdot v^n + P_n \cdot v^n$$

- W is the value of business;
- n represents the residual life of firm expressed in number of accounting periods;
- D_1, D_2, \dots, D_n are the expected dividends assignable to shareholders for every accounting period;
- P_n is the supposed terminal price at time n ;
- v^1, v^2, \dots, v^n are the discount coefficients.

Unfortunately, theoretical basic methods are not exploitable in practice because they need accurate data and precise information relative to unpredictable future events. For this reason, theory and practice have developed simplified indirect methods which draw inspiration from theoretical basic methods but using opportune simplifications. Main simplifications concern reference time horizon, income and financial parameters and a calculation method of terminal price. Specifically, reference time horizon is usually from 3 to 5 years whilst income and financial parameters are estimated considering historical results relative to last 3 or 5 years as representative results of future perspectives. Considering these simplifications, it is possible to identify other valuation methods: pure methods and complex methods. Pure methods are based on the following hypothesis: it assumes that the business life indefinitely prolongs ($n=\infty$); expected flows (earnings, financial flows or dividends) are unlimited and constant. It sees, for example, the pure earnings method.

Pure earnings method: $W = \frac{R}{i}$

- R is the perspective average earning;
- i is the discount rate.

This formula expresses the present value of life annuity with constant earning. On the other hand complex methods are based on the following hypothesis: it supposes that expected flows (earnings, financial flows, dividends) are limited to a time horizon that does not exceed 10 years. It observes the complex earnings method by way of example.

Complex earnings method: $W = \sum_{s=1}^n R_s \cdot v^s + P'_n \cdot v^n$

- v^s is the discount factor $= (1+i)^{-s}$;
- P'_n is the present terminal value of firm at time n .

Indirect methods based on “stock values” are assets-based methods: simple or complex. The enterprise is estimated considering its total assets, regardless of perspective profitability. The estimator measures the value of net assets at the date of valuation, taking account of both assets and liabilities. Assets-based methods are based on the analytic estimate of single items of the balance sheet. Every item will have to be expressed at fair value or transfer value (also called substantial value). This value will be defined by researching the equivalent market value; if the market value is absent, the professional will use reproduction value or replacement value. Therefore the adjusted net worth will be obtained and it represents the value of a business.

If the expert only considers tangible and intangible assets recorded in the balance sheet, the method is denominated simple assets-based method. On the other hand, in the event that the professional additionally considers unrecorded intangible assets, both those having a market value as autonomously transferable and those not having market value (for example know how, trademark, human capital and so on), the method is called complex assets-based method. In this specific case, the business value is obtained adding together the adjusted net worth and the value of unrecorded intangible assets. Finally, mixed methods draw inspiration from the principle of composition (Onida, 1971). According to this principle, the value of a business is determined by two components: the combination of assets and liabilities necessary to the prosecution of business activity and the perspective capability to produce earnings. In substance, the correct valuation of a business must absolutely consider both the economic-financial perspectives and the current state of net assets with which the firm is transferred (Grandis, 1993). The average value method gives equal weight to the value of net assets (substantial value) and the value of the future earnings. On the other hand, according to the Anglo-Saxon method (also called method with limited capitalization of goodwill), the company value is the value of adjusted net worth plus the value of goodwill. The value of goodwill is obtained by capitalizing the super-profit, represented by the difference between the normalized average earning and the adjusted net assets multiplied by the interest rate i (i is the interest rate considered adequate for investment in a specific business). This goodwill has got a limited duration, that depends on both subjective and objective factors.

Method of average value:
$$W = \frac{1}{2} \left(K' + \frac{R}{i} \right) \quad W = K' + \frac{1}{2} \cdot \left(\frac{R}{i} - K' \right)$$

- W is the value of a company;
- K' is the adjusted net assets or net substantial value;
- R is the future normalized average earning;
- i is the interest rate;

- $\left(\frac{R}{i} - K' \right)$ is the value of goodwill or badwill.

Anglo-Saxon method:
$$W = K' + (R - K'i) \cdot a_{\overline{n}|i}$$

- W is the value of a company;
- K' is the adjusted net assets or net substantial value;
- R is the future normalized average earning;
- i is the interest rate considered adequate for investment in a specific company;

- i' is the discount rate for super-profit;
- n is the number of years of predictable duration of goodwill (from 3 to 10).

Generally, the interest rates i and i' are identical, unless professional expressly justifies the difference between two rates. These mixed methods had been advised by UEC/FEE in the period 1961-1980. Today they are simply considered as auxiliary methods, without theoretical solidity.

5. Data analysis

The findings of this work are based on the analysis of 70 cases concerning Italian SMEs (according to the definition of European Commission), which span the period from 1978 to 2012. Specifically, we have analyzed the valuation reports, elaborated by professionals. The examined enterprises operate in the following business sectors: 50% in the retail and wholesale trade, 29% in the manufacturing industry (included 14% of the construction industry) and 21% in the services industry. The results are summarized in tables 1, 2 and 3.

Table 1: The valuation methods depending on business sectors

Valuation methods	Manufacturing industry	Retail and wholesale trade	Services sector	Total
Assets-based method	12	12	9	33
Income-based method	2	3	2	7
Mixed method	6	19	4	29*
Empirical method	0	1	0	1
Total	20	35	15	70

* 21 appraisals with the Anglo-Saxon method, 9 estimates with the average value method.

First of all, the employed valuation methods are the following: assets-based method, income-based method, mixed method and empirical method. Obviously, the choice of method varies depending on the business sector in which the enterprise operates. In fact, the company that works in the manufacturing industry is usually provided with considerable tangible assets, and consequently the expert selects the more suitable method to value such a consistency of assets. Thus, the adopted method is the assets-based method. If the valuation concerns a firm that operates in the retail or wholesale trade sector, the professional has to take account of capability to produce earnings, in addition to the significant left-over stock. Therefore in

this case, the selected method is usually mixed method.

It could seem quite strange that the assets-based method is also the most employed for the services sector. But it depends on the reason of valuation; in fact the majority of services firms had been evaluated on the occasion of contribution of a business or business unit/area, that needs official appraisal (according to the laws of Italian civil code). For this reason, the professional uses the assets-based method because it is more objective, more demonstrable and less discretionary than the others. For the formal and informal appraisals, which do not have the same legal effects of official valuations, experts opt for mixed methods.

Table 2: The valuation methods depending on the degree of valuation formalization

Valuation Methods	Officially	Formal	Informal	Total
Assets-based method	20	9	4	33
Income-based method	2	1	4	7
Mixed method	5	16	8	29
Empirical method	0	1	0	1
Total	27	27	16	70

The third table shows us the selected valuation methods considering the main reasons for estimate. The expert, who has to define the value of a firm on the occasion of contribution of a business or business unit/area through an official valuation, chooses the assets-based method because it is characterized by a high degree of demonstrability. In the other cases (monetary revaluation of minority shareholdings, transfer of business or shareholdings, informational/strategic purposes), the predominant method is mixed (specifically the Anglo-Saxon method). In fact, mixed methods mediate between income-based methods and assets-based methods, because the value of an enterprise mainly depends on the attitude to produce earnings, but without forgetting the importance of total assets.

Table 3: The valuation methods depending on the main reasons for estimate

Valuation Methods	Contribution of a business	Monetary revaluation of shareholdings	Transfer of business	Transfer of shareholdings	Strategic purpose or other reasons	Total
Assets-based	19	5	2	2	5	33
Income-based	1	0	2	2	2	7
Mixed	3	13	3	3	7	29
Empirical	0	0	1	0	0	1
Total	23	18	8	7	14	70

6. Discussion and conclusion

In conclusion, the used valuation methods by accountants to define the value of Italian Small and Medium-sized Enterprises, considering the event of a change in the decision-making owner, are the assets-based method, income-based method, mixed method and empirical ones. The empirical data clearly shows us that the preferred method to value Italian SMEs is the mixed method, particularly the Anglo-Saxon method, because the assets-based method is mainly employed for official valuations, commissioned by legal authorities.

Unfortunately, there are two methods considered theoretically correct and advised by UEC/FEE (discounted cash flow method and income method) and are not employed to define the value of SMEs, with the exception of few cases (the income method has been used in 7 cases out of 70).

But are we sure that this mixed method (in particular the Anglo-Saxon method) is lacking in theoretical foundations? This method, for n that increases to infinity, exactly coincides with the pure income-based method ($W=R/i$) which represents the best theoretical method of valuation. Additionally, the Anglo-Saxon method is less sensitive to the variation of interest rates than the method of average value.

SMEs are shaped by their entrepreneurs that strongly affect the future perspectives of profit. Therefore, in the case of changes in the decision-making owner, perspectives of profit will significantly change, as they especially depend on the entrepreneur. Thus, it is reasonable to suppose that goodwill has a limited duration, in case of changes in ownership arrangement. However it is also important to consider the assets consistency of a business, because such a consistency guarantees the prosecution of business activity, also to the different decision-making owner. When an expert has to define the value of a SME, he cannot abstract from specific peculiarities of this type of firm that inevitably condition the choice of valuation method (Chen et al., 2010): the entrepreneur is the owner and decision-maker of the firm; SMEs do not have adequate planning and control systems, therefore it is very difficult to make trustworthy previsions. Therefore it could be more appropriate to rely on historical information than forward-looking information, also because it has been demonstrated that the historical accounting-based method are able to explain the security price in the accounting regimes characterized by weaker investor protection laws, more conservative accounting standards, smaller income conservatism, and less transparent accounting system as in Italy (Barniv and Myring; 2006).

In conclusion, it would seem that theory and practice are still distant in the processes of business valuation concerning SMEs. Yet if we consider the specific characteristics of SMEs together with the purpose of valuation

(changes in the decision-making owner with a definition of a general value by an estimator), we can assert that the mixed method (Anglo-Saxon) is suitable to define the value of a small and medium-sized enterprise and theoretically correct for the specific purpose. *In fact, it allows a purification of both the value of net assets and the value of earning by subjective elements concerning the private sphere of the decision-making owner.*

The main limitation of this study is represented by the employed sample. This sample (not random or stratified) does not allow us to generalize the empirical results to a reference population. In addition, the examined reports have been elaborated by professionals, not by scholars. Further research could examine the valuation of SMEs in other European countries, to see which methods are used in practice. Moreover future studies could use different research methodologies and different samples to verify which methods are the most suitable to SMEs and to identify some variables which affect the choice of valuation methods.

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Abstract

The aim of this work is to verify which valuation methods are used by accountants to define the value of Italian Small and Medium-sized Enterprises, considering the event of a change in the decision-making owner. Moreover, the objective is also to examine if the valuation methods employed in practice coincide with those methods considered theoretically correct and suggested by international bodies like the Federation of European Accountants. An adequate valuation should strongly increase the probability of achieving development corporate processes, through business transfers or rearrangement of ownership structure with the entrance of new partners or the start of entrepreneurial successions.

The findings of this work are based on the analysis of 70 cases concerning Italian SMEs (according to the definition of European Commission), which span the period from 1978 to 2012. Specifically, we have analyzed the valuation reports, elaborated by professionals. The empirical data clearly shows us that the preferred method to value Italian SMEs is the mixed method, particularly the Anglo-Saxon method (with limited capitalization of goodwill). SMEs are shaped by their entrepreneurs that strongly affect the future perspectives of profit. Therefore, in the case of changes in the decision-making owner, perspectives of profit will significantly change, as they especially depend on the entrepreneur. Thus, it is reasonable to suppose that goodwill has a limited duration, in case of changes in ownership arrangement. However it is also important to consider the assets consistency of a business, because such a consistency guarantees the prosecution of business activity, also to the different decision-making owner. When an expert has to define the value of a SME, he cannot abstract from specific peculiarities of this type of firm that inevitably condition the choice of valuation method: the entrepreneur is the owner and decision-maker of the firm; SMEs do not have adequate planning and control systems, therefore it is very difficult to make trustworthy provisions.

Riassunto

L'obiettivo del lavoro di ricerca è verificare quali metodi di valutazione sono impiegati dai professionisti per definire il valore del capitale economico delle Piccole e Medie Imprese (PMI) italiane, in ipotesi di mutazione del soggetto economico. Inoltre l'obiettivo è anche quello di esaminare se i metodi valutativi utilizzati nella prassi coincidono con i metodi considerati teoricamente corretti e consigliati dalla Federazione degli Esperti Contabili Europei (UEC-FEE). Una valutazione adeguata aumenterebbe significativamente la probabilità di realizzare dei processi di aggregazione aziendale, attraverso trasferimenti d'impresa, riassetti della struttura proprietaria con l'ingresso di nuovi soci o l'avvio di processi di successione imprenditoriale.

Sono stati analizzati 70 casi, riguardanti PMI italiane (secondo la definizione della Commissione Europea), nel periodo 1978-2012. Nello specifico, sono state esaminate approfonditamente le perizie di stima elaborate dai professionisti. I risultati empirici mostrano chiaramente che il metodo di valutazione preferito per le PMI italiane è il metodo misto, in particolare il metodo Anglosassone (con capitalizzazione limitata dell'avviamento). Le PMI sono plasmate dall'imprenditore, il quale influenza fortemente le prospettive future di reddito. Pertanto, in ipotesi di mutazione del soggetto economico, le prospettive reddituali dell'impresa cambieranno significativamente poiché esse dipendono dall'imprenditore stesso. Perciò, è ragionevole supporre che l'avviamento abbia una durata limitata, nel caso si verifichi un cambiamento nell'assetto proprietario. È altrettanto importante considerare la consistenza patrimoniale dell'impresa, poiché garantisce la prosecuzione dell'attività aziendale, indipendentemente dal soggetto economico. Quando

un professionista deve definire il valore economico di una PMI, non può prescindere dalle peculiarità di questa particolare tipologia d'impresa che inevitabilmente condizionano la scelta del metodo valutativo: non c'è separazione tra proprietà e governo; le PMI non sono dotate di adeguati sistemi di pianificazione e controllo, di conseguenza è molto difficile fare previsioni attendibili; infine, il sistema informativo contabile non è particolarmente affidabile, dato che l'informazione contabile non è pubblica e risponde essenzialmente ad obblighi di natura fiscale.

Jel Classification: M41 Accounting

Keywords (Parole chiave): small and medium-sized enterprises, valuation (piccole e medie imprese, valutazione)

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