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Using Comparables in the Market Approach in Business Valuation

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The Market Approach is a commonly used approach for valuing a business. The IRS' Revenue Ruling 59-60 states that "the prices of stocks which are traded in volume in a free and active market by informed persons best reflect the consensus of the investing public as to what the future holds for the corporations," but that "when a stock is closely held ... the next best measure may be found in the prices at which the stocks of companies engaged in the same or a similar line of business are selling in a free and open market."

The most important aspect of applying the market approach is to select a sufficient number of market transactions that are sufficiently "similar" to the subject interest to provide a reliable valuation result. The comparables need not be identical to the subject company; that is a goal that is probably impossible to achieve.

The Revenue Ruling does not offer guidance on how many comparables are enough, but it is generally thought that a minimum of five or six are enough, if they are "good" comparables. Of course, what makes a comparable "good" is subject to interpretation. If five or six good comparables cannot be identified, the analyst may expand the selection to capture a greater number of comparables, although, by definition, they will be of a lower degree of comparability.

However, the analyst must keep in mind that a higher number of low quality comparables may be just as useless in a valuation engagement as too few good comparables. A careful review of each comparable transaction should be conducted to verify that it is appropriate to include in the analysis. Such a review should include the potential comparable's size, industry description, profitability, and the nature of the acquiring company.

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