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Pricing Small Businesses: An Application of the Edwards-Bell-Ohlson (EBO) Valuation Model

Michael F. Spivey and **Jeffrey J. McMillan***

Clemson University, Clemson, SC USA

Edwards-Bell-Ohlson (EBO) is a residual income valuation model that provides accountants and money managers with a simple but powerful way to estimate the fundamental value of a small business. This study examines the pricing accuracy of the EBO model on a sample of small companies. Actual stock prices were compared to predicted stock values produced by the two variations of EBO model. Both models' estimated prices were found to be significantly correlated with actual stock prices for the sample of small businesses examined. The pricing estimates derived by the EBO models were, on average higher than the actual prices. However, this overpricing is consistent with previous studies that find illiquidity discounts for small and closely-held businesses.

In today's business environment, there is an increasing need for timely and reliable measurement of the fundamental (intrinsic) value of shareholders' wealth. The measurement of fundamental value is useful in helping managers monitor the profitability of their divisions, helping lenders assess the security of their loans, helping in contract negotiations with labor, or helping develop executive compensations plans (Olson and Knight 1997). The desire for objective business valuations is particularly important in situations involving major business reorganizations or changes in ownership (e.g., mergers, sales, acquisitions, bankruptcy, or liquidation) (York 2003). Recognizing the opportunities in this area, CPA's and especially forensic accountants have placed more emphasis on promoting their skills as business valuation experts.[1]

[1] The AICPA has acknowledged the growing opportunities in the field of business valuation by having established a "Business Valuation and Forensic & Litigation Service" membership section.