THE SEVEN DEADLY SINS OF BUSINESS VALUATION

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Robert M. Clinger III
and
Paul Morin

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FOREWORD

Business owners, their advisors and other appraisers will find Robert M. Clinger III and Paul Morin's *The Seven Deadly Sins of Business Valuation* to be an incisive, focused, and extraordinarily well-written description of the most common major errors found in business valuation reports.

Beginning with an overview of the reasons for valuing a business interest and the standards of value that apply, the discussion then covers the standard approaches to valuation, and the most common methods and procedures used to implement them. With that as a foundation, Messrs Clinger and Morin then identify their "Seven Deadly" with extensive examples and explanations of the errors, their consequences, and the proper way to avoid them.

The Seven Sins involve:

- Incorrect adjustments to financial statements
- Improperly developed financial forecasts
- Not matching the benefit stream to the capitalization or discount rate
- Errors in estimating risks specific to a particular business
- Failing to show how the appraiser arrived at his or her conclusion
- Developing a value conclusion inconsistent with the standard of value and purpose of the appraisal
- Errors concerning valuation discounts for fractional interests (lack of control and lack of marketability)

In my opinion, there is an Eighth Deadly Sin of Business Valuation: failing to read and appreciate Robert Clinger and Paul Morin's work!

Rand M. Curtiss, FIBA, MCBA, ASA, ASA
College of Fellows, The Institute of Business Appraisers, Inc.
Master Certified Business Appraiser, The Institute of Business Appraisers, Inc.
Accredited Senior Appraiser, Business Valuation, American Society of Appraisers
Accredited Senior Appraiser, Appraisal Review & Management, American Society of Appraisers
President, Loveman-Curtiss, Inc.

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ABOUT HIGHLAND GLOBAL

Highland Global, LLC is a leading strategic advisory and financial analysis firm for domestic and international privately-held and family-owned businesses. Some of Highland Global's services include assisting clients with mergers and acquisitions, sales and divestitures, recapitalizations, management buyouts, and privatizations.

Highland Global also provides a full range of valuation services including formal valuations, limited scope valuations, fairness opinions, and expert witness/consulting services. Highland Global performs independent business appraisals and valuations for a wide range of purposes including family limited partnerships, succession planning, gift taxes/planning, estates taxes/planning, mergers & acquisitions, employee stock ownership plans (ESOPs), financing/capital raising, divorce, shareholder issues, and litigation. Highland Global's goal is to provide accurate, objective, and reliable valuations and financial analysis based on widely-accepted, well-documented methodologies.

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SEVEN DEADLY SINS OF BUSINESS VALUATION

I. INTRODUCTION

The process of valuing a business or business interest requires a number of inputs, decisions, and assumptions by the valuation professional. These, in turn, give rise to the potential for serious errors by the valuation professional, which may result in a flawed value conclusion or estimate of value. In order to understand the potential impact of these "deadly sins", it is first necessary to understand the basic premises of business valuation.

The International Glossary of Business Valuation Terms, developed jointly by the American Institute of Certified Public Accountants, the American Society of Appraisers, the Canadian Institute of Chartered Business Valuators, the National Association of Certified Valuation Analysts, and the Institute of Business Appraisers, defines valuation as

> *the act or process of determining the value of a business, business ownership interest, security, or intangible asset.*

Valuations of businesses or other assets are necessitated by a variety of situations ranging from mergers and acquisitions to tax liability determination. Generally, valuations are necessary in three broad categories: litigation, tax matters, and transactions. Some of the most common instances when valuations are required include the following:

- Privately-held business owners seeking a merger or acquisition of their company need a professional, independent business valuation to determine the fair market value of the equity in their company, in order to establish the minimum and expected price for negotiations.

- Dissenting shareholders' legal action may also require a valuation to ascertain whether the acquisition of minority shares is "fair". The premise of value is often a legally established standard of value determined by state law.

- Privately-held businesses owners must also have independent valuations

to establish the fair market value of the business for tax purposes in the event they gift interests to their children or leave ownership interests to heirs upon their death. As part of a comprehensive estate planning process, these valuations are conducted and reported to the IRS annually in years when gifts of interests are made. These valuations also typically apply to interests of family limited partnerships that are used for estate planning purposes; the interest being valued in a family limited partnership is typically an interest in a non-operating entity that may hold a combination of financial assets (stocks & bonds), real estate, or interests in operating entities.

- Privately-held business owners seeking liquidity through a transaction may opt to establish an Employee Stock Ownership Plan (ESOP). By doing this, the owner achieves personal liquidity for their ownership interest while enabling the employees to retain ownership and control of the company. ESOPs are utilized many times for small, mature companies that have a relatively stable employee base. Federal law/ Department of Labor regulations mandate that a valuation of the business be conducted upon formation of the ESOP and annually thereafter for reporting purposes.

- Marital dissolution often requires a valuation of a business for purposes of division of marital assets. Often times in marital dissolution, each side has a valuation prepared of the business or business interest subject to division. The standard of value is usually established by case law in each state. The court must then examine each valuation and the appraisers' credentials to determine which value estimate, if either, should be used.

- Shareholder buyouts, buy-sell agreements, and litigation between shareholders also require a valuation to determine the fair market value (or other standard of value established by state case law or the parties to the litigation) of the interest to be acquired. Once again, opposing valuations are usually the norm in these cases, with a judge or arbitrator making the final determination of value based upon the valuations presented by independent appraisers.

- Appraisers often provide valuations or fairness opinions to owners and shareholders of a business when there is a contemplated transaction involving the merger or acquisition of their firm. Unlike dissenting

shareholder actions, these valuations are usually not part of litigation but are provided to owners for assistance in assessing the fairness of the contemplated transaction.

- Valuations may also be included as part of a start-up firm's business plan used for seeking equity or debt financing. Likewise, valuations may be required for valuing stock options in closely-held businesses, for valuing intellectual property such as patents, trademarks, or copyrights, or for valuing economic damages resulting from a variety of issues such as death/disability of a major executive, pollution, etc.

For many purposes including tax matters and a contemplated merger or acquisition, the most common standard of value is fair market value, which the IRS defines in Revenue Ruling 59-60 as:

> *. . . [T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts . . . the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.*

Under the fair market value standard, the hypothetical buyer is assumed to be a purely financial buyer seeking a return on the investment. The financial buyer lacks synergies or strategic benefits associated with the transaction. As a result, the fair market value estimate is typically lower than the strategic value estimate, which is based upon the price that encompasses synergies or strategic benefits that could be obtained through the acquisition. Therefore, the price that a buyer typically is willing to pay for the company is equal to the fair market value estimate plus the value of any synergies associated with an acquisition of the company[1].

To arrive at the fair market value estimate, the appraiser must examine a number of factors associated with the company such as its history, financial condition, earnings capacity, dividends, industry and economic conditions, etc. The appraiser may also make adjustments to the financial statements of the privately-held company to remove any non-recurring items or perquisites to the owners. Adjustments are also made to remove any real estate owned by the company that should be appraised separately by a qualified real estate

appraiser. These adjustments are made, when reliable estimates are available, to adjust book values to market values and to provide a value based on future earnings that would not include controlling decisions regarding discretionary expenses. These factors are then incorporated into the overall analysis of the company to determine the value drivers as well as specific company risk factors that may have an impact upon the value of the company.

The appraiser must then select the appropriate approaches and methods to apply to the company's specific conditions to derive an indication of value. The approaches that the appraiser must consider include:

- **Income Approach—**The income approach derives an indication of value based on the sum of the present value of expected economic benefits associated with the company. Under the income approach, the appraiser may select a multi-period discounted future income method or a single period capitalization method.

  The capitalization method estimates the fair market value of a company by converting the future income stream into value by applying a capitalization rate incorporating a required rate of return for risk assumed by an investor along with a factor for future growth in the earnings stream being capitalized. This results in a value based on the present value of the future economic benefits that the buyer will receive through earnings, dividends, or cash flow. The capitalization method is based on the Gordon constant growth model that uses a single period proxy of future earnings to determine the present value of the asset. This method is usually employed when a company is expected to experience steady financial performance for the foreseeable future and when growth is expected to remain fairly constant.

  Multi-period discounted future income methods involve discounting a projected possible future income stream on a year-by-year basis back to a present value using an appropriate discount rate that reflects the required rate of return on the investment (compensating for risk). For the final year of the projection period, the income stream that represents the expected income stream in perpetuity is capitalized to arrive at a terminal value, which is then discounted back to a present value (at the same discount rate) and added to the present value of the prior years' income streams to arrive at the indication of fair market value.

This method is most commonly used when the company is expected to experience a period of abnormal growth or when the growth rate for the near-term is anticipated to be significantly different from the long-term rate of growth[2]. This is predicated upon the ability to create a reasonable forecast of the company's income stream for the forecast period. If these conditions are satisfied, the multi-period discounted future income method may more reliably capture the value impacts of cyclicality or abnormal short-term factors impacting the company's results than a capitalization method.

- **Market Approach—**The market approach derives an indication of value by comparing the company to other similar companies that have been sold in the past. The guideline publicly-traded company method uses the prices of similar and relevant public companies as guidelines for determining the value of a privately-held business. The direct market data method relies on transaction data of similar privately-held businesses to determine an indication of value.

  The premise of the guideline publicly-traded company method is based on the economic principle of substitution stating that one will not pay more for an asset than the amount at which they can acquire an equally desirable substitute. Revenue Ruling 59-60 indicates that the market price of stocks in corporations having their shares actively traded in a free and open market can be an indication of value when the transactions in such freely traded companies are sufficiently similar to the company being valued to permit a meaningful comparison.

  Guideline company transactions in the open market may involve either minority or controlling interests in the guideline companies. To be sufficiently similar to the company being valued, however, the guideline company must exhibit similar factors such as:

  - Investment characteristics,
  - Business size,
  - Markets served,
  - Depth of management,
  - Probable future earnings expectations.

Relevant factors to be considered focus on the characteristics of the willing buyer and include:

- Risk tolerance,
- Liquidity,
- Degree of owner involvement in management of the company,
- Expected holding period.

The guideline publicly-traded company method is appropriate when similar and relevant proxy companies may be identified and employed in estimating the value of a privately-held company.

The direct market data method develops an estimate of value for the subject company through use of transactional information on actual sales of a large sample of privately-held companies. Sources of transactional data may include databases such as the IBA Transaction Database, Pratt's Stats, DoneDeals, etc. Though similar to the guideline publicly-traded company method, there are several major differences that distinguish the two methods.

Under the guideline publicly-traded company method, a small number of companies are selected as being similar to the company being valued. They and their stock prices are compared to the company being valued to arrive at a valuation estimate. The direct market data method, however, assumes that the sample of transactions for which market data is obtained represents the statistical population of the market for similar businesses as the one being valued. The company is then compared to the market based on its relative strengths and weaknesses with respect to financial condition, performance, etc. The market value of the company is then estimated based on the prices at which other companies have sold.

The direct market data method is usually employed when there is a large enough sample of transactional data of similar and relevant companies to develop a reliable indication of value.

- **Asset Approach**—The asset approach adjusts a company's assets and liabilities to their fair market values and adds to the balance sheet the value of intangible assets and any contingent liabilities. While tangible

assets can be appraised and reported on an adjusted balance sheet accordingly, the valuation of intangible assets such as reputation, employee talent, etc. is more complicated.

One method of deriving an indication of value under the asset approach is the excess earnings method. Developed by the IRS and defined by Revenue Ruling 68-609, the excess earnings method is a hybrid of the asset and income approaches. The method was designed to value the intangible assets of a company rather than for valuing the entire company itself. The excess earnings method requires the valuation of both tangible and intangible assets then deducting the company's liabilities in order to determine the fair market value of a company. Though the excess earnings method has been used in a variety of cases such as marital dissolution or economic damage cases, the use of the excess earnings method in valuing the equity of a company is not widely accepted by all valuation professionals.

Given that most valuations are typically conducted under the premise of a going concern, the appraiser may determine that the asset approach is inappropriate for determining an indication of value. However, the appraiser may test if the company is worth more in liquidation as opposed to as a going concern by utilizing an asset approach. In addition, the excess earnings method is often not employed as the rates of return are totally arbitrary and have no foundation.

After selecting the appropriate approaches and methods, the appraiser typically adjusts the value indications to reflect the relative lack of marketability of privately-held businesses as compared to liquid and readily marketable public counterparts. These values are then reconciled to provide an indication of value or an estimated value range for the company.

The seven most common errors made by valuation professionals, which may lead to overvaluing or undervaluing the company, when conducting a business valuation include the following:

1. **Incorrect Adjustments to the Income Statement and Balance Sheet—** Given that the valuation of the business is usually a function of its earnings capacity and financial condition, incorrect adjustments to the income statement and balance sheet may produce an unreliable indication of

value. Examples of errors with respect to adjustments to the income statement and balance sheet include failure to remove real estate and associated expenses from the financial statements and failure to replace these with a market rate of rent. Also included in this 'sin' is erroneously making adjustments that only a control owner could make when valuing a non-controlling or minority interest.

2. **Ungrounded Forecasting of Earnings**—Forecasting earnings is likely the most important part of the income approach to valuing a business, since the value is driven by the firm's anticipated future earnings. Using unrealistically high growth assumptions may result in an earnings stream that is overly optimistic and that produces an indication of value that is too high when discounted or capitalized. Likewise, inconsistent assumptions regarding capital expenditures and depreciation may result in forecasts under which fixed assets are depreciated at a rate faster than which they are replaced or actually depleted. This may also skew the value indication and discredit the entire valuation.

3. **Discount Rate & Income Stream Mismatch**—Capitalizing or discounting a net cash flow to equity income stream by the firm's weighted average cost of capital (WACC) would produce an unreliable indication of value. Likewise, using a net cash flow to equity rate to discount or capitalize net cash flow to invested capital results in an incorrect value. This mismatch of the discount (capitalization) rate and income stream is a glaring error in some business valuations. The income stream used as an indication of future economic performance must be capitalized or discounted at the appropriate rate—WACC for net cash flow to invested capital and the discount rate applicable to net cash flow to equity for the net cash flow to equity income stream.

4. **Specific Company Risk Premium Estimation**—The specific company risk premium is an important element in the development of an appropriate discount rate for a specific investment. This specific company risk premium reflects the risks associated with the particular business's operations, finances, industry position, etc. Whereas the equity risk premium and the small company size premium are based on empirical evidence (compiled by Ibbotson Associates), there is no empirical data on the specific company risk premium. Estimating this risk premium is at the sole discretion of the valuation professional and is typically based

on the appraiser's experience and informed judgment. Unreasonable assumptions regarding the specific company risk premium may result in a discount rate that is too low or too high for the particular entity or asset being valued. In turn, this could lead to significant valuation errors when determining the value of a specific entity or asset.

5. **Inability to Replicate the Valuation**—It is crucial that the valuation professional's valuation be clearly written and fully explained so that the value estimate or conclusions may be replicated by a reader or third party that is not part of the valuation process. The failure to clearly delineate the reasoning, assumptions, and calculations made to arrive at an indication of value could lead a reader to believe that the values are arbitrary or that the appraiser engaged in "fuzzy math" to reach a specific value. A clearly written valuation report that carefully explains the entire process, including assumptions made and illustrates all calculations, should withstand the harshest scrutiny, ceteris paribus.

6. **Incorrect Value Conclusion for the Standard of Value**—Upon engagement, the valuation professional identifies the standard of value that will be used in developing an indication of value. For tax purposes, the standard of value (as set forth by the IRS) is fair market value. For marital dissolution, state case law establishes the standard of value which may be something other than fair market value. For transactional purposes, fair market value may be the standard, or strategic value may be used to determine the value to a specific acquirer. The valuation professional must ensure that the valuation process reaches a value conclusion consistent with the standard of value selected at the outset of the process.

7. **Application of Appropriate Discounts**—Once the valuation professional has arrived at indications of value using the selected approaches and methods, it may be appropriate to then apply discounts for lack of control and lack of marketability. Though there are a number of studies examining empirical data on implied discounts due to lack of control and discounts for lack of marketability, there is no formula or set of guidelines for determining the appropriate discount applicable to a specific investment or company. Therefore, the appraiser must once again use reasoned, informed judgment in determining the appropriate level of these discounts. Given that discounts for lack of control and

marketability may range from 10%-50%, there is a great deal of latitude for applying discounts that are too high or too low, leading to potential overvaluation or undervaluation of the subject interest.

These Seven Deadly Sins are some of the most common errors made by valuation professionals when conducting business valuations. However, these are not the only errors that may be made. The valuation professional may be engaged to estimate the value of a 1% minority interest but value a 10% or 100% interest in the valuation report. This may be an oversight, but the error still renders the valuation report meaningless for the specific engagement. Mathematical errors are also quite common and can have an adverse impact upon the credibility of the valuation and the valuation professional.

When valuing a S-corporation using the income approach, valuation professionals must determine whether tax affecting the corporation's earnings to reflect a corporate level of income tax (as opposed to just personal taxes for the S-corporation) is appropriate. It should be clear to see that tax affecting a S-corporation's earnings may be appropriate in circumstances where the most likely acquirer is a C-corporation, for example, or when the corporation's election as a S-corporation may be in question. Given that the issue of tax affecting is quite controversial at this time, with various valuation professionals taking different positions on the issue, whether this is currently a Deadly Sin with respect to valuation remains to be seen. However, it is worth noting that this may result in valuation issues if not applied appropriately.

Another common mistake involves utilizing inappropriate approaches and methods for valuation purposes. Valuation professionals must choose between the three approaches to valuing a business or interest therein: income, market, or asset approach. The fair market value standard assumes the value is on a going-concern basis. For a company that is mature but growing with no expectations for liquidation, an asset approach would be less appropriate than an income approach or a market approach. Likewise, for a non-controlling limited partnership interest a non-operating entity that holds real estate and makes no distributions, an asset approach would be more appropriate than an income approach in determining an indication of value. The valuation professional must ensure that the approaches and methods selected are appropriate for the interest being valued if a reliable indication of value is to be estimated. However, if the valuation professional provides legitimate

justification for the use of a method that may not seem appropriate, the damage from such an error may be mitigated.

Suffice to say, these errors, if made, may have a significant adverse impact upon the valuation and the credibility of the appraiser. A more thorough examination of these errors and their impact upon a valuation is necessary to more fully understand the ramifications of making such errors. Such an analysis and discussion follow.

[1] The appraisal provides an *estimate* of value, not a precise value. The actual price at which a transaction is consummated may be higher or lower than the fair market value estimate.

[2] If a company's earnings are growing at the same rate in perpetuity, the discounted future income method equates to the Gordon constant growth model, the basis of the single period capitalization method.