Nine Valuation Mistakes for Business Owners to Avoid

By Evan Levine and Nainesh Shah

Whether or not a business owner plans to sell or transfer their business in the next few years, obtaining a proper business valuation is critical. A professional valuation performed by an accredited specialist, based on accurate modeling and sound numbers, is more likely to result in maximum financial returns for the business owner— either as an ongoing business or ultimate sale. This article examines nine common mistakes related to business valuations and offers some helpful guidance for business owners and their advisors as they navigate through the complexities of owning, selling, or transferring a business.

Failing to Value an Ongoing Business

Even if an owner is not contemplating the imminent sale or transfer of business, a professional valuation of the business as a going concern is essential. To this point, a formal valuation or appraisal is exceedingly beneficial, so the owner will not be left unprepared for triggering events. For example, if there are buyout agreements in place (i.e., a buy-sell agreement), an estimation of the purchase price and establishing funding sources (e.g., insurance) will be known and can be planned for in advance. In addition, a highly valued business is likely to have estate tax ramifications that may require sophisticated estate planning. Finally, for an ongoing business, a current credible professional valuation could be instrumental in obtaining a loan, attracting key employees, and other considerations.

Once the value of a business has been determined, the owner can focus on value enhancement adjustments to various aspects of the business, including personnel, business planning, sales, marketing, legal, and operations. These adjustments can potentially increase profitability as an ongoing business and likely result in a higher price when the business is sold. Choosing a professional valuator who has experience with value enhancement can help streamline this process.

Eleventh-Hour Valuation

Unfortunately, too many business owners do not prepare a plan for the eventual sale of their company. According to a 2018 report by the Exit Planning Institute, many business owners “lack of readiness prevents them from harvesting the value of their business.” Of those surveyed, 91% lacked a written personal plan of action following the transition of their business, and 30% never gave it a thought (The State of Owner Readiness 2018 Georgia Report, https://bit.ly/3Eu15Z1).

More commonly, business owners wait until the eve of the sale to commission a valuation. By doing so, they may not be able to hire the best possible professional valuator. Moreover, since time is of the essence, an ultimate valuation prepared in haste may fall short of expectations.

Valuations not Performed by a Qualified Professional

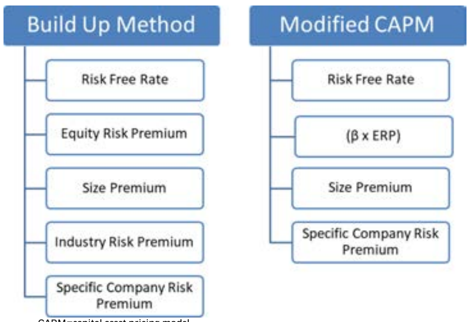
A proper credible business valuation includes numerous complex variables that must be considered. If a valuation is not performed by a qualified professional, the likelihood of mistakes and inaccuracies increases significantly. Although many business brokers and CPAs offer business valuation services, they are not likely to have the experience, expertise, and depth of knowledge as valuation professionals. Several organizations offer professional certification designations, including the ASA (American Society of Appraisers), AICPA (American Institute of CPAs), and NACVA (National Association of Certified Valuators and Analysts).

Moreover, a valuation not prepared by a qualified professional is more likely to be discredited if disputed in court pursuant to a Daubert challenge [see *Daubert v. Merrell Dow Pharmaceuticals* (92-102), 509 U.S. 579 (1993)]. If an attorney opposing the valuation files a motion for a Daubert challenge, a judge will conduct a hearing providing the opportunity for the attorney to challenge an expert witness's credentials and expertise. In defending the veracity of the expert and the valuation, it is far less likely that an individual who is not a qualified professional would be able to demonstrate the required expertise to prepare a viable business valuation or to show that the valuation methodology used is sound and valid.

Lack of Proper Due Diligence and Insufficient Data Gathering and Analysis

The lack of proper due diligence and insufficient data gathering and analysis are common mistakes in the valuation

Exhibit 1
Cost of Equity



CAPM=capital asset pricing model

process. Proper due diligence requires a thorough understanding of both the company's industry and business. To ensure the proper level of due diligence for the business is being valued, the qualified professional interviews the owners and other key stakeholders, visit the company's offices, and becomes versed in all relevant aspects of the business. As for data gathering, it is imperative that data utilized to formulate calculations are always readily verifiable from current and credible sources. Data that is unreliable or dated can be more easily challenged by opposing counsel in legal disputes.

Exhibit 2
Errors in Benefit Stream Mismatch

	Net Income	Net Cash Flow
After-tax Net Income	$ 2,500,000	$ 2,500,000
Cash Flow Adjustments		
Depreciation	-	*200,000*
Capital expenditures	-	*(225,000)*
Change in Net Working Capital	-	*(250,000)*
Change in Interest-Bearing Debt	-	-
Net Cash Flow	2,500,000	2,225,000
Times: (1+ Long-Term Growth Rate)	105.0%	105.0%
Benefit Stream to be Capitalized	2,625,000	2,336,250
Divided By: Capitalization Rate	20.0%	20.0%
Indicated Value	$ 13,125,000	$ 11,681,250
Amount of Overvaluation		**$ (1,443,750)**
Overvaluation %		**-11.0%**

Errors in Calculating Discount/Capitalization Rates

The discount or capitalization (cap) rate is one of the critical factors in the income approach to valuation. Numerous errors in computing discount or cap rate calculations can occur in multiple places. *Exhibit 1* illustrates where errors in the components of discount and cap rate calculations often occur.

When the build-up method is used to calculate these rates, the rates must be applied to their correct and corresponding benefit streams. The capital asset pricing model (CAPM) rates reflect the expected equity return of the business. If the wrong beta is used to calculate the discount/cap rate, the numbers can be distorted.

For example, using historical industry data or an average of similar companies' betas can be inaccurate because they do not necessarily reflect the valuation of the company's dynamics.

Failing to assess company-specific risk. Risk assessment is a critical factor in any business valuation. Using discount/cap rates that do not account for a company's specific risk can lead to misleading results. Every company has business-specific operational and financial factors that contribute to its risk profile, such as key-person risk, customer concentration, or patent expiration. This risk is indicative of a company's unique discount/cap rates. In addition, due to a great deal of subjectivity and nuance involved in arriving at these rates, an experienced valuator's knowledge and skill are needed to ensure an accurate estimate of value.

Errors in Valuation Approaches and Methods

There are three overall approaches to valuation: the income approach, the market approach, and the asset approach. In Revenue Ruling 59-60, the IRS ruled that all three approaches were to be considered in a valuation.

The purpose of a valuation assignment is not to create an average of the values from each of the three approaches, but rather to ensure that a rigorous and comprehensive process is undergone so that each approach is considered, compared, and used to inform the final valuation.

Where different valuation methods yield different indications of value, the valuator must clearly articulate how they arrived at a conclusion of value. Although it is sometimes tempting to weigh the indications equally, it is more important to factor the weight of each particular indication of value separately. In *Hendrickson Estate v. Commissioner* (T.C. Memo 1999-278), the Tax Court criticized, without explanation, the work of a valuator who afforded equal weight to the indications of value.

Errors in the income approach. Many errors can occur in the Income approach to valuation.

Errors in benefit stream mismatch. The right benefit stream should be adjusted for capital expenditures and working capital so that the matching capitalization rate or discount rate can be appropriately applied. Errors can occur by using accounting or book profit instead of discretionary cash or net cash flow numbers, as shown in *Exhibit 2*. Using a cash flow number for the entire company when valuing the company for an equity holder would produce erroneous numbers.

Errors in terminal value calculation. The two methods within the income approach are capitalization of earnings and discounted future earnings. Terminal value, reflected as a present value, is the value of the company at the end of the discounted cash flow period. Not discounting the terminal value to the valuation date will inflate the value of the business significantly.

Errors in growth rate factor. Many companies which experience periods of growth that exceed underlying economic growth rates, and capitalization rates (i.e., the discount rate less the long-term growth rate) depend partially on these growth expectations. Using a growth rate significantly higher than current economic conditions needs to be considered carefully, as it is unlikely to be sustained for long periods of time. The valuation difference created by using an incorrect growth rate is significant (see *Exhibit 3*).

Errors in the market approach. Using incorrect multiples in the market approach to valuation also leads to many common errors.

Improperly applying valuation multiples. When utilizing the market approach, many different multiples are used to calculate a company's value, such as revenue, earnings before interest, taxes, depreciation, and amortization (EBITDA), or earnings. Each multiple relates to a specific measure of financial performance.

When the wrong multiple is applied to the wrong benefit stream or factor, however, the resulting numbers will be erroneous. For example, a multiple based on EBITDA should not be applied to net profit.

Not understanding industry changes. A market approach valuation requires referencing historical transactions. Often, however, market factors in a given industry can change significantly in a short period. This change can render historical transaction numbers less useful, or even inaccurate.

Selecting only the lowest multiples. Using only the lowest multiples to generate value can raise red flags in court—creating the appearance of a company's value being artificially "low-balled" for favorable tax purposes.

Errors in asset approach. Including a company's operating assets in valuation calculations seems obvious because they are necessary to generate revenues and profits. Without operating assets, the business would be unable to function as a going concern. Therefore, in the asset approach to valuation, failing to revalue assets (and liabilities) with respect to an ongoing business will distort the numbers.

Failing to value non-operating assets when a company is no longer a going concern. The asset approach is more commonly used when the company is no longer a going concern when its assets are worth more than if the company was valued as an operating company. In these situations, many companies also own high-value assets that are not essential to their operations. These non-operating assets are sometimes overlooked. For example, the company may own unused land, access vehicles, or art investments that have no impact on the daily business operation. Leaving them out of calculations can deflate the business's total valuation.

Overestimating goodwill or underestimating intangible assets. Assuming that an established business has positive goodwill is a common mistake. Business goodwill only exists if a company generates earnings over and above a fair return on its tangible assets. Conversely, not considering or separately valuing the business's intangible assets, such as developed software or patents, will also lead to an inaccurate valuation.

Not considering built-in gains tax. Failing to account for the built-in gains tax with respect to the appreciated assets of an S corporation (formerly a C corporation) still within the five-year lookback period can be a mistake. The Tax Court has recognized the economic reality that capital gains taxes are considered by both buyers and sellers in establishing the purchase price of businesses (see "The Built-In Gains Tax," Scott B. Johnson, manatt, https://bityl.co/3Pzt).

Subjectivity in Minority and Marketability Discounts

Two major valuation discounts are lack of control (DLOC) and lack of marketability (DLOM). DLOC is applicable in calculating the value of an interest held by a minority owner, and DLOM is applicable when there are issues that affect the business's marketability. Depending upon the circumstances, the discount and cap rate are adjusted by DLOC and DLOM. Rather than using data relevant to a particular valuation, some valuators rely on case law for the determination of valuation discounts [In *Berg Estate v. Commissioner* (T.C. Memo 1991-279), the Tax Court rejected this practice because every case is different.] Consequently, a common mistake is failing to reconcile discount measurements with outside data sources and available studies that provide a quantitative reference point. But because these numbers can impact the valuation number significantly, extra attentiveness is essential.

Exhibit 3
Errors in Growth Rate Factor

	Reasonable Growth Rate	Inflated Growth Rate
After-tax Net Income	$2,500,000	$2,500,000
Cash Flow Adjustments		
Depreciation	*200,000*	*200,000*
Capital Expenditures	*(225,000)*	*(225,000)*
Change in Net Working Capital	*(250,000)*	*(250,000)*
Change in Interest-Bearing Debt	-	-
Net Cash Flow	2,225,000	2,225,000
Times: (1+ Long-Term Growth Rate)	*105.0%*	*110.0%*
Benefit Stream to be Capitalized	2,336,250	2,447,500
Divided By: Capitalization Rate	*20.0%*	*15.0%*
Indicated Value	$11,681,250	$16,316,667
Amount of Overvaluation		**$4,635,417**
Overvalution %		**39.7%**

Errors in Valuation Report Presentation

The final valuation document could be in the form of a summary report or a detailed report. It can be a calculation assignment or a conclusion assignment. But whatever its format, it should follow a clear, logical flow and be free of mistakes and calculation errors. It should also be consistent and cohesive.

Additionally, approaches both used and rejected in the valuation computation should be appropriately explained, with all assumptions defended and supported. In *Bailey Estate v. Commissioner* [T.C. Memo 2002-152, 83 TCM 1862 (2002)], the Tax Court criticized the appraiser for failing to do so. This is critical, because attorneys contesting valuations will focus on errors, omissions, and other mistakes to discredit the validity of the valuation as well as the expertise of the valuator.

Due to the subjectivity of valuations, it is imperative that readers be aware that the valuation analysis is the opinion of the qualified professional, not fact. Regardless of how "correct" the conclusion of the valuation may appear; it will not be acceptable to a court in the absence of a complete and comprehensive analysis. In addition, the valuation must be replicable by another valuator who reviewed the relevant valuation documents. In *Winkler Estate v. Commissioner* [T.C. Memo 1989-231, 57 TCM 373 (1989)], the Tax Court articulated perhaps one of the best arguments for a freestanding, comprehensive appraisal report.

Hiring a Valuator Who Does Not Keep Current

It is essential that anyone hired to do the valuation is current in their knowledge and skills. The art of valuation is dynamic and continually evolving. A valuator must be aware of new precedents and guidelines regularly emanating from court cases and IRS pronouncements. There are always new types of risks that need to be incorporated into valuations. For example, there is the risk of cyber-data breaches that could be detrimental to the value of a business.

Historically, valuations for private companies have utilized traditional valuation methods. Valuators of public companies have been more innovative in the ways they view different businesses and industries, which has led to new methods that can be considered for certain private companies.

One example of an innovative valuation method is customer-based corporate valuation (CBCV). Unlike the traditional top-down method, this valuation is a bottom-up method that considers each customer's value. CBCV can be applied to businesses with recurring types of revenue streams, such as subscription models. If performed correctly, a CBCV valuation could result in a higher valuation of a business than more traditional methods. A valuator who fails to consider newer and more modern approaches could be leaving money on the table.

One Size Does Not Fit All

Business valuation is both an art and a science. Not one-size-fits-all proposition, credible and reliable valuations are based on a variety of factors, including historical facts, calculations using past and current data, and subjective judgments. To be assured of accuracy, the valuation should be performed by a qualified professional who is immersed in the relevant facts and details of the company and industry.

The complex valuation process is prone to a multitude of common mistakes, errors, and omissions that can skew a final valuation number and render it inaccurate and legally inadequate. Hiring a business valuation professional requires thorough, diligent consideration to make sure an accredited, experienced, and reputable valuation partner has been chosen. ■

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