Business valuations

How to avoid common errors when determining the value of a company

INTERVIEWED BY ROGER VOZAR

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EVENT: Join Sean as he presents "10 Common Errors in Valuations and How to Effectively Cross-Examine These Issues" at a free lunch-n-learn program on June 26. Register at skodaminotti.com.

A business valuation isn't going to be very useful if it doesn't accurately reflect what a company is worth.

There are a few common mistakes made in the valuation process that can significantly affect the end result, says Sean Saari, CPA/ABV, CVA, MBA, a principal at Skoda Minotti.

"Valuation isn't a black and white discipline — it's a mix of science and art. There is a level of professional judgment that an expert exercises in every valuation, so it is important to make sure that the analysis is as sound as possible to limit critiques from those on the other side of an engagement," he says.

Smart Business spoke with Saari about valuation methods and common mistakes that are made in the process.

What are the different methods for valuing a business, and when should a particular one be applied?

The three valuation approaches are:

- Asset — Taking into account the set of assets and liabilities of a business.
- Market — Looking at sales of similar businesses or the values of comparable public companies.
- Income — Using cash flow and risk in determining value.

Valuation standards require consideration of all three methods. For example, the market approach can serve as a check that the income approach value is reasonable. Without applying and reconciling multiple valuation methods (to the extent possible for each engagement), a greater opportunity exists for both mistakes and the manipulation of the concluded value.

Besides a sale, are there reasons a business owner would want a valuation?

There are a number. One would be to settle a dispute among owners related to value. Valuations are also commonly done for gift and estate tax purposes, company financial reporting, strategic planning, and in both business and personal divorces.

What are common mistakes made in the valuation process?

There are a handful, but three common ones that can have a material impact are:

- Failure to consider all three valuation approaches. Sometimes valuation experts may be looking to arrive at a certain value and they may only be able to reach that number with one approach, whereas applying another method wouldn't support that result. They also may not have access to the data necessary to apply an approach, or may not be comfortable applying it, particularly with the market approach.
- Failure to properly analyze normalizing adjustments. Normalizing adjustments are made to a company's historical income statements in order to develop reasonable expectations for the future. Adjustments are typically made for items that are non-recurring or non-operating in nature, such as a company selling a piece of old equipment. To the extent that the gain on the sale is not normalized out, it could lead to the company being overvalued.
- Failure to tax-affect the earnings of a pass-through entity that is being valued. Although pass-through entities — S corporations, LLCs and partnerships — do not have entity-level income taxes, there are still income taxes levied at the investor level. If those taxes are not considered, you will end up significantly overvaluing the company.

The IRS has taken the position in prior cases that it doesn't like the tax-affecting of pass-through entities — it prefers that values are as high as possible for gift and estate tax purposes. However, there's pretty unanimous consensus in the valuation community that the tax-affecting of pass-through entity earnings is appropriate and needs to be considered.

What happens when the valuation is not accurate?

In a transaction context, you're going to have a hard time bridging the gap between buyer and seller. For example, if one party isn't going to consider income taxes and the other one is, it can be difficult to arrive at a purchase price that everyone can live with.

In a litigation context, inaccurate valuations leave the expert vulnerable to cross-examination by opposing counsel and increase the likelihood of the court relying on the opposing expert's valuation conclusion. ●