The Advisor

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- Top 10 Business Valuation Mistakes
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TOP 10 BUSINESS VALUATION MISTAKES

As a business owner the business valuation process seems like a big black box. You insert lots of information into it and several weeks later you get a very thick and confusing report that tells you how much your business is worth. The problem is you don't understand the process or the report and don't know how to evaluate either. When reading the report, look for these common business valuation mistakes.

Mistake #1 – Unqualified Appraiser

The most common problem with business valuation reports is that they have been prepared by someone who is unqualified. There is little, if any, regulation of the business valuation industry and it is often difficult to find firms that offer business valuation services. People tend to hire the first firm they find or their current accountant/tax preparer. Not all CPAs are competent in business valuation. In fact, many CPAs have very little or no business valuation experience or training.

Look for professionals that have at least one of the following major business valuation designations by searching their online directories.

Accredited in Business Valuation (ABV) - http://www.aicpa.org/credentialsrefweb/ABVCredentialSearchPage.aspx

Accredited Senior Appraiser in Business Valuation (ASA-BV) - http://www.bvappraisers.org/find/

Certified Business Appraiser (CBA) - http://www.go-iba.org/directory.php

Certified Valuation Analyst (CVA) - http://www.nacva.com/dir/

Mistake #2 – Not Objective

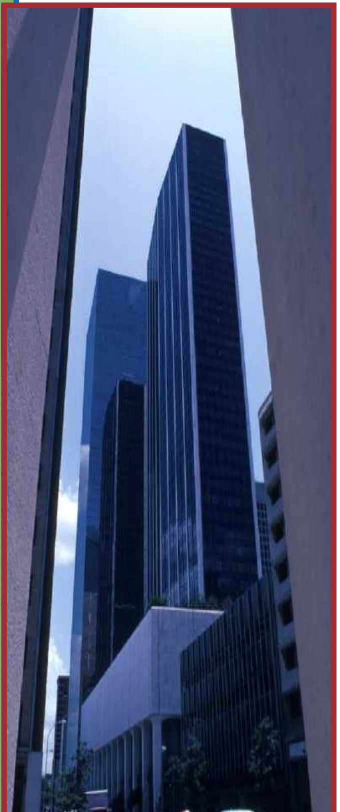
In the course of performing a valuation many judgment calls are made, so the independence and objectivity of the appraiser are critical to producing a credible result. A CPA firm that has a long, established history with the company being appraised is generally not considered independent.

Mistake #3 – Uses Rule of Thumb Formulas

Industry rules of thumb can be useful to get a "quick and dirty" estimate, but they have some serious flaws. No one really knows the quality and the quantity of the data on which they are based. The formulas typically use multiples that are expressed in ranges (like 1 to 2 times annual sales) that result in widely varying values.

Mistake #4 – Values Future Potential

A fundamental rule I learned from business brokerage is – never, ever pay for potential. Developing potential requires an investment



"SUCCESS IS WHEN PREPARATION MEETS OPPORTUNITY"

TOP 10 BUSINESS VALUATION MISTAKES (Cont.)

of time, effort and money, and also involves risk. Undeveloped potential has no value.

Mistake #5 – Uses an Arbitrary Multiple or Rate

Many valuation methods call for applying some type of multiple to company financial data. These multiples are a critical component in determining value. Yet, they often appear with little or no explanation of how they were determined and why they are appropriate.

Mistake #6 – Uses Only One Valuation Method

There are many ways to value a business. A valuation that uses only one method is suspect. Best practices require that all three valuation approaches (market, income, and asset/cost) be considered.

Mistake #7 – Does Not Define If Assets or Stock is Being Appraised

Companies can be sold in two basic ways – asset or stock sales. An asset sale is the most common type of transaction. Asset sales typically include only the inventory, equipment and intangible assets (goodwill) of a business. A stock sale is a sale of the entire entity and includes all its assets and liabilities. Most valuations estimate the value of a company at the entity level, but the valuation report should clearly indentify what property is being valued.

Mistake #8 – Counts the Value of Intangibles Twice

It is tempting to adjust the value of a company for intangibles like: name recognition, loyal customer base, a great location, etc. The company benefits from these intangibles through higher sales and improved cash flow. Therefore, valuation methods based on sales or cash flow already account for these intangibles. They should not be counted twice.

Mistake #9 – Does Not Define Whose Perspective is Being Used

The value of anything depends on whose perspective is used to determine it. The standard of value defines the perspective used in a valuation. The most common standard of value is fair market value which is based on the perspective of a hypothetical sale of the company from a hypothetical seller to a hypothetical buyer. Hypothetical is generally defined as the most-likely.

Mistake #10 – Uses Valuation Methods or Data That Don't Match

The value of a business interest is based on two criteria – marketability and control. The valuation method and data used must match the type of business interest being valued. A share of stock of a publicly traded company does not control the company and is easily sold. A 100 percent interest in a privately held business does control the business and is not easily sold. Data from public companies cannot be used to value a privately held business without being adjusted to compensate for the differences.

Conclusion

Business valuation is a complicated process. Now, you can look for these common mistakes to help you evaluate those thick and confusing valuation reports.

Written by David Coffman

"One who acts as their own council has a fool for a client"

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Please let us know if you have any questions or would like to discuss the above articles with one of our trained Business Analyst.

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