

## ***7 Deadly Sins of Business Valuation***

### ***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!

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## *Executive Summary*

A valuation professional must rely upon experience and reasoned, informed judgment in conducting a valuation and preparing a credible valuation report. The number of inputs, assumptions, and calculations that the appraiser must make in the process gives rise to potential errors that could have an adverse impact upon the indication of value and the credibility of the valuation report and the appraiser. The valuation professional must be diligent in ensuring that the valuation report is free from errors that may compromise its integrity.

Highland Global has identified the seven most deadly sins that the valuation professional may commit in preparing a valuation. These issues include the following:

- **Incorrect Adjustments to the Income Statement and Balance Sheet**—Incorrect adjustments to the income statement and balance sheet may produce an unreliable indication of value. Failure to remove real estate and associated expenses from the financial statements and failure to replace this with a market rate of rent is a common adjustment error made. Erroneously making adjustments that only a control owner could make when valuing a non-controlling or minority interest is also a common error.

The errors may result in significant disparities in value of the subject company. The real estate owned by the subject company or operating entity and associated expenses should be removed from the financial statements prior to analysis and valuation. The market value of the real estate, as developed by a qualified real estate appraiser, may then be added to the value indication for the business to determine the total value including both the operating entity and the real estate. In addition, adjustments made to the financial statement must be on a comparable basis as the interest being valued. In the case of a minority interest valuation, a minority shareholder would not have the ability to effect control decisions related to financial statement adjustments (i.e. management compensation or discretionary expenses). If the cash flows are adjusted to reflect control decision, the value estimate must be reconciled to a minority basis using a lack of control discount.

- **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. Though a company may be able to grow its earnings (or revenues for that matter) by an above trend growth rate in the short-term, this high growth rate cannot be maintained in perpetuity as the company's earnings would eventually surpass the size of the nation's economy.

Therefore, the appraiser must be cognizant of the range of growth rates that may be applicable to the subject company's future earnings and use this range to bound the appropriate growth rate applicable to future earnings. The appraiser may use an above trend growth rate for the first years of a multi-period forecast but must then use a long-term sustainable growth rate in perpetuity that is bound by a reasonable estimate of the long-term sustainable growth of the United States economy (usually as measured by GDP growth).

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. The valuation professional must ensure that in making a forecast of the subject company's earnings stream the projected capital expenditures exceed the projected depreciation in perpetuity when using a single period capitalization method or a multi-period discounted earnings method under the income approach. In perpetuity, capital expenditure will always be greater than depreciation. Otherwise, the firm's fixed assets would be depreciated at a faster rate than they are replaced. In time, with depreciation higher than capital expenditures, there would be no fixed assets left to depreciate.

It is generally accepted that the projected capital expenditures and depreciation are best estimated based on a proportional relationship between the two. For a stable, mature business, the valuation professional may examine the historical relationship between capital expenditures and depreciation over the last five years or so. As an alternative, the appraiser may consider the historic proportion of capital expenditures to sales and the historic proportion of depreciation to sales,

total fixed assets, or another metric deemed appropriate. These historic relationships may then be utilized in making the forecast of the subject company's earnings.

- **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 business valuations. Failure to match these rates and benefit streams results in an erroneous value conclusion, which may tarnish the reputation of the valuation professional. The client may also be severely disadvantaged by the disparity in value resulting from the mismatch of rate and income stream, particularly if a higher value than warranted is reported for tax purposes or a lower value is developed for transactional purposes.
- **Specific Company Risk Premium Estimation**—The specific company risk premium is an important part in the development of an appropriate discount rate/capitalization 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 investment being valued. In turn, this could lead to significant valuation errors when determining the value of a specific asset.

Given the possible arbitrary selection of this premium, there is a need for a quantifiable analysis for the specific company risk premium to further strengthen business valuations and to limit the appraiser's exposure to attacks on credibility and results. This gives rise to a factor analysis for supporting the selection of a specific company risk premium. Whether valuation professionals use a factor analysis (such as that developed by Highland Global, the complete article being available at [www.highlandglobal.com](http://www.highlandglobal.com)) or another method of selecting an appropriate

premium, great care and diligence must be taken to select and defend the specific company risk premium applied in a valuation.

- **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. The failure of the appraiser to thoroughly discuss the assumptions, approaches, and procedures used to develop the indication of value is a significant error in the preparation of a valuation report. The importance of the ability to replicate the valuation should not be underestimated. A skilled attorney or another appraiser critiquing the report would likely be able to easily discredit the valuation and the appraiser based on this issue. This not only fails a fundamental of the business valuation profession but also fails the client by compromising the integrity of the valuation report and the valuation conclusions.
- **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. 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. An error in estimating an indication of value that is not consistent with the selected standard of value may significantly impact the value conclusion. The valuation professional must ensure that the value estimate presented in the valuation report matches the standard of value if the report and its conclusions are to be meaningful and credible. Erring in this aspect will totally discredit the valuation.
- **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 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 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.

In order for the valuation to be credible and withstand scrutiny, the valuation professional should clearly explain the reasoning for the amount of the ultimate discounts selected. Consideration of a number of factors impacting each discount would be helpful in providing a solid foundation for the selection of the appropriate discount. Failure to provide enough reasoning or explanation for the selection of discounts applied to a value estimate makes replication of the value conclusion nearly impossible. These errors and failures by the valuation professional compromise the valuation and render the value conclusions irrelevant.

The errors previously discussed may have a significant adverse impact upon the indication of value produced in the valuation report. To be sure, these errors, if made, may have a detrimental effect upon the credibility of the valuation, and for that matter, of the valuation professional or M&A professional involved. To ensure a meaningful and credible valuation, the valuation professional must use experience and reasoned, informed judgment in the valuation process as well as be cognizant of the potential errors that may be inadvertently made and the impact such errors may have upon the valuation.

## *About the Authors*

### **Robert M. Clinger III, AVA**

Mr. Clinger, co-founder and Managing Director of Highland Global, LLC, has strong experience in the fields of business valuation and financial analysis. At Highland Global, LLC, Mr. Clinger provides strategic planning and financial analysis to senior management of privately-owned and family-held businesses domestically and internationally. In addition, Mr. Clinger conducts valuations and assists in exit planning for client companies. Mr. Clinger has also written numerous articles regarding economics, valuations, and merger & acquisition issues.

Mr. Clinger earned a Bachelor of Science degree in Business Administration/Finance, summa cum laude, from Coastal Carolina University. Mr. Clinger received the distinguished President's award from Coastal Carolina University as well as the Financial Executive Institute Scholar's Medallion from the Carolina's Chapter. Mr. Clinger has also earned the Accredited Valuation Analyst (AVA) designation from the National Association of Certified Valuation Analysts (NACVA).

### **Paul Morin**

Mr. Morin is a founder and Managing Director of Highland Global, LLC. He is an advisor to senior management on three key issues: strategic and financial planning and analysis, valuation, and exit option planning/execution. Mr. Morin has worked with various companies in the role of Chief Financial Officer, Controller and advisor, and has led the development, review, and selective implementation of several hundred start-up and corporate venture business plans, financial models, and feasibility analyses. He has also performed due diligence on and valuation of many potential investment and acquisition candidates.

Prior to founding his own strategy consulting practice in the late nineties and more recently co-founding Highland Global, Mr. Morin was Director of the Wharton Small Business Development Center (SBDC), a consulting group within the Wharton School's Entrepreneurial Programs.

Mr. Morin holds a Bachelor of Science degree in Economics and an MBA from the Wharton School of the University of Pennsylvania.