BY CHRIS HAMILTON, CPA



# Without Further Ado...

## Top 10 Business Valuation Errors

CPAs often advise clients regarding the value of their businesses, whether they perform the valuation themselves or help clients find and hire a qualified appraiser. In either case, the client and appraiser rely on the CPA for financial information, projections and analysis.

In addition to being cited frequently in legislation, valuation reports are required for filing estate and gift tax returns, ESOP annual reports, financial planning, estate planning, succession planning, FAS 141 and 142 compliance, and transfer pricing as well as in anticipation of a merger/acquisition.

Valuation reports contain highly technical language that can make them difficult to understand by those who are not properly trained. This can mask serious deficiencies in a report that may render its conclusions irrelevant—or wrong.

Following are common valuation errors for which CPAs can be on the lookout:

### 1. Math Errors

Even the most sophisticated reports can contain calculation errors. In a business appraisal, one error early in the process can have a dramatic impact on the conclusion of value. Verifying each calculation is a must.

### 2. Tax Issues

An example of the most common error is that the proper application of taxes is not considered.

There are several other controversial tax issues depending on the form of business being valued. The two most significant are the consideration of built-in gains and tax affecting S corp. earnings. Review how these issues were addressed and whether the assumptions, calculations and conclusions are accurate.

### 3. Incorrect Standard of Value

There are three generally accepted standards of value: synergistic/investment value, fair market value and fair value.

Strategic business acquisitions often are done at synergistic/investment value, and fair market value and fair value are theoretical values as defined by tax regulations and statutory definition. The purpose of the business appraisal will determine the standard of value to be used and the standard of value will define the value conclusion.

Take, for example, a stockholder dispute that requires a valuation report as a part of the litigation process. The standard of value in most state courts is fair value [Fair Market Value is a theoretical value that is most often used for tax (estate and gift) purposes]. If the appraiser reports the value on a fair market value standard, the report is irrelevant and will be rejected. Appraisal reports prepared for compliance with estate and gift tax rules must use the fair market value standard.

### 4. Levels of Value

If publicly traded companies are used as comparable sale data for a closely held company, it's possible that the appraiser is comparing dissimilar companies.

For example, a price-earnings ratio from a publicly traded company that is directly applied to the earnings of a closely held business will result in a marketable minority value. If the purpose of the appraisal was to determine the value of a non-control ownership interest, there must be an adjustment for the difference in marketability between the publicly traded stock and the subject company. Without that adjustment, the value conclusion may be dramatically overstated.

### 5. Incorrect Valuation Method

Asset, market and income are three approaches to valuing a business.

The asset approach values the assets of the business as the basis for value and is appropriate when valuing an asset holding company. The market approach is appropriate if truly comparable, recently sold companies can be located. The income approach, which bases the value of the business on cash flow and income, is appropriate for most businesses.

If an income approach is used for an asset holding company or an asset approach is applied to a service business, for example, it is probable that the resulting conclusion is incomplete or incorrect. Also, in California, and in most states, the use of a discounted cash flow method (income approach) would be useless in a divorce matter, as the court would reject the methodology.

### 6. Factoring in Risk

There must be an analysis of risk when using an income approach, as well as a measure of the probability that the subject company will produce the income/cash flow in the amount and for the duration that the appraiser has projected.

The quantification of risk is in the form of a capitalization rate (applied to a single stream of income) or a discount rate (used when projecting the cash flow forward until the company has stabilized earnings, then the terminal year is capitalized and the amount is discounted back to the present). This is probably the most subjective area of the appraiser's report.

Some of the more common areas associated with the analysis of risk include:

- Misuse of capitalization rate: applying rate to projected earnings.
- Misuse of discount rate: applying rate to historic earnings.
- Subjective elements disguised or made to look objective and scientific.
- Net income factored with a cash flow capitalization rate, and vice-versa.
- Applying an after-tax rate to pre-tax income, and vice versa.
- Using public company risk rates to value closely-held businesses.
- Insufficient adjustment for company specific risk factors.

### 7. Misapplication of Market Data

Many business appraisers like to use publicly traded companies to provide "market comps."

Although this isn't erroneous in itself, problems occur when using public company transaction data without adjusting for the additional risk associated with small companies (size risk) and the risks associated with the subject company (company-specific risk). This error almost always results in an overstatement in the company's value.

### 8. Combining Discounts

When valuing an interest in a business (less than 100 percent) the appraiser is likely to apply discounts for lack of control and lack of marketability. If both discounts are 20 percent, the cumulative impact may be reported as 40 percent. This would be incorrect and result in an understatement of value.

The proper affect of the discounts is not additive and should be applied sequentially (1-([1-20 percent] x [1-20 percent]) = 36 percent).

### 9. Improper Adjustments to Accounting Records

A business appraiser, regardless of valuation method, must "normalize" financial data to remove the effect of unusual or non-recurring transactions. These adjustments can include personal expenses deducted as business expenses, excessive or discounted rent paid to related entities, contracts with related entities that are above or below arms-length terms, reasonable compensation for owner/managers, etc. These adjustments should be clearly disclosed and explained in the appraisal report.

Common errors include making control adjustments (e.g. reasonable compensation) when valuing a non-control interest in the business, or making strategic adjustments (e.g. eliminating overhead costs when preparing a valuation on the fair market value basis. A strategic buyer might consider the economics of merged operations but a "hypothetical" buyer would not necessarily view the business in that light.

### 10. Growth Rates

Implicit in almost every business appraisal is a terminal growth rate: the rate of growth the appraiser projects will happen annually into perpetuity. Overstating and understating the growth rate can result in equally misleading results. For example:

A 10 percent terminal growth rate doesn't sound like much at first. Consider, though, that perpetuity is a really long time. Under this example, net income of $100,000 will grow to nearly $11 million in 50 years and $1.3 billion in 100 years. That would make it the eighth-largest economy in the world. On the other end of the spectrum, consider a 1 percent growth rate. With an average historical inflation rate of 2.5 percent to 3 percent the result of such an assumption by the appraiser is that the company is effectively dwindling and wasting away.

The terminal growth rate may or may not be highlighted in the report, but it has material impact on the conclusions and it should be considered carefully. Many valuation practitioners use a growth rate that ranges between the inflation rate and annual GDP growth rate—2 percent to 5 percent.

**Chris Hamilton, CPA, CFE, CVA, DABFA** is a partner with Arxis Financial, Inc. and member of the CalCPA Litigation Sections. You can reach him at chamilton@arxisgroup.com.