Business Valuation Basics:
What to Consider When Considering a Valuation

Sean Saari, CPA/ABV, CVA, MBA

- Calculation of Value vs. Conclusion of Value
- Business Valuation Credentials: What the Alphabet Soup Means
- The Dangers of Relying on Rules of Thumb
- Valuation Reports: Reduce, Re-Use, Recycle
- Buyer Beware: Quick-Fix Valuations May Result in More Harm Than Good

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Introduction

A business valuation is just a business valuation – isn't it? This would be akin to saying that a steak is just a steak when, in fact, there are ribeyes, strips, sirloins, and filets (just to name a few). If you are in need of valuation services, understanding the basics will help you identify what type of valuation analysis may be the best fit for your situation, much like knowing what dish calls for a lower grade chunk steak and what requires a premium filet.

This e-book will help you better understand the following:

- The difference between conclusion of value and calculation of value
- What credentials business valuation experts may hold
- Whether or not you can rely on the value indicated by an old business valuation
- The drawbacks of "quick-fix" valuation reports
- What issues may arise from using business valuation "rules of thumb"

If you are interested in learning more about the fundamental components of business valuations for companies, I invite you to continue reading this e-book.

About the Author

Sean Saari, CPA/ABV, CVA, MBA - Skoda Minotti

Sean is a senior manager with Skoda Minotti's Business Valuation and Litigation Support Group. In this role, he is responsible for the development review and issuance of valuation reports, calculation of value reports, and expert reports under valuation and consulting standards. Sean has assisted a diverse client base in litigated matters, domestic disputes, shareholder disputes, estate and gift tax filings, and financial reporting valuation issues.

Additionally, Sean serves in Skoda Minotti's Accounting & Auditing department. He is primarily responsible for performing audits, reviews and compilations for companies in a variety of industries.

Sean earned his Masters of Business Administration (with honors) from Case Western Reserve University and his Bachelors of Business Administration (with honors) from the University of Notre Dame. He is a member of the American Institute and Ohio Society of Certified Public Accountants, the National Association of Certified Valuators and Analysts, and the Center for Principled Family Advocacy. Sean is the recipient of the 2010 Jeffrey R. Salins Report Writing Award, and serves as Chair of the Marketing Committee on the Lake Catholic High School Advisory Board. He is also a member of the AICPA's ABV Exam Review Task Force and NACVA's Case Study Peer Review Team and Q&A Review Team.

Calculation of Value vs. Conclusion of Value: What's the difference?

Similar to the differing levels of service traditionally offered by accounting firms in performing audits, reviews, or compilations, business valuation engagements are now separated into two defined service categories:

Conclusion of Value

- All three valuation methods (asset-based, income-based, and market-based) are required to be considered
- Detailed development and reporting requirements must be adhered to by the valuation analyst, making the engagement more time consuming than a calculation of value
- This is the required type of report for estate and gift tax filings; Also typically required for instances in which the valuation analyst will need to defend his or her findings and report (i.e. in litigation)
- The valuation analyst opines on the value of the business or business ownership interest

Calculation of Value

- The valuation methods to be used in determining value are discussed and agreed upon beforehand between the client and the valuation analyst
- Reduced development and reporting requirements compared to conclusion of value engagement
- Ideal for planning purposes (e.g. strategic planning, transaction (purchase or sale) planning, or litigation or divorce proceedings in the settlement stage)
- Valuation analyst does not opine on the value of the business or business interest, rather, the valuation analyst applies the valuation methodologies agreed upon with the client
- Generally not defensible in litigation settings because the valuation analyst is not offering an opinion of value, rather, the analyst "calculates" a value based on methods agreed upon with the client
- Typically costs less than a conclusion of value
- Has been found to be useful in divorce situations in which a spouse will obtain a calculation of value to aid in the settlement process; If a settlement is not reached, the engagement can then escalate to a conclusion of value so that the valuation analyst can opine on a value and defend it in court, if needed

As you can tell from the discussion above, all "valuation" work is not created equal. For business owners, as well as their attorneys and other advisors, it is important to be aware of the varying levels of valuation service offered so that the appropriate type of report is obtained. You should discuss the purpose of the valuation with the valuation expert in detail as the engagement is forming so that the level of service can be tailored to your specific needs.

For a free business valuation consultation for your company or to simply meet and discuss your company's situation, give our Business Valuation Group a call at 440-449-6800.

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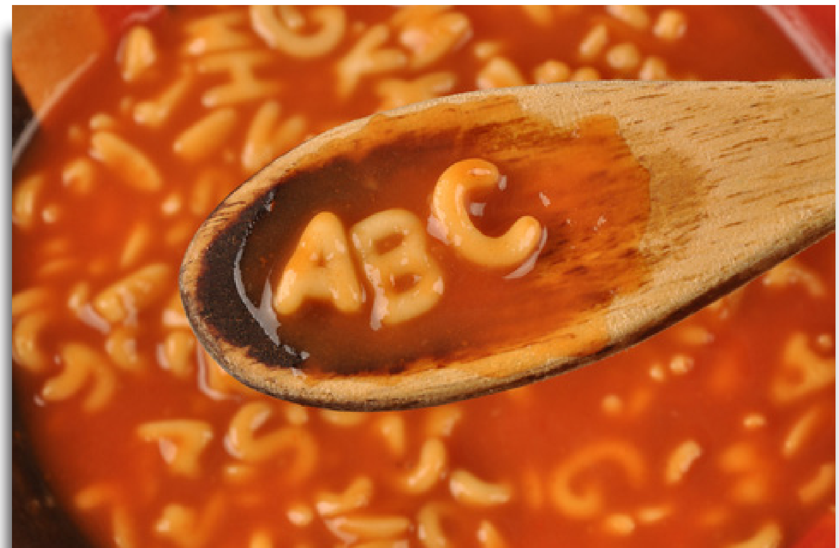
Business Valuation Credentials: What the Alphabet Soup Means

As if it isn't hard enough to remember someone's name when you first meet them, business valuation experts typically have a mass of letters after their name, too. While most people are familiar with the CPA (Certified Public Accountant) designation, there a number of other credentials that indicate proficiency and experience specifically in performing business valuations. The summary below is a "decoder ring" to some of the more common valuation credentials. I promise the secret message will not be "Drink Your Ovaltine" – I have seen Ralphie disappointed in The Christmas Story too many times to do that to you.



- **Certified Valuation Analyst (CVA) –** This credential is offered by the National Association of Certified Valuation Analysts (NACVA) and has been around since 1991. There are approximately 5,000 practicing CVAs. This is one of the more common credentials that CPA valuation practitioners attain and it is well-respected within the valuation community. You must be a CPA in order to attain a CVA designation.

- **Accredited in Business Valuation (ABV)** – This credential is offered by the American Institute of Certified Public Accountants (AICPA) and has been around since 1997. There are approximately 2,500 practicing ABVs. Like the CVA, you must be a CPA in order to attain this designation and it is highly regarded within the valuation community.

- **Certified in Financial Forensics (CFF)** – The CFF is a newly-developed credential offered by the AICPA. While financial forensics is not directly related to business valuation, sometimes certain forensic techniques are applied when gathering the data necessary to value a business. Because the experience requirements for CFF's are very similar to those possessed by business valuation experts, it is common to see professional with this designation.

- **Accredited Valuation Analyst (AVA) –** This is the same designation as the CVA, except it is for professionals without a CPA license. AVAs and CVAs must go through the same training and testing requirements.

- **Accredited Senior Appraiser (ASA)** - This credential is offered by the American Society of Appraisers and has been around since 1981. There are approximately 1,000 practicing ASAs. You are not required to have a CPA license in order to achieve this credential, but it is still highly esteemed in the valuation community.

Business Valuation Credentials: What the Alphabet Soup Means

- **Chartered Financial Analyst (CFA)** – This credential is more commonly seen in the investment banking and investment management world, but business valuation analysts will sometimes have this designation, as well. While the CFA program does not focus entirely on business valuation, it is rooted in valuation concepts and the rigorous test requirements make this a widely respected credential.
- **Certified Business Appraiser (CBA)** – This credential is offered by the Institute of Business Appraisers (IBA) and has been around since 1978. There are approximately 500 practicing CBAs. While not as popular as the other credentials listed above, it will still pop up from time to time.

Sorting through the alphabet soup of business valuation credentials can be confusing. While there is no "perfect combination" of valuation credentials for a practitioner to obtain, it is important that any valuation analyst that you hire have valuation experience and preferably one or more of the credentials listed above.

Valuation Reports - Reduce, Re-Use, Recycle?

"Go Green!" There is a big push in our office to work in an environmentally-friendly manner – from turning out the lights after leaving an area, to recycling pop cans, to our Real Estate and Construction niche group members obtaining Green Advantage Commercial/Residential (GACR) certifications. Regardless of whether global warming is a real or make-believe phenomenon, the concept of making more efficient use of the resources that we currently have will only continue to grow as the world's population increases. As the "green" movement was finding its roots a number of years ago, I remember hearing the phrase "reduce, re-use, recycle." In the world of business valuation, does the same mantra hold true?

The answer – it depends. Three major areas that must be considered before relying on the value indicated by an old business valuation are as follows:

1. **Changes in the Company, Economy and Industry –** Depending on the length of time between the original valuation date and your current date, there may have been significant changes in the Company and its future prospects. Has the Company grown or shrunk since the last valuation? How does the economic and industry outlook as of the current valuation date compare to that as of the original report date. Even moderate changes in any of these areas could have a significant impact on value.

2. **Standard of Value –** If a different standard of value is necessary for the current valuation, the value indicated by the original report may not be suitable for use. For example, if the original report was based on "investment value" for a potential acquisition and the more current analysis needs to be at "fair market value" for gift tax purposes, the old report will not likely be useful for the current purpose.

3. **Level of Value** – An "apples to apples" value may not be obtained if the original valuation was prepared on a controlling, non-marketable basis and the new valuation must be a non-controlling, non-marketable basis. Differences in value due to lack of control and lack of marketability discounts often reduce the pre-discount value of a company by 30%-50%. Unless adjustments are made to account for a different level of value, the value relied upon may wildly overstate or understate that of the current ownership interest.

Considering the rapidly changing economic climate over the past few years, there are few, if any, older valuation reports that are still relevant today. However, a good rule of thumb is that the more recent the prior valuation was performed, the more likely that has any relevance/reliability now. Be aware that most, if not all, valuation reports contain disclaimers that they are not valid for any purpose or date other than those specifically identified in the report. Therefore, if you do rely on an older valuation report to provide a current indication of value, be prepared for the expert who prepared the original report to not provide his support for the value as of the new date (unless he possibly performs additional procedures and updates the value if necessary). If you are in a position where you are thinking about re-using an older valuation report, talk with a valuation analyst and get a feel for how the value indicated in the original report may or may not apply now – there is a strong likelihood that it may be too stale to re-use.

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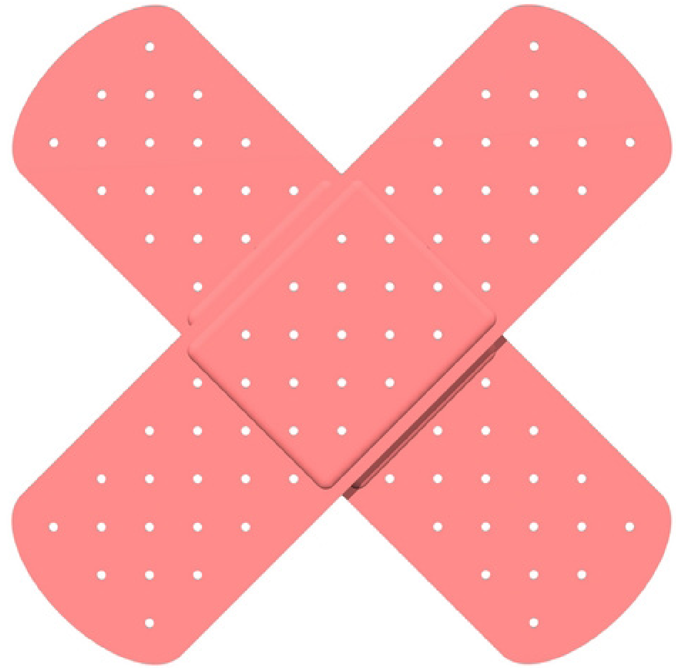
Buyer Beware - Quick-Fix Business Valuations May Result in More Harm than Good



I think we've all heard the saying, "There's no such thing as something for nothing." I think it is possible to take that a step further and say, "There's no such thing as a lot for almost nothing." With the current economic downturn, consumers have become far more judicious with their purchases and are doing all they can to squeeze as much out of every dollar spent. Personally, I'm still using a flip-phone without internet, I pretty much only get new clothes on my birthday or Christmas, and my wife and I eat at home for most meals. We are all looking for ways to reduce our spending while still maintaining a similar standard of living. In many areas, though, particularly with professional services, the old adage of "you get what you pay for" still rings true.

As business valuation experts, we have run across a number of clients who previously obtained "valuations" from companies that offer their services online for only a few hundred dollars. Oftentimes, the result is a poorly-produced, unreliable analysis that does not appropriately determine the Company's value. Further, these reports are often not admissible in the courtroom (or they are beaten up by opposing counsel if they are admitted). It is a classic example of paying a little and expecting a lot – it is also something that I think I would probably do myself to keep my expenses low if it weren't for my background in business valuation and litigation support (during which I have seen even extremely credible experts who have poured numerous hours of work into an engagement have the reliability of their conclusions and reports questioned).

It is important to note that credentialed valuation experts have certain professional standards that they must follow when they provide their services. This is meant to ensure a level of professional competency and reliability that is not present in many of the "quick fix" valuation shops. Some of the first areas that an opposing attorney will explore in cross-examination are a valuation expert's credentials and adherence to professional standards. If the expert cannot address these questions, his testimony will likely carry little weight (if it is even allowed in the courtroom).

I can appreciate wanting to keep expenses down during this difficult economic environment – I think my wife may call me "miser" more than she calls me "honey," but when faced with a valuation issue that may end up being litigated, it is worth the investment to bring in a credentialed expert who has the ability to support his or her conclusion against scrutiny from opposing counsel. To paraphrase a quote from super investor Warren Buffet, "It is better to buy something great at a fair price than buy something fair at a great price."

The Dangers of Relying on Rules of Thumb in Business Valuations

There are many tales behind the origin of the phrase "rule of thumb," some of which are more realistic than others. The story that is the most widely accepted is that woodworkers used to use the width of their thumb, rather than rulers, for quick measurements. Regardless of how the phrase got its start, a rule of thumb is considered to be an imprecise, yet convenient measurement standard. Relying solely on a rule of thumb to value a business, however, can lead to unreliable valuation conclusions.

Rules of thumb used for valuing businesses are often industry specific and are stated as multiples of revenues, EBITDA, net income, or some other metric. Rules of thumb often have their foundation in industry hearsay mixed with multiples derived from actual transactions for similar companies (although which transactions and companies are anybody's guess). Considering the unprecedented economic environment today, older rules of thumb may no longer be reliable regardless of their predictive power of value in previous years. In addition, rules of thumb often do not take into consideration the profitability of the company being valued, the industry outlook, the depth of management, and many other factors that are considered when a full business valuation is being prepared. Finally, nearly every professional valuation association (if not all of them), does not allow for a rule of thumb to be used as the primary valuation methodology. As a result, relying on a rule of thumb alone to value a business will result in a value that will not be defensible before the IRS or in litigious situations.

Although using a rule of thumb is frowned upon as a primary valuation method, rules of thumb may still be beneficial to business owners and valuation analysts. For business owners, rules of thumb offer quick and dirty estimates of value that can be useful for high-level strategic planning. For valuation analysts, rules of thumb can be used a reasonableness check for the value of a company determined by asset, income, and market-based approaches.

The important thing to remember is that a rule of thumb is a great shortcut for a business owner to use to determine the value of his or her company for strategic planning. If a defensible value is required, however, a rule of thumb should be used as no more than a cross-check against the more traditional valuation methods, such as the capitalization of earnings/cash flow method, discounted earnings/cash flow method or private company transaction method.