The Role of Valuation Specialists: Telling it Like it is or Telling it like it Ought to Be

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In Thomas Wier’s recent article, “Definition of the Lemon Market is valued at $900,000” (May/June 2002, Valuation Examiner), the author decries what he calls the lemon market as it applies to the sales of medical practices. A lemon market exists, according to the author, when potential purchasers of a product or business lack or have only inaccurate or partially complete information about the product or business. Used cars are a classic example cited by the author. A lemon market exists in the sale of medical practices, according to Mr. Wier, because:

“Physicians, although highly educated, are not experienced or educated in business and financial matters and make guesses or use inapplicable rules of thumb to make an offer on a medical practice. One such poor rule of thumb is expecting a medical practice to sell at one times gross revenue.”

According to Mr. Wier, “the lack of a complete valuation, particularly with the full descriptive elements, makes a medical practice sell at a very low price, if at all.”

Presumably a complete valuation using a more proper methodology will yield the right or higher price.

Based upon past experiences, I can empathize with Mr. Wier’s frustrations.

However, my frustration as a practicing CPA advising clients considering acquiring small businesses went in the opposite direction. I found more clients willing to pay more for closely held businesses than I thought they should.

Clients would come to me for advice about acquiring a small service or retail business usually telling me with stars in their eyes, “I always wanted to own my own business.”

Of course, there was always some kindly owner of a small business willing to sell the business to my client for the reasonable sum of $10 million or some other slightly lower but seemingly outrageous price.

In most cases I succeeded in suppressing my urge to leap across my desk and slap the client until he or she came to his or her senses. Often, I patiently attempted to explain that the price paid for a business ought to be related to the expected future return and the inherent risk associated with the venture.

Here is a representative sample of the kind of conversations I have had with prospective purchasers of small businesses in the past:

CPA: So how much has the kindly current owner earned in the past? Has he given you reliable (audited or reviewed) financial statements?

Client: No, there are none but he did give me a Quickbooks printout for the last two days of operations.

CPA: How about tax returns for the last five years? Has he given you those?

Client: Yes, here they are.

CPA: Looking over these Schedule Cs, it appears that the current owner has never made a profit and has in fact incurred significant losses.

Client: Yes, I asked him about that. But he said that the Schedule C does not include all the revenue, that the ending inventory is understated by a factor of ten, and that payroll expenses includes $75,000 paid to his fifteen-year-old daughter to be marketing director. The current owner said that with factoring in underreported revenue and inventory and less salary expenses in the future, I should net a handsome profit.

CPA: And you… believed him?

Much to my amazement my clients very often did believe the current owner’s puffery and turned around and paid what I thought was an outrageous price for the business.
So, for a long time I thought about my clients as Mr. Wier thinks about doctors, namely, that they were simply ill informed about how to properly value a closely held business. I thought it was our role and responsibility as valuation specialists to tell clients what price they ought to pay for a particular business. As professionals, we need to set these naive buyers and sellers straight.

After all, we understand the relation between risk and return. We understand how to analyze past financial information to “normalize” the data to provide a clear picture of future earnings. We understand how to capitalize expected future earnings using Cap M or WACC. We understand how to assign specific inputs to these models, because our understanding of the industry and the general economy allows us to specify the correct and exact amount of risk associated with the business being evaluated. We can tell you the correct price that ought to be paid for any given closely held business.

Well... maybe. Lately, I am having serious doubts about how sure we should be about telling other people what ought to be the right price for a particular closely held business. Why am I having doubts? First, even our most complicated and sophisticated quantitative models are applied to projections of future earnings; no matter how much we have studied the particular business, the industry as a whole, or the general economy, there is absolutely no certainty that these future earnings projections will materialize.

Second, in developing future earnings projections based upon past financial results, no two professionals are going to agree exactly on how past earnings should be normalized. Third, even if most professionals could agree upon what a normalized future earnings flow for a particular business should be, honest and significant differences of opinion are likely to result in assessing the appropriate level of risk associated with the business. Such differences of opinion will lead to different capitalization rates applied to future earnings and, hence, different valuations for a particular business.

Finally, the level and appropriateness of discounts and premiums to be applied to a base valuation is always a matter of heated controversy. Again, no two experts are likely to agree precisely on this issue.

The likelihood that any two well-trained and neutral valuation professionals will come to the same precise conclusion of value on any particular business, given all the above potential areas of legitimate disagreement, is fairly slim. So, how can a professional say with certainty that he or she knows what the precise selling or buying price of a particular business should be?

As a profession, I think we ought to focus on “telling it like it is” rather than how we think it ought to be. This inclines me very strongly to market methods of valuation. If sellers and buyers are using gross revenue multipliers to buy and sell closely held businesses, prospective purchasers or sellers need to know this. It is very useful information to anyone beginning the process of negotiating the sale or purchase of a closely held business.

I agree it is important to inform clients about basic valuation theory. They should know that we think that the value of a business ought to be based upon an accurate assessment of future expected benefits, discounted for the time value of money and the level of risk associated with the business. If and when many of our clients reject or fail to thoroughly apply our methods, we should not be so quick to look down on them. Even our most sophisticated techniques do not guarantee that we will arrive at the “right” price in any given circumstance, particularly since no two experts are likely to agree on what that price is.

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