

## **The Science and Art of Business Valuation**

*By Joseph L. Leauanae and Derk G. Rasmussen*

Business appraisals have become an increasingly attractive practice area for both large and small accounting firms. As the visibility of this niche market has grown, so too have the number of articles written about the pros and cons of developing a business valuation practice. Many of these, including the recent *Journal of Accountancy* article, *Is Business Appraising For You?*<sup>1</sup>, do a fair job of identifying the good and the bad of entering the business valuation arena.

While a great deal has been published regarding the development of a business appraisal practice, many of the pitfalls that await the unseasoned practitioner have not been identified. And primary among those pitfalls, especially for CPAs, is the reality that business valuation, by its very nature, is as much an art as it is a science.

Perhaps the most important difference between business valuation work, and the more standard accounting staples of audit and tax work, is that business valuation is still less defined. Although most CPAs are familiar with the liability issues that encumber audit and tax engagements, far fewer are as well versed in the liabilities associated with offering business appraisal services. When considering the viability of adding business valuation services to the firm roster, it is important to assess what existing skills can be capitalized on and what necessary skills must be obtained in order to become a competent business appraiser.

### **The Science**

A good business valuation product will incorporate skills that many CPAs develop independently in tax and audit work: the ability to think analytically and question the numbers. In many instances CPAs are better qualified to perform business valuations because of their in-depth knowledge of financial statements and their understanding of how accounting data can be reconciled or manipulated. This is especially important as many non-CPA business appraisers, with only limited backgrounds in accounting, are more likely to take financial data provided by management at face value or perhaps only scratch the surface when assessing the integrity of the data.

Testing the integrity of the data used in business valuations is very important. Due diligence is as imperative in business valuation work as it is in any other area of accounting or consulting services. Given the litigious or regulatory environment in which business valuations are often performed, renegeing on due diligence may erode the appearance of objectivity or fail to identify materially relevant issues.

While the application of quantitative financial techniques is only part of a complete business valuation, it is important to understand that a common problem in the business valuation process is the lack of proper financial information. The best business valuation scenario would find the appraiser receiving all of the information needed, in a timely manner, and accurately stated.

Unfortunately, in a typical engagement, a more likely scenario places the appraiser in a situation where the client does not have complete financial records and only provides those records piecemeal over time. In such instances the appraiser will likely have to act in a dual capacity—reconstructing accounting records and then using those records to value the business—within the regulatory confines of appraisal organizations to which they may be bound.

In fact, the very processes undertaken in the performance of business valuations will be controlled, to a certain extent, by the practitioner's professional affiliations with such appraisal organizations as the AICPA, the ASA, the NACVA, or the IBA. It is fairly rare and very foolhardy for a CPA to undertake business valuation work without having had some business valuation training and without having earned one or more designations from an appraisal organization.

While the analysis of financial data may seem a fairly routine task, if somewhat complex, the affiliations of the appraiser may require a more stringent analysis or may require the appraiser to adhere to ethical or operational constraints that are more restrictive than those that bind the average CPA. Although there is an emerging trend towards creating uniform standards across the various appraisal organizations, no universal standard has yet been approved or mandated.

The very fact that differences exist indicates the evolving nature of the business valuation industry. Although a number of guidelines regulate or attempt to regulate the quality of business valuation services, one appreciates that there is still a noticeable lack of uniformity between the mandates of various designating bodies. As such, business appraisers must understand exactly what quantitative analyses are required, and in many cases what analyses are not required, in order to comply with the requirements of the appraisal organizations with which they are affiliated.

## **The Art**

Although thoroughly analyzing the quantitative aspects of a business is important, a good business valuation also incorporates qualitative analyses of the business, the industry, and the economic conditions in which the business operates. Since business valuation is as much an art as it is a science, there are many nuances involved in the determination of value that cause even seasoned and respected practitioners to disagree on important issues.

Complicating matters is the fact that court rulings in business valuation cases have not always been historically consistent in setting precedents. Furthermore, in certain cases even the term

“business value” has yet to be defined. For example, business valuations performed for use in dissenting shareholder actions are usually completed under the fair value standard of value. However, “fair value” is an expression that has never been interpretively defined in Utah because the state of Utah has never ruled on a fair value case. In dissenting shareholder actions, the definition of fair value has been left to the interpretation of the state in which such actions are brought.

Unlike tax work, business valuations have no clear-cut formulae to follow. A lot of personal and professional judgment is required in deriving business value, and it is this subjective element that presents such a challenge for some accountants who seek inroads into this line of work.

The lack of a definitive one-size-fits-all approach or formula that can be applied to all valuation issues is just one of the many challenges a CPA can encounter when performing business valuations. One of the other major challenges is obtaining the necessary education and experience in business valuation work to be able to offer a useful product.

## **Education vs. Experience**

The Uniform Standards of Professional Appraisal Practice, which are referenced as either rule or guidance by most of the major appraisal organizations, contains the following statement in its Competency Rule:

Prior to accepting an assignment or entering into an agreement to perform any assignment, an appraiser must properly identify the problem to be addressed and have the knowledge and experience to complete the assignment competently; or alternatively:

1. Disclose the lack of knowledge and/or experience to the client before accepting the assignment; and
2. Take all steps necessary or appropriate to complete the assignment competently; and
3. Describe the lack of knowledge and or experience and the steps taken to complete the assignment competently in the report.

Becoming a competent business appraiser is not an overnight process. While some advertisements attempt to sell business valuation software programs as cheap all-in-one packages, the realities of business valuation work are far more complex.

With the increased use of business valuation reports in litigated matters, the experience and qualifications of the business appraiser are quickly gaining significance. While a CPA without any specific business valuation training may be able to go through the proper motions to conduct a business valuation, an educated and qualified business valuation expert will very likely be able to damagingly dissect and dispute specific areas of such a valuation. Even in non-litigated matters the strength and quality of appraiser qualifications is also important, if only to assure the

client that they are getting a good product and that they needn't look elsewhere for business valuation services.

Selling business valuation services will also rely heavily on the practitioner's reputation as an appraiser and, given the disparity between the quality and consistency of business valuation services performed by appraisers, it is important to be aware of the various credentials available to practitioners as well as the regulations adhered to by the members of each credentialing organization. The following organizations are the most prominent amongst those that offer business valuation education and confer business valuation designations.

### **The American Institute of CPAs**

The AICPA offers the ABV (Accredited in Business Valuation) designation to candidates who are CPAs in good standing, who pass an 8-hour examination, and who meet various education and experience criteria. For more information on this designation visit <http://www.aicpa.org/members/div/mcs/abv.htm>

### **The American Society of Appraisers**

The ASA grants the AM (Accredited Member) and ASA (Accredited Senior Appraiser) designations based on a candidate's ability to pass or challenge four rigorous courses and meet various other education and experience criteria, including the submission and approval of two written reports. For more information on the AM or ASA designations visit <http://www.bvappraisers.org/>

### **The National Association of Certified Valuation Analysts**

The NACVA offers a number of designations, although the CVA (Certified Valuation Analyst) is the most commonly known. A candidate can attain the CVA designation if they hold a valid and unrevoked CPA license and meet various other education and experience criteria, including the successful completion of a case study. For more information on the CVA designation visit <http://www.nacva.com>

### **The Institute of Business Appraisers**

The IBA offers a number of designations although the CBA (Certified Business Appraiser) is its most widely recognized accreditation. The accreditation requirements for the CBA designation involve various education and experience criteria, including the successful completion of an examination and the submission and approval of two reports. For more information on the CBA designation visit <http://www.instbusapp.org>

While evaluating the relative pros and cons of each appraisal organization, it should be

remembered that the incubation of a business valuation practice will require substantial research and that all of the organizations above can provide important developmental resources.

John Locke, the philosopher, once said that, “No man’s knowledge can go beyond his experience.” In the world of business valuation, no single statement could be more astute or more applicable. Education and training are important, but absent considerable experience it is very difficult to appropriately deal with the subtle yet significantly unique characteristics of each valuation assignment.

### **Surviving in an Abstract World**

At the end of the day, a solid business valuation product will successfully meld both the analytical skills of a scientist, and the intuitive perspective of an artist. While the requisite analytical skills can be learned, the intuitive perspective of the seasoned business valuation practitioner is more a result of extensive training and experience.

Those who are genuinely interested in building a valuation practice would be wise to learn under the direction and tutelage of someone who has significant valuation experience. Working within the confines of such an apprentice-type relationship will allow the artistic aspects of valuation work to be learned and honed.

While there are definitely hard and fast rules in the world of business valuation, there is also a certain degree of flexibility. It is this flexibility that will allow an apprentice to develop an intuitive sense for the art of business valuation at the hands of a knowledgeable master. It is this intuitive sense that will allow an apprentice to become an effective business valuation professional.