

Averaging Multiple Valuation Methods: Best Practice or Inviting Trouble?



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Sometimes it's still the basics that we wrestle with in our valuation engagements. And whether or not to average multiple valuation methods—methods that we consider sound and which we reasonably apply to the specific facts and circumstance—falls into that camp.

For the sake of argument, let's assume we are valuing a small-sized operating business. We'll eschew the asset approach—for good reasons that we discuss in our report, of course—leaving us with the income and market approaches. Still, during the course of our assignment we'll take several steps that “blend” the informational value of the data we gather to apply these two approaches. For example:

- We generally employ a simple or weighted averaging convention of normalized earnings for the capitalized cash flow method.
- We might average models that use Morningstar (historical and supply-side) and Duff & Phelps (conditional and unconditional) equity risk premium data when we develop a discount rate for the CCF or DCF methods.¹
- We look at measures of central tendency (median, mean, harmonic mean) when we estimate multiples using the guideline transaction and guideline public company methods.
- We consider more than one method to estimate a discount for lack of marketability so we can triangulate in on that reduction in value.

These steps are designed, hopefully, to drive our income and market approach results closer together. So on one hand, does the process of making valuation

methods more reconcilable make averaging multiple methods inappropriate or irrelevant? Or, on the other hand, is it disingenuous to inject various smoothing and averaging conventions throughout the valuation process (see above), but then draw a line when it comes to weighting multiple methods ... as if to say, “Whoa, it's way too subjective to do something like that”?

Let's make another simplifying assumption. Assume we are not talking about indications of value for the income approach (CCF or DCF) and market approach (guideline transactions) of \$3 million and \$5 million. Personally, I believe this is the circumstance that Section 7 of Revenue Ruling 59-60 wants to preclude. And given such a large disparity, it is likely that our analysis has some error we must correct or some disconnect we must resolve.

But what if the valuation results were closer – say \$4 million and \$4.5 million? Appraisers might argue over the subjectivity of weighting the results: 50/50, 60/40, 80/20.² But isn't it true that if we choose just one method, our weights are 100/0? Is that any more defensible? Shouldn't the informational value of a reasonably developed alternative method be given some weight?

If we are going to choose one method, the next step usually involves playing the corroboration or sanity-check card. We say that we considered other methods, but believe method X is more reliable and method Y provides corroboration or a sanity check. But does a more reliable \$4 million method result corroborate a \$4.5 million

method result? Or vice versa? Or does the expected investment/fair/fair market value lie somewhere between those bookends?³

Note that if we were helping a client buy/sell a business, we would be likely (even happy) to express our results as a *range* of \$4-\$4.5 million. We might even be comfortable saying it's probable that the (investment or fair market) value is neither the low number nor the high number – that the (investment or fair market) value is *probably* somewhere in between – no matter how much confidence we had in either the income approach or the market approach.

No, the problem arises when we need to come up with a single number estimate of (fair or fair market) value for litigation or estate/gift purposes. In that case, the no-averagers are going to pick \$4 million (even though the informational value of the other method indicates it is likely somewhere north of that figure) or \$4.5 million (even though the informational value of the

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other method indicates it is likely somewhere south of that amount).

When it comes to averaging multiple valuation methods, we can all point to the relevant excerpt from IRS Revenue Ruling 59-60:

Sec. 7. Average of Factors.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors (for example, book value, capitalized earnings and capitalized dividends) and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.

Many appraisers have taken this to mean don't average multiple methods. Ever. But if/when we average multiple, reasonably close methods – either explicitly with numeric weights or implicitly with informed judgment – aren't we, in fact, *actively considering other pertinent factors so that the end result can be supported by a realistic application of the significant facts in the case?* Something we wouldn't be doing – something we would be missing – if we didn't average? For more information on weighting values, see FVLE Issue 20, Aug./Sept. 2009, "Common Sense Issues in Weighting Values." 

¹ Consider that the equity risk premium, itself, is an average of 88 years of historical data from Morningstar and 51 years of the same from Duff & Phelps.

² In my experience, explicit and implicit weighting generally focuses on factors like the veracity of the financial statements, the number and size of normalizing adjustments, management's *ex post* track record of producing accurate projections, the number of guideline transactions and transactions found, the recency of those guideline transactions, the comparability of those public guideline companies, etc.

³ I know that many appraisers believe the income approach is generally more reliable than the market approach. While the point of this article is not to debate the reliability of different methods, it does play out when weighting methods are discussed. See the footnote above.

ASA Re-Launches Business Valuation Challenge Exam

The American Society of Appraisers (ASA) announces the re-launch of the Business Valuation Challenge Exam (Challenge Exam) for accreditation.

One of the requirements for advancement to Accredited Member (AM) and Accredited Senior Appraiser (ASA) is completion of four 27-hour Principles of Valuation (POV) courses, including a three-hour exam at the conclusion of each.

The Business Valuation Committee and the Board of Examiners of ASA recognize that there are many experienced business valuation professionals that already have mastered the competencies taught in the POV courses.

The Challenge Exam is geared toward those professionals who have more than 10,000 hours (5 years) of business valuation engagement experience and who stay abreast of the ever-changing landscape of the profession and is intended to test a wealth of knowledge based on the topics covered in the POV courses.

The POV courses are:

- BV201: Introduction to Business Valuation & the Market Approach
- BV202: The Income Approach
- BV203: The Asset Approach, Reconciliation of Values, Valuation Discounts and Premiums, Report Writing
- BV204: Advanced Topics-Pass Through Entities, Intangible Assets, Complex Capital Structures, Debt and Preferred Stock.

With 260 total questions, the exam is administered in two 4-hour modules to be taken on the same day. The Challenge Exam is for those who truly have already mastered the competencies taught in the POV courses and that would satisfy all other requirements for advancement to AM or ASA but who have not yet completed the coursework.

To register or to learn more about the Challenge Exam, visit <http://www.appraisers.org/Product-Catalog/Product?ID=7599> or contact Joyce Johnson at (703) 733-2123 or jjohnson@appraisers.org.