# Myths and Truths About Business Valuation

Business owners and investors often misunderstand the appraisal process and its results. Before you hire a valuation professional to appraise a business interest, it's important to understand what "value" means, including the uses and limitations of valuation reports. Here, we debunk common misconceptions about the art and science of valuing a business.

**The business valuation profession** has grown rapidly since 1980. Over the decades, it has developed from a rudimentary process into a highly sophisticated mix of art and science to determine the value of a business or business interest. However, many business owners and investors fail to understand the valuation process and its results. Here are some common business valuation myths and the underlying truths.

***Myth:*** You appraised the "fair market value" of my business. When I sell my business interest, this is the price I will receive.

***Truth:*** Fair market value (FMV) is different from a transactional (or strategic) value. FMV is hypothetical. If you look at the definition, FMV requires consideration of the *universe of hypothetical* buyers and sellers. The resulting value determination can be looked at as a "most likely" value given the hypothetical considerations. A transaction value, on the other hand, is a verifiable amount, a price at which the business actually changes hands and not an estimate of value that is the result of FMV. Transactional value may be significantly higher (or lower) than fair market value, depending on the circumstances.

***Myth:*** As a business owner, I have the best idea of what my business is worth.

***Truth:*** While the business owner might know the most about their business, that knowledge alone isn't enough to qualify the owner to value the business. Valuation has developed into a profession with accreditations, standards, and professionals with experience and knowledge in how to determine the value of a business. The valuation professional also is an objective third-party. Business owners tend to view their businesses differently than outsiders -- often through "rose-colored" glasses. Owners need to understand how outsiders view the business -- because it's hypothetical investors that determine FMV.

***Myth:*** If a business is worth $1 million, my 10 percent interest should be worth $100,000.

***Truth:*** Owning a minority (or less than controlling) interest in a business diminishes the interest's value from the pro rata value of the entire business. A minority interest cannot determine policy, set compensation for officers and other owners, or decide when and whether to sell the business or significant assets of a business. There are many other items that cannot be controlled by a minority owner. The diminished value can be materially less than the pro rata value, depending on the facts and circumstances.

***Myth:*** The owner's contributions to a business enhance the value of the business.

***Truth:*** An owner's contributions often enhance the value of a business, but there's a major exception. Owners may possess talents, relationships or other intangible assets -- often referred to as "personal goodwill" -- that cannot be transferred to buyers. Owners who contribute personal goodwill diminish the value of the business to an unrelated party. For example, if the owner has contacts with long-term customers that are not likely to transfer to a new owner, the business will likely lose those customers when the current owner leaves the business. That, of course, will reduce the value of the business.

***Myth:*** Value is value, so I can use a valuation report for multiple purposes. For example, I could use a report that is prepared for estate planning purposes to get a loan, settle a divorce or support value on a gift tax return.

***Truth:*** A business valuation is prepared for a specific business as of a specific date and for a specific purpose. If any of those parameters change, the valuation is no longer valid. Different purposes for a valuation might require a different standard or basis of value. For example, the valuation of a minority interest for gifting purposes cannot be used to determine the asking price of the business when the owner wants to sell the entire business two years later. It's important that the user of a valuation report understand its use limitations.

To attain a better understanding of business valuation, owners and investors should discuss the valuation process and various options with an appraisal professional.

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