

Davis & Company, CPA's, CVA's

The Danger of Averages

I have had the opportunity to critically review numerous valuation reports through my years of involvement with litigation. And I continue to see reckless use of averages when reconciling business valuation approaches and methods or the use of “average data” within the application of a method.

It is not uncustomary to apply an average, but it needs to be applied with caution. Consider this example: You have two buckets of water, in one bucket you have water with a temperature of 150 degrees, and in the other you have water with a temperature of 30 degrees. The average temperature of the water is 90 degrees, which is comfortable. However, if you put a hand in each bucket, you will be in for a big surprise. It is not until you blend the buckets that the average makes sense.

This is not to suggest that averages should not be used. In many cases the average of a data set makes perfect sense or is completely appropriate. But the business valuator needs to know why the average was used and why alternatives were not used.

In a specific example, consider the following results of three business valuation approaches:

Asset Approach - \$50,000
Income Approach - \$170,000
Market Approach - \$230,000

The average of the three approaches is \$150,000. But is the correct fair market value of the business?

It could be, but there are several “reconciling” questions that need answers first. Some of the questions I might raise are:

- What is the normal asset structure for this type of company?
- Did the owners distribute all of the cash?
- Have the assets been depreciated on an accelerated basis?
- What are the key value drivers in the business?
- Where is the business in its life cycle?
- How does the company compare to other companies within the industry?
- Does this industry have a high amount of business transactions?
- How comparable was the data used in the market approach to the subject company?
- What are the key variables between the theories applied in each approach?

This example was based on actual results from a franchise operation that I valued. In this case, the market approach most closely reflected the value because a “program buy” was in place with the franchisor that allowed the franchisee to sell the business to the franchisor at a standard multiple of sales. Further, there was no time expiration to the agreement. I did give a small amount of weight to the income approach as well, because potential buyers existed in addition to the franchisor, the seller was not required to sell to the franchisor, and there were instances where the seller would not want to sell to the franchisor. In this case, the use of an average would have been inappropriate.