STRIVE STRATEGIES

Straying from the Line: Identifying Expert Bias in Valuation Reports

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By: Daniel R. Young, CVA, MBA

As business valuation experts, we are often hired to provide an independent opinion of value for various types of business interests for the purposes of litigation. However, valuation experts can make decisions leading up to the conclusion of value that favor the party paying for their services (hereafter referred to as the "Client Party"). These decisions can significantly impact the outcome of legal disputes.

This article will explore the concept of expert bias, the common areas where bias can occur and provide examples to illustrate how bias can be identified and address.

Common Areas of Bias

- Selection of Valuation Methods
- Normalizing Adjustments
- Assumptions and Projections
- Discount Rates
- Identified Comparable Transactions/Guideline Public Companies

Selection of Valuation Methods

Without diving too deeply into each method, there are three generally accepted approaches in business valuation: asset approach, market approach, and income approach. A valuation analyst can perform all three approaches, or as little as just one of the approaches, given the analyst's professional opinion based on the facts and circumstances of the business. When an analyst utilizes multiple methods, expert bias can come in the form of weighting one method more heavily than another to provide a favorable outcome for the Client Party.

Example: A valuation analyst was hired by the non-business owner's legal team in a marital dissolution. In conducting the income approach (valuing the business based on future expected cash flows in the business), the expert arrives at an indication of value of $2.5 million. When performing the market approach, the expert arrives at an indication of value of $4.2 million.

To narrow the indications of value to the expert's opinion of value of the business, the expert weights the market approach 80% of the overall value and only weights the income approach 20%. See the chart below for the impact of weighting valuation methods.

	Indication of Value	Weight	Weighted Value
Income Approach	$2,500,000	20%	$500,000
Market Approach	$4,200,000	80%	$3,360,000
		Concluding Value	$3,860,000

Revenue Ruling 59-60, Section 7 discusses this issue by stating: "[…] No useful purpose is served by taking an average of several factors (e.g., 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."

While weighting valuation approaches is a common example, experts may also exclude approaches that are unfavorable. In the scenario above, an expert may reject the income approach and rely solely on the market approach to give the client a more beneficial outcome.

Normalizing Adjustments

Another area where bias can occur is in the normalizing adjustments used in the valuation. Adjustments for excess salaries, self-dealing transactions, and owners' perks can be manipulated to alter the business's value. In the case of Oakes v. Oakes and Leadwise, Inc., a marital dissolution case that was brought to the appellate court of Ohio, there were several valuation issues that needed to be ruled on. One of the issues was the valuation of a home design and development company.

The wife received annual compensation of $86,000 and was considered the principal owner and manager of the company. The company employed approximately 20 people and generated revenue between $16 million and $22 million annually.

The wife's expert imputed a salary for the wife based on his determination that the wife was paid below market compensation for the efforts and responsibilities the wife provides to the company. In imputing a higher salary of $460,000, the normalized earnings of the business reduce, and the total value of the business was approximately $5 million.

The husband's expert did not make any adjustments for the wife's salary. Even though the expert agreed the wife was underpaid, he opined that other employees were overpaid, and therefore, the total compensation of the business was appropriate. The husband's expert valued the business at approximately $6.7 million.

This scenario highlights the normalizing analysis of a company as an area for experts to impute bias into a valuation. A few considerations not explicitly discussed in the decision:

- Had the company not been "overpaying" other employees, would the company have been able to retain top talent and reach revenue levels between $16 million and $22 million?
- If a third-party owner came in to the company, would the owner pay the wife $86,000 to perform executive level services and manage the company?
- If the wife needed to step away from her position in the company and hire a replacement, what would be the compensation needed to find a qualified replacement?

Assumptions and Projections

Broadly speaking, experts might use overly optimistic revenue forecasts or underestimate ongoing expenses to inflate the business's value. This is often an area where an expert can perform research and implore a confirmation bias. For example, if an expert is working for a partner who is being bought out of a company, then the expert may dig up research on optimistic industry projections to determine the future growth of the company.

When performing a business valuation, a common question to management is if they prepare short-to-medium term projections. If the projections are extremely optimistic, an expert whose client is being bought out of the company may use the projections at face value without reviewing the accuracy of past forecasts, or challenging management on their most influential assumptions.

Discount Rates

The discount rate represents the rate of return required by an investor to compensate for the risk of investing in a particular business. It is used to convert future expected cash flow into their present value, reflecting the time value of money and the uncertainty associated with those cash flows. Especially in smaller business valuations, the discount rate is an area where the expert can use significant professional judgment. In calculating a discount rate, the analyst will use a combination of market, and nonmarket factors. Examples of market factors include the risk free rate and equity risk premium. Examples of nonmarket factors are considerations for various company specific risk.

Company specific factors are determined by the analyst based on the facts and circumstances of the company. Here are a few basic examples: If the company has significant customer concentration issues, then the analyst might increase the risk factor. If the company has strong depths of management and a succession plan in place, the analyst may reduce the risk factor. If the company has one product line, the analyst may increase the risk factor. In essence, company specific factors are an area where the analyst uses professional judgement based on their observations and analysis of the company.

In applying professional judgment, two experts valuing the same business may render significant differences in their discount rate because of their respective analyses of company specific risk factors. Let's take a look at the below example, where two experts with the same ongoing cash flow arrive at differing opinions on company specific risk.

	Expert A	**Expert B**
Market Factors	15%	15%
Company Specific Risk Factors	2%	6%
Total Cost of Equity	17%	21%
Sustainable Growth Rate	2%	2%
Capitalization Rate (A)	15%	19%
Ongoing Cash Flow (B)	$250,000	$250,000
Indicated Invested Capital Value (B / A)	**$1,666,667**	**$1,315,789**
	Variance: -$350,877 (-21%)	

Identified Comparable Transactions/ Guideline Public Companies

Let's use the valuation of a small hot dog shop in a suburb of a city with only one location; would it be appropriate for a valuation analyst to use the market value of Nathan's Hot Dogs, one of the largest sellers of hot dogs in the country? Doing so would most likely lead to an overvaluation of the small hot dog shop, given the stark contrast the small business has to Nathan's Hot Dogs. In the same example, what if the expert on the other side of the matter uses a private transaction of another small hot dog shop, but the underlying data of the transaction reflected a fire sale of the assets. As a result, the value of the small business could be undervalued. While extreme, this example of a hot dog shop is seen often, where experts cherry-pick transactions that fit the needs of their client.

Some areas of potential expert bias in applying the guideline transaction or public company approach include:

- The analyst does not provide the underlying data of the transaction/public company in their report.
- The guideline companies/private transactions are utilizing subject companies that are characteristically different from the company being valued.
- The analyst uses a completely incorrect industry code when screening for guideline data points.
- The analyst concludes a significantly higher or lower indication of value using a market approach than when using an income approach, and fails to fully reconcile and correct for this differential.

Handling Situations of Potential Expert Bias

We often have clients come to us bewildered by a valuation report they received and aren't sure what the next steps to take are.

Here are a couple important action items that can be taken:

- Engage another expert to review the valuation report. While that expert does not have to do a valuation, they have the expertise necessary to read the report and identify areas of concern, or provide peace-of-mind that the report is adequate.
- Engage another expert to help prepare deposition/cross examination questions (if needed) as the expert can ask valuation specific questions to understand if expert bias was applied.
- Engage another expert to do their own independent valuation analysis.

While experts are routinely hired as independent, objective experts, bias may nevertheless creep into the equation. It is important as the readers of the report to identify the most sensitive assumptions made by the expert and evaluate for any apparent bias.

ARTICLE BY:

Daniel R. Young, CVA, MBA

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