REVIEWING A BUSINESS VALUATION REPORT:

A GUIDE FOR ATTORNEYS AND JUDGES

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I have been in the Business Valuation Profession for approximately 40 years and have seen the typical business valuation report go from 3 to 4 pages, to now seeing comprehensive valuation reports that have 50 or more pages. A good part of this change has been mandated by the increasing complexity that has become inherent in the business valuation community.

The purpose of this paper is to attempt to provide the users of these reports, specifically the attorneys and judges that must read and understand what is really being said in those pages. Many years ago, I provided Professional Education seminars on many business valuation subjects, to include report writing. At that time, I indicated that the elements of a great valuation report could be summarized used the acronym TACO, which stood for:

Teach

Analyze

Communicate

Opine

Today, I find that the TACO concept must be taken to the next step, and I have developed the Five "Principles" ("5 P's") of the report. I believe that if the reader keeps these principles in mind while reading the report, it can be valuable in evaluating to overall quality and reliability of the report. With that in mind, let's review what I consider the 5 guiding principles to a successful valuation report.

1. PRECISION (defined as 1 - The state or quality of being precise; exactness. 2 – The ability of a measurement to be consistently reproduced.)

One of the first things I do when reviewing a business valuation report is look at the opinion or conclusion of value. The more precise the conclusion is, the more concern I have as to the validity of the appraisal. I recently reviewed a report covering a 100% equity interest in a closely held company and the appraiser determined the value of the company was $5,288,372.46. No appraiser today can operate with that degree of precision. In fact, if we look to that old standby, Revenue Ruling 59-60, we see that Sec 3.01 states "*A determination of fair market value, being a question of fact, will depend upon the circumstance in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often, an appraiser will find wide difference of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense,* *informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."* [1]

As appraiser's we must make subjective decisions regarding a myriad of items that go into the valuation conclusion. What is the specific company risk profile? What accounting adjustments must be made to the benefit stream to reflect "normalized operations? What are the appropriate discounts for marketability and minority interests?

I would suggest that if there are two reports each prepared by competent business valuation professionals, and the final opinions of value are within 10% of each other, they might well both be correct.

Look at the real world, the public stock markets. We see various analysts following a specific stock and we see a wide array of projected earnings, and even pricing targets for the stock. Why does one analyst rate the stock as a buy, while another thinks that it is hold, and still another rates the security as a sell? The only precise value on a block of closely held stock is the actual cash that is ultimately paid in an arm's length transaction, and we as appraisers cannot determine the ultimate payment.

2. PRACTICALITY (defined as "The quality of being of practical use." "Of, relating to, governed by, or acquired through practice or action, rather than theory or speculation.")

What are the practical aspects of the report? Is it written in a manner to educate the reader, or is it filled with undefined technical terms and industry jargon? A well written report helps the reader understand what the expert is trying to convey, and why the appraiser should be believed.

Is the benefit stream based on historic information or is it based on future income projections? In short, is the most important part of the valuation, the measurement of future economic benefits, practical considering the facts surrounding the entity, the industry, and the economy? As Dr. Pratt would remind us; "The economic interest measure capitalized should represent *expected* future economic income." [2] If the report uses projected benefits, are they reasonable based on the historic information?

How was the capitalization rate achieved? What methodologies were used by the appraiser? Are the conclusions of value well explained and documented in the report, or were just conclusions without support provided? It always benefits the reader if the appraiser clearly

[1] Revenue Ruling 59-60, 1959-1 CB 237.
[2] Valuing a Business, The Analysis and Appraisal of Closely Held Companies, 5th Ed. Shannon P. Pratt, McGraw Hill, 2008, page 247.

defines the work done, and where practical, provides the calculations and exhibits to support the conclusions.

3. PLAUSIBILITY (defined as "Seemingly or apparently valid, likely or acceptable; credible; merit belief or acceptance.)

Every appraisal report must include assumptions made by the appraiser. This is a natural part of the appraisal process. The question is "Are these assumptions Plausible"? Do we have an entity that has demonstrated mediocre earnings in the past years that is now showing projections that show great improvement in future earnings? Or do we have just the opposite, an entity that has been very profitable, but now is showing mediocre or no earnings? In real life, these situations can exist, the company, the industry and/or the economy impact any current value. Company fortunes can improve or they can decline. A plausible report explains the impact of those outside variables to demonstrate the reasons for the apparent changes in economic results.

What sources did the appraiser use to get economic data? What about industry data? This data is readily available, but can be expensive. But without this data, how does the appraiser present a plausible discussion regarding the company's future considering the expectations of the industry and the economy. If the economy is expected to grow by 3% over the next five years, and the industry data indicates that the industry will grow at 3% over the same period, what data is presented to support an indication that the subject company will grow by 5% a year over the next five years. It might be true, but without sufficient support, is it plausible?

What about the state/local economy? Unless the subject company operates in a national or global marketplace, the Company will be impacted more by the local economy, than the national economy. As I write this, the Colorado economy is booming, while the Illinois economy is still in the doldrums, the market the company operates in will be impacted by the local economy.

4. PROFICIENCY (defined as "Having or marked by an advanced degree of competence, as in an art, vocation, profession or branch of learning"; "a person who exhibits competence, an expert".

Does the report adequately demonstrate the proficiency of the appraiser? I'm not suggesting that a first-time appraiser cannot produce a credible report, but what I am suggesting is that there should be adequate information in the report to allow the reader to determine the background and qualifications of the appraiser. Also, did more than one individual work on the report, and what are the qualifications of those individuals. It is not unusual to find out that the signer of the report had little or nothing to do with the production of the report.

Full time vs. Part Time Practice

During my many years as a practitioner, I have consulted with many firms regarding the establishment and/or development of a business valuation niche as part of their CPA practice. In the 80" s and 90's I was of the belief that you could successfully operate a small niche BV practice on a part time basis. Today, I don't believe that is possible.

In 1998 Shannon Pratt published the "BV Body of Knowledge" as a study guide for the ABV exam. Looking at that publication today it is clear that the skill needed today to prepare a business valuation have greatly increased since 1998 when Pratt published that tome. Just as tax and audit have become much more detailed and specialized, so has business valuation. In my opinion, it is difficult enough to maintain a proficiency in Business Valuation today while practicing on a full-time basis, and I find it difficult to believe that a part-time practitioner in BV can maintain the skill set needed to complete a complex valuation assignment.

Let me be clear, although I am a licensed CPA, I certainly am not capable of performing an audit on a Company's financial statements. I performed my last audit engagement in 1974. The same with Tax. I was a practicing tax professional until 1980, and was the partner in charge of our tax practice. I'm not sure I am qualified to perform a significant tax engagement today. I find that it is difficult enough to keep up with the advancements, as well as the controversy's in the business valuation arena. BV is constantly evolving. Look at the issues of pass through entities, the appropriate use of Beta, Weighted Average Cost of Capital, among others.

I always ask the age-old question, if I start having chest pains, do I want a part time general practitioner or a full-time cardiologist to take care of me. I think the answer is obvious.

Does the appraisal report demonstrate the competency of the individual(s) that performed the engagement?

Both the report and the underlying workpapers, must demonstrate the appraiser's competency to take on the engagement. Just because the appraiser hasn't performed 100+ valuations, or that you have never performed a valuation in this specific industry does not disqualify the appraiser. Valuation Theory in a vacuum is useless, as is industry experience if you don't know how to apply appropriate valuation techniques to the data. Many years ago, I had an opposing expert who was not a valuation expert, but was an expert in the operations of the specific industry of the company being valued. The industry expert testified that he had performed more than 100 valuations using his methodology, so it had to be correct. Unfortunately, the Judge stated that just because he had used the same methodology 100 + times, did not make the methodology believable and appropriate for the valuation. A practitioner with strong business valuation skills can obtain industry expertise from many sources to include industry research data, trade associations, as well as the client. Unfortunately, the opposite is not usually true.

The report should discuss in detail both the valuation techniques used in the engagement as well as the sources and details of the industry information that is pertinent to the specific engagement. It should also detail the qualifications of the individuals who worked on the engagement.

Certifications

I get a lot of junk mail regarding business valuation conferences, courses, and webinars. What has surprised me is how many of the presenters have 10 or more certifications behind their names. I one case, I counted 16 separate certifications, (not counting the MBA and LLM) of an individual. How can one individual achieve and stay current with all those specialty designations?

In my opinion, the three most respected credentials in the valuation industry, (in order) are:

- Accredited Senior Appraiser (ASA) from the American Society of Appraisers. Requires 5 years (10,000 hrs) of full time valuation experience, passing a proctored day long exam, and review of two valuation reports. Also requires 150 hours of CPE over 5 years
- Accredited in Business Valuation (ABV) from the American Institute of CPA's. Requires involvement in 10 valuations, passing a proctored, day long exam, and 60 hours of CPE over 3 year period.
- Certified Valuation Analyst (CVA) from the National Association of Certified Valuation Analysts. No minimum experience, pass an exam, and submit a case study.

What is more important is that there is clear language in the report that allows the reader to judge the competency of the writer of the report.

5. PRICE (defined as "the amount of money expected, required, or given in payment for something)

<u>Let me make it clear that I am not suggesting that the higher the price tag on the valuation report, the better the quality of the report is.</u> Price alone does not make a quality report. I believe it is important for the user of the report to have some understanding of what it takes to perform a business valuation engagement and why the cost of the report may indicate issues that need to be addressed.

I have had the privilege of talking to many BV professionals over the years, and there are some things that are somewhat constant in the performance of a valuation

- The typical USPAP compliant valuation report requires between 70 – 80 hours of professional time, with more than 70% of that time performed by the BV professional, rather than the staff. If we do that math, how can an appraiser perform a USPAP compliant report for $3,000 - $5,000.00? Is the professional actually working for less than $75.00 per hour? Or are corners being cut to save costs?

- What about all of the research costs? Industry reports can cost up to $1,000 per industry. Economic Reports can cost several thousand dollars a year. That's fine if you are amortizing those costs over 40 or 50 reports a year, but what about only 3 to 5 reports a year.
- Can the appraiser adequately demonstrate the prior 4 "P's" in a 3 to 5 page report?
- Is the report really an "Opinion of Value", or is it something less than that? USPAP, as well as several other professional organizations allow the appraiser to perform a review report of another appraiser's valuation. However, those review reports are specifically NOT an opinion of value by the person performing the review report.
- What continuing education does the appraiser have in the BV practice? This is another cost that must amortized over the various reports prepared by the appraiser.

Conclusions and Recommendations

There should be no secrets in a business valuation report. When asked to review another appraiser's valuation report, the process always comes down to can I replicated the conclusions arrived at by the appraiser using only the report provided. There may be points of disagreement, but if there is sufficient information to allow me to replicate the conclusions, then they can be understood.

As you the reader are reviewing the report, you don't need to replicate the findings, but you do need to ask some basic questions;

- Is the report readable and can I easily understand what information is being conveyed in the report?
- Does the report inform me of the background and expertise of the appraiser?
- Is there appropriate substantiation for the data being relied upon by the appraiser? Is the economic and industry information reasonable and properly referenced?
- Are potentially contradictory issued discussed and reconciled in the report?
- Does the report demonstrate the very items referred to in Rev Rul. 59-60: i.e. relevant facts, elements of common sense, informed judgment and reasonableness?

If the reader can say yes to the above questions, then the report is most likely to be of value to the user.