

## A Sampling of Valuation Cross-Examination Questions

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As a business appraiser who has valued many companies since the 1980s, I have been asked every kind of question imaginable by attorneys over the years, either in depositions or under direct or cross-examination. Professional business appraisers must be independent and unbiased in arriving at the value for a company, whereas the attorney cross-examining the appraiser must be an advocate. Even though in reality a valuation might be reasonable, supported and valid, it is the attorney's job as opposing counsel to show otherwise so that his or her expert will prevail irrespective of the "true" value. Every question the attorney asks must be carefully picked to cast doubt on the opposing expert's methodology and to uncover and expose actual or supposed errors and flaws. Appraising is as much art as it is science. It is this element of human judgment that creates fertile ground for the cross-examining attorney to attempt to portray what may be a perfectly acceptable series of decisions in the valuation assignment as the actions of an incompetent appraiser.

For business appraisers, it is easy to accept the many everyday decisions that are made in preparing a valuation as accepted and given without giving them much thought. But that is not how cross-examining attorneys should think. Their job is to challenge the very core of what the business appraiser has accepted as a given and to portray the logic behind it as flawed or



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entirely subjective. Hence, the court will hopefully be persuaded by the attorney that the opposing valuation expert is:

- a. making it up as he or she goes,
- b. has no idea what he or she is doing, and/or
- c. is a hired gun whose opinion cannot be trusted.

The attorney's hope is that this will leave the court with the only clear alternative of going with his or her valuation expert's opinion instead. Finally, if the cross-examining attorney has an expert who the attorney knows is vulnerable or has a flawed valuation, by at least casting doubt on the other expert, the attorney will attempt to confuse the court enough to "split the baby" in reaching the court's opinion. Or, in other words, the attorney is thinking, "I will make the other expert look bad so my flawed expert will not look so awful."

### **Goals of Effective Questioning of a Business Appraiser**

The goals of the deposing or cross-examining attorney in the questioning of a business appraiser are simple:

- Gain a broad understanding of the valuation assignment. Who hired the appraiser and what was the appraiser asked to do? What did the appraiser actually do? Who did the appraiser talk to? What data did the appraiser review? What research did the appraiser undertake? What assumptions did the appraiser make? What methodologies did the appraiser employ? Why and how did the appraiser arrive at his or her findings?

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- Identify weaknesses or errors in the opposing expert's opinion.
- Determine if the attorney's own expert and his or her findings will hold up to scrutiny.
- Gauge the likelihood of success of the opposing expert if the case goes to trial and factor those findings into decisions about settling the case or putting pressure on the other side to cut their losses and settle.
- Establish how well the business appraiser holds up under pressure.
- Determine if the appraiser can explain effectively the complex concepts to a layperson.
- Conclude whether the business appraiser has slanted the facts and been an advocate, negating the entire validity of his or her finding of value.
- Detect what errors the business appraiser has made. Did the appraiser correctly understand what the business does? Has the appraiser made incorrect assumptions? Has the appraiser made any errors in math, calculation or logic that would change his or her findings?
- Establish if the appraiser has used correctly the valuation methodologies.
- Ascertain whether any "creative" methods were used that are not accepted in the valuation field.
- Figure out if the appraiser knows what he or she is doing. Is he or she competent?
- Check the appraiser's past record of testimony. Has he or she testified about similar kinds of companies using entirely different methodologies (which, by the way, may be entirely reasonable since every company is unique and the facts will drive the techniques used in each case)?
- Verify that the business appraiser has taken correctly into account any relevant case law considerations that might impact value or how certain factors must be considered in a particular setting (e.g., family law, business damages, estates and gifts).
- Determine if the business appraiser has been asked to review the other expert's results. If so, what conclusions have he or she reached?

### So Many Questions, So Little Time

The goals mentioned above present a lot to accomplish in a deposition, so it is not surprising that a deposition may take one to two full days for a relatively uncomplicated valuation assignment and multiple days for a complicated company. Although not typical, one of my depositions lasted six full days, all before the glare of a video camera, lights, sound booms and operator and in a room full of nine attorneys intently scribbling notes

at my every utterance! I cannot even get my kids to look up from the computer when I ask them to clean their rooms, so when nine attorneys are scribbling notes about my every word on capitalization rates, something is amiss in the universe.

The attorney must carefully plan the deposition in advance to be able to accomplish all of the previously stated goals. The list of potential questions to be asked of a business appraiser in a deposition or trial is virtually limitless since each business is unique. The questions will be determined by the specifics of the business being valued and how the appraiser has reached the conclusion of value.

This article does not list all the hundreds of questions that might be asked of an appraiser by an attorney as this could fill a whole book. Rather, this article provides a sampling of a few of the more interesting and also common cross-examination questions. While the article will add commentary after each question and/or broad subject, it cannot provide the "answer" to all of these questions as they often rest in the specifics of a particular valuation assignment or in the mistakes that might have been made by a particular business appraiser.

### Common Questions on Valuation

Some examples of the more common deposition or cross-examination questions I have been asked over the years (or I have seen asked of opposing experts who had serious flaws in their valuation reports) are listed below.

#### General

**1. Question**—You have valued this company at \$5 million. Would you recommend to your client that he or she purchase it for that price? Would you purchase it for that price?

**Comment**—I do not know why, but when attorneys ask this question, they usually act as if they think they have caught the business appraiser like a deer in the headlights. Business appraisers should arrive at values that are driven by a company's unique circumstances and that consider the actual market conditions of what others are actually paying for similar companies. However, I never recommend to someone what he or she ought to pay. That is the client's own decision and must reflect his or her own personal view of the world, his or her own tolerance for risk, and other considerations.

**2. Question**—Have you ever actually sold a business? Since you have not, you really do not have a clue what real buyers and sellers consider, do you?

**Comment**—This answer will be unique to each

## Cross-Examination *(continued)*

business appraiser. In my particular situation, I have a prior history of financing mergers and acquisitions as a banker, working closely with buyers and sellers in doing so, and getting intimately involved in factors that would cause a deal to occur or fall apart. Also, as a firm, Banister Financial is intimately involved with both buyers and sellers in many circumstances involving real world issues about the sale of a company or an interest. However, even when a business appraiser has not sold a business, it does not mean he or she cannot arrive at a reasonable and supported value. Assuming the appraiser has been properly trained in valuation and undertakes the diligence required to understand a company and what drives its unique value in the marketplace, such an individual can be very effective. Sadly, though, the level of expertise among business appraisers varies greatly, and attorneys should keep a sharp lookout for someone who lives solely in the world of theory but has little common sense about how buyers and sellers in the real world would size up a situation.

**3. Question**—You have arrived at a specific dollar value in your report, but value is a range, isn't it? If so, what is "accepted" within your field as the normal range, plus or minus, in percentage terms into which a value can fall? Within what range could this value fall?

**Comment**—This is almost always a trick question designed to get the appraiser to admit that the value could therefore be X or Y dollars.

**4. Question**—You have valued this company at \$5 million, but the cash flow it produces couldn't return the original investment to the buyer in a five- or seven-year period, could it? Shouldn't you have performed a "sanity" or "reasonableness check" to see if this was the case? Since your value would not pass a reasonableness check that means you overvalued it, correct?

**Comment**—For a full discussion of the validity of using a sanity or reasonableness check, see the article (available at [www.businessvalue.com](http://www.businessvalue.com)), "Is the Justification of Purchase Test Always Justified?"<sup>1</sup> There are huge flaws with the "sanity check" logic as the article clearly delineates. Nonetheless, not a year goes by that we do not run into a case where some business appraiser tries to use a sanity check, usually to either support a flawed valuation finding of his or her own or to attempt to discredit the otherwise completely valid and supported value of another.

Never confuse the reasonableness of value of something by a math calculation (e.g., if the "sanity" check does not show that the value can be paid for out of a company's cash flow over five to seven years, then sanity check proponents would say the value is too high) with its market value. At many times in many industries

(a great example was the dot.com boom), buyers were willing to pay prices that had no relation to the underlying cash flows of a company. Under a reasonableness or sanity test, because those dot.coms had no earnings or cash flow, they had no value and an appraiser would have said they were worthless. Perhaps that is what they "ought" to have been worth, but that is not what they were worth by the market. If I had owned a dot.com, I would have sold it then for how the market irrationally valued it, not for what it ought to have been worth: \$0. Therefore, business appraisers must never confuse what they think things ought to be with what things are. After all, the goal of business appraisers is to determine the market value of an asset, not their view of what they think it ought to be worth. That is why valuations not only consider the income approach, but also the market approach, in trying to estimate a reliable value for a business.

**5. Question**—You valued this company at \$5 million. Are you aware that the owner was offered \$10 million for it last year? Given this offer, how would this change your opinion of value?

**Comment**—An offer may be just that and nothing more. I might offer you \$100 million for your business, however, it is a hollow offer if I am not a ready, willing and financially able buyer. In addition, an offer does not represent a closed deal. Did the buyer undertake full due diligence to arrive at a value? Many offers never result in closed deals because the buyer finds out about hidden problems in the business or simply changes his or her mind for any number of reasons.

In addition, the past offer may have come at a very different time for the company or its industry, its prospects or circumstances, all of which can result in a major change in the value of a business over time. A relative of mine would love to sell his now worthless WorldCom stock at the price it was worth on the stock market several years ago, but I do not think he will get any takers. Finally, what were the terms of the \$10 million offer, and is it really the equivalent of a \$10 million all cash (or equivalent) value? Perhaps it was \$10 million, paid over time without interest in 20 annual installments of one-half million each. The present value, in today's dollars, of that \$10 million stream of installments may in fact be worth much less than the value of getting \$5 million in cash today.

**6. Question**—Does your report contain any math errors? If your report contained a math error in it, its findings would be unreliable, correct?

**Comment**—I will never forget the first time I was asked these questions. Even though there were no

## Cross-Examination *(continued)*

math errors present and my valuation finding prevailed, the cross-examining attorney was attempting to use psychological warfare to make me (and the attorney for whom I was working) think my report had a fatal flaw. No appraiser is perfect and errors can happen. At Banister Financial, each valuation report is reviewed prior to issuance by another professional as a quality control check to identify any errors that might be present, as well as any logic or other flaws that might need re-thinking or correction. Many firms do not do this and, we believe, make a fatal mistake in not doing so.

Also, a cardinal rule in reviewing any opposing expert's valuation report is to attempt to check every single math calculation in his or her report and to verify that all of the numbers used in the hundreds of calculations therein are in fact correct and tie back to the company's actual results. In our experience of reviewing the valuations of numerous other business appraisers in litigation cases (and for that matter in estate and gift tax valuations and many other uses), we have unfortunately found that it is a rare report indeed that does not contain at least one or several math errors of some kind. While sometimes the effect of correcting the errors is inconsequential, occasionally the effect is catastrophic to the entire validity of the valuation and the resulting value. Never, ever accept anything in a valuation report at face value. As Ronald Reagan told Gorbachev on verifying Soviet compliance with nuclear arms treaties, "Trust but verify."

**7. Question**—This company depends almost entirely on Mr. Smith for its success, doesn't it? He generates 50% of the company's sales, doesn't he? Therefore, you'd say he is a key person, wouldn't you? Are you aware that Mr. Smith has no interest in selling the company and if it were sold he would not be willing to work for someone else or sign a non-compete? Given this, how could your value of Mr. Smith's shares be reasonable? Does your value in fact assume a non-compete or that Mr. Smith would be willing to work for a buyer?

**Comment**—A professional valuation should examine the impacts of key person issues as they affect the risk to a buyer of purchasing a company. The conclusions that are drawn (and that will be unique to each company) may impact the methods the appraiser uses to value the business, as well as the rate of return (e.g., the capitalization rate) used in the income valuation approach and, possibly, the discount for lack of marketability associated with how easy or difficult it will be to find a buyer for the company's shares.

The issue of the lack of a non-compete is a complex one and the valuator may need to consider

relevant case law as to how it is interpreted. It is common, for example, for the company-owning spouse in a divorce to say something like the following:

*I can simply quit the dental practice and go across the street and open a new competing one. The old practice will be worthless since the patients will follow me to the new practice. The stock of my dental practice has no value in equitable distribution and my ex-wife should not be given any value for it.*

In some states in equitable distribution matters, the courts have the view that the spouses are departing the marriage, but that the spouse in the company or professional practice is not selling his or her interest and is going to continue to practice and realize the fruits of that ownership. "Fairness," therefore, requires that the other spouse realize his or her share of the value accordingly—not on the assumption that the value will be destroyed on purpose. Also, in North Carolina, any active appreciation (arising from the active efforts of the owning spouse, as contrasted with passive appreciation, which is due to market forces) in the value of a business after the date of separation is considered to be the separate property of the spouse who owns the business. Many attorneys are now making the clever argument that if this is the case, then the reverse must also be true. Any decline in value after the separation as a result of the active efforts of the owning spouse (e.g., causing the value to decline by leaving to compete with the company being valued) must also be that spouse's separate property, letting the spouse that caused the decline bear the full brunt of the decline.

In other types of valuations (for other than family law), the lack of a non-compete agreement does not necessarily mean that a shareholder is actually free to leave and compete. Perhaps the individual is an officer or director of the company and may be subject to valid claims that he or she breached a fiduciary duty by leaving and competing, taking customers, etc.

**8. Question**—Do you consider Shannon Pratt (an old sage in the field of valuation and a well-known author) to be an authority in the field of business valuation?

**Comment**—Every business appraiser is asked a question like this, and it is a red flag to watch out for the question(s) that follow it. The attorney will then usually ask the appraiser to read from a specific passage that might seem, on its face, to contradict what the appraiser has done. It has been my experience that those passages are:

## Cross-Examination *(continued)*

- taken out of context,
- only showing a selected part of the passage whereas a full reading would not show Pratt's view (or anyone's) to be what the cross-examining attorney claims it to be,
- Pratt's view may only be one opinion on a subject on which reasonable people in the field disagree, or
- subject matter in which Pratt himself has expressed differing views in different circumstances. Many valuation decisions are driven by the facts of a specific situation and require the judgment of the appraiser.

As a co-author of a valuation book, the *CCH Business Valuation Guide*, I can personally attest that it is impossible to write a how-to book that deals with all situations that a business appraiser might face. Finally, just because a book said "that is how you do it" two years ago does not necessarily mean "that is how you do it" today. Valuation techniques and the views about how they are used have changed significantly over time and will likely continue to do so. Note that passages from valuation books or publications can and should be used where appropriate in demonstrating where a business appraiser has in fact made an error or is truly out of sync with his or her peers in the field.

**9. Question**—Does your valuation comply with generally accepted accounting principles? Generally accepted valuation principles?

**Comment**—There is no such thing as generally accepted accounting principles that specify how to do a valuation. However, there are well-accepted valuation report standards in the field that all business appraisals should follow, such as the Uniform Standards of Professional Appraisal Practice (USPAP). Additionally, many within the valuation field believe that the Business Valuation Standards of the American Society of Appraisers (ASA) set a minimum level of quality for what must be in a well-supported valuation report. Also helpful in critiquing an appraiser's business valuation is the full checklist used by the Business Valuation section of the International Board of Examiners of the ASA in critiquing valuation reports for the competency of business appraisers attempting their final hurdle to achieve ASA accreditation in business valuation. For more on critiquing reports to ensure that they meet accepted standards, several articles at Banister Financial's website ([www.businesvalue.com](http://www.businesvalue.com)) contain an extensive discussion of how to do so.<sup>2</sup>

## Market Officer Compensation Adjustments

**1. Question**—You adjusted Mr. Smith's president salary downward in your income approach from what he actually makes, \$400,000, to what you call a market rate of \$200,000, based on XYZ Compensation Study.

- a. Mr. Smith generates 50% of the company's revenues and is crucial to its success. What if Mr. Smith isn't willing to work for a buyer for only \$200,000? Isn't your \$200,000 figure academic since he can't be replaced for that amount? Therefore, isn't your value overstated?
- b. In addition to being the president, Mr. Smith does many other things for the company doesn't he? He generates 50% of the sales, deals with banks, follows up on receivables, manages finances, handles personnel matters and fulfills other roles, doesn't he? Yet you have only used the market compensation rate for a president. Shouldn't you have also included the cost for a salesperson, a controller, and a personnel manager in arriving at the market rate? If the company were bought and Mr. Smith were to leave, is it not true that the buyer would have to hire all of these individuals to replace him?

**2. Question**—You used Economic Research Institute (ERI) data to estimate a market rate for a chief executive officer in the company's industry and in a company of the same size.

- a. What is the sample size from which your market officer compensation adjustment is drawn?
- b. It says here on your sheet from ERI that the compensation is for 2000 and 2001, but it is based on the dataset dated June 1, 2004. You are supposed to be adjusting the results for the company for the years 2000 and 2001 for valuing the company as of December 31, 2001, aren't you? If a prospective buyer of the company on December 31, 2001, would not have had access to data from a June 1, 2004, ERI study, you have erred in your use of that data for determining a value as of December 31, 2001, haven't you?
- c. You have just said you have not erred in using the June 1, 2004, ERI dataset for a December 31, 2001, valuation date. How, in fact, does ERI base its compensation results for the 2000 and 2001 print-outs upon which you relied and which you claim represented data known and knowable as of the valuation date? Are you sure it actually represents earlier data collected at that time or is it something else, like a backward trending or forecast?

## Cross-Examination (continued)

**Comment**—The reason the level of market compensation adjustment used by the business appraiser is critical is because it has a potentially huge impact on the amount of earnings that will be capitalized (in the income approach) or to which a multiple from sales of similar companies (in the merged and acquired companies method) will be applied. There is a potentially limitless array of questions that might be asked which depend upon the nature of the data, study or survey used by the business appraiser in the particular valuation, the associated flaws or limitations of the sources of data used, as well as the many issues that affect what the market level of compensation might be.

Therefore, the discerning attorney will want to fully explore these issues, understand exactly what the appraiser has done, and pinpoint where the attorney can attempt to second-guess those decisions that were made. Also, beyond just second-guessing, sometimes appraisers really do blow it and make compensation adjustments that lead to wrong valuation findings that make no sense. Finally, many business appraisers do not give the data that they use a second thought. However, to be truly professional, the business appraiser should indeed understand the data used and its imperfections (every study has them) to have a clear position on why the chosen data makes sense.

### Tax Affecting for S Corporations and LLCs

**1. Question**—You have tax affected (reduced) the company's S corporation earnings as if it were a C corporation. This had the effect of reducing the earnings you capitalized by about 40%. In turn, this had the effect of lowering the company's value, did it not? You prepared this valuation for Mr. Smith in his divorce. Mr. Smith, who owns the company, is not actually planning on selling it, is he? Won't he just continue to run the company after the equitable distribution hearing is over and continue to benefit from pre-tax earnings from a company that will not pay C corporation taxes for the foreseeable future? If so, then isn't this unfairly undervaluing the company with respect to Ms. Smith's share in equitable distribution? You want the court to award her an after-tax value but you know Mr. Smith will get to keep the business and continue to earn pre-tax earnings.

**2. Question**—Why did you tax affect the earnings in this divorce when it is widely accepted, such as in the *Gross* case,<sup>3</sup> that this is not acceptable?

**Comment**—The whole issue of whether the earnings of an S corporation or LLC should be tax affected for valuation purposes has been one of the most controversial issues in the valuation field, and the decision made by the business appraiser over how to

deal with this issue can cause the valuation finding to vary by 67% or more. Discerning family law attorneys, in particular, are beginning to latch onto this issue and pursue it to their advantage in valuation cases. Attorneys that are not up to speed on this issue will be outgunned and vulnerable. Banister Financial's website ([www.businessvalue.com](http://www.businessvalue.com)) contains numerous articles on the tax affecting debate.<sup>4</sup>

### Capitalization Rates Used in the Capitalization of Earnings Valuation Method

**1. Question**—Where did this additional company-specific risk premium of 5% come from? Is it just your opinion? Why is your opinion any better than our expert's?

**2. Question**—Are you telling me that only 5% exactly is the right specific-company risk premium? Can't value be a range? If it is a range, then what is the range within which your 5% specific-company risk premium could fall? Plus or minus 5%? 4%? 2%? (Note: This type of question can and is adapted to just about every decision in a valuation report—valuation discounts and premiums, market data method multiples, guideline public company multiples, etc.).

**3. Question**—Isn't the way you developed a capitalization rate (or company-specific risk premium) just voodoo where you plucked a rate out of the air?

**4. Question**—You used Ibbotson (or Standard & Poor's) data to develop your company-specific risk premium.

- a. Aren't there problems with the data? (Moral: The business appraiser needs to understand the strengths and weaknesses of each study and the charges leveled against them, even if inaccurate.)
- b. Why would the rate of return for a group of \$200 million revenue public companies have any validity in telling us anything about the rate of return someone would demand for buying this small, \$5 million per year local business?
- c. You are valuing a widget manufacturer. Tell me how many widget manufacturers are included in this rate of return study? You don't know, do you? How many are located in Omaha, where the subject company is located? You don't know, do you? How many have a dependency on one large customer for 60% of their revenues? You don't know, do you? In fact, you have no way whatsoever of knowing if any of the companies that make up the rate of return results are even remotely similar to the company you are valuing. Given that you do not know the an-

## Cross-Examination *(continued)*

swers to any of these questions, would you admit that this whole way of developing a capitalization rate is just a guess?

- d. You have used an additional small-company equity risk premium based on the Ibbotson microcap data (a source of information used by some business appraisers to develop discount and capitalization rates).

- How do you define small?
- How does Ibbotson define small?
- Doesn't the way Ibbotson defines small make it impossible for you to say these public companies are in fact "small" if you define small in terms of annual revenues? Since this is the case, what good is your additional small-company equity risk premium? Isn't your whole capitalization rate, and therefore your value, unreliable?
- Hasn't the whole idea of small companies requiring a higher rate of return now been disproved? (The appraiser had better know about the full debate on this issue, know what the various competing studies say, and be able to discuss why his or her view is valid).
- Hasn't the U.S. Tax Court concluded that there is no such thing as an additional small-company risk premium?
- Don't studies such as those by Standard & Poor's show statistically that other things are as or more important than size in determining a company's equity risk premium? What are they and why didn't you consider them instead?
- How do you know that buyers of small companies in this particular industry would require a higher rate of return?

### 5. Question—Long-term growth rate:

- a. Just where did you get this rate from?
- b. Is this long-term growth rate supposed to be the rate into perpetuity? Are you telling the court that this business is going to last forever? Don't many businesses fail to make it into the second or third generation?

**Comment**—There are only two elements that drive the value in a capitalization of earnings method: the income being capitalized and the capitalization rate used. The higher the capitalization rate the lower the value of a given income stream and vice versa. To win a valuation case, the cross-examining attorney must be prepared to deal with both of these broad issues (income

measure used and the capitalization rate) and attempt to convince the court that the opposing valuation expert is wrong or the judgment of his or her expert is superior. In order to do so, attorneys need the framework to understand both issues and how to critique them. Several useful articles dealing with the fundamentals of understanding the income valuation approach and critically assessing a capitalization used by a business appraiser can be found at [www.businessvalue.com](http://www.businessvalue.com).<sup>5</sup>

## Market Data Method

**1. Question**—Do the transactions you have used represent stock sales, asset sales, or some combination of both? Do you know the difference between a stock sale and an asset sale? Is a stock sale more beneficial to the buyer or the seller? Is an asset sale more beneficial to the buyer or the seller?

**2. Question**—Do any of these transactions have a purchase price that is comprised in some way of an equity kicker or earn-out component? Do you know what the terms of those arrangements are? Does the purchase price represent a true cash value as is contemplated under fair market value?

**3. Question**—Are all of the purchase prices for the transactions you used based on 100% cash prices? If not, what are the terms of the other transactions? Do seller financing, restricted public company stock or other forms of payment represent a 100% cash price as is contemplated under fair market value?

**4. Question**—If you don't know all of the terms of the transactions you are using from the transaction database, how can you reliably apply the data in valuing the company?

**5. Question**—Some of these transactions you are relying on are three years old. How can they be reliable now?

**6. Question**—Would you agree with the statement that fair market value is defined as what a hypothetical willing buyer would pay a willing seller, neither acting under compulsion and with both having all knowledge of the relevant facts? Would you agree that investment value is defined as the value of an asset to a specific buyer and which might incorporate synergistic, strategic or similar elements of value? Given that you agree with these statements:

- a. How many of the transactions listed in your use of the market data method are of fair market value buyers versus transactions that reflect investment value to a specific buyer and the related synergies?
- b. Since you don't know, wouldn't it then be a mistake to apply any of the transaction data to value the

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subject company on a fair market value basis? In fact, doesn't every transaction reflect the unique motivations of a specific buyer and seller? If yes, then how can you reliably use any of the data at all to arrive at fair market value?

**7. Question**—You are valuing a home infusion therapy company that is located in Phoenix that treats patients in their homes as well as patients under contract with a large regional hospital. It also receives 60% of its revenues from Medicare, and as a result, the company must periodically make large adjustments to its financial results to reflect write-downs of what Medicare won't reimburse. Regarding your use of transaction data in the merged and acquired companies method:

- a. How many of those acquired infusion therapy firms treat patients both in the home and under large contracts to hospitals? You can't tell from the data? Wouldn't those factors be important in deciding if the transaction was truly comparable and could be applied to the company you are valuing? Since you don't know the answers and cannot tell from the data, doesn't this make your use of the method unreliable?
- b. How many of those acquired companies rely on Medicare for 60% of their revenues? You can't tell from the data? In fact, you don't know if they rely on Medicare at all or even if they get 100% of their revenues from Medicare, do you? Wouldn't those factors be important in deciding if the transaction was truly comparable and could be applied to the company you are valuing? Since you don't know the answers and cannot tell from the data, doesn't this make your use of the method unreliable?
- c. How many of those acquired companies have to make large contractual adjustments and write-downs to revenues and receivables? You can't tell from the data? Wouldn't those factors be important in deciding if the transaction was truly comparable and could be applied to the company you are valuing? Since you don't know the answers and cannot tell from the data, doesn't this make your use of the method unreliable?

**Comment**—There are a variety of pitfalls to avoid in analyzing and applying transaction data used in the merged and acquired companies method of business valuation. Many business appraisers fail to understand the intricacies of using the method properly and, as a result, make serious errors in its application, resulting in flawed valuation findings. In our experience of review-

ing the valuation reports of others, we routinely see the same kinds of basic mistakes made which often invalidate the findings or render the valuation report of questionable quality. Attorneys who deal with valuation matters need an appreciation of these issues to avoid problems for their clients, and in litigation cases, to make sure their expert's report is prepared correctly, and to identify and expose flaws that might be present in the opposing expert's report.

Banister Financial's website ([www.businessvalue.com](http://www.businessvalue.com)) contains several articles that provide specific examples of mistakes made by business appraisers when using this method.<sup>6</sup> Those articles also provide a general description of the merged and acquired companies method and how business appraisers search out data on acquisitions and then attempt to use that information in a valuation. While widely attacked in cross-examination by attorneys as being unreliable, when properly used and in the right circumstances, the merged and acquired companies method can be a valuable tool in arriving at the value of a closely held business, large or small.

### Guideline Public Company Method

**1. Question**—Are the guideline public companies you chose truly comparable to your subject private company? Are you aware that this public company is 150 (or whatever) times the size of your company as measured by revenues? Is this truly a comparable company?

**2. Question**—Are you aware this guideline public company is no longer traded on NASDAQ, but is instead traded on the pink sheets? Are you aware that this "public" company has a weekly trading volume of only 1,000 shares? Does this, in your mind, represent a freely and actively traded market for this guideline public company?

**3. Question**—Are you aware that this guideline public company has a number of different divisions? Are you aware that the division in this guideline public company that most closely resembles the operations of your private company represents only 5% of the revenues and profits of the guideline public company? In other words, are you aware that 95% of the revenues and profits of the guideline public company are derived from operations that have no resemblance whatsoever to your private company? Does this, in your mind, make for a reasonably similar guideline public company to use in this situation?

**Comment**—Inexperienced business appraisers, in particular, often make errors similar to the ones just noted. Business appraisers routinely use electronic

## Cross-Examination *(continued)*

databases or the Internet to identify and use public companies supposedly in the same or similar line of business to value the small, closely held business. However, some appraisers have no real understanding of what those public companies do and fail to even stop to think, “Is it reasonable that I am using the price-earnings ratio of Wal-Mart to value the corner hardware store?” Appraisers need to have an understanding of the public companies being used in their valuation of a closely held, like-kind company. They need to go to the Edgar website ([www.edgar-online.com](http://www.edgar-online.com)) of the Securities and Exchange Commission to read the form 10K (like an annual report) of each public company that may be used to make sure they are appropriate for use in the valuation. If the appraiser uses a database blindly and is using data from companies that are not comparable, the cross-examining attorney may attack the valuation on just such grounds.

### Past Transactions and Buy-Sell Agreements

**1. Question**—You have valued Dr. Smith’s 25% interest in her medical practice for this divorce at \$250,000. Yet, she only paid \$5,000 to buy the shares when she originally bought in to ownership and will only receive \$5,000 per the shareholder agreement when she leaves. Therefore, how can your \$250,000 value be reasonable?

**Comment**—Every buy-in and buy-sell arrangement is unique and must be examined on the basis of its own merits and terms and the specifics of the practice at issue. This issue is discussed in detail in a two part series of an article entitled, “Do Professional Practice Buy-Sell Agreements Represent Fair Market Value,” a two-part series that can be found at [www.businessvalue.com](http://www.businessvalue.com).

### Valuation Discounts and Premiums

**1. Question**—You have 10 pages in your report regurgitating numerous studies about the discount for lack of marketability, citing averages.

- a. Isn’t an average just that? Couldn’t the 35% average discount for lack of marketability from XYZ Study, for example, be made up of the shares in some companies that sold for no discount and ones that sold for a 70% discount? If so, how can you use the data in any meaningful way to develop the 35% discount you used?
- b. How many of these transactions involved shares in a widget manufacturer of the same size as the company you valued? Therefore, how do you know if this data is even similar?

- c. You cite these studies and then you just pluck your 35% discount out of the air, correct?

**Comment**—Another article found at [www.businessvalue.com](http://www.businessvalue.com), “The 35% ‘Standard’ Marketability Discount: R.I.P.,” discusses the marketability discount in more detail.

### Reaching a Final Value

**1. Question**—How did you decide to weight the guideline public approach 40% in arriving at your final value? Why not 30% or 50%?

**2. Question**—If the court decides that the income method on which you placed 60% is unreliable, then wouldn’t it be appropriate to re-weight your guideline public company findings at 100%?

**3. Question**—Why is your value any more reliable than our expert’s value? Isn’t value all just an opinion?

**Comment**—There is nothing wrong with making a subjective decision in arriving at a value. The fact is that business appraisal, by definition, involves making subjective decisions. There is simply no escaping it. Whether or not the value of one appraiser or the other is the best supported, reliable or unreliable depends on the quality of their work; the entirety of the process they employed; and their skill, expertise and experience. Providing the answers to the above questions will take all of these issues into account.

### Conclusion

The foregoing are just a few of the endless variety of questions that might be asked in the deposition or cross-examination of a valuation expert. These questions should begin to stimulate thinking about the logic and support used for every aspect of a business valuation and how those assumptions might be questioned or attacked. Furthermore, if an attorney truly wants to be effective in valuation cases, he or she must have at least an elementary understanding of business valuation. Finally, hire a truly skilled business appraiser to assist you in reviewing and finding the flaws and problems in an opposing expert’s valuation report prior to the deposition or trial. ♦

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## Cross-Examination *(continued)*

<sup>1</sup> Gary A. Parker, George B. Hawkins, and Michael A. Paschall. "Is the Justification of Purchase Test Always Justified?" *CCH Business Valuation Alert*, vol. 1, no. 3 (February 2000). Reprint available at: [www.businessvalue.com](http://www.businessvalue.com)

<sup>2</sup> "Evaluating Valuation Reports and Testimony," *CCH Business Valuation Alert (September 2001)*, "The Most Common Sins in Faulty Business Valuations," *Fair Value (Summer 2004)*, "Why Time Travel in Business Valuation is Wrong," *Business Valuation Review (September 2002)*, all by George B. Hawkins. Also see "Kick the Habit: The Excess Earnings Method Must Go," *Business Valuation Review (September 2001)*, Michael A. Paschall. All articles are available at: [www.businessvalue.com](http://www.businessvalue.com)

<sup>3</sup> *W. Gross, Jr.*, CA-6, 2001-2 USTC ¶60,425, 272 F3d 333.

<sup>4</sup> "A Gross Result in the Gross Case: All Your Prior S Corporation Valuations Are Invalid," *Business Valuation Review (March 2002)*, George B. Hawkins, Michael A. Paschall, "Some Observations on Tax Affecting," *Business Valuation Review (March 2005)*, Michael A. Paschall. Both articles are available at: [www.businessvalue.com](http://www.businessvalue.com)

<sup>5</sup> "Critically Assessing A Business Valuation: Is the Capitalization Rate Used Reasonable," *Fair Value (Spring 1996)*, and "Understanding the Income Approach- A Primer for Judges Who Must Hear Valuation Cases," *Shannon Pratt's Business Valuation Update (March 2001)*, both by George B. Hawkins. Both articles are available at [www.businessvalue.com](http://www.businessvalue.com)

<sup>6</sup> "In Defense of the Merged and Acquired Companies Valuation Method," and "The Top 10 Errors Made Using the Merged and Acquired Companies Valuation Method," both by George B. Hawkins, *Fair Value* (Summer 2004). Available at: [www.businessvalue.com](http://www.businessvalue.com)

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