Critiquing a Business Valuation Report: A Guide for Family Law Attorneys

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Goals in Reviewing a Valuation

- Which valuation is best supported, most reliable, and most accurately and in an unbiased manner reflects fair market value?
- What are the vulnerabilities of my own expert's report? Will it hold up to scrutiny?
- At trial, how can I demonstrate the problems with the other expert's report? How can I defend my own expert's report?
- Not just for trial- in resolving any dispute, is the value reasonable? Collaborative law, etc.

This Talk Will Not Cover:

- Is my business appraiser qualified?
- What qualifications and certifications should the attorney look for and how to select an appraiser?
- Valuation is easy entry industry- not all credentials and appraisers created equally.

Be the Best Litigator You Can Be…

- Knowledge of valuation will help you win more cases.
- You call the shots and set the flow in examination and cross-examination of your business appraiser and the opposing expert.
- Bottom line- An unknowledgeable attorney with the best appraiser may still be at a disadvantage in court against a skilled attorney with a poor appraiser.
- Enable you to help your client better assess the reasonableness of a settlement offer.

Available at Banister Financial's website at www.businessvalue.com

- I will not provide a detailed overview of business valuation methods- it could take a week of seminars to adequately cover
- Nearly 100 articles on valuation methods, techniques and issues
- Sample information needs lists for valuing a company, medical, dental, law and veterinary practices, auto dealerships, general contractors, property management firms, telephone companies and more
- Sample questions for interviewing/deposing Management for a valuation
- Sample questions for interviewing/deposing a physician. Same for orthodontist.
- Key valuation cases (equitable distribution, estate/gift tax, dissenting shareholder) and major IRS Revenue Rulings

Independence- The Most Important Element of a “Good” Valuation

- Attorneys must be advocates for their clients. Appraisers must be independent and can only be advocates for their own opinion.
- No matter how technically correct a report is, if the appraiser is not independent and unbiased, his or her valuation and opinion is worthless.
- Your first focus in reviewing a report is to see if the report is in fact unbiased. If it is, then your attention shifts to those aspects of the report that are right or wrong and which appraiser’s value is best supported.

Advocacy- The Foundation on Which Most Flawed Reports Are Based

- If you can spot an advocacy report, the rest of your job is more simple.
- When the foundation is advocacy, the report, its analysis, methods and conclusions, once seen for what they are, will usually become apparent and more easy to demonstrate to the court.

Down to Business (Valuation)

- To set the stage for an overall discussion of valuation reviews we' ll go over several quick examples of flaws and show you how simple it is to use basic knowledge about valuation to find what' s wrong.

- Income Approach
- Market Approach
- Cost Approach

Income Approach Example

- Based on the present value, today, to a buyer, of a company's expected future income stream. Two methods within the income approach:

- **Discounted future income method-** Income forecasted year by year and brought back to present value today at a discount rate, a rate of return for risk.

- **Capitalization Method-** "Single period" method where annual measure is divided by a capitalization rate to give a value estimate. Instead of forecasting year by year income (as with discounted future income method), if income is expected to growth at a more or less constant future rate, can be simplified to using a capitalization rate.

Is the Cap Rate Reasonable?

Formula for the use of the Capitalization of Income Method

$$\text{Value} = \frac{\text{Income Stream, Coming Year}}{\text{Capitalization Rate}}$$

Capitalization Example

- ABC Beer Distributors

- Exclusive rights to distribute Coor's beer in a one county market in NC where there is a heavy military population

- Appraisal has been done using the capitalization of earnings method, valuing ABC's shares at $5,000,000. Your job- decide if the appraisal seems reasonable.

Is the 10% Cap Rate Reasonable?

Capitalization of Earnings Calculation-
ABC Beer Distributors

Net Income Forecasted, 20XX	**$500,000**
Divided by Capitalization Rate (10%)	**0.10**
Equals: Preliminary Co. Value	**$5,000,000**

Is the Cap Rate Reasonable? (continued)

- Is anything wrong with this cap rate?

- Begin by understanding what makes up the cap rate and breaking it down into its pieces. This provides the clues.

Is the Cap Rate Reasonable? (continued)

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Components of the Capitalization Rate

Component	Definition
Discount Rate	**Annual Rate of Return Required by Investor for Risk**
Minus: Long-Term Expected Growth Rate	**Annual, long-term expected future growth rate of earnings from co.**
Equals: Capitalization Rate	**Used in the Capitalization of Earnings Method**

Is the Capitalization Rate Reasonable? (Continued)

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The Appraiser's Capitalization Rate-
ABC Beer Distributors

Risk-Free Rate (Treasury Bond)	**5%**
+ General Equity Risk Premium for Investing in Stocks in General	**12%**
+ Company Specific Risk Premium	**1%**
Equals: Discount Rate (Annual Return for Risk)	**18%**
- Long-Term Annual Growth Rate	**-8%**
Equals: Capitalization Rate	**10%**

Is the Cap Rate Reasonable? (continued)

- The cap. rate is affected by risk (through the discount rate) and growth.
- The higher the discount rate = higher capitalization rate = lower value
- The lower the discount rate = lower capitalization rate = higher value

Is the Capitalization Rate Reasonable? (continued)

- Focus first on the discount rate (rate of return for risk).
- Hard to argue with the equity risk premium. Based here on objective industry data used by business appraisers.
- What about the company specific risk premium of 1%. Does that capture the extra risk of ABC Beer Distributors?

Is the Cap Rate Reasonable? (Continued)

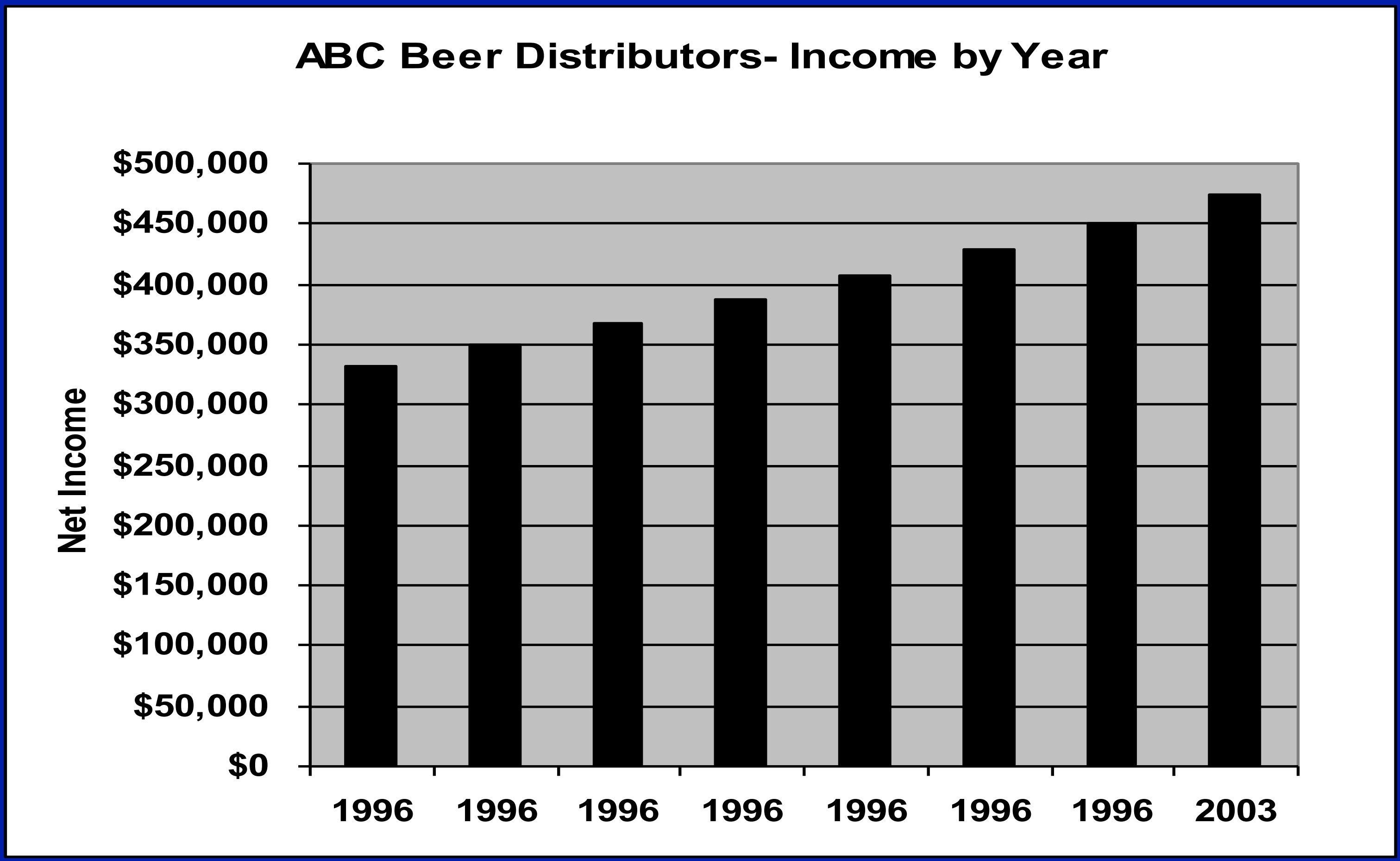
- ABC highly leveraged (dependent on debt)
- Sells Coor's beer, which has a 10% market share and may lose ground against Budweiser and Miller
- Sells to a local community where the military is a big percent of the population and where deployment around the world could seriously hurt demand for the beer as soldiers ship out. Revenues fell 30% for a year during the first Gulf War.

BOTTOM LINE- The appraiser's 1% specific co. risk premium is too low. Assume it ought to be 3% instead.

Is the Cap. Rate Reasonable? (Continued)

- What about growth in annual income? Is the appraiser’s 8% expected future growth rate too high, too low, or just about right?

Is the Cap Rate Reasonable?



Is the Cap. Rate Reasonable? (continued)

- **Has ABC been growing at 8% historically?** No. The previous chart shows 5% per year growth. Therefore, based on history, the 8% growth rate is too high.

- **What about the future?** Growth in company beer revenues is tied to growth in volume demand (based on population) and price (tied to inflation).

- **Volume-** County population forecasted to grow by 1% per year per state of NC over next 30 years.

- **Price-** Inflation forecast of 2.0% per year.

Is the Cap. Rate Reasonable? (continued)

- **Realistic future growth rate (assuming Coor' s does not lose market share) = 3.5%.**

- **Bottom Line-** Appraiser' s growth rate of 8% is too high based on history (5%) and expected future (3.5%). A buyer is buying the future.

- **Realistic growth rate-** 3.5%.

Is the Cap. Rate Reasonable? (Continued)

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The Appraiser's Capitalization Rate-
Original and Corrected for Flaws in Risk and Growth

	Original	Corrected
Risk-Free Rate (Treasury Bond)	5%	5%
+ General Equity Risk Premium	12%	12%
+ Company Specific Risk Premium	1%	3%
Equals: Discount Rate (Annual Return for Risk)	18%	20%
- Long-Term Annual Growth Rate	-8%	-3%
Equals: Capitalization Rate	10%	17%

Is the Cap. Rate Reasonable? (Continued)

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Capitalization of Earnings Calculation-
What A Big Difference Just a Little Sound Thought and Logic Can Make

	Original	Corrected
Net Income Forecasted, Year 20XX	$500,000	$500,000
Divided by Capitalization Rate (10% Before, Now 17% Corrected)	0.10	0.17
Equals: Preliminary Co. Value	$5,000,000	$2,941,176

Is the Capitalization Rate Reasonable? (continued)

- Difficult for any company to sustain an 8% growth rate forever into the future- by power of compounding would be bigger than the U.S. economy.

- However, what if the facts were different and the outlook was truly for 8% annual growth for the next four or five years, then slowing to a sustainable long-term growth rate of 3%.

- This type of situation is best suited to the discounted future income method, where the year by year forecasts take this into account.

Discounted Future Income Valuation Method

- Method usually best captures value when a company is expected to have very high growth rates over the next few years, then slow to a more mature rate of increase.

- Method can be perfectly valid in the above circumstance and is widely used by acquirors.

- Problem- Results by method easily manipulated by overoptimistic or pessimistic assumptions. Seemingly small changes in variables can have large impacts on value.

Discounted Future Income Method (continued)

How to review? Test every revenue and expense assumption and forecasted results in light of:

1) Actual historical experience
2) Commonsense about what you think might drive the business.
3) How others in the industry perform.
4) Perform sensitivity analysis.

Discounted Future Income Method- An Example

- We' ll look at the spreadsheet discounted cash flow (DCF) model of the valuator
- Examine simplistically how the DCF works
- Critique the DCF and its assumptions and findings using commonsense.
- Let you tell me changes to make in the spreadsheet to see how minor changes affect value

Market Approach

- **Guideline Transaction ("Merged and Acquired Companies") Method-** Based on prices paid in actual sales of companies.
- **Guideline Public Company Method-** Based on valuation multiples of publicly traded companies in the same or similar line of business.
- **Past Transactions in the Shares-** Prices paid in actual transactions of the shares itself.

Market Approach Example

- Will use Merged and Acquired Companies Method (No Past Transactions, No Similar Publicly Traded Beer Distributors

- Appraiser has done search and finds 3 transactions of beer distributors.

- Could not find income data, but finds that they sold for an average price/case of beer distributed of $5.00/case.

Market Approach Example (Continued)

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Valuation of ABC Beer Distributors
Using Market Approach

Price Per Case	**$5.00**
Times: ABC Beer Distributors Annual Case Volume	**X 1,000,000**
Equals: Value of ABC Distributors	**$5,000,000**

Market Approach Example

Shortcomings

- Know virtually nothing about acquired companies- brands, market, size, profitability, etc., relative to ABC.

- Is the price the price for an asset purchase without the assumption of liabilities? If so, the liabilities of ABC must be subtracted to get to the equity value (value of common shares).

Market Approach

On further inquiry (none of this is unfortunately in the valuation report), you find out:

- All 3 transactions involved Anheuser Busch Distributorships

- One is in Myrtle Beach, NC, one in Concord, NC, and one is in Raleigh, NC

Market Approach (continued)

- Is the $5.00 per case price reasonable?
- Markets not the same- upon careful study you find that forecasted future annual population growth rates of ABC's territory are much lower than those of the acquired companies.

- ABC (Rural County)- 1% per year.
- Myrtle Beach (Horry County)- 3% per year.
- Concord, NC (Cabarrus County)- 2.8% per year.
- Raleigh, NC (Wake County)- 2.5% per year.

Market Approach (Continued)

- Profit margins, risk and everything else being equal, why would a buyer pay the same price per case (or multiple of earnings, etc.) for ABC when its market is expected to grow at a fraction of that of the acquired companies.

- They would not you would not, and I would not- it is just commonsense.

Market Approach (Continued)

- ABC is a Coors distributor. The acquired companies are all Anheuser Busch distributors.

- Is this relevant?

Market Approach (continued)

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Market Share by Brand, NC
(Hypothetical- But Not Too Far From Actual)

Anheuser Busch	**50%**
Miller	**40%**
Coors	**7%**
Others	**3%**
Total	**100%**

Market Approach (continued)

- **Impact of High Market Share-** Revenues per drop of delivery drivers much higher for A-B and Miller than Coor's.
- **Implications-** Even though fixed costs are the same (driver, truck, fuel), A-B and Miller generate more revenues per drop.
- **Profitability Result-** A-B and Miller would be expected to make much more profit for the same amount of revenues (i.e., higher profit margin).
- **Buyer's Viewpoint-** Why would I paid the same price per case for a Coor's distributor as for an A-B distributor when I make much more profit per case with A-B? I WOULDN'T.

Market Approach (continued)

BOTTOM LINE- The $5.00/case value is unsupported and may materially overvalue ABC:

-Insufficient detail.

-From markets with totally different growth potential that are much greater than that of ABC.

-Based on distributors brand (A-B) that would be expected to make much more than a Coor' s distributor.

Cost Approach Example

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Asset	Value Per Books	Value at Market	Adjustment
Cash	$300,000	$300,000	
Receivables	$200,000	$190,000	Adjusted for Bad Debts
Real Estate	$500,000	$1,000,000	Adjust to market value
Equipment- Trucks, Etc.	$1,000,000	$1,000,000	Adjust to market value
Total Assets	$2,000,000	$2,490,000	
Less Liabilities	($1,000,000)	($1,000,000)	
Equals: Net Asset Value	**$1,000,000**	**$1,490,000**	

Cost Approach (continued)

- Problems
- Only looks at tangible assets. Ignores the value of the intangible right to distribute Coors, which never appears on the balance sheet.
- Does not consider that selling the assets at their increased market values would be taxable.
- Is this the value of the assets in use or in liquidation? Total differently.

Red Flags That a Valuation Might Lack Independence

- Distorted presentation of the facts or issues
- Withholding discussion of key issues that the appraiser knew about, but purposefully does not want to discuss in the report because it would not support their desired outcome
- Lack of balance in the analysis or in the selection or use of methods. Note- this does not mean all methods must be used or weighted equally
- Use of “creative” methods that are not generally accepted
- Use of antiquated method that are easily manipulated but no longer accepted (e.g., excess earnings- discussed later).

Red Flags (Continued)

- Skimpy reports short on detail.
- CPAs can prepare reports called a “calculation of value”- it is not a real valuation at all, but merely using procedures dictated by a client. Do not be fooled. A calculation of value is not worth the paper it is written on.
- Skimpy reports are often that for a reason- if the full thinking and analysis were put in the sunlight, it would be obvious that the valuation was done by an advocate or was incompetent.
- A well written and supported report should be replicable.
- The *Business Valuation Standards* of the American Society of Appraisers (ASA) and the *Uniform Standards of Professional Appraisal Practice* (USPAP) require well supported reports.

Red Flags (Continued)

- The “Valuation Weasel” refuses to issue “final” reports and continually issues reports with “Preliminary Draft- Subject to Revision,” even at valuation exchange dates.
- The Valuation Weasel “rehabilitates” and modifies his or her report once it is known what the critiquing expert has said about it. The Weasel may paper over the flaws, change the “theory” of the report, etc. Attorneys and courts ought to put a stop to this, but they rarely do. Accept only final valuation reports at exchange dates.
- It is OK for an appraiser to later fix a legitimate error- this is not what the Valuation Weasel does. The Weasel is often an advocate who uses drafts as a litigation and damage control strategy.

Red Flags (Continued)

- Use of information not known or knowable on the valuation date- this is the benefit of hindsight a buyer or seller does not have- "time travel."
- Examples of Time Travel- Comparable sales data from after the fact, later lawsuits filed, new customers or suppliers later gained or lost, use of later financial results, economic data, etc.
- See Exhibits 4 and 5 of your manuscript (also on CD) for examples of "time travel" in business valuation and why it is wrong.
- Attorneys too often don't get it with time travel.
- Attorneys think time travel is OK because it corroborates what the appraiser did or assumed at the valuation date was right or wrong. NONSENSE- A buyer and seller, standing at the valuation date, only know what that they know at that date. They do not have the benefit of hindsight.
- NC Case Example.

Red Flags (Continued)- Use of the Excess Earnings Method

- Use of methods that are unacceptable, flawed, and easily manipulated- e.g., the excess earnings method.
- *Kick the Habit! The Excess Earnings Method Must Go!-* (Article at www.businessvalue.com).
- This article outlines the major flaws with the excess earnings method, how it can be manipulated, and why no competent business appraiser should use it.
- Judges hearing family law cases should stop accepting this method.
- Even the IRS, which originally created the excess earnings method, has disowned it since the 1960s.

Red Flags (Continued)- Use of Rules of Thumb

- Use of Rules of Thumb as a Valuation Method.
- What is a rule of thumb and why is it unreliable?
- Although rules of thumb might be legitimately cited by a business appraiser, in most cases they are a recipe for a guess. That's why many business appraisers call them ROT.

Rule of Thumb Example

- Example- “Beer Distributors Sell for $5.00 to $6.00 Per Case Volume”
- Coor’ s Versus Anheuser Busch versus Miller

Red Flags (Continued)- Who Did the Work and Their Qualifications

- The Face Partner- The person who prepared much of the valuation report is not the one who testifies.

- Misrepresentation of qualifications, certifications, degree of experience.

Example of Potentially Misleading Statement About Qualifications

- Example- “His professional affiliations include memberships in… The American Society of Appraisers.”
- Only “membership” categories in the American Society of Appraisers are “Accredited Member, AM” and “Accredited Senior Appraiser, ASA.”
- Implies that individual is accredited (AM or ASA) when he is not. A candidate DOES NOT HAVE MEMBERSHIP STATUS.
- “Candidate, American Society of Appraisers,” is common on resumes. This says nothing about the person’s business valuation qualifications. A person could be a candidate but never have prepared a valuation. Look for the accredited status categories (AM and ASA, the latter requiring the most experience).

Red Flags (Continued)- Interview and Site Visit

- Experts who do not attempt to interview (or depose if required) or visit a company or practice they are valuing.
- The appraiser misses the opportunity to learn valuable information often needed for a competently prepared valuation.
- At worst the "appraiser" may just be "running numbers" to get a desired value. Truly understanding a company and the factors that affects its real value is not important to them- they're advocates.

Red Flags (Continued)- Failure to Follow USAP

- Failure to follow the Uniform Standards of Professional Appraisal Practice (USPAP).
- Failure to have a signed statement of disinterestedness as required by USPAP.

Red Flags (Continued)- Use of Valuation Software

- Often associated with advocacy or an inexperienced individual who a) does not know valuation, and/or b) wants to put numbers in to spit out a report, often with little or no thought.
- Reports produced by computer valuation software programs are not worth the paper they are written on and are rarely, if ever, used by experienced appraisers.
- The problem- you may not even know your appraiser is using such software.
- Signs of a possible computer generated report- Long sections of a generalized nature, lots of charts and graphs, a high degree of boilerplate in the narrative, and limited actual company discussion and analysis.

It Is Not Necessarily Being An Advocate to…

- Have a strong view or opinion or report conclusion, as long as it is supported and reasonable.

- Have a report where the facts are disproportionately positive or negative. The key is: does the appraiser fairly consider the entire picture and validly support his or her viewpoint?

- Have a totally different view or value of a company from that of another appraiser. Reasonable and unbiased appraisers can reach very different viewpoints about the same company. The key is: which viewpoint is more supportable?

Reviewing Reports

- Use the *ASA Report Review Guidelines (Exhibit 3)* and *ASA BV Standards (Exhibit 2)* in your manuscript and on the CD.
- Does it make sense overall?
- It is well supported and documented?
- Can you follow the analysis and calculations and replicate them?
- Is there a clear roadmap for how and why the appraiser did what they did?
- Does it make common sense?

Reviewing Reports (Continued)

- What is being valued?- It is clear what is being valued (company and interest) and at what valuation date?
- Valuation date- Is the valuation date correct?
- Standard of value? Is the standard of value used clear and defined? Fair market value, fair value, etc.? Does it meet the requirements of the purpose of the valuation, case law, etc.?
- Client- Who is the client? Does the appraiser have any relationship with the client that might call into question his or her independence? Is this disclosed in the report? A great example- a CPA who prepares a valuation of a company that is an audit and tax client of the firm.
- What are the limiting conditions and key assumptions that the appraiser made in performing the valuation? Texas real estate example.

Reviewing Reports (Continued)

- Understanding of Company and its prospects- Is there a clear articulation of what the Company does, how it is managed, its ownership, its competition, how it is financed, and the outlook for it and its industry?
- Financial analysis- Does the report analyze financial statement trends and the factors that led to the results observed?
- Industry ratio analysis- Does the report compare the Company's performance metrics ("ratios") to industry peers and attempt to discern what all of this says about the risk and outlook for the Company to a buyer?
- The result of financial and ratio analysis- The professional business appraiser gains insight into how a buyer will perceive the Company and its level of risk and attractiveness.
- Not doing financial ratio analysis- The unprofessional appraiser is just a number jockey, with no clue as to what drives value.

Reviewing Reports (Continued)

- Who did the appraiser interview or talk to? Did they talk to anybody?
- What sources of information did they rely upon? Are they comprehensive or too limited?
- What other research or analysis did the appraiser undertake?

Reviewing Reports (Continued)

- Does the report consider all potential valuation methods?
- Does it support why certain ones were used and some were not?
- Are the methods used correctly?
- Are the capitalization rates used in the income approach reasonable?

Reviewing Reports (Continued)

- Math Errors?- ALWAYS verify math calculations throughout the report.
- ALWAYS double check the financial and comparable sales data used by the appraiser to be sure it is correct and appropriate data. All too often the wrong data is used or transcribed.

Reviewing Reports (Continued)

- Are discounts (minority interest, lack of marketability) and premiums (for control) applied where needed?
- Are discounts and premiums supported and based on sound logic and data?
- Many inexperienced or biased appraisers apply discounts and premiums incorrectly. Example- applying discounts for lack of marketability based on studies of minority interests to value a controlling interest.

Tools are Available

- *ASA Valuation Report* checklist for reviewing reports- available at Banister Financial's website.
- *Business Valuation Standards* of the American Society of Appraisers- available at Banister Financial's website.
- If the appraiser is not an ASA, also compare them against their own society's valuation standards. Truly amazing how many "appraisers" don't follow their own society standards or any at all.
- Learn valuation at more than just a superficial level- it is not hard to do. You don't have to know enough to be an appraiser.

Concluding Comments

- Reviewing reports requires time, effort and an understanding of valuation.
- Reviewing reports is crucial to making sure they are what they purport to be- an reasonable estimate of value. In the litigation context, too often they are not.
- For any collaborative law matter, the parties need to know that the value makes sense. Valuations have real and major consequences in divorces to real people. Make sure they are valid.
- Investing the time and money to have an opposing expert's report reviewed can have a major impact on the outcome of the case and hopefully short circuit the need for a trial.
- If the case goes to trial, you and your expert will know how to effectively articulate the problems of the flawed report to the court in an objective, unbiased manner. Without this, you are flying blind.