A DECLARATION OF INDEPENDENCE

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In the litigation context, the world of business valuation exists between its two sister worlds of law and accountancy. In the heat of battle, many business appraisers may become confused as to their role in the process and take a position that is favorable to their client, even though that position does not represent an independent opinion as to the fair market value of an interest. This article will examine the role of all three disciplines and stress the need for independence in business valuation. While advocacy certainly has its place in the work of litigation attorneys, it is the opinion of this author (and most others in the business valuation field) that advocacy should be limited to the field of law and should not influence opinions as to the value of closely held companies.

Public Accountancy

Public accountants should be concerned solely with reporting the financial reality of a company’s reported financial results. A typical unqualified accounting opinion reads as follows:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 2000, and the related statements of stockholders’ equity, income, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company at December 31, 2000, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

As seen above, the public accountant is concerned with the truth of the situation. First of all, the public accountant conducts the audit “in accordance with auditing standards generally accepted in the United States.” Generally Accepted Accounting Principles (or GAAP) were promulgated in the 1930s in response to massive accounting fraud that precipitated the stock market crash and beginning of the Great Depression in the late 1920s. Investors lost money to a great extent due to fraudulent financial statements that inaccurately portrayed the actual financial status of companies. GAAP was a necessary measure to restore investor confidence in the stock market.

Secondly, the public accountant states that the financial statements present “fairly” the financial position of the company. The need for consistent financial reporting standards is obvious—if accountants were advocates in the way financial statements were prepared, there would be no way to objectively compare companies. A clever accountant could make a financial statement say just about anything. By booking unearned revenues and deferring actual expenses, a crafty accountant could make a company that is going down the tubes look like a highly profitable, rapidly growing superstar. As investors jumped on the bandwagon and bid up the stock price, management could quietly sell their stock positions, leaving investors with a worthless investment once the fraud was discovered. A free market system fraught with this kind of abuse would quickly disintegrate into anarchy, thus there is a need for uniform standards that are evenly applied.

In today’s financial environment, news of irregularities of public accounting can send shock waves through the market and hammer a public company’s stock price. Word that a company has changed auditors due to “differences in opinion” over how various items are accounted for can be a red flag for financial
inaccuracies. Those accounting firms that participate in questionable accounting practices at the bequest of management face severe penalties and fines if caught. One obvious and still-developing example of this in today’s market is Arthur Anderson’s involvement in the Enron debacle.

**Law**

As opposed to the necessity of independence in the public accountancy field, the practice of law in the litigation context is inherently nonindependent. Although the purpose of the law is to achieve truth and justice, the way we reach that truth and justice in the United States is through the adversary system. Under this system, each side presents his or her case and the judge or jury is left to decide where the truth lies.

Both the North Carolina and South Carolina Rules of Professional Conduct offer the following guidelines as to lawyer advocacy:

- “As advocate, a lawyer zealously asserts the client’s position under the rules of the adversary system.” In most litigation cases, the “rules of the adversary system” are as follows: present as favorable a case as possible for the client, maximizing those factors most favorable for the client and minimizing or ignoring those factors least favorable for the client. Combat an adversary by maximizing the most unfavorable factors for him and minimizing or ignoring the most favorable factors for him. Ultimately, it is left to the judge or jury to decide, with the victory often going to the party who had the most effective advocate.

- “A lawyer’s responsibilities as a representative of clients, an officer of the legal system and a public citizen are usually harmonious. Thus, when an opposing party is well represented, a lawyer can be a zealous advocate on behalf of a client and, at the same time, assume that justice is being done.” This guideline expands on the adversary system listed in the first guideline above. Under this guideline, each adversary is charged to be a “zealous advocate” on behalf of his or her client, but only when the opposing party is “well-represented.” This raises an interesting issue: when an opposing party is not so “well-represented,” does a lawyer have to back off a little bit in his zealous advocacy for his client in order for “justice to be done”? If the opposing party is represented by completely ineffective counsel, does a lawyer cease to be zealous at all? And how is “well-represented” measured—are there any objective standards? Is there any kind of handicapping system whereby a good lawyer has to “give some strokes” to a bad lawyer to level the playing field so that justice can be done?

In the real world, an effective and competent lawyer going up against an ineffective and incompetent lawyer will most likely use every advantage available to reach the most beneficial outcome for her client. Fortunately or unfortunately, the “American Way” is to win the case, not to reach the truth. Was the truth reached in the O.J. Simpson case? Simpson was acquitted in his criminal trial but convicted in his civil trial. One of these courts has to be wrong—either he did it or he did not. Yes, the burden of proof was different in each case—maybe that had something to do with it. Or, maybe Simpson was more “well-represented” in one trial than he was in the other.

However, while there can be significant shortcomings to reaching the “truth” under the adversary system, there may not be a better system to use. Short of a magical truth serum or foolproof polygraph, no other solutions currently exist. Consequently, this illustrates the advocative role attorneys must play in business valuation disputes and how that differs from the role that public accountants and business appraisers should play in the same situation.

**Business Valuation**

As demonstrated above, there is a necessity for independence in public accountancy and for advocacy in the litigation context of the legal profession. So, where does business valuation fit in between these two disciplines? Should business appraisers be independent in their work? Or, should business appraisers be advocates for a particular value or desired outcome? In the estate tax context, should business appraisers try to generate the lowest possible value to save as much estate tax as possible? Is it acceptable for the appraiser to take an unsupported 60% discount, knowing that the IRS will challenge that figure, with the parties likely settling on a lower discount? In the equitable distribution context, should the business appraiser hired by the husband-owner try to generate the lowest possible value for a company so that the husband has to pay as little a settlement as possible to his ex-wife? Or should the business appraiser hired by the non-owner-wife try to generate an unrealistically high value in the hopes of making the husband-owner pay as high a settlement as possible?

To answer these questions, one should first examine what the governing bodies in business appraisal have to say about independence and advocacy. Following are the official positions on advocacy of the three leading credentialing bodies in business valuation: the American Society of Appraisers (ASA), the National Association of Certified Valuation Analysts (NACVA), and the Institute of Business Appraisers (IBA). In addition, the Uniform Standards of Professional Appraisal Practice (USPAP), federally mandated appraisal standards, were also examined as to their position on advocacy.

**ASA Principles of Appraisal Practice and Code of Ethics**

The American Society of Appraisers (ASA) is one of the oldest credentialing bodies in the United States and the most rigorous in its requirements to achieve accreditations. The ASA rules contain the following provisions concerning advocacy:

**Section 2.2 Objective Character of the Results of an Appraisal Undertaking.** The primary objective of a monetary appraisal is determination of...
a numerical result, either as a range or most probable point magnitude—the dollar amount of a value, the dollar amount of an estimated cost, the dollar amount of an estimated earning power. This numerical result is objective and unrelated to the desires, wishes, or needs of the client who engages the appraiser to perform the work. The amount of this figure is as independent of what someone desires it to be as a physicist’s measurement of the melting point of lead or an accountant’s statement of the amount of net profits of a corporation. All the principles of appraisal ethics stem from this central fact.

Section 4.3 Appraiser’s Obligation Relative to Giving Testimony. When an appraiser is engaged by one of the parties in a controversy, it is unethical for the appraiser to suppress any facts, data, or opinions which are adverse to the case his client is trying to establish; or to overemphasize any facts, data, or opinions which are favorable to his client’s case; or in any other particulars to become an advocate. It is the appraiser’s obligation to present the data, analysis, and value without bias, regardless of the effect of such unbiased presentation on his client’s case.

Section 7.5 Advocacy. If an appraiser, in the writing of a report or in giving an exposition of it before third parties or in giving testimony in a court action suppresses or minimizes any facts, data, or opinions which, if fully stated, might militate against the accomplishment of his client’s objective or, if he adds any irrelevant data or unwarranted favorable opinions or places an improper emphasis on any relevant facts for the purpose of aiding his client in accomplishing his objective, he is, in the opinion of the Society, an advocate. Advocacy, as here described, affects adversely the establishment and maintenance of trust and confidence in the results of professional appraisal practice and the Society declares that it is unethical and unprofessional.

As seen above, the ASA’s position on advocacy is crystal clear—advocacy has no place in business valuation.

NACVA and the AICPA Code of Professional Conduct Rules

The National Association of Certified Valuation Analysts (NACVA) and American Institute of Certified Public Accountants (AICPA) rules contain the following provisions that pertain to advocacy:

Rule 102 (Integrity and Objectivity). In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

Interpretations under Rule 102—Integrity and Objectivity. Knowing misrepresentations in the preparation of financial statements or records. A member shall be considered to have knowingly misrepresented facts in violation of rule 102 when he or she knowingly (a) makes, or permits or directs another to make materially false and misleading entries in an entity’s financial statements or records; or (2) fails to correct an entity’s financial statements or records that are materially false and misleading when he or she has the authority to record an entity; or (3) signs, or permits or directs another to sign, a document containing materially false and misleading information.

The NACVA and AICPA rules also call for objective and unbiased opinions in the provision of professional services. Although the term “advocacy” is not mentioned, the explicit message is that opinions should be independent and uninfluenced by others.

Uniform Standards of Professional Appraisal Practice (USPAP)

Under the Ethics Rule of the Uniform Standards of Professional Appraisal Practice (USPAP), the following position on advocacy is taken:

An appraiser must perform assignments ethically and competently, in accordance with USPAP and any supplementary standards agreed to by the appraiser in accepting the assignment. An appraiser must not engage in criminal conduct. An appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodation of personal interests. In appraisal practice, an appraiser must not perform as an advocate for any party or issue.

Comment: An appraiser may be an advocate only in support of his or her assignment results. Advocacy in any other form in appraisal practice is a violation of the ETHICS RULE.

An appraiser must not accept an assignment that includes the reporting of predetermined opinions and conclusions. An appraiser must not communicate assignment results in a misleading or fraudulent manner. An appraiser must not use or communicate a misleading or fraudulent report or knowingly permit an employee or other person to communicate a misleading or fraudulent report.

As with the ASA, NACVA, and AICPA, the USPAP position on advocacy in business valuation is unmistakable—do not do it. In fact, the only advocacy allowed under USPAP is in support of the valuation results. However, these valuation results must be determined through independent analysis that is not influenced by the desires of any party to the matter.
IBA Business Appraisal Standards
Finally, the Institute of Business Appraisers (IBA) takes the following position on advocacy in business valuation:

Preamble 2 (in part). “The performance of business appraisal/valuation requires a high degree of skill, imposes upon the appraiser a duty of non-advocacy to the client and an obligation to the general public as a third party beneficiary of the work.”

Standard One (Professional Conduct and Ethics) 1.4 Nonadvocacy v. Advocacy.
“Nonadvocacy is considered to be a mandatory standard of appraisal. The appraiser’s obligation to serve the public interest assures that the integrity of valuations will be preserved. Hence, the appraiser may only be an advocate for his unbiased process and conclusions. The appraiser must be guided by nothing other than his informed judgment, the dictates of the client (as permitted under these standards), applicable administrative rulings, and the law. In the event the appraiser is engaged to function not as an appraiser but as an advisor or consultant, he may serve as an advocate. In such instances the appraiser shall include a statement of departure which states that any positions taken were taken as an advocate for the client.”

As seen above, the IBA standards echo the same position of nonadvocacy as the previously mentioned credentialing bodies, with one important exception: if the appraiser is engaged as an advisor or consultant, he may act as an advocate; however, he must include a statement of departure that signals to the world that he is acting as an advocate.

The IBA exception raises a good issue as to advocacy in business valuation. One potential example of the IBA exception contemplated above is when a business appraiser functions as an investment banker and is hired to sell a company (presuming the IBA standards would require this business appraiser to include a statement of departure that he is acting as an advocate in this situation). Assuming the business appraiser will earn a fee based on the total sales price of the company, it is in the best interest of both the business owner and the business appraiser to sell the company for as high a value as possible. Of course, any potential buyer of the company expects this position from the seller. In light of this, a potential buyer of the company may hire her own business valuation advisor to advise the potential buyer on what a fair price for the company should be, e.g., to advise the potential buyer on where the “holes” in the seller’s inflated value might be. In the sales context, offers and counteroffers are normal procedure, with such negotiation ultimately leading to the sale of the company at a price acceptable to both the buyer and the seller. The price at which the company is sold is the fair market value of the company; however, neither the buyer nor the seller (nor their business valuation advisors) started the negotiation at this price—they both presumably left some room in which to “strike the deal.”

The above sale scenario is a very different context than that which occurs in the litigation context. The buyer-seller scenario above involves two willing parties, either of whom is free to walk from negotiations if he or she feels the price is too high or too low. In a sale negotiation, neither party is bound by any particular opinion of value and, if a deal is ultimately struck, it is implied that both parties agree that the value is “fair.” In contrast, litigation matters reach a conclusion from which neither party has the option to walk away. Although this conclusion may be extended by appeals, ultimately, a conclusion is reached and the parties are bound by the final judgment. In the litigation context, the court is therefore concerned with the “truth and justice” aspect of the matter and is not well-served by widely disparate advocate positions by the business valuation experts. The judge or the jury needs the “truth,” not some unrealistically inflated or deflated position that benefits one party or the other.

The Dilemma
The problem, of course, arises in practice. Hardly any business appraiser is going to admit he is an advocate in the litigation context—if he does, the opposing attorney should make quick work of him. The business appraiser who is acting as an advocate will never admit this—he will say that his value is the correct value. The difficulty comes in proving that the appraiser is acting as an advocate. How is this done?

Business valuation is a combination of both objective and subjective decisions made by the appraiser, and it is guaranteed that reasonable minds will differ as to the value of an interest. However, as is often seen in the litigation context, when one appraiser comes in with a value of $5 million for a company and another appraiser comes in with a value of $1 million for a company, it is almost a certainty that at least one of these appraisers is either (1) an advocate for her client, or (2) professionally incompetent.

In the case of impeaching the business appraiser who is acting as an advocate, the best defense is a good offense. When held next to each other for comparison, a well-reasoned and objectively supported report should quickly expose a shoddy report for its inaccuracies and unsupported assumptions. Most, if not all, of these differences boil down to what makes common sense. Many formulas and theories in business valuation are quite complex. However, if these difficult concepts are distilled into their component parts, they are more easily understood, and unreasonable assumptions or errors made can easily be seen. This is why it is crucial for the attorney in the litigation context to have a thorough understanding of the particular business valuation aspects of a particular case. Without this understanding, an attorney can neither show why his business valuation expert has made reasonable and well-supported assumptions, nor can the attorney point out the obvious flaws and unreasonable assumptions made by the business appraiser who is acting as an advocate.
Conclusion
Advocacy has no place in business valuation in the litigation context. It is difficult for some business appraisers to remember this as they are often swept up in the heat of the battle by attorneys who are properly zealous on behalf of their client. However, it is critical for business appraisers to remain dispassionate as to one side or the other and to opine to an independently analyzed and well-supported opinion of value. Anything less than this and the business appraiser has compromised both his professional integrity as well as the discipline as a whole.◆