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VALUATION REPORT CONTENT IS KEY IN JOINTLY-RETAINED VALUATION ASSIGNMENTS

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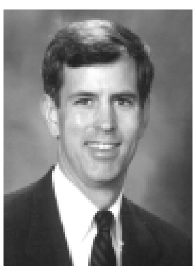
Introduction. No matter what the purpose, a professional valuation report should include a detailed discussion of the factors the appraiser considered and provide a roadmap of how he or she arrived at the final value. This is especially true in a jointly-retained assignment as the parties are not in a position to have sufficient material to critique and comment on the draft valuation, raise issues they believe should have been considered, or differ on assessments and conclusions reached. Therefore, in selecting a business appraiser, the parties to a jointly-retained assignment should carefully determine that each prospective business appraiser is able to clearly articulate their findings through a well-written and fully documented report. Poorly written valuation reports lacking sufficient detail are useless, as the report's findings cannot be sufficiently assessed. If the parties cannot determine how and why the valuator reached his or her conclusions how can they possibly believe the result is fair? This article will address a few of the many elements that constitute sound valuation report content.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Business Valuation Standards. The American Society of Appraisers (ASA) has a set of rigorous business valuation standards to which its accredited members and candidates must adhere in each business valuation assignments. These Standards include the following broad elements:

- **Independence.** The appraiser must be unbiased and independent and not act in any way as an advocate for the client or any other party in arriving at an opinion of value. If independence and ethics are sacrificed users cannot place any reliance on an appraiser's opinion of value.
- **Fee Arrangement Disclosure.** No appraiser can accept a valuation assignment where the fee paid depends on the finding of value. For example, it is unethical for an appraiser to accept a fee that is contingent on the outcome, such as a fee based on a percentage of the value. The valuator must warrant in the report that the fee arrangement is not based on the finding of value.
- **Limiting Conditions.** All reports must set forth key assumptions, conditions or restrictions that impact the estimate of value. By doing this, the reader is informed of key assumptions. For example, a common limiting condition in valuation reports is the statement that the valuator has not independently verified or audited any of the financial or other information provided by the company being valued. Or suppose a company has a lawsuit outstanding, which is a material factor that could negatively impact the business, but whose impact cannot be fully known or foreseen. The valuator would clearly want to state in the report that this uncertainty exists and its impact is unknown.
- **Professionals Participating in the Assignment.** The identity of individuals materially

participating in the valuation assignment must be disclosed. Each of these individuals must sign the report and certify their independence, a fee arrangement not contingent on the value, and other factors required in each specific society's standards, as well as those required by the Uniform Standards of Professional Appraisal Practice ("USPAP"). If a participant disagrees with the valuation findings in the report, this must also be stated, along with the nature of their dissent. In a jointly-retained appraisal, the parties usually agree on a specific, trusted person to prepare the valuation. The parties should not find out later that a staff person did nearly all of the work and analysis and that the trusted appraiser only signed off on the final product as if he or she did the work. If that staffer prepared the majority of the report, the clients have no way of knowing that the staff person is similarly qualified, experienced, level-headed, honest and diligent. Every company being valued is unique and there are literally thousands of details that combine and interact to impact the value. This is why one experienced individual should handle all major aspects of a valuation assignment and why the concept of "staff-partner leverage" does not work well in business valuation.

- **Information Sources Used.** Valuation reports ought to be replicable by the reader. Therefore, a sound business appraisal needs to include key sources relied upon.

- **The Purpose of the Valuation Assignment (e.g., estate tax, gift planning, buy-sell agreement, purchase or sale, etc.).** Valuation requirements and methodologies can differ depending upon the purpose. A valuation of a real estate holding corporation, for estate tax purposes, might be required to ignore trapped-in capital gains taxes that would be due by the corporation if it sold its real property. By contrast, in a valuation for a possible purchase of those shares, an adjustment downward in value for trapped-in capital gains taxes might be an important factor impacting value. Therefore, a valuation is only designed to be valid for a specific purpose. Any restrictions on the use of the report should be included in the narrative.

- **Standard of Value Used.** The appropriate standard of value used must be clearly set forth and defined, such as fair market value, fair value, etc.

- **Identification of the Specific Interest Being Valued.** The report must clearly state the interest that is being valued (e.g., 100 common shares in XYZ Corporation, representing 10% of the 1,000 total issued and outstanding common shares). It is not enough to state that the appraiser is valuing a "minority interest in the shares of XYZ Company." Different share holdings, even of minority interests, can have different values depending upon the distribution of a company's ownership, the potential for swing block attributes, and the impacts of relevant state law and shareholders' agreements.

- **The Specific Valuation Date Used.** The value of any asset is only valid as of given date since market conditions, the investment climate, and other factors change from one day to the next. For example, a company might be valued for a divorce where the relevant date under state law is the date of separation. At that time the company might have a value of $5,000,000. Six months later the company might lose a major customer accounting for 20% of its revenues, causing its value to drop to only $4,000,000. This is why valuations are only as of a specific date. The actual valuation date to be used is something all of the parties will need to agree on in advance of the preparation of the joint valuation.

- **The Relevant State Law Governing the Entity.** For example, if a company is incorporated in Maryland, it is important to know and understand Maryland state law since this may impact the rights of the interest holder, its income taxation, and other factors.

- **Scope of the Valuation Report.** The report should outline the scope of the procedures undertaken in the valuation, and also disclose any way in which they are limited.

- **Nature and History of the Business**. A valuation must consider both the nature and the history of a business. Understanding how a business started and has evolved over time to the present tells a great deal about the risks and opportunities that impact the company and its value. Additionally, it is important to consider the management of the business, its strengths and weaknesses, products and services offered, customers, supply relationships, sales and marketing, competition, credit relationships, contractual arrangements, facilities and location of the company's activities, and a variety of other factors that impact the business. The reader of a valuation report should come away with a clear grasp of the "who, what, when, where, why and how" of a company's business. This places the valuation findings in context and allows the reader to draw his or her own independent conclusions about whether he or she believes that the valuation findings are reasonable. By contrast, poorly written reports with little detail leave the reader knowing little more about the company than when he or she started the report. This gives the reader no basis on which to judge the validity of the report or its value.

- **Historical Financial Information on the Business.** Historical financial results and performance tell a great deal about the investment attributes of a company, the quality of its management, and its risks and opportunities. Historical financial information also serves as a clue to the company's possible future outlook. All business appraisals of an operating company (i.e., not primarily an asset holding company) should include a full summary of historic financial results of the business, including income statements and balance sheets for historical years. Business valuation standards are silent on the specific number of years to be included, however, a commonly held view is that three to five years is a minimum if the business has been in business that long. However, in cyclical companies, a five-year snapshot may not capture the full view of an industry cycle. Therefore, valuator judgment may lead to the conclusion that even more years of information ought to be included to give a more accurate representation of the business.
- **Financial Analysis.** Reports must undertake a thorough financial analysis of the business. This includes an examination of historic financial trends, the key factors impacting results, and a comparison of financial performance and financial statement ratios with industry performance measures (if available). This should also include common-sized income statements (items shown as a percentage of net company revenues) and balance sheets (items shown as a percentage of total company assets). Financial statement ratios typically include measures of profitability, liquidity, working capital, leverage, debt service coverage, asset utilization and return on equity.
- **Industry and Economic Conditions, Outlook and Impact on the Subject Company.** Each company is subject to unique industry and economic trends and forces that can heavily impact future financial and investment performance and value. The valuation report should include a discussion of these key factors and how they impact the company. For example, an industry might face a worsening outlook in the future due to a tight supply of a key raw material which will lead to higher prices and lower demand for the resulting end product. Alternatively, a government agency may be preparing to deregulate the industry, leading to greater competition and downward pressure on prices as new competitors enter the business. From an economic perspective, local, regional or national economies can impact a company and should be discussed.
- **The Current Investment Climate and Rates of Return for Similar Investments.** The investment climate at the valuation date is relevant because it impacts the rates of return buyers require for investing in different types of assets. Similarly, historic rates of return on investments similar to the company being valued may provide indications as to its current value. The valuation should consider and discuss these elements and define and discuss the specific data used and why. For example, in using the capitalization of earnings method (an income valuation approach), the valuation may depend upon a capitalization rate developed by using data based on long-term returns from investments in public companies. The report should clearly document the development of the capitalization rate and the specific resources used to develop the rate of return.
- **Past Transactions in Company Shares and Acquisition or Sale Factors.** Past transactions in the shares of the company itself, if they have occurred, can often serve as an indicator of the company's present worth. Such transactions need to be analyzed carefully to determine if they are relevant indicators of present value. Also, plans by the company to consider a sale or merger of the company (or any past solicitations by outside potential acquirors), could be highly relevant in how an investor might view the present value of the shares. These situations, if present, should be discussed, and their relevance to the value detailed. The business appraiser should place himself in the shoes of a shareholder in a company who is considering selling his shares. Suppose that four weeks before the valuation date the company entered into preliminary discussions with a possible buyer for the whole company. This would certainly be relevant information that an owner of the shares would consider if selling the shares.
- **Valuation Methods Considered, and the Ones Used.** All business valuations should given consideration to the income, cost and market approaches to valuation. A report should include a discussion of the methodologies considered, which ones were employed and why they were employed. Equally important is a discussion of why certain methods were not employed.
- **The Implementation of the Valuation Methods-** A valuation report should have a full discussion the major steps used in implementing each valuation method and any adjustments made to financial statements. Again, the reader should be able to fully replicate the valuator's process and understand the finding by each specific method.
- **Reconciliation of Findings of Value.** A reconciliation is where the business valuation

summarizes the findings by each respective valuation method and then gives the rationale for how each method was considered in arriving at a final estimate of value. This might be accomplished through an explanation of why various weightings were attached to each method. Alternatively, if mathematical weightings were not employed, the narrative should explain how the business appraiser reached the ultimate value. However, merely showing the results is usually not enough. Valuation is as much art as science and involves a great deal of judgment on the business appraiser's part. Therefore, the business appraiser should provide an explanation of the considerations in deciding which method(s) provided the most reliable indication of value and why those methods were selected.

- **Adjustments to Valuation Findings.** The report should discuss and consider any possible adjustments to the value that might be relevant. These might include adjustments for control, minority or lack of marketability discounts, key person, or other discounts. Additionally, if the business or entity has non-operating or excess assets (e.g., excess cash, investment property, and marketable securities) not needed in the day-to-day business, these adjustments to the value need to be made and clearly supported. The rationale for these adjustments needs to be clearly specified, and if studies are used as a basis, they should be cited. Many valuation reports fall miserably short in this area, particularly as concerns the analysis of discounts for lack of marketability. A report may spend 40 to 60 pages or more analyzing a company to arrive at a sound and supported preliminary value. Then, with no supporting rationale, the valuator arbitrarily, and without any stated basis or support, reduces the value by a discount for lack of marketability, often in the 30% to 40% range. This is of no help to the reader. Readers must have a clear indication of adjustments, their basis, and their rationale.
- **Final Conclusion of Value.** This is fairly straightforward, and involves a clear statement of the findings of value.

Conclusion. This article has summarized some of the key elements that should be included in a professional valuation report for any purpose. A comprehensive, well-written report is a must in jointly-retained matters. Without it the parties will not be in a position to examine and critique the analysis and logic used by the business appraiser to arrive at a supported opinion of value. On the other hand, a professional report provides this information and clear understanding of what led to the resulting value. The parties may not like or agree with the final value, but they can nonetheless see that the appraiser was unbiased, objective and had a sound basis for the resulting value. They are therefore more likely to see the process as fair and accept the result. ♦

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