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Evaluating Valuation Reports and Testimony

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The courts are full of business valuation "experts" who proclaim the value of companies in divorce, dissenting shareholder, estate and business damages matters. Matters that have a profound financial impact on clients' lives depend in part upon the trial attorney's (or his or her expert's) ability to uncover flaws in the logic of the validity and reasonableness of the findings of the other side's expert and then to convince the court accordingly. Since both experts are sometimes biased, unethical advocates for opposing high and low values, the trial judges face the daunting task of sorting out the truth, if possible, in reaching a decision.

In addition to "advocates," there are also many well-meaning "experts" who, through a lack of training, experience and/or knowledge arrive at incompetent valuation findings. Truly competent business valuators frequently encounter "local experts" who are accepted by family law judges as the local authority on valuation, even though these "experts" are basically incompetent and out of sync with modern valuation techniques.

***Kumho Tire* and *Daubert* and Their Crucial Implications.** The need for competent business valuators increases with each new case development. One recent U.S. Supreme Court case, *Kumho Tire Company, LTD. v. Carmichael*,[1] further demonstrates the growing stakes involved in expert witness testimony. In the last year alone, there has been a surge in interest by trial attorneys to use the *Kumho Tire* case as a basis for excluding expert witness testimony.

In an earlier case, *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[2] the U.S. Supreme Court considered the admissibility of expert testimony and indicated that such testimony is only admissible if it is both relevant and reliable. The Court held that the Federal Rules of Evidence "assign to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand." The *Daubert* Court cites several factors for consideration of whether the scientific theory being offered is valid, including:

- Whether the theory or technique in question can be (and has been) tested.
- Whether it has been subjected to peer review and publication.
- Whether it has attracted widespread acceptance within a relevant scientific community.
- A theory's known or potential error rate.
- The existence and maintenance of standards controlling its operation.

The *Daubert* Court stated, "The inquiry is a flexible one, and its focus must be solely on principles and methodology, not on the conclusions that they generate." The *Daubert* Court also said:

> The Rules—especially Rule 702—place appropriate limits on the admissibility of purportedly scientific evidence by assigning to the trial judge the task of ensuring that an expert's testimony both rests on a reliable foundation and is relevant to the task at hand. The reliability standard is established by Rule 702's requirement that an expert's testimony pertain to "scientific … knowledge," since the adjective "scientific" implies a grounding in science's methods and procedures, while the word "knowledge" connotes a body of known facts or of ideas inferred from such facts or accepted as true on good grounds. The Rule's requirement that the testimony "assist the trier of fact to understand the evidence or to determine a fact in issue" goes primarily to relevance by demanding a valid scientific connection to the pertinent inquiry as a precondition to admissibility.

In *Daubert*, the Supreme Court declared that scientific testimony must be able to be validated. The Court said that Rule 702 of the Federal Rules of Evidence "clearly contemplates some degree of regulation of the subjects and theories about which an expert may testify" and that the expert's testimony must be of scientific knowledge and reliable.

Clearly, *Daubert* dealt with scientific evidence offered by experts, but did not address testimony by experts in a nonscientific arena (e.g., business appraisal). Enter the *Kumho Tire* case, which involved testimony by engineers. Rule 702 of the Rules of Federal Evidence states the following:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise.

In *Kumho Tire*, the Supreme Court made clear that expert witness testimony can go beyond the scientific:

> This language makes no relevant distinction between "scientific" knowledge and "technical" or "other specialized" knowledge. It makes clear that any such knowledge might become the subject of expert testimony. In Daubert, the Court specified that it is the Rule's word "knowledge," not the words (like "scientific") that modify that word, that "establishes a standard of evidentiary reliability." 509 U.S., at 589–590. Hence, as a matter of language, the Rule applies its reliability standard to all "scientific," "technical," or "other specialized" matters within its scope. We concede that the Court in Daubert referred only to "scientific" knowledge. But as the Court there said, it referred to "scientific" testimony "because that [wa]s the nature of the expertise" at issue. Id., at 590, n. 8.

The *Kumho Tire* Court also opens the door to the validity of expert testimony outside of the scientific:

> We must therefore disagree with the Eleventh Circuit's holding that a trial judge may ask questions of the sort Daubert mentioned only where an expert "relies on the application of scientific principles," but not where an expert relies "on skill- or experience-based observation." 131 F.3d, at 1435. We do not believe that Rule 702 creates a schematism that segregates expertise by type while mapping certain kinds of questions to certain kinds of experts. Life and the legal cases that it generates are too complex to warrant so definitive a match.
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> To say this is not to deny the importance of Daubert's gatekeeping requirement. The objective of that requirement is to ensure the reliability and relevancy of expert testimony. It is to make certain that an expert, whether basing testimony upon professional studies or personal experience, employs in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field. Nor do we deny that, as stated in Daubert, the particular questions that it mentioned will often be appropriate for use in determining the reliability of challenged expert testimony. Rather, we conclude that the trial judge must have considerable leeway in deciding in a particular case how to go about determining whether particular expert testimony is reliable. That is to say, a trial court should consider the specific factors identified in Daubert where they are reasonable measures of the reliability of expert testimony.

Reviewing the Valuation Report Begins with Standards. How can one find and expose flawed and/or biased valuations and successfully articulate this to the Court? Valuation standards provide an objective roadmap against which to benchmark an expert's valuation report.

USPAP Valuation Standards. The major national accrediting bodies have each issued business valuation standards that cover the required content in a business valuation. Additionally, all business valuations prepared for any federal-related purpose are required to comply with the Uniform Standards of Professional Appraisal Practice (USPAP). The Appraisal Foundation, a body given the authority by Congress to promulgate and enforce standards for all appraisal disciplines, issues USPAP. Appraisal Foundation members are real estate-related except for the American Society of Appraisers (ASA), which, in addition to real estate, certifies appraisers in business appraisal, machinery and equipment, personal property and other disciplines.

Most USPAP standards pertain to real estate appraisal, but they also include standards pertaining to business valuation and other appraisal disciplines. There has been some uncertainty about whether or not business appraisers are required to follow USPAP in a valuation with federal government implications (for example, a valuation to be submitted to the IRS with an estate or gift tax return). According to an update in *Business Valuation Review* in 1994, it was reported that the Federal Deposit Insurance Corporation and the Office of Thrift Supervision have specifically adopted and endorsed the requirement that business valuations be required to adhere to USPAP. In addition, the Financial Management Service of the Department of the Treasury has advised regulatory agencies that all real estate appraisals must adhere to USPAP.[3] It has also been reported that an IRS official stated in a 1995 speech to the Institute of Business Appraisers that the IRS expects business appraisals to conform to USPAP (interestingly, the IRS has also recently issued its own proposed set of valuation guidelines).

Regardless of federal regulations, members of constituent societies of The Appraisal Foundation must follow USPAP. Most other nonmember business valuation societies strongly support USPAP, and their own business valuation standards, if followed, would likely lead to conformity with USPAP.

Appraisal Community Views on USPAP. An article by Randy Swad from the September 1995 issue of the CPA journal, contained in the *PPC Guide to Business Valuations*, says the following:

> … USPAP has become generally accepted in the appraisal community … a CPA who performs a business valuation that is not in compliance with USPAP would probably be in violation of the professional care standard of (Code of Professional Conduct) Rule 201…. While the case may not be quite as clear-cut as USPAP,

ASA and IBA standards have probably also achieved the status of general acceptance in the business valuation area. Thus, non-member CPAs are probably prudent to follow ASA and IBA standards.

Similarly, the American Institute of Certified Public Accountants' Consulting Services Practice Aid 93-3, Conducting a Valuation of a Closely Held Business, states:

USPAP, which are broad standards, must be adhered to when an appraisal is performed for a federally related transaction. The Preamble and Standards IX and X of USPAP provide specific guidelines for developing and reporting business valuations. Professional valuators recommend that USPAP be followed for all types of engagements, whether federally related or not.

Business Valuation Standards of Valuation Societies. The American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), and the National Association of Certified Valuation Analysts (NACVA) each have their own set of rigorous business valuation standards. In addition to these, the American Institute of Certified Public Accountants (AICPA) issues standards pertaining to certified public accountants in all types of accounting practices including managing consulting services under which business valuation would logically fall. Other than the general standards to which CPAs must adhere, Rule 201 of the AICPA Code of Professional Conduct governs those CPAs providing consulting services. Anyone regularly involved in business valuation cases should be fully conversant with all of these standards.

Expected Report Content. The following section provides a summary of some general information that would normally be expected to be included in a competent valuation report in order to meet the requirements of USPAP, and most other major appraisal society report standards.

Common Items Omitted in Poorly Prepared Valuation Reports. Often, poorly prepared, incompetent or advocacy valuations lack detail and support. The following list summarizes some of the most frequent types of report omissions found in the review of valuation reports.

Failure to cover general content issues:

- Signed certification required by USPAP.
- Clear standard of value stated (e.g., fair market value, fair value, investment value, etc.) and defined.
- Clarity as to the valuation premise, i.e., controlling or minority interest basis, and if so, exactly how many shares are being valued. Saying a share interest is a minority interest is not enough as there is a continuum of ownership percentages along which shares, depending upon their size and the distribution of ownership, could have different values.
- Valuation date clearly stated.
- Clearly stated purpose of the valuation. A valuation is only valid for a specific purpose as relevant law and case law and other factors can result in different techniques and applications of methodologies.
- Unusual or key assumptions that significantly impact the value.
- Sources of data not clearly denoted to show the scope of the report, the depth of inquiry, and to enable the reader to replicate the findings.
- Statement as to who prepared the valuation report, who materially participated in its preparation, and who assumes the responsibility for its findings.
- Qualifications of the valuation's author(s).
- Identification of the client.
- Content or issues relevant to the specific case law or State or Federal laws applicable to the valuation at hand.

Failure to fully discuss key factors impacting value:

Company overview:

- History and founders.
- When incorporated and where.
- Tax status (C corporation, etc.).
- Initial lines of business and evolution over time, current operation.

Management:

- Management and employees.
- Key person risk issues, health of key employees, turnover, management dissent.
- Contractual issues (i.e., employment agreements, covenants not-to-compete).
- Employee turnover and retention.
- Whether or not there is a unionized workforce.
- Benefits plans.

Ownership:

- Ownership breakdown.
- Existence of buy-sell or similar agreements.
- Impacts of the distribution of ownership, potential for swing block issues, voting rights to accomplish key corporate actions (e.g., simple majority, super majority, etc.).
- Past transactions in the shares and their terms.
- Offers to purchase or sell the company or its shares or assets.

Marketing, sales strategy, channels of distribution:

- How the company markets and distributes its products.
- Advertising strategy.
- Pricing strategy and the company's level of bargaining power in setting prices.
- How the product is actually sold and related implications.
- Reasons for company selection (e.g., lowest bidder, personal relationship, proprietary technology, etc.).
- Significant trends in the demand for the company's product line(s) or services.
- Geographic reach.
- Composition of customer base, concentrations to particular industries.

- Concentrations to one or several key customers, and associated risks, if any.
- Contractual arrangements, terms of sale, aging of receivables.
- Details of exclusive relationship contracts.
- Backlog. Pending major projects or orders. Status of current customer backlog. Significant changes up or down expected in the backlog and why.
- Pending or threatened loss of key customers.
- New business expected if it materially impacts company results.
- Product life cycle issues, if present, that may impact current or future operations.
- Competing technologies, products or services that might threaten the demand for the product or service in the future.
- New products planned, if any, and associated impact.
- Cyclical and seasonal factors, if any, impacting demand, cash flows.
- Whether just-in-time inventory order methods are required to meet customer needs or demands.

Suppliers:
- Products or services purchased and terms.
- Concentrations of suppliers and any associated risks.
- Recent or anticipated losses of key supplier(s) and expected impact.
- Details of exclusive distributorship arrangements, if any, terms of contract, ability to assign to buyer, etc.
- The company's level of bargaining power with suppliers.
- Possible future competition from company suppliers.

Manufacturing process (if not purchased from others):
- Locations of manufacturing facilities.
- Rate of change in manufacturing technology and its effect on the company.
- Amount and nature of research and development undertaken or required.
- Differences in sales/profitability and profit margins by product line and why (if available).

Industry:
- Where the industry currently stands in the industry cycle.
- Trends and outlook.
- Coming changes that create risks or opportunities.
- Governmental regulation.
- Foreign competition.

Dividend policy:
- Dividend policy and history.
- Intent to pay dividend in the future.

Competition:
- Major competitors.
- Strengths and weaknesses relative to the company.
- How the company differentiates itself from the competition.
- Company's market share in its product line(s) versus that of competitors, if known.
- Barriers to industry entry by new competitors.

Real estate:
- Key real estate owned/leased by the company.
- Leases from related parties, degree to which rent is above or below a market rate.
- Importance of location, if relevant.

Banking:
- Loans outstanding, pricing, security, requirement of shareholder guarantees.
- Compliance with loan covenants.
- Ability to meet collateral requirements for working capital credit facilities.
- Sufficiency of credit facilities in place to support growth related capital needs.
- Threats to continued access to credit.

Related-party transactions:
- Debt to officers, shareholders, affiliates.
- Real or personal property leases from a related or third party. Whether terms are at market rates, and if not, what adjustments are warranted.
- Other related party transactions and the extent to which a buyer of the company could continue to expect to purchase goods or services at the same rate.

Contingent liabilities:
- Pending or threatened litigation.
- Guarantees of other obligations.
- OSHA, ERISA, IRS and other regulatory problems.
- Environmental and hazardous waste issues.
- Warranty or repurchase liabilities.
- Unfunded pension plans or health care benefits.
- Self insurance liabilities in health care, workers' comp, etc.
- Tax audits and related problems.

Economy outlook and conditions:
- Local.
- Regional.
- National.

Population growth in market territory if relevant to demand of product or services

Financial analysis of the company:
- Trends and growth rates.
- Variability in key individual items and overall observed results.
- Factors which led to historic results.
- Implications of analysis for risks, outlook, etc., as relevant.
- Revenue trends.
- Adjustment to results for unusual or non-recurring income or expense items.
- Adjustment of results for officer/shareholder compensation to a market rate, along with basis for such adjustments.
- Adjustment of results for discretionary/nonbusiness related expense items.

- Adjustment for related party transactions, such as adjusting for rent to a fair market rate.
- Expense trends and comparison with industry norms.
- Operating profit margins and comparison with industry norms.
- Other income (expense) levels and comparison with industry norms.
- Pre-tax profit margins and comparison with industry norms.
- Future profit outlook.
- Liquidity and comparison with industry norms.
- Sufficiency of working capital and comparison with industry norms.
- Inventory and receivables turnover and comparison with industry norms.
- Speed of supplier payables turnover and comparison with industry norms.
- Reliance on leverage (debt) and associated debt service requirements.
- Historic and anticipated future capital expenditures.
- Need for additional capacity to support growth.
- Analysis of individual asset and liability categories.
- Off balance sheet liabilities.
- Efficiency of asset utilization and comparison with industry norms.

Valuation methodology:

- General explanation of methods available for reader understanding.
- Explanation of approaches considered and used and why.
- Approaches not used and why.
- Income valuation approach:
  - Overview.
  - Discount/capitalization rate development (basis/sources of data/reasoning).
  - Capitalization of earnings method—supporting adjustments (and basis) made to company income.
  - Discounted cash flow valuation method—forecast assumptions, basis, reasonableness.
- Market valuation approach—comparable sales (“market data method”):
  - Search procedure to identify comparable sales.
  - Databases and sources used.
  - Findings of data available.
  - Analysis and comparison with the subject company, if possible.
  - Selection of most appropriate comparables, if possible.
  - Application of comparable data to private subject company to reach value.
- Market valuation approach—guideline public company method:
  - Search criteria used to identify same or similar public companies.
  - Public companies selected and why, those not selected and why.
  - Brief overviews of relevant public companies used.
  - General stock trading data.
  - Specific comparisons of guideline companies used with the subject company.
  - Conclusions regarding the guideline company method.
  - Summary of market valuation multiples.
  - Considerations in selecting the appropriate valuation multiples.
  - Adjustments to valuation multiples for differences in risk and growth.
  - Application of valuation multiples to arrive at a value.
- Past transactions in the shares of the company.

Failure to support the valuation conclusion selected

Failure to consider and support adjustments to preliminary value:

- Premium for control (if appropriate).
- Minority discount (if appropriate).
- Nonoperating assets/working capital adjustments:
  - Excess or nonoperating assets or real property not needed in the business.
  - Adjustments for a shortfall or excess of working capital levels.
- Discount for lack of marketability:
  - Overview of relevancy.
  - Findings of relevant studies on discounts.
  - Analysis of specific factors impacting shares being valued.
- Conclusion of appropriate discount and application to arrive at final value.
- Calculation of goodwill value (if needed for particular assignment).

Accepted Standards Can Be Used to Show Noncompliance. The skeptical reader will say, “Well, the lists shown above are great, but they are just the author’s opinion. I need to be able to show that these and other items are generally accepted within the valuation field.” The lists are compiled from sources such as the standards themselves, but the skeptical reader is right! Once the business valuation has been analyzed in light of lists or other materials the reviewer may have developed, the report should be compared against the numerous standards themselves of the American Society of Appraisers (ASA) Business Valuation Standards and other organizations noted. This may seem like a daunting task, but when done as a matter of course in working on valuations, the task becomes much easier.

Consider Standard V. Business Description, which requires the following:

> A comprehensive, written business valuation report must include a business description which covers all relevant factual areas, such as:
> 1. Form of organization (corporation, partnership, etc.)
> 2. History
> 3. Products and/or services and markets and customers
> 4. Management
> 5. Major assets, both tangible and intangible
> 6. Outlook for the economy, industry and company
> 7. Past transactional evidence of value
> 8. Sensitivity to seasonal or cyclical factors

9. Competition
10. Sources of information used

Standard VI, Financial Analysis requires the following:

A. An analysis and discussion of a firm's financial statements is an integral part of a business valuation and must be included. Exhibits summarizing balance sheets and income statements for a period of years sufficient to the purpose of the valuation and the nature of the subject company must be included in the valuation report.

B. Any adjustments made to the reported financial data must be fully explained.

C. If projections of balance sheets or income statements were utilized in the valuation, key assumptions underlying the projections must be included and discussed.

D. If appropriate, the company's financial results relative to those of its industry must be discussed.

Standard VII, Valuation Methodology states:

A. The valuation method or methods selected, and the reasons for their selection, must be discussed. The steps followed in the application of the method or methods selected must be described and must lead to the valuation conclusion.

B. The report must include an explanation of how any variables such as discount rates, capitalization rates or valuation multiples were determined and used. The rationale and/or supporting data for any premiums or discounts must be clearly presented.

Standard VIII, Comprehensive Written Report Format maintains:

The comprehensive, written report format must provide a logical progression for clear communication of pertinent information, valuation methods and conclusions and must incorporate the other specific requirements of this standard, including the signature and certification provisions.

The above are a few of the many requirements of the ASA's BV Standards, shown for illustrative purposes. The professional standards of the IBA and NACVA contain similar provisions.

Where Experience Comes into Play. In addition to an analysis of specific elements of the valuation, the experienced professional will also step back from the standards and elements and look at the details that should lead to a logical flow in the analysis and conclusions. A sound professional report must provide a full, clear and detailed discussion of the various factors impacting a company; the analysis and findings about it; how these conclusions come together to arrive at a supported valuation estimate; and the sources of data used so the reader can replicate the findings.

All users of valuation reports should be very suspicious of valuation "experts" who omit detailed information. One of several things is often at work in those circumstances: (1) the value is manufactured and has no real supporting basis, (2) it is an advocacy finding and including the detail would show it to be so, or (3) the valuation "expert" is not really competent in business valuation. Any good valuator's goal should be to thoroughly communicate to the client the basis of the value. Only the advocate or the incompetent business appraiser has something to fear by opening the detail of their analysis to scrutiny.

Other Steps in Scrutinizing a Valuation. One should also examine the techniques and methodologies used. For example:

- Are methodologies generally accepted?
- Are methodologies correctly employed?
- Is the capitalization rate supported and justified?
- Are there math errors in the report?
- Is the valuation computer generated?
  Input a few assumptions, write a few paragraphs about the business, push a button, and presto, out pops a 90-page valuation report, full of charts, graphs, capitalization rate calculations, weighted average earnings, and valuation findings. The client and other readers may think the report is highly professional, supported and precise. The validity of the value depends completely upon the quality of the analysis of the company, the identification of internal and external risk factors and opportunities, and the quality of the research efforts of the valuator.
- Is the report balanced?
  Does the valuation present a fair, accurate and balanced view of the company, or does it purposely omit or exclude certain facts or issues that might skew the value toward one party?
- Does the appraiser actually understand the company?
  It is appalling how many valuation reports have perhaps a paragraph or two in total about the company, its customers, competition, management and ownership, yet also contain 15 or 20 pages of boilerplate.
- Is the expert subject to a potential conflict of interest?
  Does the author of a valuation report have a close personal or business relationship with the client that may preclude his or her ability to be independent and unbiased?

Conclusion. Well-accepted standards are available against which to test the validity, supportability and creditability of an expert's business valuation report and testimony. These standards can help to rid the courts of hired gun experts. Irrespective of the *Daubert* and *Kumho Tire* cases, clients, the courts, and all users of business appraisal services should expect and demand a professional appraisal that is supported and unbiased. In light of these recent cases, however, greater ammunition is available to go after valuation reports and experts that fail to meet these standards. ◆

End Notes

[1] 526 U.S. 137, 119 S. Ct. 1167, 143 L. Ed.2d 238 (1999).

[2] 509 U.S. 579 (1993).

[3] Peter S. Barash, JD, *Business Valuation Review*, December 1994, pp. 179-181, Business Valuation Committee of the American Society of Appraisers (Denver, CO).