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The Dart Throw Valuation Method

by: George Hawkins, ASA, CFA

Introduction

Unfortunately, a new business valuation technique is coming into use with the potential to be highly misleading to attorneys and other users of valuation reports. Marketed as a "calculation of value" or "calculation engagement," a better description would be the "dart throw valuation method." The calculation of value represents a cheap, easy and quick way to get a "value" for clients to settle cases in divorces, to assist in mediation, for knowing what a business is worth for sale, etc. What could be more seductive! Hopefully, by the time you've read this article you will agree that calculations of value are often no more reliable than picking a value using the dartboard, often with little or no basis, dressed up and perceived by clients and attorneys as real, despite whatever warning language is attached. When one of these landmines blows up, watch out.

George Hawkins

The Calculation of Value

As one example among those of various professional organizations, consider the definition of a "Calculation Engagement" as set forth by The American Institute of Certified Public Accountants (AICPA) (*Statement on Standards for Valuation Services, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, June 2007*):

> Calculation Engagement. An engagement to estimate value wherein the valuation analyst and the client agree on the specific valuation approaches and valuation methods that the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform to estimate the value of a subject interest. A calculation engagement generally does not include all of the valuation procedures required for a valuation engagement. If a valuation engagement had been performed, the results might have been different. The valuation analyst expresses the results of the calculation engagement as a calculated value, which may be either a single amount or a range.

Let's break the definition down and see where the problems start to occur.

Agree on Specific Approaches and Valuation Methods Up Front

> An engagement to estimate value wherein the valuation analyst and the client agree on the specific valuation approaches and valuation methods that the valuation analyst will use and the extent of valuation procedures the valuation analyst will perform to estimate the value of a subject interest.

A professional business appraiser almost never knows at the inception of an engagement which specific approaches and methods (e.g., capitalization of earnings or net cash flow, discounted future income, guideline transaction method, guideline public company method, cost approach) will be appropriate to use in a business valuation assignment. Every business is unique, and only after fully understanding the specific company and undertaking the appropriate research and analysis is the valuator able to make these determinations and apply them in a reliable manner. Virtually every valuation involves finding some hidden or less obvious issues that impact these decisions and the resulting value. Some of these issues are material, but would not have been unearthed short of extensive due diligence and analysis on the part of the appraiser.

By contrast, in the calculation engagement the valuation analyst and the client agree on the front end what the procedures and methods will be. How could they know? The client does not know business valuation and what impacts value. Also, the client might have a motive to hide certain facts that might lead to a high or low value in a dispute. He or she might run large amounts of personal, non-business related expenses through the business or be prepared to gain a major new customer that might reshape the business. The valuation analyst may not care. By agreeing to set procedures, however limited they may be, this takes the valuator off the hook. Chances are excellent that the valuator will never ask enough questions to find those hidden nuggets that can be so important in a valuation. After all, why should he since he's not being paid to do a real valuation and all the analysis and inquiry that entails.

Also, the goal in the first place of getting a calculation of value is to get "a quick and dirty" estimate that costs little and helps the parties resolve the case. The valuator who takes calculation engagements knows in advance that low cost is usually the driving motivation, so he or she may be incentivized to propose barebones procedures that cut corners and may only use one method (usually the capitalization method). With very little or no analysis required of the valuator and some simple math calculations this is easy money.

Real World Calculation Engagements in Practice

Banister Financial has been provided numerous calculation engagement reports over the years to review and we have yet to see one that is worth the paper it is written on. This is obviously our opinion, but our experience has been that in nearly every instance there was little or no analysis, some simple calculations (usually the income approach, with very little thought into its use), and with virtually no diligence or deeper understanding of the company or what might drive its value. Even if multiple methods are used this does not mean the calculation of value gives a reliable answer without a full and accurate understanding and analysis of the company needed to make appropriate adjustments or employ the methods properly.

Calculation of Value- Or is It?

The next part of the definition of Calculation Engagement says the following:

> A calculation engagement generally does not include all of the valuation procedures required for a valuation engagement. If a valuation engagement had been performed, the results might have been different.

Some light is starting to shine through! If a real valuation had been performed, the results might have been different. In our opinion, the truth is that a calculation engagement is typically so barebones and so little effort or analysis is undertaken that even the valuator has no clue what the value of the company or company interest really is. ***"The results might have been different"*** is the understatement of the century. The resulting calculation of value is nothing more than a recipe for a guess, pure and simple. Look at the next calculation engagement report and notice how many pages of boilerplate and disclaimers are included and how little real analysis exists. Remember, showing charts, graphs and numbers does not necessarily equal analysis.

Client and User Perceptions Are a Different Matter

Banister Financial does not and will not do calculation engagements because we believe they are misleading to clients and users, despite the caveats and disclaimers they contain. Many times a year we receive inquiries from prospective clients that go something like this:

> Attorney- I have a client in a divorce matter who has a business that needs to be valued.

> We don't want to incur the cost of a formal valuation and first want to try to settle the matter. What would you charge to do a down and dirty, calculation of value? I realize it is not a full valuation and you can put in it whatever disclaimers you want and we won't hold you to the value.

"We Won't Hold You to It"

Yeah, right. How many times have I heard that one? The reality is that someone will in fact believe it is a real and meaningful value and not a recipe for a guess, whether it is the attorney, his or her client, or the client's spouse that might also be provided the report. All least some or all of these parties, disclaimers notwithstanding, will believe the report is a real and meaningful value and base a major financial decision on it.

I know this from experience, having been contacted in numerous circumstances where a calculation of value has been prepared and one of the parties wants Banister Financial to review it. It is clear from talking to these individuals that they rarely realize what they really have is a worthless piece of paper and virtually always believe it is a real valuation opinion, just in a scaled down report. After all, an accredited valuator did it and he or she would not sign on to procedures if they were not the right ones. Plus, the report looks beefy (never mind it is 90% boilerplate) and has detailed calculations that imply precision. Finally, the client has no real idea what really goes into determining a value anyway.

The Risks Are Real- An Example

A simple, real example will show just how dangerous calculation engagements really are. I was asked to look at a calculation engagement of a company to make sure it was on the mark as to the value. Coming in at around a $1 million value, the calculation report was full of charts, graphs and numbers and its sheer size implied professionalism. Despite this heft, there was (as always seems to be the case with calculation reports) little detail to be able to review and reach a real conclusion as to the report's validity. Knowing something about the particular industry from prior assignments, I was aware that there was a great deal of acquisition activity in the industry. Admittedly knowing little about the company, my curiosity was too great to resist looking further into the matter.

Within several hours, I had compiled a lengthy list of sales of companies, the prices paid, and the resulting multiples of revenues, earnings, EBITDA, etc. Also, the multiples clustered closely, suggesting there was a pattern of pricing of companies sold in the industry. Simply applying these multiples to the results of the company at issue resulted in hypothetical values of $3.5 million to $4 million, or 3.5 to 4 times the amount in the calculation of value using the income approach. The validity of the calculation of value report became immediately suspect.

The truth is that I still knew little about the company and could not say that these were instead the values, something only the diligence, analysis and hard work of a real valuation would uncover. However, this example points out the huge financial danger of using agreed upon procedures in a calculation of value. In this instance, I had the good fortune of being able to raise a red flag. However, the reality is that most calculations of value are never questioned. Clients will in fact make major financial decisions on them, almost surely believing they are real opinions of value and being none the wiser.

Do not call Banister Financial if you want us to opine on a calculation of value or its validity. The previous example was atypical where we happened to have recently prepared a valuation in the industry and were aware of what was transpiring. However, the reality is that most calculation reports contain so little real detail as to make them impossible to adequately review. Our answer is going to be to get a real valuation.

After the Calculation of Value

The parties obtained the calculation of value, but cannot agree to resolve the matter and are now on a path eventually headed for the courthouse. Each party hires his or her own expert, discovery ramps up, and the formal process begins for the battle of the experts. The party that engaged the valuator in the first place to prepare the calculation of value may be in for a rude awakening. For example, I was in a case in North Carolina where the opposing "expert" proffered a calculation of value which was not accepted as an opinion of value. Also, some courts in other jurisdictions have ruled similarly. Consequently, there is a very real risk that the valuator cannot testify based on this work as an opinion of value in court and would have to do a real valuation to do so. That means the money that was spent was wasted and new valuation fees are forthcoming.

Client Expectations Are Set

Just as important as cost, though, are the expectations that a calculation of value creates that will now fuel more conflict in the dispute. Sure, it was a recipe for a guess, but clients never see the calculation of value that way. They believe it was a real value and whatever it was, it sets a new bar, high or low, for what they think will happen going forward when formal valuations are prepared. Once real valuations are prepared the values may be radically different than the calculation of value for any number of reasons once the company and industry are really analyzed. Somebody is going to be disappointed and upset when these realities differ from the perceptions formed based on the calculation of value. Watch out!

Mediations and Collaborative Divorce Dangers Ahead

Whatever is possible should be done to resolve disputes as amicably as possible and our firm prepares numerous joint and/or court appointed valuations. This enables parties to avoid the cost of dueling valuators and to obtain a real valuation the most economically. However, there is also a scary predisposition, particularly in mediations and in collaborative family law matters, towards the use of calculations of value. While cost is a motivator, in many instances it appears that the parties get too comfortable with the collaborative goals to question what really ought to be questioned related to the valuation itself. Also, in mediation the goal is to end the day with a settlement and to move the parties' positions together towards a common outcome which both can accept. Calculations of value fit nicely within those confines as the parties agree on what the procedures will be, even if the parties are clueless that what the calculation of value really produces is bogus. Yes, everyone can feel warm and fuzzy that the case was resolved and everyone is on good terms. However, real valuations and values are not arrived at either by unreliable calculations of value or negotiation. They are based on hard work and as much objective analysis as possible to arrive at the best supported, most reasoned value, regardless of whether it results in a desired end for the parties or a settlement.

A fear is that the increased use of calculations of value in these matters is eventually going to blow up as businesses on which settlements were reached are later sold for very different figures than the calculations of value that were based on nothing more than cursory analysis and hot air. Clients thought the calculation of value was a real value, or if warned that it was not, will later forget those warnings and want someone to blame. Clients hear what they want to hear.

Summary

We believe calculation of value engagements are greatly misleading to their users and should be avoided. Their generally much lower costs can be appealing, but do not be fooled into believing they provide anything other than a dart throw as to the value. ◆

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