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# FAIR VALUE™

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# THE MOST COMMON SINS IN FAULTY BUSINESS VALUATIONS

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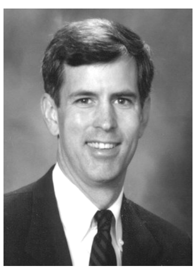
**Introduction.** The potential number of errors and flaws in a valuation report are limitless. The purpose of this article is to give readers a snapshot into the most egregious problems Banister Financial typically sees in reviewing the valuations of others. By sharing some of the more common errors, it is hoped that this will enable attorneys who must frequently use and rely upon valuations to spot these flaws and avoid bad outcomes as a result- be it in court, in an estate or in other circumstances. Also, after summarizing the most common errors, the article will provide a reference to a comprehensive resource available to assist in critiquing a valuation report for any purpose.


*George Hawkins*

**Common Errors and Flaws in Valuations.** The most commonly seen problems are summarized as follows:

**1. Advocacy-** The business appraiser acts an advocate for the client, rather than being unbiased, as must be the case for a credible valuation. Symptoms that advocacy might be present include:

a. Suppressing factors that are detrimental to the client's position and presenting only those factors that are favorable.

b. Exaggerating the importance of certain factors.

c. Preparing a report that is unbalanced in its presentation.

d. Presenting a report with few details or supporting analysis that can be analyzed or replicated. After all, if the report is that of an advocate, presenting the details and analysis would expose the report for what it is.

e. Failure to follow accepted industry valuation standards.

f. Failure to have a signed statement of disinterestedness as required by the Uniform Standards of Professional Appraisal Practice.

**2. The Report Lacks Sufficient Detail and is Not Replicable-** A report must provide a full roadmap of how the appraiser analyzed the business, key valuation assessments made, and the resulting data and steps used to reach a value. Without benefit of talking to the appraiser or reviewing his or her workpapers, the reader should be able to have a clear understanding of how and why the appraiser did what they did in a way that is supported, reasonable and unbiased. The reader may not necessarily agree with the appraiser's conclusion of value, but they should be able to see why the appraiser believes it to be valid and that a buyer might reasonably see this as the case.

**3. The Report Fails to Follow Accepted Standards-** The report fails to meet the basic standards of the profession, such as the *Uniform Standards of Professional Appraisal Practice* (USPAP), the *Business Valuation Standards* of the *American Society of Appraisers (ASA)*, and standards of other professional bodies. A more thorough discussion of these standards can be found in "Evaluating Valuation Reports and Testimony" (published in *CCH Business Valuation Alert,* authored by George Hawkins), available at Banister Financial's web site at: www.businessvalue.com.

**4. Use of "Creative" Valuation Methods That Lack General Acceptance in the Valuation Field-** This is often a sign of one of two things:

a. The appraiser is not competent and does not know what he or she is doing, and/or;

b. The appraiser is acting as an advocate to reach a desired value for the client. The appraiser probably tried accepted methods and they did not "get the client where they wanted to be" so the appraiser had to create new methods to do so.

How does the attorney in a litigation matter determine if this is the case? First, be sure to have a highly capable business appraiser review the other expert's report and summarize its good points and flaws. Second, while the attorney is not an appraiser, if he or she is going to practice in the area of litigation where valuation disputes arise, the attorney has an obligation to his or her clients to have more than a superficial knowledge of business valuation. The attorney should read valuation books, attend valuation seminars, and stay abreast of current developments in the valuation field. The attorney cannot abdicate this role to the business appraiser.

**5. Use of the Excess Earnings Valuation Method-** The excess earnings method is intellectually bankrupt, unreliable, and has increasingly fallen out of acceptance in the valuation field. The flaws and problems with the method are discussed in detail in "Kick the Habit: The Excess Earnings Method Must Go!" (by Michael Paschall) and "The Excess Earnings Method- Should it be Put Out to Pasture in Equitable Distribution Cases," (by George Hawkins) both *Fair Value* articles available at the Banister Financial website at: www.businessvalue.com.

**6. Mathematical Errors-** Oftentimes, users of a valuation report do not question the calculations in a valuation report, of which there may be hundreds. However, in an appalling number of instances, simply verifying the calculations and checking the numbers used against the source documents from which the data was supposedly drawn will uncover mathematical errors.

Note that this is not to say that one or several mathematical errors in a report, particularly minor ones, are reasons that a report ought to necessarily be discredited. Human beings are fallible and errors do happen. However, the attorney and the court should be suspicious of the business appraiser who either a) makes a number of important errors and/or b) will not admit that they are errors and correct them.

**7. Use of Information Not Reasonably Available or Knowable to a Buyer on the Valuation Date-** As discussed in the article "The Top 10 Errors Made in Using the Merged and Acquired Companies Valuation Method," found in this issue of *Fair Value*, a buyer only knows what is known at the valuation date in deciding what to pay for a company, not what happens in the future. Yet this does not stop some business appraisers in searching out and using information that was not known and had not even occurred as of the valuation date to value a company at the valuation date. This might include merger and acquisition data, financial results, economic and industry forecasts, the losses or additions of employees, customers or suppliers, and numerous other factors that simply would not have been known to a buyer or a seller in arriving at a price at the earlier valuation date. Sometimes, this use of after the fact data is intentional to try to lead to a desired end result that would not have been achieved by using the facts and circumstances at the valuation date. Other times, the use of subsequent data is simply the result of sloppiness on the part of the appraiser. Regardless of the reason, the result is an erroneous valuation. By doing so, these appraisers have time traveled, taking into account circumstances that in the real world would not have been known to a buyer or seller at the valuation date. The major error in using after-the-fact information is discussed in detail in two comprehensive articles in the Summer 2002 issue of *Fair Value*, "Back to the Future!" (by Michael Paschall) and "Why Time Travel in Business Valuation is Wrong," by George Hawkins. Subsequent versions of these articles that were later published in *Business Valuation Review*, the official publication of the Business Valuation Committee of the American Society of Appraisers, can be found at Banister Financial's web site at: www.businessvalue.com.

**8. The "Valuation Weasel"- Failure to Issue a Final, Signed Valuation Report at a Valuation Exchange Date-** Here are the signs of the "valuation weasel." A court issues and sets a valuation exchange date at which both parties must exchange expert reports. One party provides (as they should) an expert report that is in final form and is signed, representing the appraiser's final opinion of value. The other side provides the valuation weasel's report, which is not signed and is a "preliminary draft, subject to revision." This allows the weasel to review the other expert's final report, find out what is good and bad about it, and see if the weasel made any major errors in his or her report. Then, on the eve of the trial, the weasel "rehabilitates" his or her report to fix any errors and issues the final report. It is not unusual that the weasel, in light of what he or she finds in the other expert's final report, changes the underlying theory or rationale of his or her report to keep his or her value from falling apart.

Attorneys should steadfastly refuse to accept unsigned, preliminary draft reports at a valuation exchange date, or at the least, file objections with the court that the report not be admitted into evidence. Courts too, should stop being lax about letting this kind of unprofessional expert's report into evidence. Courts should be educated that this is sloppy valuation practice at best, and at the worst, may allow the valuation weasel to act as an advocate, changing the report in light of the strength or weaknesses or other information contained in the final valuation report issued by the other side. Furthermore, this practice is unfair to the side that rightly showed the full and final report at the exchange date and was willing to let its expert's report stand on its own and under scrutiny.

**9. The Person Who Prepared Most of the Valuation Report is Different From Who Takes Credit for the Project or Testifies About It-** All too often, firms have a "face partner" the client and the attorney think will be preparing the valuation report. In reality, that partner may go to the company and do the interview of management, then hand off his or her notes and the assignment to a rookie staff member, who frequently is much less experienced or lacks valuation credentials. The rookie then does most of the research, analysis, and preparation of the valuation report and conclusions. The partner may then review the report, perhaps make a few changes, and sign it. While the staff member may be noted in the report as having participated, the partner is often portrayed as the one whose analysis and work the report primarily represents. Additionally, the partner is often the one who testifies about the valuation in deposition or at trial. Sometimes, the partner will even fail to put the world on notice (as is required in the Uniform Standards of Professional Appraisal Practice) that anyone else materially participated in the project.

In situations like these, the appraiser is at best glossing over the true degree of his or her involvement in the project and in shaping the valuation report and its conclusion. At worst, the appraiser is presenting something as his or her own opinion and work when, in reality, it is the work of a junior, inexperienced individual. Regardless of which is the case, the face partner will often rationalize this by saying he or she reviewed the report, made changes, and bears final responsibility for the report and would not allow the report to be issued if it were not correct. This may be true, however, the client and the attorney are not getting what they paid for- the work of an experienced valuation expert. Furthermore, merely reviewing the work of a junior staffer who actually prepared the report may lull the face partner into a quick, less than thorough review of the report, leading to flawed results.

Regardless of who prepared the report, attorneys ought to think long and hard about hiring a firm where multiple persons prepare the valuation report. The use of partner-staff leverage, while it might work in the field of law and accounting, fails miserably in the area of business valuation. Businesses are incredibly complex, with no two companies alike and there are hundreds or thousands of issues, internal and external to the company, that collectively form the totality of what affects its value. When different people handle various pieces of this puzzle, one person does not have the intimate view of how they all fit together to affect the value. Therefore, key factors get lost in shaping the final conclusion of value. Also, practically speaking, one person will likely have to testify about the value, yet no one person intimately understands all aspects of the puzzle. Therefore, the "face partner" testifying about the value often will be unable to answer many specific questions that are leveled at him or her. While the value might be perfectly reasonable, if that person cannot articulate why his or her value is reasonable (and this is hard to do when the face partner does not know all of the issues and moving parts), his or her opinion and testimony may fail to be convincing. Finally, attorneys and their clients ought to get what they pay for. If they hire the partner for his or her experience, they ought to get the partner, not a product which is 80% prepared by a rookie analyst and 20% by the partner.

One word of warning to potential clients- valuation firms might not say they use staff-partner leverage or rookie staffers to prepare the valuation report. The euphemism used today to hide the true nature of the staff-partner leverage that is actually occurring is to call the effort a "team approach." The prospective client or court is told that "we use a team approach that brings together specialists in our firm with expertise in a given area to accomplish the best valuation product." While it may be true in very complex valuation assignments that specialized expertise may be warranted, this is very rarely the case in the typical closely held company valuation. Rather, the "specialized team expertise" is often merely double-speak for saying "we want to charge our higher partner rate, but pay a rookie staffer to do the work at a much lower rate, allowing our partners to make a windfall on the assignment."

**10. Misrepresentation of Business Valuation Qualifications or the Lack of Sufficient Training or Experience-** It is unfortunately all too common for "experts" to hype their credentials and, sometimes, to even make it appear that they have achieved a status of accreditation that they have not in fact achieved. For example, an appraiser might say on his or her resume that he or she is a "member" of the American Society of Appraisers when in fact they have not attained any accredited status with the organization and may have only gone so far as to pay their dues as a candidate of the organization. Technically, only individuals who have achieved the Accredited Member (AM) and Accredited Senior Appraiser (ASA) certifications (which have extensive requirements) have "member" status.

**11. Failure to Adequately Define and Follow the Appropriate Standard of Value-** The purpose of the valuation dictates the standard of value. For example, depending upon state law, a dissenting shareholder or corporate dissolution case may be based on the "fair value" standard, a statutory and case law concept, rather than fair market value. Additionally, although many states embrace the "fair market value" standard for equitable distribution, the actual implementation of the standard may need to incorporate dictates of statutory and case law that may cause its implementation to diverge from the oft-accepted definition. Unfortunately, one of the most common errors in a valuation is the failure of the appraiser to follow the appropriate standard, and sometimes, to follow no standard whatsoever.

**12. Failure to Consider Whether Valuation Discounts (Minority Interest, Lack of Marketability) or Premiums (e.g., Premium for Control) Are Applicable-** Valuation discounts and premiums can have a major impact on the valuation of a company or an interest in a company, yet some appraisers either do not consider their appropriate application, or they apply such data and concepts erroneously. One of the most common errors when valuing a 100% controlling interest is to utilize and rely upon the wrong studies on discounts for lack of marketability in determining the appropriate discount for the company being valued. All too often the appraiser will cite and rely upon studies such as Maher, Moroney, Emory, Willamette, the SEC Institutional Investor Study and others (discussed in more detail in "Discounts for Lack of Marketability: A Review of Studies and Factors to be Considered," by Michael Paschall of Banister Financial, and in "Marketability Discounts- The *Mandelbaum* Case Raises Key Issues," by George B. Hawkins. Both articles appeared in *Fair Value* and are available at www.businessvalue.com). These studies, however, relate to minority interests, not controlling interests.

**13. Failure to Adequately Support the Rationale for the Valuation Discounts or Premiums Applied-** In an all too common scenario, the appraiser spends 80 pages analyzing the company and diligently applying valuation methodologies to arrive at the value of an interest. He or she will then spend ten pages reciting the various studies on valuation discounts or premiums and out of nowhere and with no rationale given, cite a number that either markedly increases (in the case of premiums) or decreases (in the case of minority and lack of marketability discounts) the value. The user of the report has no idea whatsoever how the appraiser selected a specific discount.

**14. Failure to Adequately Support the Development of the Capitalization Rate Used-** Appraisers sometimes develop a discount or capitalization rate that has no basis at all, with no information provided on the data used in its development, the risk free rate, the equity risk premium, the specific company risk premium, and the long-term growth rate. One wonders just where the rate came from or if it was conjured out of nowhere. When data is cited and used, it may be done inappropriately or without support. The reader should be able to replicate what the appraiser has done and, while the reader may or may not agree with the conclusion, the appraiser should have a sound and logical support for the discount rate that makes sense.

**15. Use of a Very High Long-Term Growth Rate That is Not Sustainable in Developing the Capitalization Rate-** The capitalization rate is based on subtracting a long-term sustainable growth rate from the discount rate (the annual rate of return for risk). This long-term growth rate is not the growth rate for the next two, five or seven years, which might be much higher or lower. This long-term growth rate is the annual growth rate into perpetuity. A common error is to assume a very high long-term growth rate that is not sustainable over the long-haul and results in an understatement of the capitalization rate, and hence, an overstatement of the value. If, for example, the overall industry in which the company operates (and in which it might have a small market share) is growing 4% per year and the appraiser has used an 8% long-term growth rate, by the simple power of compounding, at some point this implies that the company will be larger than the entire industry, which clearly makes no sense.

For a more thorough discussion of this issue readers may wish to read "Critically Assessing a Business Valuation: Is the Capitalization Rate Used Reasonable?" Authored by George Hawkins and appearing in the Spring 1996 issue of *Fair Value* (and subsequently appearing in the *American Journal of Family Law*), this article can be found at the Banister Financial website at: www.businessvalue.com.

**16. Misusing Data on Multiples Paid in Merged and Acquired Company Transactions or Computing the Multiples Incorrectly-** It is hard to list all of the many errors seen from appraisers in using the merged and acquired companies method. These include:

-Incorrectly calculating the multiple.

-Applying a multiple for an asset purchase to value the stock of a company, but failing to then subtract its liabilities, if appropriate.

-Applying a one year multiple (such as price to revenues, based on the acquired company's latest year's results) to a multi-year average revenues of the subject company- the multiple must be applied on an apples to apples basis.

A more thorough list of errors can be found in the article "The Top 10 Errors Made in Using the Merged and

Acquired Companies Method," found in this issue *of Fair Value*.

**17. Failure to Visit the Company and Interview Management-** While a Company tour and management interview is sometimes not allowed by opposing counsel in litigation matters, at the very least the valuator should then ask his or her attorney to take depositions to get needed information. In non-litigation matters, there is rarely a good reason for not visiting a company for a valuation assignment, particularly if it is the appraiser's first exposure to the company.

**18. Reliance on Number Crunching Only-** Far too many "experts," particularly those coming out of an accounting background who have developed a heavy numbers orientation, focus solely on the numbers and try to use boilerplate formulas or methods to generate a result. They fail to study the company, the industry, its customers, suppliers, reasons for the company's results, the outlook going forward, and a whole host of factors that are just as important as the numbers.

In a related vein is the appraiser who relies on valuation software to do the job, popping the required data into the computer and waiting for the regurgitation of a 100 page "valuation report" that is full of impressive charts and graphs. Despite the impressive appearance of the report, there is no true analysis and independent thought or understanding of the company at all and the report is not worth the paper it is written on.

**19. Giving "Quick and Dirty Values"-** Some "experts" offer limited scope valuations where they might (and in some cases they do not even do this) briefly talk with management, do some number crunching, and issue a value, perhaps to facilitate a settlement or negotiations, or to save the attorney or client money. This is false economy and the result is a value that lacks none of the research, study or other critical steps needed to arrive at a meaningful or reliable value estimate. This type of expert may be tempted to cut corners (after all, they are offering a bare bones price, so they cannot afford to spend much time on the assignment) and short circuit the valuation process to get a number for the client, even if there is no underpinning for the result.

Attorneys and clients will proclaim, in agreeing to this kind of engagement, that they understand that it is just a "quick and dirty estimate" and they will "not hold the appraiser to the number." However, the reality is that they usually believe the number has some underlying validity and they then proceed to make very major financial decisions by relying on it- even if the value estimate is worthless. The devil is in the details of every company and this type of "valuation" is a disservice to its intended users and gives appraisers in general a black eye. Offering this kind of service borders on malpractice. Finally, if the parties agree to a settlement based on this kind of value and it later turns out that it was way off (as it probably is, except by chance), let's hope both the "appraiser" and the client's attorney have good malpractice insurance coverage.

**Tools Available to Assist in Critiquing Valuation Reports.** The Banister Financial *Business Valuation Disc™* contains checklists, articles and other comprehensive resources to assist in the review of a valuation report, as well as hundreds of articles, other items on valuation methodology, representative chapters from our book *(The CCH Business Valuation Guide*), case law (estates, gifts, equitable distribution, dissenting shareholders, reasonable compensation), and other valuable information, all conveniently indexed by topical area. If you have not already received a copy of the *Disc*, please let us know and we will be glad to send you a copy.

**Conclusion.** There are a potentially limitless number of potential errors that might be present in a valuation report. A report can certainly have a few very minor errors that do not impact its ultimate reliability or the reasoning used. However, errors can be present that do impact the validity and very core of the end result and, in some of the examples cited, taint the very foundation of the report and the integrity of the appraiser involved, such that the report and its results cannot be trusted. This article has identified the most common and egregious problems that we have found in the reports of others that we must review. Ultimately, the attorney who reviews a valuation report must think critically about every aspect of a report and make a determination if it was competently prepared, validly and reasonably supported. This is true regardless of whether the report is for an estate, litigation, purchase or sale, a divorce, or any other reason. ♦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