The Devil is in the Details

When you don't know what you don't know: **Five Steps for Evaluating Business Valuations**

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How do you know that a business valuation you receive from a financial analyst is properly done? How can you tell that it meets the proper standard of value for the scenario for which you requested it? These questions are of significant concern to legal counsel in evaluating the product of valuation professionals.

Scenario: An attorney is assisting in the transfer of a business between generations and tells the client that a valuation of the entity must be done by someone qualified to render an opinion of value. The attorney and client agree to engage a third party to render an opinion as to the value of the entity. The report is delivered to the client with a copy to the attorney. In the interest of saving time (and avoiding unnecessary fees), the attorney reads the cover letter and executive summary and uses the given number representing value on tax filings in conjunction with the transfer. Is the valuation accurate? If not, what are the potential results? Can the opinion be defended? What responsibility does an attorney owe to the client in reviewing the valuation analysis?

Often, the opinion of value given by business owners is too high, which stands to reason due to their bias towards their company. Amazingly, many opinions of value rendered by "experts" are also too high, and if you are an attorney relying on that opinion, that can be disastrous. In reviewing valuation reports that have been relied upon by attorneys and their clients for planning and to substantiate value, a significant number of the conclusions are based on improper assumptions and faulty logic, as well as a misinterpretation of financial concepts. The problem created for the attorney is that, in relying on the "expert" opinion of the valuation analyst, the attorney may actu-

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ally render poor advice to his or her client. How then does the attorney ensure that the opinion of value is accurate given the circumstances in which it is to be used?

While there are many potential areas for error in business valuation, there are five basic pieces of information that should be examined on every valuation report used in the course of a client engagement. It is crucial that anyone examining a valuation report be familiar with the basic components in order to, at a minimum, notice any "red flags" that may cause an opinion of value to be in error.

1) Who is giving the opinion?

The biggest errors can be avoided at the outset of the engagement. Having an industry consultant or a competitor of the subject company render an opinion of value is generally one of the biggest mistakes attorneys make. In an effort to simplify the process and perhaps to save the client professional fees, an accurate valuation conclusion is sacrificed.

These laymen are typically wrong in their conclusions. Even though well meaning, they are not familiar with recognized methods in finance and valuation and often use "rules of thumb" that are not acceptable methodologies. For example, consultants and competitors often opine as to "what I'd pay for the stock" or "here's what I've seen in the industry" but have no data or methodology to back up the conclusions. Relying on a simple letter with no actual review of data or methodology that would bring the opinion into conformity with any generally accepted doctrine of the financial valuation community will often result in flawed planning and will not withstand a challenge.

Another potential issue is the use of the company's preparers of income tax returns and/or financial statements to render value conclusions. While this may seem to be the best resource for such information, the valuation process largely involves deconstructing what the accountants have pieced together. There are inherent conflicts in asking an accountant to be an analyst of value by examining his own work for adjustments that depict the actual value of the subject company. This is compounded given that most accountants for closely held entities are attempting to diminish taxable net income to the shareholders, which is a wholly different exercise than determining what is actually available to the shareholders.

An independent analyst is the better choice to determine value objectively. The independent analyst brings a fresh set of eyes to the situation and is also more likely to give an unbiased view in determining components of risk, largely a factor in divining company value.

2) Is the analysis based upon the correct definition of value?

How value is defined depends on the circumstances in which the valuation is to be used. This is elementary, but not infrequently reports based on improper definitions of value are produced and relied upon by attorneys. Sometimes the valuation includes a definition of value that is industry specific, but if the valuation is to be used for federal estate or gift tax purposes, this is incorrect. For federal estate and gift tax purposes, the correct definition of value is "Fair Market Value" as set out in Revenue Ruling 59-60 (often referred to as "a willing buyer and willing seller knowing all relevant facts"). If the valuation is for tax purposes and the report does not clearly state this, it should cause the attorney to more closely examine the report and perhaps ask the analyst to redo the report to ensure compliance.

Another value definition that is often used out of context is investment value, the value of an entity to a specific buyer. This is the scenario that leads to the discussion, "I know of a company that was sold for ... " Those situations must be examined from the buyer's perspective with an understanding of the cost of capital and strategic intent. Using investment value in any other circumstance is incorrect and should never be relied upon out of context, such as in a tax environment.

3) Does the analysis examine all three generally accepted valuation methods?

There are three general methodologies for valuing entities: the asset method, the income method and the market method. These three methodologies are those accepted by the Internal Revenue Service, and each needs to be examined. The asset method determines company value by adjusting the value of assets and liabilities to market value and subtracting the liabilities from the assets. The income method discounts the economic earnings of the company at some rate representing the risk of receiving those earnings. The earnings and risk measures are open to interpretation by the analyst, and this is a prime area for problems. The market method examines similar companies that have seen transaction activity in recent years. These transactions give an indication of the relative value of the subject company but should be scrutinized to determine how much they reflect the nature of the current environment and the similarity to the subject company. Many of the transactions reviewed in the market method show investment value and represent the value perceived by a specific buyer.

If the analyst does not clearly show in the report that each method has been considered, it is not compliant with accepted valuation principles under Revenue Ruling 59-60. Furthermore, the analyst must state which method he is relying upon for the determination of value and why. It is not sufficient to simply average the methods to derive business value. The value conclusion should clearly state the rationale for selecting the method and provide quantitative data on the selection method.

4) Does the analyst select a reasonable economic income stream and a reasonable measure of risk?

The income method requires an analyst to select an income stream that clearly represents the economic earnings realized by shareholders. The most readily accepted income stream is referred to as "free cash

flow to equity." In other words, how much cash was available to distribute to the shareholders after paying for equipment purchases and adjusting for the increase or decrease (through repayment) of debt. A recently reviewed valuation report revealed a number for the income stream that did not take repayment of debt into account, and as a result, the valuation conclusion was greatly increased (as much as 10 times the actual value of the entity).

The calculation of risk is the "wild card" in valuation. The earnings stream received by the shareholders must be discounted by a rate representing the risk the shareholders have in the enterprise. The best way to check this for reasonableness is to ask, "Is this rate an adequate return for a shareholder to require on his stock in the company?" If the rate is not greater than the rate one would expect on a publicly traded small-cap stock, then it is probably too low. There are specific risk measures that the analyst should examine, and if the methodology is not spelled out in the report, it should prompt the attorney to ask for an explanation of the logic.

5) Does the analyst properly use and justify discounts from entity value?

The potential exists for problems in the use of discounts. The issue is debatable as to who should determine the discounts to be taken from the per share value of the entity as a whole. In cases where lack of marketability, lack of control and/or minority discounts are in order, the attorney may feel more adept at deciding what, if any, discount is appropriate based upon legal precedents. Some attorneys may prefer to have the analyst render an opinion on these discounts using similar database analysis. However, there are discounts that should be considered analytically based upon expert study. A prominent example is determination of the discount potential for publicly traded stocks that are thinly traded even though the value seems readily definable based on the stock price. The shareholder in question may have a large share of the stock that would be difficult to sell without depressing the public price. This is an issue for many small banks or other smaller public companies in South Carolina in particular. Not getting a valuation report that considers potential discounts in such a situation can pose significant risks. Any discounts taken in these instances should be statistically justified by the analyst based upon a study of the trading volumes and probable changes in price given the offering of a block of shares on the market, not simply provided as a guess of what is acceptable.

As a matter of best practice, there is a fairly easy way to ensure that the valuation conclusion is accurate and that the report adequately documents the necessary issues. Always ask for an exit meeting with the analyst in order to have him or her present the logic behind the conclusion and answer any questions on potential challenges by the Internal Revenue Service or by other interested parties who may be affected by the conclusion.

Additionally, for entities that are continuing on, as opposed to those being sold to third parties, the valuation report can provide valuable insights for increasing future value. This element may provide owner/managers and their successors with information similar to that an analyst would produce for investors in a public company. Presented correctly, this can make a valuation report even more valuable and can make the cost of the report seem negligible relative to the information derived.

Determining whom to select for the valuation engagement, understanding the criteria for determining value and understanding the basic components of the valuation report can assist the legal practitioner in not only avoiding malpractice, but in providing higher quality legal advice and strategic input to the client.

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