Common Mistakes in Valuation Reports

Valuation is both an art and a science. A good valuator approaches the subject from a well-rounded business perspective, is able to see deeper than the numbers and formulas, and clearly communicates the foundations upon which the opinion of value is built.

A well researched, soundly reasoned report can be instrumental in generating a settlement agreement in a dispute. The single most important factor in determining the value of a report to your case is usually the expertise of the individual preparer – not necessarily the cost of the report or the reputation of the firm preparing it. In many larger firms, even those with sterling reputations, economics dictate that partners parcel out the valuation assignment to staff members with varying degrees of training and experience. Staffers who are short on business experience usually don't know how to dig deep into the company being valuedso it is important to evaluate the individual preparer's ability to defend his or her report.

Estimating the value of a small business or professional practice is much more than a mechanical, formulaic exercise. To be sure, the preparer should be familiar with and know when to apply the applicable standard of value, and not rigidly apply "customary" business valuation methods, asset appraisal methods, or "generally accepted" rules of thumb. As judges and opposing council look more critically at valuation reports, boilerplate write-ups or one-size-fits-all approaches no longer hold up under scrutiny. An experienced preparer knows what does or does not make sense in a given situation.

Following are some of the most common mistakes found in valuation reports. In future issues of this newsletter I'll address many of these items in greater depth.

Apples to oranges

Understanding both the quality and the composition of the earnings stream being valued is critical to arriving at a fair opinion. Common errors made by inexperienced (or biased) preparers include:

- Applying price/earnings multiples to earnings streams or time periods that are not comparable , such as applying the average P/E ratio for Fortune 500 manufacturing companies to the earnings stream of a $1 million service company or using the risk-free cost of capital on a small company.

- Commingling pre- and post-tax data ,such as applying a post-tax price/earnings ratio to a pre-tax income stream.

- Relying on industry averages without adequate analysis of how the subject company relates to the industry.

Site visits and interviews

CPAs will sometimes rely exclusively on historical financial statements, and fail to perform site visits or inquire of management as to the entity's future prospects. It is quite common in small businesses for historical financial statements to be systematically distorted (e.g., understating earnings), usually for reasons of tax reduction or a pending divorce; and reliance on those statements exclusively will generate an equally distorted opinion of value. The analyst should always be asking "does this make sense?" (See case study #1 in "Is It Fraud or Incompetence?" on page X.).

Rates and discounts

Differences of opinion often arise between valuation experts as to capitalization rates and discounts. Common mistakes involving capitalization rates include:

- Using rates from inconsistent time periods

- Applying rates on "safe" investments to small businesses (which are inherently much riskier)
- Failing to match the capitalization rate with the earnings base
- Mistaking historical results for required rates of return.

Mistakes with discounts include the following:

- Applying a discount or premium to a level of value when it is not applicable
- Ignoring the rules of the jurisdiction that the report was prepared for
- Applying a discount without understanding the data and procedures used in compiling the underlying discount studies.

Sundry mistakes

Other common mistakes include reports that are too brief and do not provide adequate explanation of the expert's thought process; failure to understand what is being valued (assets vs. stock, which assets and liabilities are included, multiple entities covered in one opinion); and not considering the entity's ownership characteristics.

I have reviewed numerous reports where the valuator assumed, without basis in fact, that the successes of the past will carry the company far into the future, or conversely where the evaluator focused solely on one weak aspect of the business and quickly assumed that the company had no apparent value whatsoever. Too often, reports will seem to obsess on minor points and dwell on them for page after page, while they spend no more than a sentence or two on key foundations of the opinion of value, such as:

- Discussing the computational method used
- Explaining why that method was better than the alternatives
- Providing insight into the usage of "comparable" companies
- Showing how the capitalization rate or discounts used were derived
- Explaining why some valuation methods were used while others were discarded.

The first thing you should do when evaluating a valuation report is to check the credentials of the preparer. Then look for the common mistakes that I've outline above. If you need further advice, consult a Certified Valuation Analyst who has experience in both business and in business valuations.

Coming in the Winter issue of *Goldman's Critical Support*: a closer look at capitalization rates and discounts in valuation reports.