THE RECORDER

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Value Propositions

10 common errors to avoid in expert valuations

By James A. Andersen

When reviewing your expert's valuation of a closely held business — or that of an opposing party's — it is critical to identify the most common errors that can cause a court to discredit or even disregard a report. The following checklist, along with detailed explanation, serves as a quick guide to avoid the most obvious deficiencies:

1. Is the standard of value followed? Has the analyst carefully disclosed and defined the applicable standard of value? Has the standard of value been followed consistently throughout?

There are four standards of value, all of which may yield a substantially different result. The three most common are fair market value, investment value and fair value. Fair market value is the hypothetical "willing buyer/willing seller" concept for a going concern, which is typically used in estate and gift tax matters as well as buy/sell agreements. Investment value, often reflected in M&A transactions, recognizes synergistic benefits and is the value to a particular investor based on individual investment requirements and expectations. Fair value is created by legal statute and is most typically involved in dissenting shareholder and corporate dissolution statutes. A fourth standard — intrinsic value — is similar to investment value and is most often used by security analysts when valuing stocks.

Inconsistent utilization of the designated standard is commonplace in valuations that I have reviewed. An example would be taking discounts in a fair value engagement for a minority interest, typically not allowed but often used in fair market value engagements.

2. Are all three valuation approaches considered?

There are three valuation approaches: income, market and asset approaches. It is important to remember that all three approaches need to be considered though not necessarily used. If they are not used, an explanation in the report needs to describe why the excluded approach is not relevant.

3. Is the internal analysis consistent?

Examples include making sure that the analyst hasn't mismatched pricing multiples or capitalization rates to the wrong economic income measure. Using a cash flow multiple for one company and comparing it to an earnings stream (non-cash flow) from another company is inconsistent and incorrect. Normalizing financial data (adjusting for compensation, perks, etc.) and comparing it to companies that have not normalized their financials is also inconsistent and will result in an incorrect analysis.

4. Is there sufficient support for selected variables and the methodologies used?

Any analyst should document the data used, the procedures performed and the valuation conclusions reached. Also, with regard to the three valuation approaches, while it is incorrect to not consider all three approaches, it is equally inappropriate to utilize all of these the methodologies without having support for the approaches being selected.

For example, an analyst might appropriately utilize the income approach while also wishing to include the market approach, feeling that more than one method should be used to arrive at the final conclusion of value for the company. The problem, however, is that there is a total lack of available data for market comparisons, and utilization of the market approach will be incorrect and unsupportable.

To make matters worse, the analyst would be blending an unsupported market approach with an income approach that is appropriate, which now makes the overall conclusion incorrect. In my experience, it is best to select and use the best approach for your valuation assignment. This will typically mean using one and maybe two methods to arrive at your valuation conclusion.

5. Do the numbers add up?

Mathematical errors are more common than anyone cares to admit. Be sure to check all numerical calculations for accuracy, and make sure rounding conventions are consistent.

6. Does your analyst rely too heavily on rules of thumb?

While rules of thumb often serve as reality checks, they should not be used as the stand-alone basis from which to derive substantial intangible asset value. Classic examples include valuing accounting firms and insurance brokerage service companies. Accounting firms, for example, have often been valued, under a common rule of thumb, at 1 times gross income.

Applying such a global approach to all accounting firms is problematic for a number of reasons. The first is that firms with gross receipts in excess of $1 million normally don't sell but are absorbed by larger entities. Another reason is that book-keeping and tax practices often sell at a high multiple while consulting and litigation services that have non-repeat business may have no value at all. Insurance brokerage service companies can sell for 1.3-2.0 times net commission income. However, this will not include life insurance commissions (non-repeat business).

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The point I am trying to make is that when applying any rule of thumb on a global basis for all companies in a particular industry, the analyst must have a complete understanding of the underlying accounting data and revenue sources; otherwise the application will be flawed. A rule of thumb is a market multiple approach, and using it as a stand-alone valuation method requires that all of the underlying accounting and revenue sources be analyzed. In addition, the analyst needs to understand what data he or she is comparing when looking at similar companies as potential comparables.

7. Has sufficient data been gathered for the company being valued and has the research been performed in enough depth to render a reasonable estimate of value?

The analyst should have conducted all relevant research, clearly threading the data into the quantitative and qualitative analysis in order to reach a supportable valuation conclusion. The following are some of the key elements that need consideration:

- Economic information and trends: Has the overall condition of the national, regional and local economies been considered? How will the current condition of the economy affect the company being valued?
- Industry information and trends: Does the analyst understand the industry of the company being valued? How does the company being valued perform in relation to other businesses in the same industry? Does the analyst understand the barriers of entry for this industry?
- Company specific information: Did the analyst do a site visit? Does the company have an exit strategy and succession plan? Is there depth in management? How about diversification of product lines?

8. Has the due diligence been adequate for the company being valued?

The analyst should have reviewed all relevant contracts and corporate documentation, including internal financial statements and external marketing statements. It is critical to understand pending and contingent liability issues; the severity of the issues can destroy the company.

As part of this process, corporate counsel should be consulted and should be asked for an opinion or perspective as to the severity of the existing or pending litigation (which might be difficult to get in writing because of the confidential nature of the matter at hand).

9. Does the analyst understand inter-company and related party transactions?

Most valuation engagements have numerous inter-company and related party transactions. Some of the issues that come up include:

- The company leases industrial and office space from the shareholder or shareholders. Are the leases at fair market value? Has a real estate appraiser been contacted to render an opinion as to what the fair market value is of the leased properties, presuming that they are related party transactions? If it is determined that leases are not at fair market value, have appropriate add backs or deductions been made in the normalization process?
- Does the company employ relatives of the majority shareholders? Do the relatives actually work for the company? If so, are their wages at fair-market value? If not, have appropriate add backs or deductions been made in the normalization process?

10. Presuming the utilization of a CPA valuation analyst, has the analyst complied with the requirements of the newly issued valuation standards recently published by the American Institute of Certified Public Accountants?

The newly published standards are mandatory in compliance for all CPAs. It is critical that the valuation analyst has a clear understanding of the standards and when they are or are not applicable to the assignment at hand.

In summary, the above points represent many of the critical areas that an attorney should be aware of when reviewing the valuation report of an expert. Understanding your own expert's report is essential. However, having the attorney and his expert being aware of the deficiencies of the opposing side's valuation report can often be a game breaker in getting the desired result in a court proceeding. ❖

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