

# The Chattanooga, Chattanooga, TN

## **Mike Costello: Evaluating The Valuator – Valuation Report Review**

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by Mike Costello  
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When a valuation practitioner provides a report, how do you really know if it's any good? Although the value may appear reasonable, the valuation report's technical contents may be hard to follow. "What's the difference between a discount rate and a capitalization rate?" you may ask. "What do 'net free cash flow' and 'guideline company' mean? Help!"

If you've ever had trouble evaluating whether an appraiser has written a good report, you're not alone. Juries often have to decide this issue. Rather than rely on blind faith, here are some guidelines and resources to consider when reviewing business valuation reports.



Mike Costello

#### What To Look For

To start, take the time to read the entire report. If you don't have the time (or the patience), ask your company's controller or another trusted manager to review it and jot down a list of questions. Generally, the report should contain the following basic information:

Definition of the entity being valued. This definition should include the "as of" date, the company's name, the number of shares, the valuation's purpose and the entity type. When it comes to applying valuation discounts, an important part of the definition is the basis of value: Is it a controlling or minority interest? Is the interest marketable or nonmarketable?

Company information. Throughout a valuation report, the appraiser should consider a company's unique characteristics. Internal factors to consider include the company's:

- History,
- Ownership,
- Management,
- Products and services,

Customers,  
Suppliers,  
Facilities, and  
Employees.

Appraisers should also consider external factors that affect the company, such as the national and local economies, government regulations, and demographic trends.

Valuation procedures. An experienced valuation practitioner will perform a site visit as well as a detailed financial analysis. Any information he or she uses in the report should have been available (or at least foreseeable) at the valuation's "as of" date. For instance, if an appraiser is valuing a business as of June 1 and a tornado destroys the facilities on June 2, he or she shouldn't consider the tornado's effects.

Valuation methodology. Appraisers can choose from a variety of approaches and methodologies. Depending on the company's unique characteristics, some methods make more sense than others do. A valuation report should discuss all of the valuation practitioner's options, including why some approaches may be more appropriate than others.

Valuation discounts. After applying a valuation approach, the appraiser should discuss whether to apply valuation discounts (or premiums) to the preliminary value. Common discounts include the minority interest and marketability discounts. If discounts are applied, the valuation practitioner should discuss when he or she chose a specific discount, based on empirical evidence and the company's unique characteristics. Novice appraisers often simply apply averages from empirical studies without providing support for their numbers. Such unsupported discounts can make you vulnerable to an IRS or courtroom attack.

Value conclusion. Finally, ask whether the value conclusion makes economic sense, considering both the hypothetical buyer and the hypothetical seller. For example, in divorce cases, spouses that own businesses are often criticized for considering only the hypothetical buyer, thereby undervaluing the business.

#### Other Points To Check

If your expert covered everything listed above, you may be confident that he or she prepared a quality report. But if you need more convincing, you may want to review:

Workpaper files. To save time (and possibly money), some valuation practitioners omit certain details from their reports. For example, an expert may perform a thorough financial analysis but only touch on it briefly in the report. Regardless of the report's contents, the workpaper file should contain in-depth information about the steps your valuation practitioner took to value the business. To better understand your expert's work, ask for a copy of his or her workpaper file.

In a litigation setting, consider issuing a subpoena for the opposing expert's files. You may find evidence in an inexperienced valuation practitioner's files, such as draft versions of reports, confidential memos or uncleared review points, which could help you improve your case.

Valuation organization guidelines. Most experienced appraisers belong to one or more professional organizations specializing in business valuation, such as the National Association of Certified Valuation Analysts (NACVA), the Institute of Business Appraisers

(IBA), or the American Society of Appraisers (ASA). Each organization lists report requirements. Contact the one to which your expert belongs to find out exactly what his or her report must include.

Another valuation practitioner. Chances are, your valuation report will contain complex analyses that you can't fully comprehend. Ask your valuation practitioner to explain any confusing information. You might also want to contact another valuation practitioner and hire him or her to review your expert's report. This alternative is especially practical if you're bogged down and don't feel comfortable handing your valuation report to a company insider for review.

If you're involved in litigation, it's often a good idea to hire another expert to review the opposing expert's report. In such a review, your valuation professional can point out weaknesses and flaws in the opposition's report, and can help develop more pointed deposition and trial questions. Attorneys are legal experts but not necessarily valuation experts—so a valuation report can be as confusing to them as it is to business owners.

### IRS Guidelines and Revenue Ruling 59-60

The IRS provides a wealth of useful information when it comes to valuation reports. One such useful source is the IRS's Business Valuation Guidelines, which include the International Glossary of Business Valuation Terms and the Valuation Report Checklist. To download a free copy of the IRS guidelines, click on "free downloads" at the Business Valuation Resources' Web site at [www.bvlibrary.com](http://www.bvlibrary.com).

Revenue Ruling 59-60 is another useful IRS resource. This ruling clearly defines the term "fair market value" and provides a list of eight items valuation practitioner's need to consider when valuing a business, including:

1. The nature of the business,
2. The economy,
3. The company's adjusted book value,
4. The company's earning capacity,
5. The company's dividend-paying capacity,
6. Goodwill,
7. Sales of comparable companies, and
8. Prior transactions of the company's stock.

Don't Take Chances

If you're sending the report to the IRS or using it in court, you certainly want to minimize your risks. These steps can help increase your confidence that a valuation report is well-supported and well-reasoned. Please call with any valuation questions you may have. We would be glad to advise you.

### Local Case Study

In recent litigation, we became involved in reviewing both the plaintiff's and the defendant's expert business valuation reports in a shareholder oppression lawsuit. The plaintiff's expert had recently died, and his firm did not have another credentialed business valuation expert to testify concerning the value of the business.

The defendant's expert, a Certified Valuation Analyst (CVA), gave testimony at trial, and a CPA/ABV (Certified Public Accountant Accredited in Business Valuation) from Decosimo

Corporate Finance also testified. The defendant's attorney called this the classic "battle of the experts", because each valuation expert gave many good reasons to support his respective company value.

The jury never had the opportunity to decide the valuation issue, so we'll never know who won this "battle". The parties reached a confidential settlement before the judge sent the decision to the jury.

But we do know this, each expert fought diligently in defending his valuation of the company.

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He has written several articles for the Tennessee CPA and the AICPA's Management Consultant newsletter.

He was the Managing Director and President of Costello, Strain & Company, PC, a CPA firm he established in May 1984. The firm was merged with Joseph Decosimo and Company, LLP, CPA's in September 2003. Joseph Decosimo and Company, LLP was founded in 1972 and today is one of the top 100 CPA firms in the nation.)