



ARE THE VALUATION REPORT AND THE CONCLUSION OF VALUE REASONABLE?

Analysts studying private companies and valuing ownership interests and other advisors relying on a valuation report should be guided by the question: “Is the conclusion of value reasonable?” Ultimately, the attorneys may also ask: “Does the conclusion of value suit my purposes as an advocate for my client?” But when reviewing a business valuation report, an attorney’s focus on key parts of a valuation can be an invaluable reasonableness test of the report content and conclusions. The HILL, BARTH & KING Valuation Group offers this article:

- **As a Guide to Valuation Report Review, and**
- **As a Guide to Considering the Reasonableness of the Value Conclusion**

Valuator Independence

The business valuator and attorney, although part of a “team” representing the client, play very different roles that often can be summarized, and contrasted, as follows:

“The attorney is an advocate for the client.”

“The business valuator is an advocate for an independently determined estimate of value.”

The valuator’s independence and objectivity must be in form and substance; and should be reflected in the valuation report’s tone and content, as well as in the analyst’s testimony in a legal process. Professional judgment, a key component in valuation, is open to attack in adversarial circumstances in an attempt to portray the valuator as having a biased agenda. The valuator must in fact remain objective and avoid the perception of any results-oriented conclusions.

The valuator can play the role of client advocate and valuation advisor, but must ensure the client has engaged the valuator on this advocacy basis.

Valuation Report Checklist

The following are fundamental components of a valuation report and have great impact on the valuation process and estimate of value. Critical factors (what is being valued, the valuation date(s), the standard of value, and the appropriate level of value) that define the valuation are often unclear and uncertain when the analyst is engaged. A mistake made with respect to these factors can cause expensive mistakes and expose the client to various adverse consequences.

1. **Standard of Value**: typically this is the *fair market value* standard, but some engagements call for *fair value* or *investment value* standards. Given similar business facts and circumstances, the assumptions and conceptual guidelines of each standard of value would likely result in very different estimates of value. If in litigation support, has the standard of value been stipulated? Consideration of hypothetical transactions reflecting the standard of value can test reasonableness even if no such transaction is being contemplated. (See Premise of Value.)

Valuation requires the valuator to act as a proxy for the investor(s), and the standard of value defines the investor and his/her motivations.

2. **Level of Value**: levels of value are *control*, *(minority) freely traded*, or *non-marketable minority*. Transactions in the real world take place at the control (highest) and non-marketable minority value (lowest). The context of the levels of value is affected by the standard of value. Errors result from the use of mismatched data (e.g., after-tax cash flow rates of return applied to pre-tax earnings) in a valuation method, or when the method produces a level of value inconsistent with the interest being valued or the purpose of the valuation.
3. **Valuation Date**: seems like a no-brainer, but is often uncertain, particularly in litigation support, because advisors have not have agreed upon, or stipulated, the valuation date.
4. **Premise of Value**: typically *going concern premise* or *liquidation premise*. The premise of value is a critical factor providing assumptions about the likely transactional circumstances applicable to valuing the business and ownership interest. A business may be valued under both premises of value; and when valuing a controlling interest in an unprofitable company with excess assets, orderly liquidation value may become the primary premise of value. In a control valuation, the standard of value requires consideration of the likely realizable value from a hypothetical sale even if an actual sale is not contemplated.
5. **Income Approach to Valuation**: when applying the commonly used Income Approach to valuation, the future benefit stream used is either a control or minority benefit stream, and the rate of return used to convert the future benefits to present value must be appropriate for, and applicable to, the benefit stream (e.g., after-tax cash flow rates of return applied to estimated after-tax cash flows). Valuators often fail to apply the correct rate of return data to the correct (or most appropriate) benefit stream. After-tax cash flow is often a preferable benefit stream because, unlike earnings, it is a measurable economic return on investment.

6. **Normalizing adjustments required in a control level valuations:** adjustments to book earnings intended to result in establishing the company's market-based, or economic, earnings. Normalizing adjustments, such as to abnormal salaries and related party rental payments, and the basis for the adjustment and data relied on, should be understood by all users of the report. Certain adjustments are appropriate in a minority level valuation.

7. **Rates of Return:** the essence of valuation is estimating an appropriate risk-adjusted rate of return for equity capital or invested capital (debt plus equity). The purpose of the valuation dictates an appropriate type of return, although equity value can be derived from invested capital value. An estimate of value is very sensitive to the rate of return; and the rate quantified or implied by the valuation method should be adequately explained in the report. Estimates of value and discounts from estimates of control or freely traded value are all about investor rates of return. The valuator should be able to put the rate of return in context relative to similar and alternative investments with varying levels of investment risk. Typically, small, private businesses are very risky compared to many alternative financial assets. There is no perfect, or consensus, required rate of return; but a well-prepared report should reference and explain the components of the required rate of return. Rates of return appropriate for large public companies are not appropriate for small company valuation.

8. **Growth Rates:** growth is an important value driver; and the absence of growth is a risk factor. As valuation is a forward-looking study, growth rates relevant to the estimate of value should reflect common sense given economic conditions, industry outlook, and market and business risks. A common valuation method, the single period capitalization method, is a perpetual growth model; and a small company's long-term sustainable growth rate in the model is not likely to outpace real economic growth and inflation. Perpetual growth rates above 5% should be viewed with skepticism and used carefully. Overstated growth rates inflate the value estimate. Abnormal growth for a specific number of years can be incorporated into the discounted cash flow model.

9. **Small Company Risks:** much uncertainty is attached to typical private companies that are high risk compared to many alternative investments available to investors. Higher risk requires a higher return to compensate the investor for taking high risk. A non-exclusive list of specific company risks includes:
 - Economic risk during downturn in business cycle
 - Industry risk
 - Small size
 - Business concentrations
 - Key person dependency and thin management
 - Financial risk from high leverage

Risk can sometimes be mitigated by particular company strengths or competitive advantages such as exceptionally strong management and barriers to entry.

10. ***Discount Analysis, Use of Market Data and Reconciling the Minority Investor's Required Rate of Return***: discounts are the means by which the investor (usually a minority investor), given the outlook for growth in value and cash distributions, reduces the cost of investment to generate the investor's required rate of return. The significance of discounts demands adequate market data, analysis and reconciliation of rates of return. Merely proclaiming a 35% discount jeopardizes the client's case. Thorough substantiation of discounts includes evidence of the reasonableness of the discount and reconciling investor rates of return.

Implications for the Attorney

The above list does not include all the factors in any given valuation that may be significant to a particular estimate of value. For instance, the scope of this checklist does not include the market or asset-based approaches to valuation; and lack of control and marketability discounts may involve the most significant analysis and conclusions in a particular engagement. Each valuation engagement is different, and the specific value drivers, risk factors and other key facts should be identified and considered. Assuming a draft report is prepared for review, the attorney, or other advisor, can read the report with an eye of the fundamental items and factors listed above. Further, the attorney can consider the report content in light of the attorney's expectations about what is in the client's best interest. Discussions can take place and issues can be resolved pursuant to finalizing the report and preparing the analyst for testimony, if any. The analyst must remain objective and within the bounds of his/her area of competence and expertise.

Valuation is not an exact, precise undertaking even though the valuator may be engaged to make an unambiguous estimate of value. Reasonableness testing can prevent any particular factor from moving the estimate of value outside a reliable and justifiable value range.

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The business valuation profession is attempting to spread the word that valuation knowledge and methodologies can be powerful business planning and problem solving tools. HBK business valuation experts are using valuation techniques and resources to add value to existing client services.

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Inquiries to discuss specific valuation or transaction advisory matters are welcomed.

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