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RED FLAGS IN VALUATION REPORTS

Valuation reports are often voluminous and highly complex. Here are some simple qualitative tools to spot red flags and to assess the overall reasonableness of a valuation report.

By Alina Niculita, Business Valuator

The task of reviewing a valuation report can be a daunting one, especially to someone without valuation training. Family law attorneys are often presented with valuation reports for their clients or for the opposing side and are faced with the question of whether the valuation is "good." Short of becoming an appraiser overnight, what is a busy attorney to do to decide whether a valuation report passes a basic "smell test"?

This article offers several relatively simple tools for attorneys to gauge the reasonableness of a valuation report. If the valuation report raises red flags based on these tips, the attorney can decide to hire another appraiser to perform a professional appraisal review.

Professional Standards and Credentials

A good place to start evaluating a valuation report is to see if the author has any credentials in business valuation and if the report complies with valuation standards. Currently there are three professional associations in the U.S. that issue valuation standards and offer professional designations in business valuation:

- American Society of Appraisers (ASA),
- American Society of Certified Public Accountants (AICPA),
- National Society of Certified Valuation Analysts (NACVA).

In addition to the above, the Appraisal Foundation issues the Uniform Standards of Professional Appraisal Practice (USPAP) that include standards for all appraisal disciplines. While having a business valuation credential and following business valuation standards is not a guarantee of reasonable valuation work, it does establish minimum requirements for work quality. In addition, to maintain their designation, appraisers must comply with continuing education requirements.

Clear Assignment Definition

The valuation report should be clear on what its assignment is, meaning that the valuation report includes the following information: the property to be valued, the ownership characteristics of the property to be valued, the valuation date, the purpose of valuation, and the standard of value. An example of a valuation assignment is: "The fair market value of 100 shares of common stock in ABC, Inc. as of June 30, 2018, on a minority non-marketable basis for purposes of marital dissolution."

It would be very irregular if the valuation report did not include such information, as the valuation methodology and the value are driven by these parameters. If the report does include the assignment definition, the attorney can ask the following questions:

- Was the correct property valued?

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- Was the correct valuation date used?
- Was the correct standard of value used?
- Were the discounts applied appropriate?

The Report is Comprehensive

An appraisal report commonly includes several sections that culminate with an opinion of value. It is relatively easy to judge whether something included in the report is reasonable – but valuation reports can also contain errors of omission that are more difficult to detect. An example of an omission is to exclude a certain valuation procedure or method because of a "lack of data." Attorneys should be alert to valuation reports that state that a certain valuation procedure was not performed, or a valuation method was not applied, and investigate the underlying reason for the omission. The "Valuation Quick Checklist" in the sidebar shows the typical sections of a valuation report.

Converging Indications of Value

There are three valuation approaches – the income, market, and asset approaches – and each comprises two or more methods. As a result, a typical valuation report includes two or more indications of value. While the indications of value are typically different amounts, they are also typically not significantly different from each other. Obtaining indications of value for the same property that are far apart from each other may indicate errors in the valuation. Errors may include assumptions errors, methodology errors, or math errors. If a report includes two or more indications of value that are significantly different from each other and they are averaged to get to the conclusion of value without any further explanation or support, that may be a red flag.

Reasonable Financial Projections

A central concept in business valuation is that value today equals future expected cash flows discounted back to present. In practice, the "future expected cash flows" come in the form of financial projections. When using financial projections, appraisers are faced with the question of whether they are reasonable for valuation purposes.

Some characteristics of reasonable projections include:

- They present the most likely picture of the business in the future based on all available information as of the valuation date,
- They appear credible in the light of the historical performance of the business, its industry, and the overall economy,
- They are not too optimistic or too pessimistic,
- They do not include upward or downward bias based on the wishes or needs of a party.

If the projections used in the valuation report appear unreasonable compared to the company's past performance, the performance of its industry, or appear biased, this issue may need further investigation.

Valuation Quick Checklist

1. Identification of the property
2. Effective valuation date
3. Definition of value
4. Purpose of appraisal
5. Actual or assumed ownership characteristics
    a. Marketability
    b. Degree of control
6. Basic company information
7. Economic and industry outlook
8. Sources of information
9. Financial statement analysis
10. Valuation methodology
    a. Income approach
    b. Market approach
    c. Asset approach
11. Valuation synthesis and conclusion
12. Appraiser's qualifications
13. Contingent and limiting conditions

Sources of Information

The valuation of a business is based on information that is known or knowable as of the effective valuation date. Appraisers sometimes use professional judgement to decide whether to use older information than they would prefer or information after the valuation date. Although in some situations that may be appropriate, the use of old and potentially outdated information or information that would not be known or knowable as of the valuation date is a source of inquiry.

Report Bias

Credible valuation reports contain objective analysis grounded in reasonable methodology and credible data sources. Sometimes valuation reports contain unsupported inputs that tend to favor extreme valuations – for instance, unsupported high (low) valuation multiples and low (high) discount rates that result in high (low) valuations. When all or most of the key inputs and adjustments in a valuation report are such that they result in an extreme low or high valuation, that may be a red flag that needs a closer look. ■

This article has been adapted from Valuing a Business: The Analysis and Appraisal of Closely Held Companies *(McGraw-Hill Education, 5th Edition), by Shannon Pratt with Alina Niculita. The Director of Valuation at Morones Analytics, Alina is an industry expert who has co-authored several books, chapters, and articles on business valuation theory and methods.* www.moronesanalytics.com

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