10 Questions To Help You Evaluate A Valuation Report

12/8/17 – Steve Brunner

Not all business valuation reports are created equal. So it's critical that attorneys scrutinize information prepared by valuation experts — both their own and their opponents' — for signs of weakness or susceptibility to challenge in court. Here are 10 questions you should ask when reviewing a report.

1. **What are the expert's qualifications?**

   Does the expert possess business valuation credentials, such as Accredited Senior Appraiser (ASA), Certified Valuation Analyst (CVA) or the American Institute of CPAs' Accredited in Business Valuation (CPA/ABV) designation? Although these credentials aren't required for an individual to serve as an expert witness, they carry a great deal of weight with the courts. Courts often find experts with relevant industry experience to be more persuasive.

2. **Which standards were followed?**

   The report should explain which valuation standards were used and why. This depends in part on the expert's credentials. Standards used by ASAs, for example, generally conform to Uniform Standards of Professional Appraisal Practice (USPAP). CVAs are subject to standards established by the National Association of CVAs (NACVA), while CPAs must follow the AICPA's Statement on Standards for Valuation Services (SSVS). Other credentialing organizations have established their own standards or adopted or modified another organization's standards.

   You must become familiar with any applicable standards to ensure that the expert follows them appropriately. Courts, for example, may reject an expert's report prepared in accordance with USPAP if it fails to contain a signed "USPAP certification." And SSVS allows CPAs to perform limited scope analyses, called "calculation engagements," which generally aren't suitable in a litigation context.

   Some experts are credentialed by more than one organization. Here, it's important for the valuation report to discuss the choice of valuation standards — particularly if there are any conflicts between them.

3. **Which approaches and methods were used?**

   Business valuation methods generally fall under one of three approaches: 1) income, 2) market, and 3) asset.

   Depending on the type of business being valued and the circumstances, a valuator may apply one, two or all three approaches. In some cases, valuators use a weighted average of several approaches; in others, they rely on one approach but calculate value under one or more other approaches as a backup.

   The valuation report should discuss all three approaches and explain why certain approaches were weighted more heavily than others or why they weren't used. It should discuss the expert's selection of specific methods within each approach. Failure to articulate the reasoning behind the selection (or rejection) may make the report vulnerable to attack.

4. **Are projected earnings or cash flow consistent?**

   The discounted cash flow (DCF) method and other income-based valuation methods often rely on the client's projections. There's nothing inherently wrong with this but, if the company's projected earnings are inconsistent with its track record, a good valuation report will recognize this fact and explain why the company's financial performance is expected to be different in the future.

5. **Does it consider owner compensation?**

   When valuing a controlling interest in a closely held business, the report should address owner compensation.

   It's not unusual for owner-employees to receive above-market or below-market compensation, for various business and tax reasons. In such cases, the valuator will "normalize" the compensation to develop a clear picture of the company's potential cash flow and earnings in the hands of a hypothetical buyer.

6. **Are calculations reasonable?**

   When using DCF or other income-based methods, the expert's calculation of the appropriate discount or capitalization rate can have a huge impact on the valuation conclusion.

   Typically, these rates fall within a certain acceptable range. A rate that falls outside the norm — absent an explanation as to why it's appropriate — may be a red flag indicating the expert has manipulated discount or capitalization rates to achieve a desired result.

7. **Are market multiples adjusted?**

   The market approach often involves the use of market multiples, such as price-to-earnings, derived from comparable public companies or from "guideline transactions" involving comparable companies. The valuator should adjust those multiples to reflect differences between the subject company and comparable companies in terms of size, risk, industry and other factors.

8. **Are valuation discounts within the acceptable range?**

   Like discount and capitalization rates, valuation discounts (for lack of marketability or control, for instance) should fall within a reasonable range. A valuation report that fails to consider discounts or uses discounts that are unusually high or low may be suspect.

9. **Is the expert independent?**

   A valuation report prepared by an investment banker or an advisor who has a financial stake in the outcome may fall under suspicion. Although they may serve as experts, such parties have a conflict of interest that the court will note when weighing their testimony. It's preferable to engage independent experts to testify on critical valuation issues.

10. **Is the report "recycled"?**

    Clients may push to reuse previously prepared valuation reports to save money. This is usually a bad idea. Business value can fluctuate dramatically, even in a short time.

    Plus, value often depends on the *purpose* of the valuation: The value of a business for purposes of divorce may be different from its value for a merger or acquisition.

    Unless the previous report valued the same business interest for the same purpose, it may be vulnerable to challenge if reused in connection with litigation.

Be prepared

These are just a few of the many questions you should ask when reviewing a valuation report. Careful examination of this critical document can reveal flaws or weaknesses in a valuation expert's testimony — either yours or the opposition's.