

# VALUATION observations

## It's OK to Question the Valuation Report!

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Business valuation opinions are sought for a variety of reasons. Commonly, they are used to support significant corporate or shareholder transactions in which many stakeholders have a financial (and often personal) interest. Given the importance of these transactions, and by connection, the valuation opinions used to support them, it is imperative that the affected parties thoroughly review the valuation report, and have the opportunity to provide feedback before it is finalized.

The following is a sampling of the many important questions to ask when reviewing a business valuation report:

### 1. Does it pass the "smell test"?

First and foremost, does the concluded value appear reasonable, particularly in light of what you may know about the value of the business? This may be difficult to answer, especially for privately-held companies in unique industries or with uncommon company characteristics (e.g., a large customer concentration). However, some basis of comparison may exist, through old valuations, purchase offers, or even industry-specific "rules of thumb".

### 2. Has the appraiser accurately described the purpose of the valuation?

It is important for the appraiser to

describe the purpose of the valuation, as this purpose dictates the appropriate standard of value, level of value, and premise of value (discussed below), which in turn can have a significant impact on the value outcome.

The appropriate *standard of value* depends on the purpose of the valuation, and can include market value, fair market value, fair value, etc. For many situations, the appropriate standard is legally mandated, although in other cases it may be determined by the parties involved. Regardless, the use of an improper standard can have unfortunate unintended consequences on value.

*Levels of value* reflect the specific characteristics of the interest being valued, with the most common relating to the level of control and marketability possessed by an owner of the interest. The selection of the level of value can have a material impact on the assumptions taken by the appraiser, and ultimately, on the concluded value.

For example, applying pricing multiples of liquid, publicly-traded securities to privately-held company stock (which does not have an observable market) can lead to an inflated share price.

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## It's OK to Question the Valuation Report! (continued)

Most commonly, the appropriate ***premise of value*** is to consider the value of the company based on the income-producing ability of its assets (i.e., as a “going concern”), but if the situation dictates, it may be more appropriate to consider the value of the assets through an orderly or forced liquidation.

### ***3. Did the appraiser demonstrate an understanding of the business?***

Simply put, an appraiser must understand the company in order to accurately value it. Otherwise, future earnings potential, opportunities, risks, and other important factors may be misjudged. Further, since most valuations use one or multiple market-based approaches, a lack of understanding of the business may cause the appraiser to choose inappropriate comparable companies, leading to an inaccurate valuation.

### ***4. Are the methodologies sufficiently explained and assumptions well-supported?***

Due to the complex nature of business valuation reports, the appraiser has to conduct numerous analyses and rely on certain assumptions. In a high quality valuation, all methodologies are sufficiently explained and all analyses and assumptions well-supported, so that they can be understood and critiqued by an educated reader. This is especially important in certain regulated situations (e.g., tax-related valuations), when the stand-alone valuation report may be the only direct testimony permissible in court.

### ***5. Is the valuation based on future performance potential?***

Valuation analysis is a forward-looking exercise, as a prospective investor in the equity of a company will benefit only from the company's future performance (more specifically, its ability to generate cash flow). Therefore, valuation methods should only utilize historical performance metrics (e.g., latest twelve month or five-year weighted average EBITDA) to the extent that those metrics reflect future performance potential, or historical performance should be adjusted to reflect future expectations (as discussed below).

### ***6. Has the appraiser considered and appropriately applied normalization adjustments?***

Reported earnings often include nonrecurring, non-cash, and other unusual or discretionary transactions that distort the cash flows that would otherwise be available to the subject company and its shareholders. These transactions should be adjusted so that reported results reflect the company's normalized, ongoing operating performance.

### ***7. Has the appraiser appropriately considered potential “diluters” of value?***

Some companies have complex ownership structures or creative compensation arrangements in place that affect the return available to a

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## **It's OK to Question the Valuation Report!** **(continued)**

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shareholder of the common stock. As such, when valuing an ownership interest in the common stock, the valuation must consider and appropriately model the potential dilution on value that can occur from the presence of these items, which can include: convertible notes, SARs, options, warrants, phantom stock, preferred stock, etc.

While affirmative responses to the above questions may give the reader comfort as to the quality of the valuation report, in some cases it may be advisable to have another valuation expert conduct an independent review of the report. These experts can be in the best position to judge the overall quality and suitability of the report, and can detect complex errors that may not be noticeable to the "untrained" eye.

GBQ Consulting's business valuation group issues hundreds of valuation opinions annually, and we frequently review valuation reports for our clients. The authors of this article can be reached using the contact information provided herein. 

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