Feature Article

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Betrayed: True Stories of Valuation Report Betrayal

Beware of no man more than thyself. Certainly, this proverb from an unknown philosopher should be the business valuator's credo for every valuation report prepared. As I have grown in the business valuation profession, I have often been reminded of something my dad used to tell me: "*Learn from the mistakes of others. You can never live long enough to make them all yourself.*" However, I must admit that I have learned quite a bit from my own missteps while traveling the road to "the perfect valuation."

My very first boss used to say that he "stubbed his toe" when he flubbed-up. However, when I miscued, it was judged by him to be a **mistake**. I asked him once about the difference between a "mistake" and a "stubbed-toe." His answer was simple. My shortcomings were **mistakes**; his were **stubbed toes**!

So, I am dedicating this article to those of us who have stubbed our toes, tripped, and on occasion, may have fallen on our … (well, you get the idea). My hope is that you can learn from the mistakes discussed and avoid the embarrassment of being betrayed by your own written valuation reports.

Case No. 1:

In this case, the subject of the valuation was a 100% interest in the equity of an orthodontic practice. The purpose of the valuation was to determine the fair market value of the interest for equitable distribution pursuant to a divorce action. The practice was a solo practice, grossing $2 million per year. The shareholder doctor was paid $250,000 per year in salary, and the S-Corporate earnings (after deducting officer salary) ranged from $650,000 to $900,000 per year. The valuator for the "in-spouse" prepared a valuation report that quite readily betrayed his opinion of value. How?

All aspects of a valuation report should support the valuator's opinion of value. In this particular case, the valuator seemed to forget the fact that his opinion should make sense based upon the information contained in the report. The opinion of the valuator was that the fair market value of the controlling 100% equity interest in the practice was $270,000. But, the mere historic book value or the equity on a cash basis balance sheet reflected $365,000, of which $275,000 **was cash and cash equivalents**! Imagine being that valuator, and trying to convince the trier of fact that an orthodontic practice with $2 million in gross cash receipts per year had an equity fair market value of only $270,000, when there was $275,000 of cash included in the historic book value of $365,000!

Let's forget about the enterprise and professional goodwill arguments in this case. In essence, here is what the valuator for the in-spouse was trying to represent:

- There was absolutely no goodwill in the practice or to the doctor (though this is one of the largest grossing solo practitioner practices in the country, according to orthodontic studies).
- The informed willing seller would be willing to sell $365,000 in cash basis historical equity, of which $275,000 was cash, for only $270,000.
- The contracts and accounts receivable of the practice had absolutely no value whatsoever!

What orthodontist (49 years old, reasonably informed and under no compulsion to sell) would be willing to sell such a practice for only $270,000?

The CPA valuator would have been well served to ask a few questions before opining the value:

- Does the opinion make sense, in relationship to all other information within the report?
- If the CPA valuator were to advise the doctor as to what the equity of the business was worth for *actual sale purposes*, would the opinion of value be different?

In short, the valuator in this case did not go back through the valuation report and review the information it contained. A thoughtful review of the historical balance sheet, indicating an equity value that was greater than the opined value (for a profitable practice) should have rung some bells for the valuator. Instead, the valuator's bell was "rung" in the courtroom.

Case No. 2:

In this case, the subject was a one-third voting and participating interest in a printing company. The purpose of the valuation was to determine the fair market value of the subject interest for equitable distribution purposes in a divorce action. The three equal shareholders (brothers) all participated in the business on a full-time basis. The brothers admitted that they got along quite well together and had done so for several years. There were few disagreements among them, and they harmoniously worked to ensure that all perquisites of ownership were evenly split.

The business was quite profitable, and in addition to many fine perks, each shareholder earned between $80,000 and $90,000 per year *in excess of normalized officer salaries* for that industry. This fact was arduously discussed and set forth in the "in-spouse's" valuator's report.

The valuator for the in-spouse also did a fine job of explaining and building a discount rate and converting it into a capitalization rate. The report's explanations for applying the capitalization rate to a single cash benefit stream were very well taken.

Unfortunately, the valuator (while stating that the valuation was using the Fair Market Value Standard) only relied upon one valuation method: Capitalized Cash Flows. While explaining why all other methods were not acceptable (in his opinion), he really set forth a convincing argument for using the Capitalized Cash Flows method in this case.

The Fair Market Value Standard of valuation must consider the positions of both the hypothetical willing buyer AND the hypothetical willing seller. The valuator for the in-spouse, while setting forth only ONE valuation solution caused me to ask the question: Could this one solution provide the number that would sufficiently *satisfy **both** the willing buyer and willing seller*?

The valuator opined a value for the one-third interest of $234,000. The valuator then provided a good deal of discussion as to why that number made sense to the hypothetical willing purchaser. Little was said about the hypothetical willing seller. In order to determine whether or not that number "was reasonable" and made sense to the hypothetical seller, I applied the valuator's own logic and arguments for use of the Capitalization of Benefits method. In the most recent year, the third shareholder received $84,000 in excess of a normalized salary, according to the valuator's report. If the shareholder really were to sell his interest, he would also be selling his ability to receive in excess of normal compensation. So, I capitalized the $84,000 by using the valuator's built up and converted cap rate of 16.6%. The result was $506,024. I then realized that the 16.6% cap rate was based on "after-tax" cash flows, and the $84,000 represented the same as a "pre-tax" cash flow. So, by using a 34% tax rate, I converted the .166 into a pre-tax rate (.166/.66) of .252. Capitalizing the $84,000 using the .252 rate indicated to me that *just the value of the forgone excess salary*, would approximate $333,333.

I asked myself the question: Would a reasonably informed seller, under no compulsion to sell, *really* consider selling an entire one-third interest in a profitable business for only $234,000 when just the indicated value of forgone excess salary was $333,333? And, what about the value of other forgone benefits (Lexus, health insurance, trips, life insurance, future retirement contributions by the company, etc.)?

In this case, the valuator should have asked whether or not the conclusion made sense. The valuation report was very detailed in so many ways. Yet, the report betrayed the valuator's opinion of value. It appears that the valuator forgot that there are two sides to the valuation coin. One side of the coin commemorates the knowledgeable and willing seller, and the other side of the coin commemorates the knowledgeable and willing purchaser. The parties ultimately agreed upon a $345,000 value for the subject third interest. That represents a 47.4% increase over the valuator's opined value of $234,000. The huge disparity between the valuator's opinion of value and the agreed-upon value makes it appear that the valuator lost the coin toss.

Conclusion

So many times, I find that valuators allow their reports to betray them because the valuator does not really understand the standard of value that they purport to use. The failure to follow the definition of value is one of the most common valuation errors. The definition of value used can significantly affect the valuation methods used and how they are applied. Thus, valuators should carefully consider how the definition of value affects the specific engagement and ensure that it is reflected in the report.

Our valuation reports memorialize facts and circumstances surrounding a valuation subject, our thoughts, work and, ultimately, our professional conclusions. Sometimes I think of it as building a water-tight box. As we build our valuation reports, we should remember that the reports must "hold water" and yet, not drown us in the process.

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