Common Deficiencies in Business Valuation Reports

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Legal professionals who deal in matters such as fairness opinions, shareholder disputes (including oppression and appraisal remedies), mergers & acquisitions, and other situations involving the valuation of business interests frequently have occasion to review business valuation reports. Irrespective of the reason a business valuation report has been prepared, at issue is whether it is internally consistent, and whether the value conclusions set out therein are reasonable and supportable.

In many cases, business valuation reports contain deficiencies that in isolation or in combination can impair the overall credibility of its conclusions, and by extension the valuation expert(s) who prepared it. This article addresses some of the deficiencies commonly found in business valuation reports, including:

- unsubstantiated assumptions;
- inconsistent assumptions;
- inadequate analysis of the business and industry;
- inappropriate valuation methodology(ies); and
- misapplication of the valuation methodology(ies) adopted.

Business valuation reports typically contain a section that sets out various assumptions regarding the business itself, and other matters pertinent to the valuation exercise at hand. Assumptions may also appear in other sections of the report, or in the accompanying schedules. In some cases, business valuation reports contain generic assumptions that apply to most businesses or in most situations, but which are not applicable in the current circumstances. Internal inconsistencies may become apparent when the assumptions are read in conjunction with the section of the report that describes the business itself and the industry in which it operates, or in the section explaining the valuation approach adopted.

In addition, the analysis and conclusions contained in a business valuation report may be premised on certain assumptions that have not been explicitly stated. The existence of implicit assumptions typically is more difficult to identify, but sometimes comes to light where the report is reviewed by a valuation expert acting on behalf of opposing counsel.

Another common deficiency in business valuation reports pertains to the adequacy of the valuation experts' analysis. The valuation of any given business interest requires a comprehensive review of the business itself, the industry in which it operates, and relevant economic factors. It is important for the report writer to reasonably ensure the

accuracy and completeness of all material facts that influence the value conclusion. By reviewing the section of the report that describes the business and industry conditions, the reader should get an indication as to whether or not the valuation expert has been reasonably thorough in his or her analysis. The business and industry analysis should provide a balanced and objective assessment of strengths and weaknesses of the business, as well as the principal risks and opportunities that it faces.

When assessing the adequacy of the analysis conducted, the reader also should examine the 'scope of review' section of the business valuation report to determine the:

- breadth and depth of the documents and other information reviewed;
- extent to which information originating outside of the business was obtained, which may be more objective than information provided by a shareholder or employee of the business; and
- individuals (owners, managers, and so on) involved in the business who were interviewed.

When examining the scope of review, the reader should be particularly cognizant of information that should have been obtained, or individuals who should have been interviewed, but were not. Where significant, a limitation in the scope of review should give rise to a qualification in the report to the effect that the value conclusion may change if information subsequently obtained reveals a material change in the completeness or accuracy of the facts or assumptions on which the valuation expert relied.

Another common deficiency in business valuation reports is the adoption of an inappropriate valuation methodology(ies) when developing a value conclusion. While numerous valuation methodologies exist, a methodology that typically is preferred both in theory and practice is one based on cash flows (i.e., the 'discounted cash flow' methodology or the 'capitalization of discretionary cash flow' methodology). Other methodologies sometimes are used as a secondary approach to test the reasonableness of the conclusions derived pursuant to a cash flow based methodology. However, these other valuation methodologies seldom are appropriate as a primary approach to value determination. In particular, a value conclusion may be suspect where the valuation expert has adopted a 'rule of thumb' or so-called 'comparable companies' or 'comparable transactions' as the primary valuation methodology. It is rare that the value of a particular business interest can be determined principally through reference to 'comparables', and any attempt to do so typically is fraught with difficulties and is open to challenge at trial.

Finally, business valuation reports sometimes misapply the valuation methodology(ies) adopted. Where substantiated, such misapplications constitute 'technical errors' that can either be proven or dispelled by reference to an independent authoritative source. Technical errors in the application of a valuation methodology often surface in the form

of internal inconstancies between the basis upon which the prospective cash flows of a business have been determined and the rates of return that are adopted.

In the end, the value conclusion for any given business interest should represent a highly plausible synthesis that is reached following the valuation expert's objective consideration of material facts, assumptions, and expectations at the valuation date. Underlying this is the need for realistic and internally consistent assumptions, a thorough analysis of relevant business, industry, and economic factors, and an appropriate valuation methodology, properly applied.

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