GUIDE TO UNDERSTANDING BUSINESS VALUATION REPORTS

For Attorneys, Accountants and Business Owners

Abstract

This guide explains what goes into a valuation report and the important elements

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Introduction: Attorneys, accountants and business owners frequently retain business valuation specialists to value a business or an ownership interest in a business. The purpose of the valuation can be for any number of reasons such as equitable distribution in a divorce, buy-out of a partner interest, estate and gift tax planning, shareholder dispute, among other reasons. In any event, what is presented by the valuation specialist can be a 50 to 100+ page written report which is a considerable amount of information to digest.

If you're like most people, the first thing you do when presented with a valuation report is to look for the concluded value which is probably disclosed within the first few pages. But, because you're inquisitive and it's your job to understand HOW the valuation specialist arrived at the value conclusion, you read on. You start flipping through the report and wonder why it takes so many pages to estimate the value and you question if all of it is important.

So, what does it all mean and what are the important elements to the valuation report? This guide helps to answer these questions and explains the various aspects of the report. It is not meant to cover all the details and nuances that comprise a valuation report/analysis. Doing so would require reading through a 900 page textbook on the topic. Rather, this guide gives a concise overview of what is covered in a standard valuation report. It discusses the main elements of the report and it provides useful information to help you understand the analysis typically seen in a valuation report.

Method Behind the Madness: Assuming we are dealing with a report written by a qualified valuation analyst associated with a reputable organization *(such as the American Institute of Certified Public Accountants (AICPA), American Society of Appraisers (ASA), The Institute of Business Appraisers (IBA), National Association of Certified Valuators and Analysts (NACVA)*), there are specific standards the valuation specialist must follow when performing a valuation analysis and writing the report. For the purpose of this guide, we are using the AICPA's Statement on Standards for Valuation Services No. 1 (SSVS No.1) for a written detailed report.

According to the SSVS No. 1, a written report is used to *"… communicate the results of the engagement to the client and is structured to provide sufficient information to permit the intended users to understand the data, reasoning, and analysis underlying the valuation analyst's conclusion of value".*[1] The written detailed report should include the following sections (as applicable)[2]:

- Letter of transmittal

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[1] AICPA, Statement on Standards for Valuation Services No. 1: Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset, June 2007, p. 23

[2] Ibid, p. 24

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The standards allow the analyst the discretion to position the sections in the body of the report where he/she deems appropriate as long as the report flows in a logical manner. The important point is that the report (and analysis) is conducted under authoritative guidelines or standards which include the broad categories noted above.

The individual sections are discussed below. They are arranged in a logical sequence within the report so that the analyst presents a coherent, concise analysis. The intended users of the report may not agree with certain aspects of the underlying analysis and concluded value (which is usually the case with at least one party in a litigation-related case), but as long as the reader can follow and understand the analyst's thought process without any (or very few) questions, the analyst has done his/her job.

Side Note: In a well-written valuation report, the end-user should understand how the analyst got from A to Z with Z being the concluded value. Although the end-user may not agree with some of the analysis due to its subjective nature, a well-written report will result in minimal questions for the reader.

►Report Section: Transmittal Letter, Table of Contents and Introduction

The table of contents speaks for itself. The transmittal letter and introduction are frequently combined (at the analyst's discretion).

Why it is important – The transmittal letter and introduction are the sections most people read first to find out the value. These sections summarize important aspects of the valuation including the parameters used and the scope of the valuation engagement. Here, you will find the *who, what* and *why* of the valuation including the following:[3]

a) The identity of the client
b) Purpose and intended use of the valuation
c) Intended users of the valuation report
d) Description of the specific subject interest for which value is being sought
e) Whether the subject interest is a controlling or non-controlling interest
f) Identity of the subject entity
g) Valuation date
h) Applicable premise of value
i) Applicable standard of value

The analyst has the discretion to disclose additional information to help the user(s) understand the valuation work performed and / or to emphasize a point.

Side Note: It is important to pay special attention to the disclosures noted above since each one has an effect on how the valuation will be conducted which may impact the value. Using an incorrect standard of value, a wrong valuation date or a different intended purpose will likely lead to a value result that is not appropriate.

►Report Section: Source of Information

This section discloses the relevant sources used throughout the valuation process relating to financial statement information, industry data, market data, economic data, empirical information (supporting the various inputs and assumptions), documents provided by company management, and other information deemed necessary by the analyst.

Why it is important – It indicates who provided what type of information and it shows the end-user that the valuation analysis is well-supported by empirical, reliable and authoritative data.

Side Note: Some analysts make general disclosures of the relevant data / information used while other analysts give full descriptions of such data /information. In any event, it's important to understand who provided what information particularly in a litigation setting. One party (plaintiff or defendant) of a case may be the only source of information which may have bias implications. This section gives the reader an idea of the extent and reliability of the data used in the analysis.

[3] Ibid, p. 25

►Report Section: Analysis of the Subject Entity and Related

Nonfinancial Information

This section presents a lengthy discussion of the subject company profile and other non-financial information that is applicable to the valuation. Below lists the typical information included in the report with an explanation as to why it is important to the valuation analysis.

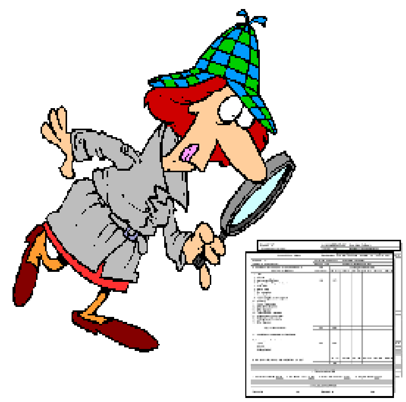
Topic of Discussion	Why it is important? It addresses and discusses the following:
Nature, background and history	What the company does and how it evolved
Facilities	The company location(s) and whether the facilities are owned or leased (lease terms)
Organization structure	Parent companies/subsidiaries; management structure and ownership hierarchy
Classes of equity ownership (and any rights attached)	Ownership structure, ownership heirarchy and rights and where the subject interest ranks within in the ownership structure
Key Management	The key people involved in the success of the business, their responsibilities and impact on the business if they leave
Company products / services Geographic / industry markets	How the company makes money; the type of products / services it provides; the market(s) and geographic area(s) it serves
Key customers / suppliers	Diversification of the customer base; degree of customer dependency and loyalty; profiles of key suppliers and other available sources of procurement should the company lose a supplier
Competition	Competitiveness of the industry; the company's competitive advantages / diadvantages
Business Risks	Key risks specific to the company's business
Strategy and future plans	Company prospects going forward including any major changes in operations or expectations
Regulatory environment	The regulatory environment the company's industry is subjected to - if it is highly regulated and the effect on business
Economic environment	The overall economic climate - nationally and locally (if applicable) and its effect on the company and investor community
Industry profile	The industry's risks, future prospects, growth rate, competitive nature, etc.

Although this section is less about the numbers, it is a very important part of the valuation process. Valuation standards require the analyst to obtain sufficient nonfinancial information to enable him/her to understand the subject entity and the environment in which it operates. This section serves that purpose. It describes the overall profile of the company in terms of its industry, the products or services it sells, who it sells to, its history / evolution and the company's inherent business risks.

> *Side Note:* As Warren Buffett once said: "Never invest in a business you cannot understand." This axiom applies to conducting a business valuation. How can you reasonably determine the value of a company without a general understanding of its business model, industry, risks, etc.? That is the purpose of this section. It should provide the reader with a sufficient understanding of the business – enough to make the numbers more meaningful (next section).

►Report Section: Financial Statement / Information Analysis

As the title suggests, this section delves into the numbers aspect of the analysis – the financial statements (balance sheets and income statements). Historical financial statements are presented along with any forecasts or projections. The analyst makes adjustments to the historical financial statements in order to show them on a "normalized" basis. The subject company's performance is then measured using key financial ratio analysis, trend analysis and a comparative analysis to evaluate whether the company is more or less risky than its peers.



Why it is important – Financial statement analysis is key to assessing the company's past operating performance, it's financial position, it's future prospects, and risks. This section points out the company's strengths and weaknesses. After reading this section (and the previous section describing the company's profile), the reader should have a good understanding of the nature of the company and its performance compared to its peers. It also helps the reader understand why the analyst used certain valuation methodologies (discussed later in the report).

Let's dig a little deeper into the financial analysis part of the report.

Financial Statement Adjustments - When valuing a closely-held business, the analyst must determine if the income statement requires adjustments in order to make the best possible estimate of true future economic earnings power. This is known as "normalizing" the financial statements which involves removing certain income and expense items that do not contribute to the economic earnings of the business.

Side Note: A normalized financial statement is more reflective of a company's true economic position and depicts the entity's operations based on what a prospective buyer might expect. Normalized financial statements also provide an "apples-to-apples" comparison when measuring the operating results and financial position of the subject company against the industry.

Adjustments to the income statements generally fall into one of the following four categories:

1. Differences between the business' accounting practices and either GAAP or the most common industry accounting practices.

2. Non-recurring or extraordinary events, discontinued operations, or other unusual items that may not reflect the business' future economic earnings capacity.

3. Certain discretionary expenses or related-party revenue and expenses to reflect the results of the business' operations under conditions similar to what a prospective buyer might expect in the future. These types of adjustments are applicable when the ownership interest being valued has the ability to make such adjustments.

4. Adjustments may be made in order to present the income statements in a format that will be more conducive to the appraisal analysis (e.g. - separation of depreciation and/or amortization expenses, income and expenses related to non-operating assets and liabilities).

Side Note: Adjustments can have a significant impact on earnings – particularly adjustments to normalize owner's compensation (also referred to as officer's compensation) which, in many cases, is very subjective and open to challenge. The appropriate level of compensation for the owner of the company is often a contentious area for litigation-related valuation engagements.

Balance sheet accounts may also be adjusted for reasons such as asset write-downs, write-offs or reserves for certain balances, or to segregate non-operating assets.

Side Note: Non-operating assets are common in privately-held businesses. They are assets recorded on the books but they are not necessary to business operations (e.g. - an accumulation of excess cash beyond what the business needs to operate, a boat or condo not used for business purposes).

Adjusted Financial Statements – So, we now have a set of adjusted income statements and balance sheets – what next? This section includes a financial ratio analysis of the subject company with a comparison to industry benchmarks and a narrative analyzing and explaining any notable trends, volatility, unusual variances, and any significant items worthy of comment. Also included is a description of the type of assets owned by the company and liabilities. The ratio analysis is key to measuring the company's operating performance (i.e. - profitability, growth trends) against its peers and assessing the company's overall relative risk and future prospects.

> *Side Note:* The financial statement analysis is not just about the numbers. A comprehensive report should include a commentary on what the numbers mean and the overall implication on value. The reader should come away with the understanding of how the company is performing (especially compared to its peers), its financial risk and future expectations.

►Report Section: Valuation Approaches and Methods Considered

This part of the report is a critical aspect of the valuation analysis since it describes the techniques used in estimating value. There are three primary approaches utilized by business valuators in determining the value of an entity:

- the asset-based approach
- the income approach
- the market approach

To determine which approach is best for the entity being valued, the analyst must consider any sales of comparable or similar companies within the industry (if reliable), the expected future cash flows (i.e. - the profitability of the entity), and the net underlying assets and associated liabilities of the entity. There should be a discussion in the report describing the three approaches and why an approach was used and/or not used.

The following are the three primary methods of valuation typically included in valuation reports.

Asset Approach

The asset approach establishes value by netting the fair market value of a business' assets and the associated liabilities to determine the net asset or net worth of a business entity. This approach is usually of greatest importance when estimating the value of investment or holding companies, asset intensive manufacturing companies or companies with little or no profits. This approach would also be applicable if a liquidation value is being sought.

Under the asset approach, the analyst considers any adjustments that are required to reflect assets and liabilities at their fair market values. This approach generally doesn't include any of the entity's intangible assets (such as customer lists / relationships, tradename, workforce, etc.) because generally accepted accounting principles do not require the recording of intangible assets (except if purchase accounting was required in a previous acquisition transaction).

Side Note: If the company is generating decent positive cash flow, the asset approach would typically not be used since the value of the entity lies not in its net assets per se, but in the entity's ability to generate an adequate future earnings stream (i.e. - earning a return on investment). With profitable companies, the value of the entity's net tangible assets is typically below the value of the cash flow using the income approach (see below). An asset approach, therefore, generally reflects a "floor" of value.

Income Approach

Under the income approach, there are generally two methodologies used:

Capitalization of Earnings: Under this method, the analyst estimates the entity's ongoing earnings (or cash flow) base for a representative single period. The earnings (or cash flow) base is then divided by a capitalization rate to determine the value of the business. This method is most applicable to entities that are generating profits. The capitalization rate consists of a combination of various factors in determining the appropriate market rate of return for the riskiness of the investment considered (reduced by an expected constant growth rate). One important premise is that this method assumes a stable growth rate for the future.

		benefit stream (earnings)		$ 100,000		
Value	=	-------------------------	=	------------	=	$ 476,190
		discount rate - growth rate		25% - 4%		

Discounted Future Cash Flows: The discounted future cash flows method (or "DCF") is based upon the theory that the total value of a business is the present value of its projected future earnings or cash flow, plus the present value of its terminal value. This method requires that future cash flows and a terminal value assumption be made. The amount of projected earnings or cash flows and the terminal value are then discounted to the present using an appropriate discount rate. This method places heavy reliance on projected earnings or cash flow, if, in fact, such projections can be reasonably estimated.

Side Note: A word about forecasts or projections: It is typical that many small, privately-held businesses do not maintain formal forecasts or budgets of operations. In such cases, the analyst relies on historical financials particularly if future growth is expected to remain steady. However, a forecast is typically necessary in cases where the company expects uneven growth in the near future or operations are expected to materially change.

Side Note: Determining the appropriate capitalization rate and discount rate under the two income approaches noted above involves a degree of subjectivity. The importance of the earlier discussion and analysis of the company's strengths, weaknesses and risks come into play here. The analyst incorporates the company's risk profile into his/her estimate of an appropriate cap rate or discount rate.

Market Approach

The theory behind this approach is that the value of a business entity can be estimated by comparing the entity being valued to similar businesses, business interests or securities that are for sale or have recently been sold. The basic assumption of this approach is that business entities in the same or similar industries will be valued by the pubic in a similar manner. There are generally two types of methodologies under the market approach - the guideline public company method and the transaction method.

Guideline Public Company Method

It has often been stated that all values are best tested and determined in the marketplace. However, when valuing an interest in a privately-held company, no active marketplace exists. One alternative is to seek guidance from the prices investors are willing to pay for securities of *publicly traded* companies, in the same industry, with comparable financial and operating characteristics. Utilizing various industry multiples, such as price to revenues (P/R) or price to earnings (P/E), the analyst can estimate the value of other companies in the same industry. With this information it is then possible to come up with an estimate of the fair market value of an interest in a company with no active market.

Side Note: It is not common for analysts to consider this method to value a privately-held company unless the company's revenues are relatively large and there are a sufficient number of public companies that are comparable to the subject entity. The differences between a private company and a publicly-traded company are generally too vast to be considered comparable and there are typically alternative methods that are more reliable in determining a private company's value.

Transaction Method

This method involves utilizing actual sales transactions of comparable companies to determine pricing multiples that are used to estimate the value of the subject company. There are numerous databases that analysts use which publish merger and acquisition activity of privately-held companies.

Side Note: Comparability and a sufficient number of transactions are key factors in determining whether this method can be relied on by the analyst. Depending upon the industry, there may be hundreds of comparable transactions - or none at all. Generally, analysts would like to have a sample of at least 10 or 12 comparable transactions.

Other Methods

Another methodology sometimes used by valuation analysts under certain circumstances is the capitalization of excess earnings method. This is a hybrid of the asset and income approaches based on IRS Revenue Ruling 68-609 and it is often used in valuing goodwill (intangibles). It is a single-period capitalization of the amount of earnings that are greater than the earnings (or return) expected on the entity's tangible assets (also known as "excess earnings"). The resulting value represents the company's goodwill (or total intangible assets).

►Report Section: Valuation Discounts

The next part of the valuation report deals with certain discounts that might be applied to the values derived from the valuation methods described above. The key word is *might* since the application of the discounts and their amounts depend on the facts and circumstances of the valuation engagement. The discounts are for lack of control (also known as a minority interest discount) and lack of marketability. There are many database sources (in the form of studies and market information) that are used and / or referenced by analysts for empirical information to support the estimated discounts. This information is typically summarized within the report.

Why it is important – The lack of control discount is applied because an investor would not buy a non-controlling interest for its pro-rata value since he/she would have no control over the management of the business (or its assets). A discount for lack of marketability is applied because there is no market to liquidate the subject interest (or investment) in contrast to, for example, a publicly-traded stock which can be sold within three business days.

To what degree these discounts apply depends upon a multitude of factors such as:

- the standard of value used;
- the amount of control attributable to the subject interest;
- the degree of restrictions imposed on the transferability of the subject interest (i.e. - restrictions cited in a shareholder agreement);
- valuation methodology used;
- jurisdictional rules.

These discounts can slice as much as 40% or more off of the value determined by the valuation methods. So, the impact can be quite large and should be well-supported by the analyst.

Side Note: This is one area that involves a high degree of subjectivity and is, therefore, scrutinized often by opposing parties and tax authorities. As noted above, a well-documented thought process and supporting empirical evidence is important to counter the inevitable challenges.

There are other discounts that may be applied such as blockage discounts, key person discount, built-in capital gains discount, among others; however, the discounts for lack of control and marketability are the most common.

►Report Section: Non-Operating Assets

As noted previously, there may be assets deemed to be non-operating, or not necessary for the continuing operations of the business. Examples may include excess cash or working capital that has accumulated, vehicles, a boat or condo not for business use. Such assets may have a liability attached (e.g. - debt financing for a condo) which is netted against the asset. In any event, non-operating assets are added to the value of the operating company.

Why it is important – It is important for the analyst to identify any non-operating assets and value them separate from the operating company. Doing so allows the analyst to depict both values (the value of the operating company and the value of non-operating assets) in order to avoid any potentially misleading conclusions, depending upon the purpose of the valuation.

Side Note: Discounts for lack of control and lack of marketability may be applied to these assets depending upon the facts and circumstances of the valuation engagement. For example, if the subject interest being valued is a minority interest, a discount for lack of control would typically be applied to the asset.

►Report Section: Reconciliation of Value Estimates and Conclusion of Value

This section summarizes the values determined by each of the valuation approaches considered and concludes on a single value or range of values. Because analysts may utilize more than one valuation methodology, he/she may be faced with multiple estimates of value. Seldom do the different methods agree exactly and, in many cases, the values can be materially different. Therefore, the report should show a reconciliation of the various estimated values and explain why they are different and why one methodology was selected over the other. It is common for the analyst to apply weights to the various methodologies. This should be accompanied by an explanation of the weighting system used.

Valuation Method	Indicated Value		Weight		Estimated Value
Income Approach		x	75%	=	$ 4,125,000
Capitalization of earnings	$ 5,500,000				
Market Approach					
Transaction method	$ 5,900,000	x	25%	=	$ 1,475,000
Asset Approach					
Adjusted net asset method	$ 3,200,000	x	0%	=	$ -
Concluded Value			100%		$ 5,600,000

Why it is important – Most analysts would agree that more is better – that is, being able to rely on multiple valuation methods in determining value rather than just one. However, multiple methodologies mean differing values and a decision has to be made as to which one(s) should hold more weight. This may be highly subjective. Therefore, it is critical that the analyst provides a clear explanation as to how and why he/she concluded on a particular value (or range of values).

Some reports will have a "sanity check" section where the concluded value is measured for reasonableness against some independent metric. The intent here is to include additional empirical evidence or analysis to support the concluded value.

> *Side Note:* In many cases, one methodology may serve as a sanity check for the primary method used and relied upon. For example, the transaction method (market approach) is often used as a secondary means to support the income approach (if it were the primary method).

►Report Section: List of Assumptions and Limiting Conditions

Somewhere within the body of the report or in the appendices/exhibits is a list of assumptions and limitations under which the engagement was performed. This list covers a wide variety of assumptions used by the analyst and limitations imposed on the analyst which range from restrictions on the distribution of the report to sources used by the analyst.

Why it is important – This section alerts the reader to the scope under which the valuation engagement was conducted and it should be reviewed carefully. It is important that the reader understand the parameters, restrictions, issues, etc. that were part of the valuation analysis since they may have certain implications on the concluded value.

> *Side Note:* The valuation analyst reserves the right to include any and all matters he/she believes to be worthy of disclosure - many of which are meant to drive home a point or emphasize a fact.

►Report Section: Representations of the Analyst

Reports issued under the SSVS No. 1 contain a list of representations of the analyst in which he/she summarizes the factors that guided his/her work during the engagement.

Why it is important – Similar to the list of assumptions and limiting conditions, it contains certain disclosures that describe the facts and circumstances under which the valuation was conducted.

►Report Section: Qualifications of the Analyst

Information containing the qualifications of the analyst should be included.

> *Side Note:* Always be sure to utilize the services of a professional who has exhibited the requisite skills / expertise for the subject valuation work. This also includes having the appropriate designations or certifications in business valuations from the various reputable organizations (AICPA (American Institute of Certified Public Accountants), NACVA (National Association of Certified Valuation Analysts), IBA (Institute of Business Appraisers), USPAP (Uniform Standards of Professional Appraisal Practice), among others.

►Report Section: Exhibits / Appendices

Valuation reports generally present the relevant schedules consisting of the various financial statements and financial information of the subject company, calculations, third-party empirical data and information, compiled data supporting the assumptions, and any other schedules or exhibits helpful to the valuation analysis. Some of this information may be included within the body of the report or located in the exhibit section depending upon the preference of the analyst.

> *Side Note:* Regardless of where this information is presented within the report, the important thing is that it includes only relevant information that supports the concluded value. Be aware of reports with superfluous/extraneous information. I have occasionally seen reports with non-essential information; for example, a report that presents a set of financial ratios that are not relevant to the subject company's industry or are not meaningful. This information may look good, but it may only be "filler" to make the report *look* more comprehensive and may confuse the reader. If you are not sure of the purpose of certain disclosed information, then it's quite possible that it's

About This Guide

This guide is based on the valuation reporting standards format of the AICPA's *Statement on Standards for Valuation Services No. 1 – Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset*. Although there are other authoritative and reputable organizations within the valuation industry that have adopted their own reporting standards, valuation reports, for the most part, are similar in terms of content and structure.

The SSVS No. 1 gives the valuation analyst considerable discretion as to the length of the report, content, structure, etc. It is, by no means, a complete or comprehensive template of a valuation report. The valuation analyst uses judgement in determining what is relevant for inclusion in the report. What is expressed in a report depends upon the facts and circumstances of the valuation assignment, and each one is different.

This guide was written to provide an overview of the typical valuation report and the areas of importance as cited in the SSVS No.1. It offers a broad view of the valuation process to enhance the user's understanding of the report's content and the significance of certain aspects of the report.

If you have any questions or comments about this guide or anything related to business valuations, or need help on a particular related topic, please don't hesitate to contact me at

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