Anatomy of an Inflated Valuation Report

By Stuart Weiss, CPA/ABV

I recently had the chance to review a valuation report for a family limited partnership prepared by what I believe to be a reputable firm. By my standards, the report is huge—142 pages. It contains some very good material, but a lot of it is boilerplate and padding. Now I've been criticized in the past for writing short reports, but I do not believe in padding the document so that I can charge a higher fee.

Interestingly, this same firm and I were being considered for a valuation engagement, and my quoted fee was much lower than that firm's. I decided to take a closer look at that massive report to see why it was so big. Was I leaving something out?

Backstory. All of this came about not too long ago when a gentleman called me out of the blue and asked me to value four family limited partnerships that had been part of his father's estate. He had received a quote of $20,000 from his father's lawyer and wanted to know if I could do the work for less money. He complained that the estate had already paid about $20,000 to value the underlying real estate in the FLPs, each of which contained apartment complexes in the same city with the same management.

After studying the documents, I came up with a lower fee and had him sign the engagement letter. A week later, he called me very apologetically to say that his attorney, a partner with a 1,000-lawyer international firm, insisted on using a valuation firm that he had used before. He felt it would be better to have that firm in his corner in case of an audit.

After much persuading, the client stuck with me, even though I was not the attorney's preferred valuation professional. How did I overcome the attorney's objection? The client mentioned to me several times that he liked the fact that I was a CPA and had an MBA from Stanford (time to boost my alumni donations), even though I never took a valuation course there. In fact, he never asked about my valuation credentials. To be sure, he also liked the fact that my fee was about 40% less than the lawyer's quote. Granted, there were four FLPs, but much of each report would be the same. Why should I charge for cutting and pasting?

I asked to see a sample FLP appraisal from the attorney's preferred valuation firm to make sure that I covered the same bases. Shortly thereafter, I received the 142-page report. As I mentioned, I have been chastised for my short reports. Attorneys tell me that if it's too short, it's obviously lightweight. Never mind that I make sure that my reports comply with SSVS1, the AICPA's valuation standard. I have trouble with the notion of inflating a report to justify a higher fee.

I always believe that I can learn from other people's work, especially if the work is generated by a reputable firm, which this firm appears to be. So what can I learn from this massive tome? Let's take a look at it and see what makes it so huge. (For the sake of confidentiality, no names will be mentioned here.)

Picking it apart. The first thing to notice is that the appraiser is a CPA and an ASA. Therefore, the report must simultaneously comply with USPAP and SSVS1. This adds some documentation, although it's not clear in the report what part complies with which standard. It just states that it complies. The report also has generous amounts of white space on every page.

There is a 15-page description of the subject property, most of which appears to be lifted from the operating agreement. I typically attach the operating agreement to the report and only quote the parts of the agreement that affect the discounts for lack of control or marketability.

Then comes the economic section—another eight pages with sections on consumer spending and the stock market that don't have much to do with the subject property. Only one page is devoted to the Florida real estate sector, the germane topic.

Moving on to the valuation section, the report quotes Revenue Ruling 59-60 and lists the eight factors that should be considered when valuing the stock of closely held companies—as do I. The 142-page report also lifts two pages from the revenue ruling verbatim. I'm not sure why that's needed. I'm already up to page 35.

One glaring omission from the report was a lack of consideration of an income approach. True, in many cases, an income approach will not produce a meaningful result because the distributions from a flow-through FLP merely cover the minority interest holders' taxes and not much else. The report assumes an asset approach without discussion.

The next section discusses the three components of the FLP: cash, real estate, and a note receivable. For the cash component, the report discusses the relevance of closed-end government bond funds and examines the price discount from net asset values. However, the report takes several pages to describe what's in a table. I personally thought the table was self-explanatory. Then, the author spends several more pages describing a regression analysis to see whether the data are sensitive to other variables such as size of the fund, yield, and total return. It concluded that they weren't. It might be interesting, but I think most readers would be thrown off by this detour, especially since it didn't really tie into the goal, which is to determine a discount for lack of control.

For the real estate portfolio, the author uses data from Partnership Profiles Inc., which is fine. Again, the report spends several pages describing what's in a table that to me is self-explanatory. For the five-year note, the author uses closed-end equity funds. I'm not sure why he didn't select closed-end bond funds, which could have used some explanation.

Now the fun part begins. Pages 52 through 126 discuss the discount for lack of marketability. They read like an academic paper. Some of it is interesting, and it is completely reusable on other engagements. But there is very little applicability to the subject FLP. There are six pages on the "cost of flotation" method and a discussion of studies "germane to lack of marketability for controlling interests," even though the subject interest is minority.

There's another 10 pages on LEAPS analysis, seven pages on pre-IPO studies, and more than 20 pages on restricted stock studies. You can read several pages on the LiquiStat database and another 20 pages on various quantitative methods such as the Black-Scholes Options Pricing Model, the Longstaff Upper Bound Lookback Put Option Model, and so on. Most of it is theoretical, and almost none is used to calculate a value for the subject interest.

Now we get into how the author determined the DLOM. For the primary weight indicator, he averaged a "rate of return method (35.9%) with a LEAPS analysis (0%) to arrive at 18%." This received a weight of 3/6. For the secondary weight indicator, he used the median of pre-1990 restricted stock studies (33%). This received a weight of 2/6. For the tertiary weight indicator, he took an average of Emory and Willamette pre-IPO studies (48.2%), the LiquiStat database (34.6%), and the post-1990-to-1997 restricted stock studies (21.6%), which equals 34.8%. This received a weight of 1/6. The weighted average of all of these studies was 25.8%. But he concluded an allowance for lack of marketability of 33%. There was no explanation of why he didn't use 25.8%. To conclude, the three asset classes were reduced for their various discounts for lack of control, which, in turn, was reduced further by a DLOM.

The rest of the report was the author's CV (which is impressive), 21 assumptions and limiting conditions, and a copy of USPAP Standard 10, which focuses on business appraisals.

Of the 142 pages, perhaps 10% was work unique to this assignment.

Let's be honest about what we're selling.

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Why Do Private Firms Linger on the Selling Block?

By Marc Vianello, CPA, ABV, CFF, and Paul Murray, CPA

The time it takes to market and sell a privately held business continues its downward trend. The length of time depends on many factors, but there are three key variables: industry, price, and the month the sale listing appears. This is revealed in the latest update of an ongoing study, *Marketing Period of Private Sales Transactions*.

Background: The business valuation concept of marketability deals with the liquidity of ownership interests. How quickly an owner can convert an investment to cash represents the period of time it will take the seller to liquidate an investment. The time period can vary greatly depending on the standard of value in play. For example, liquidation sales can occur quickly and can result in much lower prices than orderly sales. Selling periods for the latter usually are much longer than for liquidation sales as sellers explore the marketplace of potential buyers in the hope of realizing prices greater than liquidation.

The certainty that the seller will realize the estimated sale price (value) of an investment represents the price volatility of the investment during the period that it is being offered for sale. If market prices for similar investments fall dramatically while the marketplace is being explored, then the seller will have lost the opportunity to lock in the higher price that existed at the time the sell decision was made. Conversely, if the sale price is fixed for some reason (e.g., a listing agreement) and market prices for similar investments rise dramatically during the marketing period, the seller will have lost the opportunity to realize the increased value.

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Valuing Customer Relationships: Does the Distributor Method Miss the Mark?

By Dan Guderjohn, CFA, ASA, CPA/ABV, and Robert Reis, CFA

Customer relationships are nearly always one of the identified intangible assets in purchase price allocations. While valuation of this asset has traditionally been carried out with the multiperiod excess earnings model (MPEEM), the distributor method (DM) has recently been proposed as a more suitable alternative in some circumstances. (*Editor's note:* See the May 2012 issue of *Business Valuation Update*.)

For example, when some other asset, such as a brand or technology, is the primary enabling

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