Writing a Credible and Effective Valuation Report

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Each valuation report that we prepare is the final product of many hours of work, including a site visit, a management interview and a careful analysis of the economy, the industry and the company. The written report is the only tangible product delivered to the client; if it is not well written, the credibility of all of your work may be called into question. It may be unfair, but it is a reality. Although there are many ways we can assure a high degree of credibility in our reports, we sometimes sabotage ourselves with poorly written ones.

In my practice, and as a member of the Institute of Business Appraisers’ Qualifications Review Committee, and as a member of IBA who is accredited in Business Appraisal Review, I have seen many business valuation reports. Some are quite good, and some are sorely lacking. The shortcomings of the latter group are not always apparent to the untrained eye of the client or the client’s attorney, but in the hands of a knowledgeable adversary, any shortcomings will be turned against you.

In all cases, obvious or not, such weaknesses diminish the quality of the work product, and cast doubt on the perceived credibility and reliability of the underlying work and, therefore, the value conclusion.

With practice, persuasive writing is a skill that can be acquired, but there are a number of ways to enhance the quality of your written product. This article is not intended as a lesson in writing, but rather as a broad outline of some components of an effective report, based on my experience as a reviewer of business valuation reports. Some of the comments in this article are a matter of style and preference, and are presented as strong suggestions. Most of the comments, however, should be adhered to in all circumstances.

Effective persuasive writing is different from other types of writing. In persuasive writing, we are tasked with convincing the reader of the validity of our opinion. For business valuations, this is accomplished by explaining fully to the reader each and every step in our analysis, the reasons for taking each step, the data employed in each step, and where that step leads us next. This provides a series of stepping stones clearly linking the analysis, from the raw data through to the value conclusion.

The report must flow in a logical, sensible manner that is easily followed by the reader. A very effective logical sequence for the report is to begin by describing the purpose of the report, the interest being valued and a broad overview of the subject company. We must acknowledge that the reader needs to be educated about a number of things, such as:

- Identify the client – is it the company, one of the shareholders, an estate, a non-owner spouse, the court?
- A brief description of the subject company – its industry, size, location.
- What is being valued – common stock, a general partnership interest, non-voting stock.
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- This may sound obvious and unnecessary, but if there are multiple classes of outstanding interests, such as preferred stock, limited partners, options or warrants, this is important information to disclose.
  - What is the purpose of the valuation, and who are the intended users of the report.
  - What is the valuation date – this is present in every report, of course, but the reader needs to know why this date is significant, so the concept of “information known or knowable” should be explained.
  - What is the standard of value, and how is that defined.

From there it is best to work from the “global” to the “local,” by presenting an analysis of the national economy, then the local economy, then the industry. After that stage has been set, a very detailed analysis of the company would describe, among other things, its:

- History
- Ownership
- Officers and management
- Organization chart
- Its industry, including SIC or NAICS codes
- Products and services
- Markets served
- How it markets and sells
- General financial history and trends
- Outlook and forecast

Next would be a detailed description of the company’s financial and operating history, discussing in detail any necessary normalizing adjustments. This would involve a comparison of the company’s results over time and what this means for the company’s future, and would include an analysis of the company’s balance sheets, income statements and financial ratios.

Once this foundation has been set, comparisons can be made to the industry, in order to position the company in the context of its industry peers and competitors. Only now can the actual valuation procedures be applied, first explaining to the reader those approaches and methods that are available, then selecting and applying the appropriate methods. This will be followed by the consideration and application of appropriate valuation discounts or premiums, reconciling the value indications, and a conclusion of value.

The IBA’s Applicant’s Handbook provides guidance on writing an effective report. Among the Handbook’s general comments are that production values count – that is, “the appearance of an appraisal report is an important contributor to the credibility of the appraisal result.” Thus:

- Every page except the cover must be numbered
- A compete table of contents must be included
- Charts and graphs must be used effectively – that is, the data presented must be relevant to the narrative and support the analysis being presented
- The body of the report should not be cluttered with lengthy tables, such as five years of detailed income statements. Rather, relevant summary data (such as revenues, gross profit, major expense categories, and pre-tax income) should be presented in the body of
the report, accompanied by a discussion of its relevance to the valuation analysis. The full table of data, if necessary, should be presented as an appendix.

- Sources must be identified in all cases. References to studies, books, articles, etc., must be accompanied by complete and proper citations in order to permit the reader to locate the original source upon which you are relying.

Another important concept discussed in the Handbook is the idea of replicability, meaning the reader is provided with sufficient information to replicate the analysis. This is not to say that the reader will be in full agreement with your value conclusion, only that he/she can follow the manner in which the analysis was performed, with no significant unanswered questions.

The Handbook also states “Support of subjective factors must include discussion of applicable empirical information…discussion of why the value for the subject falls where applicant believes it does…” This is a common weakness in many valuation reports. To say that the equity risk premium is x% because a particular book says so, is insufficient. You cannot ask the reader to simply rely on your superior knowledge and training, and accept such statements without adequate, replicable, support.

You must first adequately describe what an equity risk premium is, and what it attempts to measure. Next, discuss how the empirical data was assembled, describing the studies in general terms (with proper footnotes, of course), followed by explaining why this empirical data is applicable to the subject company. (A detailed, highly technical discussion is counterproductive – we must be able to explain the concepts and the data in plain language, and point the reader, by way of footnotes, to the source data.) Only then have you adequately supported your position, and given the reader enough information to decide whether he is in agreement with your analysis and conclusion. Since reasonable people can, and do, differ on many aspects of business valuation, you may not necessarily persuade the reader to agree with your conclusion, but there should be no unanswered questions of how you arrived there.

Perhaps the easiest credibility-killer to avoid is the typographical error, including poor punctuation (a missing or misplaced apostrophe is maddening!). Whether a mere spelling error or use of the wrong word (companies/company’s, their/there, verses/versus), these errors are easily eliminated. Careful proofreading costs very little, but it pays great returns. Be sure to also periodically proofread those portions of your reports that are common from one report to the next – those sections describing the requirements of Revenue Ruling 59-60, or explaining in general terms the different business valuation approaches and methods. It is easy to overlook these areas, and to assume they are free of typographical errors.

If you use economic or industry reports written by outside parties be sure to proofread them as well, not just for typographical errors, but also for inconsistencies, or statements that might conflict with other information you have received. If the client tells you that the industry outlook is poor, but the third-party report says otherwise, you will need to reconcile these differing statements.

You must also be a careful editor of the content of these outside party reports. The typical economic report and outlook runs up to ten or twelve pages or more, and includes sections on the gross domestic product, interest rates, housing starts, unemployment, business inventories,
currency exchange rates, etc. Be sure to include in your report only those sections that are relevant to the subject company, and explain why it is relevant. For example, if you are valuing a local restaurant, dry cleaner or other business that relies on customers from within the immediate area, then housing starts in the Kansas City district, or where the Russell 2000 is projected to be next quarter, may not be relevant pieces of information. All irrelevant information should be excluded from your report; to include it is to invite the reader to assume that you do not understand how the economic analysis impacts the subject company.

Likewise, be sure to focus on the correct industry. If you are valuing a distributor of electronic components whose only customers are defense contractors, then an analysis of the defense industry may be more relevant than an analysis of the electronics industry. Likewise, if you are valuing a credit card processing company whose only clients are gas stations, then it may not be appropriate to analyze the credit card processing industry, which would have a much different focus. Since the subject company’s prospects are closely tied to the service station industry, this may be the more appropriate industry to analyze. Analyzing the wrong industry is a sure way to destroy the credibility of all that follows, including your opinion of value.

Mathematical errors or internal inconsistencies can be very damaging, but are easily avoidable. If you say “revenues, as shown on page 50, were $1 million,” be sure to cross check that revenues figure, and be sure it is, in fact, on page 50. Inconsistencies in the projections include items like interest expense growing or declining at a different pace than interest-bearing debt; inventory or receivables increasing or declining to the point where turnover ratios don’t make sense; cash balances growing and accumulating, rather than distributions being made to the shareholders; depreciation expense that is too low or too high when compared to the existing asset balances and projected capital expenditures; staffing levels or marketing costs that cannot support expected growth; etc. Your proofreading step should include a final check of all the numbers, cross-references and footnotes.

Also avoid statements that cannot be quantified, such as:

- The cash balance is “acceptable” or “adequate” – the point may be made by comparison to industry norms for cash or working capital coverage, or financial ratios, so that acceptability has been defined by industry norms
- “Strong” growth – it is best to present a numerical value for growth, in dollars or percent, and let the reader assess if it is strong
- Improved “significantly” – as above, better to present a numerical value, and let the reader decide
- Management is “competent” or “capable,” or has “vision” - this can be demonstrated by discussing the educational or employment history and experience of management

Since, by and large, our audience is not made up of sophisticated business valuation experts, we need to explain complex matters with easily understandable language. Be sure to define such items as strategic or synergistic buyer, capitalization rate, EBITDA, etc. But be sure to define these terms properly – I have seen reports that defined a term in contradiction to the International Glossary of Business Valuation Terms included in the report as an appendix.
This means we must also be aware of competing views in our profession regarding the use of certain data. For example, if we use SBBI, whose data begins with 1926, we must acknowledge that there are competing schools of thought that rely on much shorter time frames. It may not be necessary to describe all competing viewpoints in the literature; at the least, we should explain to the reader why beginning with 1926 is the right thing to do.

A well-written report includes many references to other, published materials, such as books, articles and whitepapers. These references may take the form of either footnotes (at the bottom of the page where the reference appears) or as endnotes (all shown at the end of the report). Footnotes are preferred because the reader does not need to flip to the back of the report each time an endnote is referenced. You must also give proper attribution to the original source, even if you do not quote it directly. There are many inexpensive reference books on the proper style for formatting footnotes and endnotes.

Often I see reports that say something like “In his book, John Doe says marketability is important to investors.” While not wrong (assuming that Doe’s work is otherwise properly cited), this is a poor presentation. We, as business valuation professionals, may have the deepest respect and admiration for Mr. Doe, but the reader likely doesn’t know who he is, and this is a distraction to the reader. Moreover, the reader doesn’t, and shouldn’t, even care who he is - all that is relevant is whether marketability is important to investors, and what that may mean for the value of the subject interest. Hence, it is far better to assert that “marketability is important to investors,” provide the reasons why, and cite Doe’s work in a footnote. This is a much more authoritative way to make the point. It is the reasons that are important to the analysis, not the author.

Regardless of how such points are presented, the most important thing is to explain why the statement is true. Just because Doe, and presumably you, believe marketability is important to investors does not mean you have persuaded the reader. You must explain the reasons why it is important to the investor, so that your audience can decide whether he or she agrees. This is why our reports must persuade; although the reader may ultimately differ with our conclusion, there should be no mystery regarding our analysis and reasoning.

It is also best to use the active voice, rather than the passive voice, which simply means that we say “We analyzed the financial statements” rather than “The financial statements were analyzed.” The active voice makes it clear we are taking responsibility and ownership of our analysis and conclusion.

Many business valuation reports contain statements like “we analyzed five (5) years of financial statements.” This, too, is not necessarily wrong, but is not recommended. Such parenthetical repetitions act as speed bumps for the reader, interrupt the flow of the narrative, and add absolutely nothing to the quality of the report. No one has been able to explain to me why “five” is subject to misinterpretation and must be clarified by presenting the numeral, as well.

When analyzing multiple years of historical financial statements, it is not enough to simply present the data. To state that, over the past five years the current assets ranged from a high of $x to a low $y does not constitute analysis – it is just a recitation of data that is readily apparent from the historical balance sheet. An analysis will explain why the balance changed – why did
receivables (or inventory or salaries or utilities) go up or down? What is management doing about it? What is the implication for the future?

We typically analyze five years of the subject company’s financial history, but sometimes the appraiser presents only one year of industry data. This represents an inadequate and unconvincing financial analysis. The purpose of such an analysis is to compare the company’s results to the industry. You cannot identify trends over time, and draw any conclusions regarding an industry comparison, with only one year of industry data. All of the major providers of such data make at least five years of data available – there is no excuse to shortcut this part of the analysis without adequate explanation, and to do so impairs the credibility of the analysis.

Another unacceptable shortcut is to conclude that, since management is “unable” to make projections, we are limited to using the single period capitalization method by default. However, it is important to recognize that using the single period capitalization method is akin to projecting the future. For example, assuming the cash flow being capitalized is $100,000, and the long term growth rate is 4%, then you are implicitly concluding that cash flow in five years will be $121,665. Even if you are using the single period capitalization method, you have projected the future. In addition, how can management run a business without some expectation of future revenues? It is a rare company whose industry is so volatile as to make projections nothing more than guesswork.

Speaking more broadly, as professional, qualified appraisers, we are expected to apply our own critical thinking skills to the engagement. Would the hypothetical willing buyer simply accept management’s supposed inability to project future revenues, expenses and cash flow, and capitalize some arbitrary weighted average of prior years’ results? (If management is unable or unwilling to perform a reasoned estimate, then any other number used is arbitrary.) Or, instead, would the hypothetical buyer hire a Certified Business Appraiser to analyze the company’s history and outlook, and make an informed judgment about future cash flows? Better to apply some thoughtful analysis to the projections, than to abdicate your responsibility as an analyst.

There is also another side to this coin. If management has prepared detailed projections, it is not appropriate to simply accept them at face value without question. Even though management is better informed about the business, the industry and competition than we are, we still have a responsibility. We are appraisers, not forensic accountants, so there is much data we must accept as accurate and reliable, without verification – industry data, historical financial statements, etc. However, if something comes to our attention that causes us to question the information provided to us, we are obligated to question it until we are satisfied with the results.

Thus, projections that appear to be unreasonably optimistic or pessimistic should not be accepted without question. If we believe it is appropriate to do so, we must modify the projections before using them in our analysis, fully explaining to the reader our reasoning, of course.

Carefully review your assumptions for the terminal year with a critical eye. Remember that the percentage relationships of the amounts in the terminal year, such as a gross profit of x%, or EBITDA of z%, are expected to continue into perpetuity. It also means that all dollar amounts will grow by the same long term growth rate into perpetuity. This may seem acceptable at first glance, but can lead to trouble. If capital expenditures in the terminal year are $50,000 and non-
cash charges for depreciation are $45,000, then these figures will be $52,000 and $46,800 in the next year, using a 4% growth rate, and so on. This relationship is unsustainable over the long run. Given this pattern, and sufficient time, the balance of fixed assets will ultimately become negative, which of course, is not possible.

Similarly, if the terminal year reflects negative cash flow due to the paydown of debt, given enough time the balance of debt will become negative. Therefore, in the terminal year, cap ex must be equal to or greater than the noncash charge for depreciation, the change in working capital usually must be a reduction of cash flow, and changes in long term debt can only be equal to greater than zero.

Remember also that, in the single period capitalization method, Year 1 is the terminal year, so these relationships must be reviewed for the capitalization of earnings method.

Business valuation reports include many terms that are unfamiliar to the reader, and these may be explained in the report, or as part of a glossary contained in an appendix. Use of quotation marks around a word should be avoided. I have seen statements like

- This approach is “theoretically” correct, or
- This is considered the most “pure” valuation method

Known as scare quotes, such usage is inadvisable. Scare quotes are quotation marks around a word or phrase indicating that the word or phrase is not used in its literal or usual sense. If the word does not signify its literal or usual meaning, it would therefore require further explanation – ideally, it should not be used at all. Such usage, and the required further explanation, simply serve to clutter the report – better to avoid scare quotes altogether, and just use careful, precise language.

There are many components to an effective valuation report; some are technical, some are stylistic, and the requirements may change from one report to another. In general, if you lead the reader step by step through your analysis, proceed in a logical way, do not assume the reader has the degree of technical knowledge that we do, and anticipate and respond to the likely questions that will arise in a reader’s mind, you will produce a written report that will be every bit as thorough, thoughtful and convincing, as all the underlying work that led up to it.