The Business Valuation "Baker's Dozen": Questions Legal Counsel Should Consider Asking (and the Expert Should Expect to Hear) in Deposition/Cross-Examination—And Why

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Business valuation in a family law setting requires a broad understanding and reasonable application of generally accepted business valuation theory and practice. This discussion identifies 13 questions that a testifying expert should expect to hear, and opposing legal counsel ("counsel") should consider asking, in a deposition/cross-examination. The questions typically are relevant with regard to any business valuation performed in a family law context. Responses to the questions can provide significant information (1) regarding the foundation for an opposing expert's valuation analysis and opinion, and any weaknesses that can be exploited, and (2) that can be used to support the valuation variables underlying the valuation analysis and opinion of counsel's own expert.

Introduction

For nearly 30 years, the author has provided business valuation services in a wide variety of settings, including transactional settings, tax and other regulatory settings, and litigation settings. The demand for business valuation services and related financial advisory service support within the family law context has been constant, if not increasing.

The preparation of credible business valuation opinions, regardless of the context in which they are prepared, require:

1. a broad understanding of financial, economic and valuation theory;
2. compliance with relevant business valuation professional standards; and
3. consideration and application of appropriate legal and regulatory guidelines, including judicial precedents.

For purposes of this discussion, this collective body of business valuation theory and guiding principles comprise what will be referred to as generally accepted valuation practice ("GAVP").

Because "analyst judgment" typically plays a significant role in the application of GAVP and developing business valuation opinions, the question of "art versus science" often is raised with regard to the valuation process. To characterize a valuation process as "art," however, inappropriately implies that the analyst judgment incorporated in an appraisal is devoid of any reasonable empirical support or foundation.

Unfortunately, assumptions in a valuation process that are not appropriately documented and supported necessarily should be characterized as arbitrary, thereby rendering them more art than science. In the author's experience, however, this is more the exception than the rule when business valuations are completed by well-qualified, experienced analysts.

Herein lies the challenge faced by legal counsel ("counsel") when attempting to discredit or impugn the valuation opinion of a valuation testifying expert. Piercing the foundation of a qualified financial expert opinion in a manner that does not give an expert the freedom to claim "analyst judgment" as a recurring defense requires collaboration and coordination between counsel and his/her financial expert.

The effectiveness of such collaboration and coordination can be increased significantly by incorporating the following business valuation "baker's dozen" of questions in a deposition/cross-examination of an opposing testifying expert:

1. Based on the professional associations in which you are a member, and your professional designation(s)/certification(s), what valuation professional standards are relevant to your engagement and please describe how you have complied with those professional standards?
2. Please identify companies that you have previously valued that operate in the same industry classification as the subject company(ies) in this engagement.
3. Are there any errors in your analysis/report that you would like to bring to the court's attention?
4. What were the total hours billed by your firm to complete the engagement, and what percentage of the time did you bill?
5. Please describe the "reasonableness test" you completed at the conclusion of your engagement and the findings of your "reasonableness test."
6. What level of intangible asset value, or "goodwill," is implied by your valuation opinion, and why is the indicated level reasonable?
7. Please explain your basis for excluding any of the three generally accepted valuation approaches (i.e., the income, market, and asset-based approaches) from your analysis.
8. Please explain how you have established "normalized earnings" for the subject company, and the basis for any "normalizing adjustments."
9. Please explain the basis for your selection of valuation pricing multiples within your market approach (including both the guideline publicly traded company method and the guideline transactions method).
10. Please explain the basis for the weighting you have applied to each valuation approach and method value indications used to establish your opinion.
11. Is business valuation as much "art" as it is "science?"
12. Please explain how you have considered "key person risk" in your valuation.
13. Please explain the basis for any valuation adjustments (e.g., premium for ownership control or discount for lack of ownership control, discount for lack of marketability) you have applied in arriving at your opinion of value.

The questions are intended to be directed at counsel's opposing valuation testifying expert, with the expectation that they have been developed in collaboration with counsel's own valuation testifying expert.

Therefore, it is expected that counsel's own valuation testifying expert has already:

1. developed credible responses to each question as relating to his/her own analysis and opinion, and
2. reviewed the opposing expert's analysis and opinion and developed an idea regarding likely responses counsel will receive from the opposing testifying expert.

The following discussion addresses the "baker's dozen" of suggested business valuation deposition/cross-examination questions previously identified. The questions identified are not intended, initially, to induce "gotcha" responses from an opposing expert.

However, the responses should produce information to counsel that:

1. enables counsel to develop a reasonable understanding regarding the foundation for the opposing testifying expert's analysis and opinion,
2. facilitates more detailed inquiries, the responses to which may result in discrediting certain aspects of a testifying expert's analysis and opinion, and
3. provides direct and indirect support for the analysis and opinion offered by counsel's own testifying expert.

For each question, discussion is provided regarding:

1. the basis for each question (i.e., why counsel should consider asking each question),
2. a general response that likely will be received from the valuation testifying expert under examination, and
3. how a response provided by the opposing business valuation expert can be used to support the analysis and opinion offered by counsel's own valuation testifying expert.

1. Based on the valuation professional associations in which you are a member, and your professional designation(s)/certification(s), what valuation professional standards are relevant to your engagement and please describe how you have complied with those professional standards?

<u>Basis for question</u>: Business valuation professionals typically are "qualified" to render opinions in court as "experts" based on the proven attainment of relevant and adequate education, experience and training.

The training aspect of an expert's qualifications typically includes attaining professional designations/certifications conferred by a valuation professional organization ("VPO") that attest to the mastery of specific business valuation body of knowledge by an individual.

Business valuation designations/certifications typically recognized by the courts include (among others):

- Certified Public Accountant ("CPA"), granted by the American Institute of Certified Public Accountants
- Accredited in Business Valuation ("ABV"), granted by the American Institute of Certified Public Accountants
- Accredited Senior Appraiser in Business Valuation ("ASA"), granted by the American Society of Appraisers
- Certified Valuation Analyst ("CVA"), granted by the National Association of Certified Valuators and Analysts
- Chartered Financial Analyst ("CFA"), granted by the CFA Institute

As indicated, each of the business valuation designations/certifications identified above is conferred by a different VPO. And, each VPO promulgates its own set of professional standards.

Experts who are members of these various associations and who maintain the identified designations/certifications are expected to comply with the relevant professional standards when providing business valuation services.

Asking question (1) forces the valuation testifying expert to identify those standards which he/she is bound to comply with and to explain how his/her analysis complies with the relevant professional standards.

<u>General Response</u>: An experienced valuation testifying expert typically will produce a report that states, explicitly, that his/her analysis complies with the relevant professional standards binding him/her as a result of membership in identified professional associations. Further, an experienced valuation testifying expert typically will respond that his/her valuation process is designed to comply with relevant professional standards.

<u>Use of Response</u>: A valuation testifying expert who affirmatively states that an analysis and opinion have been developed in compliance with relevant business valuation standards is subject to impeachment if it can be established that the subject analysis and opinion deviate from the identified standards.

While some deviations may be deemed minor, a major deviation from the relevant business valuation standards, or multiple, minor deviations, can be used to impugn the credibility of the testifying expert's analysis and opinion.

If counsel's valuation testifying expert has produced an analysis and report that are compliant with the VPO to which he/she belongs, establishing any points of noncompliance by the opposing testifying expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert. This is particularly effective when the testifying experts share common professional associations and credentials.

2. Please identify companies that you have previously valued that operate in the same industry classification as the subject company(ies) in this engagement?

<u>Basis for question</u>: The "experience" aspect of a valuation testifying expert's qualifications includes both experience completing business valuations in general, and experience valuing companies of the specific type involved in the subject dispute. Broad and long-term valuation experience typically are recognized by the courts as providing a solid foundation for the capable delivery of business valuation services and related opinions.

However, the "first-time" valuation experience, or limited valuation experience in a particular industry, often presents a circumstance that allows counsel to challenge an opposing valuation testifying expert's analysis in a manner that calls into question the depth of understanding that the expert possesses with regard to the analysis of certain types of companies, and his/her ability to complete a fully informed valuation.

Asking question (2) forces the valuation testifying expert to provide specific examples of companies that he/she has valued in a particular industry, thereby enabling counsel to determine if further examination will result in demonstrating that the opposing testifying expert has rendered an opinion that is assailable based on limited familiarity with the subject company industry and factors that affect value.

General Response: An experienced valuation testifying expert typically will express that he/she has completed prior valuations of companies operating in the same, or "related," industries as the subject company. Further, an experienced valuation testifying expert typically will express that relevant business valuation professional standards have been complied with in completing the analysis and developing the opinion.

Such professional standards typically require that a valuation analyst who has not previously valued a company within a particular industry perform the necessary research required to develop a reasonable understanding of the industry, thereby providing a sound foundation on which to base his/her analysis and opinion.

Use of Response: A valuation testifying expert who possesses limited valuation experience in the subject company industry should be challenged with additional questions designed to emphasize his/her limited understanding of the subject company industry. This is particularly relevant in those circumstances where the subject company operates in a highly regulated industry or an industry with specialized practices (e.g., health care, utilities, hedge funds).

If counsel's valuation testifying expert has prior experience in the relevant industry, the ability to demonstrate specific, relevant experience comparable to, and potentially exceeding, that of the opposing expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert.

3. Are there any errors in your analysis/report that you would like to bring to the court's attention?

Basis for question: Errors, even insignificant ones, are unfortunate for the analyst. Identifying even a single major error in an opposing testifying expert's analysis may render the expert's opinion irrelevant and unreliable.

A series of minor errors can call into question the level of care and diligence exercised by an expert, thereby reducing the credibility and reliability of his/her opinion in the eyes of the court.

Generally, errors relate to computational (i.e., mathematical) or procedural (i.e., business valuation process) issues. Accordingly, errors should be distinguished from differences in "analyst judgment." Qualified valuation professionals can, and do, often arrive at different valuation positions based on unique assessments of a set of facts and circumstances.

However, "analyst judgment" can be pushed toward the direction of "error" when such judgment results in valuation assumptions or positions that are not well-reasoned because they are not consistent with, or supported by, empirical data.

Asking question (3) forces the valuation testifying expert to identify any known errors in his/her analysis.

General Response: An expected response to question (3) by an experienced valuation testifying expert is, "I am not aware of any errors in my analysis that would cause me to change my opinion." Because all valuation testifying experts are human, achieving perfection in any business valuation circumstance is not a realistic pursuit.

Therefore, experienced valuation testifying experts typically allow for a small margin of error when responding to question (3). Further, business valuation models and internal professional standards review processes relied on by experienced analysts typically are designed to prevent and identify any significant issues before a valuation opinion is finalized.

Use of Response: A testifying valuation expert who states that his/her analysis is error free is subject to impeachment if it can be established that the subject analysis does contain errors. Once again, the identification of a material error, or a series of minor errors, can serve to totally discredit an opposing testifying expert's opinion.

For this reason, the first process counsel's own valuation testifying expert should complete in preparation for the deposition/cross-examination of the opposing valuation analyst is to test and recalculate the components of the opposing testifying expert's analysis.

If counsel's valuation expert has completed a thorough and accurate analysis, identifying errors committed by the testifying expert may serve to strengthen the credibility of the analysis and opinion offered by counsel's testifying expert.

4. What were the total hours billed by your firm to complete the engagement, and what percentage of the time did you bill?

Basis for question: Generally, a business valuation of any size is completed by a valuation team that includes a number of analysts with varying degrees of education, training and experience; research professionals; and support staff.

Each of the participants on the engagement team typically "bills," or "charges," the engagement for time committed to an engagement based on varying billing rates relating to qualification levels.

Asking question (4) forces the valuation testifying expert to identify his/her time specifically committed to an engagement. While fees often are the focus of counsel inquiries, assessing commitment based on time typically provides a more meaningful indicator of the level of involvement and the role the opposing expert played in developing the analysis and opinion offered.

General Response: An expected response to question (4) by an experienced valuation testifying expert is, "Based on my position with the firm, and the size and scope of the engagement, I would estimate that my time to commitment to the engagement approximated 20 percent to 25 percent of the total time billed through the most recent billing cycle.

Often, a valuation testifying expert is asked to produce internal engagement accounting records that enable counsel to identify all individuals who worked on a particular engagement, the hours worked, and the tasks performed.

Use of Response: Whether estimated by the valuation testifying expert, or established based on consideration of the engagement time accounting records, establishing an understanding of the time committed by a valuation testifying expert to a particular business valuation allows counsel to establish a sense of the level of effort dedicated to the matter by the expert.

A disproportionately high level of commitment or number of hours provides an opportunity to emphasize unique challenges encountered in completing the engagement. A disproportionately low level of commitment or number of hours provides an opportunity to challenge the adequacy of effort committed to the analysis and opinion.

If counsel's valuation testifying expert can establish that a reasonable level of effort was committed at touch points throughout the engagement, the credibility and reliability of the analysis and opinion offered by the expert may be enhanced.

5. Please describe the "reasonableness test" you completed at the conclusion of your engagement and the findings of your "reasonableness test."

Basis for question: An expert opinion resulting from a business valuation that is developed consistent with GAVP typically includes some form of "reasonableness test."

Such a test is designed to evaluate the reasonableness of the resulting valuation conclusion by performing logic tests, such as whether, based on the concluded value (i.e., price), (1) the cash flow expected to be generated by the subject company could support reasonable financing terms, or (2) implied valuation pricing multiples are reasonable relative to comparable valuation pricing multiples attributable to publicly traded companies or acquired companies operating in the same industry classification as the subject company.

Asking question (5) forces the valuation testifying expert to step away from GAVP and provide a "big picture," logical assessment of the reasonableness of the valuation conclusion and opinion offered.

General Response: When the circumstances warrant, an expected response to question (5) by an experienced valuation testifying expert is, "I have developed my analysis and opinion consistent with GAVP, and the indications of value resulting from each of my valuation approaches and methods occur within a fairly tight range. This mutually supporting evidence provides me with a high level of confidence that both the key assumptions supporting my analysis and the overall conclusion are reasonable."

Use of Response: A valuation testifying expert who provides the general response noted above may indeed have a defensible position. However, a narrow range of values produced by a valuation analysis completed consistent with GAVP does not necessarily guarantee that the concluded value is reasonable.

A simple example to dispel this notion is represented by a valuation conclusion that is weighted heavily on indications of value tied directly to a normalized earnings level for the subject company that were improperly calculated or unreasonable based on the facts and circumstances.

Indications of value resulting from market approach and income approach methods based primarily on an unreasonable level of normalized earnings may occur within a narrow range of value. However, relying on the narrow range of value to support the reasonableness of the assumptions supporting each valuation method, and the overall valuation conclusion, clearly would be inappropriate and misleading.

If counsel's valuation testifying expert has completed a meaningful "reasonableness test" regarding his/her valuation conclusion, and it can be established that the opposing valuation expert has not or has been proven to have relied on a faulty reasonableness test, the credibility and reliability of the analysis and opinion offered by counsel's expert may enhanced.

6. What level of intangible asset value, or "goodwill," is implied by your valuation opinion, and why is the indicated level reasonable?

Basis for question: Generally, intangible asset value, or "goodwill," represents the amount of value implied by a valuation conclusion in excess of the value of the tangible assets controlled by the subject company. Typical tangible assets include cash, accounts receivable, inventories, property, plant and equipment, and other assets that, typically, have a "physical" existence.

Identifying the level of intangible asset value or goodwill implied by a valuation conclusion and assessing whether it is consistent with the facts and circumstances is a form of reasonableness test.

Asking question (6) forces the valuation testifying expert to identify the amount of "value" included in his/her valuation conclusion that is most challenging to maintain or transfer because it is dependent on difficult-to-measure factors such as customer/client/patient loyalty, brand recognition, technologically driven effectiveness and efficiency, reputation, specialized skills, and creativity, to name a few.

General Response: An expected response to question (6) by an experienced valuation testifying expert is, "Each business valuation is affected by the specific facts and circumstances existing at the valuation date, which in turn affects the level of intangible asset value, if any, implied by a valuation conclusion. The level of intangible asset value resulting from business valuations can therefore vary widely and is based primarily on the economic earnings a company is expected to generate and the persistence of those earnings."

Use of Response: In certain circumstances, the reasonableness of the level of intangible asset value implied by a business valuation can be analyzed by examining the level of intangible asset relative to total asset value or revenue for comparable businesses. This is particularly true regarding certain professional practices, such as medical and dental practices.

Empirical data are available that can enable an assessment of the reasonableness of intangible asset value implied by a valuation conclusion based on the ratio of intangible asset value relative to gross receipts (i.e., collected revenue) for a medical practice or dental practice.

If counsel's valuation testifying expert has completed a meaningful assessment of implied intangible asset value resulting from his/her valuation conclusion, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

7. Please explain your basis for excluding any of the three standard valuation approaches (i.e., the income, market, and asset-based approach) from your analysis.

Basis for question: Generally, the valuation professional standards of the previously discussed VPOs that confer business valuation designations/certifications require their members to comply with their standards and consider the three generally accepted business valuation approaches when completing business valuations: the income approach, the market approach, and the asset-based approach.

It is noteworthy that the requirement to "consider" the three generally accepted business valuation approaches does not "require" that each approach must be used and relied on to produce a credible business valuation opinion.

The valuation approaches applied in a valuation engagement are based on the facts and circumstances particular to the engagement and analyst judgment.

Asking question (7) forces the valuation testifying expert to explain why a particular approach(es) were excluded from his/her analysis.

General Response: An expected response to question (7) by an experienced valuation expert is, "Relevant valuation standards allow an analyst to exercise judgment in determining which valuation approaches are most relevant in a particular valuation, based on consideration of the relevant facts and circumstances."

Use of Response: Business valuation professional standards and analyst judgment do afford a business valuation expert latitude regarding which approaches to incorporate in a business valuation. However, certain companies, such as retail, manufacturing and service companies, typically are most reasonably valued using income and market approaches, while asset-intensive companies, such as real estate holding and real estate development companies, are most reasonably valued using the asset-based approach.

Counsel can challenge an expert who excludes from his/her analysis any valuation approach that typically would be relied on to estimate value based on the business focus of the subject company.

If counsel's valuation testifying expert has, based on reasonable consideration of relevant facts and circumstances, incorporated valuation approaches in his/her valuation analysis that were excluded by the opposing valuation expert, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

8. Please explain how you have established "normalized earnings" for the subject company, and the basis for any "normalizing adjustments."

Basis for question: Normalized earnings represent the level of earnings that a subject company reasonably would be expected to generate in future operating periods based on the efficient and effective operation of the business under "normal" operating circumstances.

Normalized earnings typically are estimated for the subject company based on consideration of a historical average (straight or weighted) covering an operating period deemed relevant for the purpose of estimating the most likely level of long-term future earnings.

All material nonrecurring items—both revenue and expense—should be removed from historical earnings to estimate a normalized earnings base, including the impact of revenue and expense items that do not reflect arm's-length business transactions.

Depending on the duration and operating stage of the subject company, and based on consideration of economic and industry conditions existing as of the valuation date, normalized earnings sometimes reasonably can be based on the subject company's most recent operating results.

Typical adjustments made to "normalize" the earnings of a business include the following:

- Removing nonrecurring revenue/income items, such as insurance recoveries, litigation awards and income or significant gains realized on the sale of assets
- Removing nonrecurring expense items, such as asset write-offs, litigation settlements, regulatory fines and penalties, and losses realized on the sale of assets
- Adjusting owner compensation and benefits to reasonable, market-based levels
- Adjusting related-party activity (e.g., family member compensation and benefits, rental arrangements, supplier relationships) to reasonable, market-based levels

Asking question (8) forces the valuation testifying expert to define normalized earnings in the context of his/her analysis and explain the rationale for normalizing adjustments.

General Response: Based on the significant impact that normalized earnings can exert on a valuation analysis and opinion, an experienced valuation testifying expert typically responds to question (8) by referring to a schedule or exhibit in his/her analysis that provides detail supporting the calculation of normalized earnings.

Use of Response: The calculation of normalized earnings often represents the most critical aspect of a business valuation because the level of normalized earnings typically flows directly into the income and market valuation approaches used to estimate the value of the subject company.

Counsel can challenge an expert who has incorporated unsupported or unreasonable normalization adjustments, or who has relied on an unreasonable operating period for the purpose of developing normalized earnings.

If counsel's valuation testifying expert has established a solid foundation for developing normalized earnings, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

9. Please explain the basis for your selection of valuation pricing multiples within your market approach (including both the guideline publicly traded company method and the guideline transactions method).

Basis for question: The market approach—whether based on the guideline publicly traded ("GPT") company method or the guideline transactions method—is based on the principle that the value of a subject company can be estimated based on consideration of the prices that investors are willing to pay for ownership in reasonably comparable businesses.

Market-based valuation pricing multiples are estimated by analyzing (1) the observed relationship between the value (i.e., price) of each GPT company/guideline transaction and (2) the relevant operating fundamentals, such as revenue, earnings and cash flow.

Based on consideration of differences in the risk profiles among the subject company and the GPT companies/guideline transactions, market-based valuation pricing multiples are selected for the subject company and applied to the relevant operating fundamentals of the subject company to develop indications of value.

The risk profile assessment typically includes considering relative differences in several of the following factors among the subject company and the selected GPT companies/guideline transactions:

- Size, including assets, revenue, customers/clients, products/services
- Geographic presence and markets served
- Market position
- Management depth
- Total capital and access to capital
- Profitability
- Historical and expected growth
- Variability in earnings and cash flow
- Capital investment and working capital needs

Asking question (9) forces the valuation testifying expert to provide a basis for the selection of valuation pricing multiples.

General Response: When the subject company is noticeably smaller than the GPT companies/guideline transactions, an expected response to question (9) by an experienced valuation testifying expert is, "Based on consideration of differences in size, historical and expected operating results, growth prospects, and other key factors distinguishing the subject company from the GPT companies/guideline transactions, valuation multiples were selected for the subject company near the low end of the market-based range."

Use of Response: Generally, the selection of valuation pricing multiples incorporated in the market approach is based on the risk profile assessment previously identified and on analyst judgment. Though analyst judgment varies, counsel can challenge an expert who has selected market-based valuation multiples for the subject company that appear to be inconsistent with the risk profile assessment.

If counsel's valuation testifying expert has established a solid foundation for the selection of market-based valuation pricing multiples, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

10. Please explain the basis for the weighting you have applied to the valuation approaches and methods used to establish your opinion.

Basis for question: The weighting applied by a valuation testifying expert to establish a valuation opinion, similar to the selection of valuation approaches and methods incorporated in a business valuation, is based on consideration of the facts and circumstances in a particular valuation and analyst judgment. Valuation professional standards allow analysts to exercise such judgment.

Further, recognized valuation standards do not require analysts to follow or present any specific quantitative weighting to the indications of value resulting from a business valuation in arriving at a final opinion of value.

Asking question (10) forces the valuation testifying expert to provide the rationale for the valuation conclusion presented.

General Response: An expected response to question (10) by an experienced valuation testifying expert is, "Relevant valuation standards allow an appraiser to exercise judgment in determining the relative weight to apply to the indications of value in a particular valuation based on consideration of the relevant facts and circumstances."

Use of Response: While valuation professional standards and analyst judgment do afford a valuation testifying expert latitude regarding the weighting to apply to indications of value in arriving at a final opinion of value, the weighting —whether explicit or implicit—typically correlates with the quantity and quality of information serving as the foundation for each valuation approach and method.

Counsel may challenge an expert whose weighting process and resulting valuation opinion appear to be arbitrary and inconsistent relative to the indicated range of value and the "relevance and reliability" of each valuation approach and method based on the facts and circumstances.

For example, establishing a valuation opinion at the "high end" of a valuation range, represented by the indicated value resulting from the GPT company method, would seem arbitrary and inconsistent if the subject company is significantly smaller than each of the GPT companies.

If counsel's valuation testifying expert has concluded an opinion of value that is reasonably situated within the indicated valuation range based on consideration of the relevant facts and circumstances, and it can be established that the opposing valuation testifying expert has not, the credibility and reliability of the analysis and opinion offered by counsel's testifying expert may be enhanced.

11. Is business valuation as much "art" as it is "science?"

Basis for question: While analyst judgment typically plays a significant role in developing a business valuation opinion, such judgment exercised by an experienced analyst is best described as "reasoned and informed" judgment.

As a result, it is a mischaracterization to describe a well-reasoned and credible business valuation completed by a qualified and experienced analyst as reflecting as much art as it does science.

Asking question (11) forces the valuation testifying expert to provide perspective regarding the level of technical sophistication and the adequacy of support he/she believes backs the analysis completed and the related opinion rendered.

General Response: An expected response to question (11) by an experienced valuation testifying expert is, "A credible business valuation is based on the thorough application of GAVP and the exercise of well-reasoned, informed judgment by a qualified and experienced valuation professional. As a result, it is my opinion that business valuation is more science than art."

Use of Response: Counsel can challenge an expert who gives equal weight to the notion that business valuation is as much art as it is science. An expert espousing such a position can be cast in the light of having developed an analysis and opinion that are grounded more in analyst judgment than objective analysis and empirical support.

If counsel's valuation testifying expert has been consistent in the application of GAVP and thorough regarding the consideration and presentation of empirical data in exercising reasoned and informed judgment, while the opposing valuation testifying expert elects to emphasize that business valuation is as much art as it is science, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

12. Please explain how you have considered "key person risk" in your valuation.

Basis for question: Key person risk represents risk to business operations attributable to reliance on the special skills, talents and abilities of an individual. The concept of key person risk is premised on the notion that the loss of a key person can exert a significant, detrimental impact on the going concern operations of a subject company.

Within a valuation process, key person risk can be addressed in different ways, including the following:

- Purchasing insurance on the health/life of a key person
- Incorporating a key person risk premium when developing the discount/capitalization rate used to complete the income approach
- Applying a direct key person discount to develop the final opinion of value

Asking the question (12) forces the valuation testifying expert to specifically address how key person risk has been considered in the valuation process.

General Response: An expected response to question (12) by an experienced valuation testifying expert is, "The discount rate [developed in a specific schedule or exhibit] incorporates a specific risk premium to address key person risk."

Use of Response: Key person risk is a widely recognized risk within the business valuation profession. While key person risk is particularly relevant regarding the analysis and valuation of smaller companies, key person risk also can exist in very large companies.

The identification and assessment of key person risk is a reasonable expectation in the valuation of most closely held companies.

Counsel can challenge an expert who fails to provide an assessment of key person risk and/or fails to specifically identify how key person risk has been considered for the purpose of completing the valuation.

If counsel's valuation testifying expert has incorporated an assessment of key person risk and incorporated the related impact in his/her analysis, and it can be established that the opposing business valuation has not completed such an assessment or incorporated any key person risk impact in his/her analysis, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

13. Please explain the basis for any valuation adjustments (e.g., premium for ownership control or discount for ownership lack of control, discount for lack of marketability) you have applied in arriving at your opinion of value?

Basis for question: The ownership interest in the subject company that is includable as divisible property in a marital estate has inherent attributes that impact value. Generally, a controlling ownership interest (i.e., typically greater than 50 percent ownership) in the subject company normally would be valued at a pro rata interest of the controlling level of value for the subject company.

A noncontrolling ownership interest (i.e., typically less than 50 percent ownership), on the other hand, would be valued at a pro rata interest of the controlling level of value, discounted for lack of control.

Further, the valuation of an ownership interest in a privately owned company typically would reflect a discount for lack of marketability to reflect the detrimental impact on value attributable to the nonpublic (i.e., relatively illiquid) status of the ownership interest.

It is beyond the scope of this discussion to address the many factors and circumstances that affect controlling versus noncontrolling ownership interests in companies, and the magnitude of adjustments required to adjust from a controlling level of value to a noncontrolling level of value.

Similarly, it is beyond the scope of this discussing to address the many factors and circumstances that affect the liquidity of ownership interests in private companies, and the magnitude of adjustments required to reflect the detrimental impact that illiquidity typically exerts on such interests.

Finally, courts are varied regarding whether discounts for lack of control and lack of marketability are warranted at any level when estimating the value of business ownership interests subject to property division in a marital dissolution context.

Asking question (13) forces the valuation testifying expert to specifically address what adjustments have been incorporated in his/her analysis, the magnitude of such adjustments, and the basis for any valuation adjustments incorporated in the analysis.

General Response: An experienced valuation testifying expert typically will produce an analysis/report that identifies valuation adjustments, the magnitude of such adjustments, and the basis for the adjustments.

Use of Response: Counsel can challenge an expert who fails to provide a basis for valuation adjustments and the magnitude of the adjustments presented in an analysis.

If counsel's valuation testifying expert has incorporated rational support for the valuation adjustments and the magnitude of valuation adjustments incorporated in his/her analysis, and it can be established that the opposing business valuation has not provided such support, the credibility and reliability of the analysis and opinion offered by counsel's expert may be enhanced.

Summary and Conclusion

Rendering a credible and supported business valuation opinion in a family law context requires the analyst to demonstrate that he/she possesses relevant and sufficient (1) education, (2) experience and (3) training, and that he/she has adhered to GAVP.

Counsel facing the task of challenging an opinion rendered by an opposing valuation testifying expert can collaborate with his/her own valuation testifying expert to develop deposition/cross-examination questions, responses to which can serve to:

1. inform counsel regarding the foundation for the opposing valuation testifying expert's analysis and opinion and weaknesses in the foundation that can be attacked and
2. establish support for key aspects of the analysis and opinion offered by his/her own valuation testifying expert.

This discussion identifies a business valuation "baker's dozen" of deposition/cross-examination questions that regularly can be considered by counsel when addressing the analysis and opinion offered by an opposing valuation testifying expert.

While counsel may have reservations about asking certain questions of experienced valuation analysts due to concerns regarding relative differences in valuation knowledge that favor the valuation analyst, the questions identified provide relevant information that typically is required in order to appropriately understand and challenge the opposing testifying expert's analysis and opinion.

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