Understanding the Appraisal Review Process

Lisa H. Tran and Irina V. Vrublevskaya

The review of another valuation analyst's family-law-related work product requires an understanding of generally accepted valuation practice, including relevant valuation standards and relevant judicial precedents. This discussion addresses (1) applicable standards to consider when completing an appraisal review, (2) the applicable standards to follow in a valuation engagement or a calculation engagement, and (3) some common inconsistencies or errors identified during an appraisal review.

Introduction

In many litigation cases, particularly in marital dissolution matters, a valuation analyst ("analyst") is often asked to review and critique the opposing analyst's analysis and opinions. The process of reviewing another analyst's report is not limited simply to identifying possible calculation errors in the analysis. The review of another analyst's work requires the reviewer to (1) adhere to applicable standards when conducting the appraisal review and (2) determine if the opposing analyst's work was developed consistent with generally accepted valuation practices and applicable standards.

This discussion will focus on the appraisal review process and the applicable standards analysts typically follow when completing such engagements.

The Appraisal Review

An appraisal review is the "process of developing and communicating an opinion about the quality of all or part of the work of another appraiser."[1] An appraisal review is intended to provide information to the intended users about the credibility of the work under review.

While litigation circumstances often drive the need for an appraisal review, the motivation for an appraisal review may be as simple as a client seeking a second opinion, or "comfort," regarding a valuation that has already been completed. Rather than hiring another analyst to complete a new valuation, it is typically easier and less costly to obtain a review opinion regarding the completeness, accuracy, and reasonableness of the first valuation.

"Stakeholders in the appraisal process look to a reviewer to provide them with assurance the opinion provided by a valuation analyst is reliable."[2] These stakeholders may include judges, legal counsel, clients, divorcing spouses, and regulatory bodies who may not have the theoretical or technical training in business valuation, but need to make significant decisions based on the acceptability of a valuation.

Applicable Standards for an Appraisal Review

When reviewing another analyst's work, the reviewer should follow the applicable professional standards for appraisal review, development, and reporting. These standards may include the following:

1. The Appraisal Foundation Uniform Standards of Professional Appraisal Practice (USPAP)
2. The Professional Standards promulgated by National Association of Certified Valuators and Analysts (NACVA)

3. The Statement on Standards for Valuation Services No. 1 (SSVS), promulgated by the American Institute of Certified Public Accountants (AICPA).

Uniform Standards of Professional Appraisal Practice

USPAP was developed by the Appraisal Standards Board of the Appraisal Foundation and is applicable for certain valuations.

USPAP Standard 3, Appraisal Review, Development, and Reporting[3] is directed toward developing a credible opinion of the quality of another analyst's work. It addresses the content and level of information required in a report to communicate the results of an appraisal review engagement. However, this standard does not dictate the form, format, or style of an appraisal review report. Standard 3 calls on the analyst to understand and correctly employ the methods and techniques necessary to produce a credible appraisal review.

According to USPAP Standard 3, in developing a review, the analyst should determine whether the analyses, opinions, and conclusions presented in the work under review are appropriate and credible within the context of the requirements applicable to that engagement. These requirements may include (1) the applicable standards for the engagement; (2) completeness, accuracy, and adequacy of the analysis; and (3) relevance and reasonableness of the analysis, given the regulations, or intended use, of the valuation work under review. The reviewer should provide a reasonable explanation for any disagreement with the work under review.

National Association of Certified Valuations and Analysts

Standard VI—Business Valuation Review of the Professional Standards[4] promulgated by NACVA are applicable to review engagements of appraisals where the subject interest is a business, business ownership interest, security, or intangible asset. Based on NACVA standards, a business valuation review is intended to determine the credibility of a valuation.

Based on NACVA standards, the reviewer must provide an opinion, and support for the opinion, regarding whether the valuation under review is appropriate and not misleading. The review opinion can be presented in either a written or an oral report. The reviewer should opine whether the valuation under review is appropriate within the context of the requirements applicable to that valuation. The reviewer should state the reason for any disagreement with the appraisal under review.

Based on NACVA standards, the scope of the review should be sufficient to provide a basis for rendering a credible review opinion "regarding the relevance, reliability, completeness, and reliable application of the business valuation methodology under review, and its consistency with generally accepted valuation practices."[5]

As a result, the reviewer needs to consider the completeness, reasonableness, and accuracy of the valuation under review in the context of applicable laws, regulations, and intended use requirements.

American Institute of Certified Public Accountants

SSVS[6] is binding with regard to business valuations performed by members of the American Institute of Certified Public Accountants. However, if an AICPA member performs a review engagement, but does not develop an independent value conclusion, SSVS is not applicable. SSVS does not cover review appraisal engagements and does not have a provision that corresponds to USPAP Standards Rule 3.

This means that an AICPA member may review the analysis, including, but not limited to, items such as sources, approaches and methods, mathematical issues, logical issues, consistency, or clarity issues, without following SSVS.

The AICPA member may provide corrected values resulting from the correction of any errors identified during the review process. However, "if the CPA also concludes that the corrected values represent the CPA's value conclusion, SSVS would apply."[7] SSVS also would apply if the CPA develops a value conclusion that is presented as his or her opinion of value.

Business Valuation Review Process

When conducting a business valuation review, the analyst should determine whether the work product under review provided a credible and reliable opinion of value that is consistent with generally accepted valuation practices as of the valuation date. Generally, valuation stakeholders base the credibility of a valuation, in part, on consideration of the inclusion of all known facts and circumstances.

Credibility is understood to relate to the connection between (1) the opinion of value and (2) the relevance, completeness, and application of generally accepted valuation methodology.

The elements of a credible opinion include, but are not limited to, the following:

1. Adequate disclosure
2. Completeness
3. Nonadvocacy
4. Relevance
5. Reliability
6. Transparency

The reviewer should consider whether the valuation under review presents or considers all material known facts and circumstances about the valuation process that was conducted. Further, the valuation report should include sufficient relevant disclosures that help stakeholders understand the foundation for the analyst's conclusions.

Did the analyst include and assess all facts and circumstances known without limitation or exclusion? Are the data, assumptions, and explanations in the valuation presented in sufficient detail for a reader to understand and duplicate the process? Are the assertions and estimates considered logical? Was the analyst objective in formulating his or her opinion? Does the particular standard, method, or procedure form a supportive basis for the analyst's opinion? Were the methods used appropriately applied?[8]

The analyst should consider whether the approaches and methods used in the valuation were relevant to the objective and purpose stated in the valuation. The reviewer's goal is to establish whether the analyst appropriately performed the analysis based on the requirements of the engagement, in terms of the stated purpose, standard of value, valuation date, intended use, and generally accepted valuation practices.

In applying this "credibility" framework, the reviewer can assess the valuation to determine if the valuation process undertaken resulted in a credible and reliable opinion of value. In the review process, the analyst develops an opinion regarding the appropriateness and credibility of the analyses, opinions, and conclusions within the context of the requirements applicable to the valuation.

The analyst also develops and identifies reasons for any disagreement with the valuation. When conducting a valuation review, the analyst should "identify and articulate the components of a valuation report that (1) require additional support, (2) are inherently inconsistent, (3) lack relevance to the purpose of the engagement, [and] (4) have an impact on credibility."[9]

A analyst may need to complete independent research and analysis to produce a credible appraisal review. Some of the review methods and techniques necessary to produce a credible review are presented below.

Valuation Review "Checklist"

The typical narrative valuation report contains a number of sections. These sections include the following:

- A description of the subject business interest and the effective valuation date
- The purpose and objective of the engagement
- The standard of value
- A description of the subject company and an analysis of historical and projected financial operating results
- A discussion of relevant industry and economic conditions
- A discussion of generally accepted valuation approaches and methods
- The selection and application of relevant valuation approaches and methods
- The value conclusion, including discussion of relevant valuation adjustments (e.g., control premium or discount for lack of control, discount for lack of marketability, blockage discount, key person discount)

Additionally, and consistent with most valuation standards, a typical valuation report includes information such as the analyst's credentials, assumptions and limiting conditions, and an analyst's certification or representation.

Based on the numerous components incorporated in a typical valuation report, a review "checklist" serves as a useful tool when the analyst is engaged to review a valuation report.

A review checklist helps the reviewer critically assess the validity of the report and reliability of the conclusions. It also helps the reviewer establish whether the report appropriately identifies and includes sufficient, accurate, and consistent discussion of the components of a valuation analysis and the related report.

The following list identifies the broad categories that the analyst can consider when reviewing a valuation report. The list is presented in a manner consistent with the order that a reviewer may expect to find the related information presented in a typical valuation report.

- Definition of the valuation assignment
  - Definition of the subject property/entity (including the size of the subject ownership interest)
  - Purpose and objective of the valuation
  - Standard of value
  - Characteristics of ownership (including control and marketability characteristics)
- Premise of value
- Effective date of the valuation and date of report
- Sources of information
  - Site inspection and interviews
  - Company financial statements
  - Information known or knowable as of the valuation date
  - Past transactions
- Description of the company
  - Capitalization and ownership
  - Company background and operations
- Economic and industry data and analysis
- Analysis and adjustment of company financial statements
- Comparative ratio analysis
- Income approach and methods
  - Discounted cash flow method
  - Capitalization of cash flow method
- Market approach and methods
  - Guideline publicly traded company method
  - Guideline merged and acquired company method
  - Backsolve method
- Asset-based approach and methods
  - Asset accumulation method
  - Adjusted net asset value method (capitalized excess earnings method)
- Valuation adjustments—discounts and premiums
- Synthesis and conclusion
  - Overall assessment
  - Comprehensiveness
  - Accuracy
  - Coherence and cohesion
  - Internal consistency
  - Incisiveness
- Signature of the analyst or the analyst's firm
- Analyst's curriculum vitae
- Analyst's certification or representation
- Contingent and/or limiting conditions or assumptions

Further, the valuation may include specific definitions of terms, formulas, and standards of value, as they may vary from one context to another. The valuation should be well documented and include sufficient information about the source materials considered. The valuation should be adequately documented so that another qualified analyst, in this case the reviewer, would be able to locate the identified source materials and replicate the analysis.

Chapter 19 of *Valuing a Business*[10] and Chapter 25 of the *The Lawyer's Business Valuation Handbook*[11] present checklists that can be considered for the purpose of reviewing a business valuation report. When using these checklists, it is important that the reviewer understands that not every item on these checklists will be applicable or relevant to every valuation engagement. Further, sometimes certain information can only be found in the original analyst's work papers or through a diligence interview with the original analyst.

Applicable Standards for a Valuation or a Calculation Engagement

One aspect of a valuation review assignment is establishing whether the valuation was developed consistent with applicable professional standards. The valuation should clearly state what professional standards were applied in the development of the opinion of value and the report. These may include standards presented in USPAP, SSVS, NACVA standards, or American Society of Appraisers (ASA) standards with regard to business valuation development and reporting.

The valuation may be either a valuation engagement or a calculation engagement. The format of the written report may be a (1) detailed report, (2) summary or restricted report, or (3) calculation report. The valuation report should identify the type of engagement and/or the type of report issued. The analyst reviewing the valuation should confirm that it is documented in a manner that complies with the professional standards applicable to the type of the engagement (valuation or calculation) and the format of the report.

In a valuation engagement, the analyst selects and uses the valuation approaches or methods deemed to be appropriate to arrive at a reasonable conclusion of value with regard to the subject interest. The conclusion of value resulting from a valuation analysis may be presented in a detailed report or a summary/restricted report.

A summary report presents the conclusion of value in a shortened, summarized version of a detailed report. The presentation of a valuation conclusion in a detailed report or a summary report typically is based on "the level of reporting detail agreed to by the analyst and the client."[12]

If the valuation is a valuation engagement, the following professional standards specific to a valuation engagement may apply:

- NACVA Professional Standards: II, General and Ethical Standards; III, Scope of Services (B)(1) Valuation Engagement; IV, Development Standards; and V, Reporting Standards (C)(1) Contents of Report for detailed reports and (C)(2) Contents of Report for summary reports
- SSVS Section .21(a); Sections .23 through .45, for valuation engagements; Sections .48 (a) and (b); Sections .51 through .70, for detailed valuation engagement reports; and Sections .71 and .72, for summary valuation engagement reports
- USPAP: Standard 9, Business Appraisal, Development, and Standard 10, Business Appraisal Reporting; specifically, Standard 10-2(a) for a detailed report and Standard 10-2(b) for a summary/restricted report
- ASA: BVS-I, General Requirements for Developing a Business Valuation, and BVS-VIII, Comprehensive Written Business Valuation Report

In a calculation engagement, the analyst and the client agree on the valuation approaches and methods to be used, and the extent of the procedures to be performed. A calculation engagement results in a calculation of value and is presented in a calculation report.

If the analysis is the product of a calculation engagement, the following professional standards specific to a calculation engagement may apply:

- NACVA Professional Standards: II, General and Ethical Standards; III, Scope of Services (B)(2) Calculation Engagement; IV, Development Standards; and V, Reporting Standards (C)(3) Contents of Report for calculation reports
- SSVS Section .21(b); Section .46, for calculation engagements; Section .48(c); and Section .73 through Section .77, for calculation reports

Neither USPAP nor ASA standards have an alternative to a valuation engagement, such as a calculation of value. The analyst may be required to follow USPAP in performing a valuation. In this case, the analyst should follow all applicable USPAP standards.

In addition to analyzing the valuation for accuracy or reasonableness, the analyst has the objective of establishing whether the valuation complies with applicable professional standards.

Computational Errors

Many errors committed in a business valuation engagement are the result of a lack of understanding regarding valuation principles or the improper application of valuation methods. However, a reviewer has the responsibility to establish that the work under review is complete and free of computational errors.

Computational or mathematical errors generally fall in the category of (1) mathematical calculation errors and (2) incorrect formulas. Based on the extensive use of computerized, linked worksheets to complete valuations, errors often result when worksheets are not properly linked or formulas are modified without verification.

Additional human errors occur simply as a result of inputting incorrect numbers retrieved from third-party source documents (e.g., subject company financial information or publicly obtained documents).

A thorough review includes the recalculation of amounts and values presented in the subject report, including (1) footing (summing vertically), (2) cross-footing (summing horizontally), (3) cross-referencing (confirming the consistency of amounts produced in multiple places), and (4) recalculating amounts and value indications presented in the attached exhibits and schedules.

Examples of measures that often are not presented consistently throughout a report include revenue, earnings, income tax rates, and outstanding debt amounts.

Application of Generally Accepted Business Valuation Principles

The specific methods and procedures applied to value a business will vary based on the facts and circumstances specific to each engagement.

However, the basic principles of business valuation generally remain consistent.

All other factors remaining constant, the use of generally accepted valuation practices and methods by multiple analysts should result in reasonably reconcilable conclusions of value for a subject interest. This, of course, assumes the same (1) subject interest, (2) definition of the assignment, (3) standard and premise of value, (4) valuation date, (5) access to the same subject company information, and (6) industry and economic conditions.

Consistent adherence to and application of generally accepted business valuation principles and procedures provides a reasonable expectation of consistency in an analyst's work product. This consistency enables a reviewer to complete the review process in an orderly manner, using applicable standards as a guide.

In many valuation reviews, the primary errors identified typically relate less to computational errors and more to inconsistencies in the application of business valuation principles. Below are examples of some common theoretical inconsistencies committed by analysts.

Common Inconsistencies and Errors

In using the discounted cash flow (DCF) method or the direct capitalization method, an analyst may mismatch the discount rate and the expected earnings. The discount rate should match conceptually to the definition of income being discounted. The analyst should use the weighted average cost of capital to discount net cash flow to invested capital investors (debt and equity stakeholders) and the equity discount rate to discount net cash flow to equity investors.

If the analyst does not understand that there are conceptual differences between the DCF method and the direct capitalization method, he or she may inappropriately implement the methods. The direct capitalization method is an abridged, or summary, of the DCF method. The direct capitalization method typically is the relevant valuation method within the income approach to value a company with stable growth. The DCF method typically is appropriate for valuing a company with high or erratic growth.

In the valuation of some closely held companies, an adjustment for executive compensation may be required. According to Internal Revenue Service Revenue Ruling 68-609, "If the business is a sole proprietorship or partnership, there should be deducted from the earnings of the business a reasonable amount for services performed by the owner

or partners engaged in the business." Shareholder employees of successful closely held companies sometimes pay themselves compensation in excess of indicated market-based compensation for services rendered. If compensation is not adjusted, the business value of the company may be understated.

In development-stage or unprofitable corporations, shareholder executives sometimes pay themselves below-market compensation. Failure to adjust compensation may result in a business value that is overstated as a result of the understated operating expenses and the resulting overstatement of earnings. In general, adjustments for compensation typically are made when valuing controlling ownership interests. This is because only the controlling shareholder has the ability to change such compensation.

Some privately held companies own assets that are not part of their operations. If nonoperating assets are given separate consideration, any income generated or expenses incurred with regard to the nonoperating assets should be separated from the earnings used to complete an income-based valuation method. Sometimes, an analyst may separate the nonoperating assets from the overall value of the business but maintain the income generated by the nonoperating assets in the earnings used to value the company, thereby artificially inflating the value conclusion.

Some analysts mistakenly believe that asset-based approach methods can be used only with a liquidation premise of value. The asset-based approach can be used with all premises of value—going concern or liquidation. Typically, the asset-based approach is most relevant when the subject company in an asset-intensive company (i.e., a real estate holding company or another form of holding company).

When applying the different valuation methods, it is important for an analyst to understand the level of value indication each method initially produces and whether the value indication represents a controlling or noncontrolling level of value. An income approach method can produce either a controlling or a noncontrolling indication of value depending on the earnings level or cash flow incorporated. The guideline publicly traded company method typically concludes a noncontrolling level of value, while the merged and acquired company method and asset-based methods typically concludes values on a controlling level.

When a valuation analysis reconciles the indications of value resulting from different valuation methods to arrive at a single concluded value, it is important that the value indications are reduced to a common basis—whether controlling or noncontrolling.

Sometimes, when completing a business valuation, it is tempting to use hindsight as direct evidence of value, and to consider events that occurred after the effective valuation date. The consideration of subsequent events and related information that was not known or knowable as of the effective valuation date, and that ultimately would affect the estimation of value as of the effective valuation date, is typically inconsistent with developing a relevant value opinion as of a specific date.

As stated in the *International Glossary of Business Valuation Terms*, and reproduced verbatim in SSVS, the "effective date," also referred to as the "valuation date" or the "appraisal date," is "the specific point in time as of which the valuator's opinion of value applies."[13] Within the valuation profession, achieving the appropriate valuation objective established in an engagement is contingent on consideration of information that is known or knowable as of the effective valuation date. However, certain valuation standards indicate that an analyst may consider a subsequent event (i.e., an event occurring after the effective valuation date) if the event was known or knowable as of the valuation date and if the event occurs within a reasonable time frame relative to the effective valuation date.

Reasonableness of Assumptions and Conclusions

In conducting an appraisal review, the analyst should consider the reasonableness and appropriateness of the assumptions, adjustments, and conclusions made in the appraisal. For example, is it reasonable to apply the average or median guideline company multiples to the fundamentals of the subject company for the purpose of estimating a value?

Simply relying on the average or median guideline company multiples without performing comparative analysis between the subject company and the guideline companies implies that the subject company is identical to the guideline companies. It is rare that a subject company and the guideline companies are identical based on their financial characteristics.

Another area where the analyst can easily err is in the estimation of the expected income used in the direct capitalization method. Sometimes, an analyst will simply rely on the average of historical financial results to estimate expected earnings. Income approach methods are forward looking, but sometimes, the future simply is not a repetition of past performance.

By (1) completing a thorough review of the subject company's past operating results and (2) considering prospective operating results for the subject company in light of expected industry and economic conditions, an analyst establishes a solid foundation for estimating a normalized income level for the subject company.

After a value for the subject company has been estimated, an analyst can test the reasonableness of the value conclusion by reviewing the implied range of values derived from the various valuation methods employed. If properly applied and based on reasonable assumptions, the valuation methods used ideally produce a narrowly dispersed range of values for the subject company. If the different valuation approaches and methods used result in materially different value indications, the consideration, review, and potential modification of key assumptions incorporated in the valuation process probably may be warranted.

Another method often used to test the reasonableness of a value conclusion is to calculate certain implied valuation, or pricing, multiples. The pricing multiples for the subject company implied by the value conclusion should compare reasonably to similar pricing multiples for the guideline companies.

Observed differences among the implied pricing multiples for the subject company and the guideline companies should be rationalized. For example, identified differences in size, profitability, and growth among the subject company and the guideline companies are reasonable grounds for differences in pricing multiples.

Preparing a Valuation Review Report

A valuation review report communicates the results of the review. According to NACVA standards, the reviewer's findings and conclusions should be stated in the form of an opinion. According to NACVA Standard VII and USPAP Standard 3, when developing a valuation review and a written or oral valuation review report, the analyst should identify (1) the client or intended user, (2) the intended use of the opinion, (3) the purpose of the appraisal review, (4) the work under review and the characteristics of that work (ownership interest, valuation date, the original analyst, etc.), (5) any extraordinary assumptions and hypothetical conditions necessary in the review, and (6) the scope of work necessary to produce a review in accordance with the scope of work rule.

The analyst also should identify the characteristics of the property or market area in the work under review.

The review report content and level of information should be specific to the needs of the client and the intended users, the intended use, and the requirements applicable to the engagement. The reporting requirements in USPAP Standard 3 represent the minimum level of information for an appraisal review report. The analyst should supplement the report with information sufficient enough for the intended users to understand the report properly and not be misled. Such additional information may include the disclosure of research and analyses performed and not performed.

Once the analyst has identified sufficient information regarding the work under review and the research and analyses performed, he or she should state his or her opinion and conclusions about the work under review, including the basis for the opinion offered. In stating his or her opinion, the analyst should include the reasons for any disagreement with the work under review.

Typically, a business valuation review does not entail the completion of a valuation and is not construed as an opinion of value or a calculation of value. A business valuation review is not intended to provide a second opinion of value. However, certain review engagements may request that the analyst develops an opinion of value. If the analyst develops an opinion of value or review opinion regarding the subject of the review, all applicable professional standards relevant to the issuance of an opinion will apply.

Conclusion

Many business valuation errors can be avoided if valuation standards and principles are properly implemented when completing the valuation. The improper or inconsistent application of generally accepted valuation practices can lead to unreasonable value conclusions, causing the client to seek the review and evaluation of a business valuation work product.

A valuation review involves the reviewer (1) following applicable standards in conducting the appraisal review and (2) determining if the opposing analyst's work was developed consistent with generally accepted valuation practice, including applicable valuation standards. As a result, it is important for the reviewer to understand the valuation review process and relevant standards in order to effectively serve a client and the court in litigation settings, such as a marital dissolution context.

Notes:

1. Francisco Rosillo, "A New Perspective on Business Appraisal Review," *Valuation Strategies* (January/February 2011).
2. Ibid.
3. Standard 3 in *2016-2017 Uniform Standards of Professional Appraisal Practice* (Washington, D.C.: The Appraisal Foundation, 2016).
4. Statement on Standards for Valuation Services No. 1, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset,* VS Sec. 100 (New York: American Institute of Certified Public Accountants, 2007), Standard VI.
5. Ibid., Standard VI (B).
6. Ibid.
7. *Companion to PPC's Guide to Business Valuations* (Fort Worth, TX: Thomas Reuters, 2010).
8. Rosillo, "A New Perspective on Business Appraisal Review."
9. Ibid.
10. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, *Valuing a Business*, 4th ed. "Reviewing a Business Valuation Report" (Chapter 19) (New York: McGraw-Hill, 2000), 453–475.
11. Shannon P. Pratt, "Chapter 25—Checklist for Reviewing a Business Valuation Report," *Business Valuation Review* 28, no. 2 (Summer 2009): 100–119.
12. SSVS, VS Sec. 100, Section .48(b).
13. Ibid., International Glossary of Business Valuations Terms.

Lisa Tran is a vice president and the financial accounting valuation services practice leader in our Portland, Oregon, practice office. Lisa can be reached at (503) 243-7510 or at lhtran@willamette.com.

Irina Vrublevskaya is a manager in our Portland, Oregon, practice office. Irina can be reached at (503) 243-7504 or at ivborushko@willamette.com.