

*Summer 2017*

## **How to Prepare a Critique of a Valuation Report in a Litigation Setting**

A recent ASA “webinar” has described how to prepare a critique of another business valuation practitioner’s report in the context of litigation. Conducted by an experienced appraiser, the session explored the review concept incorporated in USPAP. A comparison was made with requirements of ASA and to a limited degree, the AICPA<sup>1</sup>. The learning objectives included the purpose and objective of issuing a critique or review report; a survey of its key elements; the requirements set forth by the valuing societies in reviewing a report; and examples of the language typically used.

A review report covering another practitioner’s appraisal report is described by USPAP Standard Rule No. 3. The Ethics Committee issued guidance regarding compliance with USPAP’s jurisdictional rule. USPAP requires that a review report be either an Appraisal Report or a Restricted Use report - the latter being generally restricted by use to one client. There are no exception to reporting other than the jurisdictional exception rule [i.e. when the court specifies the contents of the report.] However, “instructions from the client or attorney do not establish a jurisdictional exception.” The ASA’s procedural guidelines defines the expert as one who is qualified by knowledge, skill, experience, training or education in performing business valuation services and/or related financial analyses. The same guidelines address both BV and the quantification of damages. The the report must include: the identity of the client, description of the assignment, effective dates, intended use, document limitations, methodology, analysis, assumptions, report date and exhibits. Work papers are generally retained by the appraiser for 5 years, or 2 years after the matter is settled.

In 1987, USPAP established the first guidelines for enforcement of the quality of appraisals of real property in connection with federally supervised bank loans. All appraisal organization/societies eventually became members of USPAP and, even though many have nothing to do with real estate, they adopted the USPAP standards. When in 2006 the Dodd Frank Act became law, real estate regulations tightened and appraisal reviews became mandatory for real estate lenders.

USPAP defines an appraisal as the act or process of developing an opinion of value of, say, a business interest. Appraisal Review is the act or process of developing and communicating an opinion about the quality of another appraiser’s work performed as part of an appraisal. The scope of work is the type or extent of research and analysis in an appraisal or appraisal review assignment. The ASA defines valuation as the act or process of

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<sup>1</sup> The AICPA’s Statement on Standards for Valuation Services No. 1 does provide a litigation exception, in contrast with the ASA or USPAP.

determining the value of a business interest, security or intangible asset, i.e. the definition is comparable with what USPAP calls an appraisal. A Limited appraisal is an estimate as to the value of a business interest; it excludes some procedures required by an appraisal. A calculation is a an approximate indication of value of a business interest based on the performance of limited procedures agreed upon by the appraiser and the client.

Correspondingly, the ASA BV Standard describes an Appraisal as the act or process of determining the value of a business interest, security or intangible asset. The objective is to express an unambiguous opinion of value supported by procedures deemed relevant by the appraiser. The objective of a limited appraisal is to express an estimate of value. Development excludes some procedures which are required in an appraisal. A calculation's objective is to provide an approximate indication of value based on performance of limited procedures agreed upon by the appraiser and client.

Historically, USPAP had "departure rules" until 2006, when they were replaced with the scope of work rule. However, the scope of work could not be so limited that results are not credible and must be appropriate for the intended use. Calculation or limited appraisal can be in compliance with USPAP, but USPAP puts responsibility on the appraiser to decide what is appropriate.

Generally, the appraiser is qualified to critique an appraisal report based on his/her skills, knowledge, experience and training. Federal Rues of Evidence 702 states that " a witness who is qualified as an expert by knowledge, skill, experience, training or education may testify in the form of an opinion."

USPAP Standards Rule 3 states that "in developing an appraisal review assignment, an appraiser must identify the problem to be solved, determine the scope of work necessary to solve the problem, and correctly complete research and analyses necessary to produce a credible appraisal review. In reporting the results of an appraisal review assignment, the reviewing appraiser must communicate each analysis, opinion and conclusion in a manner that is not misleading." Standards Rule 3-2 states that the report must indicate whether or not the reviewer will develop his/her own opinion of value, or merely comment on the quality of the work performed by the original appraiser. If the review report includes the reviewer's own opinion of value, the requirements of USPAP Standards 9 and others apply; otherwise, only Standard 3 applies. Standards rule 3-3 c indicates that the scope of work of a review assignment may not be the same used by the original appraiser. In particular, the reviewer is not obligated to duplicate the procedures used by the original appraiser, particularly those deemed credible by the reviewer. Those deemed not credible must be replaced with information or analyses developed in conformity with USPAP Standards 3, 9 and others, if other disciplines are involved, so as to produce credible results.

Generally, in developing an appraisal, an appraiser must:

- identify the client and other intended users;
- identify the intended use of the appraiser's opinions and conclusions;
- Identify the standard and definition of value and the premise of value;
- Identify the effective date of the appraisal;
- Identify the characteristics of the subject property that are relevant to the standard and definition of value and intended use of the appraisal;

- Identify any extraordinary assumptions necessary to the assignment;
- Identify any hypothetical conditions necessary in the assignment;
- Determine the scope of work necessary to produce credible assignment results in accordance with the scope of work rule.

Both Extraordinary Assumptions [AE] and Hypothetical Conditions [HC] must in all instances be conspicuously noted. An AE assumes as fact otherwise uncertain but likely information about physical, legal or economic characteristics; or about conditions external to the subject property, such as market conditions; or about the integrity of data used in the analysis. An HC is a condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist, but is used for analytical purposes.

USPAP also issues Advisory Opinions in order to explain with example how the standards apply; those covering appraisal review include AO-20 and 28. The latter requires that appraisers must be ready to demonstrate that their scope of work is sufficient to produce credible results.

Typical language used in appraisal reviews with no reviewer's opinion of value include:

"The value opinion stated in the appraisal value is not adequately supported."

"The value conclusion is not appropriate or not reasonably given the data and analyses presented."

"The value opinion was not developed in compliance with applicable standards and requirements."

"I reject the value conclusion as lacking credibility due to errors and/or inconsistencies found."

"The value conclusion is not appropriate due to a significant math error. If calculated properly, the value conclusion would change to \$---. This solely represents a recalculation and not a different opinion of value by the reviewer."

If the reviewer includes his/her value conclusion, then typical language becomes:

"I do not concur/disagree with the value."

"In my opinion, the value is incorrect and should be \$---."

"In my opinion, the value is too high/low."

The requirements of USPAP Standards Rule 3 include:

The identity of client and intended users; intended use and purpose of the appraisal review; identify work under review and date, date of opinions and appraiser who did the work; scope of work used for the review; reviewer's opinion and conclusions and reasons for disagreement.

The reviewer must: state which opinion or analysis of the original appraisal is deemed accepted as credible; summarize any additional information relied on and reasoning for the reviewer's opinion of value; clearly state all extraordinary assumptions and hypothetical conditions connected with the reviewer's opinion and whether their use might have effected the assignment results; include a signed certification and a statement of qualifications to demonstrate the reviewer's competency to perform the review.

## **Duff & Phelps expert speaks on forensic work in the valuation of Buy-Outs**

Forensic analysis is not just about uncovering fraud, according to an expert designated both as a forensic examiner and a business appraiser. The issues were discussed during an interview conducted by an attorney known for his interest in buy-outs and “business divorces.” Although some of the work involved in valuation for buy-out litigation may be termed forensic in nature, and thus may occasionally call for a specialist for assistance, in practice the assignment would typically require the forensic skills generally ascribed to an experienced business appraiser. In the area of requested information, the appraiser could, in addition to financial statements and tax returns, “drill down” and, should there be any open issue, also ask for a trial balance, general ledger and specific company account details or even credit card or bank statements. Even tax returns, which by definition follow uniform governmental rules, occasionally require more information to substantiate, particularly as one of the parties to the litigation has control of the data. This is largely governed by experience, and an understanding of how accounting records are prepared. “Normalization” entries by an appraiser must generally be supported by scientific or at least logically applied inquiries in such common instances as a controlling owner taking too much - or too little - in the way of compensation. This generally is done in comparison with industry norms. The attorney’s blog can be found at <http://www.soundcloud.com/businessdivorcetroundtable>

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**J.L. Pierson, ASA is an experienced business appraiser who supports the NY, NJ and CT business communities from his base in Darien, CT. His clients are closely-held businesses with revenues of up to \$300 million in all industries, as well as owners of family limited partnerships/LLCs, professional corporations and their advisors. He specializes in business valuation for estate/gift tax, succession planning, sale/purchase and litigation such as shareholder and corporate disputes and divorce, corporate development and transactional support purposes. This newsletter is generated internally to reflect key development in BV which may affect users.**

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**J.L. PIERSON, ASA  
368 Heights Road # 2392  
Darien, CT 06820**

**<http://www.NYNJCT-BV.COM>  
(203) 325-2703  
(203) 434-4648**

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**(203) 325-2703 (203) 434-4648**