

Financial Valuation *and* Litigation Expert

IEWS AND TOOLS FROM LEADING EXPERTS ON VALUATION, FORENSIC/FRAUD AND LITIGATION SERVICES



Editor's Outlook

Jim Hitchner

jhitchner@valuationproducts.com

Happy New Year! I hope you had a wonderful holiday season, filled with joy and even a little rest!

We're kicking off this issue with some interesting (dare I say "amazing"?) excerpts from the court cases of Carole S. Gailor, Esq. After reading her white paper, I was eager to share some of these anecdotes with our readers, and I thank Ms. Gailor for generously allowing me to do so! Any of you who testify as expert witnesses will undoubtedly recognize some of the dilemmas presented here. Hopefully, you will learn how to avoid some of these common pitfalls as well.

Don Wisheart brings us the brouhaha of what he has cleverly dubbed the "battle of the betas." Don witnessed the lively exchange of ideas on total beta, the total cost of equity, and the Butler Pinkerton calculator that transpired at the recent American Society of Appraisers (ASA) Boston conference. He brings us the highlights of the debate among Dr. Christopher Tofallis, Peter Butler, Larry Kasper, Dr. Aswath Damodaran and Roger Grabowski.

Next Mike Mard takes a look at the "methodology and techniques long accepted by real estate appraisers" and questions the inconsistency between these techniques and fair value for financial reporting.

Continued on next page

CROSS-EXAMINATION *A View from the "Other" Side*

The following discussion and cross-examination excerpts are from the actual cases of Carole S. Gailor, Esq., with Gailor, Wallis & Hunt, PLLC, in Raleigh, NC. Ms. Gailor and her firm specialize in marital dissolution cases and, as you will see, she is very knowledgeable in the area of valuation. She has written a paper titled, "So You Think We Don't Check? Surviving Cross Examination of the Appraisal Expert."© This discussion and these excerpts are taken (with permission) from Ms. Gailor's paper with edits.

We are sure you will find some of these excerpts funny, some scary, and all highly educational. Some of us who testify learned the hard way; we hope this article allows you to learn the easy way.

Ms. Gailor: The skill of lawyers in cross-examination of business valuation experts is increasing as their knowledge and understanding of business valuation methodologies and standards continues to expand. Many lawyers are fully capable of reading, understanding and deconstructing a business valuation report for purposes of cross-examination.

As a business appraiser who performs business valuation for litigated cases, you must be aware that every element of your analysis, every piece of data on which you rely in forming a conclusion of value, and the application of your selected methodologies will be scrutinized and analyzed for errors, inconsistencies or failure to conform to the applicable professional standards. Your appraisal report will be checked and rechecked, every piece of data will be chased down and verified, every source will be confirmed, and your resume will be thoroughly reviewed for veracity. Lawyers look not only for significant errors, but for the accumulation of small mistakes that cumulatively damage credibility— "death by a thousand cuts." The purpose of this manuscript is to:

- discuss areas of business appraisal where errors are likely to occur
- learn how to avoid or minimize errors or areas of vulnerability in preparing your business valuation report
- help you to think like the lawyer who will be cross-examining you.

Continued on page three

EXPERTS in this Issue

Jim Hitchner Editor's Outlook	1
Don Wisheart on Battle of the Betas	13
Mike Mard on Fair Value and Real Estate	16

Darrell Dorrell on Forensic Accounting	18
Court Case <i>Black vs. Commissioner</i>	20
Panel of Experts	22
Cost of Capital Corner	24

Financial Valuation and Litigation Expert

Publisher Valuation Products & Services
Editor in Chief James R. Hitchner, CPA/ABV/CFF, ASA
Managing Editor Karen Warner, M.A., Valuation Products & Services
Director of Operations Cully Burnet, M.A., Valuation Products & Services

PANEL OF EXPERTS

Mel H. Abraham, CPA/ABV, CVA, ASA	Mel H. Abraham
R. James Alerding, CPA/ABV, ASA, CVA	Clifton Gunderson, LLP
Terry Allen, CPA/ABV, ASA	The Financial Valuation Group
Steve Babitsky, JD	SEAK, Inc.
Don Barbo, CPA/ABV	Deloitte Financial Advisory Services, LLP
Neil Beaton, CPA/ABV, ASA, CFA	Grant Thornton, LLP
Bruce B. Bingham, FASA	Capstone Valuation Services, LLC
Kristopher A. Boushie, CPA/ABV, CVA	Quantus Consulting LLC
Stephen J. Bravo, CPA/ABV, ASA, CBA, MST, CFP, PFS	Apogee Business Valuations
Rod P. Burkert, CPA/ABV, CVA, MBA	Burkert Valuation Advisors, LLC
Thomas F. Burrage, CPA/ABV/CFF, CVA, DABFA	Burrage & Johnson, CPAs, LLC
Stacy P. Collins, CPA/ABV, CFF	Financial Research Associates
Larry R. Cook, CPA/ABV, CBA, CDFA	Larry R. Cook & Associates, PC
Michael A. Crain, CPA/ABV, ASA, CFA, CFE	The Financial Valuation Group
Mark O. Dietrich, CPA/ABV, MBA, MST	Dietrich & Wilson, PC
Darrell D. Dorrell, CPA/ABV, MBA, ASA, CVA, CMA, DABFA	Financial Forensics
Robert E. Duffy, CPA/ABV, CFA, ASA	Grant Thornton, LLP
Edward J. Dupke, CPA/ABV/CFF, ASA	Clifton Gunderson, LLP
Nancy J. Fannon, CPA/ABV, ASA, MCBA	Fannon Valuation Group
Jay E. Fishman, FASA	Financial Research Associates
Carla G. Glass, CFA, FASA	Hill Schwartz Spilker Keller, LLC
Robert P. Gray, CPA/ABV, CFE	Parente Randolph, LLC
Robert J. Grossman, CPA/ABV, ASA, CVA, CBA, MST	Grossman Yanak & Ford, LLP
Chris Hamilton, CPA, CFE, CVA, DABFA	Arxis Financial, Inc.
J. Michael Hill Sr., FASA, CBA	Hill Schwartz Spilker Keller, LLC
J. Michael Hill Jr., ASA, CPA/ABV	Hill Schwartz Spilker Keller, LLC
Thomas E. Hillton, MS, CPA/ABV/CFF, ASA, CVA	Anders Minkler & Diehl, LLP
James R. Hitchner, CPA/ABV/CFF, ASA	Financial Valuation Advisors, LLC
Steven Hyden, CPA/ABV, ASA, CM&AA	The Financial Valuation Group
Michael G. Kaplan, CPA, CVA, CFFA	Michael G. Kaplan
Mark G. Kucik, CPA, CVA, CM&AA	Kucik Valuation Group, LLC
Eva M. Lang, CPA/ABV, ASA	The Financial Consulting Group
M. Mark Lee, CFA	Eisner LLP
Howard J. Lewis, AVA	Institute of Business Appraisers
Derald L. Lyons, MT, CPA, CVA	Lyons & Seacrest, PC
Michael J. Mard, CPA/ABV, ASA	The Financial Valuation Group
L. Gail Markham, CPA/ABV, CVA, CFP	Markham Norton Mosteller Wright & Co., PA
Harold Martin Jr., CPA/ABV, CFF, ASA, CFE, MBA	Keiter, Stephens, Hurst, Gary & Shreaves, PC
Gilbert E. Matthews, CFA	Sutter Securities Incorporated
Z. Christopher Mercer, ASA, CFA	Mercer Capital
Dr. Shannon P. Pratt, FASA, MCBA, CFA, CM&AA	Shannon Pratt Valuations
William C. Quackenbush, ASA, CBA	Advent Advisors, LLC
James S. Rigby Jr., CPA/ABV, ASA	In Memorium (1946-2009)
Scott R. Saltzman, CPA, CVA, ASA, CFFA	Saltzman, LLC
Ronald L. Seigneur, CPA/ABV, ASA, MBA, CVA	Seigneur Gustafson, LLP
John J. Stockdale, ASA, CPA/ABV	John J. Stockdale
Robin Taylor, CPA/ABV, CFE, CVA, CBA	Dixon Hughes, PLLC
Gary R. Trugman, CPA/ABV, MCBA, ASA, MVS	Trugman Valuation Associates
Linda B. Trugman, CPA/ABV, MCBA, ASA, MBA	Trugman Valuation Associates
Stacey D. Udell, CPA/ABV/CFF, ASA, CVA	Gold Social Gerstein, LLC
Daniel R. Van Vleet, ASA, CBA	Stout Risius Ross
Richard M. Wise, FASA, MCBA, CVA, FCA, FCBV, CA/IFA, CFE	Wise, Blackman LLP
Donald P. Wisheart, ASA, CPA/ABV, CVA, MST	Wisheart, Inc.
Kevin Yeanoplos, CPA/ABV/CFF, ASA	Brueggeman and Johnson Yeanoplos, P.C.

EDITOR'S OUTLOOK, continued

Making his debut on our Panel of Experts, Darrell Dorrell poses the question, "Are you a forensic accountant?" To help you answer that question, Darrell helps you to identify the skills that are attributed to a forensic accountant and details the seven steps to help you along if you are journeying to become one.

Chris Treharne rounds out the issue with a new court case regarding estate and gift tax. As always, we conclude with "Cost of Capital Corner."

VPS/FCG STRAIGHTtalk Series

No bias. No agenda. No nonsense.

An exciting new webinar...

Hitchner Valuation Update II

What's NEW, What's GOOD and
What's IMPORTANT

January 14, 2010

1:00 pm - 3:00 pm (EST)

(Noon Central, 11:00 am Mountain, and 10:00 am Pacific)

JAMES R. HITCHNER, CPA/ABV/CFF, ASA

Managing Director, Financial Valuation Advisors

CEO, Valuation Products and Services

President, The Financial Consulting Group

Editor and Coauthor, *Financial Valuation Applications and Models*, 2nd edition

Coauthor, *Financial Valuation Workbook*, 2nd edition

Editor in Chief, *Financial Valuation and Litigation Expert*

Jim will wade through the constant barrage of information and reduce the frustration of keeping up. He will save you scores of hours and free you up for profitable, billable work.

CLICK HERE NOW FOR DETAILS OR TO REGISTER

Although the information in this journal has been obtained from sources that Valuation Products & Services, LC, believes to be reliable, we do not guarantee its accuracy, and such information may be condensed or incomplete. This journal is intended for information purposes only, and it is not intended as financial, investment, legal, or consulting advice. Valuation Products and Services, LC, disclaims all responsibility for its content.

While the authors have used their best efforts in preparing these articles, they make no representations or warranties with respect to their applications to a particular assignment. Each financial analyst should analyze his/her own situation carefully in determining the appropriate use of data and information. Each author's views and opinions are his/her own, and the other authors may agree or disagree with the articles presented here.

© Copyright 2009, Valuation Products and Services (VPS). All rights reserved. This journal may not be reproduced in whole or in part without the express written permission of VPS.

BRIEF AND NON-INFORMATIVE REPORT SECTIONS

In the following excerpt, the company valued by the appraiser was a grading construction company. The appraiser (who had free access to the business owners) was deposed concerning the report's brief and non-informative statement concerning the company's customers, competition and labor force, which is set out as follows:

Report Excerpt:

Customers

The Company provides services to public and private commercial owners located primarily in the vicinity of Durham, NC. Its contracts are awarded using either the bidding process or negotiation. However, the Company is subject to competitive prices even in the negotiation process.

Employees

The combined companies employ approximately 30 people, including operators and administrative personnel.

(by Ms. Gailor)

Q. Now, the totality of information you report with respect to the customers of the company is that the company provides services to public and private commercial owners located primarily in the vicinity of Durham, NC, correct?

A. That's the first sentence, yes.

Q. That's all you say about the nature of the customers, correct?

A. Correct.

Q. One sentence about the company's customers?

A. Correct.

Q. Is it your contention that the one sentence in your report about the company's customers is sufficient discussion to meet the requirements of USPAP?

A. I think I've met the basic requirements of USPAP.

Q. To say only that the company provides services to public and private commercial owners?

A. Yes.

Q. That's it, that's all you have to say and you think you have met the requirements of USPAP?

A. I think so.

Q. What does a reader of the appraisal or a potential buyer of Smith Grading learn about the company's customers from reading your report?



A. Well, the reader would—would learn that the customers are primarily commercial customers including concentration of this work is primarily around Durham, NC. And what would be critical is that it would be private commercial owners; there's not a lot of residential work being done by the company.

Q. Does it say anything about what the percentage of work is between public and private?

A. No.

Q. Is that important?

A. Well, it— it may vary. So it's—

Q. Are the customers of the company predominantly new customers or repeat customers?

A. Well, there's a little of both.

Q. Where does it say that in the report?

A. It doesn't say that.

Q. Why not?

A. It doesn't state that...

Q. For those companies for which Mr. Smith is on limited bid lists, are any of those repeat customers of his?

A. Yes.

Q. So it sounds like he may have repeat customer work as opposed to all new customers. Is that correct?

A. I think he has some. That's my understanding.

Q. Don't you think knowledge of repeat business would be material and relevant for a potential buyer or reader of this report to know?

A. I'd say it could be.

Continued on next page

Q. If you gave some thought that this information might be relevant and material to a potential buyer or reader of the report, why didn't you include it?

A. Well, I didn't think it was that material...

Q. Name three of the company's most frequent general contractor customers for which the company works?

A. I don't have that information.

Q. Don't you think it would be relevant to a potential buyer or a reader of the report as to who Smith Grading's most frequent customers are?

A. I think it could be useful information.

Q. Well, why didn't you include it in the report?

A. Well, I didn't think it was necessary for one thing. And I— I was also aware, you know, that those factors would— would not affect what the ultimate value was of the business.

Q. So you agree that the information would be useful to a potential buyer, right?

A. I think it would be useful.

Q. But you didn't include it in the report?

A. Correct.

Q. Don't you think that a reader of the report or potential buyer would want to know if Smith Grading were doing DOT work and how much on the average?

A. Well, here again, that might be useful information.

Q. If it's useful information, why didn't you include it in your appraisal?

A. I didn't consider it that material.

Q. You didn't include it in your work file, either, did you?

A. No.

Q. You didn't include any information on Smith Grading's most frequent customers in your work file, did you?

A. No.

Q. Who are Smith Grading's three primary competitors?

A. They would primarily be the -- the grading companies that are in the Raleigh-Durham area.

Q. I'm asking you who are Mr. Smith's three main competitors?

A. I— I couldn't give you the names.

Q. Did you ask Mr. Smith?

A. I believe so.

Q. What did he tell you?

A. I forgot.

Q. Did you write it down?

A. No.

Q. And you forgot it?

A. Yes.

Q. You didn't put it in your work file in a note when he told you?

A. No.

Q. Do you not think it would be relevant information to include in your appraisal for purposes of the reader of the report or a potential buyer to know who Mr. Smith's three main competitors are in the area?

A. I think I should disclose that.

Q. But you did not?

A. I didn't.

Q. In your report, under "Employees," you say, "The combined companies employ approximately 30 people including operators and administrative personnel," correct?

A. Correct.

Q. What are the "combined companies?"

A. I don't recall why I've got it written that way. I'm only valuing one company. So I— I don't know. I can't answer that question. I'm just aware of one company. [This error arose from the expert's use of valuation software and failure to remove old data from the template he used].

Q. Then why does it say "combined companies"?

A. I— I can't answer that question.

Q. Is that an error?

A. It— it may be. I just don't recall if there's another reason I would have worded it that way.

Q. Well, if you were a reader of this report and under "History and Nature of the Business" you read that there were "combined companies," would you think that there was another entity out there?

A. I would at least question that, yes.

Q. You can't tell me sitting here whether there is another company or whether it's an error. Is that right?

A. No, I cannot.

Continued on next page

EQUIVOCATIONS (HEDGE WORDS) AND OVERSTATEMENTS

Use of hedge words or overstatement by an expert not only provides fertile ground for cross-examination but also can undermine the credibility of the expert and the confidence the finder of fact will have in the opinion. Examples of such words are: *about, probable, likely, feasible, plausible, apparently* or *appears, can reasonably believe, it is not unreasonable to believe, it can be argued, or arguably, on average, or for the most part*. All of these words imply hesitation to voice a firm, well-supported opinion and the perception of a less empirical basis for the information and conclusions in the report. The words *substantial* or *substantially*, and *significantly* are not only hedge words, they are overstatements designed to emphasize, without content. The following are some examples from actual valuation reports:

- (i) "Current risk-free rate. This is measured as the yield to maturity on long term U. S. Treasury bonds, which was about 6.5 percent as of the valuation date."
- (ii) "The local franchise appears to fund their own promotions and advertising without assistance from national corporate."
- (iii) "It can be argued that because a small, closely held company is not easily sold, a discount should be applied..."
- (iv) The selected data shows that, on average, Mr. Smith was paid well in excess of fair market compensation. Therefore adjustments to officer's compensation are required and the adjusted fair market compensation should be substantially less than what Mr. Smith was paid historically.

In the case which is the source for quote (iv) above, the expert was attempting to justify as reasonable, a compensation figure less than the actual compensation paid to the officer/shareholder.

(by Ms. Gailor)

- Q. Define "substantially" less.
- A. (Pause)..... A lot less.
- Q. Generally, in terms of percentages, when you use the phrase "substantially less" what do you mean?
- A. I don't know how to answer that.
- Q. Well, try.
- A. (No response)
- Q. Do you generally understand "substantially" less to be

- 10 percent less, 20 percent less, 50 percent less or a greater amount?
- A. It depends on the case.
- Q. You did not have an understanding of the term *substantially* when you prepared your report?
- A. Of course I did!
- Q. All right. Then define "substantially" as you used it in your report?
- A. The word means "a lot more."
- Q. Did you find it difficult to be reasonably precise in your choice of the words and phrases you utilized in your report?
- A. Business valuation is not "reasonably precise" (snappy retort by expert using fingers to show "quotation marks" around the words "reasonably precise.")
- Q. Then your proposed reduction in reasonable compensation is not "reasonably precise" is it...

PLAGIARISM

Astounding as it may seem, expert witnesses sometimes plagiarize material from other authors and sources, implicitly adopting the work as their own. In one case while attempting to locate the valuation resources that supported the expert's discussion of control premiums, the search not only located the rather obscure source, but also revealed that the expert's "analysis" regarding the control premium was plagiarized and adopted by the expert as his own. Contact with the author, an economist, revealed that he had not given permission for his published materials to be used without attribution. Discovery of the plagiarism completely discredited the opposing expert and forced opposing counsel to concede that his expert's valuation critique was compromised. As a result, opposing counsel's negotiating position was substantially weakened, as the value of the business interest was the single largest asset of the marriage. In addition, the plagiarism was a violation of applicable ethical standards. All of this would have made fertile ground for cross-examination if opposing counsel had not wisely stipulated to the other expert's value when confronted with the facts prior to trial. Obviously, another strategy would be to spring the plagiarism issue at trial. The results would undoubtedly be difficult to explain away.

In another case, the following cross-examination occurred of an expert who cited to what he contended were business valuation authorities without attributing the material to his actual source: *Valuing Small Businesses and Professional Practices* (2nd ed. 1993, by Shannon Pratt, Robert Reilly and Robert Schweih, McGraw Hill, which was outdated [3rd edition out] as of the valuation date.

Continued on next page

(by Ms. Gailor)

Q. In your report, you cite to— I think it's page 11— a text by Paul B. Baron, *When You Buy or Sell a Company*. It appears to have been published in 1986, correct?

A. Correct.

Q. With respect to the statement you attribute to Mr. Baron, which says (quoting the report), "Paul Baron, veteran business broker suggested that figure [debt service on acquisition debt] should not be more than 30 to 50 percent of the after-tax cash flow," that's a direct quote from Shannon Pratt's book, is it not?

A. I believe so.

Q. How come it's not in quotation marks?

A. It should be.

Q. Should be, shouldn't it?

A. Mistake.

Q. And similarly the next sentence (quoting the report), "Walter Jurek advocates allocating 50 percent of the net cash flow to servicing after debt..." is another direct quote from Mr. Pratt's book, is it not?

A. I would have to see. You may be right. That's correct.

Q. Why isn't it in quotes?

A. Should be.

Q. Was it a mistake?

A. Yes, ma'am.

Q. You adopt as your own statement, Mr. Pratt's statement that "Paul Baron's a veteran business broker..." and footnote to the book he [Mr. Baron] wrote in 1986. Was he still a "veteran business broker" in 2002 or 2003?

A. I can't answer that question. I don't know.

Q. Why did you call him a "veteran business broker?" Maybe he's not even working anymore?

A. He could be. I don't know.

Q. Did you check?

A. No.

Q. Did you try to find him on the Internet to see if he was still viable?

A. No.

Q. Did you do the same with Walter Jurek?

A. No.

Q. Do you know what Mr. Baron's or Mr. Jurek's credentials are?

A. No.

Q. Do you know whether either one of them has any credentials of any kind?

A. I do not.

Q. Do you know what their reputation was in the business valuation community as of the time you wrote your report?

A. No, I do not.

Q. Mr. Baron's book was written in 1986. Do you know whether or not that book has been revised or updated since 1986?

A. I do not.

Q. Do you know whether it's still in print?

A. I do not.

Q. I'm going to show you a document, which has been collectively marked as Exhibit No. 15 and ask if you can identify that, please?

A. Yes, this is our CEIR Economic Research along with an e-mail confirming that we're able to use their entire report in our engagement as long as we attribute to them in a bibliography or a footnote.

Q. All right. What did you do with that information that you have there in your report from CEIR?

A. We took a lot of this information and put it in our economic report.

Q. And did you put it verbatim or did you put it in— did you synthesize the information and put it in?

A. Some of the information is verbatim and some of it is synthesized.

Q. Okay. On pages 8 through 15 of your report, tell me which is verbatim and thus would have an attribution or quotation marks?

A. Well, again, based on our agreement we did not— our understanding was that we did not need to report it with quotation marks and footnotes as long as we attributed it to them in the bibliography.

Q. Okay. Well, tell me which parts are quoted and which aren't...

Q. Do you know what plagiarism is?

A. I do.

Q. What does it mean?

A. Plagiarism is when you use somebody's work word for word and you don't give them credit for it.

Continued on next page

- Q. Trying to pass it off as your own work?
A. Right.
- Q. Okay. So we agree on the definition. And as a professional, you agree, certainly, that it's appropriate to write attribution to the author of the material that you're copying rather than present it as your own?
A. Correct.
- Q. And there's clearly, in your report as to the interest rate section on pages 9 and 10 of the 2005 report, there are no quotation marks?
A. That is correct. And we would amend our report to include that. If I may keep a copy of this?
- Q. And then look at page 2 on the *Economic Outlook*, look at section 1.2 and tell me if that first paragraph is not a quote from the *Economic Outlook Update*.
A. Uh-huh. It certainly looks like it.
- Q. Okay. Except there is an error. It was incorrectly quoted. If you look on the fourth sentence of your report of that paragraph number 1, it says that, "The third quarter figure was the highest growth rate since the 4.3 increase in the fourth quarter of 2005"; correct? That's what your report says.
A. It is, that's correct.
- Q. And that's erroneous?
A. That's correct.
- Q. Because the *Economic Outlook Update* says that it was the highest growth rate since 2004?
A. I think that was a typo.
- Q. Not only was it plagiarized, it was plagiarized incorrectly; correct?
A. Correct.
- Q. All right. Then go to the next section at the bottom of the page 10 on your report on stock markets.
A. Uh-huh.
- Q. And in the *Economic Outlook Update* go to section seven and tell me if— isn't it true that the entire paragraph on stock markets is copied verbatim from the first paragraph of the section captioned, Stock Markets, in the *Economic Outlook Update*?
A. It looks substantially the same.
- Q. It's not substantially the same, it's identical.
A. It's the same. Okay.
- Q. Okay. You agree? It's identical? Do you want to read it?

- A. As I say, it looks substantially the same, so I'll agree that it's identical.
- Q. You will agree that it's identical. All right. If you'll turn to the next page -- it really starts at the bottom where it says, employment, on page 10 and then there's two paragraphs in the employment section. If you'll turn to section five on the *Economic Outlook Update*. Are you with me?
A. Yeah.
- Q. And I'll ask if you'll agree that the entire section on employment in your report on pages 10 and 11 is copied verbatim from the first two paragraphs of section five of the *Economic Outlook Update*?
A. Yes.
- Q. You agree that they're identical?
A. I do.
- Q. You agree that it's plagiarized?
A. I agree that they're identical.
- Q. Do you agree that it was plagiarized?
A. As I say, I am still in shock and I will agree in that they are identical and that we did not footnote them.
- Q. And it's plagiarized. By your definition and understanding of what plagiarism means, it's plagiarized material, isn't it?
A. Yes.
- Q. All right. Now, are there any other plagiarized materials in this report?
A. Again, not to my knowledge. And I'm sure you're going to show me something.

This cross-examination illustrates the reason why all sources and authorities footnoted by the expert or cited as a resource should be obtained and checked against direct quotations, as well as the general text of the report. Further, an expert's general discussion of a topic, such as the three approaches to valuation and various methodologies within those approaches, or a general discussion of premiums and discounts, is hardly ever wholly original. You may find that the expert's discussions will closely parallel the discussion in a published text, treatise, article or even continuing education materials. In several instances, IBA and NACVA course materials have been cited by an expert without attribution. This makes it important to tailor the request for production of documents at deposition to include all written materials (texts, treatises, articles, periodicals, on-line materials, etc.) reviewed, considered or otherwise contributing to the opinions stated in the valuation report.

Continued on next page

REPORT MISTAKES

One of the first things a lawyer wants to have an opposing business valuation expert testify to is his commitment to his valuation report in form and substance. This line of questioning should establish that the expert thoroughly reviewed the report both prior to submission and before testifying and knew others would rely on the report as being correct. The result from this line of questioning is: (1) an expert who commits to his or her report without hesitancy; or (2) an expert who is on guard, wary that an error in the report was missed when reviewed, who qualifies his answers much as the expert did in the following examination. If there are mistakes in an appraiser's report, whether in form or substance, the expert who is totally committed to his report will be embarrassed when he is forced to admit the mistakes. The expert who equivocates, loses credibility from the start. This line of questioning, in the case represented by the excerpt below, sets up the expert for a later series of forced admission of multiple errors.

(by Ms. Gailor)

Q. Do you want to make any changes at this time, either substantively or in format or anything else to your report?

A. Not that I am aware of.

Q. So no changes?

A. That's correct.

Q. You are committed to and comfortable with the form and substance of your report?

A. Yes.

Q. Is your report accurate in all respects?

A. To the best of my knowledge.

Q. Did you check the report for accuracy before you submitted it to plaintiff's counsel?

A. Yes ma'am.

Q. Proofed it?

A. To the best of my ability, yes.

Q. Do you believe that it is important for a business appraisal or critique to be free of errors, typographical or otherwise?

A. Yes ma'am.

Q. And you obviously reviewed your report for form and substance before appearing here today?

A. I reviewed it several times.

Q. And are you satisfied with it in form and substance?

A. Obviously. I wouldn't issue it if I believed there were some substantive errors.

(The expert's tone was sarcastic at this point).

The expert in the excerpt above had made multiple errors and omissions in his report - substantive, typographical and otherwise. The following is one of the end results of the cross-examination of this expert with regard to one of the several errors, after setting up his commitment to his report in the beginning of the examination.

(by Ms. Gailor) (Error in Use of Pricing Multiple)

Q. You state in the last paragraph that the "seller financing in two transactions would have reduced the pricing multiple and the value under this method (Merged and Acquired) by 5.5 percent," correct?

A. Um-hmm.

Q. My question is what "value" are you referring to when you make that statement?

A. (pause).....it sounds like such a simple question and I am trying to understand where you are going?

Q. This isn't a trick question.

A. This would have reduced the BizComps pricing multiples and the derived value of [the Company] about 5.5 percent.

Q. Ok. So you're talking about Mr. Jones's [wife's appraiser] value of [the Company] would have been reduced by 5.5 percent? Is that what you are stating?

A. The pricing multiples.

Q. Well, in your report you say "pricing multiples" and "value." It implies you reduced the pricing multiples and the value by 5.5 percent. (emphasis added)

A. Well, let me look at something here. (Witness reviews documents) Okay, now I know where you are going.

Q. I am not going anywhere. I am just asking you what you meant.

A. I understand what you are asking me then. What I did in my calculations is I reduced the entire net value [of the Company as that value was determined by the wife's appraiser]. I should have reduced the pricing multiples by 5.5 percent.

Q. Instead of reducing the value of the Company by 5.5 percent, correct?

A. That's correct.

Q. You made a mistake?

A. I did.

Q. Why did you make that mistake?

A. I can't answer that question.

Continued on next page

Q. It's basic methodology, isn't it?

A. I should have discounted the multiples....

CREATIVE BUT UNSUPPORTABLE METHODS AND TECHNIQUES - RULES OF THUMB

The ever-popular "rule of thumb" is not a valuation method. It is a single multiple, typically of unknown origin, applied to earnings, cash flow, revenues or some other indicia of a company's financial condition. The source of a rule of thumb is nearly always anecdotal. Rules of thumb are almost universally regarded by authorities in the field as guesswork, speculative, unreliable calculations of value. Experts who use a rule of thumb attempt to justify and legitimize it as a valuation "method" under the market approach. While few experts will use a rule of thumb as a primary valuation method, it is utilized more often to corroborate or justify the conclusion of value reached by a primary valuation method. Cross-examination typically reveals that a rule of thumb has little, if any, basis in fact or reality. Two or three inquiries will typically result in such a wide range of "industry" multiples that the multiples are meaningless. Thus, if the application of the primary valuation methodology is incorrect, the value or range of value produced by application of the selected rule of thumb multiple will not validate or justify anything. The following excerpt is a cross-examination of an expert who relied heavily on a rule of thumb.

(by Ms. Gailor)

Q. Can you define the term rule of thumb in the valuation context?

A. It's sort of a generalized— typically they're multiples of easily derived numbers. They're not indicators of value. A lot of times brokers use them, and not doing a formal valuation, but in trying to get an indication of value or a range of values.

Q. You cite as a reference to a book called *The Handbook of Small Business Valuation Formulas and Rules of Thumb*, third edition by Glenn Desmond, correct?

A. Yes, that's correct.

Q. What's this book about?

A. That book, in addition to several like that, are books that are used by brokers and business appraisers that list rules of thumb for different businesses in different industries.

Q. In your opinion, is Mr. Desmond an authority on valuation formulas and rules of thumb?

A. I -- I think -- yes, I think his book would be considered authoritative, yes.

Q. Do you know how he defines rule of thumb?

A. No, I do not.

Q. Do you agree with his statement that rules of thumb are typically expressed as multipliers of gross revenues, operating income, or some other factor?

A. Yes, I would agree with that.

Q. Do you agree with his statement "formula valuations or rules of thumb are not substitutes for careful consideration of other appropriate valuation methods that are applicable to the business being appraised?"

A. Yes, I do agree with that.

Q. Isn't it true that small businesses, to which valuation formulas and rules of thumb apply, are typically those with net revenues at a range of \$100,000 to \$3,000,000?

A. I don't know that I have any knowledge of that in order to answer yes or no.

Q. Please look at page 18 of Mr. Desmond's book. Do you agree that this is the book that you said is authoritative regarding rules of thumb?

A. Yes.

Q. Under the heading, "Concepts, Terms and Definitions," would you read what Mr. Desmond says about the application of rules of thumb to small businesses?

A. He says, "Small businesses, to which valuation formulas and rules of thumb multipliers apply, are typically those with net revenues in a range of \$100,000 to \$3,000,000."

Q. Turning to page 6 of your report, does this show a chart summarizing income and expenses of Arbor Financial in the years 1995 through 2000?

A. Yes, it does.

Q. Can you tell me what the net revenues are for Arbor Financial from 1995 to 2000?

A. Oh. For 1995, is 8.871 million. For 1996, 9.566 million. For 1997, 10.539 million. 1998 is 10.214 million. 1999 is 11.618 million. And according to the 2000 draft financials, the total revenues are 15.415 million.

Q. So it's obviously fair to say that the net revenue of AF between 1995 and 2000 far exceeded the \$100,000 to \$3,000,000 range spoken of by Mr. Desmond?

A. Yes. I don't think they would be considered a small business.

Q. Do you agree that formula multipliers offer easy calculation, but obscure the details?

A. Yes, I agree with that.

Continued on next page

Q. Do you agree that net revenue multipliers are particularly troublesome because they are blind to the business's expense and profit history?

A. If he's speaking of net revenue multipliers as a rule of thumb, yes, I would agree with that.

Q. Are you familiar with the article, which is entitled, "The Problem with Rules of Thumb in the Valuation of Closely Held Entities," by Jay Fishman?

A. Yes.

Q. Did you read this article before you authored your report of Arbor Financial?

A. No, I did not.

Q. Do you agree that rules of thumb or industry formulas are a variation on the direct market comparison approach?

A. I never really thought of it in that manner. I don't know. I mean, I just...

Q. Do you agree with the statement that the single multiple or percentage must be derived from an adequate information base?

A. Yes, I would agree with that.

Q. Do you agree that the transactions from which the rule of thumb was derived must involve reasonably similar businesses?

A. Yes, I would agree with that.

Q. If the terms of the deal were not 100 percent cash on the date of sale, but were subject to earn-outs or contingencies such as meeting revenue targets, the value of the deal might be less than its face value, is that correct?

A. The cash value of the deal may be less than the face value, yes.

Q. If Company A was purchased for a million dollars in cash, what's the value of the deal?

A. A million dollars.

Q. If Company B is purchased for a million dollars to be paid over ten years at increments of \$100,000 a year with no interest, is the value of the deal different than the value of Company A's deal?

A. Yes, it is.

Q. Would you agree that the present value of a million dollars paid over 10 years is less than a million dollars today in cash?

A. Yes, I would.

Q. And would you agree, then, that it's important to know the terms pursuant to which the purchase price of the business would be paid?

A. Yes.

Q. Do you agree that one of the problems with rules of thumb is that they assume a typical entity?

A. Yes, and that's why they're not used as a method of valuation.

Q. Would you agree that because the user of a rule of thumb lacks knowledge of the actual transaction, that distortions can occur due to differences in profitability or capital structure or management or other considerations?

A. Yes.

Q. Are you aware of the positions of Messrs. Pratt, Fishman, Griffith and Wilson in *The Guide to Business Valuations* regarding the use of rules of thumb?

A. I'm not specifically familiar with their position, no.

Q. Please turn to Exhibit 29B. Can you identify this document?

A. It's pages 749 and 750, which are Chapter 7 of *The Guide to Business Valuations*, 12th edition.

Q. Now, looking at Section 707 on page 749, the following statement is made by the authors: "Limitations of using rules of thumb include insufficient data to derive a proper multiple: Consultants may not be able to identify specific transactions or obtain enough guideline company data to derive a multiple. Also, there may not be enough information on the actual terms of sale. For example, there may be favorable financing terms on some guideline companies, which may require adjustment." Do you agree with that statement?

A. I agree with that statement in the context of attempting to use rule of thumb as a method of valuation.

Q. Do you agree with the statement that says, "Difficulty in defining a typical business from which to make adjustments. A rule of thumb is assumed to apply to the valuation of a typical business. Obviously, no typical businesses exist. Thus, rules of thumb will always contain some degree of error"?

A. I agree with that statement in using rules of thumb as a method of valuation.

Q. Would you turn to Exhibit 29C and identify this document?

A. It's pages 303 and 304 from a book called *Valuing Small Businesses and Professional Practices*, second edition.

Q. And the authors are?

A. Pratt, Reilly and Schweih.

Continued on next page



Q. You have previously acknowledged them as authorities in the field of business valuation?

A. Yes, I do.

Q. Starting at page 303 at the bottom, which starts with "Reliance on Rules of Thumb....?"

A. Yes.

Q. Do you agree with the statement that rules of thumb are "dumb, greatly oversimplified and highly unreliable?"

A. The statement's too broad for me to agree or disagree with it. It would have to have more—I'd need more information, what context you're talking about.

Q. Do you agree with the statement relative to rules of thumb that "simplicity is often achieved at considerable loss of realism?"

A. Again, I think the question's too broad to—for me to give an answer to.

Q. Do you have any authority for the proposition that rule of thumb multipliers should be used as a means of valuing a business or applying a sanity check to a business whose revenue is between \$8 and \$15 million dollars?

A. I don't think that there is any authoritative source that would state those specific parameters.

Q. On page 2 of Defendant's Exhibit 29(A), do you agree with the statement made by Mr. Fishman that says, "Since most industry formulas or rules of thumb are derived from textbooks, trade publications, representations or other similar sources of information, they are poor substitutes for the direct market comparison approach?"

A. I would—yes, I would agree that rules of thumb are not a substitute for the direct market comparison approach.

Q. Did you check the *Business Reference Guide, 2001*, to determine whether there was a rule of thumb published for investment management firms?

A. Yes, I did.

Q. Did you find one in the 2001 guide?

A. No, I did not.

Q. Would you turn to page 416, I think, of that book?
(Witness complies)

Q. Would you agree with the statement at the bottom of page 416 that says, "A rule of thumb is a homemade recipe for making a guess. It is an easy to remember guide that falls somewhere between a mathematical

formula and a shot in the dark."

A. I think that statement is a little inflammatory for my tastes, but I do agree with the concept that the rule of thumb is a guide and that it's not an indicator of value, but would provide a range of values.

Q. In your December 14, 1999, valuation, can you document a single publicized source of the multiple of three to five times assets under management that you quote on page 8?

A. I had conversations with Mr. Roberts for one. He said three to five times revenue.

Q. And who is Mr. Roberts?

A. Bob Roberts, who is a principal with Roberts Financial Advisors.

Q. My question is can you document a single publicized source of the multiple of three to five times assets under management that you quote on page 8?

(Witness is silent)

Q. You say in your report that, "Many analysts quote a price to assets under management of 3.5 based on 1999 transactions in this market," correct?

A. Correct.

Q. Who are the many analysts that you are talking about?

A. I don't know the specific names of the many analysts...

Editor's note: First off, I want to thank Carole Gailor for allowing us to publish excerpts from her well done presentation on cross-examination of valuation experts. Ms. Gailor is a very good and respected attorney, and, as you have just seen, she clearly has enough sound knowledge about valuation to really be dangerous. Whether they like it or not, valuation analysts who work in the litigation area know that it is an advocacy system of justice for the attorneys. It is the attorney's job to probe for possible weaknesses and attempt to reduce the credibility of an expert. The best defense against this is for the expert to be prepared and to tell the truth. We hope that Ms. Gailor's shared experience presented here helps you to do just that.