

Mary Vandenack provides the transcript from Legal Visionaries podcast on Navigating Valuation Pitfalls: Insights from the Experts

TRANSCRIPT:

Mary: On today's episode, my guests are Evan Levine and Nainesh Shah. Evan is a founding partner of Complete Advisors, which is a New York valuation and an advisory firm responsible for business development. Evan has 33 years of experience advising business owners on various financial and planning matters. Nainesh is a founding partner of Complete Advisors and heads the valuation department. He is a CFA, CVA, and serves on the National Association of Valuation Analyst Board. Nainesh specializes in valuing unique and complex entities and assets for gift, estate tax, and charitable planning. I asked Evan and Nainesh to participate in today's episode to discuss a topic titled, Common Errors in Valuation Reports. We have done a couple other episodes that are on the website for the podcast. And most recently, we've talked about value in the unique and complex assets, which was a really fun podcast and I'm looking forward to today's podcast. Thanks for joining me today.

Nainesh: Thank you, Mary. Always pleasure to be on your podcast.

Evan: Great to be back. Thank you, Mary. And thank you for all you do.

Mary: And so, let's talk about some of the most frequent errors that you have encountered in valuation reports.

Nainesh: Evan, do you want to start?

Evan: I'll let you start. If you don't mind.

Nainesh: I think in simplest form, Mary, the errors occur or gets included in the report because valuator is too aggressive or they get swayed by client, which shouldn't happen, but sometimes it does. And that creates errors or mistakes or challenges that IRS can... That comes across from IRS. But in a more specific way, errors can be connected with mistakes with the calculation or mistakes in understanding the discount rate that should be applied. And we can go into a lot more detail on others, but there are multiple places that error occurs.

Mary: And I'm just going to throw out something that I do when I'm working on a valuation is, you do try and engage the client, but not in a way that they're trying to sway you, that you get the proper information so that you have...because I think one of the next areas that I was going to ask you about is proper due diligence and data gathering. If that's not done right, that can lead to flawed valuation reports. Is that fair?

Nainesh: Absolutely.

Mary: And what are your thoughts on that?

Nainesh: If you are missing data, if you don't grasp the data, simple thing is we all had difficulty with COVID and visiting the business or facilities that we are trying to value. But that sometimes is necessary depending on type of business. And I tell clients and others, is there are three components to the report. Valuation monies, gathering the data. So that's what you're talking about. And then analyzing the data and then writing the report. But gathering the data is a crucial factor and sometimes whether clients don't have it or their data system is not good enough, they resist to give you data. All of that slips into your valuation analysis, which can be flawed.

Mary: So, let's talk about valuing assets. And there's two broad categories, both have a lot of subcategories. And that's tangible assets and intangible assets. But let's talk a little bit about the most common errors or challenges in valuing these two categories.

Nainesh: So, a tangible asset, there are business valuers and then there are hard asset valuers. So, you can think about real estate appraiser or a jewelry appraiser or some fine art appraiser. So, when you're thinking about tangible assets which are not connected with a business, you have to bring in the experts because I'm definitely not qualified to value realistic. And so, we always think about bringing in an expert for whatever need that may be. And when you think about intangible asset, think again, what you're trying to figure out is what is it worth? So, it can be brand name or just some patent or something similar. And then you have to think in terms of how to value it. Does it get valued in a typical income approach or do you have to tweak that and figure out what else you need to think about in terms of valuing? If it is an ongoing business, usually what happens...and let me give you example. There are cases that you might have come across, but timberland, I've seen a couple of cases about valuation of a

timberland. So, timberland itself is an asset, but if it is an ongoing business, would you value the income stream or do you value the asset? And IRS have taken position that asset is the value and judges have taken position in favor of clients saying you should be using income stream too value and that the difference can be wide.

Mary: So, I'm just going to ask a follow-up question on that. So, when we talk about the timberland example, then let's say we have judges saying you must value the business as a stream of revenue, that income. Even if the real estate were worth more, if all those trees got knocked down and something was built on it?

Nainesh: So, I think the logic is what is expected of that business. If the timberland is in the family for the last 150 years and there is no indication that they're ready to sell, then I think judges make a good point that if there is expectation that nobody is going to sell this property, but not worth much other than the income stream. But if that is an indication from whatever, that there is a potential for this to sell, then the tangible asset should come into play.

Mary: And I think that almost goes back to something that Evan mentioned in another episode that we did, which is the IRS revenue procedure 59-60 that talks about what fair market value is considered. And so, if we're valuing a property that is a business and it happens to be on some land, we're valuing the business. As opposed to looking at the real estate and valuing it for its highest and best use, which would be a different issue if we're valuing the real estate and saying is its highest and best use to be timberland or is its highest and best use and that becomes pretty important. I know I've made arguments in the estate tax world where somebody tried to value it at highest and best use when there was no intent for it to be used that way. So, it's a significant difference that I think is important.

Nainesh: It's a good point, Mary and you have seen multiple cases in favor of the clients taking a position that we are not going to sell this.

Mary: So, in your experience, what are some of the key factors that contribute to the inaccuracies we've been discussing in valuation reports and how can you address or avoid them?

Evan: Well, I could start with one, Nainesh, if that's okay?

Nainesh: Sure, please.

Evan: I think a key factor that contributes to errors and Nainesh, correct me if I'm wrong, is hastening the turnaround time. So, I have learned in my personal and business life when I've made mistakes, looking back on those mistakes, almost always, if not always, the mistakes occurred because something was rushed. And something that we run into a thorn in our side as practitioners is clients oftentimes want it fast or faster than we're comfortable doing it. And we had a conversation recently with an advisor, an attorney who advises the owners of professional sports teams, baseball, football teams and so forth. And he said, he tells them all the time over and over that valuation work can be done either good or fast. It can't be both. So, I think as simplistic as it sounds, one contributing factor to mistakes in valuation reports is when they're rushed. It takes time. It could take 15 weeks, 18 weeks or more if it's complex to do the proper type of report.

Mary: And one of the challenges with that is those of us practicing particularly in the estate and gift tax realm, is we might be trying to make gifts by a certain timeframe and the value might change by the time it gets done and we're trying to pin a certain date. Without going into the strategies today, there's a lot of ways to deal with that because it is important that the valuation be accurate and correct, so as opposed to getting caught up in the time. Now, when you're dealing with a sales transaction, there's a little different type of pressure than the estate and gift tax, but there are still strategies to resolve it.

Nainesh: Yeah, and then to be more specific in terms of where the error gets slips in is a mismatch. So, if your benefit stream includes taxes and your discount rate doesn't include tax, then there's a mismatch. So, valuator and the person who's reading the report has to be aware that there are no mismatches that happens in the report.

Mary: So really important thing in my experience is finding the right valuation expert. And I've learned that they really vary in terms of skillsets, types of assets, things like that. So, when somebody's looking for a valuation expert, what do they need to think about?

Nainesh: What is their specialty? So, some valuers are focused on say, healthcare space, and there are a lot of nuances to understanding government payment and contracts and that type of thing. Some valuers

are just focused on intellectual property, some are focused on names and the value of a name. The broad space of valuation that is connected with complexity. So, you need to make sure, as a legal expert who's advising a client, that you are connecting with the right valuation expert. A lot of valuation specialists might be dealing with just simple businesses. It's nothing wrong with it and you can and it's necessary and required, but when there's a complexity, you need to find the right expert.

Mary: Are there specific industries or types of assets? And you mentioned that there might be experts in the healthcare space, and I assume maybe there's experts in the crypto space, et cetera. But is there a certain industries or types of assets where assets occur more commonly than others?

Nainesh: That's a good question, Mary. And I haven't given a lot of thoughts that I would think more so than error, where would two different valuers value their valuation comes out with a wide range. And wherever there is a challenge on clearly defining the benefit stream, challenge of understanding the underlying risks and challenge of defining the structure of an instrument or entity, you will see a wide range and you can call it an error, or you can call it...can you support your logic, your idea properly? So, I would say most of where there's a complexity, you'll see a lot of differences.

Mary: So, in another episode that we did, we talked about the importance of a narrative in a valuation process. And I'm assuming that's one measure that can be taken to help mitigate the issue that you're talking about. Are there others?

Nainesh: Yeah, so in terms of the error, the error can be you're not supporting your report with enough information. So, you need to make sure that you have the right footnotes. You need to make sure that there are appendixes that's connected with that and exhibits, proper exhibits. As a valuator, what you should be thinking about is can someone with a similar knowledge replicate my work using this report? And if they can't, then there's something wrong with your report. And as a reader of a report, that's what you should be thinking about. Does this report make sense and is it supported well enough? So that's where the error can slip in is, yes, I might have a logic. The value of the company can be say, \$50 million and my logic can be, this is a discount rate, this is the benefit stream, this is

cashflow, whatever. If I'm not supporting that with enough information, then it's in my mind and not in the report.

Mary: So, what I tell my associates is that when they write a legal recommendation that my client, even though not a legal expert, should be able to understand what they're recommending and why. And I think that's what you're saying about valuation reports. A novice who is not an expert in valuation should be able to understand the business, the data that was used to come up with the valuation and the process that was used for the valuation. Is that fair?

Nainesh: Absolutely. Because you're not writing this, you are writing it for someone to read this. It could be IRS agent or someone else. And going beyond, and maybe I'm repeating this, but can someone with a similar knowledge replicate your work with the data provided in that document?

Mary: And this is a follow-up question, but it's not uncommon for legal disputes to arise concerning valuation reports. So, what strategies can be used to defend a report's conclusions?

Nainesh: Maybe continuing on our thoughts from earlier question. Say you are in front of a judge, and you are a witness as a valuator, and you're trying to defend your valuation. And the attorney on the other side is going to challenge you on every single thing. And if your report is not supported properly and you cannot defend and your narrative is not cohesive, judge is going to question you. So, you want to bring in a person on the stand who would be able to defend most of the things that is in the report, all of the things. Going back to... I keep thinking about that Michael Jackson case. In the end, what happened in that case is IRS didn't really get what they wanted. And the challenge was the witness they brought as a valuator couldn't answer a lot of questions and the authenticity or credibility was not established.

Mary: So this goes back to Evan's earlier point of not rushing a report because you want a report that's well done, well-supported, well written, easy to follow, and easy to defend. And the time that goes into that and doing it right really does matter. Let's talk about collaboration of professionals in this process, whether it's in preparation of the report or litigation. How can the professionals involved work together to support a valuation?

Nainesh: Yeah, I think we work with attorneys all the time and usually we have a good access to clients. So, one thing that you want to make sure is as a team, you have good access to the information. The second point would be once the valuation report is done, I think the legal experts should read it, make sure that it's well done. Or sometimes what happens, even small things. If it is not signed in multiple places, that can be a question. Is the ID number of a valuator in the report? That could be a question. What standard does it follow? Is it clearly specified? All of this, all the small things can accumulate on avenues...

Evan: I was going to say also qualifications of the appraiser is another requirement that came up in a case recently.

Nainesh: Yeah, and so as a team accessing the data, analyzing it, doing it in time. Of course, time is a factor because everybody's looking for...do certain things in a certain timeframe, but still we make sure that the final copy of report is well done. Somebody else has to be aware and read it and make sure that it's done.

Mary: And I personally, when I'm involved, I like to read the report and have some discussion afterwards in terms of just how the structure works.

Nainesh: Yeah. We usually do a draft meeting. That would be a good thing for...I don't know if that's a normal for a lot of the valutors do that. Draft meetings can have a client and an attorney in it, and then we can discuss and if there are any questions that can arise because of that.

Mary: Right. And if I'm the attorney involved and let's say it's Form 706, I'm going to file a federal estate tax return or a gift tax return. I want to be able to explain that report to an auditor if I get audited.

Nainesh: Right and we are seeing that there are more and more audits in the valuation. Probably you are seeing that too. But IRS is trying to go after the valuation reports.

Mary: They've been attacking valuation for a very long time. They've been finding some ways to do it more effectively and we have a lower number. Currently, federal state tax returns and federal gift tax returns. And they have a team that is specialized in that. So, we are seeing that currently. Well, let's talk a little bit about a really hot, current topic, which is artificial intelligence. And I'll share that I was just at a meeting with some advisors to

the Internal Revenue Service and we were discussing the one guy had run. You always have the top scams in the top areas that are being looked at by the IRS, and we were using ChatGPT in this particular case and asked the question, "What are the top things the IRS are looking at?" and keeping in mind that ChatGPT currently is only trained through 2021, but we got a list of some really interesting stuff. And you're probably familiar with the case where a brief was filed in court recently by a lawyer, and that's a challenge with the whole generative artificial intelligence. There's uses that are great for it and there's uses that you should...three letter word run, R-U-N, not use it for, right? How's the artificial intelligence impacting valuations?

Nainesh: It's a really good question. So, the more complex and more unique work is less and less artificial intelligence can help. By the way, what you were talking about earlier about this case and legal brief with a lot of errors, that's something technically called hallucination when the AI gives you wrong information. I think there is a room for AI in report writing currently. It can help you put your thoughts together quickly, but I think it will be long... we are long way from artificial intelligence to write most of the report. And as you mentioned, so many errors, you have to be careful. So, I would avoid relying on it. Will we be there 10, 20, 50 years from now? I would think so. I don't think Evan would agree with me. Evan, do you have any thoughts?

Evan: Well, I think it's man or woman plus machine is going to be the winning model. It's going to be the machine or the computer or the intelligence assisting the human. There'll always be room for humans when it comes to creative and complex projects. And then of course, the narrative and the storytelling and the empathy and all these things. So, there's a place for it, but we'll see how it goes...

Mary: I think it's person plus AI is correct, and those who learn to harness it are going to have a significant advantage. But I've just given an example in preparing for this podcast today. I did review these and put a couple questions through like, what question should I ask a potential advisor who I'm asking to value, and I used a certain type of company, and I got a pretty good responses. And then I asked what considerations should I consider in valuing a international cosmeceutical company? And I got a pretty good list of at least some considerations. So, I think in solving the blank page problem is what I've heard is a great use for it.

Nainesh: Yeah, I totally agree with that. And then if you flip the question. So, I can see a good model can take the whole valuation report and read it quickly and then tell you, "These are the five errors that I see as a AI," that can happen faster than AI writing the full report. So, let's see how it plays out.

Mary: Yeah, I do like that idea. I have to say that, as you know, I write and speak a lot. So, I've been taking my presentations and articles and uploading them to have them reviewed. And like sad to say that I get a lot of good recommendations to improve my work. All right. Well, let's ask the last question. It's really important. So legal professionals, it's really important to prevent. I'm big about planning and prevention as opposed to being in litigation. And there will always be plenty of work for my litigator friends, but I prefer not to be the one who's making that happen for them. So, for those of us who are on the planning end trying to help clients avoid going through the litigation process, what can we do to help prevent or address valuation report areas before they end up in litigation?

Nainesh: As I always say, you need to make sure that you are working with a right valuation analyst who understands the space or the entity or the business that needs to be valued. But even after that, I would wish that more attorneys take time to read the report and ask questions if necessary. And over time, you become a team and you understand each other's strength and weaknesses, and that can help. So, avoiding litigation should be the criteria. Why would you want to give a chance to get your report challenged? Too much work involving that. And also, don't be aggressive. So, if you talk about errors, one error could be what is the discount that you are taking for lack of marketability? What is the discount that you're taking for the lack of control? And is it well-supported? So those are some of the simple things that IRS will look at. If your number, if discount for lack of marketability or discount for lack of control starts with three in the front, you are going to get challenged,

Evan: Right. And then of course, it takes three or maybe more to tango. The valuation professional, the attorney or the CPA. And then like Nainesh said at the beginning, the client sharing the data. If there's no data, there's no report. Right, Nainesh? If they're not going to share enough information, then we can never get to the finish line.

Nainesh: Yeah.

Evan: Correct me if I'm wrong.

Nainesh: And you've seen it. We see clients who hesitate, who don't want to give information for whatever reason. Their motivation can be many reasons, but we didn't continue. We just...at standstill.

Evan: We had an inquiry recently about a company that was looking... Or an attorney that needed their client's company valued, and they had a subsidiary in Beijing. And they said about a third of the documents are in Mandarin. Is that going to be a problem? And I had the initial conversation with the client, and I said to Nainesh, a third of the documents are in Mandarin. Is that a problem? And Nainesh said, "The language itself is not a problem. We have software that could interpret those documents. The question again is, are we going to get the information that we need? If we don't get the information, if we don't get the data, no report. So, they have to be willing to share and be open and transparent to get the job done."

Mary: So, I think the point about one collaboration to team is really important. And I would mention on the professional aspect of my system. So, my background is finance, economics, and accounting. So, I do read the reports myself. There are attorneys working on these projects who might not have that background, but that's where you can find consulting attorneys who aren't interested in taking on your client but would be happy to help and just make sure that you're okay. So, let's make sure you have the right team in general together. And a lot of accountants can also step in and serve that role if the attorney doesn't have the particular expertise to question some of the numbers. Well, we're at the end of our time today. Any last thoughts?

Nainesh: I would say errors are way more common than you would think, and that's why you need to pay attention and be involved in the process. And if it is complex or unusual entity that needs to be valued, look for the right partner.

Mary: Well, thanks so much for joining me today. As we reach the end of our episode, I want to thank our sponsors, Interactive Legal, Foster Group, Veterans Victory, and Carson's Private Client. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.