Basic Bankruptcy Training Program for Judges

(Finance and Accounting Part II: Appraisals)

REVEWING APPRAISER'S REPORT

USAID FILE JUDEGE TRAINING PROGRAM

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APPRAISER'S REPORT

- Valuation reporting – IVS 3
- Critical importance:
  - Final step in the appraisal process
  - All business in single Value (communicating the value conclusion)
  - Confirming the basis/purpose of the appraisal
  - Reflecting any assumptions or limiting conditions
- Report requirements
  - Description of Property Which is Subject of an Appraisal report *(tangible, intangible assets, good will, legal rights, etc.)*
  - Statement of the Objectives of the Appraisal Work *(determine a value, estimate a cost, forecast earning power, ascertain certain facts)*
  - Statement of the Contingent and Limiting Conditions to which the Appraisal Findings are Subject *(obtaining information/data from reliable sourced that could be verified, fractional, hypothetical, preliminary reports)*

APPRAISER’S REPORT

- Description and Explanation in the Appraisal Report of the Appraisal Method Used
- Statement of the Appraiser’s Disinterestedness
- Signatures of the Appraisal Report and Inclusion of Dissenting Opinions
  (Supervising authorities, collaborating appraisers issuing joint report)
- General principles. The reader must be able to understand:
  – The purpose and scope of assignment
  – The steps taken to carry it out
  – The conclusion reached
  – The logical flow of data and rationale that lead to and supported the conclusion

Report Organization and Content

- Introduction
  - Description of the Assignment
    - Who was retained by whom to do the appraisal
    - Applicable standard of value
    - Definition of the property being appraised
    - Effective date of the appraisal
    - Purpose or purposes of the appraisal
  - Summary description of the company
  - Capitalization and ownership
  - Definition of applicable standards of value
  - Sources of information
  - Valuation approach or approaches and conclusion

Report Organization and Content

- Economic Data (relevance)
- Industry Data (sector analysis)
- Description of the Company
  - Background
  - Operations
  - Management
  - Ownership
  - Past Transactions (stock/assets)
  - Summary of Positive and Negative factors
- Comparative Transaction Data

Report Organization and Content

- Financial Statement Analysis
- Valuation Approaches and Conclusion
  - Discussion of valuation approaches
  - Description of the procedure, data, and results for each approach used
  - Relative weight to be accorded the various approaches
  - Premiums and/or discounts, if applicable
  - Summary and conclusion

Report Organization and Content

- Prefatory Material and Appendixes
  - Statement of Appraiser’s Disinterest
  - Assumptions and Limiting Conditions
  - Qualifications of Appraisers
  - Other Appendixes

Purposes of the Appraisal

- Relation between Appraisal methodology and Purpose of Appraisal
- Gift, Estate, Inheritance Tax – *(fair market value)*
- Selling out, Merging, Acquiring, or Divesting *(investment value)*
- Going Public
- Buy-Sell Agreements
- Martial, Partnership and Corporate dissolutions
- Damage Cases
- Bankruptcy Liquidations/Reorganizations

Standards of Value

- *Fair Market Value* – "… the cash or cash equivalent, price at which property would change hands between a willing buyer and a willing seller, both being adequately informed of the relevant facts and neither being compelled to buy or sell…"
- *Fair Value* – "…the same as FMV, but more generic *(disregards premiums and discounts)*…"

Standards of Value

- *Investment Value* – "…while market value could be called – the value of the market place, the Investment Value is the specific value of goods or services to a particular investor (or class of investors) for individual investment reasons. Differs from FMV by:
  – Estimates of future earning power
  – Differences in perception of the degree of risk
  – Difference in tax status
  – Synergies with operations controls or owned, etc.…"

Standards of Value

- *Going-Concern Value* – "…is not a value but rather assumption about the business's status. Could be estimated as *Fair Market Value, Fair Value or Investment Value* on a going-concern basis, i.e., should be understand as the total value of the entity as a going concern…. understood also as excess value of intangible assets (good will)…"

Standards of Value

- *Liquidation Value* – "… the net amount the owner can realize if the business is terminated and the assets are sold off piecemeal… *Orderly liquidation* – the sale of assets over reasonable time period in attempt to get the best available price for each asset… *Forced liquidation* – sale of assets as quickly as possible, frequently all at one time at an auction sale…"

Standards of Value

- *Book Value* – "… is not a standard of value, but an accounting term, not an appraisal term… represents historical cost less depreciation and amortization and less liability accounts as shown on a balance sheet…"

Approaches to Value

- Categorization I:
  - Discounted Income Approach
  - Asset Appraisal Approach
  - Comparative appraisal approach
- Categorization II:
  - Discounted Future Earnings or Cash Flow (DCF)
  - Capitalization of current, normalized, or historical earnings

Approaches to Value

- Capitalization of current, normalized, or historical cash flow
- Capitalization of dividends or dividends capitalization capacity
- Multiple of gross revenue or physical volume
- Excess earnings approach
- Adjusted net asset value
- Ratio of price to book value or adjusted net asset value
- Prior transactions in or offers for the stock adjusted to current conditions

DCF Approach to Value

- *Value of money in time*

  Consider deposit of 1,000$ (PV) and fixed interest rate on bank deposits 10% (i).

  *The Value of money deposit at the end of the first year will be equal to 1,000$ +1000*10% or 1,100$ (FV1). For the next year this will equal to 1,100$ + 1,100*10% or 1,210$ (FV2)*

The Future Value of the current money could be described as:

FV1 = PV+PV*i or FV1 = PV*(1+i)

FV2 = PV*(1+i)+PV*(1+i)*i or FV2 = PV*(1+i)*(1+i) or

$$FV2 = PV*(1+i)^2$$

$$PV = \sum \frac{FVi}{(1+i)^i}$$

DCF Approach to Value

- *Net free cash flow*

  Net income (after taxes)

  +Noncash charges (amortization/depreciation)

  - Capital expenditures (the net changes in fixed and other noncurrent assets*)

  - Changes in working capital*

  + Net changes in long term debt*

  = *Net Free Cash Flow*

* *Assumes amounts are those necessary to support projected operations*

DCF Approach to Value

- *Required Rate of Return/Discount rate*

$$PV = \frac{E_0 * (1+g)}{R - g}$$

PV – Present Value

E_0 – Base level of earnings from which the constant level of growth is expected to proceed as of the valuation date

g – Annually compounded rate of growth in earnings

R – Discount Rate (Required rate of total return)

Example:

Company has 1,000,000$ annual earnings which will constantly grow at 2% annually. The owner is looking for 20% total rate of return from this business. How much is worth today this business? (Answer: 5,666,667$)

DCF /Capitalization Approach to Value

- *Discount rate:* A rate of return used to convert a series of future income amounts into present value
- *Capitalization rate:* A divisor used to convert a defined income to an indicated value

Example:

If an income stream of 10,000$ were to be capitalized at 25% equals a capitalized value of 40,000$. If a business is worth the value of its 4 year income stream of 10,000$ annually. Then its value would be 40,000$.

$$P/E \text{ ratio} = \frac{1}{\text{Capitalization rate}} = \frac{1}{0.20} = 5.0$$

Discount Rate = Capitalization Rate and reciprocal to P/E ratio only when no appreciable growth or decline is anticipated from the earnings base being capitalized.

DCF Approach to Value

- PV of Net Cash Flow

$$PV = \sum \frac{FVi}{(1+i)^i} + \frac{Residual\ Value}{(1+i)^i} (RV)$$

$$RV = \frac{Earnings}{Capitalization\ Rate} \quad or \quad RV = \frac{E_0 * (1+g)}{R - g}$$

DCF Approach to Value

- *Example:* If a company expects to earn 10,000$ the first year, 11,000$ the second year, 12,000$ the third year and 13,500$ the fourth and all subsequent years, and income stream is to be discounted at a Discount Rate of 30%, how much this company would be worth?

$$PV= \frac{10,000\$}{1+0.3} + \frac{11,000\$}{(1+0.3)^2} + \frac{12,000\$}{(1+0.3)^3} + \frac{13,500\$/0.3}{(1+0.3)^3}$$

$$PV= 40,145\$ \approx 40,000\$$$

Appraisals in Bankruptcy

- *Bankruptcy Liquidation*

  Used appraisal methods: Asset Approach - *Orderly Liquidation and Forced liquidation*

  Standard of Value: *Liquidation Value*

- *Bankruptcy Reorganization*

  Used appraisal methods: Income/ Comparison Approaches – *DCF and Capitalization or P/E multiple*

  Standard of Value: *Going-concern Value*

Bankruptcy Liquidation or Reorganization

- The Creditors of the insolvent company and the Bankruptcy Judge are to choose between Liquidation or Reorganization at the Reporting Hearing, How to decide?

The basic rule is that:

If the company's Liquidation Value exceeds its Going-concern Value, then should decide for Liquidation, and vice versa

If the company's Going-concern Value exceeds its Liquidation Value, then should decide for Reorganization.

Review of Appraiser's Report

- IVGN11 - Reviewing Valuations
- Purpose of Reviewing Valuations:

  Need to ensure the accuracy, appropriateness, and quality of Valuation Reports.
- Provisions to test for credibility check:
  - the apparent adequacy and relevance of the data used
  - and enquiries made
  - the appropriateness of the methods and techniques
  - employed
  - whether the analysis, opinions, and conclusions are
  - appropriate and reasonable, and
  - whether the overall product presented meets or exceeds Generally Accepted Valuation Principles

Review of Appraiser's Report

- *Types of Valuation Reviews:*
  - Administrative (compliance) reviews *(checks whether valuation meets or exceeds the compliance requirements or guidelines of the specific market and of the Bankruptcy Judge)*
  - Technical reviews *(whether the analyses, opinions, and conclusions in the report under review are appropriate, reasonable, and supportable)*
  - Desk reviews *(limited to the data presented in the report, checks for the accuracy of calculations, the reasonableness of data, the appropriateness of methodology, and compliance with client guidelines, regulatory requirements, and professional standards)*
  - Field reviews *(includes inspection of the exterior and sometimes the interior of the subject property and possibly inspection of the comparable properties to confirm the data provided, may also include confirmation of market data, research to gather additional data)*

Common Errors in Appraisal Reports

- Failure to conform to Applicable Standard of Value
  - *to do "appraisal" without determining the Standard of Value*
  - *to determine one standard of value and to analyze for another and conclusion to be misconstrued*
- Internal Inconsistencies
  - *when you have feeling that they have been written by two or more people*
  - *the scope of valuation and assumed approach to value does not match the actual methodology used later on*
- Extensive and Irrelevant reports
  - *annoying fat reports fill with irrelevant information*
- Emphasis of Items Not in Proportion to Their Relative Importance
  - *especially when developing the earnings base, the capitalization and discount rates*

Common Errors in Appraisal Reports

- Undefined Jargon
  - *use of abstruse or ambiguous terms without definition*
  - *each term used should be defined in a special appendix in order the reviewer to be able to determine whether goals of appraisal are met or not*
- Inadequate Comparative Data
  - *inadequate gathering or presentation of comparative transaction data*
  - *appraisal based on partial or inappropriate market data*
  - *lack of clear exposition in comparative analysis, including whther data had been adjusted, which one and for which period*
- Leaps of Faith
  - *presentation of fact or conclusion with no accompanying documentation, critical assertions should be carefully checked*