Faulty judgment in valuation

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Few would say a company's worth is equal to its book value, but that is the verdict of two judges in a case involving one of Spain's largest companies.

Financial experts tend to agree that book value is not a good determinant of share value, especially in the case of well-established companies whose future direction seems assured. However, judicial decisions handed down in July 2008 on the value of one of the biggest companies in Spain run counter to this logic and show an apparent "lack of common sense."

In his article, "Dos sentencias con tremendos errores sobre valoración" ("Two Decisions with Tremendous Valuation Errors"), IESE Prof. Pablo Fernández explains how two judges arrived at what he calls a "delusional" conclusion: that the value of a company should be set according to its book value.

Contradictory reports

The story began in 2005, when a group of minority shareholders decided to sell their shares, and the company, exercising its preferential right of acquisition, opted to buy them.

To set the value of the shares, Professor-Auditor A was called in to give a valuation. In his report, he considered the book value of the company as "the most representative of true share value," giving a value of 5.4 billion euros. In a subsequent revision, he raised the amount to 5.9 billion euros, or 79.90 euros per share.

A report by Finance Professors B and C countered that argument. Their report looked to the future rather than to the present to assess the value of the company: "All companies [...]

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have a management team, brands, relationships with customers and suppliers, and organizational systems, which are part of the company's ability to generate flows (money)."

They established, based on "discounted cash flows," the minimum value of the shares at 14 billion euros, or a valuation of 196.40 euros per share.

According to their report, the ratio between real value and book value would be 2.4 - lower than the average among companies quoted on the Spanish stock exchange at that time, which was 3.7. The figure is even more conservative when compared with the European (4.1) and global (4.74) averages.

Following a report by Professor-Auditor D, in which he described the report by Colleague A as an "accurate diagnosis," Professors B and C wrote yet another report reiterating their position. The forecasts made by B and C subsequently proved correct in terms of net profit, although not in terms of investment, a factor that must be taken into account when valuating a company, given that investment, if wise, will become profit in the future.

Meanwhile, Professor-Auditor D did his calculations based on the real-asset method without itemizing land or buildings and assuming the dismissal of all employees.

On May 14, 2007, a ruling by Judge E established the fair value of each share at 196.40 euros, in line with the opinion of Finance Professors B and C. The reason he dismissed the reports of Professors-Auditors A and D was that they "allude to and consider the value of the group's assets for a supposed dissolution and noncontinuity of the company." This ruling was appealed by the company.

"Delusional" valuations

The outcome of this appeal was two further rulings that demonstrate, according to the author, a great "lack of common sense" on the part of the judges who issued them. The first ruling set the fair value of the shares at the company book value, while the second reversed the 2007 ruling.

The first of these rulings justified the decision with arguments such as the fact that discounted cash flow analysis "would be plausible if the share package being sold gave powers of control, including the power to make changes in financial and trade policy."

It also considered that "the valuation report by the designated auditor is in accordance with the procedures regulated by the technical standards of auditing, [...] is sufficiently

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documented and gives a valuation that is fully within the parameters set by the technical standards."

However, the technical auditing standards say nothing about the outcome of valuations. These are just two of the arguments used in making this "delusional ruling."

Judge G was guided by the reports of Professors-Auditors A and D. The latter, however, had earlier written opinions contradicting these criteria. In previous publications, they had indicated that company book value is faulty insofar as it does not consider the company as a whole as a profit-producing entity.

The second decision overruled the decision by Judge E. In doing so, it states that the "real value [...] should be calculated not by an expert in economics and business, but specifically by an auditor," whose guiding criterion should be the technical standards of auditing. Thus, it places the figure of the auditor at the center of the equation.

Based on the same academic report, the judge concluded that "the claim contained in the opinion [of Finance Professors B and C], that the discounted cash flow method is the only conceptually correct valuation method, cannot be accepted, because what matters is not what the science of economics might consider 'conceptually correct' but rather what the auditing standards establish as appropriate for such valuations."

According to Fernández, there are so many decisions lacking in common sense in this case that a huge number of questions are left unanswered. For example, why did these two judges ignore the evidence available to them that showed that the value of other companies in the sector was much higher than their book value? Why did the two Accounting Professors-Auditors assess the value of one of the largest companies in Spain at its book value? Why did they contradict their own previous publications? The answers do not appear to be simple.

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