Business Valuation Update

Business Valuation Update™
August 2018, Vol. 24, No. 8

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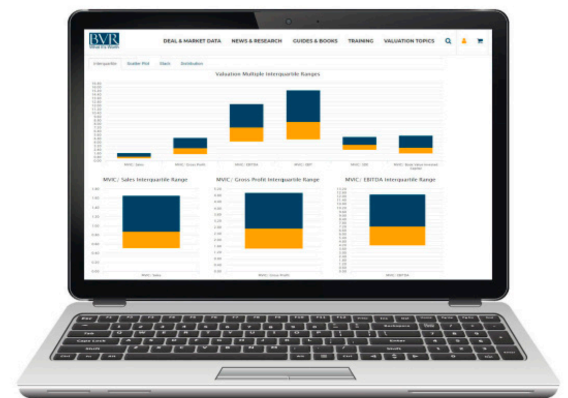

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Vol. 24, No. 8, August 2018

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Twelve Practical Ideas From NACVA's 2018 Annual Conference

The ability to gather all kinds of useful tips and advice from leading valuation practitioners is one of the benefits of attending conferences. There was no shortage of good ideas at the annual conference of the National Association of Certified Valuators and Analysts (NACVA) in Las Vegas this past June. Here are just a few pieces of helpful guidance from some of the sessions we attended. Of course, there was much more than we can cover here, and you can watch recorded broadcasts of the conference sessions, which will be made available on NACVA's website (www.nacva.com).

1. Augment the standard DCF for the TCJA. A number of sessions dealt with the Tax Cuts and Jobs Act (TCJA), which impacts "everything" in business valuation. There is still much to be

continued on page 4...

DealStats Ushers in Next Generation of Transaction Data

BVR has revolutionized *Pratt's Stats*, the leading private-company transaction database, with the imminent release of *DealStats* this summer. *DealStats* merges *Pratt's Stats* and *Public Stats* transactions into one powerful platform and is sure to delight users with new state-of-the-art search capabilities, additional data fields, easy saving and report generation, and much more. "*Pratt's Stats* was long overdue for a major upgrade and *DealStats* is a remarkable improvement. It is faster, more robust, and fully customizable," says Adam Manson, director of valuation data at BVR, who spearheaded the development of *DealStats*.

Major changes. The first thing you'll notice in *DealStats* is a new modern look that is vastly more user-friendly and flexible. But this is not just window dressing. You can now identify and select

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comparable transactions much more easily than before. Plus, the search capabilities are much more powerful. "*DealStats* allows you to search on any field in the database," says Manson. "While *Pratt's Stats* limited searches by predetermined fields, *DealStats* takes searches to the next level with easy saving options for searches and search layouts" (see Exhibits 1 and 2). Enhanced search functionality lets you specify terms such as "greater than," "less than," "between," "equals," "does not equal," and so on, Manson points out. And now, instead of having to go back and forth after changing search criteria, *DealStats* instantly displays the new transaction results.

Plus, you can now save your search results and return to them at any point in the future—one of the most frequently requested features from users! There are no longer any caps on transactions or statistics—and you can select multiple industries at one time.

Other major upgrades include:

- *New data fields. DealStats* includes 15 new data points, including the lives of intangible

Ask the Experts

Q: *We had two appraisers work on a valuation report. Should they both sign the report?*

A: You can have dual signatures on a valuation report, but, in a litigation setting, it may result in both experts being called to testify, which could be a problem, says James Hitchner (Valuation Products and Services). You may want to pick one expert as a primary appraiser and one as assisting the primary appraiser, he advises. Hitchner made his remarks at the annual business valuation conference of the New York State Society of CPAs (NYSSCPA) in New York City in May.

BUSINESS VALUATION UPDATE

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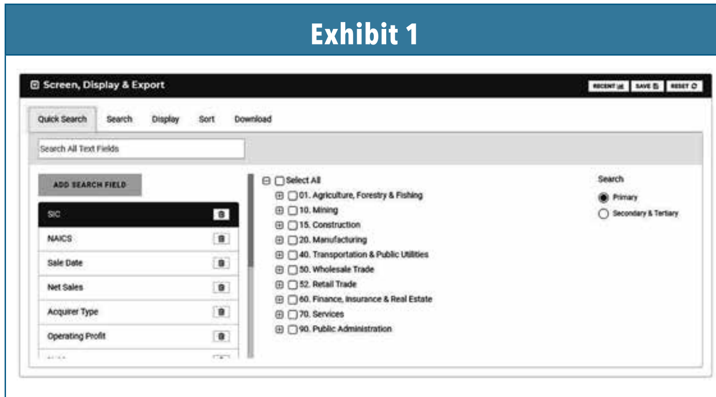
Exhibit 1



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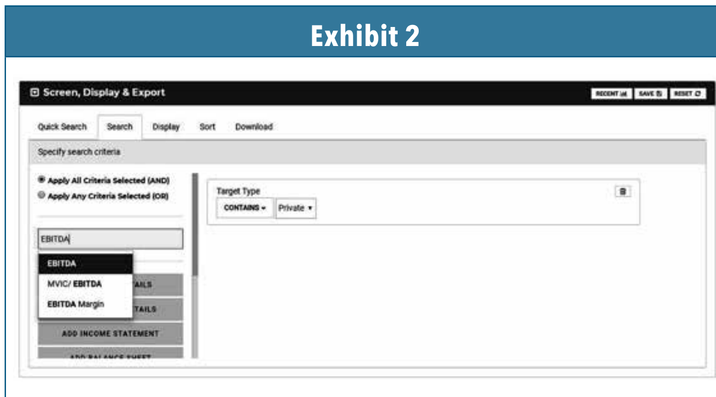

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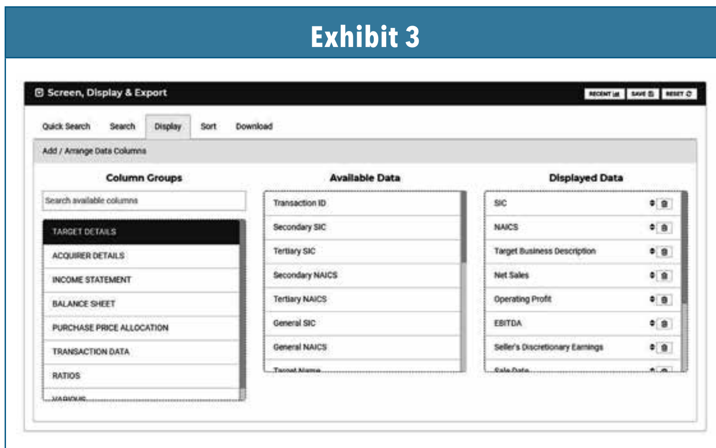

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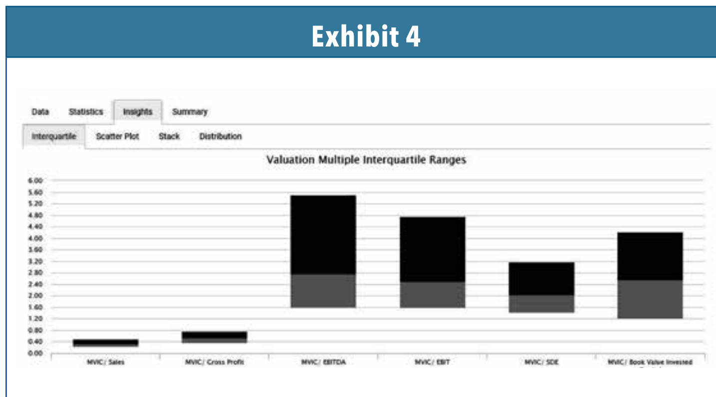

assets and additional profit margins not previously provided.

- *Real-time updates. DealStats* is updated in real time as transactions are entered. *Pratt's Stats* was updated manually once per month.
- *Customized views.* You can now customize the fields you want to view and analyze (see Exhibit 3).
- *Easier downloads.* With *Pratt's Stats*, you needed to export every field, but *DealStats* allows you to download all the available fields, or you can select just the ones you want.
- *Graphic presentation capabilities.* You can visually analyze selected data through interquartile ranges, scatter plots, distribution graphs, and stacked bar charts (see Exhibit 4).
- *Easier reports. Pratt's Stats* limited the amount of reports you could generate at one time. With *DealStats,* you can now generate PDFs for as many transactions as you want with just one click.
- *Companion guide. DealStats* has a companion guide that contains useful information, such as how to choose comparable companies, how to select and apply multiples, and how to utilize/search the online *DealStats* platform.

"I think it's important to note that this is the beginning, not the end—we already have a list of additions, upgrades, and enhanced functionality that we'll be bringing to the platform. Stay tuned!" says Manson.

More information. Go to bvresources.com/dealstats for more details. If you have questions, you can contact Adam Manson at adamm@bvresources.com or 503-479-8200, ext. 105. ◆

Twelve Practical Ideas

... continued from front page

learned, and further IRS guidance on the various provisions (especially the new qualified business income deduction for PTEs) is highly anticipated. In general, the new tax law may trigger higher costs of capital due to changes in the corporate tax rate and new limitations for interest expense deductions. But there are competing effects due to the expectation of increased net cash flows. Of course, a key part of the analysis is what the subject company will do with the future tax savings.

A complicating factor for future cash flows is the effect from long-term sunsetting provisions (such as bonus depreciation). Does this mean you can no longer do a standard five-year DCF? Not necessarily. Consider doing a side analysis of certain new law provisions and then layering in the results to the five-year DCF. Described as a "bolt-on" by Jim Hitchner (Valuation Products and Services), he said he had one being tested and will make it available to everyone for free (we'll let you know when it's available).

As a side note, if you have a valuation date between the dates President Trump was elected (Nov. 8, 2016) and when the new tax law was passed (Dec. 27, 2017), should you factor in "pre-enactment expectation" into your valuation? There's no definite answer, but it's something to think about, especially if the valuation date is in the days just before enactment.

2. Avoid the advocacy trap. How can two highly qualified valuation experts come up with such different conclusions? Different legitimate assumptions about the many variables and inputs in a business valuation can affect the opinion of value, pointed out Marc Bello (Edelstein & Co. LLP) and Courtney Sparks White (Blue Sky Business Valuation LLC). There can also be differences in legal guidance, information availability, and access to management and other materials during the due diligence process. And, of course, mistakes can be made, the speakers observed.

We point out that another reason for a valuation gap is inadvertently falling into an advocacy role. Sometimes, the attorney or client will select an expert who can be "led astray" or by withholding important evidence or providing unreasonable

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assumptions. Experts need to challenge the evidence and assumptions and must approach the valuation from a purely objective standpoint.

3. Consider exit planning services. A case study presented by Bob Grossman and Melissa Bizyak (both with Grossman Yanak & Ford LLP) illustrated the nightmare of an ambiguous buy-sell agreement. This points up a good opportunity for valuators to help craft these and also do an annual valuation—part of an exit planning practice area.

Exit, or succession, planning is an area with many benefits for appraisers. It can be a great consulting opportunity to get involved as financial "facilitators" to deal with tough issues of estate planning, asset transfers, and passing on substantial management responsibility to the next generation. All credentialed business appraisers with a certain degree of experience should be familiar with the specific components of exit planning: (1) traditional M&A planning; (2) "key" employee transfers; (3) next-generation (family) transfers; and (4) buy-sell agreements/appraisals. Exit planning strategies begin with the broad question: What is the business worth? The discussion then branches out into three possible exit scenarios: a sale of the company, an internal transfer to employees, or a transfer within the family.

Regardless of the ultimate scenario, the end game is a carefully crafted buy-sell agreement that can help avoid personal and financial disasters—as the case in the NACVA session sadly illustrated.

4. Read the BI policy. The most important piece of advice when calculating the value of business interruption (BI) is to read the insurance policy, said Kerrie Merrifield (Axiom Forensics). And don't ignore the fine print. What the policy says will dictate what you do from a valuation standpoint. For example, there are restrictions that limit the loss value that can be claimed, such as a "waiting period." If there's a disaster and people can't get to your business, the business interruption loss clock starts to tick after a certain number of business hours have elapsed. Also, business interruption may not be covered if the triggering event, such as an earthquake, is not covered.

A very engaged audience had a number of interesting questions. Is a business covered if clients are damaged? Yes, said another audience member, who pointed out that "contingent business interruption" coverage applies if a client is damaged and the subject company experiences a loss of business from that client. Another attendee asked: "Can you take growth into account?" Yes, said Merrifield, you can look at the prior three years and factor trends into your analysis.

A common pitfall is to forget about "saved" expenses in your analysis. If you don't include them, you will get attacked on that point, said Merrifield.

5. Dig into weeds to value cannabis firms. Valuing a cannabis firm? It's the ultimate challenge, say Ron Seigneur (Seigneur Gustafson LLP) and Stacey Udell (HBK Valuation Group). Risk is a major factor, with company-specific risk premiums ranging from 30% to 40%. When valuing a cannabis firm, focus on four specific issues: license rights, lease, location, and legislative environment. In terms of valuation approaches, there's a scarcity of comparable transactional data from the market, which means appraisers must rely on the income approach. The trouble is revenue projections can be especially tricky, so experts need to rely on management interviews and site visits to examine such things as the size of the facility and the nature of the technology in use in order to estimate potential production. Then, take a look at third-party resources, such as "Cannabis Benchmarks," which tracks national prices and number of harvests in order to help project out the revenue.

Seigneur and Udell are co-authors (along with Brenda Clarke) of a new book, *The Cannabis Industry Accounting and Appraisal Guide*.[1]

1 Available at bvresources.com/products/guides-and-books.

6. Use forensics. Don't get blindsided by the opposing expert doing a forensic analysis and making large normalization adjustments, warned Bello and Sparks-White. Especially for a valuation in a litigation setting (such as marital dissolution), the expert should have both valuation and forensic experience so that forensics can be included in the analysis. This helps the engagement run smoothly and at a reasonable cost, without requiring two separate experts. What should you do if you didn't get the information that allowed the other side to do the forensic analysis? You can either walk away from the engagement or keep the option open to update your opinion, the speakers advised.

> **In some states, financial expert witnesses are required to turn over their personal financial information.**

7. Check state law re: personal financial data. Some audience members were surprised to learn that, in some states, financial expert witnesses are required to turn over their personal financial information to determine whether or not they are a "professional witness." But such is the case, according to Alan Zipp (Alan Zipp, CPA, PC), a CPA, attorney, and accredited in business valuation. Check your state's rules on this, he advised, also noting that there's no definition for "professional witness."

In his session on expert witnessing, Zipp also advised that, if you as a testifying expert have any weaknesses, they should be brought out during direct examination. "Admit it, own it," he counseled. You'll take the wind out of the sails of the opposition before it comes out on cross-examination, which you don't want to happen.

8. Pay more attention to compensation. Under the new tax law's 20% PTE deduction rules, it's more important than ever to make sure your analysis of reasonable compensation will survive the increased regulatory scrutiny that's expected. The concept of the determination of reasonable compensation from a valuation standpoint hasn't changed, but more diligence is needed in collecting information that will support your determination, said Stephen D. Kirkland (Atlantic Executive Consulting), an expert who deals solely in compensation issues.

As part of the PTE tax relief, the owner's reasonable compensation figures into the calculation of the Section 199A deduction. For a business owner to get the most out of the Section 199A deduction, there will be a balancing act between reasonable compensation and the other variables that limit the deduction under the new law. There's the ongoing desire to reduce compensation to minimize self-employment taxes, but there's now also the desire to increase compensation, so it doesn't limit the 199A deduction.

Kirkland also points out that the new tax law also has some major implications for compensation amounts publicly traded companies and tax-exempt organizations, including hospitals and universities, pay executives. If compensation amounts publicly traded companies and tax-exempt organizations pay are used for benchmarking purposes, the new law's changes could also influence the amounts determined to be reasonable compensation for executives and professionals at other employers, he said.

Kirkland suggests using a checklist designed to initiate the collection of the data you will need to estimate reasonable compensation.[2]

9. See FAQs on calculation engagements. Not many attendees were aware that the AICPA has issued a document that includes 48 FAQs on

2 See "Checklist for Initial Information Request to Analyze Replacement Compensation," *Business Valuation Update,* June 2018.

calculation engagements.[3] We're aware that some valuation experts will not get involved with calculation engagements, but we saw no evidence of that stance here. Zachary Meyers, the incoming chair of the NACVA standards committee, said he used calculation reports "quite a bit" in litigation engagements. They are what attorneys want, and they can be a "perfect fit" for helping in a settlement, and 98% settle in his experience, he said. Audience members chimed in about their use of calculation engagements: One uses them for M&A work, and another uses them in conjunction with the support of buy-sell agreements (he does them annually). No one in the audience denounced their use. Someone pointed out that USPAP does not preclude the use of calculation reports.

10. Check your pretax discount rate. Here's a common error even the "big shots" make, said Everett Harry (Harry Torchiana LLP) in his session on modelling and discounting damages. Is it correct to convert an after-tax discount rate (ATDR) to a before-tax discount rate (BTDR) using this formula: [BTDR = ATDR/(1 - tax rate)]? No, he says. The correct formula for computing BTDR from ATDR assuming a constant growth rate (g) and tax rate (TR) is:

$$BDTR = [(ATDR - g)/(1 - TR)] + g$$

This avoids tax affecting the growth rate, he pointed out.

11. Don't bury your calculations. Veteran valuation expert Chris Mercer (Mercer Capital) gave a wonderful keynote address on the BV profession in transition, pointing out that there's a great opportunity for Gen Xers and millennials because of the aging of the profession. A show of hands revealed that most attendees at the conference were baby boomers. Mercer presented statistics that backed this up. For example, the median age of NACVA members is 53 years old, similar to the age of BV professionals in the other valuation professional organizations.

If you are involved in a lost profits engagement on the plaintiff side, include any intervening causes in your analysis.

Along his trip down memory lane, Mercer presented some very practical tips. One is "never bury your calculations in a spreadsheet." That is, make sure they show up discretely somewhere and not just as an embedded formula. If they're not shown, you'll forget how you did the calculation, and it will "mess you up" later.

12. Consider intervening causes for lost profits. If you are involved in a lost profits engagement on the plaintiff side, include any intervening causes in your analysis, advised P. Dermot O'Neill (P. Dermot O'Neill, CPA PC). That way, you're "in control" of the matter. If you don't address it, the defendant will challenge you, claiming that changes in competition, pricing, economic conditions, or some other factor impacted the plaintiff's financial results during the damages period.

These intervening causes could also explain the financial results of the peers used as comparable firms in a yardstick analysis. They may also help explain a company's recovery and help illustrate whether or not the plaintiff was able to mitigate losses during the damage period. Bottom line, it's better to address intervening causes upfront as opposed to getting "hammered" with it on cross-examination, said O'Neill.

Future issues of *BVU* will cover these topics and more from this valuable conference further. The 2019 NACVA annual conference will be held in Salt Lake City. ◆

3 aicpa.org/content/dam/aicpa/interestareas/forensicandvaluation/resources/standards/downloadabledocuments/aicpa-vs-section-100-calculations-faqs.pdf.

Delaware's Unwarranted Assumption That Capex Should Equal Depreciation in a DCF Model

By Gilbert E. Matthews, CFA, and
Arthur H. Rosenbloom

Every valuator's kit bag includes income-based approaches such as discounted cash flow or the direct capitalization of earnings by which to determine fair value or value using other standards.

Delaware fair value proceedings have predominantly adopted the erroneous assumption that capital expenditures should equal the sum of depreciation and amortization in determining terminal value. The assumption makes sense only if one assumes the non-real-world scenario of both no growth and no inflation, as we demonstrate in more detailed fashion in the next section of this article.

Further, survey data based on published financial statements confirm the fact that capex typically exceeds depreciation. A study published in 2004 showed that, over the period from 1986 to 2001, on average, capex exceeded depreciation by 21%, though the amount varied across industries.[1] A current example, and to a similar effect, is contained in a January 2018 document published by the Stern School of Business at New York University, which shows that, on average, capex exceeded depreciation by 16.5%. It too shows differences between and even within given industries.[2]

Why capex should exceed depreciation. The assumption that depreciation equals capital expenditures is only appropriate if it is also assumed that there is no growth and no inflation. However, many valuators and courts do not recognize that the normalized capital expenditures of a growing company must materially exceed depreciation over time. Indeed, inflation alone makes it a rare occurrence for depreciation to be adequate for replacement cost; Professor Bradford Cornell points out that the traditional approach "errs by failing to account for the impact of inflation" and that "depreciation is rarely equal to [maintenance capex] even if there are no additional working capital requirements."[3]

In any given year, capital expenditures can be lower than depreciation, but a company cannot grow unless its *normalized* capex exceeds depreciation.[4] This can easily be demonstrated by using the simple example of a company that is growing at 3% annually and depreciates its assets on a straight-line basis over a five-year period to a zero residual value. If its capital expenditures are $100,000 in the first year and increase 3% annually, capex in Year 6 would be $115,900. As shown in Exhibit 1, depreciation in Year 6 would be $107,800, 7% less than capex.

1 Daniel L. McConaughy and Lorena Bordi, "The Long-Term Relationships Between Capital Expenditures and Depreciation Across Industries: Important Data for Capitalized Income-Based Valuations," 23 *Business Valuation Review* 14, 2004.

2 Aswath Damodaran, "Capital Expenditures by Sector (US)," available at pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/capex.html.

3 Bradford Cornell and Richard Gerger, "Estimating Terminal Values With Inflation: The Inputs Matter–It Is Not a Formulaic Exercise," 36 *Business Valuation Review* 117, 118, 2017.

4 There are limited circumstances where depreciation could exceed capex for many years. For example, if a single-facility company built and equipped a factory, its depreciation could exceed capex for an extended period. Also, to the extent that new equipment is either consistently cheaper to manufacture or consistently more efficient in use, recurring depreciation expense to recurring capital expenditures will increase. This discussion is based on depreciation on a GAAP basis and does not consider accelerated depreciation under the Tax Cuts and Jobs Act enacted in December 2017.

The longer the depreciation period, the greater that the difference between capex and depreciation. Exhibit 2 shows that, for 15-year straight-line depreciation and a 3% growth rate, depreciation in Year 16 is only 81% of capital expenditures. Put differently, capex is 24% higher than depreciation.[5]

In most DCF calculations, terminal value is 70% of the total value or more. Therefore, the error of equalizing depreciation and capex can have a material effect on discounted cash flow valuations.

Jim Hitchner, the author of several books on business valuation, has asked valuators in his webinar audiences "How do you typically handle depreciation and capex when calculating cash flows?" The responses published in his bimonthly newsletter, *Financial Valuation and Litigation Expert,* can be seen in Exhibit 3.[6]

These results show the increasing recognition in the valuation community that capital expenditures should exceed depreciation.

Delaware's default rule is capex equals depreciation. These facts notwithstanding, case law in Delaware appraisal demonstrates a strong tendency to genuflect to the faulty assumption that capex and depreciation should be equal. The baleful effect of such an approach raises DCF valuations to excessive levels.

The first mention of the capex-depreciation relationship in Delaware was in 1992:

> [T]he proxy statement discloses IBC's expectation that capital expenditures in

Exhibit 1. Five-Year Straight-Line Depreciation With 3% Growth

Year Purchased	Capital Expenditures ($000)	Depreciated in 2023	
		%	Amount ($000)
2018	100.0	10%	10.0
2019	103.0	20%	20.6
2020	106.1	20%	21.2
2021	109.3	20%	21.9
2022	112.6	20%	22.5
2023	115.9	10%	11.6
Total			107.8

Exhibit 2. Fifteen-Year Straight-Line Depreciation With 3% Growth

Year Purchased	Capital Expenditures ($000)	Depreciated in 2033	
		%	Amount ($000)
2018	100.0	3.333%	3.3
2019	103.0	6.667%	6.9
2020	106.1	6.667%	7.1
2021	109.3	6.667%	7.3
2022	112.6	6.667%	7.5
2023	115.9	6.667%	7.7
2024	119.4	6.667%	8.0
2025	123.0	6.667%	8.2
2026	126.7	6.667%	8.4
2027	130.5	6.667%	8.7
2028	134.4	6.667%	9.0
2029	138.4	6.667%	9.2
2030	142.6	6.667%	9.5
2031	146.9	6.667%	9.8
2032	151.3	6.667%	10.1
2033	155.8	3.333%	5.2
Total			125.9

Exhibit 3. Hitchner Surveys Re: Depreciation and Capex When Calculating Cash Flows

	June 2011	June 2013	February 2015	June 2017
Capex less than depreciation[!]	6%	4%	6%	2%
The same or very similar	66%	68%	55%	45%
Capex more than depreciation	28%	28%	38%	53%

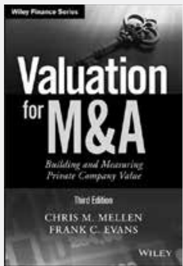
5 Moreover, to the extent that capital expenditures include land, the difference is greater because land is not depreciated.

6 *Financial Valuation and Litigation Expert*, Oct.-Nov. 2012; Dec. 2013-Jan. 2014, p. 4; Oct.-Nov. 2015, p. 4; Feb.-March 2018, p. 4.

the future will approximate depreciation charges.

Salomon Brothers Inc. v. Interstate Bakeries Corp., 1992 Del. Ch. LEXIS 100 (May 1, 1992) at *14.

M&A Valuation



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In the long-running *Technicolor* case, the court stated:

> I will calculate fixed capital investment as 1.8% of the following year's net sales, and depreciation as 1.8% of net sales.
>
> *Cede & Co. v. Technicolor, Inc.*, 2003 Del. Ch. LEXIS 146 (July 11, 2003) at *83; *aff'd in part, rev'd in part on other grounds,* 884 A.2d 26 (De. 2005).

The Court of Chancery explicitly ruled in 2012 that terminal value should be calculated on the assumption that capital expenditures and depreciation were equal, but it relied on both a prior case and a valuation text that did not support its conclusion:

> The petitioners' challenge is grounded in the sound valuation principle that because the terminal value is meant to capture the present value of all future cash flows of the company, typically the net cash flow figure used to generate the terminal value should be normalized, rather than "unrealistically extrapolate[] [a company's] short run circumstances into perpetuity" [citing *Kleinwort Benson Ltd. v. Silgan Corp.* ("*Kleinwort Benson*"), 1995 Del. Ch. LEXIS 75 (Del. Ch. June 15, 1995) at *21]. The Gordon growth model indicates the equity value of a firm assuming full distribution of its net earnings [citing Z. Christopher Mercer, *The Integrated Theory of Business Valuation* (Peabody 2004), p. 15]. One of the important implications of this assumption is that "[c]apital expenditures are equal to depreciation" [citing Mercer, p. 15, and *Kleinwort Benson* at *21].
>
> *In Re: Appraisal of The Orchard Enterprises, Inc.* ("*Orchard*"), 2012 Del. Ch. LEXIS 165 (Del. Ch. July 18, 2012) at *54.

The references to Mercer's text are misguided because Mercer's example on the cited page

expressly assumes a company with *no growth*. A growing company needs capex greater than depreciation in order to sustain its growth.

The reference to *Silgan* is odd because the court in that case actually used depreciation greater than capital expenditures:

> Kovacs correctly recognized the need for an adjustment in the data so that capital investment relates to growth and depreciation in a sustainable manner. [This sentence was quoted in a footnote in *Orchard*.] ... Kovacs testified that *capital investment should slightly exceed depreciation* to sustain perpetual growth.... Kovacs' theory that capital expenditures should slightly exceed depreciation is just as plausible as the "zero out" approach, *so I will not alter Kovacs' terminal value calculation*. [emphasis added]
>
> *Kleinwort Benson* at *21-22.

A 2013 decision rejected expert testimony that capital expenditures should be greater than depreciation in the terminal value calculation and accepted testimony that they would be equal:

> Gokhale used depreciation figures from the 2009 LRP and set capital expenditures equal to depreciation. Kursh made the assumption that depreciation would be higher than capital expenditures into perpetuity…. Because I have adopted Gokhale's model as a general framework, I adopt his treatment of capital expenditures and depreciation, as well.
>
> *Towerview LLC v. Cox Radio, Inc.*, 2013 Del. Ch. LEXIS 159 (Del. Ch. June 13, 2013) at *90-*91.

In 2014, the court again accepted the assumption that capex and depreciation should be equal:

> I therefore adopt … Kimball's assumption that "[d]epreciation and capital expenditures are assumed to be equal over the long-term." [quoting the expert's report]
>
> *Laidler v. Hesco Bastion*, 2014 Del. Ch. LEXIS 75 (Del. Ch. May 12, 2014) at *44.

In 2016, the court explicitly rejected expert testimony that capex should be greater than depreciation over the long term:

> In the last year of the projection period, however, the Updated Base Case contemplated an amount for depreciation that exceeded capital expenditures. To bring the two into harmony, Hausman assumed that capital expenditures would exceed depreciation over time by an amount sufficient to cause net amortizable assets to grow at the Company's long-term growth rate. Fischel chose to increase capital expenditures to equal depreciation. The record shows that the Company historically had high levels of depreciation relative to capital expenditures, so it is more reasonable to assume depreciation would decrease during the terminal period to match capital expenditures. This decision adopts that approach.
>
> *Merion Capital v. Lender Processing*, 2016 Del. Ch. LEXIS 189 (Del Ch. Sept. 21, 2016) at *72-*73.

The clearly erroneous decisions—Delaware cases where capex is less than depreciation in the terminal value calculation. It is virtually impossible for depreciation to be greater than capital expenditures in perpetuity since depreciation is based on prior years' capex. Nonetheless, in a 2004 decision in a consolidated fiduciary and appraisal action, the court accepted a terminal value based on a growth model in which capital expenditures in the final year on the projection period were $9.1 million and depreciation was $21.8 million:

> Nor is there merit to the defendants' criticism (articulated through Matthews) that

> in Zmijewski's terminal year (2002), depreciation exceeds CapEx, a state of affairs that cannot go on forever. The flaw in this criticism is that Zmijewski's projected cash flows only; he did not forecast the individual components of free cash flow, including CapEx or depreciation. Accordingly, there is no basis to conclude that Zmijewski's forecasts perpetual divergent depreciation and CapEx.
>
> *In re Emerging Communications, Inc. Shareholders Litig.*, 2004 Del. Ch. LEXIS 70 (Del. Ch. May 3, 2004) at *57, n.56.

The court's explanation is puzzling. In this case, terminal value was derived by applying a growth rate of 2.9% to a free cash flow that was calculated by adding depreciation to, and deducting capex from, projected EBIT. The computation of terminal value was based on a forecast in which depreciation perpetually dwarfed capital expenditures, a mathematical impossibility regardless of the accounting method used.

The plaintiff in this case received a judgment with respect to more than 20% of the outstanding shares. Due to the size of the award and a decline in the value of the company subsequent to the 1998 transaction date, the amount of the judgment exceeded the equity value of the company in 2004. Therefore, the Court of Chancery's error could not be appealed to the Delaware Supreme Court because the defendants were unable to bond the appeal.

Another 2004 decision also used a projection in which depreciation materially exceeded capital expenditures. In that case, capital expenditures were projected to be $100,000 per year, while depreciation and amortization declined from $487,000 in the first year of the projection to $368,000 in the final year.[7] The opinion calculated terminal value based on 5% perpetual growth of projected free cash flow,[8] effectively assuming that capex and D&A both would grow at the 5% rate.

The rare Delaware decisions where capex exceeded depreciation. In a 2007 decision, capital expenditures were estimated at $25 million in the terminal year and depreciation was $22.7 million.[9] In this case, the court used the projections in the company's proxy statement[10] and did not comment on the fact that capex were higher.

In a 2015 decision, the Court of Chancery relied on a DCF analysis in which capital expenditures exceeded depreciation over time. In this case, it appears that both experts took this view:

> [T]he experts arrived at different plowback ratios, which is the percentage of net operating profit after tax that is reinvested in capital expenditures. The idea is that "[i]n order to adequately support a perpetual growth rate in excess of expected inflation (i.e., positive real growth), a firm will need to reinvest in capital expenditures at a sustainable rate that is above that of projected depreciation." [quoting expert testimony at trial]
>
> *In Re Appraisal of Ancestry.com, Inc.*, 2015 Del. Ch. LEXIS 21 (Jan. 30, 2015) at *36-*37.

Federal cases. The small sample of federal decisions that expressly discuss capex and depreciation in income-based valuations shows a mixed bag of adherence to or departure from the heuristic idea that capex and depreciation should be equal.

7 *Lane v. Cancer Treatment Centers of America, Inc.*, 2004 Del. Ch. LEXIS 108 (Del. Ch. July 30, 2004) at *111. Although the amount of amortization is not specified in the opinion, the size of the company makes it unlikely that it would have been the major component of depreciation and amortization.

8 Ibid. at *116.

9 *Crescent/Mach I Partnership, L.P. v. Dr Pepper Bottling Co. of Texas*, 2007 Del. Ch. LEXIS 63 (May 2, 2007) at *59.

10 Ibid. at *52.

A U.S. Tax Court decision used a DCF analysis in which capex was lower than depreciation.[11] A U.S. Bankruptcy Court decision based its valuation on the assumption that depreciation should equal capex; the court rejected plaintiffs' claim that capital expenditures should be *less* than depreciation.[12] On the other hand, a U.S. Tax Court decision used a valuation where annual capital expenditures were 28.2% greater than depreciation.[13]

The issue was addressed again in a 2010 decision where the U.S. District Court accepted expert testimony that capex would exceed depreciation and rejected the testimony that they should be equal:

> Bayston assumes capital expenditures of approximately 109% of depreciation. This follows from … a belief that capital expenditures must outpace depreciation if the company intends to manufacture the number of units necessary to achieve terminal value revenue assumptions.…
>
> On the other hand, Giesen assumes that capital expenditures will equal depreciation in the terminal period.… According to Bayston, Giesen's analysis is flawed because it implicitly assumes revenue growth without additional investment in ATS's asset base.
>
> * * *
>
> Bayston's assumption that ATS will experience 6% volume growth and 3% revenue growth appears more reasonable than Giesen's for the terminal period. This indicates additional investment in the asset base is necessary at a level consistent with Bayston's analysis.
>
> *Albert Trostel & Sons Co. v. Notz*, 2010 U.S. Dist. LEXIS 108778 (E.D. Wisc., Sept 28, 2010) at. at *36-38.

Responsibility of experts to explain relationship to judges. There's some light at the end of the valuation tunnel. As discussed above, the valuation profession has, from June 2011 to June 2017, moved from a situation in which only 28% of valuators typically assumed that capex would exceed depreciation to one in which 53% did so. While far too many valuation practitioners continue to perpetuate the error that fact-based data reveal, there is movement in the right direction.

In valuation cases, the courts normally rely on expert testimony to guide and inform them. The courts' errors in their DCF calculations can be attributed to the failure of valuation experts to understand and explain why capex must exceed depreciation. One can only hope that more enlightened experts are engaged and that their expert reports and testimony will reflect the realities we have tried to illustrate. While one would expect that, since the correct approach will result in lower DCF valuations, the lesson will be emphasized by respondents' experts, and its impact should be evident to and considered by those called by petitioners as well. ◆

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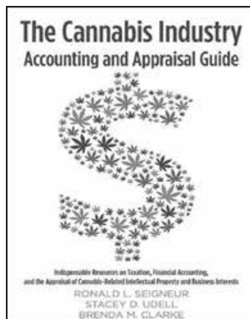
11 *Estate of Gallagher v. Commissioner*, T.C. Memo 2011-148 (U.S. Tax Ct. 2011). The court's calculation assumed that depreciation was 3.1% of revenues and that capital expenditures were 2.8% of revenues.

12 *In re: Nanovation Technologies, Inc.*, 364 B.R. 308; 2007 Bankr. LEXIS 1862 (Bankr. N.D. Ill., May 7, 2007).

13 *Estate of Simplot v. Commissioner, 112 T.C.* 130, 164 (U.S. Tax Ct., 1999), *rev'd on other grounds,* 249 F.3d 1191 (9th Cir., 2001).

Book Review:
The Cannabis Industry Accounting and Appraisal Guide

By Neil J. Beaton, CPA/ABV/CFF, CFA, ASA



The Cannabis Industry Accounting and Appraisal Guide,[1] recently released by industry leaders Ronald L. Seigneur, Stacey D. Udell, and Brenda M. Clarke, is an indispensable resource for investors, owners, managers, attorneys, accountants, and valuation analysts alike, working with or alongside professionals within the budding and ever-evolving cannabis industry.

The authors, all certified public accountants and possessing other professional designations in valuation and financial forensics and with decades of practical experience, bring insight and focus to an industry in a state of flux and growth. *The Cannabis Industry Accounting and Appraisal Guide* spans 220 pages, including several useful appendices.

The book lays an important foundation with a brief history of cannabis dating back over 3,000 years but pivots nicely to highlight the myriad of legislative actions over the past century to the present. Topics span legislative issues such as the classification of cannabis federally as a Schedule 1 Drug under the 1971 Controlled Substances Act and the implications of the June 29, 2011, "Cole Memo" by then Deputy U.S. Attorney General James M. Cole, which gave guidance on the ways by which state AGs should pursue (or not pursue) prosecution of those in the business of the cultivation, as well as more practical topics such as the processing and sale of marijuana and marijuana-infused products, tax structures, accounting issues, and valuation.

Additional insights explaining why Americans, as well as many around the globe, are increasingly turning to marijuana for medical uses and how this is impacting industry growth and change at such a rapid rate. The authors have thoroughly explained why the cannabis industry can be so difficult to assess and value. A deeper dive is provided outlining the complexities of cannabis industry forecasts including factors such as the implications of federal illegality, excessive comparative income tax and compliance burdens, lack of access to banking and other financial services, lack of consistency from state to state and even from municipality to municipality, lack of historical market and benchmarking data due to the relatively short duration of the regulated side of the industry, high startup costs, and much more.

Again, on the practical side, the authors provide guidance on how to structure a business entity, discuss the importance of reliable bookkeeping and financial accounting, and provide clarity on the implications of IRC Sections 471 and 280E. The book ties the importance of §280E to detailed guidance on bookkeeping, including providing a sample chart of accounts touching on the important and unique needs of the cannabis industry. In the case of a tax audit, the authors describe what can be expected based on their experience in addressing tax audits. Even though taxes have changed on the federal level, the book discusses specific sales and excise taxes relevant to different states' laws since the economics of the cannabis industry are specifically regulated by the states versus the federal government.

Nonetheless, guidance on choices for entity selection and the pros and cons between Subchapter C corporations and pass-through entities is particularly relevant given the recent 2017 Tax Cuts and Jobs Act (TCJA), which lowers

1 The book is available at bvresources.com/products/the-cannabis-industry-accounting-and-appraisal-guide.

C corporation tax rates and may affect pass-through entities due to the complex Qualified Business Income deduction.

The reader is given many useful insights on the methodologies that can be useful in valuing a cannabis business including knowledge of market multiples and the unique issues that cannabis businesses face in a constantly changing environment. As a bonus, the authors explain and provide a greater understanding of how to interpret an appraisal report that is compliant with recognized professional appraisal standards.

The book provides a wealth of information on business and intellectual property appraisal nuances applicable to the cannabis sector and how these nuances can be addressed. The authors all have significant experience with business and IP appraisal, as supported by the professional credentials they hold, and all have been endorsed by various courts and tribunals to provide expert testimony as financial experts. This experience cannot be underestimated as they provide specific practical points for clients and professionals alike to avoid a negative situation.

The book is well-organized, discussing numerous key concepts critical to understanding the industry and providing "call-out" boxes throughout the text highlighting certain concepts. And, if that were not enough, the authors provided a plethora of relevant and incredibly helpful appendices and resources should readers, perchance, be unable to find answers to their questions from the content provided. ◆

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A Veteran Valuer Looks at the BV Profession

By Robert E. Kleeman, Jr., CPA/ABV, ASA, CVA

There has been a great deal of discussion lately about the future of the business valuation profession. While I applaud every effort to raise the technical quality of our work product, I question many of the paths that are being taken—including the recent decision by the AICPA to allow non-CPAs to get the ABV credential (more about that later).

I have been involved in the valuation profession for more than 40 years now, with the last 38 years as a full-time practitioner. I started as a sole practitioner, was a partner in a small local firm, senior manager with a "Big Four" firm, and then spent the next 19 years of my career developing and ultimately being the senior technical partner for BV in a top 20 CPA firm. Now I'm a sole practitioner again.

I still attend BV professional meetings each year, hoping to pick up new information on how to do some part of the valuation better, perhaps some innovation or use of data, and just to feel the pulse of the BV community. I do not like what I am seeing and hearing.

I started my business valuation work "pre-Pratt" and have had the privilege to meet and work with many of the giants of our profession. However, as I look over my shoulder, I believe that I see a path to the destruction of the BV practice as we know it today. It has already begun. Business valuations by mail for $750. Can't-miss formulas, just fill in the blanks. Comparable company valuations based on questionable databases. Practitioners subcontracting out major pieces of the valuation engagement and then just signing the report for their client. The proliferation of numerous credentials—I saw a résumé that had 16 valuation and litigation credentials for the professional, plus being a CPA and MBA. How many things can one person be expert in?

This paper is not focusing on "Joe the Plumber" who has a single truck and a part-time helper and basically concentrates on residential repair jobs. Many small business entities in the U.S. economically have little or no fair market value other than the liquidation of their assets. I am also not focusing on the buyer who is not buying a business but is buying a job, working 60-plus hours per week, with no real profit after owner's compensation.

What I am focusing on are the many, profitable, growing small to medium businesses that need the help of a competent business valuation professional.

Four absolute rules of BV. I believe that, when I started in the BV industry, I learned four rules or laws that I still believe are the major drivers of professional valuation services today. I believe that if the profession is to successfully sustain itself as a profession and not a provider of a commodity service, we need to review and dissect these four laws and make sure we are using them correctly today.

The four immutable rules of business valuation are:

1. *"A determination of fair market value, being a question of fact, will depend on the circumstance in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing*

> *those facts and determining their aggregate significance."*[1]

Let's deconstruct this discussion and see how it is still vital today and why we need to make sure we are following the instruction the rule provides.

'[F]air market value, being a question of fact, will depend on the circumstances in each case.' Since fair market value is a question of fact, and depends on the circumstance in each case, by definition, each valuation is unique. In all the years I have been practicing valuation, I have never come across two valuations where the facts and circumstances were exactly the same. This is true even though I have valued individual McDonald's, Burger King, and Pizza Hut franchises. No two stores had the same facts and circumstances involved. Issues such as demographics, location, and local competition are important. So are issues such as some multi-store operations versus a single-store operation. There are certainly similarities in the operations of a McDonald's franchise, but the value of Franchise A may be quite different than Franchise B. What about the Pizza Hut franchise that only sells pizza versus the store that has a beer and wine license as well? Could this have an impact on value? Of course!

1 Rev Rul 59-60, Sec 3.01 1959-1 C.B 237.

'Valuation is not an exact science.' Why not? What is a science? Webster's defines a science as "the intellectual and practical activity encompassing the systematic study of the structure and behavior of the physical and natural world through observation and experiment." Chemistry is a science. Every time you mix the elements properly, you get a predetermined result. Every time you formulate H_2SO_4, you get sulfuric acid. The salt on your table is NaCl, or sodium chloride. These formulas just don't change. That certainly is not the case with the valuation of a closely held entity.

How can valuation be a science? Two very competent appraisers can look at the same business and arrive at different conclusions as to the value. Why is that possible? Because valuation is not a science. It encompasses judgmental issues. What is the risk involved with the specific entity? What is the real growth potential of both the market and the specific company? Can the specific company actually exceed the growth rate of the industry? Does the specific company have the financial strength to grow at the industry rate? These and a myriad of other questions are not

August Tip From the Field

Common Pitfalls of Solvency Opinions

One of the things courts often criticize in solvency opinions is the lack of independent scrutiny of management projections. Another issue that commonly arises is the inappropriate application of valuation discounts and premiums. Also, sometimes it's forgotten that, unlike a valuation, a solvency opinion is a binary decision. That is, the subject entity is either solvent or it's not. From a practice management perspective, experts suggest that solvency opinion pricing should reflect more risk if more parties rely on the opinion.

Source: Solvency Opinions: Legal Insights and Best Practices for Valuation, BVR webinar, June 5, 2018. Available at sub.bvresources.com/trainingeventpast.asp?WebinarID=641.

scientific, they are based on the experience and judgment of the appraiser.

Why does the Rev. Ruling specifically state that *"[n]o general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock"?* The answer is crystal clear; no formula captures the many nuances found in a closely held company. From product to management to financial stability to competition, each of these factors must be analyzed and considered before reaching a conclusion of value.

2. *"It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value should be considered."*[2]

The revenue ruling provides us with eight factors *"to be considered."* (emphasis added) There are no absolutes in this list. So what are we considering? History, current and expected economic conditions, financial analysis, dividend capacity, goodwill, and comparable sales. No formulas are listed. Sure, we can use math for financial ratio analysis, but the consideration of the various factors again is a judgmental and common-sense issue.

We, as valuation professionals, are required to acquire as much data as possible to then examine and analyze that data and apply that data to the facts and circumstances that are part of our valuation engagement. True valuation professionals are "data junkies," and never have all the data they might desire. As Colin Powell once commented, if the general waits until he has 100% of the data, the war will be over before a decision is made. Since we will never have all the data we might desire, we must go with what we have, using judgment, reasonableness, and common sense to guide us toward the conclusion of value.

3. *"In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings."*[3]

What do Ford, General Motors, Toyota, and Honda have in common? They all are in the business of manufacturing automobiles. Yet let's look at their respective market valuations. At the time this article was written, GM stock was selling at a P/E ratio of 6.99, with a dividend payout of 4.22%. Ford had a dividend yield of 5.54% yet was selling for a P/E ratio of 6.01. Toyota had a dividend payout of 2.96% with a P/E ratio of 10.3, and Honda had a dividend yield of 2.63% and a P/E ratio of 6.04. What does this tell us? Ford had the highest dividend yield yet the lowest P/E ratio. Why? The public's perception of growth, future success, market, and product adaptability. Public perception cannot be measured with a formula. This is even more relevant to a closely held entity. No "public perception" is available. We don't have analysts following the company.

2 Ibid., Sec 4.

3 Ibid., Sec 6.

We don't have the CFO of the company giving us guidance as to future earnings. Yet we must factor those same issues into our valuation conclusion. What is the risk involved? How do we measure the very items discussed in Rev. Ruling 59-60?

As contemplated in the Rev. Ruling, things can and do change. History may be a guide, but it is not an answer. Projections may be a guide, but are they reliable? Can a technological change impact the subject company? If yes, how do you measure the impact and factor that into your valuation conclusion?

4. *"Because valuations cannot be made based on a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors … and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance."*[4]

Again, we have the specific reference to the fact that there cannot be prescribed formulas. In over 40 years of business valuation, the one truth I truly understand is that no two businesses are exactly the same. I don't care whether they are car dealers, hamburger stands, or widget manufacturing entities. Each business has unique characteristics that need to be understood and applied to the information prior to reaching the conclusion of value.

4 Ibid., Sec. 7.

Public Comps

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I believe that this is true with statistical analysis. When we apply the statistical analysis to the data, what are we really achieving? An idea that the data are meaningful? That we have outliers? That, statistically, our answer should fall somewhere within the "range" that the statistics provide? While helpful, all the statistics in the world only provide us with additional information *to be considered*. They don't provide us with the answer; they are but just one tool available to the valuation professional.

Now that I have discussed the four laws, let's discuss how they impact the current business valuation climate.

There is no magic bullet. Current practitioners seem to me to be searching for the Holy Grail. There is no such thing as the "perfect valuation." It didn't exist 30 years ago, it doesn't exist today, and I doubt it will exist in the next 25 years. I hear questions such as:

- How do we get bulletproof data? What do I do if the data are flawed?
- Where can I find a formula that will calculate the valuation?
- Why is determining a capitalization rate so difficult? Isn't there a better formula to use? Where can I get the "beta" for a closely held firm? Is "beta" applicable to a closely held entity?
- How can I be more precise in my conclusion of value? I don't want my valuation opinion to be questioned.
- Why does the engagement take so much professional time?

I'm sorry if this disappoints you, but there is no magic formula, no hard and fast rules, and no single publication where you can get the perfect answer to your valuation. I can't point to a single class or textbook that will cover all the issues. It's great to take a class on how to value a widget manufacturer, but, without a basic understanding of the valuation process, the how-to class is useless. When I performed my first valuation in the late 1970s, I purchased every publication available relative to valuation of closely held businesses. That amounted to about four inches of shelf space. Now I look at my library, and I am shocked at the volume of information I have. And that doesn't include all the information I have online that doesn't require shelf space.

Experience comes in years, not in a spreadsheet. I'm sorry to report that you cannot have 10 years' experience if you have only been practicing for five years. The math is working against you. Don't get me wrong, every one of us in the BV profession had to start somewhere, and all of us were neophytes. Every time you work on a valuation engagement, your depth of understanding should be increasing. Filling out spreadsheets, just entering data, does not expand on the body of knowledge that is necessary to be an accomplished business valuation expert. I hate to disagree with many of the governing bodies of our profession, but taking a one-day valuation course will *not* provide you with the skills you need to complete a full USPAP-compliant valuation report. We seem enamored with the idea of taking CPE, getting "credentials," and occasionally completing a BV engagement makes us an expert in the profession. That is a start, but it is not the end result. The true expert in the profession has years of experience and understands that other similar professionals may not agree on all the positions taken but is willing to discuss those differences intelligently. I don't hold a lot of stock in the CAPM method. I don't believe you can accurately determine a "beta" for most closely held entities. Others in the profession disagree with me. That is what makes a profession strong: the honest discussion of ideas and concepts and the understanding of both your and the opposing opinion. Look at the many years of work on the taxation of pass-through entities. Is there a hard and fast rule today? No, the discussion is still evolving, and that is good for the profession.

Training should be rigorous and ongoing. We as a profession need to take a hard look at our training, from the brand-new valuation analyst to the old experienced veteran. Training must be logical. You must start with the basic concepts, slowly move to the intermediate issues, and finally become familiar with the "state of the art" or "emerging" issues. I don't think we do that today. The profession seems to be more focused on revenues from training, rather than training for professionals. I have some of the same criticism of the credentialing process. I won't endorse or condemn any specific programs, but I do question the sanity of anyone presenting a multiday course, with no intervening time to apply the information, that ends with an exam that earns a credential. Humans can be very good at reading information and regurgitating that info on an exam form. That doesn't mean the individual "understands" the concepts and applications of the information. I am continually shocked when I talk to a young BV professional that can talk the talk but, when pressed, can't walk the walk. I was recently shocked to see a major professional group offer a CPE program to "credentialed individuals" on how to complete the initial engagement. Credentialed yet never has completed a BV engagement? How is this possible?

One of the areas of CPE that I do not see anybody providing is CPE for the advanced practitioner. Many years ago, the AICPA BV conference was the leading "advanced" conference on BV issues. Now it is advertised as an intermediate conference, and a great many of the faculty are part-time practitioners, that may or may not be past the intermediate level of competence. It is the advanced practitioners that are the thought leaders for the future growth of the profession. Unless we are projecting that the BV profession will be a large group of part-time, intermediate-level practitioners in the future, where are we developing those future leaders?

Judgment, common sense, and reasonableness. When I was with the large CPA firm, I used to ask my staff members one question about their valuation conclusion. The question was: Would you put your money in this deal at that price? If the answer was no, then how can you justify the value?

We talked about training above. There is a need to continually increase your skills, whatever level you are at. There is always something new to learn. Sometimes, you learn that the proposition being put forward doesn't work. That's OK. I can't begin to describe the changes in the BV profession over the last 40 years. Even today, there are still issues that are unsettled. Is a sub S more valuable that a C corp? Should there be a discount for lack of marketability where a sale is not a foreseeable event? If I use publicly traded information, is that really a minority value?

The one thing I can state has not changed is the need for practitioners to use their mental capabilities. Data are data. They must be converted into something usable to produce a valuation conclusion. The data and conclusion must be reasonable. The valuation professional must use his or her judgment in many areas of the engagement. And the final work product must make sense, to both the preparer of the valuation, as well as to the user of the valuation.

We provide an opinion, not a factual determination of the value of an entity. This opinion is based on the data, the facts and circumstances of the specific engagement, and the appraiser's judgement, experience, and common sense. I don't know why there is a move to remove the human element from the equation, but I believe that, if we remove the human element, our valuations will be nothing more than computer-generated non-sense.

The full-time vs. part-time debate. I have commented on this in past writings and still strongly feel that the BV practice has become so complicated and demanding that it is difficult, if not impossible, to provide these services part-time. What has happened to the "part-time" auditor? How does that auditor keep up with

the professional standards, the CPE, and the expertise required to produce a quality audit? The same is true in the tax practice. When it comes to CPE, and the need to get 40 hours per year, where do we spend our time to get that 40 hours? Tax? Audit? BV? Is the goal to become marginally competent in many areas, or to become very competent in a single area? What makes us believe that business valuation is simple enough that we can practice in audit or tax and then do justice to a part-time BV practice?

Credential madness. It is time to stop the "madness" of credentials. NACVA published a chart that lists 12 designations in valuation or forensic accounting. Add to that subspecialties such as divorce, expert witness certifications, and others, and we have more than 16 certifications in this practice area. Who are we kidding? It is high time that the profession looks long and hard at the issue of certifications. Are they for the public's benefit? Or are they for the purposes of generating revenues for the groups granting the certification? Worse yet, each of the credentialing organizations tout their credential as the most stringent, or the "best." They can't all be right. Does the public really understand the difference between ABV, ASA, CVA, etc.?

Since first writing this article, the AICPA made a decision that needs to be mentioned here. On May 22, the AICPA Council (the organization's governing body) unanimously passed a resolution to open up the ABV credential to non-CPAs.[5] Currently, to get the ABV designation, you must:

- Hold a CPA certificate;
- Have 75 hours of CPE in business valuation;
- Have 150 hours of business valuation experience; and
- Pass the ABV exam.

Under the new proposed non-CPA "qualified finance professionals," those individuals must:

- Have 75 hours of CPE in business valuation education;
- Have 1,500 hours of business valuation experience; and
- Pass the ABV exam.

On June 18, an open letter to the AICPA was released that 32 prominent business valuation professionals, including many individuals that were part of the creation of the ABV credential, signed.[6] The open letter makes the following points to the AICPA:

- The AICPA did not reach out to current ABV holders for comment. In fact, the entire process was kept secret until the council was asked to vote on the change.
- The issue of licensing is not addressed. Currently, CPAs are licensed by the states where they practice. These state agencies have enforcement power over the activities of CPAs. Non-CPAs will not be subject to enforcement activities because they will not be licensed and therefore are not under the jurisdiction of the state regulatory agencies.
- There has been *no* transparency in this substantial change to an existing credential.
- There is a complete "failure to uphold the standards of the profession." Ethics, conflict issues, and the like are not addressed at all, let alone the enforcement of the professional conduct of the non-CPA practitioner.
- Lastly, the open letter asks the AICPA to reconsider its decision and get the input of

5 See AICPA Website, May 25, 2018 announcement, "ABV Credential Opened to Qualified Finance Professionals."

6 The entire letter can be seen at bit.ly/2MA4ESX.

the current ABV holders and the leaders of this portion of the profession.

A survey has been set up for comments from the current ABV holders and others that this change impacts, so please make your position known.[7]

I have grave concerns about this issue. As discussed above, the AICPA CPE Business Valuation conference has deteriorated from an advanced, cutting-edge program to a program the AICPA describes as intermediate. This does not give me great comfort that current CPAs are receiving the best business valuation education. How will the AICPA regulate the business valuation training of non-CPAs? Let me be perfectly clear. I am not suggesting that, if you are not a CPA, you cannot become a BV professional. I have been an ASA for more years than I have held my ABV, and I received my ABV as part of the initial class. A path currently exists for non-CPAs to obtain a valuation credential.

I see no compelling reason for this change, other than a revenue-generation issue for the AICPA. I do not believe it is in the public interest or the best interest of the CPAs, whether they practice valuation or not. Clearly, the AICPA did not properly vet this proposal with current ABV holders or others that this change impacts. I did not learn about the issue until the day the vote was taken at council, and then only because a member of council, who happens to hold the ABV, posted a message on LinkedIn. He had no advance notice of the issues either.

I also suggest you read the articles that have further discussion of this issue.[8]

What do I suggest? I view this paper as a call to arms, both to the older, experienced practitioners and to those practitioners that hope to make BV a full-time career.

I ask all of you to get involved. Change will only come from the inside. The status quo is a long-term recipe for disaster.

It is time to remake our CPE, to recognize that, in between those theoretical training sessions, the practitioner needs time to apply those concepts in the real world. It is one thing to understand the concept; it is another totally different ability to apply the theory to the real world. Then, and only then, is it time for the practitioner to move on to the next level of training.

Lastly, I ask all of you to get involved. Change will only come from the inside. The status quo is a long-term recipe for disaster. I am reaching the end of my practice. I have numerous years of full-time experience. I have taught BV courses to CPAs and attorneys. Where is the next generation of full-time professionals? Are you willing to address the hard issues relating to CPE, full-time practice, and certifications? For the good of the profession, I hope the answer is a resounding *yes*. I also encourage you to make your thoughts known about opening the ABV credential to non-CPAs. ◆

Robert E. Kleeman Jr., *CPA/ABV, ASA, is managing director of OnPointe Financial Valuation Group LLC based in Englewood, Colo. Kleeman has more than 40 years' experience as a CPA and in the valuation of business interests, including both publicly and closely held businesses and intangibles. Kleeman also has extensive experience as an expert witness and has provided testimony regarding business valuation and commercial damage issues.*

7 A link to a survey on this issue can be found at bvresources.com/articles/bvwire/make-your-voice-heard-in-the-aicpa-abv-controversy.

8 "AICPA's move to allow non-CPAs to get ABV sparks strong reaction," *BVWire,* June 20, 2018; "CPAs object to AICPA offering ABV credential to non-CPAs," *AccountingToday*, June 21, 2018.

Letter to the Editor: Comments on an Article on the Number of Transactions for the GCTM

Editor's note: This letter is in response to the article "Valuation Experts Clash Over Analysis of Transactional Data" and accompanying supplement that appeared in the April 2018 issue of BVU. *The comments in this letter are specific to the issue of how many transactions to use in the guideline company transaction method (GCTM). This letter is from Robert C. Schlegel, FASA, MCBA, a veteran business valuation professional who is also an instructor in the ASA's accredited valuation classes.*

I'm following the five- or 30-transaction number arguments with a little bit of sadness. Too often we tend to become "rules-based" when in fact critical thinking should prevail. Like Gary Trugman, I focus on the analysis of the market evidence as the necessary step, not just a rote number of transactions. BV work is not mechanical, and no magic number or boundary would deserve a flag on a checklist.

In ASA's BV201 course concerning the market approach, we don't specifically encourage a set number of transactions but rather emphasize "adequate data" and "refinement of the selection" in the appraiser's judgmental process. One might start with 40 or 50 transactions from a gross first cut and then winnow the list down in successive passes. Realistically, Ray Miles, in describing his use of his "direct market data method," was commonly cited as desiring somewhere around 15 transactions or so. Usually some point of central tendency is used, such as a median of the various multiples. But it is not uncommon for appraisers to select another multiple between the high and low with meaningful rationale and support. Having too few transactions risks skewing the midpoints with flyers in the data. Having too many transactions may cause more work without reasonably improving the insight from the evidence. One can torment the data in regression analysis, as some have suggested, and the coefficient of variation statistic does show an overall "goodness of fit." But similarity of the transactions to the subject, via industry, size, yield, and perhaps the age of the transaction, requires judgment.

I think that most BV professionals would feel comfortable with 12 to 20 transactions as a peer group, but that is not sanctity. It isn't the number; it is the judgment of similarity that this market evidence has relating to the subject entity. Transaction evidence should be considered with other methods such as public-company evidence, income models, and adjusted net tangible and intangible assets in reaching our final opinion.

To go further with this method, one failing that we have in most transaction databases is the lack of depth or understanding of financial conditions for prior years behind the companies that were acquired. We cannot see historical trends or volatility. There are also inconsistencies and, sometimes, duplications in the databases. Transactions represent historical data occurring in prior economic periods, often with different buyer-seller pressures and motivations. It is hard to distinguish a financial buyer from an investment (strategic) acquirer. Consequently, we deal with dirty data, but those are what we have.

These prior transactions from *Pratt's Stats* (soon to be relaunched as *DealStats*), BIZCOMPS, IBA, or others generally favor smaller companies where the business purpose and focus of earnings are similar. Larger companies (and maybe selecting larger transactions) may show less comparability in this method because size may impart variety in revenue sources and products/services, larger geographic markets, economies of scale affecting earnings levels, better access to capital

(affecting cost of capital), improved management depth, and (thinking like Michael Porter) more competition.

Transaction evidence itself is anathema to pure-hearted analysts who dismiss all transaction evidence for lack of similarity and thus rely solely on an untainted income approach. While the numerator may be pure, the denominator itself in an income approach is largely based on gross public-market evidence (as is capital structure). Capital structure also comes from market evidence, so, for example, designing a WACC model while making light of market evidence can be a huge inconsistency. Our work is essentially opining on value based on comparable market evidence. If we substitute our own feelings of what the market would do, we run the risk of concluding intrinsic value instead of fair market value (or fair value based on market participants). Transaction evidence helps to bring sanity and real-life comparisons to our reports for readers to understand and, despite the shortcomings, helps to create a firmer foundation with several supporting legs for our opinion (or conclusion of value). But if you ultimately select five or 30 transactions (or some other number—your choice!), the evidence should support your opinion.

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Work File Checklist for the Selection of Royalty Rates

Under the Mandatory Performance Framework (MPF) for the Certified in Entity and Intangibles Valuation (CEIV) credential, valuation experts will be expected to have a certain amount of documentation in their work files. Regardless of whether you hold the CEIV credential or not, anyone doing fair value for financial reporting should comply with these new rules.

Practice aid. A good compliance tool is a work file checklist that reflects what the MPF requires. In past issues of *BVU*, we presented checklists for a number of valuation areas. In this issue, we give you a checklist for how to document the selection of a royalty rate when valuing intellectual property assets or rights such as trademarks, trade names, or patents. The MPF points out that the foundation of the relief from royalty method is that a buyer would be relieved from the need to pay a royalty for the right to use an intellectual property asset. "Therefore, market-based royalty rates appropriate for a specific intangible asset must be estimated," the MPF says. "If market-based royalty rates are not available, simulated royalties or rules-of-thumb rates are often used."

An important point the MPF stresses is that valuation professionals should understand the terms of observed royalty rates. These terms include upfront payments, graduated rates, or a percentage of revenue versus royalty per unit sold. It's also important to understand whether a licensee or a licensor is responsible for any expenses.

This checklist is based on what is contained in the two MPF documents, which you can download from a special website set up for the CEIV credential (ceiv-credential.org). ◆

Work File Checklist:
Minimum MPF Requirements for Royalty Rates

The valuation professional, at a minimum, must document the following in writing within the work file, if applicable:

- ☑ The criteria used to search for third-party licensing agreements and the rationale for using or excluding an initial list of data in the analysis;
- ☑ The lists and data produced during the search;
- ☑ The process used in analyzing the third-party licensing agreements and support for the selection of the royalty rate used;
- ☑ The rationale for using or excluding licensing arrangements of the subject entity when determining a reasonable royalty rate;
- ☑ The reasonableness of all rules-of-thumb methods considered and used in estimating or supporting a royalty rate to value the subject asset;
- ☑ Identification of sufficient excess earnings or cash flow to provide economic support for the selected royalty rate.

Be aware that these are minimum requirements, so more information may be necessary. In future issues, we will provide other checklists that will go into specifics of the documentation requirements for other methods, inputs, and assets/liabilities.

(*Source:* This checklist is derived from the document "Application of the Mandatory Performance Framework for the CEIV." The information in this checklist has been summarized and adapted. See the actual document for additional explanation and requirements at ceiv-credential.org.)

New Analyses Reveal U.S. and Global BV Standards in Sync

There has been some criticism about the fragmentation of the business valuation profession and particularly about the standards. Regulators and some observers had the perception that the five sets of U.S. BV standards various credentialing and standard-setting organizations issued somehow were at odds with each other. Likewise, the three sets of international standards could also be perceived as being in conflict. However, two new analyses reveal that this is not the case.

Two comparison charts. At the recent annual conference of the National Association of Certified Valuators and Analysts (NACVA), two charts were presented that give side-by-side comparisons of the U.S. and international business valuation standards. The U.S. chart compares the standards set by NACVA, IBA, AICPA, ASA, and USPAP (see a small excerpt in Exhibit 1). The international chart compares the standards from the IVSC, RICS, and the CICBV (see a small excerpt in Exhibit 2). Both of these charts are available free on BVR's website.[1]

1 Go to bvresources.com in the "Free Resources" section under "Articles and Webinars."

Exhibit 1. Excerpt From Domestic BV Standards Comparison Chart

I. Introduction					
				AICPA-SSVS-VS Sec. 100	
NACVA	**IBA**	**USPAP**	**ASA**	**Calculation**	**Valuation**
These principles-based Standards have been developed to provide guidance to members and other valuation professionals performing valuation services. The use of professional judgment is an essential component of estimating value.					
A. Preamble Members of the National Association of Certified Valuators and Analysts (NACVA) shall comply with the standards and definitions herein. NACVA will adopt changes to and interpretations of the Standards when necessary.	X IBA STD				
II. General and Ethical Standards					
NACVA	**IBA**	**USPAP**	**ASA**	**Calculation**	**Valuation**
A member shall perform professional services in compliance with the following principles:					
A. Integrity and Objectivity A member shall remain objective, maintain professional integrity, shall not knowingly misrepresent facts, or subrogate judgment to others. The member must not act in a manner that is misleading or fraudulent.	X	Ethics Rule (177–186)	Principles of Appraisal Practice and Code of Ethics ("PAPCE") Par 2.2, 4.3, and 7.5	Secs. .03/.14	Secs. .03/.14
B. Professional Competence A member shall only accept engagements the member can reasonably expect to complete with a high degree of professional competence. If a member lacks the knowledge and/or experience to complete such engagements with a high degree of professional competence, the member is not precluded from performing such engagements. In such instance, the member must take steps necessary to gain expertise through additional research and/or consultation with other professionals believed to have knowledge and/or experience prior to completion of such engagements.	X	Competency Rule (299–337)	Par 3.4 and 4.2	Secs. .03/.11/.12	Secs. .03/.11/.12

Mark Hanson (Schenck SC), Mark Kucik (The Kucik Valuation Group LLC), Carl Steffen (WSRP LLC), and C. Zachary Meyers, who were part of the team that developed these charts (which took several years) were on hand at the NACVA conference to explain the charts. Their intent was to show that all the standards are essentially addressing the same issues and do not conflict with each other. They started this effort—which has been going on for several years—to address the concerns of the SEC and other regulatory agencies that the standards are confusing and that they conflict with each other. After drafting the first version of the charts, they were distributed to the various standard-setters for their comments and corrections, similar to an exposure draft. After some revisions, they were disseminated again for comments to make sure they were accurate.

Taking a look at the standards side by side was an eye-opener, they said. There are some subtle differences, but the principles are very close. As for the differences, they can be interpreted as being covered in one of the other standards but worded a little differently. Bottom line, the standards do not conflict and all basically say the same thing.

Exhibit 2. Excerpt From International BV Standards Comparison Chart

NACVA	IVSC [IVS1] [IVS2]	RICS/Red Book [RIC1]	CICBV [CICBV1]
I. Introduction			
These principles-based Standards have been developed to provide guidance to members and other valuation professionals performing valuation services. The use of professional judgment is an essential component of estimating value.	Introduction and IVS Framework	Introduction/PS 1	Code of Ethics ("Code")/ Standards 110/120/130/210/220/ 230/310/320/330/410/ 420/430
A. Preamble Members of the National Association of Certified Valuators and Analysts (NACVA) shall comply with the standards and definitions herein. NACVA will adopt changes to and interpretations of the Standards when necessary.	Code of Ethical Principles for Professional Valuers ("Code")/IVS Framework ("Framework")	RICS Rules of Conduct for Members ("Code") and PS 1/PS 2-1	Code 101/Standards 110/120/130/210/220/ 230/310/320/330/410/ 420/430
II. General and Ethical Standards			
NACVA	**IVSC [IVS1] [IVS2]**	**RICS/Red Book [RIC1]**	**CICBV [CICBV1]**
A member shall perform professional services in compliance with the following principles:	Code/Framework	PS 1 and PS 2	Code 101
A. Integrity and Objectivity A member shall remain objective, maintain professional integrity, shall not knowingly misrepresent facts, or subrogate judgment to others. The member must not act in a manner that is misleading or fraudulent.	Code Par 12/ Appendix A2.1–A2.13/Framework (40.1/40.2)	Code Part II and PS 2	Code Ethical Principles
B. Professional Competence A member shall only accept engagements the member can reasonably expect to complete with a high degree of professional competence. If a member lacks the knowledge and/or experience to complete such engagements with a high degree of professional competence, the member is not precluded from performing such engagements. In such instance, the member must take steps necessary to gain expertise through additional research and/or consultation with other professionals believed to have knowledge and/or experience prior to completion of such engagements.	Code Par 12(c)/ Appendix A2.14–A2.19/Framework (50.1/50.2/50.3)	Code Part II-4 and PS 2	Code 102

The standards may be perceived to be different because organizations write their standards for their own members, who have different needs and levels of education in business valuation. For example, the AICPA's SSVS No. 1 standard is over 70 pages long, while the corresponding NACVA standard is eight pages. A casual observer would think the two standards are vastly different, but it's not true. The audience for the AICPA standard is its entire membership of CPAs, most of whom have no education in business valuation. The NACVA audience is its members, who have all gone through courses in business valuation. Therefore, the CPA needs a lot more background about valuation methodologies and approaches. If you extract all of that extra material, the principles are basically the same, they said.

It's hoped that various organizations around the world can use the two charts to further unify accepted standards. ◆

Remarkable Progress for the Insolvency and Registered Valuer Programs in India

By Raymond Moran, ASA, MRICS

The Insolvency and Bankruptcy, and Registered Valuer program regulations have been implemented in less than two years, a remarkably fast period of time. I was fortunate to be able to meet with some of the key regulators and Registered Valuer Organizations (RVOs) driving this process during the Third BV Summit in Delhi on June 15. I met with Dr. M.S. Sahoo, chairperson of the Insolvency and Bankruptcy Board of India (IBBI), and Makarand Lele, president of the Institute of Company Secretaries of India, to discuss how these changes in bankruptcy and insolvency regulations were being implemented, their impact on the valuation profession, and the outlook for valuers in India.

Great potential. The Insolvency and Bankruptcy Code (IBC) of 2016 took the place of existing bankruptcy regulations in India and coincided with the creation of the IBBI on Oct. 1, 2016. Dr. Sahoo, an attorney and experienced regulator who has served with the Securities and Exchange Board of India (SEBI), National Stock Exchange, Competition Commission of India, and Secretary of the ICSI among other public positions, discussed how some of these changes came about so quickly. Dr. Sahoo has been quoted as saying the IBC "has the potential to push up GDP growth by about 2%, apart from improving ease of doing business, developing corporate debt market, promoting entrepreneurship, and helping inclusive growth, in the days to come."[1]

The IBBI has registered insolvency professionals from the ranks of chartered accountants as well as company secretaries and has set in place examinations for professionals to become registered as Insolvency Professionals. Dr. Sahoo describes the code as not a procedure for recovery or liquidation, but rather a resolution process under which creditors can expect to recover amounts from future earnings, rather than a sale of a firm's assets. The process is designed to move quickly and is triggered by a debtor or creditor making an application and an interim insolvency professional then being appointed. This individual then forms creditor committees and makes attempts to get an approved plan in 180 days.

Related to the IBC is the Registered Valuer program that provides for real estate, machinery and equipment, and business valuers to be

1 "Bankruptcy Code Can Push GDP by 2%, Says MS Sahoo," *BW Businessworld,* April, 2017.

tested and accredited and to receive the Registered Valuer designation. The Registered Valuer program will be in effect by September 30. The process is well underway and is required in order for valuers to sign insolvency and valuation reports in India. Many valuers have taken the required 50 hours of approved education, passed examinations, and have received their designations.

Dr. Sahoo noted that six RVOs are currently registered on the IBBI website, and he expects a few more to emerge. The three largest—the Institute of Chartered Accountants of India (ICAI), which has over 100,000 members, and the ICSI and the Institute of Cost Accountants of India, which have approximately 50,000 members each—are driving the creation of standards for valuers to follow. There's a general consensus that the current number of RVs will undergo consolidation at some point after the September 30 deadline for Registered Valuers. Standards are now in place and/or being approved for valuing financial and tangible assets, and Dr. Sahoo suggested additional standards could be addressed for issues such as mining and mineral extraction, fine arts and artifacts, and individual bankruptcies as the process unfolds. The IBBI is very interested in global valuation regulations, issues, and organizations worldwide, and I was asked as many questions about the state of the valuation profession in the United States as I was able to ask regarding India.

Growth of valuers. Dr. Sahoo couldn't comment on how many valuers would receive the designation. Given the large number of real estate valuers in India and the size of the accounting organizations and the CFA Institute India, which has over 13,000 members, the number of Registered Valuers should grow quickly. He's bullish on the growth of the Indian economy and expects these insolvency and valuation regulations and standards to do their part in growing the Indian economy. He did state that demand for standards and an improved process is more on the financial asset side than tangible assets.

I asked if he or the IBBI would attend the IVSC AGM this fall in Dubai, given the working relationship with the IVSC, but Dr. Sahoo said he hadn't been invited *yet*. Hopefully, we'll see him there to report on the progress after the September 30 deadline.

I also met with Makarand Lele and his colleagues at the ICSI at their headquarters in Delhi to discuss the role of company secretaries. ICSI was organized under an act of Parliament (The Company Secretaries Act of 1980), and it functions under the jurisdiction of the Ministry of Corporate Affairs. With ties to other company secretary groups in other countries, four regional offices, and 69 chapters in India, ICSI is a large organization whose members handle and process all legal aspects of securities filings, mergers and acquisitions, insolvency and bankruptcy, and all legal aspects of corporate governance. The ICSI has a 90-hour online Certificate Course in Valuation, which it offers to its members, focusing on valuation analysis, DCF modelling, trading, and transaction comparables. Lele is very keen to stay abreast of global valuation trends and issues for the ICSI members and working with several valuation firms and organizations for valuation education and courses for its members.

The June 15 BV Summit Delhi followed the same format and agenda as the prior summits but had several exhibitors in the halls in addition to the mix of private equity, bankruptcy and insolvency, and valuation professionals attending. The panels were crisp, and the questions were probing, as participants now understand the new regulations that have been rolled out and received significant exposure through the RVOs, financial media, and regulators. ◆

Raymond Moran, *ASA, MRICS, is CEO of MG Valuation LLC (New York City) and is on the board of the International Institute of Business Valuers (iiBV). A frequent speaker and author on valuation issues, he can be reached at rmoran@mgvaluation.com.*

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A monthly roundup of key developments of interest to business valuation experts.

Regulators, Standard-Setters, VPOs

Uproar over AICPA opening ABV to non-CPAs

An Open Letter[1] to the American Institute of Certified Public Accountants (AICPA) urges it to reconsider a recent decision by its governing board to allow non-CPAs to be eligible for the Accredited in Business Valuation (ABV) credential.

The letter, signed by a number of prominent CPA/ABVs, states that doing so will dilute the credibility of the ABV credential, confuse the public, harm the reputation of CPAs, and impact "the financial well-being of current and future CPA/ABVs by assisting non-CPA appraisers to better compete with CPAs."

In addition, the letter takes the AICPA to task for not being transparent in the process because AICPA members and stakeholders were not consulted prior to the change. What's more, the signers of the letter believe that the AICPA Council (the organization's governing board) "was not fully informed as to the implications of this change," the letter says.

BVU reached out to the AICPA, and it has issued the following statement:

> We believe that the CPA is the best foundation for the ABV credential, but we also recognize that many highly qualified accountants/ finance professionals do not plan to perform audits and do not sit for the CPA Exam. With an increasing demand for valuation services, the need for additional valuation professionals who would be held to the standard of excellence as established by the CPA profession became evident. So, with careful consideration and approval from AICPA Council, the AICPA decided to open the credential up to qualified professionals who meet the high professional and educational standards, have the extensive requisite valuation experience, who pass the rigorous exam, adhere to the AICPA code of conduct and fulfill annual continuing education requirements. This not only will help maintain the high professional and valuation standards established by the AICPA but will help elevate the entire valuation profession. It is our belief that this is preferable to having those qualified professionals seek a less rigorous credential in Valuation. We believe that increasing the quality of the valuation professional will serve to protect the public interest by increasing clarity, consistency and transparency in valuation work.

What are your thoughts on this? A discussion on this matter has been set up on BVR's LinkedIn page.[2]

The Appraisal Foundation seeks board candidates

The Appraisal Foundation is currently conducting its annual search for qualified candidates to serve on the Appraiser Qualifications Board (AQB) and the Appraisal Standards Board (ASB). The AQB is responsible for establishing the minimum education, experience, and examination qualification criteria for real estate appraisers. The ASB is charged with developing, interpreting, and amending the Uniform Standards of Professional Appraisal Practice (USPAP). Familiarity with USPAP is a prerequisite of service on the ASB, and a minimum of 10 years of appraisal experience is required. Individuals selected for these positions will serve a term of one to three years starting on Jan. 1, 2019. The deadline for filing an application is August 17.[3]

ASA 2018-2019 election results

Robert B. Morrison (Morrison Valuation & Forensic Services) has been elected international president of the American Society of Appraisers (ASA). Other newly elected individuals include: Bruce A. Johnson (Munroe, Park & Johnson Inc.), business valuation discipline governor; Ernest A. Demba (Demba Valuation Services LLC) and Jack Young (NorCal Valuation Inc.) received a tie vote as chair of the appraisal review and management discipline committee (there will be a run-off election); newly elected business valuation discipline committee

1 bit.ly/2MA4ESX.

2 linkedin.com/groups/1888911.

3 Application can be found at appraisalfoundation.org.

members are: Nancy M. Czaplinski (Duff & Phelps), Matthew R. Crow (Mercer Capital), KC Conrad (American Business Appraisers), Gary T. Frantzen (Alvarez & Marsal), and Ryan A. Gandre (Stout). This committee has five open seats for members at large. More election results can be viewed on the ASA's website at appraisers.org in the "Newsroom" section. Those elected officially took office on July 1.

NCCA renews NACVA status

The National Commission for Certifying Agencies (NCCA), a division of the Institute for Credentialing Excellence, has renewed the accreditation of NACVA's CVA credential for another five years. In his quarterly message[4] to members, Parnell Black, NACVA's CEO, noted that the CVA is the only valuation credential the NCCA accredits.

Methods and Approaches

Landmark study re: FMV of physician pay

An article in an upcoming issue of *hfm Magazine*[5] presents groundbreaking research and data analytics that challenge commonly held beliefs about survey data, physician compensation, and fair market value. Mark O. Dietrich (Mark O. Dietrich, CPA, PC) wrote the peer-reviewed article, which appears in the July issue of the *Journal of the Healthcare Financial Management Association* (HFMA). He makes the case for the entire healthcare industry to rethink its approach to the FMV of physician pay.

The government has been reaping hundreds of millions of dollars in fines from hospitals in lawsuits that have emerged out of the acquisition of medical practices. The thrust of the cases is the measurement of the FMV of physician compensation, which has typically been based on survey data. But this practice is often flawed because it is based on several false premises, including that the surveys have statistical significance for the 90% or so of physicians not included in the surveys. Also, survey data can be inconsistent with local-market conditions. The misuse of survey data leads to losses in acquired physician practices, which is the key quantitative analysis the government uses for the test for commercial reasonableness. Significant losses lead the government to believe that hospitals are paying for referrals, a violation of the Stark Law that triggers the big fines.

In the new article, Dietrich advises that the use of surveys should be limited to rough benchmarking and the focus should rather be on localized relative value unit (RVU) data that reflect actual local-market conditions. Dietrich discusses this issue and provides a complete alternative to the reliance on surveys to determine fair market value in the *BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements*, which he co-wrote with Tim Smith (Ankura).[6]

Read this case before writing your next valuation report

Not long ago, the speaker at a conference we attended asked the audience whether anyone was familiar with the *Gallagher* case. Very few hands were raised, and the speaker was surprised. During a recent webinar,[7] former IRS manager Michael Gregory also talked about this Tax Court case in the context of what the IRS wants to see in a valuation report.

The *Gallagher* case is a great example of the need to fully explain your conclusions. The judge (Halpern) had many problems with experts just stating things without explaining them. The very detailed opinion addresses nearly every aspect of private-company valuation, including the application of the guideline public-company method and income approaches. It also has a particular focus on tax affecting, adjustments to financial statements and cash flow projections, calculation of the rate of return, application of subsequent events, and the determination of discounts for lack of control and lack of marketability.

The case, *Estate of Gallagher v. Commissioner,* T.C. Memo. 2011-148, is available at *BVLaw*.[8]

4 nacva.com/content.asp?contentid=622.

5 hfma.org/hfm.

6 The book is available at bvresources.com/products/bvr-ahla-guide-to-valuing-physician-compensation-and-healthcare-service-arrangements.

7 sub.bvresources.com/bvstore/cd3.asp?pid=CD609.

8 bvresources.com/products/bvlaw.

Research Papers, Studies, Reports

New study: 'Mass' conversion from PTE to C corp

A new study[9] by Penn Wharton predicts a "mass conversion" of pass-through businesses to C corporation under the Tax Cuts and Jobs Act. Likely converts are those professional services businesses that don't qualify for the new 20% qualified business income deduction (QBID). These firms are attracted to the lower corporate tax rate of 21%, as opposed to the pass-through rate of around 40%, particularly if they have the ability to defer paying out dividends, the study says. Researchers forecast that 235,780 U.S. business owners will switch from pass-through entity owners to C corporations.

In a blog post, the S Corp Association says pass-through businesses are converting, just not "massively" yet. That will come when the deduction expires. "We're not sure how 'mass' this conversion is, given that there are more than four million S corporations and nearly that many partnerships and LLCs," it writes. "Their estimate is less than five percent of the total population here. Less than one percent if you include sole proprietors." The real "mass" conversion is yet to come, it says, but only if Congress fails to make the deduction permanent.

New research refutes notion of private-company discounts

There is no evidence that unlisted firms sell at discounts compared to listed firms, according to a new paper.[10] This goes against the routine assertion by academics, practitioners, courts, and regulators, who generally believe the opposite is true. The researchers say their results "hold under a number of different approaches and after controlling for known determinants of acquisition pricing."

Hints of optimism in the apparel industry

Although e-commerce keeps chipping away at traditional brick-and-mortar retail, "hints of optimism have emerged within the sector," according to the Duff & Phelps "Quarterly Apparel Report for Spring 2018."[11] The report identifies trends and provides insights across the apparel sector, including in-depth analysis of the global industry, focusing on key themes, issues, and opportunities. Try it on for size!

New Books, Guides, Publications

New resource for valuation of cannabiz

The Cannabis Industry Accounting and Appraisal Guide is a new book from Canna Valuation, a firm devoted to the licensed and regulated cannabis industry. The book provides useful information for appraisers and accountants about the unique financial aspects and intricacies related to businesses operating in this area. The book's authors are Ron Seigneur, Stacey Udell, and Brenda Clarke. The book is available at bvresources.com/products/the-cannabis-industry-accounting-and-appraisal-guide.

Miscellany

Why is fair value relevant to all BV experts?

Talking with some attendees at the recent NYSSCPA conference in New York City, we were discussing M&A, and someone was asked whether he had read the exposure draft on valuing contingent consideration,[12] a Valuation for Financial Reporting (VFR) advisory that The Appraisal Foundation (TAF) issued. His answer was: "No, I don't do fair value work." That may be a typical answer and understandable because one would not need to keep up with all of the minutiae of fair value developments if he or she did not practice in that area. But the more general developments should be followed because many of the issues apply in other valuation contexts. Speaking of which, there are three other TAF advisories: control premiums, the valuation of customer-related assets and contributory assets, and economic rents. All valuation experts should be aware of this guidance, which contains recommended best practices, methodologies, and examples—some of which will apply in other types of engagements, not just fair value.

9 budgetmodel.wharton.upenn.edu/issues/2018/6/12/projecting-the-mass-conversion-from-pass-through-entities-to-c-corporations.

10 papers.ssrn.com/sol3/papers.cfm?abstract_id=3159730.

11 duffandphelps.com/insights/publications/m-and-a/apparel-quarterly-update-spring-2018.

12 appraisalfoundation.sharefile.com/share?#/view/sc41120833cf4a009.

Global *BVU* News and Trends

Business valuation news from a global perspective.

Regulators, Standard-Setters, VPOs

TAF's Bunton discusses USPAP-IVS link

In an interview,[1] David Bunton, president and CEO of The Apprpanaisal Foundation (TAF), was asked about the relationship between USPAP and the International Valuation Standards (IVS) and how TAF is equipping U.S. appraisers with the information they need to apply IVS.

"In addition to other activities with the IVSC, both organizations have collaborated on 'A Bridge From USPAP to IVS 2018' (Bridge),"[2] Bunton says. "The Bridge document was developed to assist appraisers familiar with USPAP in producing a valuation that is also compliant with IVS. The Bridge describes additional steps necessary to ensure compliance with both standards.

"While we note that this joint effort unveiled more commonalities than differences in the two sets of standards, there are a few areas where there are noted differences. For instance, IVS has more extensive requirements for the initiation of the assignment by communicating with the client via a Scope of Work. In addition, appraisers developing a report to satisfy both USPAP and IVS must use the IVS terminology relative to Assumptions and Special Assumptions because while USPAP does not require use of the terms, IVS does. Regardless, the Foundation encourages appraisers to study the Bridge document carefully and note these differences."

New brand evaluation standard approved

The International Organization for Standardization (ISO) has unanimously approved a new global standard for brand evaluation, ISO 20671, that becomes effective in November.[3] The Marketing Accountability Standards Board (MASB) represented the U.S. in the development of the standard under the auspices of the American National Standards Institute (ANSI). Understanding that "brands are one of the most valuable yet least understood of assets," the standard provides a framework for systematic, recurring brand reviews. Developed over several years by branding experts from numerous fields, it covers the entire process: from brand development to brand performance to brand valuation. This qualitative standard on brand evaluation supports ISO 10668—the international standard on quantitative brand valuation, adopted in 2010.

1 ivsc.org/news/article/professional-insight-us-standard-setter-shares-a-vision-of-the-future-for-valuation-professionals.

2 appraisalfoundation.sharefile.com/d-s1463ebad4f94ee9a.

3 iso.org/obp/ui/#iso:std:iso:20671:dis:ed-1:v1:en.

CAS translates Asset Appraisal Law

The China Appraisal Society (CAS) launched an English version of the Asset Appraisal Law, which is designed to strengthen international communication and cooperation. The law was enacted in 2016 and was the nation's first asset appraisal law.

ASA joins iiBV

The American Society of Appraisers (ASA) is the newest member valuation professional organization (VPO) of the International Institute of Business Valuers (iiBV). "As ASA moves to enhance and accelerate world-wide membership, we compliment our iiBV colleagues for the strength of global education that they have achieved, doing an admirable job of writing universal content so that it is internationally relevant in countries outside of the U.S.," says Sharon A. Desfor, ASA international president. "The iiBV is delighted to be once again collaborating with the ASA in pursuit of high quality BV education to elevate the reputation and credibility of business valuers globally with users of valuation reports and government regulators. Their experience and leadership bring a wealth of knowledge to the iiBV and we are looking to ASA's support in the iiBV's pursuit of high quality BV education," says Edwina Tam, chair of the iiBV board of directors.

Research Papers, Studies

BV where no developed markets exist

James Searby (FTI Consulting) has published an article[4] in the *Middle Eastern and African Arbitration Review 2018* on the issues arising during a business valuation in countries without developed financial markets.

4 globalarbitrationreview.com.

BVLAW CASE UPDATE

Featured Case

Financial Advisor's Fairness Opinion Not Materially Misleading

***City of Hialeah Emples. Retirement Sys. v. FEI Co.*, 2018 U.S. Dist. LEXIS 11989 (Jan. 25, 2018)**

A shareholder in an Oregon business alleged top executives misrepresented financial information in the proxy accompanying the company's merger. Board members said that a set of lower projections was a more reasonable indicator of the company's future performance than a set of higher projections. For this reason, the board had asked the financial advisor to rely on the lower projections when developing its fairness opinion. The plaintiff claimed the board sought to lower the valuation of the company's intrinsic value, essentially to make the final sales price appear fair to shareholders. Further, the financial advisor "double discounted" risk in the discounted cash flow analysis supporting the fairness opinion. In a decision that makes clear the protection afforded certain financial statements, the court granted the defendants' motion to dismiss.

Two sets of projections. The plaintiff, a city employees' retirement plan, used to be a shareholder in the defendant company, FEI—an Oregon corporation that designed and manufactured a range of microscopy products and solutions providing images and answers on a micro-, nano-, and picometer scale. In September 2016, a Delaware company, Thermo Fisher, acquired FEI. The individual defendants were members of FEI's management and board of directors.

In fall 2015, FEI management prepared two sets of projections. The higher projections represented an aggregation of department-specific forecasts that managers at various business units across FEI had developed. The lower projections represented a downward adjustment of the higher projections by FEI senior management "to reflect FEI group-level dynamics." In December 2015, FEI used the higher projections when it acquired a third party (DCG Systems Inc.). After this acquisition, the board updated both sets of management projections.

Throughout the first half of 2016, FEI performed extremely well. In early 2016, FEI's president and CEO began discussions with the eventual buyer about a possible transaction. FEI's CEO and its chairman of the board met with Goldman Sachs (Goldman) about retaining the latter as financial advisor. Goldman disclosed that it previously had worked for the buyer, but the board found Goldman's past engagements did not create a conflict of interest that would interfere with Goldman's serving as financial advisor to FEI. The board's agreement with Goldman specified that Goldman would receive $10 million contingent on the announcement of a merger and $35 million contingent on the closing of the merger. FEI then provided Goldman with a copy of the updated management projections sets. At the time, neither the company nor Goldman expressed a view that one set of projections was more realistic or reasonable than the other.

The buyer's initial offer was $96 per share, a price the board found "insufficient in comparison to the value embodied in the Company's standalone plan." After the buyer raised its offer to $103 per share, the board directed Goldman to explore whether anyone else was interested in an acquisition. Two other parties came forward. FEI told the buyer that $103 per share was not sufficient and provided the higher projections to "convey the intrinsic value of FEI." A few weeks later, the other parties informed FEI they were no longer interested in negotiating an acquisition. In May 2016, the buyer raised its offer to $105 per share. In discussing the new price, the board began calling the higher projections "unrealistic." Ultimately, the parties settled on $107.50 per share.

Board members met with Goldman, which provided the financial analysis that appeared in the proxy statement to the company's shareholders. In its fairness opinion, Goldman found that, based on the lower projections, the $107.50 was a fair price. The board approved the acquisition and recommended the merger to FEI's shareholders for approval. The merger went through.

In its complaint, the plaintiff alleged the individual defendants promoted the acquisition to secure liquidity for hundreds of thousands of shares of illiquid FEI stock worth more than $42.8 million combined. Also, board members stood to benefit from an accelerated vesting of their unvested stock options and restricted stock units—a benefit not available to other stockholders. And members of the management team would receive up to $29 million in change-of-control benefits once the merger closed and obtain salary increases and tens of thousands of additional shares of restricted stock upon the signing of the merger.

Contested proxy. The plaintiff's complaint focused on the proxy in which the board recommended that company shareholders vote for the acquisition. The merger proxy included both sets of management projections and explained that the board had asked Goldman to rely on the lower projections, believing the lower projections "were more likely to reflect the future business performance of FEI on a standalone basis than would the [higher projections]."

The proxy further stated that the higher projections failed to include adjustments by senior management "to reflect the historical reality that it was rare for all of FEI's business units to achieve their projected financial goals in any particular year." The board said the higher projections represented an "upside case" that was contingent on all business units performing at planned levels, an assumption that did not align with FEI's historical experience. Therefore, the higher projections were less likely to reflect a reasonable estimate of the company's future performance on a standalone basis than were the lower projections.

The proxy included an additional caveat: that management projections were "not fact and should not be relied upon as being necessarily

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indicative of actual future results" and that "actual results may be materially better or worse than those contained in the management projections."

The higher projections table omitted certain line items that the lower projections table included—changes in net working capital, capital expenditures, and unlevered free cash flow.

The plaintiff's complaint was primarily based on section 14(a) of the 1934 Securities and Exchange Act and SEC Rule 14a-9, which "disallow the solicitation of a proxy by a statement that contains either (1) a false or misleading declaration of material fact, or (2) an omission of material fact that makes any portion of the statement misleading."

To prevail, the plaintiff had to show that the contested proxy included a material misrepresentation or mission that harmed the plaintiff and that the proxy solicitation itself, "rather than a particular defect in the solicitation materials," created an essential link in completing the transaction. Further, the Private Securities Litigation Reform Act (PSLRA) requires that the plaintiff establish that the defendant's act or omission of an act caused the loss for which the plaintiff seeks to recover damages. Put differently, the plaintiff must show "loss causation."

The plaintiff argued the proxy included false and misleading statements because it stated that the board believed the higher projections were unrealistic. According to the plaintiff, this was objectively and subjectively false. Moreover, Goldman's discounted cash flow analysis, which underpinned the fairness opinion, improperly double counted for risk. And the proxy misrepresented the higher projections by omitting line items and did not disclose the key assumptions and underlying data Goldman used for its fairness opinion.

'Forward-looking statement.' The defendant filed a motion to dismiss. It argued the board's statement regarding the management projections was protected under the PSLRA safe harbor provision that protects "forward-looking statements." The latter include any statement concerning financial projections, management's plans and objectives for future operations, future economic performance, or assumptions underlying or related to those issues.

The plaintiff denied that the statement was a forward-looking statement and, in the alternative, claimed that the statement was not protected because it lacked "sufficient cautionary language or risk disclosure." Further, the board knew that the statement was false.

According to the court, the higher and lower projections were "quintessential forward-looking statements." Further, the board's statement in the proxy that the higher projections were significantly less likely to be a reasonable estimate of the company's future performance than the lower projections was an "assumption underlying or related to" the company's future economic performance. Therefore, this statement also was a forward-looking statement that was protected by the safe harbor provision.

The court recognized there were board statements of present and historical fact that were not forward looking. But, since the plaintiff did not allege that those statements were false or misleading, they were of no consequence.

The court further found that the proxy included a lengthy cautionary statement that identified various factors that could affect the actual results. There was language in bold about "the uncertainties inherent in the Management Projections" and a caution to shareholders "not to place undue, if any, reliance on the projections included in this proxy statement." In combination with the forward-looking statement, the cautionary statement was sufficient to justify dismissal of the case at the pleadings stage, the court found.

At the same time, the court provided an alternative analysis that led to the same conclusion. The court explained that, assuming the safe harbor provision did not apply and there was a false or misleading statement, for the plaintiff to survive

the defendants' motion, it had to show that the higher projections actually more accurately represented the company's prospects (objective falsity) and, crucially, that the defendants believed this was so (subjective falsity).

As to objective falsity, the court noted both sets of projections were developed in the ordinary course of business during the same internal review process, in fall 2015, and both sets forecast the same performance for the company through 2016. The company's quarterly reports aligned with both sets of projections. Further, a public company statement following the first quarter of 2016 predicted full-year revenue to be in the range of $1.02 billion to $1.05 billion and EBITDA to be in the range of $235 million. These ranges were lower than those appearing in both sets of management projections for 2016. Also, the plaintiff mentioned the company's rebounding from "a temporary industry downturn," which allowed for the inference that the public statements "may have been most consistent with the more modest projections," the court said. Finally, the board's statement about the lower projections being more realistic was based on the assumption that historically it was rare that all business units achieved their projected financial goals. The plaintiff's acknowledgment of a temporary industry "downturn" seemed to support the board's statement, the court found.

According to the court, the record also did not show the board acted in bad faith and with improper motive. Both sets of projections were subject to the same review process and were created months before FEI discussed an acquisition with the buyer. Also, there was no allegation that any individual defendant was on both sides of the deal. Further, the proxy discussed the interests of the defendants. Even if they were to reap substantial benefits as a result of the merger, they would not benefit to the detriment of other stockholders "were the stock to be sold at less than fair value," the court said.

No 'aggressive' discounting. The plaintiff's attack on the financial advisor's fairness opinion also was unsuccessful. According to the plaintiff, the financial advisor's DCF analysis on which the fairness opinion was based "double discounted" the company's value by "aggressively discounting" the already discounted lower projections "once more for risk." Further, Goldman applied a discount rate of "9.5% to 11.5%" that was improperly high, the plaintiff maintained.

The defendants noted that the discount rate in a DCF analysis does not reflect risk but determines the present value of a business. The court agreed, finding the plaintiff failed to sustain its claim that the fairness opinion was a material misstatement.

The court also rejected the plaintiff's theory that the discount rate was too high, noting that the discount rate in a DCF analysis "reflects a financial analyst's judgment, and disagreement over the rate does not form the basis of a § 14(a) claim."

Moreover, the proxy disclosed Goldman's analysis undergirding its fairness opinion. "If Goldman Sachs did apply a higher discount rate than is consistent with industry standards, any 'shoddy' analysis was available for shareholders to observe and consider in their decision," the court noted. Also, the plaintiff did not sufficiently allege that the inputs or assumptions on which the fairness opinion relied were inaccurate or misleading. By extension, the plaintiff failed to show the fairness opinion was materially misleading.

Finally, the court found that omitting certain accounting details in the summary of the higher projections was inconsequential. The plaintiff did not show that there was a "substantial likelihood" that the disclosure of these details would have "significantly altered the 'total mix' of information available" to investors. In other words, the omitted details were not material.

Based on all these factors, the court granted the defendants' motion to dismiss the plaintiff's complaint. At the same time, the court allowed the plaintiff to amend its pleadings within 14 days. ◆

New cases are analyzed and added to *BVLaw* each month. This table provides a review of the newly added cases. To read the analysis of these cases, please visit bvresources.com/bvlaw (subscription required).

Latest Cases Added to *BVLaw*

Case Name/ Full Citation	Experts	Case Type	State/ Jurisdiction	Digest Summary
City of Hialeah Emples. Ret. Sys. v. FEI Co. 2018 U.S. Dist. LEXIS 11989 (Jan. 25, 2018)	N/A (plaintiff); N/A (defendants)	Dissenting Shareholder	Federal/ Oregon	Court rejects dissenting shareholder's proxy challenge, finding board member statements about management projections are protected under applicable act's safe harbor provision; also, court says financial advisor's fairness opinion did not double count for risk in underlying DCF analysis.
Jimenez v. Jimenez 2018 Ariz. App. Unpub. LEXIS 442 (March 22, 2018)	None (husband); none (wife)	Marital Dissolution/ Divorce	Arizona	Appeals court affirms trial court's decision to give wife portion of value of goodwill in two restaurants husband set up with new partner during separation, where restaurants carried husband's name and featured recipes he had developed during the marriage; goodwill is a community asset.
Wiegers v. Richards-Wiegers 2018 Alas. LEXIS 63 (May 11, 2018)	None (husband); unknown (wife)	Marital Dissolution/ Divorce	Alaska	Alaska high court finds trial court was not required to value husband's shares in closely held company under the liquidation approach the company historically had used in buy-out situations; trial court's "true asset" approach was based on credible expert testimony.
Verition Partners Master Fund Ltd. v. Aruba Networks, Inc. (Aruba II) 2018 Del. Ch. LEXIS 160 (May 21, 2018)	Paul Marcus (petitioners); Kevin Dages (company/respondent)	Dissenting Shareholder	Delaware	Court of Chancery denies petitioners' motion for reargument, finding that, in light of high court's *Dell* and *DFC* decisions, the decision to use the unaffected market price as the fair value indicator was not so "ridiculous" or "absurd" as to indicate the Court of Chancery misapprehended the law.
San Bernardino Cty. Trans. Auth. v. Byun 2018 Cal. App. Unpub. LEXIS 3611 (May 25, 2018)	Unknown (plaintiff); Anthony Ghosn (defendants)	Expert Testimony	California	In eminent domain case, appeals court says trial court's exclusion of defendants' valuation expert was justified where expert simply adopted another expert's valuation without testing the raw financial data and being able to substantiate the other expert's assumptions and conclusions.

BVR TRAINING EVENTS

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Cannabis Industry and Valuation Update
August 7, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Ronald Seigneur (Seigneur Gustafson LLP), Stacey Udell (HBK Valuation), and Brenda Clarke (Seigneur Gustafson LLP)

Valuing Healthcare Brands
***Part of BVR's Special Series presented by the* BVR/AHLA Guide to Healthcare Industry Finance and Valuation**
August 23, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: W. James Lloyd (PYA) and Annapoorani Bhat (PYA)

Prospective Financial Modeling with Excel
Part of Special Series on Advanced Modeling and Methodologies
August 29, 10:00 a.m.-11:40 a.m. PT/1:00 p.m.-2:40 p.m. ET
Featuring: Mark Shirley (V&L Consultants)

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September 24-28
Chicago, IL
www.amaaonline.com

IVSC Valuation Expo
September 30-October 3
Las Vegas, NV
www.ivsc.org

2018 Advanced BV Conference
October 7-10
Anaheim, CA
www.appraisers.org

2018 International Appraisers Conference
October 7-10
Anaheim, CA
www.appraisers.org

CM&AA Certification
October 22-26
Malibu, CA
www.amaaonline.com

AICPA Auto Dealership Conference
October 25-26
Orlando, FL
www.aicpa.org

NACVA Financial Consultants' Accelerated Training Institute
October 29-November 3
Chicago, IL
www.nacva.com

AICPA Forensic & Valuation Services Conference
November 5-7
Atlanta, GA
www.aicpa.org

CFA Institute Conference: Equity Research and Valuation 2018
November 6-7
New York, NY
www.cfainstitute.org

AICPA Health Care Industry Conference
November 7
Las Vegas, NV
www.aicpa.org

2018 ESOP Las Vegas Conference and Tradeshow
November 8-9
Las Vegas, NV
www.esopassociation.org

AICPA Oil & Gas Conference
November 11-13
Denver, CO
www.aicpa.org

For an all-inclusive list of valuation-related seminars and conferences, BV education classes and credentialing programs, and all BVR events, go to bvresources.com/bvcalendar.

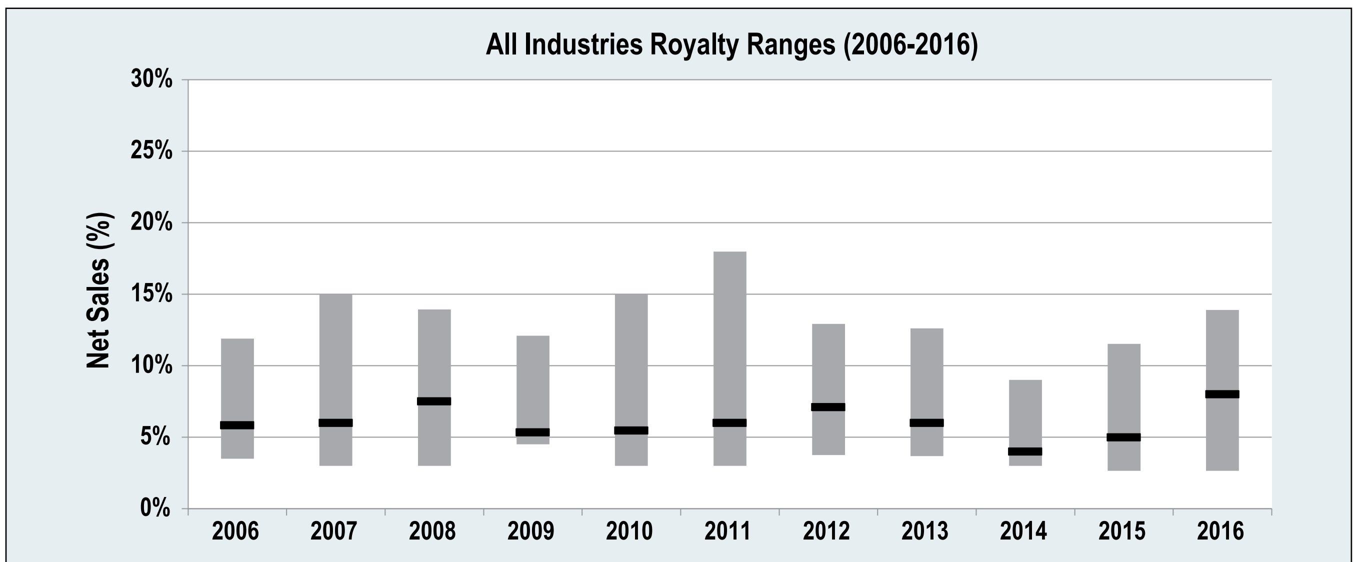
BUSINESS VALUATION DATA SPOTLIGHT

ktMINE Royalty Rate Data

This graph displays the interquartile ranges for royalty rates as a percentage of net sales for all industries between 2006 and 2016 from the ktMINE: Royalty Rate Comparables & Full Text Licensing Agreements Database. As the graph shows, the median royalty rate was between 4.0% and 8.0% for the period analyzed, and the interquartile range was between 6.00 and 14.97 percentage points. While specific comparables would be needed in a valuation, this graph is a useful benchmark to display median royalty rates and their spread over a 11-year period.

More analysis, as well as industry-specific analysis, can be found in the *BVR/ktMINE Benchmarking Royalty Rates Guide,* 2017-2018 global edition, available at bvresources.com/publications. The guide provides analyses on median royalty rates and interquartile ranges, data on exclusive deals, key licensing highlights by industry, and more from the ktMINE: Royalty Rate Comparables & Full Text Licensing Agreements Database.

Individual license agreements and royalty rates can be found in the ktMINE: Royalty Rate Comparables & Full Text Licensing Agreements Database, available at bvresources.com/ktMINE. The database also includes access to an online statistical analysis center and the ability to export license agreement summaries and royalty rates. ◆



Get the data you need for your next valuation.

ktMINE Royalty Rate Comparables

Access 17,000+ licensing agreements, 65,000+ royalty rates, and run unlimited searches.

Economic Outlook Update Reports

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***Pratt's Stats* Private Company Comparables**

Summer 2018: *Pratt's Stats* will become *DealStats*, a powerful upgraded transaction data platform.

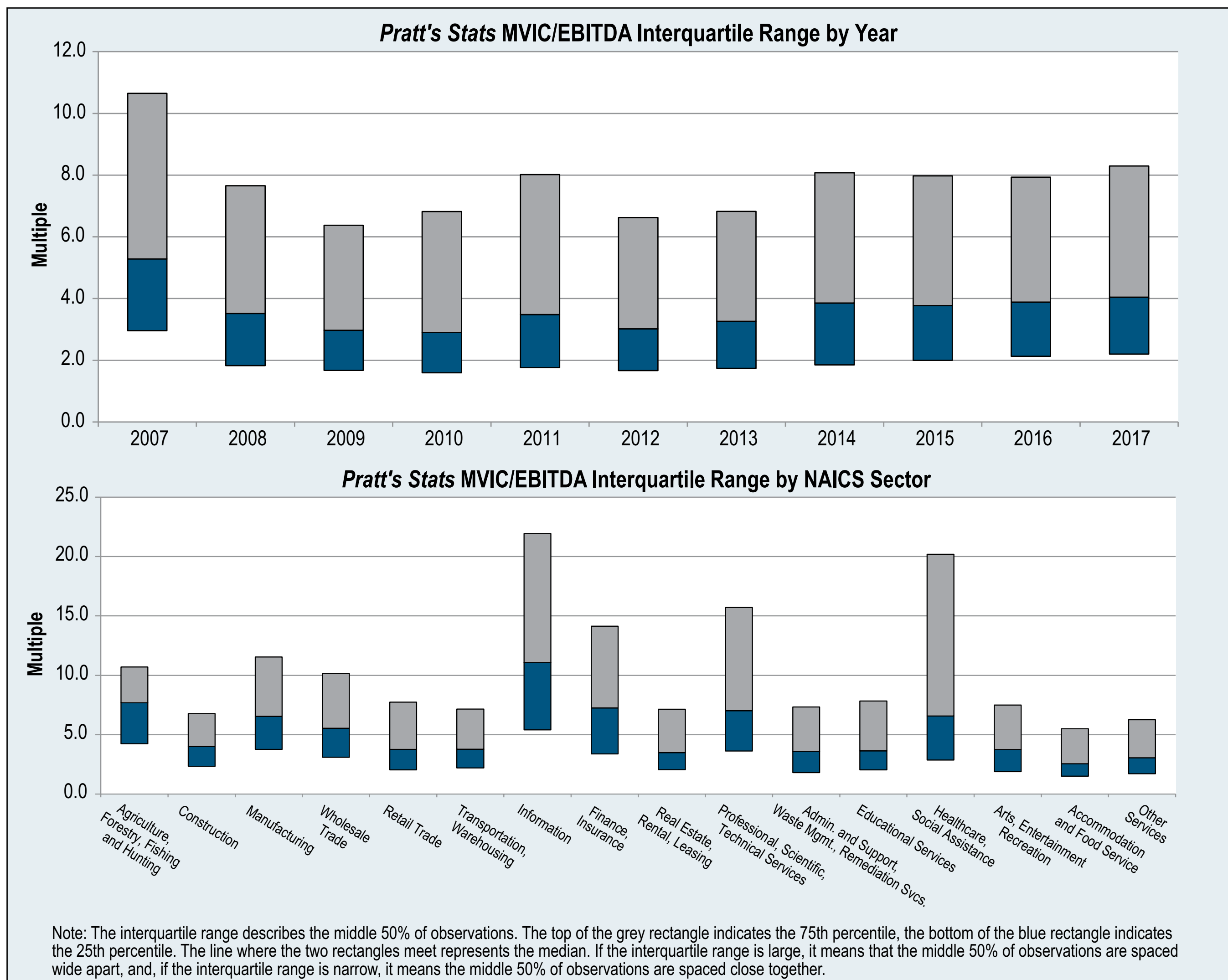
Learn more at: bvresources.com

Pratt's Stats MVIC/EBITDA Trends

The graphs displays the interquartile range of the MVIC/EBITDA multiple by major NAICS sector and by year in the *Pratt's Stats* database.[1] For the period analyzed, the information sector had the greatest median MVIC/EBITDA multiple. It appears that the accommodation and food service sector had the least dispersion between its first quartile and third quartile (25th percentile and 75th percentile), while the healthcare and social assistance sector had the greatest dispersion. The accommodation and food service sector had the lowest median MVIC/EBITDA multiple. When reviewing the data by year, the median MVIC/EBITDA was the highest in 2007, at slightly more than 5.0. Since then, the median MVIC/EBITDA multiple has consistently been under 4.0 and often close to 3.0. It appears that 2007 had the most dispersion in the MVIC/EBITDA interquartile range, while the dispersion has been relatively consistent in recent years.

Pratt's Stats is a private-company transaction database that provides financial details on over 29,300 acquired private businesses. Business appraisers, financial advisors, investment bankers, M&A professionals, and business owners use *Pratt's Stats* as a comparable transaction data source for sold businesses across all industry sectors. A subscription to *Pratt's Stats* comes with free access to the *Pratt's Stats Private Deal Update*, a quarterly publication, which analyzes *Pratt's Stats* data trends. The *Pratt's Stats* database also features the *Pratt's Stats Analyzer*, an Excel-based tool, which assists in analyzing data. The *Pratt's Stats Private Deal Update* is available on the *Pratt's Stats* "Subscriber Services" page, and the *Pratt's Stats Analyzer* is available for download after searching the database. ◆

1 In *Pratt's Stats*, market value of invested capital (MVIC) is the term used for selling price. In addition to showing the median MVIC/EBITDA multiple by sector and year, the interquartile range provides a measure of dispersion.



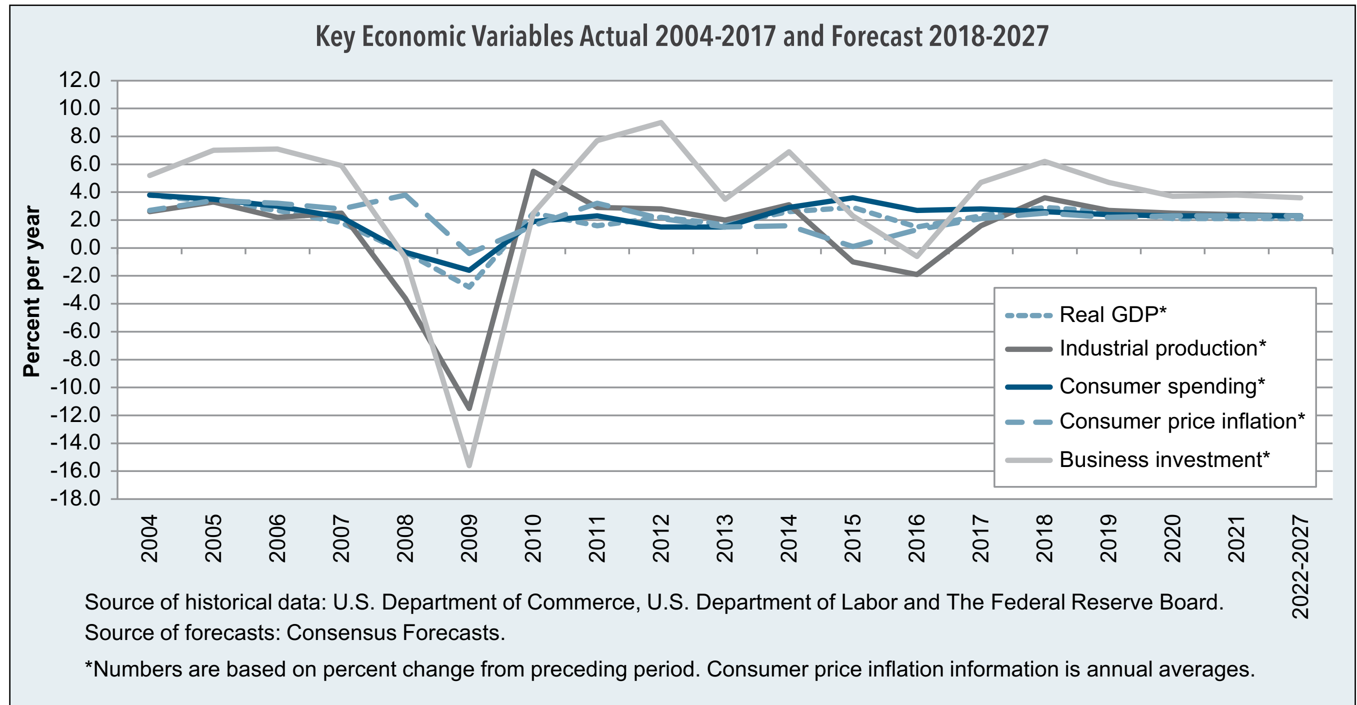
Note: The interquartile range describes the middle 50% of observations. The top of the grey rectangle indicates the 75th percentile, the bottom of the blue rectangle indicates the 25th percentile. The line where the two rectangles meet represents the median. If the interquartile range is large, it means that the middle 50% of observations are spaced wide apart, and, if the interquartile range is narrow, it means the middle 50% of observations are spaced close together.

Economic Outlook for the Month

(From BVR's *Economic Outlook Update*)[1]

This section is an excerpt from BVR's *Economic Outlook Update* (*EOU*). The *EOU,* a convenient and cost-effective resource, provides a review of the state of the U.S. economy and forecast for the future. Leading experts in the BV profession rely on the *EOU* as the basis for the current economic conditions and forecast portions of their valuation reports. ◆

1 The *Economic Outlook Update* is published monthly and quarterly by Business Valuation Resources, LLC (BVR). Visit BVResources.com/EOU or call 503-479-8200, ext. 2.



Quarterly Forecasts 3Q 2018-1Q 2019 and Annual Forecast 2018-2019

	Quarterly			Annual			
	3Q 2018	4Q 2018	1Q 2019	2018	*(prior forecast)*	2019	*(prior forecast)*
Real GDP*	3.0	2.9	2.5	2.9	*2.8*	2.6	*2.6*
Consumer spending*	2.6	2.5	2.3	2.6	*2.5*	2.4	*2.4*
Business investment*	5.6	5.4	4.5	6.2	*5.8*	4.7	*4.7*
Consumer price inflation*	2.4	2.0	1.9	2.5	*2.5*	2.2	*2.2*
Real disposable personal income*	2.8	3.0	3.2	2.4	*2.4*	2.8	*2.8*
Unemployment rate	3.8	3.7	3.6	3.9	*3.9*	3.5	*3.6*
Industrial production*	3.1	2.9	2.7	3.6	*3.8*	2.7	*2.7*

Source of forecasts: *Consensus Forecasts - USA*, June 2018.

Notes: Quarterly figures are percent change from prior quarter, at seasonally adjusted annual rates (except unemployment which is the average for that period).

Annual rates are percent change from preceding period (except unemployment, which is the average for that period).

Every month, Consensus Economics surveys a panel of 30 prominent United States economic and financial forecasters for their predictions on a range of variables including future growth, inflation, current account and budget balances, and interest rates.

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PERIODICALS

August 2018 Cost of Capital Center

Duff & Phelps' 2018 Cost of Capital Data for *BVU*

Base U.S. Cost of Equity Capital
(R_f + Median $RP_{m+s,\ all\ portfolio\ 25s}$ + ERP Adjustment)[1,2,3]

Source: Duff & Phelps Cost of Capital Navigator, Risk Premium Report Study[4]

	Using the Historical Equity Risk Premium, Spot R_f[5]	Using the Supply-Side Equity Risk Premium, Spot R_f[5]	Using the Duff & Phelps Conditional ERP & Normalized R_f[6]
Dec. 31, 2017	16.2%	15.2%	15.1%
One Year Ago	17.4%	16.4%	16.7%

General Monthly Cost of Capital Data

Treasury yields[7]	
30-day:	1.77%
5-year:	2.73%
20-year:	2.91%
Prime lending rate:[7]	5.00%
Dow Jones 20-bond yield:[8]	3.96%
Barron's intermediate-grade bonds:[8]	4.79%
Dow Jones Industrials P/E ratios:[8] (Represents median figures)	
On current earnings:	24.2
On 2018 operating earnings est.:	15.4
On 2019 operating earnings est.:	14.2
High yield estimate:[8]	
Mean:	15.4%
Median:	8.5%
Long-term inflation estimate:[9]	2.28%
Long-term rate of growth GDP:[9]	2.20%

BVR's Private Company Cost of Capital Index[10] (July 1, 2018)

Company Revenue ($thousands)	Cost of Capital
1,000	18.8%
5,000	17.1%
10,000	15.4%
15,000	14.4%

1 R_f = Risk-free rate

2 Median RP_{m+s} = The median "risk premium over the risk-free rate" associated with Portfolio 25 for the eight measures of size used in the Risk Premium Report Study from the *Cost of Capital Navigator*. The size measures are: market value of equity, book value of equity, five-year average net income, market value of invested capital (MVIC), total assets, five-year average EBITDA, sales, and number of employees). For each measure of size, 25 portfolios are created (Portfolio 1 is the largest, Portfolio 25 is the smallest).

3 The equity risk premium (ERP) adjustment is needed to account for the difference between the forward-looking ERP as of the valuation date and the historical (1963-present) ERP that was used as a convention in the calculations performed to create the Risk Premium Report Study "risk premium over the risk-free rates," size premia, and other valuation data. For example, the Duff & Phelps Conditional ERP as of Dec. 31, 2017, is 5.0%, and the 1963-2017 historical ERP used in the calculation of the premia in the *Cost of Capital Navigator* Risk Premium Report Study was 5.28%, implying an ERP adjustment of -0.28% (5.0% - 5.28%).

4 In 2018, Duff & Phelps transitioned the *Valuation Handbook* series to an online platform, the *Cost of Capital Navigator*, which guides analysts through the process of estimating the cost of capital, a key component of any valuation analysis. For more, visit bvresources.com/navigator.

5 The Duff & Phelps *Cost of Capital Navigator* uses long-term risk-free rates from the Federal Reserve Economic Data website at federalreserve.gov/datadownload/Build.aspx?rel=H15. The series used is the 20-year constant maturity U.S. government bond (as of Dec. 31, 2017, in this example); series unique identifier: H15/H15/RIFLGFCY20_N.B.

6 Risk-free rate (normalized). The Duff & Phelps conditional U.S. ERP as of Dec. 31, 2017 (5.0%) was developed in relation to a 3.5% "normalized" risk-free rate, implying a base U.S. cost of equity capital of 8.5% (5.0% + 3.5%) at that time. The Duff & Phelps conditional U.S. ERP "one year ago" as of Dec. 31, 2016 (5.5%) was developed in relation to a 3.5% "normalized" risk-free rate, implying a base U.S. cost of equity capital of 9.0% (5.5% + 3.5%) at that time. The Duff & Phelps recommended ERP should be used with the risk-free rate that it was developed in relation to. For more information, visit DuffandPhelps.com/CostofCapital.

7 Source: The Federal Reserve Board as reported by the BVR *Risk-Free Rate Tool*, located in Free Resources at bvresources.com/riskfreerates.asp, July 1, 2018.

8 Barron's, June 25, 2018.

9 10-year forecast; Federal Reserve Bank of Philadelphia, Livingston Survey, June 15, 2018.

10 After-tax cost of capital (calibrated for 35% tax rate and mid-period convention) for average/typical risk company. For use on unlevered, after-tax expected free cash flows. Based on *Pratt's Stats* data and Dohmeyer, Burkert, Butler and Tatum's Implied Private Company Pricing Line (IPCPL). See the IPCPL page at bvresources.com/ipcpl.

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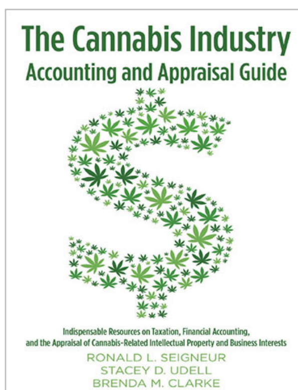
Learn the unique financial aspects and intricacies related to operating a cannabis business



The cannabis industry is undoubtedly the fastest-growing industry in the U.S. and has created one of the greatest business opportunities of the 21st century. While this industry may be outside of the comfort zone for accountants, lawyers, valuation experts, consultants, and potential investors, it can also open doors to a new client group that up until several years ago didn't exist.

The Cannabis Industry Accounting and Appraisal Guide, authored by Ron Seigneur, Stacey Udell, and Brenda Clarke, provides useful information for appraisers and accountants about the unique financial aspects and intricacies related to businesses operating in the cannabis industry. It includes everything a cannabis business owner needs to know about choosing a business structure, basic accounting, setting up an accounting system, taxes, how to avoid an audit, the basics of valuation, and how to build value into your business for the future.

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