BVR
What It's Worth

2018

Excerpt from:

Business Valuation Update

YEARBOOK

Timely news, analysis, and resources for defensible valuations.

Business Valuation Update
Yearbook 2018

BVR
What It's Worth

111 SW Columbia Street, Suite 750, Portland, OR 97201

(503) 479-8200 • www.bvresources.com

BVR

What It's Worth

Editor: Andy Dzamba

Publisher: Sarah Andersen

Managing Editor: Monique Nijhout-Rowe

Senior Copy Editor: David Solomon

Chair and CEO: David Foster

President: Lucretia Lyons

Chief Revenue Officer: Lisa McInturff

Customer Service: Melissa Snow

Print/PDF ISBN: 978-1-62150-144-2

EPUB ISBN: 978-1-62150-145-9

Library of Congress Control Number: 2018932940

Table of Contents

Introduction

It was another eventful year for the business valuation profession in 2017, and *BVU* continues its tradition of 20-plus years by bringing you the latest thinking in methodologies as well as up-to-date news and analysis, changes in regulations and professional standards, publications of interest, and practice-building ideas. What follows is a wrap-up of the notable developments of 2017, which are covered in depth in the collection of articles you'll find in this *Yearbook*.

Regulatory. At an IRS public hearing in Washington, D.C., there were a record number of speakers, including from the AICPA, ASA, and NACVA, to oppose the controversial proposed IRC Section 2704 regulations designed to curb estate valuation discounts for minority interests. Almost all of the speakers agreed that the rules were so broad and convoluted that they should be withdrawn permanently or completely revised.[1] In October 2017, the Treasury officially withdrew the proposed regs.

The Public Company Accounting Oversight Board (PCAOB) solicited comments on two standard-setting proposals it issued in 2017: one on auditing accounting estimates including fair value measurements and the other on the auditor's use of the work of specialists (including valuation experts). One of the matters the new rules seek to reinforce is that of "professional skepticism" over information you get from management or other third parties.

An ongoing study of PCAOB inspection reports on auditing firms found that the number of audit deficiencies tied to fair value measurements (FVM) declined for the second year in a row, but they're still high. The valuation and litigation consultancy firm Acuitas Inc. conducted the analysis, the "2017 Survey of Fair Value Audit Deficiencies,"[2] which found that fair value deficiencies are increasingly attributable to a surge in business combination engagements.

A 2017 settlement between KPMG and the Securities and Exchange Commission (SEC) over alleged overvaluations of assets marked a shift in the agency's enforcement focus, observers said. The agency had primarily targeted policies, procedures, and internal controls, but, in this settlement, the SEC set its sights on the actual valuation of assets.[3]

1 "Strong Pushback of Sec. 2704 Regs at IRS Hearing" (*BVU*, January 2017).

2 www.acuitasinc.com/documents/2017_PCAOB_Fair_Value_Audit_Deficiencies_Survey-FINAL.pdf.

3 "SEC Settlement Over Fair Value Signals Shift of Focus" (*BVU*, October 2017).

The Department of Labor (DOL) continued its tough stance on ESOP valuations and prevailed in a number of cases.[4] Importantly, the DOL and First Bankers Trust Services Inc. (FBTS) entered into a settlement agreement[5] that essentially mirrors the DOL/GreatBanc Fiduciary Process Agreement that covers ESOP transactions and valuation issues. The two agreements should be required reading for ESOP trustees and their financial advisors.

Standards and guidance. In November 2017, the third working group at The Appraisal Foundation (TAF) issued Valuation for Financial Reporting (VFR) Valuation Advisory #3, The Measurement and Application of Market Participant Acquisition Premiums.[6] These guidelines are in the context of fair value for financial reporting and do not address premiums in other contexts, such as tax or disputes. The fundamental perspective of the working group is that a premium for control is not always warranted. Also, the group recognizes an ongoing need for benchmark data, but they should not be used as the sole input for the estimation of a premium. Auditors (who follow TAF advisories) will scrutinize comparables much more closely in the future. A fourth working group is developing guidelines on valuing contingent consideration.

TAF also issued the 2018-19 version of the Uniform Standards of Professional Appraisal Practice (USPAP) with enhanced features available in both print and electronic versions. The enhanced print version includes cross-references to applicable FAQs. Additionally, the electronic version includes hyperlinks to FAQs and other relevant references throughout the document, as well as a hyperlinked table of contents, footnotes, and an index.

The AICPA is working on several practice aids that valuation experts should watch out for. There will be a big impact on the valuation process for alternative investment funds with the coming of the AICPA's *Private Equity & Venture Capital Accounting and Valuation Guide.* A draft is expected to be released in April 2018 or May 2018. The guide is expected to be over 650 pages and contain examples of exercising valuation judgments and provide more in-depth industrywide guidance leading to greater global consistency. The AICPA also has a task force developing a practice aid on business combinations.

There has been some criticism in the past concerning the fragmentation of the business valuation profession and the multiple sets of BV standards that have been issued. The perception has been that the standards may be at odds with each other—but that is not the case, according to an analysis of the five sets of North American standards.[7] A side-by-side chart that compares the standards of NACVA, IBA, AICPA, ASA, and USPAP shows that the standards have some subtle differences, but these can be interpreted as being covered in one of the other standards but worded a little differently. The authors of the chart, Mark Hanson (Schenck SC), Mark Kucik (The Kucik Valuation Group LLC), and Carl Steffen (WSRP LLC), are finalizing a similar chart of the international standards (IVS, Canada, and RICS) that also demonstrates that they do not conflict with each other.

4 "2017's Top Business Valuation and Damages Cases" (*BVU*, January 2018).

5 *Acosta v. First Bankers Tr. Servs., Inc.*, S.D.N.Y., No. 1:12-cv-08648-GBD, consent order and judgment, Sept. 21, 2017.

6 appraisalfoundation.sharefile.com/d-sf6c518cbd8a41df9.

7 "Tale of the Tape: Different BV Standards Do Not Conflict" (*BVU*, August 2017).

On the accounting front, expect to see more asset acquisitions and fewer business combinations as a result of the new "Definition of Business" rules from the Financial Accounting Standards Board (FASB), which start to kick in during 2018. As a result, two areas will see heightened scrutiny: a company's workforce value, which must be recognized in an asset acquisition, and noncompete agreements. Also, new lease accounting rules are designed to more accurately reflect the financial picture of firms that lease assets. For example, a trucking company can show no trucks on the balance sheet if they are all leased. In addition, there are sweeping new rules for revenue recognition.[8] Of course, accounting changes of this sort generally would not impact the underlying economic value of a firm, but they do have impacts that valuation experts need to consider. For example, certain ratios will change when the new rules are implemented.

New credentials. A major accomplishment in 2017 was the launch of the new credential for fair value for financial reporting for U.S. publicly traded companies, Certified in Entity and Intangible Valuations (CEIV). The AICPA, ASA, and RICS have spearheaded this effort, and the credential is now being issued.[9] A Mandatory Performance Framework (MPF) requires professionals to better document their assumptions, which will help make auditors more comfortable with valuation estimates. While CEIV holders are required to comply with the MPF, it should be considered best practices for anyone doing this type of work. We quote this paragraph from the MPF:

> **Valuation professionals without the CEIV credential.** As noted previously, the framework and the Application of the MPF were designed for use by all valuation professionals. Although only those valuation professionals who have the CEIV credential are required to adhere to the MPF documents, the Performance Requirements Work Stream believes that adhering to the MPF documents should be considered best practice by valuation professionals who do not have the CEIV credential and who perform valuation of a business, business interest, intangible asset, certain liabilities, and inventory used to support management assertions made in financial statements issued for financial reporting purposes.

The AICPA also announced in 2017 that it is developing a second new credential on its own, Certified in Valuation of Financial Instruments (CVFI).[10] Public comments are being reviewed on an exposure draft of a "disclosure framework" similar to the CEIV's MPF.

Methodology. The standard boilerplate in many valuation reports that explain the estimation of a discount for lack of marketability (DLOM) may go by the wayside with the introduction of a new model, the Restricted Stock Study Quintile Calculator (RSQC).[11] Many valuation experts use restricted stock studies when developing a DLOM, but certain characteristics of the issuer of the restricted stock can impact the discounts in the studies. The RSQC model is designed to adjust for those characteristics in order to develop a relevant sample for the subject company. The source of the restricted stock discount data in the model is the Stout (FMV) Restricted Stock Study.

8 "What You Should Know About FASB Changes to Revenue Recognition and Lease Accounting" (*BVU*, July 2017).

9 "ASA BV Chair Discusses Recent Changes to New FV Rules and CEIV" (*BVU*, April 2017) and "AICPA BV Chair Nathan DiNatale Discusses the New CEIV Credential" (*BVU*, February 2017).

10 "AICPA Fields Questions About New CVFI Credential" (*BVU*, October 2017).

11 "Using a Restricted Stock Study Quintile Analysis for a DLOM" (*BVU*, November 2017).

The discussion of personal versus enterprise goodwill got kicked up a notch when a family law attorney and several top valuation experts provided interesting perspectives on the allocating of enterprise and personal goodwill.[12] Discussed were a twist on the excess earnings method, the strengths and weaknesses of the multiattribute utility model (MUM), and a new residual method based on the purchase price allocation concept. Also, the new concept of "pure" personal goodwill was discussed—a concept that broke new ground in divorce law when an appellate court in Wisconsin held that all the salable personal goodwill in a professional practice (as evidenced by a noncompete agreement) is a divisible marital asset.[13] This is an area that should be further discussed and brought to the courts' attention in every jurisdiction.

A methodology under increased pressure on a number of fronts is the use of prospective financial information (PFI). The perception is that too many valuation experts simply accept projections and forecasts they're given without applying enough scrutiny—or any scrutiny at all.[14] The matter has been an issue in court cases and has been the focus of rule makers and standard setters. Valuation experts should become familiar with the Mandatory Performance Framework (MPF) for the CEIV credential, which includes significant performance requirements related to PFI. The architects of the fair value quality initiative recognized the concern over PFI and included a section on professional skepticism in the MPF, which lays out the factors and common procedures to consider when preparing an assessment of a company's PFI. These include, but are not limited to: a comparison of prior forecasts to actual results, a comparison of PFI to industry expectations, checking PFI against other internally prepared financial information for consistency, a comparison of entity PFI to historical trends, an understanding of who prepares the PFI and how often is it prepared, and the performance of mathematical and logic checks.

Tax affecting the earnings of a PTE has been an issue of much debate in the valuation community, but we may be having a different conversation about it soon. The tax-affecting issue has been argued in a number of Tax Court cases in which the IRS and the court have refuted the notion that shareholder-level taxes affect a firm's value, so the valuation conclusions in these cases were based on earnings not being tax affected. The valuation community disagrees, so a number of models were developed that are designed to reflect the impact of shareholder taxes on value. At the time of this writing, two cases are pending in Tax Court, one in which both sides made very similar adjustments using the S corporation economic adjustment model (SEAM).[15] The other case is the *Estate of Michael Jackson*, in which the court denied the IRS's motion to exclude testimony concerning tax affecting, with the judge writing: "It is highly likely that the proper use of the discounted cash flow method will be an important issue in this case. Whether and how to take tax effects into account in that valuation will likely be crucial to the final numbers."

12 "Attorney's Slant on Three Methods to Estimate Personal Goodwill" (*BVU*, May 2017).

13 *McReath v. McReath*, 2011 WL 2706249 (July 12, 2011).

14 "Do You Share Business Valuation's 'Dirty Little Secret'?" (*BVU*, May 2017).

15 *Cecil et al. v. Commissioner of Internal Revenue.*

In the meantime, the debate continues. A new statistical analysis of data in the *Pratt's Stats* private-company transaction database explains how transaction size and the entity form of the buyer and seller support the existence (and the magnitude) of a PTE premium.[16] Also, there is a view that there is a "bright-line rule" that precludes tax affecting S corporations under the fair market value standard.[17]

In the healthcare arena, some groundbreaking research and data analytics have emerged to challenge commonly held beliefs about survey data, physician compensation, and fair market value. Most practitioners focus on survey data, especially data from the MGMA, in establishing reasonable or fair market compensation. But this method is said to be based on several false premises, including that the surveys have statistical significance for the 90% or so of physicians not included in the surveys.[18] The fair market value of physician compensation is an essential issue in the government's qui tam (whistleblower) cases it has been winning in False Claims Act (FCA) lawsuits against a number of hospitals, which have been hit with hundreds of millions of dollars in fines. These lawsuits—and there will be more coming—have been triggered by hospitals acquiring medical practices, which raises the bar for appraisers and employing physicians.

Data and publications. Private-company business transaction data in *Pratts Stats* increased to over 28,000 acquired private companies plus up to 150 data points that include six valuation multiples and 13 financial ratios. During 2017, one of the largest business brokerage firms in the United States and Canada, Murphy Business & Financial Corp., started to contribute its private-company transaction data to *Pratt's Stats*. BIZCOMPS, *Done Deals,* and the *IBA Market Database* also expanded their number of private-company transactions.

BVR launched a new data product in 2017: The Fairness Opinion Research Service (FORS) that enables professionals to easily know "what's market" and benchmark their work against hundreds of board books, proxies, and fairness opinion letters filed at the SEC over the last five years.

Two of the leading books on business valuation published revised editions in 2017: *Financial Valuation: Applications and Models (FVAM),* 4th edition, + Website, by James Hitchner, and *Understanding Business Valuation: A Practical Guide to Valuing Small- to Medium-Sized Businesses,* 5th edition, by Gary Trugman. *BVU* published reviews[19] of both books, which are available from BVR.

BVR added to its line of industry-specific special reports under the series title *What It's Worth*. New entries in the series are: law firms; HVAC companies; electrical contractors; and oil, gas, and alternative energy assets.

16 Eric J. Barr and Peter L. Lohrey, "Inside *Pratt's Stats:* Impact of Entity Form on Selling Price" (*BVU,* December 2017 (Part 1) and January 2018 (Part 2)).

17 Alan Zipp, "Tax Affecting S Corporations: It's Not a Matter of Whether. It's a Matter of When," (*BVU*, December 2017).

18 Mark Dietrich, "Revisiting the Meaning of Fair Market Value" (*BVU*, April 2017).

19 Ronald Seigneur, "Book Review: *Financial Valuation: Applications and Models,* 4th Edition + Website" (*BVU*, June 2017), and James W. Brockardt, "Book Review: *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses,* 5th Edition" (*BVU*, January 2018).

Some of the other books and guides of note published in 2017 include:

- *Narrative and Numbers: The Value of Stories in Business*, Dr. Aswath Damodaran;
- 2017 editions of the Duff & Phelps *Valuation Handbooks - Cost of Capital* series (two U.S. and two international editions);
- *BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements*, 2nd Edition, Mark Dietrich and Timothy Smith;
- *The Business Valuation Bench Book*, Jay Fishman and William Morrison;
- *Discount for Lack of Marketability Guide and Toolkit*, James Hitchner, Jim Alerding, Josh Angell, and Kate Morris;
- *The BVR Private Company Value Benchmark Guide*, 2017-2018 edition;
- *BVR/ktMINE Royalty Rate Benchmarking Guide,* 2017/2018 global edition;
- *A Practical Guide to Bankruptcy Valuation,* 2nd edition, Dr. Israel Shaked and Robert F. Reilly; and
- *Business Valuations and the IRS: Five Books in One*, Michael Gregory.

All of these books are available from BVR.

Practice management. During 2017, BVR published the findings of a survey that examined BV firm performance, compensation, billing rates, marketing and practice development, and more.[20] Some of the issues that are keeping practitioners up at night include increased competition, fee pressures, hiring, and succession planning. Among the other findings were that about two-thirds of BV firms said they expect to do more business than the previous year. Also, traditional face-to-face techniques continue to be the best methods to bring in valuation business, such as one-on-one meetings with prospective clients, public speaking, and joining business organizations such as associations, committees, and boards.[21]

Another survey, this one done by a leading BV practitioner and report reviewer, discovered a declining trend in the quality of valuation reports—and not just in the style of writing, but in the framework (i.e., professional standards) and content as well. Some of the major issues include struggles with the section on discounts and premiums, as well as not tying sections of the report such as the company background, economic overview, and industry outlook back to the subject company.[22]

20 www.bvresources.com/products/the-bvr-business-valuation-firm-economics-best-practices-guide.

21 See "30 Field-Tested Ideas to Bring in More BV Business" (*BVU,* January 2017) and "How Do Your BV Firm's Billing Rates and Practices Stack Up?" (*BVU,* September 2017).

22 Rod Burkert, "Ongoing Survey Reveals Need to Improve Report Writing" (*BVU,* October 2017).

Global. The International Valuations Standards Council (IVSC) made some impressive advances over the past year, releasing a final version of IVS 2017 in its efforts to harmonize valuation standards for the global economy.[23] Also in 2017, the IVSC's new boards became operational—a Standards Review Board that will amend and approve international valuation standards. The new board has two focused subject matter expertise boards reporting to it: a Tangible Assets Standards Board (covering real estate, plant and machinery, and personal property) and a Business Valuation Standards Board. Another subject matter expertise board will also be formed: a Financial Instruments Board. This is all part of the IVSC's new infrastructure within which focused boards will continuously revise and improve IVS to help ensure that they add value and can be implemented by valuation professional organizations (VPOs) around the world.

During 2017, the IVSC also issued an Agenda Consultation Paper on future revisions to IVS, which is part of the IVSC's new efforts to continually evolve IVS instead of issuing completely revised standards every few years. Public comments are being reviewed, and the IVSC will release a document giving the rationale for how it prioritizes areas of future focus.

Work toward a global valuation credential moved forward as the International Association of Consultants, Valuators and Analysts (IACVA) and the International Institute of Business Valuers (iiBV) joined forces to boost IACVA's International Certified Valuation Specialist (ICVS) designation. The two groups will develop in-class and online certification training and testing that will reflect IVS and will be translated into other languages as well as allow for the addition of nation-specific modules. This is designed to bring consistency to valuation practices around the world, which can diverge quite significantly.

A discussion about offshoring some of the components of a valuation engagement triggered some lively debate. Many valuation experts rule out this practice, but there are those who do indeed use it. For those who consider it, there are certain things to think about.[24]

That's a look at some of what happened in 2017, and *BVU* looks forward to keeping you fully informed of important developments during 2018.

Sincerely,

Andrew Dzamba
Executive Editor
Business Valuation Update

23 "Final IVS 2017 Seeks to Standardize Conduct and Approach to Global Valuation" (*BVU*, March 2017).

24 Bharat Kanodia, "Look Before You Leap Into Offshoring Some Valuation Components" (*BVU*, May 2017).

BVR
What It's Worth

bvresources.com

Trustworthy business valuations start here.

About Business Valuation Resources

Every informed stakeholder in business valuation, performance benchmarking, or risk assessment turns to Business Valuation Resources (BVR) for authoritative deal and market data, news and research, training, and expert opinion. Trust BVR for unimpeachable business valuation intelligence. BVR's data, publications, and analysis have won in the boardroom and the courtroom for over two decades.

Deal & Market Data

- Pratt's Stats
- Public Stats
- BIZCOMPS
- PitchBook Guideline Public Company Comps Tool
- Economic Outlook Update
- FactSet Mergerstat/BVR Control Premium Study
- Stout Restricted Stock Study™
- Valuation Advisors Discount for Lack of Marketability Study
- ktMINE Royalty Rate Data & License Agreements
- First Research Industry, State & Province Profiles
- BizMiner Industry Financial Reports
- Mergerstat Review & Mergerstat Review Monthly
- Duff & Phelps Cost of Capital Navigator
- Valuation Handbook – U.S. Guide to Cost of Capital
- Valuation Handbook - U.S. Industry Cost of Capital
- Valuation Handbook – International Guide to Cost of Capital
- Valuation Handbook – International Industry Cost of Capital
- Butler Pinkerton Calculator – Total Cost of Equity and Public Company Specific Risk Calculator

News & Research

- Business Valuation Update
- BVLaw
- Economic Outlook Update
- Business Reference Guide Online

Training & CPE

- Webinars
- Web Workshops & Special Series
- Desktop Learning Centers
- Self-study CPE
- eLearning

Guides, Books & Reports

- Digital Library
- Guides & Books
- Special Reports
- Legal Compendiums
- Yearbooks

Learn more about all of our offerings at:

bvresources.com

Contact us at: 1-503-479-8200 or info@bvresources.com