

BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Business Valuation Year in Review 2018

The new tax law, lively debates, new guidance, a strong protest, and a simpler approach to estimating cost of capital were just some of the highlights in the business valuation profession during 2018. Now going into its 25th year, *Business Valuation Update* continues to capture 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. Here are some of the notable developments of 2018, which are covered in-depth within the pages of *BVU*.

Regulatory. At the start of the new year, the Tax Cuts and Jobs Act, enacted in December 2017, was on the minds of every valuation expert. The first impression from experts was that it will impact almost every aspect of business valuation in a variety of contexts.¹ How the new tax law is implemented affects business cash flow, operations, and long-term strategy that will impact all business valuations. In general, businesses will be more valuable because of the new law's tax breaks that will increase cash flow. It is now necessary to have more in-depth discussions with management to make sure its plans and projections reflect the use of any expected tax benefits. It is also more important than ever to consult with

a tax professional about the tax impacts of the new law on your subject company.

There was a dearth of guidance during 2018 from the IRS in the form of regulations that help explain the new law. One provision in particular, the deduction for "qualified business income" for owners of a pass-through entity, was particularly troublesome.² In August, the IRS eventually issued proposed regulations for the QBI deduction³ as well as on the new law's limitation of business interest expense deductions.⁴

Other regulatory matters of interest:

- The Public Company Accounting Oversight Board (PCAOB) has a new board and is working on standards designed to address ongoing audit deficiencies in fair value.⁵
- The Department of Labor (DOL) kept up its tough crackdown on ESOPs, which included valuations. In October, members of Congress asked the White House to intervene.⁶

1 Several articles cover the new tax law, such as: "Valuation Experts Give Initial Thoughts on Tax Reform" (*BVU*, February 2018); Chris Mellen, "Q&As on the Impact of the 2017 Tax Act on Business Valuation" (*BVU*, April 2018); Guy Sanschagrin, "New Tax Legislation Consequences on U.S. Transfer Pricing and Intangibles" (*BVU*, May 2018); "Tax Reform Puts Broader Spotlight on Reasonable Comp" (*BVU*, April 2018).

2 Mark O. Dietrich and Kevin R. Yeanoplos, "How the New QBI Deduction Impacts the Hypothetical Buyer and Seller" (In two parts: *BVU*, March 2018 and July 2018).

3 "IRS issues long-awaited QBID guidance" (*BVU*, News and Trends, October 2018).

4 "IRS issues guidance on interest expense limits" (*BVU* News and Trends, June 2018).

5 "New Board and Pending Standards Highlight PCAOB Update" (*BVU*, September 2018).

6 "Congressional members accuse DOL of undermining ESOPs" (*BVWire*, Oct. 17, 2018).

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- A Court of Appeals struck down the DOL's fiduciary rule, which had originally proposed to include ESOP appraisers in the definition of fiduciaries (this decision created a conflict among circuits).⁷

Standards and guidance. At the 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 result: The standards do not conflict and all basically say the same thing. In the past, regulators and some observers have perceived that the different sets of standards somehow were at odds with each other, but this is not the case, according to the analyses. The U.S. chart compares the standards set by NACVA, IBA, AICPA, ASA, and USPAP, and the international chart compares the standards from the IVSC, RICS, and the CICBV.⁸

Here is some other guidance issued during 2018:

- The Appraisal Standards Board issued a Second Exposure Draft of proposed changes for the 2020-21 edition of the Uniform Standards of Professional Appraisal Practice (USPAP)⁹;
- The AICPA issued an exposure draft of a "performance framework" that establishes parameters of documentation requirements for its Certified in Valuation of Financial Instruments (CVFI) credential¹⁰;
- The Alternative Investment Management Association (AIMA) issued a *Guide to Sound*

- 7 "Appellate court KOs DOL fiduciary rule" (BVU, News and Trends, May 2018).
- 8 "New Analyses Reveal U.S. and Global BV Standards All in Sync" (BVU, August 2018).
- 9 "USPAP 2020-21 second exposure draft issued" (BVU, News and Trends, October 2018).
- 10 "Comments due on CVFI framework" (BVU, News and Trends, October 2018).

*Practices for the Valuation of Investments*¹¹; and

- The AICPA's Financial Reporting Executive Committee issued an early working draft of Inventory Valuation guidance that is part of the upcoming *Business Combinations Accounting and Valuation Guide* on how to estimate the fair value of inventory acquired in a business combination in accordance with FASB ASC 820, Fair Value Measurement.

ABV protest. There was widespread criticism over the AICPA's decision to allow non-CPAs to be eligible for the Accredited in Business Valuation (ABV) credential. An Open Letter to the AICPA, signed by a number of prominent CPA/ABVs, stated 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.¹² The AICPA stood its ground while some state CPA societies also criticized the change. A call went out for a boycott of the AICPA's annual Forensics and Valuation Services Conference, and attendance was notably diminished compared to prior years.

The AICPA Council (the AICPA's governing body) reconsidered the change during its October meeting, and members voted in favor of continuing to implement the change. While this clears the way for other qualified professionals who are not CPAs to be allowed to qualify for the ABV credential, we may not have heard the end of this matter.

Alternative cost of capital resource. Early in 2018, Duff & Phelps began to transition its *Valuation Handbook - Cost of Capital* series to an online platform, the Cost of Capital Navigator.¹³ The hardcover versions of the *Handbook* would no longer be published.

Later in the year, Business Valuation Resources launched an alternative platform, the Cost of Capital Professional, which was designed as an independent, transparent, and less complex resource rooted in academics.¹⁴ One idea behind the new BVR platform is that skill and professional judgment should be aided, not replaced by, a "black box" of complicated mathematics. Also, the resource should be affordable to all, not just the big firms. Data for the platform is from multiple sources, including the University of Chicago's Center for Research in Security Prices (CRSP) data, Professor Aswath Damodaran's data resources, and the U.S. Federal Reserve on Treasury bond yields. The platform allows the user to choose the period of historical return data for the analysis. A free trial for the Cost of Capital Professional was launched in November and was scheduled to run for the rest of 2018.

The growing complexities of various aspects of business valuation—especially in estimating the cost of capital—prompted an interesting article that speaks to the danger of a valuation analyst merely following a model or process at the expense of professional judgement and the "art" of valuation.¹⁵

Fair value credentials. The credential for fair value for financial reporting launched in 2017 gained some traction in 2018 but has not taken off completely as the Big Four firms took a wait-and-see approach. As of May, about 100

11 "New guidance for AI fund valuations" (BVU, News and Trends, July 2018).

12 "Uproar over AICPA opening ABV to non-CPAs" (BVU, News and Trends, August 2018 plus ongoing coverage); see also Robert E. Kleeman, "A Veteran Valuer Looks at the BV Profession" (BVU, August 2018).

13 Roger J. Grabowski, "Duff & Phelps Moves Cost of Capital Data to Online Platform" (BVU, February 2018).

14 "BVR to Launch New Platform for Estimating the Cost of Capital" (BVU, November 2018).

15 R. James Alerding, "Have We Lost the Forest for the Trees?" (BVU, December 2018).

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individuals had earned the credential and about 750 were in the pipeline.¹⁶ The credential, Certified in Entity and Intangible Valuations (CEIV), was developed by the AICPA, ASA, and RICS along with a framework that 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 framework (Mandatory Performance Framework), it should be considered best practices for anyone doing this type of work.

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

Approaches and methodologies. Several articles presented new approaches and challenges to existing methodologies in a variety of valuations contexts, including:

- Physician compensation¹⁷;
- Adjustments to market multiples¹⁸;
- Valuing earnouts¹⁹;
- Active/passive appreciation of assets in divorce²⁰;

- Capital expenditures and depreciation²¹;
- S corp valuations²²;
- Risk of contract renewal²³;
- Fairness opinions²⁴; and
- Levels of value.²⁵

BVU wishes to thank all of its contributors for providing us with excellent and thought-provoking articles.

Crossed swords. It’s no great revelation that business valuation experts often disagree with each other. Some of these disagreements played out on the pages of *BVU* during 2018. The use of statistics in analyzing the transactional databases was one issue that sparked a lively debate. One point of argument concerned the minimum number of transactions that should be used from a database such as BIZCOMPS or *Pratt’s Stats* (now *DealStats*). According to one expert, at least 30 transactions should be used. No, say other experts, the minimum should be five transactions. And that’s not the only point that’s being fiercely debated. Other bones of contention include stratifying the data, filtering, the R-square coefficient, harmonic mean, minimum number of

16 “Growing Status of Fair Value Sparks Record Attendance at ASA FV Conference” (*BVU*, July 2018).

17 “Use and Misuse of Survey Data to Set Physician Compensation” (*BVU*, January 2018) and “Dietrich and Smith’s Debate Challenge Re: FMV of Physician Pay” (*BVU*, March 2018).

18 James T. Budyak, “Market Multiple Adjustments: Get a Grip on GRP” (*BVU*, February 2018).

19 Erica Wilson and Vincent Biemans, “Earnouts and the Monte Carlo Method: Practice Tips for Implementation” (*BVU*, May 2018).

20 Mark G. Filler, “Using Jensen’s Alpha to Separate Active and Passive Appreciation” (*BVU*, June 2018).

21 Gilbert E. Matthews, MBA, CFA, and Arthur H. Rosenbloom, “Delaware’s Unwarranted Assumption That Capex Should Equal Depreciation in a DCF Model” (*BVU*, August 2018).

22 Sarah B. von Helfenstein, “Testing the S Corp Value Premium for Realism and Reasonableness” (*BVU*, October 2018).

23 Matthew Gold, CFA, and Matthew Ashby, “A Method for Quantifying Contract Renewal Risk in Valuations” (*BVU*, September 2018).

24 Gilbert E. Matthews, “Stale Fairness Opinions in Related Party Transactions Should Be Updated” (*BVU*, September 2018).

25 Andrew Strickland, “Rethinking the Traditional Levels of Value—Continuing the Conversation” (*BVU*, December 2018).

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transactions, the elimination of outliers, market multiples, and more, so the debate is not over.²⁶

Valuation experts also dueled over the matter of calculation engagements. An article asserted that the increasing use of calculation engagements “seriously compromises” historical valuation standards of reliability and independence. The author feels that the dangers of calculation engagements are that they are being offered in contexts for which they were never intended, are prone to bias, and confuse users who don’t know the difference between a calculation and a full valuation.²⁷ Several valuation experts wrote a rebuttal article that made the case for calculation engagements and discussed recent AICPA guidance on this matter.²⁸ Another expert wrote that people who believe that calculation engagements are inherently biased and unreliable do not have a fundamental understanding of business appraisal.²⁹ Plus, USPAP experts submitted comments pointing out that calculation engagements can be completed under the Scope of Work Rule of USPAP.³⁰ They will elaborate in a future article, and there will be other follow-up articles on this matter as well.

New books and resources. A number of noteworthy new books were reviewed during the year, including Gary Trugman’s 5th edition of *Understanding Business Valuation: A Practical*

Guide to Valuing Small to Medium Sized Businesses.³¹ Also reviewed were books on physician compensation and healthcare service arrangements³² and the cannabis industry.³³ An interview with the editors of the *Comprehensive Guide to Economic Damages*, 5th edition, which was released in August, discusses what’s in the updated edition and how the guide is distinguished from other books on damages.³⁴ There were some significant enhancements made to the 2018 edition of *Mergerstat Review*, including updates to historical data, new tables that show premiums paid over the targets’ enterprise values, a change to industry categories, better defined foreign seller ownership roles, and the inclusion of “transaction value” instead of base equity price.³⁵

Overhaul of Pratt’s Stats. The leading private-company transaction database, *Pratt’s Stats*, was long overdue for a major upgrade. That happened over the summer with the release of *DealStats*, which merged *Pratt’s Stats* and *Public Stats* transactions into one powerful platform. Improvements include new state-of-the-art search capabilities, additional data fields, easy saving and report generation, and much more. Plus, it’s faster, more robust, and fully customizable. A number of further additions, upgrades, and enhanced functionality will be integrated into the platform in the near future.³⁶

26 “Valuation Experts Clash Over Analysis of Transactional Data” plus Special Supplement (BVU, April 2018).

27 Michael Paschall, “‘Breaking Bad’ in the Business Valuation Profession” (BVU, July 2018).

28 Jim Alerding, Jim Hitchner, and Ed Dupke, “Calculation Engagements: The REAL Story” (reprinted from Financial Valuation and Litigation Expert, August/September 2018, available in the BVR website’s Free Resources section in Articles & Webinars).

29 Alan S. Zipp, “Valuation or Calculation: A Bad Appraisal Is Still a Bad Appraisal” (BVU, November 2018).

30 Carla G. Glass and Jay E. Fishman, “Calculation Engagements and USPAP” (BVU, December 2018).

31 James W. Brockardt, “Book Review: *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium Sized Businesses*, 5th Edition” (BVU, January 2018).

32 Greg Endicott, “Book Review: *The BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements*, 2nd Edition” (BVU, June 2018).

33 Neil J. Beaton, “Book Review: *The Cannabis Industry Accounting and Appraisal Guide*” (BVU, August 2018).

34 “New Guidance in Updated Edition of Economic Damages Book” (BVU October 2018).

35 “Major Changes Enhance the 2018 Edition of *Mergerstat Review* of M&A Activity” (BVU, November 2018).

36 “*DealStats* Ushers in Next Generation of Transaction Data” (BVU, August 2018).

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Practice building. A number of experts offered some very timely action tips on various practice-building topics, such as:

- Marketing and the use of websites and social media³⁷;
- Special problems with building a niche BV practice within a CPA firm³⁸;
- Improving the BV work product³⁹; and
- Cutting-edge techniques to collaborate with the IRS.⁴⁰

Global. In recognition of the fact that business valuation is a global profession, *BVU* has offered ongoing coverage of the international scene. The International Valuation Standards Council (IVSC) has seen a 70% increase in membership

in the last two years, and all of the new members have committed to adopting the IVSC's International Valuation Standards (IVS). In many of the IVSC-member countries, governmental agencies have adopted the IVS, such as in Saudi Arabia, Indonesia, and Mexico. Also, many other valuation professional organizations (VPOs) such as CICBV in Canada, ANEVAR in Romania, and recently the Pan-American Union of Valuers in Latin America (UPAV) have adopted the IVS as part of their membership requirements for business appraisers.⁴¹

A series of three Business Valuation Summits were held in India, where the valuation profession continues to grow. A focus of the summits was a discussion of the draft regulations for the Registered Valuer program, issued by the Ministry of Corporate Affairs (MCA) and implemented by the Insolvency and Bankruptcy Board of India (IBBI).⁴²

That's a look at just some of what happened in 2018, and *BVU* will continue its tradition of keeping you fully informed of important developments in the BV profession during 2019.

37 "BV Firm Marketing Experts Reveal Practice-Building Insights" (June 2018).

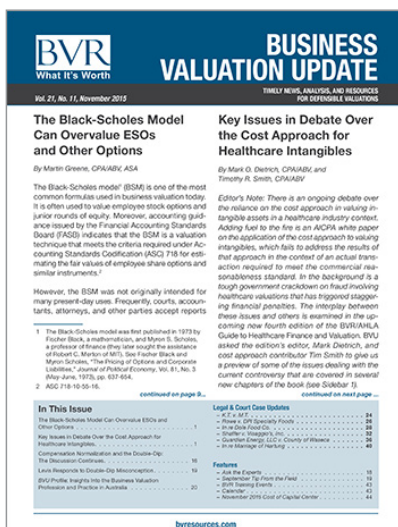
38 Robert E. Kleeman, "Building a Successful BV Practice Within a CPA Firm" (*BVU*, December 2018).

39 Clint Cronkite, "Improving Our Work Product (and Professional Image) ... One Review at a Time" (*BVU*, March 2018).

40 Michael A. Gregory, "Case Study Reveals How to Use Neuroscience to Collaborate With the IRS" (*BVU*, May 2018).

41 David Foster, "IVSC Annual Meeting Emphasizes Standards Adoption" (*BVU*, December 2018).

42 Raymond Moran, "Draft Regulations Take Center Stage at the BV Summit in Mumbai" (*BVU*, July 2018).



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