Valuation: What$ it Worth?

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Valuation has been around ever since man first looked into a horse's mouth. Valuation disagreements began as soon as the second man looked.

Ever since that first horse appraisal (and by the way, valuation and appraisal are synonymous), the valuation profession has become ever more complex. Much of this has to do with technology, from the printing press to that iPhone tethered to your waist. Recently, however, consistency has trumped complexity such that those two horse appraisers must now follow commonly accepted processes. This article is about those commonly accepted processes and my next article will present a complex flowchart of those processes.

The AICPA's Statement on Standards for Valuation Services #1

This article will address the statement issued June 2007 by the American Institute of CPAs (AICPA) and which I played a role in developing. There are about 450,000 CPAs in the U.S., 340,000 of which are members of the AICPA. The Statement on Standards for Valuation Services #1 (SSVS) entitled *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* is effective for all "engagements to estimate value" after January 1, 2008 and applies to all CPAs in public practice who are members of the AICPA. The enforcement is on AICPA members, which, frankly, is not a huge club. However, virtually every state board of accountancy has adopted SSVS as a standard of valuation practice and into their accountancy laws. If a licensed CPA were to violate his/her state's regulation on SSVS, then that practitioner can be disciplined and may be suspended or terminated as a licensed CPA. Now *that* is a club!

Accordingly, a CPA who looks into that horse's mouth better follow SSVS! By following these standards, two practitioners valuing the same subject interest should either come close in their valuation opinions or be able to reconcile why not. The trail will be revealed.

So what is this valuation standard? SSVS has two major parts: Developmental and Reporting guidelines. Since the Developmental component, which includes scope and analytic considerations, reflects the essence of the procedures to complete in a valuation engagement, it is the most critical. Every valuation of a business, business ownership interest, security or intangible asset performed by a CPA who is in public practice must perform these processes. Below are the first three sections of the SSVS; I've excluded the Reporting disclosures due to space limitations.

Introduction and Scope

An analyst engaged to estimate value of subject interest must first identify any other applicable standards or regulations. The analyst, as a CPA, should comply with:

- AICPA Code of Professional Conduct
- Relevant governmental regulations
- Other professional standards

SSVS applies whenever analyst uses valuation approaches and methods and professional judgment in the process. As such the analyst must identify any specific exceptions from SSVS and if SSVS is not applicable, then the analyst must follow any other relevant standards.

Further, the analyst must determine if there are any Jurisdictional Exceptions that apply to any portion of engagement. Governmental, judicial, or accounting authority that differ from SSVS take precedence for the applicable parts of the valuation engagement; SSVS still applies to all other parts of the engagement unaffected by those other bodies. This Jurisdictional Exception is particularly relevant if a CPA is retained in a litigation matter as an expert. In that situation, the valuation analyst should follow the applicable published authority or stated procedures with respect to that part applicable to the valuation in which the CPA is engaged. Put differently, the jurisdictional requirements trump the SSVS requirements.

Overall Engagement Considerations

The analyst must first determine if AICPA's professional competency rule is met (AICPA Code of Professional Conduct, Rule 201A). This is more difficult than most CPAs fully comprehend, believe it or not. Generally, if numbers are involved, a CPA (and perhaps many judges) automatically believes s/he is qualified. Valuation, however, is different from financial accounting that generally involves recording and classifying historic transactions. First valuation education is different from accounting knowledge. Valuation involves finance, economics, and other fields that are not covered much in accounting education. Second and more important, every subject company to be valued is in a specific industry. Valuation requires good judgment which is enhanced by industry experience. Your qualification questions as a referral provider should emphasize the nature of the analyst's specific valuation and industry experience.

As the analyst continues weighing the overall engagement considerations, s/he should consider the nature and risks of the valuation services and the client expectations. This will include disclosing any assumptions and limiting conditions in the report and a determination by the analyst that objectivity is met. The AICPA ethical rules say objectivity is a state of mind and requires the analyst to be impartial, intellectually honest, disinterested, and free from conflicts of interest. Any breech of these requirements must be fully disclosed and consent obtained from the client (AICPA Rule 102-2).

In the AICPA Code of Professional Conduct, independence is a term of art--linked with audits and other attest services—and is distinct from objectivity. As such, the CPA-analyst who works in a full service accounting firm must determine if the firm's (attest) independence is impaired. One problem occurs if the analyst's firm provides attest services (e.g., audit, review, or compilation of financial statements) to a client and the client also wants the firm to perform a valuation. If this firm does the valuation, its independence is impaired from performing the attest services. (See AICPA Code of Professional Conduct Interpretation 101-3).

As we continue the overall engagement considerations, the analyst should establish an understanding with the client. Lawyers know this step as a contract, a meeting of the minds. Good practice reduces the agreement to a signed engagement letter before commencing work. One can modify the agreement if significant events change during the engagement (especially scope or date of value changes). The engagement letter should also disclose and contract to the Assumptions and Limiting Conditions expected in the final report. Appendix A of SSVS has examples. Further, SSVS requires disclosing limitations and restrictions on scope or data in the report.

Finally, as part of the overall engagement considerations, the CPA should determine if a 3rd party specialist's work will be relied upon. Common reliance might include the work of a real estate or machinery and equipment appraiser. In the event of such reliance, the CPA should note in the report the level of responsibility, if any, being assumed by the CPA analyst. The CPA should consider including the 3rd party report in valuation report.

Development Guidelines

The SSVS development guidelines cover the analysis portion of the project. First, the analyst and client agree on the type of engagement, a “valuation engagement” (a comprehensive analysis) or a “calculation engagement” (a limited analysis). The client’s budget and use of the work often determine the type of service. As a practical matter, it’s my belief that only a valuation engagement—rather than a calculation engagement—should be used for offering expert testimony.

- For a valuation engagement, the analyst applies his or her own judgment in selecting the proper valuation approaches and methods.
- For a calculation engagement, however, the analyst and client agree on limited valuation methods and procedures.

For either type of service, the analyst should determine if there are hypothetical conditions (e.g., the value of a business if it had not been injured). Using hypotheticals are proper in general as long as they are disclosed in the report. Next, the analyst should determine the nature and extent of information needed to perform analyses. This includes nonfinancial information which should be sufficient to understand the operational risks of the subject entity. Sufficient ownership information (including classes of equity and their respective rights) on the subject entity should also be obtained as well as financial information on the subject entity for the relevant period of time. By now, the CPA analyst should be accruing a clear understanding of the subject entity's business and financial risks.

At this point in the engagement, I'm generally exhausted and usually out of fee. It's also at this point that the "real" valuation work begins, first by determining which valuation approach or approaches should be used. Space does not allow a full explanation of each approach, but here is a general outline:

If the Income Approach is to be used, determine if the:

- Capitalization of Benefits Method is to be used,
- Discounted Future Benefits Method is to be used, or
- Subject Interest is an Intangible Asset and applicability of the Multi-period Excess Earnings Method (MPEEM).

If the Asset Approach is to be used when Subject Interest is a Business, Business Ownership Interest, or Security, consider the following related to premise of value:

- Individual or aggregate value of assets and liabilities,
- Identification of assets and liabilities, and
- Liquidation costs.

If the Asset Approach is to be used and the Subject Interest is an Intangible Asset, consider:

- Type of cost to use (reproduction or replacement), and
- Depreciation, obsolescence, remaining useful life.
- The Market Approach should be used when Subject Interest is a Business, Business Ownership Interest, or Security. The Market Approach methods are:
- Guideline Public Company,
- Guideline Public Transactions, and
- Guideline Sales of similar subject interests, such as securities or business interests.

If the Market Approach is to be used and the Subject Interest is an Intangible Asset, the Market Approach methods include:

- Comparable uncontrolled transactions method,
- Comparable profit margin method, or
- Relief from royalties' method.
- For all Market Approach work, the analyst should consider:
- Qualitative and quantitative comparisons,
- Arm's length transactions and prices, and
- Dates and relevance of market data.

For all approaches, the CPA analyst should describe the rationale and support for the valuation methods used. Note that multiple methods can and often are used for a single subject, whether it’s a stock interest or an intangible asset. The CPA analyst should determine if any valuation adjustments are needed to particular methods. For business, business ownership interest or security, these adjustments may include discounts or premiums for lack of marketability, lack of liquidity and minority or control issues. Controlling versus noncontrolling ownership interests have specific adjustments to consider. For intangible assets, the analyst should determine if an obsolescence adjustment is needed. Finally, the analyst can arrive at a conclusion after reconciling results from different and multiple valuation approaches and methods used, assessing reliability of results under different approaches and methods, and determining if the conclusion of value should reflect results of one or more approaches and methods. All approaches are considered, but the final opinion or conclusion of value may be comprised of only one or some aggregate of several.

We are still not quite done, however. The analyst should now consider if any subsequent events occurred and whether they are relevant. If so, the analyst should determine if the valuation is meaningful to the user beyond the valuation date. If so, then the analyst should consider a disclosure of the subsequent event and its effect on value. Finally, the CPA analyst should confirm that documentation quantity, type and content are sufficient to support the valuation report in accordance with the CPA professional code of ethics. The analyst then should issue the report and ensure that documentation retention policies are sufficient. This generally means retaining the documentation and report, whether electronic format or paper, for several years.

As you can see, the valuation process is complicated and fraught with danger because, well, horses bite.