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Forensic Accounting, Business Valuation and Consulting Services

in this issue

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- Standards for Valuation
- Approaches & Methods
- Determination of Value
- Conclusion

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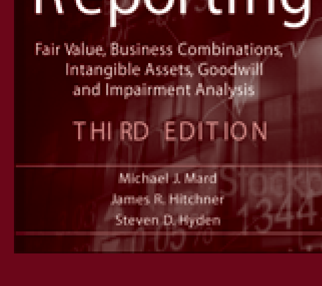
Michael J. Mard is a principal of The Financial Valuation Group of Florida, Inc. Mr. Mard has been a full-time business appraiser and expert witness for over 25 years, specializing in intangible assets, specifically intellectual property. He has developed analyses that have been reviewed and accepted by the Securities and Exchange Commission, major accounting firms, the IRS and the courts. Mr. Mard has provided expert testimony approximately 125 times related to intangible assets, intellectual property, business damages, marital dissolution, shareholder disputes and IRS matters. Full Bio [PDF]

Valuation for Financial Reporting

Fair Value, Business Combinations, Intangible Assets, Goodwill and Impairment Analysis

THIRD EDITION

Michael J. Mard
James R. Hitchner
Steven D. Hyden



Michael Mard, among many others, was involved in the creation and development of SSVS. If you would like an electronic version of SSVS, email info@fvgfl.com and a copy will be provided to you. Please put "SSVS Copy" in the subject line.

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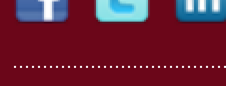

Transparency in Collaboration

Principles of Transparency Specific to the Valuation Process

Part 2 of 7 in a Series
By
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Collaboration in litigation requires transparency, but little is written or discussed about it. This is the second of a series of articles discussing and setting forth principles of transparency related to business valuations and financial analyses performed in a collaborative process setting. This second article will propose principles for transparency specific to the valuation process and subsequent articles will provide tools and guidance related to directly implementing those principles.

In my first article last month, I proposed specific principles of transparency applicable to a financial analyst, including a business valuator, working in a collaborative process. Those principles are designed to allow the verification, reproduction, and evaluation of findings and conclusions and include:

- Clarity of scope of roles, responsibilities and objectives,
- Open process for formulating reporting,
- Public availability of information,
- Accountability and assurance of integrity,
- Shared vocabulary,
- Benchmarking or verification of work performed, and
- Fees based on time and materials.

But what of the work itself? I have proposed general and specific principles to assure transparency of the work performed by a financial expert in a collaborative process. While my proposals are preliminary, they are intended to form a basis for future discussion and development.

The AICPA's Statement on Standards for Valuation Services No. 1 (SSVS)

Effective in 2008, the American Institute of CPAs (AICPA) required the Statement on Standards for Valuation Services No. 1 (SSVS) entitled Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset for all "engagements to estimate value." The SSVS has now been adopted by virtually every state as a regulation for compliance with the CPA license. There are two components to SSVS: Developmental and Reporting. This article will focus on the Developmental component, which includes scope and overall engagement considerations and reflects the essence of the procedures to complete in an appraisal engagement. Every appraisal on business, business ownership interest, security or intangible asset performed by a CPA must be accountable to these processes. A summary of the first three sections of the SSVS and their application to financial experts in a collaborative law setting follows.

Introduction and Scope

SSVS applies whenever an analyst is engaged, either directly or indirectly, to estimate the value of a subject interest. The process involves two key elements: 1) application of valuation approaches and methods, and 2) professional judgment. 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.

Critically, the analyst must determine if there are any Jurisdictional Exceptions that apply to any portion of the engagement. Governmental, judicial, or accounting publications that differ from SSVS take precedence for the applicable sections of the valuation engagement; SSVS is still effective for all other sections of the engagement. This Jurisdictional Exception is particularly relevant if a CPA is retained in a litigation matter as an expert. In that situation, the jurisdictional requirements trump the SSVS requirements. In a collaborative engagement, the CPA and both counsels should agree at the outset as to the Jurisdictional Exceptions and how those exceptions will be treated. Otherwise, the practitioner will be forced to complete the analysis "with and without" considering the Jurisdictional Exception. For instance, case law constraints may be applicable but without the parties agreement on the acceptable level of constraint, the collaborative practitioner may be forced into a "with and without" analyses, first with the constraint and second without it.

Overall Engagement Considerations

Competence: A CPA must first determine if Rule 201A, Professional Competence, of the AICPA Code of Professional Conduct is met (see Transparency in Collaboration, Principles of Transparency Specific to Financial Analyses, Part 1 of 7 in this Series). This is more difficult than most CPAs fully comprehend. Typically, if numbers are involved a CPA automatically believes he or she is qualified to do the work. Valuation, however, is as similar to "traditional" CPA work as a thorough bred is to a plow horse. First there are advanced educational requirements involving finance which are typically not part of the CPA curriculum. Second and more important, every subject company to be valued is in a specific industry. The analyst should have that industry experience before accepting the client. Valuation experience is gained much like an apprenticeship. When considering a valuation specialist, your qualification questions should include the nature of the analyst's specific valuation and industry experience.

Objectivity: SSVS requires the analyst to weigh the overall engagement considerations and 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. SSVS specifically states "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 understood before an assignment is undertaken.

Independence: In the CPA professional code of ethics, objectivity is distinguished from independence. As such, the CPA analyst must determine if independence is impaired. One common breach occurs if the valuation analyst's firm also provides attest (e.g. audit) services to the valuation client. Firms must meet independence requirements in providing attest services and individual CPA practitioners in that firm are not accepted. In short, the auditor is not allowed to perform the valuation.

Assumptions and Limiting Conditions: As we continue the overall engagement considerations, the analyst should establish an understanding with client. Lawyers know this step as a contract, a meeting of the minds. CPAs should require a signed engagement letter before commencing work and then 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. Further, SSVS requires disclosing limitations and restrictions on scope or data in the report.

3rd Party Specialists: Finally, as part of the overall engagement considerations, the practitioner 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 Assumptions and Limiting Conditions section of the report the level of responsibility, if any, being assumed by the analyst. The CPA should consider including the 3rd party report in their valuation report.

Development Guidelines

The AICPA used the word "Development" in SSVS to describe the methodology. The analyst should first determine type of engagement, a "valuation engagement" (an unqualified opinion) or a "calculation engagement" (agreed upon procedures). It's my belief (not an SSVS requirement) that only unqualified opinions in "valuation engagements" should be used for litigation assignments. However, calculation engagements can be a powerful and efficient tool used in collaborative law engagements. For a valuation engagement, the analyst:

- Analyzes the subject interest,
- Considers all approaches and methods, applying those that are appropriate, and
- States the results of the engagement as a conclusion of value.

For a calculation engagement, the analyst:

- Agrees with the client on the limited valuation methods and procedures, and
- Calculates value in accordance with client agreement.

For either engagement, the analyst should determine if there are hypothetical conditions. Such hypotheticals are allowed as long as there is full disclosure in the report as to why hypothetical conditions were used. 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 subject entity. Sufficient ownership information (including classes of equity and their rights) on the subject entity should also be obtained, as well as financial information for the relevant period of time.

Valuation Approaches & Methods

At this point of the engagement, 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 summary:

- **Income Approach:**
  - Capitalizes some measure of the company's earning capacity at a rate reflective of the return on assets (which is commensurate with the risk) that would be required by a hypothetical investor, or
  - Estimates fair value based on the future available cash flows an asset can be expected to generate over its remaining useful life.
  - 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.
- **Asset Based Approach (used when Subject Interest is a Business, Business Ownership Interest, or Security):**
  - Based on the proposition that the informed purchaser would pay no more for an asset than the cost of producing a substitute asset.
  - Establishes value based on the cost of reproducing or replacing the property, less depreciation from physical deterioration and functional and economic obsolescence, if present and measurable.
  - Generally provides the most reliable indication of the value of land improvements, special-purpose buildings, special structures, systems, and special machinery and equipment.
  - If the 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 Subject Interest is an Intangible Asset, consider the following related to premise of value:
    - Type of cost to use (reproduction or replacement), and
    - Depreciation, obsolescence, remaining useful life.
- **Market Approach**
  - Internal Transactions Method produces an estimate of value by a review of relevant past transactions in the entity's stock.
  - External Transactions Method produces an estimate of value by comparing the subject company with comparable privately held companies (or business interests) that have been sold.
  - Guideline Public Company Method produces an estimate of value by comparing the subject company with various valuation multiples of publicly traded companies.
  - For all methods, consider:
    - Qualitative and quantitative comparisons,
    - Arms-length transactions and prices, and
    - Timing and relevance of market data.
  - For intangible Assets, Market Approach methods may include:
    - Comparable uncontrolled transactions method,
    - Comparable profit margin method, or
    - Relief from royalties method.

For all approaches, the analyst should set forth in the report the rationale and support for the valuation methods used. He or she should determine if any valuation adjustments are needed. For businesses, business ownership interest or securities, 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.

Determination of Value

Finally, the analyst can arrive at a conclusion of value after reconciling results from different 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.

We are still not quite done, however. The analyst should now consider if any subsequent events occurred. 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 report disclosure of the subsequent event, including the impact on the numbers.

Lastly, the analyst should confirm that documentation quantity, type and content are sufficient to support the valuation report in accordance with the proposed General Principles in **Transparency in Collaboration**, *Principles of Transparency Specific to Financial Analyses*, Part 1 of 7 in this Series, specifically the proposed General Principle for all collaborative professionals to obtain sufficient relevant data to afford a reasonable basis for conclusions and findings.

Conclusion

This article focused on the application of specific principles of transparency to a financial analyst working in a collaborative process and provided an introduction to the valuation process. Future articles will address:

- The asset-based (or cost) approach,
- The market approach,
- The income approach,
- Applicable discounts and premiums, and
- Suggested checklists for use by non appraisers.

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