Submitting a BV Report for Accreditation

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Presenters

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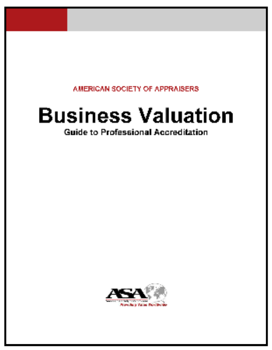
William Quackenbush, MBA, ASA, MCBA, ABAR is a director of Advent Valuation Advisors and has more than 40 years of business experience. Mr. Quackenbush has provided expert witness testimony and/or been deposed as such in both State and Federal Courts and in both arbitration and mediation settings. Mr. Quackenbush has taught business valuation throughout the US and worldwide for nearly 20 years and was the author of one of the ASA's credentialing courses in Business Valuation. He was a contributing author of the “IFRS Fair Value Guide: The IACVA International Handbook” published by John Wiley and Sons, is a contributing editor to The Financial and Litigation Expert, and has been a technical reviewer for two editions of the AICPA’s text on Business Valuation. He served as the Chair of the ASA's Business Valuation Committee and is currently the Vice Chair of the Board of Examiners (BV).

Today’s Agenda

- ASA Guidelines for BV Reports



Check for the most up to date *BV Accreditation Guide* at:
http://www.appraisers.org/Accreditation/accreditation-guides-forms

- Points To Remember
- Common Flaws in BV Reports
- Suggestions
- Questions

Polling Question #1

How would you describe yourself:

A. Candidate

B. Accredited Member

C. Accredited Senior Appraiser

D. Other

BV Appraisal Report Guidelines

Advancement in BV requires the submission of one comprehensive written business valuation report

ABC COMPANY
APPRAISAL REPORT

- Reports are reviewed by members of the ASA Board of Examiners on a fatal flaw basis.
- Report must comply with BVS-VIII of the ASA Business Valuation Standards
- The report must include the use of both the income approach AND the market approach
- Must include explanations of how factors such as discount rates, valuation multiples, and premiums or discounts were determined and used.

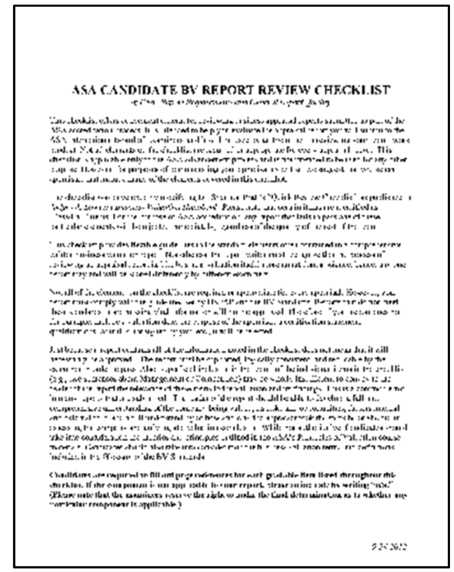
BV Report Review Checklist

- Developed by modifying Dr. Shannon Pratt’s “Quick Review Checklist”[1]

- Candidates must complete the ASA Candidate BV Report Review Checklist and submit it with application

- Not all elements on the checklist are required or appropriate for every appraisal report

- Pass/Fail items are clearly marked


ASA CANDIDATE BV REPORT REVIEW CHECKLIST

[1] as published in Judges & Lawyers *Business Valuation Handbook*

Pass/Fail Items

- ☐ Name of company
- ☐ Form of ownership
- ☐ Portion to be appraised
- ☐ Name and standing of party hiring the appraiser
- ☐ Effective valuation date
- ☐ Date report prepared
- ☐ Purpose of the appraisal
- ☐ Degree of control
- ☐ Definition of standard of value
- ☐ Capital structure
- ☐ Distribution of ownership
- ☐ Sources of information
- ☐ Income statements presented with sufficient detail and history to review for possible adjustments
- ☐ Balance sheets presented with sufficient detail and history to review for possible adjustments
- ☐ Adequate explanation of what adjustments were made to the Company's financial statements or an explanation of why none were necessary
- ☐ Company's financial ratios, income statement, balance sheet, etc. compared with themselves over time to identify trends
- ☐ If projections of balance sheets or income statements were utilized in the valuation, key assumptions underlying the projections must be identified and discussed.
- ☐ Are the valuation methods all on one consistent level of value (e.g., all on a minority interest basis or all on a controlling interest basis)?
- ☐ Appraiser certification (including statement included that no person other than those identified had any significant professional input
- ☐ Statement of limiting conditions
- ☐ Signature of appraiser

Pass/Fail vs Fatal Flaw Issues

- Pass/Fail Items are those items that we require to be in the report. Their exclusion may not be “fatal” in terms of impairing the concluded value but are considered to be required content for credentialing.
- Fatal flaw items are errors that impair the concluded value and are evidence of insufficient competency for credentialing.
- Non-fatal flaw items in and of themselves will not cause failure.
  - Minor or isolated mathematical errors such as rounding
  - Judgement issues based on a subjective analysis of data or information. A company specific risk premium, for example.
  - Typographical or spelling errors, as long as they are not pervasive.
  - Alternative procedural choices. Using CRSP data vs. Risk Premium Report data to derive the cost of equity, as long as it is consistently applied and correctly employed.

Polling Question #2

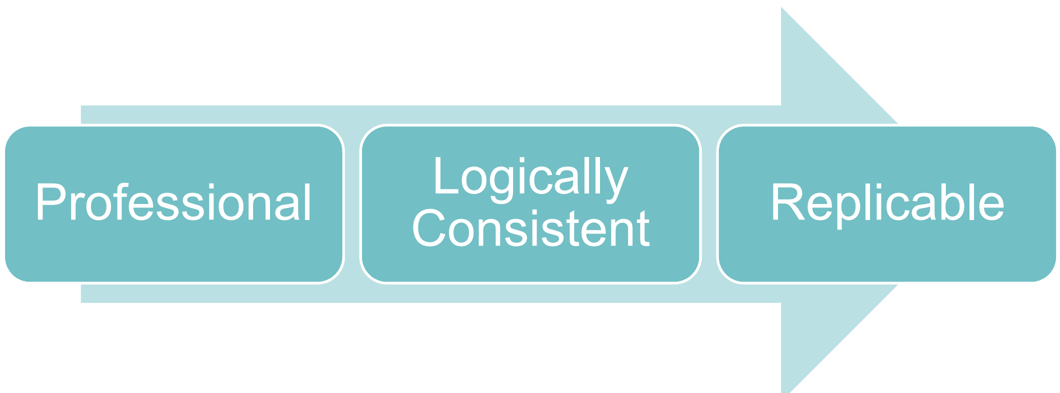
Reports submitted for accreditation are required to be comprehensive written business valuation reports.

A. True

B. False

Points to Remember

- The report submission should demonstrate the candidate's body of knowledge and be:



Must be supported, logically consistent, and **replicable by the examiner** in order to pass.

- Rote inclusion of the checklist items does not mean it will be approved.

Points to Remember

The reader of your report should be able to develop…

A full and comprehensive understanding of the Company being valued

The risks and opportunities to the Company

The internal and external factors impacting the Company

A full understanding of how and why the steps taken in assessing the Company and the valuation conclusion

Points to Remember

- It is incumbent on the report writer to <u>make clear their reasoning</u>, **especially in areas that lack universal acceptance**
- Candidates should take into consideration:

  (a) the theories and principles outlined in the ASA's <u>Principles of Valuation course materials</u> and

  (b) the business valuation terms and definitions included in the <u>Glossary of the BV Standards</u>
- ASA prefers the Candidate submit an appraisal report that was prepared for an actual client assignment, however, it is acceptable for the Candidate to redact certain client-specific information
- <u>If</u> a firm's standard report is <u>not a comprehensive report</u>, **the Candidate is allowed to expand the original report to make it a <u>demonstration report</u>**

Polling Question #3

If a Candidate’s actual report does not include the required elements for a comprehensive written report, the Candidate should:

A. Prepare a report based on a hypothetical client.

B. Submit the report for accreditation.

C. Expand the report to include required elements.

D. Not submit a report for accreditation.

Common Flaws in BV Reports

- “Big Picture” Issues
- Common Flaws by Subject Area
- Suggestions

ABC Company
Appraisal Report

Common Flaws in "Big Picture" Terms

Understandability	• Is the report understandable to the reader?
Accuracy	• If the report and listed data sources were handed to another competent appraiser, could all of the data provided be independently checked for accuracy and thoroughness?
Replicability	• Could another competent appraiser follow the thought process leading to the conclusion (not necessarily agree with the conclusion, but be able to understand how it was formed)?
Clarity	• Did the appraiser clearly appraise the property that was identified to be appraised?
Methodology	• Is the appraisal methodology appropriate for the purpose of the appraisal, the relevant standard of value, the ownership characteristics (e.g., control and marketability), and any controlling case law precedent?

Common Flaws in "Big Picture" Terms

Consistency	• Is the report internally consistent (e.g., nothing in one place that seems to contradict something somewhere else)?
Comprehensiveness	• Is the report comprehensive (e.g., does it do everything it promises to do; are all the topics included that seem necessary to support the conclusions reached)?
Omissions	• Are there any obvious omissions in the report?
Logic	• Does the report logically lead to convincing support for the conclusion(s) reached?
Professionalism	• Is the report format professional (spelling, grammar, layout)?

Example: Integration Failure

Market Multiple = Inverse of Capitalization Rate

1 ÷ (Risk – Growth)

1 ÷ (Discount Rate – Growth)

$1 \div ((R_F + R_{ERP} + \mathbf{R_{SIZE}} + \mathbf{R_I} + \mathbf{R_{CSR}}) - \mathbf{Growth})$

- Are risk and growth issues treated similarly as between the income approach and the market approach?
- Inconsistent treatment would indicate failures of Logic, Accuracy, and Consistency

Common Flaws in BV Reports

- Lack of support for subjective factors
- Company Overview
- Industry Analysis
- Financial Statement Analysis
- Financial Statement Adjustments
- Selection of Income Method
- Income Approach Application
- Market Approach Application
- Discounts/Premiums
- Reconciliation
- Inconsistencies in report
- Use of outdated sources
- Math (errors, calculations not provided)
- Not in a logical sequence
- Overreliance on exhibits or footnotes
- Use of valuation software

Support of Subjective Factors

Examples of Insufficient Support:

- "In the opinion of the appraiser, a capitalization rate of 25% will be suitable for the subject."
- "When compared to the other approaches, the income approach should be given the greatest weight."
- "Average annual growth rate for the last five years is 8.9%, so we will project future income at this rate."
- "The average control premium observed in the Mergerstat Studies was 35%, so this is what we will use for the subject."
- "Numerous authorities suggest a range of discount rates from 20% to 35%, so for this subject we will use the average of these, or 27.5%."

Source: *CBA/MCBVA Applicant's Handbook*. Institute of Business Appraisers.

Financial Statement Analysis

- Analysis is only mere statement of facts with no discussion of why:

  Example:

  > "Sales in the LTM increased 4.5% from the prior year.
  > EBITDA margin increased to 8.9%"

- Reliance on RMA or other generic data and then use of public companies in the market approach with no comparable analysis
- Insufficient detail of statements for reader.
- Use of only a few years of performance without explanation of why limited.

Financial Statement Adjustments

- Failure to make or discuss normalization adjustments to financial statements
- Inconsistent control adjustments relative to level of value
- Lack of support for compensation adjustments
- Failure to make adjustments for one-time events
- Failure to adjust the income statement impacts of balance sheet adjustments
- Failure to carry though the adjustment logic throughout all analysis. For example, normalizing rent expense for company owned facilities, but not impacting value for market value of RE, or potential for imbedded capital gain.

Selection of Income Approach Method

- High growth company, major changes in client base/services, and single period utilized without explanation
- Valuation uses both direct capitalization and discounted cash flow (DCF) methods (with inconsistent assumptions and results)
- DCF method is not used for the sole reason that the company does not prepare projections

Income Approach

- Capitalization or discounting of economic income other than net cash flow (i.e. EBITDA, pre-tax income)
- Failure to adequately discuss projection assumptions
- Depreciation is greater than capital expenditures into perpetuity
- Improper treatment of interest-bearing debt
- Failure to support growth rates used
- Failure to understand the impact of terminal value inputs
- Failure to use appropriate present value factors

Income Approach

- Use of capitalization rate as discount rate or vice versa
- Unsupported use of average or most recent year's economic income in the direct capitalization method
- Failure to use the projected next year's economic income in the direct capitalization method
- Terminal value based on valuation multiples from market approach without regard to specific circumstances of subject company or the difficulties in estimating what the market multiple will be in the future

Income Approach

DCF Example:

	XX01	XX02
EBITDA	43.4	82.1
WACC PV Factor 11.6%	0.8961	0.8029
PV Figure	38.9	65.9

Plus Terminal Value $82.1 million/(11.6% - 6% growth rate) =
$1,446.2 million x .8021 = $1,176.0 million+ $38.9 million + $65.9 million =
$1,280.8 million or $1,273 million after deducting $7.8 million in interest bearing debt.
Since the economic benefit is after-tax, the analyst applied a combined rate of 40% and applied it to this figure. Therefore, the present value of equity is equal to $764 million on a marketable, noncontrolling ownership interest basis.

Problems:

- Benefit stream mismatch: discounted EBITDA with WACC
- Used current year benefit stream in terminal value
- Erroneously tax-effected indicated value of equity

Income Approach

Direct Capitalization Example from Same Valuation:

Net Income: $19.4 million
Capitalization Rate: 5.6%

→

Equity Value
$347 million

Problems:
- Again, benefit stream & required rate of return **mismatch**
- Different growth rate assumption than in the DCF method
- Indicated value of equity is less than half of the value from the DCF method

Income Approach

Direct Capitalization Example:

($000s)	2013	2014	2015	2016	2017	Average
Normalized Net Income	825	1,524	1,533	(31)	2,568	1,284
Add: Depreciation	1,382	1,229	1,518	1,266	1,109	1,301
Less: Capital Expenditures	(1,571)	(898)	(680)	(296)	(270)	(743)
Less Changes in Working Capital	(341)	(420)	125	12	(52)	(135)
Add: Increases in Debt	(111)	(12)	-	-	-	(25)
Adjusted Net Cash Flow to Equity	184	1,423	2,497	950	3,355	1,682

Used for
Direct Capitalization

Income Approach

Discount Rate Issues

- Improper use of cost of capital data (i.e. risk-free rate, equity risk premium, size premium, industry risk premium)
- Use of Deciles 10b or 10z
- Minimal or no discussion of company-specific risk premium factors
- Use of quantitative factors in company-specific risk premium that lack an empirical basis or defy common sense

Polling Question #4

Which of the following is NOT a flaw in applying the income approach?

A. Depreciation is projected to be greater than capital expenditures.

B. Use of the average of historical cash flows in the direct capitalization method.

C. Use of the company’s actual capital structure when valuing a controlling interest.

D. Application of the DCF method even though the company does not prepare projections.

Market Approach

- Inconsistent assumptions with income approach
- Using guideline companies that are not comparable
- Failure to use guideline company method when guideline company betas or volatilities are used in the valuation
- Lack of comparative analysis of subject and guideline companies

Multiple Selection

- Automatically applying the mean or median multiple without regard to any differences between the subject company and the guideline companies
- Failure to explain/support multiple adjustments in any meaningful way
- Failure to consider profitability in selection of revenue multiples
- No discussion of why the fundamentals (metrics) were selected
- Reliance on general multiples or rules of thumb

Multiple Selection

No discussion of multiple selection process

Examples:

- “multiples were selected based on Company X judgment” (footnote to table)

- “Multiples were adjusted for differences in size, risk and growth” (no comparative analysis provided or detail to replicate calculations).

Control Premium/DLOC

- No discussion of facts and circumstances of subject interest
- Use of discount for lack of control (DLOC) when value of noncontrolling ownership interest could have been valued directly
- Application of DLOC to noncontrolling indication of value (or control premium applied to control indication)
- DLOC based on "average" control premium that is inconsistent with magnitude of normalization adjustments
- Failure to include any empirical data to support the discount or premium
- Use of closed end fund discounts for noncontrolling ownership interest in operating company

Discount for Lack of Marketability

- No discussion of facts and circumstances of subject interest that may impact the DLOM
- No discussion of empirical studies
- Reliance on average of restricted stock studies and/or IPO studies without further analysis of subject interest
- Reliance on only most recent restricted stock studies. Conversely, the failure to use recent empirical studies

Discount for Lack of Marketability

- Overreliance on Mandelbaum factors without consideration of other relevant factors
- Use of court cases as support for DLOM
- Use of restricted stock studies and IPO studies to derive DLOM for controlling interest
- Reliance on option pricing models for DLOM without regard to facts and circumstances of subject interest

Interests in Pass-Through Entities

- Failure to take into consideration any adjustments to account for the tax status of the subject company
  (*Note: the ASA does not recommend or require the use of any specific valuation models*)
- Valuation models related to noncontrolling ownership interests in pass-through entities applied to controlling ownership interests

Reconciliation of Value

- Performing a valuation method that is not relevant to the subject valuation (i.e. performing asset approach for a noncontrolling ownership interest), then weighting it 0%
- No discussion or support for weights accorded to each of the valuation methods
- Inconsistent values from different approaches without reconciling why there is a large difference in value
- Values from different approaches are too close to each other (may indicate that numbers or weightings were manipulated)

Polling Question #5

A discount for lack of control (DLOC) must be applied when valuing a noncontrolling ownership interest.

A. True

B. False

Report Format & Presentation

All analysis and data in Exhibits

- Unnumbered exhibit pages – making it near impossible for reader to follow
- Unreferenced or mis-referenced exhibits in report
- Report Body contains all boiler plate / All assignment specific content in exhibits
- All valuation discussion and/or decisions in footnotes to schedules

Data is illegible

- Schedules include print so tiny that it cannot be read

Suggestions

- Read and follow the guidance in:
  (a) the BV Accreditation Guide,
  (b) the ASA BV Standards,
  (c) USPAP, and
  (d) the BV Report Review Checklist.

- If your firm does not prepare detailed reports, take the time to expand an actual report to a demonstration report that meets the ASA requirements.

- Apply valuation principles and methodologies that are consistent with leading valuation treatises and ASA Principles of Valuation courses.

- Review report templates to make sure that reports are up to date in terms of references and application of valuation principles. Get rid of non-applicable boilerplate.

Suggestions

- Don’t select the most complicated project you have ever worked on to submit.
  - No one earns bonus points for difficulty to offset other problems
  - Unnecessary complexity increases the risk of a fatal flaw
  - If you are submitting a report that values an equity component, does it really make sense to include an appendix that also values derivative debt instruments?
- Stay mainstream: don’t use this report to test new valuation theory
- If you have a mentor, have him or her review your report – at least at a high level.
- CHECK MATH!

Polling Question #6

Which of the following are key factors in evaluating valuation reports submitted for accreditation?

A. Is the report replicable?

B. Is the report consistent?

C. Is the report comprehensive?

D. All of the above.

Questions ?