Business Valuations

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What CPAs and Attorneys Should Know About the New AICPA Valuation Standards

After six years of drafts, debates, and deliberations, this past summer—in June 2007, the American Institute of Certified Public Accountants (AICPA) issued its Statement on Standards for Valuation Services No. 1 (the Statement). The Statement applies to any AICPA member, regardless of technical discipline, who performs an engagement to estimate the value of a business, business ownership interest, security, or intangible asset. The Statement identifies these members as "valuation analysts."

Valuation analysts must comply with the Statement whenever they perform a valuation engagement involving a conclusion of value or a calculated value. The only exceptions are: (1) when the valuation is part of an attest engagement; (2) when a client or third party has provided a subject value, and the analyst does not apply any independent analysis; (3) engagements to determine economic damages (unless inclusive of an estimation of value); and (4) jurisdictional exceptions for governmental, judicial, or accounting authorities. The Statement is effective for all applicable engagements after January 1, 2008, but earlier adoption is encouraged.

Parties who rely on valuation reports—including attorneys, bankers, and transaction principals—will now be able to define alternative levels of valuation services and reports. They will benefit from increased transparency, consistency, and reliability of valuation reports. What follows are the key points regarding the effect and application of the new Standards:

1. Competency. The Statement requires the analyst to possess a level of knowledge sufficient to identify, gather, and analyze valuation data; consider and apply appropriate valuation approaches and methods; and use professional judgment.

2. Objectivity. "Objectivity is a state of mind." The Statement defines objectivity as imposing the obligation to be impartial, intellectually honest, disinterested, and free from conflicts of interest."

3. Independence. If the valuation analyst also performs an attest engagement, then the analyst must meet the requirements of Rule 101 of the AICPA Professional Standards ("Independence") and Rule 102 ("Integrity and Objectivity").

4. Types of engagements. The Statement permits: (i) a valuation engagement, expressed as a conclusion of value, with applied methods and approaches selected by the analyst; and (ii) a calculation engagement, for which the analyst and client agree on the methods and extent of procedures, resulting in a calculated value.

5. Factors to consider. In a valuation engagement, the Statement lists eight factors: (i) the nature of the subject interest, including financial and non-financial data; and type of ownership interest (ii)the scope of the valuation engagement (iii) the valuation date (iv) the intended use of the valuation (v) the applicable standard of value (vi) the applicable premise of value (vii) any assumptions and limiting conditions (viii) any applicable governmental regulations or other professional standards

6. Valuation approaches and methods. In a business or security valuation, the valuation analyst should consider: the income, market, and asset-based approaches. The first two also apply to an intangible asset valuation, plus the cost approach.

7. Rules of thumb. The Statement permits rules of thumb and/or industry benchmarks as reasonableness checks but discourages their use as the only method to value a subject interest.

8. Valuation adjustments. The analyst should consider whether valuation adjustments should be made; e.g., price premiums or price discounts (lack of control and/or marketability).

9. Conclusion. In determining the conclusion of value, the analyst should: (i) assess the reliability of results under different valuation approaches and methods using the information gathered in the valuation engagement; (ii) correlate and reconcile the results gathered from the different valuation approaches and methods; and (iii) determine whether the conclusion of value should reflect (a) the result of one valuation approach and method or (b) a combination of results.

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10. Subsequent events. In most cases, the analyst should consider only those events existing prior to and at the valuation date. Should a "subsequent event" (after the valuation date but before the report is issued) impact value, the analyst should consider only those events "known or knowable" at the valuation date.

11. Documentation. The Statement requires the valuation analyst to apply professional judgment to determine the type, quantity, and content of documentation. These may include information gathered and analyzed to understand value, assumptions and limiting conditions, restrictions on scope, etc.

12. Calculation engagement. At a minimum, the analyst should consider: (i) the client; (ii) the subject interest; (iii) the degree of ownership control and marketability; (iv) the purpose and intended use of the calculated value; (v) the intended users; (vi) the valuation date; (vii) the applicable premise and standard of value; (viii) the sources of information used; (ix) the agreed-upon valuation approaches and methods; and (x) any subsequent events.

13. Valuation report. The Statement defines a valuation report as a "written or oral communication to the client about the conclusion of value or the calculated value of the subject interest." Exceptions include reports for "controversy" proceedings, unless the analyst forms a conclusion of value or calculated value. The report should identify any use restrictions.

14. Written reports. For a valuation engagement, the Statement permits a "detailed" report and a "summary" report; the distinction depends on the level of reporting detail. The detailed report should enable intended users to understand the information, reasoning, and analyses underlying the conclusion of value and should include these sections: (i) Letter of transmittal; (ii) Table of contents; (iii) Introduction, including an overall description of the valuation engagement; (iv) Sources of information; (v) Analysis of the subject entity and related non-financial information; (vi) Financial statement/information analysis; (vii) Valuation approaches and methods considered; (viii) Valuation approaches and methods used, identifying each method used and the reason(s) for their use, including rules of thumb; (ix) Valuation adjustments (if any); (x) Non-operating assets, non-operating liabilities, and excess or deficient operating assets; (xi) Representation of the valuation analyst, including eight specific statements; (xii) Reconciliation of estimates and conclusion of value, including specific disclosures; (xiiI) Professional qualifications of the valuation analyst; and (xiv) Appendices and exhibits, including examples, assumptions, and limiting conditions.

The summary report provides an abridged version of a detailed report and does not require the same level of data. At a minimum, it should include twenty-three specific statements, including the subject interest, the valuation date, the purpose of the valuation, and the premise and standard of value.

For a calculation report, the analyst should identify: (i) any hypothetical conditions used in the calculation agreement (including the basis for their use); (ii) any assumptions and limiting conditions of the engagement; (iii) how a specialist's work was used; (iv) any application of the jurisdictional exception; (v) any subsequent events (in certain circumstances); and (vi) the calculated value.

Lastly, an oral report may be used in a valuation engagement or in a calculation engagement. The valuation analyst should document in working papers the substance of the oral report that was communicated to the client.

Note: A complete copy of the Statement, presentations, and an FAQ are available at http://bvfls.aicpa.org.

May an Attorney's Lien Include an Independent Appraiser's Fees?

Bero-Wachs v. The Law Office of Logar and Pulver, 2007 Nev. App. LEXIS 19 (May 3, 2007)

It was a good gamble: A Nevada law firm filed an attorney's lien on the assets of a divorce client for failure to pay her fees and costs. The law firm also included the fees and costs she failed to pay the forensic accountant, whom she hired (on her attorney's recommendation) to track down her husband's income and value his medical practice.

Although the client contracted separately with the analyst, her attorney had worked closely with him on the "relatively complex" valuation and his attempts to find assets. After a hearing and several posttrial motions, the client wrote a letter to both the lawyer and the expert saying that she refused to pay for their services.

The attorney then filed the "combined" lien with the district court, which upheld its attachment to all assets except alimony. The wife appealed, claiming that the lien couldn't include the accountant's fees.

Statute is clear

The state Supreme Court looked to the controlling statute and found it "unambiguously" dictated that an "attorney at law" has a lien on the client's assets for fees "which the attorney has rendered" or that have

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"been agreed upon by the attorney and client."

Given this plain language—and the plainly independent relationship between the client and the forensic analyst—the Court denied the inclusion of the latter's fees in the lien. If the attorney had contracted with the analyst or had some other direct liability for the fees, then perhaps the outcome would have been different; but this time, the appraiser gambled on a difficult case and client, and lost.

Divorce Court Credits Buy—Sell And Discredits 'Controlling' Owner—in Business Value

Silver v. Silver, 2007 Ohio App. LEXIS 2428 (May 25, 2007)

In divorce cases, courts often hear business valuations among a host of testimony regarding the owner's temperament as a spouse and/or a parent. At times, it must be impossible to separate "personality" evidence from "professional." At other times, the personal information may be related if not relevant to the business valuation, especially in the case of a small, closely held company with a single owner.

The Silver case addressed the three major issues common to marital dissolutions: the custody of the couple's children, the support of the children, and the valuation of a business. The husband in this case was the sole shareholder of the business--an employee consulting/recruiting firm, organized as an S corporation.

Controlling parent, controlling owner

In discussing the children's issues, the trial court determined that the husband—although possessing a cool and logical demeanor—was "[i]n reality…controlling and manipulative and very absolute in his thinking." When it came time to determine support and valuation of the husband's business, these same character traits appeared to influence the court's ruling.

The husband's expert valued the business at $59,000 with goodwill ($13,000 without). The wife's expert valued the business at $380,000. In considering the disparate values and, in particular, evidence of the husband's income, the magistrate exercised "heightened scrutiny." As sole shareholder, the husband could "control distribution and retention of the net profits of the business." Moreover, there was the possibility of manipulation of income.

For example, the experts valued the business as of the end of 2004, when the husband's annual income was approximately $146,000. By contrast, for the years 2001 through 2003, he earned an average of $94,000. Although the husband argued that a share of future net income could be needed for capital expenditures, he did not offer specific evidence of what these might be. Moreover, both experts agreed the business was not capital-intensive.

Buy-sell is credible evidence

In considering the overall value of the business, the magistrate favored the analysis by the wife's expert, including his "avoidance of factors generally used in the valuation of publicly traded companies." The expert also relied on a 2004 buy-sell agreement--which valued 100% of the company stock at $400,000--as a credible indication of fair market value. The magistrate accepted this view, especially as there was no contravening evidence.

Finally, the magistrate discussed "at length how certain key numbers or percentages could significantly affect the valuation of a business." As the wife's expert provided a better explanation for the numbers he used than did the husband's expert—and in consideration of all the evidence, the magistrate valued the business at $380,000. Based on the sufficiency of the record, the appeals court affirmed.

Which is More Credible: An Owner's Projections or Those Used for Financing?

Aukeman v. Aukeman, 2007 Mich. App. LEXIS 1524 (June 12, 2007)

In assessing the value of a business during divorce proceedings, it's not unusual for attorneys to obtain—and analysts to review—financial statements and/or projections prepared by the company (or its owner) to apply for lender financing. It's also not unusual to hear the owner-spouse forecast projections for the company far below those in the loan application. The question for the trial court judge: which is more credible?

Values double, depending on the source

In Aukeman, the husband testified that weekly sales for his business averaged $58,000, and he predicted that future sales would increase only slightly. His expert used that figure to value the business--which owned and operated three grocery stores--at just over $1.53 million.

By contrast, the wife's expert relied on sales projections the husband/owner created to obtain financing for one of the grocery stores. Predicting weekly sales averages of $122,000, the wife's expert valued the business at just over $3 million.

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Faced with such divergent valuations, the trial court did what many before it have done: It discredited both, finding that the experts relied on speculative projections—and confirming once again that any source of projections must be reliable and well-supported. Accordingly, it valued the business between the two assessments, at $2,225,000, and the appeals court affirmed, finding the value within the range established by the evidence.

'Splitting the Difference' Is Not an Acceptable Valuation Method in Divorce

Augoshe v. Lehman, 2007 Fla. App. LEXIS 6367 (April 27, 2007)

In an attempt to reach fair and equitable solutions, divorce courts will often "split the difference" between the parties' disparate business appraisals. If the court makes an adequate record, including competent evidence to support its ultimate value conclusion, the "midpoint" determination may withstand reconsideration and/or subsequent appeal.

But in this case, the trial court made no such record in deciding the value of a Florida motel, purchased by the parties during a short (three-year) marriage. At trial, the wife's expert had presented two valuations, one based on the comparable sales approach ($4.40 million) and another based on the income approach ($4.31 million). The only evidence of value offered by the husband was the $2,842,858 purchase price for the motel.

Court cites Solomon

The trial court concluded the motel was worth $3,576,429, and the husband appealed. On review, the appeals court was unable to find "any competent evidence to support this finding," other than that the value was the "exact midpoint" between the purchase price and the income approach valuation by the wife's expert. Citing the Florida case of Solomon v. Solomon (which is hard to resist repeating, simply for the irony of the name), the appeals court found that "simply splitting the difference" between two divergent appraisals was an "improper method of valuation," and it remanded the case for further findings.

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