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BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

# A Veteran Valuer Looks at the BV Profession

*By Robert E. Kleeman, Jr., CPA/ABV, ASA, CVA*

There has been a great deal of discussion lately about the future of the business valuation profession. While I applaud every effort to raise the technical quality of our work product, I question many of the paths that are being taken—including the recent decision by the AICPA to allow non-CPAs to get the ABV credential (more about that later).

I have been involved in the valuation profession for more than 40 years now, with the last 38 years as a full-time practitioner. I started as a sole practitioner, was a partner in a small local firm, senior manager with a "Big Four" firm, and then spent the next 19 years of my career developing and ultimately being the senior technical partner for BV in a top 20 CPA firm. Now I'm a sole practitioner again.

I still attend BV professional meetings each year, hoping to pick up new information on how to do some part of the valuation better, perhaps some innovation or use of data, and just to feel the pulse of the BV community. I do not like what I am seeing and hearing.

I started my business valuation work "pre-Pratt" and have had the privilege to meet and work with many of the giants of our profession. However, as I look over my shoulder, I believe that I see a path to the destruction of the BV practice as we know it today. It has already begun. Business valuations by mail for $750. Can't-miss formulas, just fill in the blanks. Comparable company valuations based on questionable databases. Practitioners subcontracting out major pieces of the valuation engagement and then just signing the report for their client. The proliferation of numerous credentials—I saw a résumé that had 16 valuation and litigation credentials for the professional, plus being a CPA and MBA. How many things can one person be expert in?

This paper is not focusing on "Joe the Plumber" who has a single truck and a part-time helper and basically concentrates on residential repair jobs. Many small business entities in the U.S. economically have little or no fair market value other than the liquidation of their assets. I am also not focusing on the buyer who is not buying a business but is buying a job, working 60-plus hours per week, with no real profit after owner's compensation.

What I am focusing on are the many, profitable, growing small to medium businesses that need the help of a competent business valuation professional.

**Four absolute rules of BV.** I believe that, when I started in the BV industry, I learned four rules or laws that I still believe are the major drivers of professional valuation services today. I believe that if the profession is to successfully sustain itself as a profession and not a provider of a commodity service, we need to review and dissect these four laws and make sure we are using them correctly today.

The four immutable rules of business valuation are:

1. *"A determination of fair market value, being a question of fact, will depend on the circumstance in each case. No formula can be*

# BUSINESS VALUATION UPDATE

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*devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift cases. Often, an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."*[1]

Let's deconstruct this discussion and see how it is still vital today and why we need to make sure we are following the instruction the rule provides.

**'[F]air market value, being a question of fact, will depend on the circumstances in each case.'** Since fair market value is a question of fact, and depends on the circumstance in each case, by definition, each valuation is unique. In all the years I have been practicing valuation, I have never come across two valuations where the facts and circumstances were exactly the same. This is true even though I have valued individual McDonald's, Burger King, and Pizza Hut franchises. No two stores had the same facts and circumstances involved. Issues such as demographics, location, and local competition are important. So are issues such as some multi-store operations versus a single-store operation. There are certainly similarities in the operations of a McDonald's franchise, but the value of Franchise A may be quite different than Franchise B. What about the Pizza Hut franchise that only sells pizza versus the store that has a beer and wine license as well? Could this have an impact on value? Of course!

**'Valuation is not an exact science.'** Why not? What is a science? Webster's defines a science

1 Rev Rul 59-60, Sec 3.01 1959-1 C.B 237.

as "the intellectual and practical activity encompassing the systematic study of the structure and behavior of the physical and natural world through observation and experiment." Chemistry is a science. Every time you mix the elements properly, you get a predetermined result. Every time you formulate $H_2SO_4$, you get sulfuric acid. The salt on your table is NaCl, or sodium chloride. These formulas just don't change. That certainly is not the case with the valuation of a closely held entity.

How can valuation be a science? Two very competent appraisers can look at the same business and arrive at different conclusions as to the value. Why is that possible? Because valuation is not a science. It encompasses judgmental issues. What is the risk involved with the specific entity? What is the real growth potential of both the market and the specific company? Can the specific company actually exceed the growth rate of the industry? Does the specific company have the financial strength to grow at the industry rate? These and a myriad of other questions are not scientific, they are based on the experience and judgment of the appraiser.

Why does the Rev. Ruling specifically state that *"[n]o general formula may be given that is applicable to the many different valuation situations arising in the valuation of such stock"*? The answer is crystal clear; no formula captures the many nuances found in a closely held company. From product to management to financial stability to competition, each of these factors must be analyzed and considered before reaching a conclusion of value.

2. *"It is advisable to emphasize that in the valuation of the stock of closely held corporations or the stock of corporations where market quotations are either lacking or too scarce to be recognized, all available financial data, as well as all relevant factors affecting the fair market value should be considered."*[2]

The revenue ruling provides us with eight factors *"to be considered."* (emphasis added) There are no absolutes in this list. So what are we considering? History, current and expected economic conditions, financial analysis, dividend capacity, goodwill, and comparable sales. No formulas are listed. Sure, we can use math for financial ratio analysis, but the consideration of the various factors again is a judgmental and common-sense issue.

We, as valuation professionals, are required to acquire as much data as possible to then examine and analyze that data and apply that data to the facts and circumstances that are part of our valuation engagement. True valuation professionals are "data junkies," and never have all the data they might desire. As Colin Powell once commented, if the general waits until he has 100% of the data, the war will be over before a decision is made. Since we will never have all the data we might desire, we must go with what we have, using judgment, reasonableness, and common sense to guide us toward the conclusion of value.

3. *"In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business; (2) the*

2 Ibid., Sec 4.

*risk involved; and (3) the stability or irregularity of earnings."*[3]

What do Ford, General Motors, Toyota, and Honda have in common? They all are in the business of manufacturing automobiles. Yet let's look at their respective market valuations. At the time this article was written, GM stock was selling at a P/E ratio of 6.99, with a dividend payout of 4.22%. Ford had a dividend yield of 5.54% yet was selling for a P/E ratio of 6.01. Toyota had a dividend payout of 2.96% with a P/E ratio of 10.3, and Honda had a dividend yield of 2.63% and a P/E ratio of 6.04. What does this tell us? Ford had the highest dividend yield yet the lowest P/E ratio. Why? The public's perception of growth, future success, market, and product adaptability. Public perception cannot be measured with a formula. This is even more relevant to a closely held entity. No "public perception" is available. We don't have analysts following the company. We don't have the CFO of the company giving us guidance as to future earnings. Yet we must factor those same issues into our valuation conclusion. What is the risk involved? How do we measure the very items discussed in Rev. Ruling 59-60?

As contemplated in the Rev. Ruling, things can and do change. History may be a guide, but it is not an answer. Projections may be a guide, but are they reliable? Can a technological change impact the subject company? If yes, how do you measure the impact and factor that into your valuation conclusion?

4. *"Because valuations cannot be made based on a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors … and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance."*[4]

Again, we have the specific reference to the fact that there cannot be prescribed formulas. In over 40 years of business valuation, the one truth I truly understand is that no two businesses are exactly the same. I don't care whether they are car dealers, hamburger stands, or widget manufacturing entities. Each business has unique characteristics that need to be understood and applied to the information prior to reaching the conclusion of value.

I believe that this is true with statistical analysis. When we apply the statistical analysis to the data, what are we really achieving? An idea that the data are meaningful? That we have outliers? That, statistically, our answer should fall somewhere within the "range" that the statistics provide? While helpful, all the statistics in the world only provide us with additional information *to be considered*. They don't provide us with the answer; they are but just one tool available to the valuation professional.

Now that I have discussed the four laws, let's discuss how they impact the current business valuation climate.

**There is no magic bullet.** Current practitioners seem to me to be searching for the Holy Grail. There is no such thing as the "perfect valuation." It didn't exist 30 years ago, it doesn't exist today, and I doubt it will exist in the next 25 years. I hear questions such as:

- How do we get bulletproof data? What do I do if the data are flawed?
- Where can I find a formula that will calculate the valuation?

3 Ibid., Sec 6.

4 Ibid., Sec. 7.

- Why is determining a capitalization rate so difficult? Isn't there a better formula to use? Where can I get the "beta" for a closely held firm? Is "beta" applicable to a closely held entity?

- How can I be more precise in my conclusion of value? I don't want my valuation opinion to be questioned.

- Why does the engagement take so much professional time?

I'm sorry if this disappoints you, but there is no magic formula, no hard and fast rules, and no single publication where you can get the perfect answer to your valuation. I can't point to a single class or textbook that will cover all the issues. It's great to take a class on how to value a widget manufacturer, but, without a basic understanding of the valuation process, the how-to class is useless. When I performed my first valuation in the late 1970s, I purchased every publication available relative to valuation of closely held businesses. That amounted to about four inches of shelf space. Now I look at my library, and I am shocked at the volume of information I have. And that doesn't include all the information I have online that doesn't require shelf space.

**Experience comes in years, not in a spreadsheet.** I'm sorry to report that you cannot have 10 years' experience if you have only been practicing for five years. The math is working against you. Don't get me wrong, every one of us in the BV profession had to start somewhere, and all of us were neophytes. Every time you work on a valuation engagement, your depth of understanding should be increasing. Filling out spreadsheets, just entering data, does not expand on the body of knowledge that is necessary to be an accomplished business valuation expert. I hate to disagree with many of the governing bodies of our profession, but taking a one-day valuation course will *not* provide you with the skills you need to complete a full USPAP-compliant valuation report. We seem enamored with the idea of taking CPE, getting "credentials," and occasionally completing a BV engagement makes us an expert in the profession. That is a start, but it is not the end result. The true expert in the profession has years of experience and understands that other similar professionals may not agree on all the positions taken but is willing to discuss those differences intelligently. I don't hold a lot of stock in the CAPM method. I don't believe you can accurately determine a "beta" for most closely held entities. Others in the profession disagree with me. That is what makes a profession strong: the honest discussion of ideas and concepts and the understanding of both your and the opposing opinion. Look at the many years of work on the taxation of pass-through entities. Is there a hard and fast rule today? No, the discussion is still evolving, and that is good for the profession.

**Training should be rigorous and ongoing.** We as a profession need to take a hard look at our training, from the brand-new valuation analyst to the old experienced veteran. Training must be logical. You must start with the basic concepts, slowly move to the intermediate issues, and finally become familiar with the "state of the art" or "emerging" issues. I don't think we do that today. The profession seems to be more focused on revenues from training, rather than training for professionals. I have some of the same criticism of the credentialing process. I won't endorse or condemn any specific programs, but I do question the sanity of anyone presenting a multiday course, with no intervening time to apply the information, that ends with an exam that earns a credential. Humans can be very good at reading information and regurgitating that info on an exam form. That doesn't mean the individual "understands" the concepts and applications of the information. I am continually shocked when I talk to a young BV professional that can talk the talk but, when pressed, can't walk the walk. I was recently shocked to see a major professional group offer a CPE program to "credentialed individuals" on how to complete the initial engagement. Credentialed yet never has completed a BV engagement? How is this possible?

One of the areas of CPE that I do not see anybody providing is CPE for the advanced practitioner. Many years ago, the AICPA BV conference was the leading "advanced" conference on BV issues. Now it is advertised as an intermediate conference, and a great many of the faculty are part-time practitioners, that may or may not be past the intermediate level of competence. It is the advanced practitioners that are the thought leaders for the future growth of the profession. Unless we are projecting that the BV profession will be a large group of part-time, intermediate-level practitioners in the future, where are we developing those future leaders?

**Judgment, common sense, and reasonableness.** When I was with the large CPA firm, I used to ask my staff members one question about their valuation conclusion. The question was: Would you put your money in this deal at that price? If the answer was no, then how can you justify the value?

We talked about training above. There is a need to continually increase your skills, whatever level you are at. There is always something new to learn. Sometimes, you learn that the proposition being put forward doesn't work. That's OK. I can't begin to describe the changes in the BV profession over the last 40 years. Even today, there are still issues that are unsettled. Is a sub S more valuable that a C corp? Should there be a discount for lack of marketability where a sale is not a foreseeable event? If I use publicly traded information, is that really a minority value?

The one thing I can state has not changed is the need for practitioners to use their mental capabilities. Data are data. They must be converted into something usable to produce a valuation conclusion. The data and conclusion must be reasonable. The valuation professional must use his or her judgment in many areas of the engagement. And the final work product must make sense, to both the preparer of the valuation, as well as to the user of the valuation.

We provide an opinion, not a factual determination of the value of an entity. This opinion is based on the data, the facts and circumstances of the specific engagement, and the appraiser's judgement, experience, and common sense. I don't know why there is a move to remove the human element from the equation, but I believe that, if we remove the human element, our valuations will be nothing more than computer-generated non-sense.

**The full-time vs. part-time debate.** I have commented on this in past writings and still strongly feel that the BV practice has become so complicated and demanding that it is difficult, if not impossible, to provide these services part-time. What has happened to the "part-time" auditor? How does that auditor keep up with the professional standards, the CPE, and the expertise required to produce a quality audit? The same is true in the tax practice. When it comes to CPE, and the need to get 40 hours per year, where do we spend our time to get that 40 hours? Tax? Audit? BV? Is the goal to become marginally competent in many areas, or to become very competent in a single area? What makes us believe that business valuation is simple enough that we can practice in audit or tax and then do justice to a part-time BV practice?

**Credential madness.** It is time to stop the "madness" of credentials. NACVA published a chart that lists 12 designations in valuation or forensic accounting. Add to that subspecialties such as divorce, expert witness certifications, and others, and we have more than 16 certifications in this practice area. Who are we kidding? It is high time that the profession looks long and hard at the issue of certifications. Are they for the public's benefit? Or are they for the purposes of generating revenues for the groups granting the certification? Worse yet, each of the credentialing organizations tout their credential as the most stringent, or the "best." They can't all be right.

Does the public really understand the difference between ABV, ASA, CVA, etc.?

Since first writing this article, the AICPA made a decision that needs to be mentioned here. On May 22, the AICPA Council (the organization's governing body) unanimously passed a resolution to open up the ABV credential to non-CPAs.[5] Currently, to get the ABV designation, you must:

- Hold a CPA certificate;
- Have 75 hours of CPE in business valuation;
- Have 150 hours of business valuation experience; and
- Pass the ABV exam.

Under the new proposed non-CPA "qualified finance professionals," those individuals must:

- Have 75 hours of CPE in business valuation education;
- Have 1,500 hours of business valuation experience; and
- Pass the ABV exam.

On June 18, an open letter to the AICPA was released that 32 prominent business valuation professionals, including many individuals that were part of the creation of the ABV credential, signed.[6] The open letter makes the following points to the AICPA:

- The AICPA did not reach out to current ABV holders for comment. In fact, the entire process was kept secret until the council was asked to vote on the change.
- The issue of licensing is not addressed. Currently, CPAs are licensed by the states where they practice. These state agencies have enforcement power over the activities of CPAs. Non-CPAs will not be subject to enforcement activities because they will not be licensed and therefore are not under the jurisdiction of the state regulatory agencies.
- There has been *no* transparency in this substantial change to an existing credential.
- There is a complete "failure to uphold the standards of the profession." Ethics, conflict issues, and the like are not addressed at all, let alone the enforcement of the professional conduct of the non-CPA practitioner.
- Lastly, the open letter asks the AICPA to reconsider its decision and get the input of the current ABV holders and the leaders of this portion of the profession.

A survey has been set up for comments from the current ABV holders and others that this change impacts, so please make your position known.[7]

I have grave concerns about this issue. As discussed above, the AICPA CPE Business Valuation conference has deteriorated from an advanced, cutting-edge program to a program the AICPA describes as intermediate. This does not give me great comfort that current CPAs are receiving the best business valuation education. How will the AICPA regulate the business valuation training of non-CPAs? Let me be perfectly clear. I am not suggesting that, if you are not a CPA, you cannot become a BV professional. I have been an ASA for more years than I have held my ABV, and I received my ABV as part of the initial class. A path currently exists for non-CPAs to obtain a valuation credential.

5 See AICPA Website, May 25, 2018 announcement, "ABV Credential Opened to Qualified Finance Professionals."

6 The entire letter can be seen at bit.ly/2MA4ESX.

7 A link to a survey on this issue can be found at bvresources.com/articles/bvwire/make-your-voice-heard-in-the-aicpa-abv-controversy.

I see no compelling reason for this change, other than a revenue-generation issue for the AICPA. I do not believe it is in the public interest or the best interest of the CPAs, whether they practice valuation or not. Clearly, the AICPA did not properly vet this proposal with current ABV holders or others that this change impacts. I did not learn about the issue until the day the vote was taken at council, and then only because a member of council, who happens to hold the ABV, posted a message on LinkedIn. He had no advance notice of the issues either.

I also suggest you read the articles that have further discussion of this issue.[8]

**What do I suggest?** I view this paper as a call to arms, both to the older, experienced practitioners and to those practitioners that hope to make BV a full-time career.

It is time to remake our CPE, to recognize that, in between those theoretical training sessions, the practitioner needs time to apply those concepts in the real world. It is one thing to understand the concept; it is another totally different ability to apply the theory to the real world. Then, and only then, is it time for the practitioner to move on to the next level of training.

Lastly, I ask all of you to get involved. Change will only come from the inside. The status quo is a long-term recipe for disaster. I am reaching the end of my practice. I have numerous years of full-time experience. I have taught BV courses to CPAs and attorneys. Where is the next generation of full-time professionals? Are you willing to address the hard issues relating to CPE, full-time practice, and certifications? For the good of the profession, I hope the answer is a resounding *yes*. I also encourage you to make your thoughts known about opening the ABV credential to non-CPAs. ◆

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8 "AICPA's move to allow non-CPAs to get ABV sparks strong reaction," *BVWire,* June 20, 2018; "CPAs object to AICPA offering ABV credential to non-CPAs," *AccountingToday*, June 21, 2018.