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BUSINESS VALUATION UPDATE

TIMELY NEWS, ANALYSIS, AND RESOURCES FOR DEFENSIBLE VALUATIONS

Hot Topics at the 2022 VSCPA Forensic and Valuation Conference

It was back to in-person attendance at the 22nd annual Forensic and Valuation Conference hosted by the Virginia State Society of CPAs. Some attendees did participate online, but the rest enjoyed face-to-face contact with some well-known and excellent speakers. Harold Martin (Keiter) chaired the two-day conference and acknowledged the help of a task force in putting the event together. Here is some of what we learned.

Hardball questions. The opening session was a "Hardball With Hitchner" panel, designed to tackle tough questions and issues. Jim Hitchner (Financial Valuation Advisors Inc.) ran the session, and Kevin Yeanoplos (Brueggeman and Johnson Yeanoplos PC), Ron Seigneur (Seigneur Gustafson LLP), and Harold Martin (Keiter) joined him.

The first issue that came up was the problem of normalizing income for small businesses. Do you determine the adjustment? Analysts should not be asking management, "Is there any discretionary spending?" Instead, a number of questions should be asked, such as: "Does the company maintain any cars, real estate, or other property for the personal use of employees?" "Does the company pay rent to a related party?" or "Does the company foot the bill for employee travel that is not all business related?" You get the idea. Of course, normalizing compensation may be the biggest adjustment, and it was discussed in a separate session covered later in this article.

Someone in the audience asked about dealing with unreported income—the "personal piggy bank," as one panel member put it. The first question to ask is how material the unreported income may be because it may cost more to uncover it than it's worth. The panel suggested that a high-level lifestyle analysis may be helpful. A question from the audience asked about software that can be used for this. Some analysts use Ocrolus to examine bank statements and help facilitate a lifestyle analysis.

"What cost of capital platforms do you use?" Panel members use, of course, either the Kroll Navigator or BVR's Cost of Capital Professional, and some use both, and they essentially produce the same results. A remark was made that the Navigator has the "nastiest" license agreement—it states that Kroll can change anything it wants and not tell the user. It was pointed out, though, that this is probably language required for legal purposes and it would be hard to imagine Kroll would actually do that. The panel also remarked that the entry of BVR's less costly platform to the market has helped keep the prices for these platforms down considerably.

Another question: "For valuations for divorce, have the COVID-19 delays resulted in do-overs of valuations?" Yes, in some cases. Of course, it's not up to the analyst to decide this and the client should be approached if this becomes an issue. But the courts have been wanting more current valuations, so they will use valuation dates that are not precedent.

Hitchner posed a question: "Have you ever been challenged as to whether you have verified the economic data you use in your reports?" The

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main sources of economic data (Mercer, BVR, Tagnify, and KeyValueData) all have "great information," he said. But most of them are loaded with disclaimers and caveats saying they are not responsible for the accuracy of the data. Plus, all of the sources need more footnotes and citations for the data they report, he says. Opposing counsel could ask: "Did you verify the economic data? Your answer should be: "I've investigated the sources of the data, and I believe them to be reliable."

Also, do not include an entire economic research report in your valuation report—just include the parts that you actually use. Otherwise, it will be fair game for opposing attorneys to question you about every single thing in the entire economic report. Hitchner recalled that he was asked on the stand, "What is chained dollar growth rate?" This term was in the full economic report he included in his report's appendix. That was the last time he did that—now he just attaches the part of the economic report he actually uses.

A final question: "How do you see the future of the business valuation profession?" Very bright, the panel said, noting there is a "a ton" of BV work out there ("we're turning business away"), but the trouble is finding talent—there's a big shortage of qualified people, so firms need to ramp up recruiting. A later session gets into more detail on this topic.

Income approach. Hitchner conducted the next session on what he considers "best practices" in using the income approach. He presented a number of poll results (done from his webinar audiences) that did not reveal any seismic shift in terms of approaches and data sources being used. One thing he did mention was that he was considering adding Damodaran's implied ERP to his spreadsheet models, noting that this would be the first change to his models in 15 years.

He reiterated what he considers the "dirtiest little secret" in valuation, which is that no real

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due diligence is done on client-provided projections. He stressed that appraisers must not simply accept the projections the client provides, plug them into a discounted cash flow analysis, slap on a discount rate, and be done with the analysis. Some clients may know enough about how a valuation is done to try to manipulate their projections accordingly. Similarly, clients may change projections in anticipation of litigation. An appraiser needs to perform an independent review and keep a record of his or her questions to management. The analysts should not "own" the projections, that is, do them without collaborating with management. This may be acceptable in some contexts (such as for M&A purposes), but not for others, especially for litigation.

Effective recruiting. A welcome session talked about a major issue in the valuation profession today—how to attract and retain qualified professionals. Harold Martin was joined again with Yeanoplos and Seigneur to talk about their experiences. Martin commented that his firm experienced turnover in professionals with three to five years of experience and then had trouble replacing them. The firm expanded its search beyond its home base in Virginia into Washington, D.C., and Charlotte, N.C. Colleges have also been targeted. Martin is an adjunct professor and noted that his firm hired two students over the past year, which he says gives you a "blank slate" to work with—and you don't have to "unlearn" them of any bad habits. Yeanoplos agrees—his firm also goes right to schools for prospects. But Seigneur likes to bring in experienced candidates with a few years doing tax returns under their belts (his firm has a tax practice).

Should a new valuation hire be a CPA? Some say it's essential because the designation has instant credibility. The CPA has a foundation in the language of business that may be considered crucial. The recent uncoupling of the CPA and ABV credentials brought this analogy: If you needed surgery, would you want an MD/surgeon or just a surgeon? Others say "maybe" a CPA is essential—accounting is certainly important—but finance majors can also work out very well. Our comment is that, while numbers are important, they don't always tell the story of a business and what makes it tick, which is essential in a valuation, so an MBA may be a good choice.

The panel gave these critical steps for effective recruiting:

- Acknowledge the strengths and weaknesses of your firm's current structure and identify staffing gaps and whether existing employees can fill them;
- Be creative about recruitment and avoid getting locked into one approach;
- Be creative with print ads and appeals for candidates; personalize advertisements; and
- Use a recruiter's network and give it permission to seek candidates through social media and alumni networking groups.

Once the new employees are on board, the focus needs to shift to keeping them there. The panel gave these tips on retaining qualified staff:

- Be open with your firm employees. Share the firm vision and use your existing staff to recruit; they know your firm and your firm culture better than anyone.
- Be flexible with work expectations; do you offer flexible work schedules?
- Develop an internal leadership or mentoring program; establish a partner-in-training program.
- Be transparent; invite the next generation of leaders to be active participants in management meetings.

The panel also had a good discussion of succession planning, as the workforce is aging and

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practitioners will be transitioning out of their firms. If valuation firms are like most small businesses, an exit plan is not something that has been well thought out.

Reasonable comp errors. One of the "gotchas" when determining reasonable compensation for the owner of a private closely held business is failing to adjust for productivity, say Yeanoplos and Seigneur. Compensation paid above a reasonable amount can arise from a number of productivity factors, such as working more hours on average while producing more—or producing more but working an average number of hours. In either case, an adjustment would be necessary. Other productivity factors can include a percentage of collections and duties performed (wearing more than one hat). Two other main "gotchas" are failing to account for commingled profit and not considering an implicit return on assets, they said.

Yeanoplos also discussed key court cases involving reasonable compensation, including: (for the multifactor test) *Pulsar Components, Inc. v. Comm'r*, T.C. Memo 1996-129, and *Haffner's Service Station v. Comm'r*, 326 F.3d 1 (1st Cir. 2003), and (for the independent investor test) *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833 (7th Cir. 1999); *Midwest Eye Center*, T.C. Memo 2015-53; and *Aries Communications*, T.C. Memo 2013-97. He also discussed some matrimonial decisions involving reasonable compensation, including *Schiro v. Schiro*, 706 N.W.2d 27 (Mich. 2005), and *In re Marriage of Porter*, unpublished (Wash. App. 2007).

The IRS Job Aid for Reasonable Compensation was also discussed, which states that the tax courts favor the market approach, which involves the use of compensation surveys.[1] The speakers provided a 12-point checklist for determining the reliability of such surveys, which highlights the need to understand exactly the nature of the data in the survey—for example, whether the data are collected on a national or regional basis, whether they include business profits as compensation, how big the samples are, and how the survey defines job titles, and so on.

The speakers went through a case study of determining reasonable compensation in a physician practice, which requires a special approach. Compensation surveys in the healthcare sector should only be used for benchmarking purposes—they should not be relied upon as the only approach. The speakers went through the resource-based relative value scale (RBRVS) approach. This is a fee schedule that uses a complex formula to determine the payment due a physician for patient services and takes into account such factors as the resources used, practice expenses, malpractice expenses, geographic location, and others. It measures direct compensation and benefits for physicians and excludes other costs or revenues unrelated to the physician's personally performed clinical services. RBRVS reveals how much of what is collected should go toward paying doctors instead of overhead. The amount of collections could be allocated to physicians based on compensation vis-à-vis overhead and insurance, which allows the provider to set compensation based on conditions in the local market.[2]

Another point to be made is that the subject of executive compensation can be a very sensitive issue because many business owners are defined by the amount of pay they receive. Early on, the analyst should explain to the client what normalizing pay means and that it may have to be done. Interestingly, some panel members normalize officers' compensation when valuing both majority and minority interests, while others do not normalize comp for control interests.

1 irs.gov/pub/irs-utl/Reasonable%20Compensation%20Job%20Aid%20for%20IRS%20Valuation%20Professionals.pdf.

2 See the *BVR/AHLA Guide to Valuing Physician Compensation and Healthcare Service Arrangements*, 2nd edition, for a complete discussion; bvresources.com/products/bvr-ahla-guide-to-valuing-physician-compensation-and-healthcare-service-arrangements.

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Also, the audience was interested in the observation the speakers made concerning the potential opportunity they see for valuation experts to specialize in reasonable compensation, including outside of business valuation (e.g., for tax cases).

Guideline transactions. The second day of the conference started off with Harold Martin and two of his colleagues at Keiter, Asif Charania and Gregory Saunders, discussing the guideline transaction method. While the market approach may be less relevant now given the recent events in the market, it still must be considered in all valuations (per Rev. Rul. 59-60)—it cannot simply be dismissed. The speakers remarked that, even if zero weight is given to the market approach in a valuation, they explain how they applied the approach, including what databases were used and the search criteria.

An interesting question came from the audience during a discussion about adjusting transaction multiples. The analyst must adjust multiples from transactions that took place in a very different environment than the date of the valuation, as we're seeing with the current high inflation. But why not adjust restricted stock studies if those transactions were in a very different environment. Although not exactly on topic, the speakers remarked that it is a "great question." No one in attendance said they did that, but it's food for thought.

The speakers gave a great overview of the market approach, transaction considerations, the importance of understanding transaction terms, and the availability of relevant financial information. They also examined two Virginia court cases involving experts who used the transaction method. In one case, the expert (who was a neutral) made a "clearly palpable error," but the judge did not set aside the valuation, saying it all added up to "professional judgment."[3] This is not considered a good opinion, and it shows that it is not easy to successfully attack a neutral expert. In the other case, an expert failed to analyze the transactions selected properly, and that expert's valuation was considered less reliable.[4] The speakers remarked that they have yet to see as good a case as this one on an expert's failures with the transaction method.

On the hot seat. Attorney Martin Cunniff (Fields PLLC) joined Harold Martin and Ron Seigneur for a session on surviving cross-examination. *BVU* readers have seen a great deal within these pages about giving expert testimony, but there's always something new to learn at these sessions.

The session posed a series of common questions an expert would get on the stand and what the recommended answers should be. One question that many valuation experts—who also do some other work (such as forensics or taxes)—get from opposing counsel to make them look bad is: "You are not a full-time appraiser, isn't that true?" Cunniff, who has extensive litigation experience and who teaches attorneys how to cross-examine, says one way to answer this is to simply say, "Yes" and "leave it alone." One thing the very good experts know is when to just "give it away" and not to quibble about everything. Another technique to use is what Cunniff teaches as a three-word method: "pause … agree … overcome." The pause gives your attorney the opportunity to object (and it shows that you're (maybe) thinking about your answer) and throws the opposing attorney a little because he or she likes to move fast. The "agree" part is to agree at least partially because triers of fact do not like the parties arguing with each other, so this technique overcomes that.

Cunniff, however, liked Seigneur's answer, where he turned the question around in his favor, responding: "I'm glad you asked that question," which catches opposing counsel off guard. And he continues by saying that practicing in other

3 *Olli Salumeria Americana, LLC v. Charles S. Vosmik v. Bank of America.*

4 *Joseph Jones v. A Town Smoke House & Catering Inc. et. al.,* Circuit Court of Waynesboro, Virginia, CL19000199-00.

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areas (e.g., taxes, among other things) brings additional perspectives to the engagement. So, he turned a potentially damaging question around in his favor.

Elusive assets. Cheryl Hyder (Hyder Consulting Group) and Kirstine Connors (YHB CPAs and Consultants) offered a good overview of what constitutes marital property and equitable distribution in Virginia. One of the marital assets that proves very elusive is passive appreciation of a business. In Virginia, passive appreciation is not a marital asset, so it needs to be carved out. But how? The speakers noted that the "best" treatise on this topic (at least from their perspective in Virginia) is from Brett Turner.[5] Courts have become more demanding in terms of proof, so a number of quantitative models have emerged. The speakers mentioned several methods, including a with-and-without analysis, an individual excess earnings technique, Mercer's rate and flow analysis, and Dr. Ashok Abbott's methodology that measures the passive appreciation impact due to macroeconomic factors. They showed an example of Dr. Abbott's analysis of the full-service restaurant industry, which shows that 59% of the increase in value in this industry from 1992 to 2019 is due to passive macroeconomic factors (such as population level, real personal income, etc.). This is on a national level, but it gives a big picture that can be used as a starting point for settlement purposes and further analysis. The speakers noted that BVR and Dr. Abbott are developing an automated tool for doing the calculation.[6]

Dysfunctional IRS. In court, the IRS has lost every one of its last seven cases, so there's some dysfunction going on at the agency, says Mike Gregory (Michael Gregory Consulting LLC). The agency picks and chooses what it wants to take to court, and, in the past, it picked the ones it could win. The agency historically had a good track record. In the 11 years Gregory was with the IRS, it didn't lose a case.

Gregory is now in private practice, and he helps with conflict resolution between taxpayers and their advisors and the IRS. He mentioned that he is currently working with several appraisers who have been hit with penalties for submitting appraisals the IRS feels are too far off the mark. Making matters worse, the agency is not sharing the actual figure it is using for determining whether a penalty should be imposed, suggesting that this is running afoul of the Taxpayer Bill of Rights. Gregory remarked that the IRS has been doling out appraiser penalties like a small-town sheriff hands out more speeding tickets when the town needs to fill its coffers. The recently enacted Inflation Reduction Act that gave the IRS a big funding boost may change the agency's tune, but that remains to be seen.

A question came in from the audience on USPAP and valuations for tax purposes. Some valuation experts are under the impression that, for valuations for federal estate and gift tax purposes, all business valuers are required to comply with USPAP. Is that true? The Internal Revenue Manual does not say that, Gregory noted, and the definitions of "qualified appraiser" and "qualified appraisal" do not support the notion that all appraisers require USPAP compliance. Unless the appraiser's designation requires it (such as the ASA), there's nothing that says you're required to use USPAP for estate and gift tax purposes, he said.

Final note. Much more was discussed at the conference than can possibly be covered here. BVR looks forward to next year's event, which, if the past is any indication of the future, will be another excellent event. ◆

5 scholarlycommons.law.wlu.edu/cgi/viewcontent.cgi?article=1963&context=wlulr.

6 See "New Toolkit for Passive Appreciation Takes Shape," *Business Valuation Update*, Vol. 28, No. 6, June 2022.

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